DEALER MARK-UP

Problem Statement: When consumers finance an automobile purchase through a dealer, bank and nonbank indirect auto lenders allow auto dealers significant discretion to mark up risk-based interest rates, and often engage directly in the process of setting a consumer's contract rate. These mark-ups are not transparent to the consumer. Permitting dealer mark-ups has a disparate impact on the rates paid by protected class borrowers.

Scope of Problem:

- In 2011, 40 million new and used automobiles were sold[1], of which approximately 60% obtained dealer financing[2]. Approximately 40% of sales that were dealer financed received some form of dealer mark-up[3].
- Preliminary analysis of data obtained through Supervision suggests that, controlling for certain factors, African American applicants are paying $170 to $255 more than non-Hispanic white applicants, and Hispanic applicants are paying $145 to $194 more than non-Hispanic white applicants.
- Assuming an average purchase price for a vehicle is approximately $22,500[4] a loan term of 60 months[5] and within the participation caps currently observed by the industry of 250 basis points, this translates to potentially $400 in additional interest charges paid by protected class borrowers or an upper-bound estimate of $2.2B in aggregate overpayment of interest per origination year[6]. This estimate assumes that all loans pay as agreed and for the full contract term; borrowers do not prepay or default.

Stakeholder Perspectives:

- Consumers and civil rights groups oppose dealer mark-up and the issue has been prioritized by the National Consumer Law Center and the Center for Responsible Lending; the NCLC litigated similar cases against captive lenders in the 1990s
- Creditors (banks and non-banks) derive no benefit from dealer mark-ups but compete for dealer business
- Dealer mark-ups are a significant source of revenue for auto dealers

Rationale for Rulemaking: Dealer markup is most effectively addressed by a market-wide solution. If the CFPB concludes that individual auto lenders have violated the ECOA, supervisory corrective action will be ordered on a case-by-case basis. Prospective orders will require each large bank lender to engage in specified actions to prevent future harm, including actions to address/eliminate markups. The serial elimination of markups at supervised institutions may prompt those large bank lenders to discontinue their auto lending programs, thereby increasing dealers' reliance on nonbank lenders that control approximately 40%[7] of the marketplace, and are currently outside of the CFPB's supervisory authority. Even if large banks who are subject to supervisory remedies attempt to stay in the business, they may be subject to uneven competition in which nonbanks paying large markups will attract large portions of available business through automated loan origination systems used by most dealers – systems designed to optimize the profitability of lender choice to the dealer. While the LP2 process may ultimately bring nonbanks under examination and supervisory sanction, this will not occur until a year or more after large

[1] Moody's Auto Navigator "Auto Stat" May 22, 2012.
[2] Experian Automotive, "State of the Automotive Finance Market, First Quarter 2012" page 14.
[3] ILLM phone conversation with JD Power representative.
[4] CNW (average car value for both prime and sub-prime consumers)
[5] CNW
[6] ILLM prepared "Fair Lending Auto Example" last updated 8/22/12
[7] ILLM analysis of Big Wheels 2012 report

banks become subject to supervisory sanction. Therefore, the ultimate consolidated examination process would continue to yield case-by-case, thereby resulting in serial remediation and continuing market dislocation, because CFPB cannot sanction the dealers who are the source of discrimination. Those dealers will continue to drive business to lenders who pay yield-based markup. To the extent rulemaking can facilitate an industry-wide solution, it would avoid this result.

Scope of Potential Approaches to Rulemaking

	Description of Alternative
A	ECOA/Reg. B rulemaking giving specific examples of indirect auto lender activity that render these lenders "creditors" under ECOA. Unclear if a rule can do more than highlight auto lender liability for discrimination effectuated by third party originator.
B	UDAAP rulemaking addressing the practice of permitting mark-ups. Significant legal risk in using UDAAP this way.
C	TILA/§1032 rulemaking addressing disclosures of dealer mark-ups. Lack of authority to draft rules governing auto dealers. Efficacy of disclosures in impacting industry practice uncertain.

Potential Risks of Rulemaking:

- If dealer mark-ups are eliminated, dealers may increase price of cars or after-sales products in ways that perpetuate (or even accentuate) current disparities. Alternatively, credit costs could be redistributed to smooth disparities but with some consumers paying higher rates
- Rulemaking would likely activate the dealer community in opposition to the Bureau

Scope of Alternative Approaches to Rulemaking

	Description of Alternative
A	Incent voluntary adoption by lenders • ANPR coupled with Supervisory Bulletin • Enforcement Action(s) coupled with Supervisory Bulletin • LP2 proposal coupled with Supervisory Bulletin • LP2 proposal coupled with a Whitepaper based on anonymized bank data from trade group
B	Pursue supervision / enforcement without market-wide solution

Rulemaking Alternative A – Regulation B Amendments re: "Regularly Participates"

- Under section 1691b(a) of ECOA, the Bureau has the authority to prescribe regulations necessary to prevent "circumvention or evasion" of the ECOA, or "to facilitate or substantiate compliance with" the ECOA.

- Regulation B defines creditor as follows: Creditor means a person, who, in the ordinary course of business, regularly participates in the decision of whether or not to extend credit. The term includes a creditor's assignee, transferee, or subrogee who so participates. . . . A person is not a creditor regarding any violation of the act or this regulation committed by another creditor unless the person know or had reasonable notice of the act, policy, or practice that constituted the violation before becoming involved in the credit transaction. 15 U.S.C. § 1691a(e) and 12 C.F.R. § 1002.2(l).

