



1700 G Street, N.W., Washington, DC 20552

November 4, 2013

The Honorable Spencer Bachus
U.S. House of Representatives
2138 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus,

Thank you for your September 24, 2013 letter about indirect auto lending practices and compliance with anti-discrimination laws, such as the Equal Credit Opportunity Act (ECOA) of 1974. I appreciate the opportunity to continue a dialogue with you on this important issue and have responded to your questions below.

- 1) You asked about the data and assumptions the Consumer Financial Protection Bureau relied upon to substantiate our determination that a commonly-used markup and compensation policy creates fair lending risk for indirect auto lenders.

The Bureau's March 21, 2013 Auto Bulletin was published to offer guidance to all indirect auto lenders within the Bureau's jurisdiction about compliance with the fair lending requirements of ECOA.¹ The Auto Bulletin did not set forth substantiated findings of discrimination, but instead highlighted the fair lending risk inherent in some indirect auto lenders' markup and compensation policies based upon the discretion those policies permit. As we noted in the Auto Bulletin:

...some indirect auto lenders have policies that allow auto dealers to mark up lender-established buy rates and that compensate dealers for those markups in the form of reserve. . . .Because of the incentives these policies create, and the discretion they permit, there is a significant risk that they will result in pricing disparities on the basis of race, national origin, and potentially other prohibited bases.

As we noted in our August 2, 2013 letter to you (August 2, 2013 Letter), the Auto Bulletin explains that the standard practices of indirect auto lenders likely make them "creditors" under ECOA and that a lender's discretionary markup and compensation policies may alone be sufficient to trigger liability under ECOA if the lender regularly participates in a credit decision and its policies result in discrimination. By describing the relevant laws and regulations that apply to indirect auto lending, the Auto Bulletin's intent was to help indirect auto lenders recognize and

¹ Indirect Auto Lending and Compliance with ECOA, CFPB Bulletin 2013-02, Mar. 21, 2013 *available at* http://files.consumerfinance.gov/f/201303_cfpb_march -Auto-Finance-Bulletin.pdf.

mitigate the risk of discrimination resulting from discretionary dealer markup and compensation policies. This is the type of fair lending risk of which lenders need to be aware and monitor in their portfolios.

In our press release we stated that “[r]esearch indicates that markup practices may lead to African Americans and Hispanics being charged higher markups. . . .” Our August 2, 2013 Letter to you elaborated on this statement, noting that, historically, the failure to properly or consistently monitor discretionary policies and practices for compliance with anti-discrimination laws has been a contributing factor in discrimination in auto lending and in other product markets, like mortgages. This historical experience has been documented by scholars² and is reflected in relevant case law³ and Department of Justice enforcement actions.⁴ This same research supports the monetary level of consumer harm referenced in the Bureau’s press release.

- 2) Your letter also requested the detailed methodology that measures whether discrimination is present in an auto creditor’s portfolio.

You specifically requested a more detailed explanation of our proxy methodology, appropriate controls and disparity “threshold.” Demographic information, such as race, sex, and ethnicity, is not collected by non-mortgage lenders. However, this information is vital to assessing fair lending compliance. Thus, federal regulatory and enforcement agencies have long used proxy methods in non-mortgage data analysis. As we noted in the August 2, 2013 Letter, various proxy methodologies are publicly available and have been used for decades in a number of different civil rights contexts, including voting rights cases, Title VII cases, and constitutional challenges, including jury selection and equal protection matters. In addition, federal banking regulators have made clear that proxy methods may be used in fair lending exams to estimate protected characteristics where direct evidence of the protected characteristic is unavailable.⁵

² For example, *see* Cohen, Mark A. (2012). “Imperfect Competition in Auto Lending: Subjective Markups, Racial Disparity, and Class Action Litigation.” *Review of Law and Economics* vol. 8, no. 1 (21-58). Working Paper available at <http://ssrn.com/abstract=951827>.

³ *See, Coleman v. Gen. Motors Acceptance Corp.*, 196 F.R.D. 315 (M.D.Tenn. 2000), *vacated and remanded on unrelated grounds*, 296 F.3d 443 (6th Cir. 2002); *Jones v. Ford Motor Credit Co.*, 2002 WL 88431 (S.D.N.Y. Jan. 22, 2002); *Smith v. Chrysler Fin. Co.*, 2003 WL 328719 (D.N.J. Jan. 15, 2003); *Osborne v. Bank of America Nat’l Ass’n*, 234 F.Supp.2d 804 (M.D. Tenn. 2002); *Wise v. Union Acceptance Corp.*, 2002 WL 31730920 (S.D. Ind. Nov. 19, 2002).

