

CFPB Bulletin 2013-02

Date: March 21, 2013

Subject: Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act

This bulletin provides guidance about compliance with the fair lending requirements of the Equal Credit Opportunity Act (ECOA) and its implementing regulation, Regulation B, for indirect auto lenders that permit dealers to increase consumer interest rates and that compensate dealers with a share of the increased interest revenues. This guidance applies to all indirect auto lenders within the jurisdiction of the Consumer Financial Protection Bureau (CFPB), including both depository institutions and nonbank institutions.

Background

While consumers may seek financing for automobile purchases directly from a financial institution, many seek financing from the auto dealer. The auto dealer may provide that financing directly or it may facilitate indirect financing by a third party such as a depository institution, a nonbank affiliate of a depository institution, an independent nonbank, or a “captive” nonbank (an auto lender whose primary business is to finance the purchase of a specific manufacturer’s automobiles).

In indirect auto financing, the dealer usually collects basic information regarding the applicant and uses an automated system to forward that information to several prospective indirect auto lenders. After evaluating the applicant, indirect auto lenders may choose not to become involved in the transaction or they may choose to provide the dealer with a risk-based “buy rate” that establishes a minimum interest rate at which the lender is willing to purchase the retail installment sales contract executed by the consumer for the purchase of the automobile. In some circumstances, the indirect auto lender may exercise discretion in adjusting the buy rate, making underwriting exceptions, or modifying other terms and conditions of the financing as a result of additional negotiation between the indirect auto lender and the dealer.

The indirect auto lender may also have a policy that allows the dealer to mark up the interest rate above the indirect auto lender’s buy rate. In the event that the dealer charges the consumer an interest rate that is higher than the lender’s buy rate, the lender may pay the dealer what is typically referred to as “reserve” (or “participation”), compensation based upon the difference in interest revenues between the buy rate and the actual note rate charged to the consumer in the retail installment contract executed with the dealer. Dealer reserve is one method lenders use to compensate dealers for the value they add by originating loans and finding financing sources. The exact computation of compensation based on dealer markup varies across lenders and may vary between programs at the same lender. After the deal is consummated with the consumer, the

retail installment contract may then be sold to the lender, which has already indicated its willingness to extend credit to the applicant.

The supervisory experience of the CFPB confirms that some indirect auto lenders have policies that allow auto dealers to mark up lender-established buy rates and that compensate dealers for those markups in the form of reserve (collectively, “markup and compensation policies”). Because of the incentives these policies create, and the discretion they permit, there is a significant risk that they will result in pricing disparities on the basis of race, national origin, and potentially other prohibited bases.

Indirect Auto Lenders as Creditors Under the ECOA

The ECOA makes it illegal for a “creditor” to discriminate in any aspect of a credit transaction because of race, color, religion, national origin, sex, marital status, age, receipt of income from any public assistance program, or the exercise, in good faith, of a right under the Consumer Credit Protection Act.¹

The ECOA defines a “creditor” to include not only “any person who regularly extends, renews, or continues credit,” but also “any assignee of an original creditor who participates in the decision to extend, renew, or continue credit.”² Regulation B further provides that “creditor” means “a person, who, in the ordinary course of business, regularly participates in the decision of whether or not to extend credit” and expressly includes an “assignee, transferee, or subrogee who so participates.”³

The Commentary to Regulation B makes clear that an assignee is considered a “creditor” when the assignee participates in the credit decision. The Commentary provides that a “creditor” “includes all persons participating in the credit decision” and that “[t]his 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.”⁴

Even as assignees of the installment contract, indirect auto lenders are creditors under the ECOA and Regulation B if, in the ordinary course of business, they regularly participate in a credit decision. The CFPB recognizes that there is a continuum of indirect lender participation in credit decisions, ranging from no participation to being the sole decision maker with respect to a particular transaction, and that a lender’s practices and conduct may place it at various points along this continuum. The CFPB also recognizes that credit transactions in indirect auto lending take many forms. However, information gathered by the CFPB suggests that the standard

¹ 15 U.S.C. § 1691(a). ² 15 U.S.C. § 1691a(e). ³ 12 C.F.R. § 1002.2(l). ⁴ 12 C.F.R. pt. 1002, Supp. I, § 1002.2, ¶ 2(l)-1.

practices of indirect auto lenders likely constitute participation in a credit decision under the ECOA and Regulation B.

