Indirect Auto Finance and Protections Against Discrimination

The Best Approach to Preventing Pricing Discrimination

Recommendation: The Bureau should amend Regulation B to advance its non-discrimination principles by granting a safe harbor from claims of illegal pricing discrimination to motor vehicle dealerships that adopt and implement in good faith a policy that limits a dealership's pricing discretion to recognized legitimate non-discriminatory considerations.

The Process: Consumers can buy a car by paying cash, by obtaining a loan from a third-party lender and bringing the check or cash to the dealership, or by obtaining financing through the dealership. The great majority of purchases are financed through the dealership, called "indirect financing."

In the indirect financing process, the dealership takes the credit application and sends it electronically to one or more finance sources (typically several) that regularly take assignment of that dealership's auto finance contracts. Each potential finance source ("assignee") responds with the terms of a credit offer or a denial. The dealership selects the assignee it will use and conveys the terms to the consumer. The finance source quotes to the dealership a "buy rate," which is its wholesale rate for the particular transaction and varies based on the consumer's creditworthiness and deal terms. The dealership quotes an APR to the customer that is usually higher than the wholesale buy rate; it is a retail APR.

If the dealership and the consumer accept the terms of the offered deal, the dealership extends credit to the customer by entering into a retail installment sale contract (not a "loan") and assigning the contract to the selected finance source. The assignee compensates the dealership for its services (dealerships typically staff a finance-and-insurance department with several employees) from the spread between the wholesale and retail rates, often disparagingly referred to as "dealer markup." After the customer accepts the financing terms, the dealership clears any financing stipulations the assignee requires such as income verification and employment status, then collects signatures, provides copies to the customer, and sends the file to the assignee, often electronically.

It is important to note that the interest rate is negotiable. (Indeed, the contract states that fact in bold print, perhaps not the ideal time for the disclosure, but still before the deal is finalized.) The dealership quotes a retail rate it believes the customer will accept, but often must lower the rate in negotiations. Moreover, certain manufacturer promotions of below-market rates do not allow an APR increase over the wholesale buy rate. In these cases (or when the consumer successfully negotiates away the increase), the assignee pays a flat fee for the contract.

The Benefits of Indirect Financing: This process is extremely efficient. As we know, a creditor's major cost is acquiring new customers. With indirect financing, the cost is greatly reduced and generally limited to establishing and maintaining relationships with dealerships. There is little or no direct-to-consumer advertising cost for finance source, except for the occasional promotional interest rates offered by captive finance companies that are subsidized by the manufacturer.

The economic savings to consumers is best illustrated by comparing the rates of any bank that offers both an indirect and direct credit program for auto finance. (Nonbanks, such as Ford Motor Credit and Toyota Motor Credit, are usually prevented by state law from offering direct loans to finance auto purchases; they can only buy contracts from dealers.) The wholesale "buy rate" quote by such banks to buy a contract from the dealership is typically substantially lower than its direct loan retail rate. Even with the dealer's "markup," the retail price quoted by the dealership is often lower than the rate the same bank would have quoted to a consumer for a direct loan made by a bank branch.

This pricing difference makes economic sense. The efficiencies that characterize indirect financing account for this favorable rate. Potential assignees compete for the opportunity to buy the contract. The dealership can send an application to as many indirect finance sources as it likes with virtually no marginal cost increase. In contrast, a consumer shopping for credit gains none of these efficiencies; applying with multiple lenders is a time-intensive process, which may be why many consumers to not do this.

Finally, indirect financing is popular with consumers. They gain the benefit of the potential assignees' competition with each other with no shopping cost. They are approved for financing, often within minutes, and can leave the dealership with their car purchase and established financing.

The Criticism of Indirect Financing

Consumer groups (and even Commissioner Slaughter at the FTC) criticize the process, often for a couple of reasons. First, they misunderstand the distinction between wholesale and retail rates and believe every customer should be offered the wholesale buy rate, calling it "the rate for which the consumer qualifies." Even the CFPB has often said that the buy rate reflects the creditor's risk of lending to the consumer, without considering the cost of the retail part of the transaction.

