Consumer Financial Protection Bureau
1700 G Street NW, Washington, DC 20552

INTERNAL MEMORANDUM / CONFIDENTIAL
PRE-DECISIONAL & DELIBERATIVE
DRAFT

DATE: May 8, 2013

TO: SEFL Assistant Directors

FROM: Young (Ken) Shim (Examiner-in-Charge, Northeast Region)

RE: **ARC Memo for Ally Financial, Inc. (AFI) and Ally Bank (AB)[1] Dealer Mark-up Issue**

Docket No. [redacted]

I. Overview

On September 10, 2012, the Bureau commenced a targeted review of AFI and AB to test for fair lending compliance in its domestic consumer automobile finance portfolios.[2] The review covered transactions from April 1, 2011 to March 31, 2012 (the "Review Period"). Ally booked [redacted] loans during the Review Period, and the Office of Research selected [redacted] of those transactions for analysis. These transactions involved [redacted] unique dealers with [redacted] dealers accounting for [redacted] of the volume by amount financed. The review team, including the Office of Fair Lending and Equal Opportunity, the Office of Research and the Office of Enforcement, identified disparities in the average interest rate mark-up charged to African-American, Hispanic and Asian (non-subvented loans only) borrowers relative to the average interest rate mark-up charged to non-Hispanic white borrowers. These mark-up disparities were caused by Ally's discretionary dealer mark-up policies. As a result, the review team made a preliminary determination that Ally had violated the Equal Credit Opportunity Act (ECOA).

The Office of Fair Lending formally communicated our preliminary findings to Ally by sending a Fair Lending Potential Action and Request for Response Letter on January 15, 2013 (the "PARR Letter"). The PARR letter stated the disparity amounts and outlined our analytical methodology. It also informed the Bank of the possibilities of public enforcement action and DOJ referral. On February 11, 2013, Ally submitted a written response to the PARR Letter, in which Ally contends that it has not violated ECOA because our analytical methodology incorrectly omitted several control variables that explained the disparities. Ally further contends that if ECOA violations are determined, formal enforcement is an inappropriate remedy.

Several representatives of Supervision, Office of Fair Lending, Office of Enforcement, and Office of Research met with Ally management, consultants, and counsel on March 21, 2013 to discuss Ally's response to the PARR letter and our respective modeling methodologies. A follow-up meeting was held on March 27, 2013 to discuss Ally's *Pilot Monitoring Program for Dealer Finance Income.*

[1] AFI and AB are referred to collectively as "Ally."
[2] Both AFI and AB hold indirect consumer automobile loans, but the portfolios were analyzed as one as systems and processes are the same for both. The primary difference between the portfolios is that AFI holds lower credit quality paper.

After consideration of Ally's written response and several follow-up meetings, the review team concluded that Ally failed to demonstrate the relevance of the additional controls to the mark-up determination process and failed to provide an adequate business justification for its indirect mark-up policy. As a result, the review team concluded that Ally's policy of permitting dealers to mark-up retail installment contracts has resulted in disparate impact by causing members of protected classes to pay statistically significant higher rates of interest on retail installment contracts in violation of ECOA.

The review team recommends that Ally be subject to a public enforcement action for the discrimination identified in the CFPB's examination of Ally Financial Inc.'s and Ally Bank's indirect automobile loans booked from April 1, 2011 to March 31, 2012 and Ally's failure to establish a suitable dealer monitoring program.

