cfpb Consumer Financial Protection Bureau

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

May 1, 2014

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

Dear Representative Bachus:

Thank you for your letter about indirect auto lending and the Consumer Financial Protection Bureau's (Bureau) guidance for complying with anti-discrimination laws. I appreciate the opportunity to work with you and indirect auto lenders to address the fair lending risk.

As you note in your letter, the Equal Credit Opportunity Act (ECOA) does not prohibit discretionary markup and compensation polices; rather, in the credit context, a creditor practice is discriminatory in effect if it has a disparate impact on a prohibited basis, unless the creditor practice meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact. The Bureau's March 21, 2013 Auto Bulletin[1] makes clear that when a lender maintains a discretionary pricing and compensation policy, an important tool for limiting fair lending risk is to engage appropriate controls and robust compliance management to address the potential for discrimination.

One example of a discretionary pricing and compensation policy that employs appropriate controls and robust compliance management is in the Bureau's and the Department of Justice's (DOJ) recent Consent Orders resolving the agencies' enforcement actions against Ally Financial Inc. and Ally Bank (Ally). The Consent Orders require Ally, should it opt to retain a discretionary pricing and dealer compensation system, to employ caps on that discretion and to adopt a comprehensive compliance management system, which includes: regular notices to dealers explaining the ECOA, stating Ally's expectations with respect to ECOA compliance, and articulating the dealer's obligation to price contracts in a non-discriminatory manner, including in exercising discretion to set a consumer's contract rate when such discretion is permitted; quarterly analysis of dealer-specific contract pricing data for disparities on a prohibited basis resulting from Ally's dealer compensation policy; quarterly and annual analysis of portfolio-wide contract pricing data for disparities on a prohibited basis resulting from Ally's dealer compensation policy; appropriate corrective action with respect to dealers who are identified in the quarterly analysis of dealer-specific contract pricing data for disparities on a prohibited basis, or otherwise identified, culminating in the restriction or elimination of dealers'

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[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.

ability to exercise discretion in setting a consumer's contract rate or exclusion of dealers from future transactions with Ally; and prompt remuneration of affected consumers when analysis identifies statistically significant disparities in dealer markup on a prohibited basis. This is just one example of an appropriate compliance management system, and the Auto Bulletin notes that "[t]he CFPB recognizes that the appropriate program will vary among financial institutions."

As I mentioned during my appearance before the Committee in January, the Bureau remains in dialogue with industry and open to learning about and examining additional proposed changes to current discretionary dealer markup and compensation policies. A few examples of changes that lenders have raised in this dialogue include employing lower dealer markup caps and implementing robust compliance management systems that include consumer remuneration. In general, the Bureau welcomes proactive proposals from lenders that demonstrate a commitment to fair lending.

As noted in the Auto Bulletin, lenders may choose to address the fair lending risk created by discretionary pricing and compensation systems by adopting an alternative nondiscretionary system. The Bureau's dialogue with industry also has yielded lender suggestions for alternative structures to address the fair lending risk associated with discretionary dealer markup and compensation policies. As I mentioned in my January testimony, it is encouraging that lenders and other market participants are exploring ways to address fair lending risks in the indirect auto market.

As noted in previous Bureau statements, permitting discretion in pricing and tying compensation to the exercise of that discretion could significantly increase fair lending risk. Therefore, as noted above and in the Auto Bulletin: an "important tool for limiting fair lending risk in indirect auto lending is developing a robust fair lending compliance management program. The Bureau recognizes that the appropriate program will vary among financial institutions." The Auto Bulletin and our Supervisory Highlights provide examples of the features of such robust compliance management systems.

In addition, we noted in the Auto Bulletin that "[f]or some lenders, additional compliance-management components may be necessary to address significant fair lending risks" and we suggested that "indirect auto lenders that retain dealer markup and compensation policies may wish to address the fair lending risks of such policies by implementing systems for monitoring and corrective action" and provided the following four examples:

- *sending communications to all participating dealers explaining the ECOA, stating the lender's expectations with respect to ECOA compliance, and articulating the dealer's obligation to mark up interest rates in a non-discriminatory manner in instances where such markups are permitted;*

This communication might specifically focus on fair lending risk and communicate the lender's expectations about compliance, the fact that the lender will be closely monitoring such risk, and the consequences of non-compliance. Lenders may provide periodic reminders about fair lending risk and compliance expectations, and may also want to make fair-lending-specific training available to dealers.