Second, analyses done on the average cost of the markup paid by minorities and non-Hispanic whites sometimes (but not always) show higher average markups to minorities. The Bureau performed its analyses using no controls that would ensure the comparison of similarly situated consumers.

In contrast, with appropriate regression controls, this racial difference typically evaporates. The evidence from regressions that control for credit-score tier have shown no statistically significant and material differences between whites and minorities ***within*** a tier. This suggests that the difference in average markups by group is an artifact of credit score rather than race or national origin and is thus not illegal discrimination.

The criticism is usually expressed as a concern about "discretionary markups." It is correct that a dealership's pricing decision can be viewed as discretionary and, accordingly, potentially arbitrary or discriminatory. However, the CFPB cases were brought with no claim (or evidence) of intentional discrimination by dealerships (or by assignees). A recent FTC case, however, alleged intentional discrimination by a dealership, quoting directions by a manager to charge black and Hispanic borrowers higher markups. Unlike CFPB settlements, this case alleges animus toward minorities and less favorable retail pricing based on it.

Solutions

Agencies have typically taken one of two approaches to concerns about auto pricing discrimination.

- The CFPB's approach constrained the markup over the buy rate that the bank or finance company could permit on any contract it purchased and thus limited the dealership's range of discretion. The CFPB had initially preferred to require assignees to pay only a single flat rate for each contract, but no company would settle on that term. (Indeed, the one known bank that implemented a flat fee, BMO Harris, suffered a dramatic loss of volume following this policy.)

Thus, dealerships under order would continue to have pricing discretion, just within a smaller range, usually capped at 125 basis points, or 1.25 percentage points. Many dealerships reacted by moving more of their business to companies not under a CFPB order. Note that this approach is an indirect and highly imperfect solution to any pricing discrimination. By constraining discretion, the CFPB hoped that pricing disparities would decline. But such a requirement does nothing to directly address any discrimination that may be occurring and limits a dealership's use of legitimate, non-discriminatory factors in setting retail rates.

- The Department of Justice and the FTC have taken a different approach in cases involving dealerships. The DOJ pioneered this approach with two settlements in 2007. The centerpiece of this approach was eliminating pricing discretion based on improper factors but allowing discretion based on legitimate pricing considerations, such as meeting a customer's better offer from another lender or forgoing any markup on deals involving promotional rates (when the promotion did not permit them) or on a car sold to an employee. The FTC adopted this approach in its settlement in May 2020 with Bronx Honda.[1]

The DOJ/FTC approach works like this:

- Each dealership adopts a written position on the markup it will charge on every deal unless a legitimate non-discriminatory consideration exists. The dealership is free to chose whatever standard markup it prefers, constrained only by the limitations imposed by assignees and the local competitive market.[2] The dealership agrees never to charge more than this amount, but it can charge less in specified circumstances (the DOJ-approved legitimate reasons).
- When the dealership charges a lower markup than its policy specifies, it must document the reason on a form and retain the form.

This approach has been adopted as a best practice by major dealership trade associations, including the National Association of Minority Auto Dealers.[3] The approach (Fair Credit Program) has been voluntarily implemented by many dealerships.

After over two years of debate and revisions, this approach has also been adopted by the American Bar Association. It was proposed by three pro-consumer sections of the American Bar Association, and endorsed as amended by the Business Law Section, comprised mostly of lawyers representing creditors and other businesses.[4] The ABA House of Delegates approved this resolution at its annual meeting on August 3, 2020, where it passed with the broadest support of any of the scores of resolutions considered (336-16). The passage of this resolution obligates the ABA to lobby for its adoption with federal, state, and tribal governments.

Dealerships are currently not required to adopt this program, although may have. Other dealerships have chosen to adopt an alternative strategy that protects them from pricing discrimination claims, such

[1] FTC v. Liberty Chevrolet d/b/a Bronx Honda is attached.
[2] My research shows that the maximum markup rate imposed by dealerships varies greatly, often based on geography. In more competitive markets (such as those where credit unions provide aggressive competition), average markup rates are considerably lower than in markets where there are fewer lower-priced competitors.
[3] The trade associations' Fair Credit Compliance Policy and Program is attached.
[4] The adopted Resolution is attached.

as charging the same markup on every deal. (This approach is far too inflexible for most dealers, however, although I know some who use it.) Others believe that their internal compliance training is sufficient to mitigate the risk of a discrimination claim. However, under the DOJ and FTC settlements, and under the ABA resolution, dealerships that faithfully implement the program will have a safe harbor from pricing discrimination claims. The documentation requirements provide the evidence of compliance.