II. Institution-Focused Factors

<u>Background/Size of Institution</u>

Ally is the largest auto loan lender in the United States.[3] In 2012, Ally originated [redacted] of automobile loans for [redacted]. As of December 31, 2012, Ally's domestic consumer automobile portfolio totaled approximately [redacted]. Ally's consumer automobile finance business is 100% indirect lending, mainly in the prime market. Ally purchases retail contracts from its network of dealers, which total approximately [redacted]. In a typical transaction, a car dealer collects loan application information from a car buyer and sends the information to Ally and other lenders via an automated system. If the loan application meets Ally's underwriting criteria, it offers to purchase the contract at a specified interest rate, commonly known as the buy rate.[4]

As common in the indirect auto finance business, the interest rates that borrowers pay are often higher than the rate at which Ally buys loans from the dealers. Ally purchases loans from the dealers at a specified "buy rate," which Ally determines using a proprietary underwriting and pricing model, but will purchase installment contracts priced higher than the buy rate, subject to certain limitations.[5] The difference between the buy rate and the contract rate is known as the "dealer mark-up" or "mark-up." Dealers receive some or the entire mark-up from the lender upon purchase of the contract and represents additional compensation to the dealer from the transaction. This discretionary mark-up policy and practice is the root of the pricing disparities discovered during the review.[6] On average, dealers charged African-American, Hispanic and Asian (non-subvented loans) borrowers a higher mark-up than what they charged non-Hispanic white borrowers.

---

[3] Based on 2011 Experian data.

[4] In general, the dealer typically sends loan application information to multiple lenders. If more than one lender is willing to make the loan, the dealer chooses the lender to which it sells the loan.

[5] Ally limits the mark-up to 250 basis points for contracts with terms of 5 years or less and 200 basis points for contracts with terms of greater than 5 years and for contracts from the lowest credit tier regardless of term.

[66] Although the statistical analysis revealed statistically significant buy rate disparities, these were insufficiently large, less than 5 basis points, to warrant further analysis.

Consumer Financial
Protection Bureau

1700 G Street NW, Washington, DC 20552

It should also be noted that Ally is in process of a major reorganization that will nearly eliminate its participation in the mortgage market and that will eliminate its international automotive business. This is being done to limit liability from the mortgage business and to improve capitalization and the balance sheet so that Ally can proceed with an IPO to raise capital to pay off the U.S. Treasury's TARP investment, which represents a 74% ownership in the company. [redacted] Ally will likely be more resistant to remedial actions it perceives as undermining the automobile financing business than other entities for which automobile finance is just a component of the institution's business.

The committee should also be aware of AFI's current status with respect to the Bank Holding Company Act as it may represent leverage to motivate Ally to settle this matter quickly without a public enforcement action. AFI owns certain subsidiaries, primarily insurance companies that it will have to divest if it is unable to qualify as financial holding company under the Bank Holding Company Act (BHCA). The Federal Reserve Board granted it last one-year extension under the BHCA in December 2012, which expires December 24, 2013. In order to qualify as a financial holding company, AFI and its bank subsidiary must, among other requirements, be considered well-managed under the BHCA. Admittedly, it is less than certain that AFI will qualify as a financial holding company regardless of the CFPB's action in this matter, but if the CFPB pursues a public enforcement action for ECOA violations, it is unlikely that the prudential regulators will accord a "2" rating for the management component of the CAMELS rating regardless of improvement in other areas.

Level of Cooperation During the Exam

Overall, Ally was cooperative throughout the examination. Ally provided sufficient space for the examiners to work, provided access to key management officials, provided the examination team with all the information requested, answered the exam team's question, and worked diligently with Bryce Stephens with respect to the initial and subsequent date requests. The only exceptions were the withholding of certain documents, including the scope of its fair lending statistical analysis for indirect auto lending, under claims of attorney-client privilege, initial resistance to providing the exam team with access to underwriters, and initial resistance to providing the exam team with read only access to the [redacted] underwriting system. The privilege issue was rooted in their concerns that the Dodd-Frank Act did not permit them to retain privilege over privileged documents provided to the CFPB. After the law was amended to address this issue, Ally provided us with information previously withheld.