⁴ *See, e.g., United States v. Springfield Ford, Inc.*, No. 2:07-cv-03469-PBT (E.D. Pa. Aug. 21, 2007); *United States v. Pacifico Ford, Inc.*, No. 2:07-cv-03470-PBT (E.D. Pa. Aug. 18, 2007); *United States v. NARA Bank, et al.*, No. 2:09-cv-07124-RGK-JC (C.D. Cal. Nov. 18, 2009); *see also United States v. Countrywide Fin. Corp.* No. 2:11-cv-10540-PCG-AJW, (C.D. Cal. Dec. 28, 2011); *United States v. AIG Fed. Sav. Bank*, No. 1:99-mc-0999 (D. Del. Mar. 4, 2010).

⁵ *See Interagency Fair Lending Examination Procedures*, at 12-13, available at <http://www.ffiec.gov/PDF/fairlend.pdf> (explaining that “[a] surrogate for a prohibited basis group may be used” in a comparative file review and providing examples of surname proxies for race/ethnicity and first name proxies for sex); *see also*, <http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2012/first-quarter/fair-lending-webinar.cfm>.

In general, the proxy methodology used depends on the characteristic being proxied. For example, to proxy for gender, the Bureau relies on a first-name database from the Social Security Administration that reports counts of individuals by gender and birth year for first names occurring at least five times for a particular gender in a birth year.⁶ The proxy method assigns a probability that a particular applicant is female based on the distribution of the population across gender categories (male or female) for the applicant's first name.

There is a greater variety of methods to proxy for race and national origin. A common method for proxying the probability that an applicant is Hispanic or Asian is to use the surname database published by the Census Bureau.⁷ Another method to proxy for race and national origin—typically referred to as “geocoding”—uses the demographics of the census geography (e.g., census tract or block group) in which an individual's residence is located, and assigns probabilities about the individual's race or national origin based on the demographics of that area. This method is frequently used to proxy the probability that an applicant is African American, and it can be used to proxy for other racial and ethnic groups as well.

Over the last decade, another method to proxy for race and national origin has been developed that integrates the surname and geographical approaches described above. This method was developed by health research economists,⁸ and it combines the respective probabilities generated by the surname and geographical proxies. Published research has found that the integrated approach produces proxies that correlate highly with self-reported race and national origin data and is more accurate than using surname or geography alone.⁹ The Bureau uses the integrated proxy as the primary method for proxying race and national origin in our non-mortgage analyses.

We are aware of proxy methods for race and national origin that use nonpublic information, such as proprietary databases developed in the private sector matching first or middle names to certain racial or ethnic groups. For the purpose of conducting our supervisory work, we have chosen to use proxy methods that rely solely on public data so that lenders can replicate our methods without the need to recreate or purchase proprietary databases as part of their own fair lending compliance management systems.

You asked about the Bureau's rationale for the statement in the August 2, 2013 Letter that, “[t]he concept of using proxies for unavailable data is a widely accepted mathematical and statistical approach used across many disciplines, including, to our understanding, by the auto industry itself for marketing purposes.” This observation did not speak to the legal relevance of proxies with respect to ECOA liability, but rather to their widespread acceptance and adoption.

⁶ <http://www.ssa.gov/oact/babynames/limits.html>.

⁷ <http://www.census.gov/genealogy/www/data/2000surnames/index.html>.

⁸ Marc N. Elliott et al., *A New Method for Estimating Race/Ethnicity and Associated Disparities Where Administrative Records Lack Self-Reported Race/Ethnicity*, HEALTH SERVICES RESEARCH 43:5, Part I (Oct. 2008).

⁹ Marc N. Elliott et al., *Using the Census Bureau's Surname List to Improve Estimates of Race/Ethnicity and Associated Disparities*, HEALTH SERVICES & OUTCOMES RESEARCH METHODOLOGY (2009) 9:69-83.

You have also asked about other available proxy methods. As we noted above, proxy methods vary based on the characteristic being proxied (race, national origin, or gender), and there are several reasonable methods of proxying for each of these characteristics. Some methods, for example, use solely surname or geocoding. The Federal Reserve Board, which publicly released some of its proxy methods in July, uses a surname Census database to determine if a borrower is Hispanic and geocoding to determine majority minority census tracts.¹⁰ Other methods, like the Bureau's, integrate the same sources of data into a single proxy for race and national origin. We have chosen the integrated method because we consider it appropriate and helpful in evaluating the large and complex portfolios of the auto lenders supervised by the Bureau. Similarly, we expect lenders to choose a proxy method that will support a compliance management system commensurate with their size, organizational complexity, and risk profile.

You also inquired about controls applied to the analysis of dealer participation. As we explained in our August 2, 2013 Letter, each supervisory examination or enforcement investigation is based upon the particular facts presented by the entity under review. Thus, in our analyses we consider analytical controls which are appropriate to each particular entity. The controls are dependent upon the particular lender's policies, practices, and procedures. We further noted in our August 2, 2013 Letter that when lenders share with us the nature and results of their own analyses, we are open to hearing specific explanations for the decisions they have made to include particular analytical controls that reflect a legitimate business need. Because of this case-by-case determination we cannot identify each control that we apply in the analysis to ensure that borrowers are similarly situated.