The proposed recommendation would continue to allow dealerships complete flexibility in how they choose to meet the requirements of the ECOA and Regulation B. It would also provide dealerships (and the financial institutions that buy their retail installment sales contracts) with certainty that implementing the Fair Credit Program would meet their obligation to avoid illegal discrimination in pricing credit to their customers. Consumers benefit, as well, because they will not experience illegal discrimination in in obtaining financing from dealerships that adopt the Fair Credit Program.

Why a Safe Harbor?

The regulations implementing the various parts of the Consumer Credit Protection Act are replete with safe harbors. They generally occur in the regulations' appendices. This approach has proven over 50 years to be a successful solution to providing clear guidance to financial institutions without stifling innovation.

For example, Regulation B (implementing the ECOA) contains a principles-based rule regarding adverse-action reasons. The reasons disclosed must be the "principal and specific" reasons. Creditors were understandably concerned about how to know how specific a "specific" reason must be. Is "delinquent credit obligations" specific enough? Or must the creditor say how many days delinquent, how many times, and on what type of credit accounts? In its appendices, Regulation B offers many examples of acceptable adverse action notices, including one with reasons preprinted, which can be checked off by the creditor. (This safe-harbor notice said "delinquent credit obligations" was sufficiently specific.)

In the early days of ECOA and Regulation B enforcement (and don't hold against me my direct experience with this issue – and my age!) many creditors took great comfort from the guidance implicit in the safe harbors provided by the reasons in these appendices. Now, 44 years later, fewer creditors use this particular safe harbor. Although the various safe-harbor examples in the Regulation B appendices continue to provide useful guidance, many creditors are sufficiently confident with their alternative (innovative?) approaches to abandon the safe-harbor protections.

The existence of these safe harbors, in my experience, has not wed creditors to their use beyond the examples' actual usefulness to them. Creditors abandon them when they feel confident that an innovative alternative meets the regulation's requirements and provides other benefits. The continued existence of the safe harbors causes no harm. Some creditors (often those new to consumer lending and with simple underwriting systems) continue to use them. Their continued presence in regulations for creditors that don't use them causes no problems.

Are Other Options Better than a Safe Harbor?

A No-Action Letter has some of the benefits of a safe harbor in reducing regulatory uncertainty, but not all the benefits of a safe harbor. A No-Action Letter generally is issued only to a single company, although the Bureau has employed a No-Action Letter Template that a single party (such as a service provider or trade association) could seek on behalf of others, but the Template would not be binding on the Bureau and thus lacks the main benefit of receiving a No-Action-Letter.

Under the Bureau's current No-Action Letter policy, each dealership wishing to use the Fair Credit Program would be required to apply separately for a No-Action Letter to benefit from the letter's protection. This burden is potentially mitigated by the Bureau's own No-Action Letter policy providing a streamlined application and review process for similar requests. Yet preparing a request for a No-Action Letter would still impose significant costs on dealerships, which are often small businesses.

Further, a No-Action Letter only provides an entity with the Bureau's discretionary determination not to exercise supervision or enforcement activity against specific aspects of a product or service. A No-Action Letter does not protect a company that obtains the letter from actions by other federal or state regulators or enforcement agencies or private actions by consumers. A safe harbor, in contrast, provides the same liability protection that compliance with the regulation itself provides.

A second alternative exist with the Bureau's "Sandbox" policy. The Bureau has adopted a policy it calls its Compliance Assistance Sandbox policy, or CAS. As the Bureau stated when it issued the final policy, CAS approvals "offer a regulated entity that confronts regulatory uncertainty the binding assurance that specific aspects of a product or service are compliant with specified legal provisions." A CAS approval provides an explicit safe harbor from liability under the applicable statute. Unlike a No-Action Letter approval, a Sandbox approval provides the recipient with immunity from actions by any federal, state, or private party.

