Market: Auto Finance
Problem: Dealer Mark-up of Finance Charges

Problem Statement

Finance and insurance offices at auto dealers have the discretion to mark up the interest rates that consumers are charged on their indirect auto loans. The dealer then receives a payment from the lender based on the increase over the "buy rate" required by the lender. If consumers are unaware that this is the case or believe that the dealer is working to obtain financing for the consumer solely to be able to sell the car, consumers may not shop sufficiently for auto financing, and therefore may pay higher interest rates than they would if they were aware that the rates could be marked up and that the dealer benefits by doing so. These discretionary markups, also called dealer reserves, potentially have an adverse impact on protected groups; observable differences have been documented.

Comment [KMW1]: Added.

Analysis

Problem Statement:
Auto dealers have the discretion to mark up interest rates that consumers are charged on their auto loans. Consumers are not always aware of this, and because of the sequential nature of bargaining over price of the motor vehicle, value of the trade-in, and then financing when making a vehicle purchase at a dealer, have difficulty comparing the different loan and vehicle price combinations available to them, and therefore may pay higher interest rates than they would if they were aware of the rates available to them. These discretionary markups potentially have an adverse impact on protected groups; observable differences have been documented. NCLC brought multiple actions against finance companies alleging that dealer mark-ups had a disparate impact on a prohibited basis. The consent agreements resolving the matters imposed a 2.5% cap (250 bps) on the amount of the mark-up and have all expired.

Comment [KMW2]: Added trade-in as a factor. May not be necessary but shows the components of the deal.

Firms' incentives and constraints:

- Dealer
  - Retains most of the difference between the customer APR and the buy rate (the rate at which the lender is willing to buy the customer contract, similar to a Yield Spread Premium in the mortgage context)-.
  - Has discretion to make loan offer based on prior about consumer's willingness to accept terms.
- Lender
  - Revenue from fees net of cost of funds and costs of default

Comment [KMW3]: Should we reference YSP?

Comment [RG4]: Prior knowledge? Experience?

Consumers' goals and constraints:

- Goal is to minimize vehicle purchase price and cost of financing. Decisions are affected by consumer budget constraints, such as ability to make a downpayment.
- High pressure sales environment: two stage process of negotiating purchase price then financing
  - May think that they must use dealer negotiated financing in order to secure price.
- Consumers may be unaware of direct-financing channel
- Buy rate is not disclosed to consumers and consumers may be unaware that the rate is negotiable
- Limited attention
  - Exhaustion from shopping.

- Terms are personalized: based on credit history and possibly contingent on purchase price.

Implications:
Dealers do not retain the risks of the auto loans that they broker, so they have an incentive to mark up loan interest rates as much as possible. The process of negotiating a vehicle price and loan terms is time consuming and the offer is personalized and complicated, making comparisons between different offers difficult. Consumers differ in their knowledge of and ability to compare their auto financing options, so price discrimination between consumers of similar observable financial characteristics exists in the auto finance market. Observable differences in final loan terms for minority groups have been documented. ~~This may be due to different initial offers by dealers or due to differences in effectiveness negotiating contract terms by group.~~

Comment [RG5]: See comment below.

Consumer Harm

Size of market:
The auto lending market is estimated to be $425 billion per year.[1] 80% of these loans are acquired through the indirect (dealership) financing channel. Total outstanding auto loan balances are approximately $670 billion as of Q1 2011.[2]

Number of affected consumers:
Assuming an average loan size of $11,700[3], approximately 36 million consumers per year will finance an automobile purchase.

Impact per affected consumer:
An estimated $25.8 billion in interest rate markups will be paid by each annual cohort of borrowers across the life of their auto loans assuming an average rate markup of 2.47%.[4] On a per-borrower basis, the average impact is $714 over the life of their loan.[5]

Vulnerable population(s) affected?
People of color and women are disproportionately affected (i.e., pay larger markups) as demonstrated in data and analysis generated in litigation against the major finance companies in the last decade.

Type of harm?
Discrimination results in not only economic harms, but also emotional, dignitary, and inherent harms.

Important Unknowns

- To what extent has the market begun to increase dealer payments, given the recent expiration of binding settlement agreements imposing caps?
- To what extent have the caps imposed in binding settlements been effective in preventing illegal disparities in dealer markups?

Comment [KMW6]: Suggest explaining earlier.

[1] CFPB estimate based on data from Experian, Moody's and CNW Research
[2] Federal Reserve G19 Report, Q1 2011
[3] CNW Research data (included new franchised, used franchised, and used independent but excludes used casual)
[4] Center for Responsible Lending, "Under the Hood", April, 2011
[5] Ibid

- To what extent are consumers aware that they can shop for auto loans? For a given consumer, how will the terms of his loan differ ~~is~~ if he shops versus if he goes through the dealer's F&I office?
- ~~Are minority groups initially offered the same loan terms as non-minorities with similar characteristics and is the difference in markups generated by the negotiation process, or are the differences caused by dealer discrimination? This is actually testable through mystery shopping experiments.~~

Applicable laws

ECOA/Fair Lending – disparate impact of markups on minorities and women have been documented.
UDAAP – the role of the dealer as a broker with a concealed conflict of interest is a classic unfair practice, a principle established by FRB rules in the mortgage area prior to Dodd-Frank. However, we lack jurisdiction over dealers. See below.

Potential Policy Intervention(s)

Fair lending: Major players in the market include depository institutions that are subject to supervision today. Supervisory guidance could be issued regarding appropriate fair lending standards ~~that parallels the settlements in the 2005 cases, capping or setting safe harbors for mark-ups~~. "Voluntary" conformity with bank supervisory guidance could be encouraged for nonbank lenders. Enforcement could be cued up for those entities with illegal disparities ~~who chose to ignore the guidance~~.

On the Dealer side, we lack jurisdiction to act directly. However, we should explore a joint rulemaking with the FTC and possibly the FRB that would cover the same activity by the dealer as originator and the lender as purchaser of the marked up contract. FTC has indicated preliminary interest in such an effort, and FTC is directed by section 1029 of DF to consult with OSA about service member issues in auto finance. Such a rulemaking could require disclosure of the conflict of interest or go further (as the FRB did) and ban dealer compensation based on the rate or other terms of the contract.

BEST ARGUMENT PRO: The fair lending issue is an established compliance problem that is time sensitive due to the settlement expiration and the dynamics of the market, and would not be opposed by the lending industry (if we can make it stick across the board). It is a relatively easy early win with high impact and low cost.

BEST ARGUMENT CON: If we remain without a director and can only affect half the market, non-DI lenders may take over the market, betting that we or the FTC can't make the ECOA claim stick against them in time to stop their market share grab.

Comment [RG7]: Although we would anticipate that a defendant might argue that disparities caused by the negotiation process are not illegal, as a matter of law we don't view this as rising to the level of a legitimate business need. Thus, we recommend deleting.

Comment [RG8]: I don't know that we want to create a safe harbor or policy around the caps established in private litigation. Those caps would still leave adequate room for significant disparities against protected groups. For example, similar caps in the mortgage industry have still produced large disparities.

Comment [RG9]: Just a heads up that for purposes of this exercise, I understand that we are to assume that we have a director.

Comment [KMW10]: I think the best argument against involves the dealer exclusion and the litigation risk that this raises. While dealers, like brokers, expose the lender to ECOA liability, the fact that dealers are exempt may raise unique challenges in accessing data that the lenders do not have, but the dealers do (value of trade-in, fees information).