- The Official Staff Commentary to Regulation B states: *Assignees.* The term creditor includes all persons participating in the credit decision. This may include an assignee or a potential purchaser of the obligation who influences the credit decision by indicating whether or not it will purchase the obligation if the transaction is consummated.

- A series of federal court rulings in ECOA cases brought in the early 2000s rejected indirect auto lenders' defenses claiming that they were not creditors because they were assignees who did not participate in the auto dealers' credit transactions and lacked reasonable notice of the alleged discrimination. As support for finding that the lenders were creditors who participated in the credit transactions and had reasonable notice, the courts noted that the lenders
    - generated risk-based interest rates for the dealers' customers and authorized the dealers to mark up the rates (Jones v. Ford Motor Credit Co., 2002 WL 88431 (S.D.N.Y. Jan. 22, 2002);
    - also processed the loan in accordance with its policies and procedures, bore the risk of default, and compensated dealers for originating the loans by rebating to them a portion of the mark-up (Osborne v. Bank of America Nat. Ass'n., 234 F.Supp.2d 804 (M.D. Tenn. 2002)); and
    - influenced the credit decision by setting price parameters for the contract between the dealer and consumer and indicating whether they would buy the contract if the transaction were consummated, and provided the loan documentation (Wide ex re. Estate of Wilson v. Union Acceptance Corp., 2002 WL 31730920 (S.D.Ind. Nov. 19, 2002)).

- Indirect auto lenders under the Bureau's supervision have claimed that they are not creditors. Yet our examinations have confirmed that in addition to the factors listed in the previous bullets, these indirect auto lenders often have substantial involvement in establishing the terms and conditions of the retail installment sales contract for the purchase of automobiles. For example, even after communicating terms and conditions to the auto dealer, indirect auto lenders will adjust the borrower's interest rate by sanctioning tier bumps (placing a borrower into a better credit tier than underwriting dictates) and rate shaves (offering a lower rate than assigned to a credit tier) when booking the retail installment contract.

- In this rulemaking, the Bureau would propose amendments to Regulation B, perhaps in form of additions to the Staff Commentary, affirming the activities that constitute regular participation in auto dealer financing by indirect auto lenders, rendering them creditors.

Rulemaking Alternative B – A Section 1031(b) UDAAP Rule

- Section 1031(b) of Dodd-Frank authorizes the Bureau to prescribe rules applicable to a covered person or service provider it identifies to be engaging in unlawful unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.[8]

- Indirect auto lenders and dealers enter into contracts which facilitate mark-ups and also jointly set the price of auto loans. Under these contracts, the indirect auto lenders approve the origination of the auto loans at a mark-up and allow for kickbacks to the dealers. These agreements are "in connection with" the origination of auto loans, and the practice of dealer mark-ups potentially violates Section 1036 of Dodd-Frank.

- Dealer mark-ups/ kickbacks are potentially deceptive. When a consumer walks into the auto dealer's financing office, the consumer is told by the dealer financing represetantative to complete an application, and that the representative will search its database for interest rates that "are available" from indirect auto lenders. This is a very different experience from that in a retail store where a consumer wishes to purchase, for example, a refrigerator, and is given only one interest rate at which he/ she can finance the purchase. The process at the car dealership potentially misleads the consumer to believe that the representative is looking for the lowest rate available for the consumer, and that the rate he/ she is offered is completely based on credit risk, both of which are not true. In fact, the practice of dealer mark-ups actually incents the dealer to steer the consumer to the contract rate with the largest mark-up or kickback, which may not be the best contract rate for the consumer.

- Dealer mark-ups/ kickbacks are potentially unfair.
  - There is substantial injury to consumers in the amount of the mark-up.
  - The injury is not reasonably avoidable because consumers do not know about the mark-ups to negotiate, and are unlikely to shop for another rate after undergoing a lengthy car buying process at a dealership.
    - ⇨ *Gibson v. Watson Chevrolet-Geo, Inc., 112 F.3d 283 (7th Cir. 1997)* – consumers were likely to behave differently if they knew about dealer mark-ups on third party add-on products.
  - The injury is not outweighed by countervailing benefits to consumers or competition. Reasonable origination costs that are incurred by the dealer or indirect lender can be compensated for without the payment of kickbacks, and studies have shown that mark-ups increase the risk of default for consumers.

- Dealer mark-ups/ kickbacks are potentially abusive because they take advantage of the inability of the consumers to protect their own interest in selecting auto loans. By obtaining multiple interest rates from indirect auto lenders in the presence of consumers who have negotiated the price of a car, and are looking for financing, dealers are taking unreasonable advantage of the consumer's reasonable belief that they are acting in the consumer's interest when offering financing. Furthermore, consumers spend several hours at a car dealership before learning about their financing terms, and are unlikely to walk away in order to spend hours at another dealership or seek financing from a bank, and then return to the same dealership to buy the car.

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[8] The language of section 1031(b) of Dodd-Frank is very similar to 15 U.S.C. Sec. 1639(l)(2)(A), the TILA section relied on by the Federal Reserve Board to promulgate the Yield Spread Premium rule, which restricted certain compensation practices of loan originators related to mortgage loans.