An approval under the Bureau's new Sandbox policy grants the recipient an explicit safe harbor, a recognition by the Bureau of the value safe harbors can provide in creating regulatory certainty and promoting innovation. However, a Sandbox safe harbor is intended to be temporary, generally lasting only two years. The Bureau expects that the limited-time approval "may ultimately be used to help support an amendment to a regulation or Commentary, negating the need for further extensions of one-off assistance."

An approval under the Bureau's new Sandbox policy has many of the policy benefits of a safe harbor. Indeed, if the Bureau accepts the Taskforce's recommendation of a safe harbor for dealerships under the Fair Credit Program, dealerships may decide to apply for a CAS approval pending the completion of a rulemaking that would build the safe harbor into Regulation B, its appendices, or commentary. But the advancement of this result would be enhanced by the Taskforce's recommendation that I propose.

Based on my research, I see no disadvantages of a safe harbor over other ways of promoting innovation we are prepared to cite with approval, such as a No-Action Letter or Compliance Assistance Sandbox approval.

As the widespread support of the ABA House of Delegates reflects, this recommendation can directly address illegal pricing discrimination by auto dealerships. Other solutions, at best, merely reduce its likelihood or improve the chance of detection. However, unlike this recommendation, the other approaches are not only imperfect but also discourage dealership actions that promote competition and benefit consumers.

The Taskforce should make this recommendation.

Attachments

The consent decree in the FTC's case against Bronx Honda is available at: [HYPERLINK "https://www.ftc.gov/system/files/documents/cases/bronx_honda_stipulated_final_order_liberty_chevrolet.pdf"]. The relevant order provision appears as Section V., on pages 7-9.

Fair Credit Compliance Policy & Program [HYPERLINK "https://www.nada.org/WorkArea/DownloadAsset.aspx?id=21474838176"]

Fair Credit Compliance Policy & Program Summary [HYPERLINK "https://www.nada.org/WorkArea/DownloadAsset.aspx?id=21474838180"]

American Bar Association Resolution, adopted as amended on August 3, 2020, is below.

REVISED 116B

RESOLUTION

RESOLVED, That the American Bar Association urges federal, state, local, territorial and tribal governments to:

a) ~~adopt and~~ enforce fair lending laws and other federal, state and local laws targeting unfair or deceptive acts or practices to address discrimination in vehicle sales and financing markets;

b) adopt laws and policies that promote the adoption of an enhanced nondiscrimination compliance system for dealer compensation for arranging and/or originating a vehicle finance contract by offering a safe harbor against pricing discrimination claims for dealers that faithfully implement the NADA/NAMAD/AIADA Fair Credit Compliance Policy and Program;~~loan or a flat percentage fee for dealer compensation;~~ and

c) adopt legislation requiring that the purchase of any voluntary vehicle protection product may not be made a condition of the sale or lease of the vehicle, and that there is clear and conspicuous disclosure of pricing of voluntary protection products by dealers through reasonable means, such as a pricing sheet, menu, and/or website, before a consumer purchases a vehicle;~~the timely notice and disclosure of pricing of add-on products by dealers on each vehicle through reasonable means, such as a pricing sheet and/or website prominently displayed and available at its location, before a consumer negotiates to purchase a vehicle;~~

~~FURTHER RESOLVED, That the American Bar Association urges Congress to amend the Equal Credit Opportunity Act, 15 U.S.C 1691, to require documentation and collection of the applicant's race, gender and national origin for vehicle credit transactions, through applicant voluntary self identification using disaggregated racial and ethnic categories, made available through a Demographic Information Addendum, or some equivalent measurement;~~

FURTHER RESOLVED, That the American Bar Association encourages state, local, territorial and tribal bar associations to work with consumer, dealer and creditor representatives to offer educational programming and materials to lawyers and consumers to help them understand and navigate purchases and financing of vehicles and understand consumers' legal rights with respect to such purchases and loans.