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ICYMI – House Report on the CFPB and Indirect Auto Lending

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Two days before Thanksgiving the Republican staff of the House Committee on Financial Services published a fairly unflattering review of the role of the Consumer Financial Protection Bureau (CFPB) in regulating indirect auto lending. Titled "Unsafe at Any Bureaucracy: CFPB Junk Science and Indirect Auto Lending," the report provides a follow-up to several articles published in the American Banker in September. That series of articles cited internal CFPB documents which gave an exclusive look into CFPB litigation strategy in cases involving indirect auto lending. This website for this report actually contains what appear to be several of the documents quoted in the American Banker. The report and these documents provide a glimpse into CFPB decision-making.

The Congressional report first challenges the legal basis upon which the CFPB uses the 'disparate impact' theory of legal liability for cases brought under the Equal Credit Opportunity Act (ECOA). Beyond challenging the legal basis for the CFPB's 2012 bulletin on Fair Lending, the report also notes that ECOA does not contain the same encompassing language as other statutes (including the Fair Housing Act) for which the Supreme Court has upheld the validity of discrimination claims based upon disparate impact.

The report next discusses dealer compensation under a Retail Installment Sales Contract. The CFPB has taken the view that the ability of dealers to mark-up consumer rates opens up the possibility that rates will be set on prohibited bases, and so creditors may be subject to disparate impact liability under ECOA. The report also argues that, in the case of 'spot deliveries,' in which the dealer extends credit to the customer without first receiving responses from any potential lender, the ultimate lender should not be considered a 'creditor' under ECOA.

The report then delves into how the CFPB determines disparate impact liability. Based upon the case *Smith v. City of Jackson*, the report notes that there are three items which must be proven; first, the CFPB must identify a specific policy or practice adopted by a creditor; second, the CFPB must demonstrate a disparate impact on a prohibited basis; and finally, the CFPB must show a causal relationship between the challenged practice and the alleged disparate impact.

With regards to identification of a specific policy or practice adopted by a creditor, the report references the case of *Wal-Mart Stores, Inc. v. Dukes*, noting that the Supreme Court held that a policy of allowing discretion (in this case, in employment matters), by itself, should not raise an inference of discriminatory conduct under the legal theory of disparate impact. The report cites an internal CFPB memorandum which recognizes the potential weakness of extending disparate impact liability to the context of indirect auto lending, given the *Dukes* decision.

The report then turns to the second part of the disparate impact requirement, that the CFPB must demonstrate a disparate impact on a prohibited basis. This part of the report spans ten pages – almost one-fifth of the report-- and is worth a read for anyone involved in the statistical analysis of fair lending. Because creditors are not allowed to inquire about race, color, religion, and other prohibited bases within the credit transaction, a fair lending analysis may instead use a proxy for race, such as the BISG method used by the CFPB. This method incorporates information about a borrower's surname and physical location to imply a probability regarding the borrower's race and ethnicity.

The BISG method has been criticized for, among other things, failing to take into account differing probabilities among members of different races will enter into a lending transaction (in the context of indirect auto lending, the this would be differing probabilities, by race, of borrowing money to purchase an automobile). An internal CFPB memorandum cited in the report recognizes that proxy methods which rely on proprietary (that is, not-public) data for estimating race and ethnicity proxies "are likely to achieve a greater level of accuracy in identifying the race/ethnicity of particular individuals" but that the CFPB rejected using proxy methods based upon proprietary data. The CFPB justified this rejection by arguing that basing the proxy upon publicly-available information would enable the industry (lenders and dealers alike) to conduct analyses of their own portfolios in a manner consistent with the CFPB, possibly leading to voluntary corrective actions. This rejection of the use of proprietary data naturally comes at the expense of less accuracy of the proxy itself.

The report goes on to note that, once the CFPB released its proxy methodology, it was indeed subject to criticism. In November 2014 Charles River Associates ("CRA") released their own analysis of the CFPB's methodology. The report cites the various weaknesses of the CFPB methodology identified by CRA (which are familiar to any reader of CRA's analysis), including the aforementioned weakness of not including data on the relative participation rates across races in auto lending transactions. Another weakness mentioned in the report is in the context of a response from an (unnamed) institution which had received a Potential Action and Request for Response letter from the CFPB. In its response the institution noted that most of its minority customers lived in majority-White census tracts, and that its own regression methodology was therefore better suited than the CFPB's to estimate pricing disparities on the basis of race.

The report then discusses the third aspect of the disparate impact requirement, that the CFPB must show a causal relationship between the challenged practice and the alleged disparate impact. The report provides a simple example of how individual dealer pricing practices could lead to an appearance of pricing disparities based upon race, when in fact there was no such disparity. The report also argues that customer creditworthiness can be a factor in dealer mark-up, since dealers may have higher costs for less-creditworthy borrowers and may also make less on the purchase transaction itself. Notably both the DOJ and the CFPB have taken the position that borrower creditworthiness is only a factor in the buy-rate, and should not be reflected in dealer mark-up. It is notable as well that the internal CFPB documents referenced in the report state that the inclusion of factors (such as used by the unnamed institution referenced above) relating to creditworthiness were "not invalid or unreasonable."

The report next delves into the business justification for lenders not to simply allow dealers to charge a flat fee, noting that Ally termed this approach "corporate suicide" because of the competitiveness in the industry.

Finally, the report discusses the overall CFPB effort to limit (or even eliminate) dealer discretion on mark-ups. The correspondence cited in the report makes clear that the CFPB saw an opportunity in the Ally case to achieve a significant settlement which could sway the industry to move away from discretion, as Ally had a strong incentive to reach a settlement (it wanted to change its status to a financial holding company by a certain date), rather than engage in protracted litigation.

The report provides a useful summary of how the CFPB views fair lending in the context of indirect auto lending. The report and CFPB internal documents (often heavily redacted) are available at http://financialservices.house.gov/hearingslegislation/staff-reports.htm