You have also asked about "the threshold at which the Bureau determines that statistically significant disparate impact is present." Consistent with the Bureau's peer agencies, the Bureau makes case-by-case assessments of whether to pursue supervisory or enforcement activity in response to statistically significant disparities. This assessment is not based solely on the size of statistical disparities, but rather varies based on a number of additional relevant factors, for example the extent of consumer harm, the nature of the activity under consideration (e.g., underwriting, pricing, fees), and whether the statistical findings are supported by additional evidence of discrimination.

- 3) You requested an explanation of how the issuance of the Bureau's March 21, 2013 Auto Bulletin is consistent with federal law.

As a preliminary matter, it is helpful to note that the Bureau has a number of tools at its disposal when dealing with practices that cause consumer harm, including nonpublic supervisory action, enforcement actions, rulemaking, and consumer education, among others. There are many factors that the Bureau considers when deciding which tools to use, and in determining what is the most appropriate tool to address a certain issue. When we consider whether to engage in rulemaking, a

¹⁰ <http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2013/080613.pdf>

¹¹ 15 U.S.C. § 1691 *et seq.*; 12 C.F.R. pt. 1002 *et seq.*

key question is whether existing laws, regulations, and official commentary already address the topic under consideration.

The ECOA and Regulation B, which was the result of notice and comment, make it illegal for a “creditor” to discriminate in any aspect of a credit transaction because of race, color, religion, national origin, sex, marital status, age, receipt of income from any public assistance program, or the exercise, in good faith, of a right under the Consumer Credit Protection Act.¹¹

The Bureau published the Auto Bulletin to remind lenders of their responsibilities under ECOA and to offer guidance on how to address the identified risks to all indirect auto lenders within the jurisdiction of the Bureau. Consistent with Bureau procedures, the Bulletin was reviewed prior to issuance to ensure compliance with all legally applicable requirements. The Administrative Procedure Act (APA) sets out the principles by which federal agencies engage in regulatory activity and in applicable cases allows for comments from affected parties and the general public concerning an agency’s activity. The APA does not impose a notice and comment requirement for general statements of policy, non-binding informational guidelines, or interpretive memoranda. Accordingly, the Bureau was not statutorily required to solicit comments about the Auto Bulletin.

The Bureau advised the Federal Reserve Board and the Federal Trade Commission, who are also responsible for administering and/or enforcing ECOA, about the Auto Bulletin prior to its publication.

You have asked whether the application of the Auto Bulletin is prospective in nature or also applies to market conduct occurring prior to its issuance. The ECOA was enacted nearly four decades ago and the relevant provisions of Regulation B and its Official Staff Commentary were in effect more than a decade ago. Both the ECOA and Regulation B govern discrimination in any aspect of a credit transaction, including conduct that pre-dates the Auto Bulletin.

- 4) Your letter requested the Bureau’s measurement of how an industry move to compensate dealers for arranging financing through a “flat fee per transaction” would affect the marketplace and the consumers it serves.

The Auto Bulletin expresses the Bureau’s views regarding the fair lending risks present in any indirect automobile lending program that permits dealers discretion to increase consumers’ interest rates for reasons not supported by a legitimate business need. The Bulletin advises lenders that the Bureau will closely review the operations of indirect auto lenders subject to its jurisdiction and employ the appropriate tool to address any unlawful conduct. The Bureau frequently provides information highlighting the existing risk of certain behaviors for which lenders should monitor in their compliance programs.

¹¹ 15 U.S.C. § 1691 *et seq.*; 12 C.F.R. pt. 1002 *et seq.*

Flat fees are mentioned in the Bulletin merely as one example of a non-discretionary compensation mechanism; the Bulletin does not mandate flat fees or any other particular system of dealer compensation. It is our understanding that a number of indirect auto lenders currently compensate auto dealers using a variety of non-discretionary or flat fee programs, and lenders may choose to adopt a variety of means, including, but not limited to, alternative compensation policies, to address fair lending risk. However, the Bureau has not undertaken a study of how market-wide adoption of a single non-discretionary compensation program would affect the availability of credit, nor has it attempted to analyze the impact of all the potential actions lenders may take to eliminate discrimination from their indirect auto lending programs. As a general matter, however, the Bureau believes that fair lending and the legitimate business needs of creditors are compatible.

Thank you for bringing your concerns to the Bureau's attention and for the opportunity to respond. I look forward to working with you on this important issue as the Bureau continues to work to help markets operate more fairly and effectively for consumers and businesses.

Sincerely,



Richard Cordray
Director