For example, an indirect auto lender is likely a creditor under the ECOA when it evaluates an applicant's information, establishes a buy rate, and then communicates that buy rate to the dealer, indicating that it will purchase the obligation at the designated buy rate if the transaction is consummated. In addition, when a lender provides rate sheets to a dealer establishing buy rates and allows the dealer to mark up those buy rates, the lender may be a creditor under the ECOA when it later purchases a contract from such a dealer. These two examples are illustrative of common industry practices; indirect auto lenders may also be creditors under other circumstances.

The Liability of Indirect Auto Lenders for Discrimination Resulting from Markup and Compensation Policies

An additional consideration for auto lenders covered as creditors under the ECOA is whether and under what circumstances they are liable for pricing disparities on a prohibited basis. When such disparities exist within an indirect auto lender's portfolio, lenders may be liable under the legal doctrines of both disparate treatment and disparate impact.⁵

An indirect auto lender's markup and compensation policies may alone be sufficient to trigger liability under the ECOA if the lender regularly participates in a credit decision and its policies result in discrimination. The disparities triggering liability could arise either within a particular dealer's transactions or across different dealers within the lender's portfolio. Thus, an indirect auto lender that permits dealer markup and compensates dealers on that basis may be liable for these policies and practices if they result in disparities on a prohibited basis.

Some indirect auto lenders may be operating under the incorrect assumption that they are not liable under the ECOA for pricing disparities caused by markup and compensation policies because Regulation B provides that "[a] person is not a creditor regarding any violation of the [ECOA] or [Regulation B] committed by another creditor unless the person knew or had reasonable notice of the act, policy, or practice that constituted the violation before becoming involved in the credit transaction."⁶ This provision limits a creditor's liability for another creditor's ECOA violations under certain circumstances. But it does not limit a creditor's liability for its own violations — including, for example, disparities on a prohibited basis that result from the creditor's own markup and compensation policies. Additionally, an indirect auto lender further may have known or had reasonable notice of a dealer's discriminatory conduct, depending on the facts and circumstances.

⁵ See CFPB Bulletin 2012-14 (April 18, 2012) (reaffirming that the legal doctrine of disparate impact remains applicable as the CFPB exercises its supervision and enforcement authority to enforce compliance with the ECOA and Regulation B). ⁶ 12 C.F.R. § 1002.2(I).

Limiting Fair Lending Risk in Indirect Auto Lending

Institutions subject to CFPB jurisdiction, including indirect auto lenders, should take steps to ensure that they are operating in compliance with the ECOA and Regulation B as applied to dealer markup and compensation policies. These steps may include, but are not limited to:

- imposing controls on dealer markup and compensation policies, or otherwise revising dealer markup and compensation policies, and also monitoring and addressing the effects of those policies in the manner described below, so as to address unexplained pricing disparities on prohibited bases; or
- eliminating dealer discretion to mark up buy rates and fairly compensating dealers using another mechanism, such as a flat fee per transaction, that does not result in discrimination.

Another important tool for limiting fair lending risk in indirect auto lending is developing a robust fair lending compliance management program. The CFPB recognizes that the appropriate program will vary among financial institutions. In our most recent Supervisory Highlights, we set out the following features of a strong fair lending compliance program, which are applicable in the indirect auto lending context:

- an up-to-date fair lending policy statement;
- regular fair lending training for all employees involved with any aspect of the institution's credit transactions, as well as all officers and Board members;
 - ongoing monitoring for compliance with fair lending policies and procedures;
 - ongoing monitoring for compliance with other policies and procedures that are intended to reduce fair lending risk (such as controls on dealer discretion); review of lending policies for potential fair lending violations, including potential disparate impact;
- depending on the size and complexity of the financial institution, regular analysis of loan data in all product areas for potential disparities on a prohibited basis in pricing, underwriting, or other aspects of the credit transaction;
- regular assessment of the marketing of loan products; and meaningful oversight of fair lending compliance by management and, where appropriate, the financial institution's board of directors.⁷

For some lenders, additional compliance-management components may be necessary to address significant fair lending risks. For example, indirect auto lenders that retain dealer markup and

⁷ Consumer Financial Protection Bureau, *Supervisory Highlights: Fall 2012* (Oct. 31, 2012), available at <http://www.consumerfinance.gov/reports/supervisory-highlights-fall-2012>.

compensation policies may wish to address the fair lending risks of such policies by implementing systems for monitoring and corrective action by:

- 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;
- 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;
- 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; and
- 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.

The CFPB will continue to closely review the operations of both depository and non-depository indirect auto lenders, utilizing all appropriate regulatory tools to assess whether supervisory, enforcement, or other actions may be necessary to ensure that the market for auto lending provides fair, equitable, and nondiscriminatory access to credit for consumers.