Willingness and Ability to Comply

Ally argued repeatedly that it is not legally liable for dealer mark-up disparities because it is not a "creditor" under ECOA. Consistent with that view, Ally did not monitor dealers for mark-up disparities during the review period, or for periods before or subsequent to the review period. This is a noteworthy omission in the Ally's fair lending compliance program given court cases settled unfavorably to creditors for alleged ECOA violations for yield spread premiums and dealer mark-up in the wholesale mortgage business and in the indirect automobile lending business, respectively.

Despite its legal position, Ally began developing a fair lending monitoring program for consumer automobile finance sometime in 2012, but did not reveal any details of the program until the meeting on March 21, 2013 because of attorney-client privilege. The CFPB's initial review indicates that the program is not sufficiently robust with respect to prompt dealer corrective as the program does not contemplate termination the dealer relationship until after Ally performs three statistical analyses indicating discrimination, a process that will take at least 30 months. Also, the methodology for measuring potential disparities appears flawed as race and ethnicity is included as a proxy variable, which is inappropriate for a model testing for discrimination based on race and ethnicity, and as credit score is considered a variable, for which Ally has yet to demonstrate as causal relationship to pricing. .

III. Violation-Focused Factors

Disparity and Damages Estimates

As stated above, the review team found that African American, Hispanic and Asian (non-subvented loans only) borrowers were charged higher mark-ups than non-Hispanic white borrowers. These differences in mark-ups were not explained in our comparative file review. The Office of Research estimated the following mark-up disparities and damages:[7]

Ally Financial/Ally Bank - Observed Disparities and Consumer Impact
Period of Study: April 1, 2011 to March 31, 2012

Prohibited basis	Subvention/non-subvention	# pb observations	Estimated disparity in mark-up	Est. value of overpayment	Overpayment per borrower
Asian/Pacific Islander	Non-subvention	[redacted]	0.215	$1,469,073	$160.75
Black	Non-subvention	[redacted]	0.289	$21,709,581	$231.72
Hispanic	Non-subvention	[redacted]	0.196	$13,361,785	$161.48
Black	Subvention	[redacted]	0.220	$2,899,239	$191.62
Hispanic	Subvention	[redacted]	0.143	$1,628,417	$126.87
Total Adverse Impact		[redacted]		$41,068,095	$192.32

The damages above are significant in the aggregate because of Ally's large volume of transactions, but are not particularly large per borrower. Compared to mortgage loans, automobile loans are relatively small and short-term, which limit the impact of the interest rate disparity on individual borrowers. For example, applying the largest disparity, 29 basis points, to a $25,000 five year auto loan results in an increase in the monthly payment of $3.28, or $196.80 over the term of the loan. Nonetheless, the results of our review indicate discrimination under disparate impact theory against members of protected classes of approximately $41 million during the review period.

Likelihood of Past and Future Violations

Ally allowed discretionary dealer mark-up prior to the review period. There is no reason to believe that protected classes did not also pay higher average mark-ups in years prior to the review period.

[7] The Office of Research's estimated mark-up disparities are based upon a model without any controls and are statistically significant to establish a *prima facie* case of discrimination in violation of ECOA.

If Ally implements an effective, well-considered fair lending monitoring program with effective dealer sanctions, it may reduce disparities in the future; however, the pilot program as presented is unlikely to significantly reduce mark-up disparities. Nonetheless, whatever the program implemented by Ally, it will likely take a few years before its effectiveness can be reasonably assessed.

Importance of Deterrence

The indirect automobile financing model accounts for a substantial majority of auto loans in the United States, and allowing discretionary dealer mark-up is a common business practice among indirect auto lenders. Settlements of class action lawsuits during the last decade, most notably *Jones v. Ford Motor Credit,* caused indirect auto lenders to cap dealer mark-up (Ally's caps of 200-250 bps are most common), but substantial pricing discretion remains within those caps. Therefore, deterring other indirect auto lenders from permitting mark-ups without adequate monitoring, as has been Ally's practice, is an important goal, but it also must be recognized that dealers have many financing outlets from which to choose. Therefore, it is uncertain that an enforcement action against Ally alone would have much effect as dealers can choose to deal with other lenders. A stronger deterrent effect can probably be accomplished through enforcement actions against multiple lenders with practices similar to Ally.