- *conducting regular analyses of both dealer-specific and portfolio-wide loan pricing data for potential disparities on a prohibited basis resulting from dealer markup and compensation policies;*

Lenders looking to improve their monitoring or existing compliance management systems may want to consider employing a reasonable proxy methodology. As I described in my November 4, 2013 letter, the Bureau uses an integrated proxy as the primary method for proxying race and national origin in our non-mortgage analyses. The Bureau's integrated approach combines two sources of information in order to proxy an applicant's race or national origin: the surname database published by the Census Bureau,[2] and the demographics of the census geography (e.g. census tract or block group) in which an individual's residence is located. 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.[3] In addition, for the purposes of our supervisory work, the Bureau has chosen to use proxy methods that rely solely on public data so that lenders can, if they choose, replicate our methods without the need to recreate or purchase proprietary databases as part of their own fair lending compliance management systems. We expect lenders to choose a proxy method that will support a compliance management system commensurate with their size, organizational complexity, and risk profile.

Dealer-specific analysis would identify any dealers who are pricing loans in a way that results in disparities on a prohibited basis such as race, national origin, or sex, which would then be the subject of corrective action. Portfolio-wide analysis is another key component. Through portfolio-wide analysis, lenders can identify any harm caused by pricing policies permitting markup, including identifying any disparities on a prohibited basis that are occurring across the entire portfolio. These types of analyses are commonly conducted as part of fair lending compliance management systems (CMS). The specific statistical analysis will consider analytical controls that are appropriate to each particular case, depending on a particular lender's policies, practices, and procedures. When building statistical models, lenders should remember that only those factors required by business need should be factored into the analysis.

Additionally, lenders should isolate dealer markup, which has been the focus of the Bureau's analysis, from an analysis of overall contract rate. The Bureau's analysis considers creditworthiness factors, like credit scores and debt to income ratios; characteristics of the collateral; and terms of the deal, such as the amount financed, down payments, the existence of a manufacturer discounted rate, and loan term. These factors are typically taken into account by lenders in arriving at the appropriate "buy rate," and thus the Bureau's analysis of dealer markup accounts for them by focusing only on the difference between the buy rate and the added cost of the discretionary dealer markup. Because the above-cited factors are already taken into account when determining the appropriate buy rate and are, therefore, considered in the overall interest rate the consumer receives, it is generally, absent additional evidence of legitimate business need in conjunction with their consideration in setting the dealer markup, not appropriate to reapply those factors in an analysis of only the dealer markup.

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[2] *See* http://www.census.gov/genealogy/www/data/2000surnames/index.html.

[3] 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.

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 or relevant factors that reflect a legitimate business need. Lenders can and should take creditworthiness and terms of the loan into account in the pricing of credit. The Bureau's focus is on the fair lending risk created by policies that allow dealers the discretion to mark up each consumer's buy rate after the lender has already taken these factors into account in determining the risk-based buy rate for a particular loan, and then compensating dealers by giving them a share of that mark up. The Bureau understands that the scope of the monitoring regime may vary based on the nature, size, and complexity of the lender's auto lending operations.

- *commencing prompt corrective action against dealers, including restricting or eliminating their use of dealer markup and compensation policies or excluding dealers from future transactions, when analysis identifies unexplained disparities on a prohibited basis;*

Lenders may escalate actions where discriminatory disparities are found. These might include, for example, more stringent monitoring, limits on pricing discretion, and, at some point, termination of the relationship. These actions will demonstrate the seriousness with which a lender considers these issues. While these actions likely will drive overall disparities down, lenders should be cognizant of the fact that their ultimate obligation is to address portfolio-wide disparities, and dealer-level corrective action may not be enough.

- *promptly remunerating affected consumers when unexplained disparities on a prohibited basis are identified either within an individual dealer's transactions or across the indirect lender's portfolio.*

Remediation of portfolio-wide disparities should be provided to those consumers who have paid more because of race, ethnicity, or other prohibited bases. Lenders will need to identify the affected consumers, provide refunds, and adjust their interest rates going forward. Lenders should consider the need for dealer-level remediation on case-by-case basis. Remediation is prospective and may need to be repeated if disparities are not resolved over time. Just as in other areas, an effective CMS around dealer markup requires lenders to monitor consistently for fair lending violations and take appropriate remedial action based on what they find.

The Bureau remains open to having further discussions with you and indirect auto lenders as we work together to reduce fair lending risk. Thank you for your continued interest in this important issue. I look forward to working with you to ensure that markets operate more fairly and effectively for all market participants.

Sincerely,

Richard

Richard Corday,
Director