



The Fallacy of Flats

Beware of Claims that Flat Fees Eliminate a Dealer's Risk of Violating Fair Credit Laws

Since at least early 2013, the Consumer Financial Protection Bureau (CFPB or Bureau) has exerted substantial pressure on indirect finance sources to change the way they compensate automobile dealers for originating credit contracts with consumers. The Bureau has taken this action based on its belief that finance source compensation policies that allow dealers to exercise discretion in determining the amount they earn for originating consumer credit contracts (known as “dealer participation” or “dealer reserve”) create a “significant risk” that certain groups of consumers (based on race, national origin, or other prohibited factors) will pay more dealer participation than other groups of similarly situated consumers, in violation of the federal Equal Credit Opportunity Act (ECOA).

Because the Bureau believes that dealer pricing discretion is the source of this fair credit risk, the Bureau declares that finance sources can take one of two actions to address it. A finance source can *constrain* dealer pricing discretion by imposing a series of controls on that discretion and monitoring the dealer participation earned in the credit contracts it purchases from dealers. Alternatively, a finance source can forgo this process by *eliminating* dealer pricing discretion and compensating dealers with “another mechanism, such as a flat fee per transaction, that does not result in discrimination.”¹

But if finance sources were to adopt a flat fee pricing mechanism,² would that indeed eliminate dealer pricing discretion and the risk of unlawful pricing disparities that the Bureau maintains results from such discretion? For the individual finance source that adopts a flat

fee policy, the CFPB states that the answer is “yes.” **However, for the dealers who sell paper to that finance source as well as to other finance sources, the answer is decidedly “NO.”**

The reason flat fees would not eliminate dealer pricing discretion – even if every finance source were to adopt them – is simple. Dealers typically sell credit contracts to a variety of finance sources, each finance source would set its own flat fee, and dealers would exercise discretion in selecting the finance source to which they would sell the contract. Thus, far from eliminating dealer discretion, flat fees would merely shift the primary exercise of that discretion from *intra-finance source discretion* (that is, the discretion a dealer exercises in determining how many basis points to add to the wholesale buy rate offered by a single finance source) to *inter-finance source discretion* (that is, the discretion a dealer would exercise in determining which flat fee amount to choose from among the competing offers it received from multiple finance sources).

Flat fees therefore would not eliminate dealer pricing discretion. This in turn means that, to the extent such discretion creates a risk of discrimination to the consumer, flat fees would not eliminate that risk. And, if this risk of discrimination exists for the consumer, then a risk of liability for that discrimination exists for the dealer.³ Consequently, in identifying the adoption of flat fees as a silver bullet for eliminating fair credit risk, the Bureau has come up with a purported solution for individual finance sources and individual finance sources alone. It has not come up with a solution for the other two parties to an indirect financing transaction – the consumer and the dealer.⁴

¹ CFPB Bulletin 2013-02 (Mar. 21, 2013).

² A “flat fee pricing mechanism” generally refers to a finance source policy that compensates dealers for originating consumer credit contracts with a flat dollar amount per transaction, a percentage of the amount financed, or another fixed formula for determining the dealer’s compensation. These policies do not permit dealers to exercise any form of pricing discretion, such as offering consumers a discounted annual percentage rate (APR) in order to earn their business.

³ As with finance sources, dealers are exposed to significant liability for ECOA violations.

⁴ A broad industry adoption of flat fees in response to pressure from the CFPB would also create the risk of steering consumers to high-cost credit contracts, as dealers would be incentivized to sell their credit contracts to the finance source that offers the highest flat fee (which likely would result in higher APRs being paid by consumers).

Because dealer pricing discretion is a feature of the indirect financing market that cannot and will not be eliminated by Bureau pressure on finance sources, then dealers, finance sources, and the government should consider ways to realistically and effectively manage the pricing discretion that dealers exercise. And this should be done in a manner that addresses the fair credit risk to each of the three parties to an indirect financing transaction (the consumer, the dealer, and the finance source) while preserving the overwhelming consumer benefits that result from a highly competitive marketplace.

Fortunately, a tool exists that can help accomplish this objective. It is the [NADA Fair Credit Compliance Policy & Program](#). The NADA program is modeled on a very well thought out fair credit compliance program contained in Department of Justice consent orders with two automobile dealers in 2007. A dealer who adopts the NADA program generally establishes a pre-set standard dealer participation rate (SDPR) that the dealer (i) adds to the wholesale buy rate offered by the finance source to which the dealer will assign the credit contract and (ii) includes in the offer of credit to the consumer. The dealer follows this approach for all offers of credit to consumers that involve dealer participation. However, the dealer can deviate downward from its SDPR and offer the consumer more favorable credit terms if any of several allowable deviations are present. One example of an allowable deviation – each of which consists of a good faith, pro-competitive factor that is unrelated to the consumer’s background and therefore consistent with ECOA – is lowering the SDPR to “meet or beat” a competing offer that has been presented to the consumer. The dealership employee making the credit offer records the actual dealer participation rate included in the credit offer and the reason for any deviation from the SDPR. The dealer also appoints a program coordinator who reviews the transaction to ensure it was properly executed and who otherwise conducts training, oversight, and reporting to ensure the dealer’s fair credit compliance program is faithfully carried out.

The NADA Fair Credit Compliance Policy & Program is not required, and has not been adopted as a safe harbor, by any federal agency. Its adoption by a dealer is completely optional. Nevertheless, NADA believes the program provides a dealer who adopts it with a viable

means of managing the dealer’s fair credit risk – and, in turn, the fair credit risk presented to its customers – while allowing dealer pricing discretion to be exercised in a standardized manner that lowers the cost of credit for consumers. This approach should appeal not just to dealers, but also to indirect finance sources and the CFPB as they consider ways to address fair credit risks at the retail level.

With regard to flat fee compensation programs, dealers can enter into them and NADA expresses no opinion as to the relative merit of any particular flat fee or other compensation program. The decision to enter into any compensation program, whether involving dealer participation, a flat fee, or another compensation arrangement, is an individual one that the dealer should make in consultation with its legal counsel. **However, NADA cautions dealers to be wary of any claims that flat fee compensation programs somehow eliminate the dealer’s risk of violating fair credit laws.** For the reasons stated above, these programs do not eliminate that risk for dealers who sell their contracts to multiple finance source partners. And, because they do not eliminate that risk, dealers who enter into flat fee compensation arrangements must decide how they will manage that risk, much as the NADA Fair Credit Compliance Policy & Program sets forth an optional mechanism for managing the fair credit risk associated with compensation programs involving dealer participation.

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