Clarity of the Law

The ECOA prohibits any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction on the basis of race, color, religion, national origin, sex or marital status, or age (15 U.S.C. § 1691). Charging African Americans, Hispanics and Asians (non-subvented) loans only)higher average markups than the markups charged to non-Hispanic white is a clear violation of ECOA.

Although during the course of the review, Ally officials have argued that it is not a creditor under ECOA, in its response to the PARR letter, Ally focused its legal argument on what it considers to be the CFPB's inappropriate application of disparate impact theory. Ally argues that purchasing retail installment contracts at a premium over its buy rate is not a specific policy or practice causing disparate impact, but "a decades old industry-wide business model engrained in the fabric of commercial law."

Based on the facts currently available to us, we believe Ally is a creditor within the meaning of ECOA, 15 U.S.C. § 1691a(e), because it regularly participates in the credit decision (*e.g.*, by underwriting the loans and offering buy rates). In the few cases involving similar facts, courts have rejected arguments that similar lenders were not creditors. However, none of these cases litigated this issue at trial. Therefore, while we consider our arguments to be strong, there is some litigation risk related to this issue, but that same risk will exist in any enforcement action against an indirect auto lender.

The government has brought only one fair lending case against an indirect auto lender in recent years.[8] However, the DOJ has brought several fair lending cases against wholesale mortgage lenders alleging disparities in the yield spread premium charged by mortgage brokers. This is significant because from a litigation perspective as there are a great deal of similarities between litigating fair lending cases against indirect auto lenders and wholesale mortgage lenders.[9] Defendants in both types of cases tend to rely on similar legal and factual arguments. In fact, Ally has made some of the same arguments that the government often heard from wholesale mortgage lenders. Therefore, while the government has not pursued many fair lending cases against indirect auto lenders, it has dealt with multiple similar cases before, indicating a solid legal foundation to pursue fair lending cases against indirect auto lenders. Therefore, we believe that disparate impact theory applies to Ally's policy and practice of purchasing retail installment contracts with mark-ups, thus encouraging dealers to mark up, thus causing or facilitating the discrimination noted in the CFPB's statistical analysis.

IV. Policy-Focused Factors

Automobile lending is a priority for the Bureau and is one of the two current areas of focus for the Office of Fair Lending. Ally is one of [redacted] that are included in the current round of fair lending auto exams.[10] Preliminary findings indicate that the other [redacted] are likely to have similar dealer mark-up issues, though they differ in terms of the sizes of disparities, the number of consumers affected, and the adequacy of the fair lending compliance programs. There may be other factual differences between the lenders' relationships with their dealers.

Two factors suggest that Ally should be resolved through public enforcement. First, damages are high due to Ally's large number of indirect auto loans. Second, Ally did not monitor dealer mark-up during the Review Period. Although Ally is in process of developing a monitoring program and recently notified its dealer network of that it will begin monitoring contracts for possible discrimination, it will be some time before a monitoring system is fully implemented and operational.

[8] The DOJ sued Nara Bank in 2009 alleging fair lending violation due to mark-up disparities. See http://www.justice.gov/opa/pr/2009/September/09-crt-1063.html. The case settled. In the past, private litigants also sued auto finance companies under ECOA alleging mark-up disparities. It should be noted that at the time of the alleged violations, Nara Bank (a bank formed in Southern California to serve the Korean community) was a relatively small bank with a limited dealer network, six (five under common ownership) of whom were named as co-defendants in the case.

[9] While legally similar, prosecuting fair lending cases against indirect auto lenders does present an additional technical hurdle because race and ethnicity data, while readily available in mortgage data because of HMDA, have to be proxied for auto loan data.

[10] [redacted]