**Indirect Auto Lending:**
**Talking Points on Proxy Methodology and AFSA Policy Paper**

Since long before the Bureau was created, regulators, consumer advocates, and others have recognized that indirect auto lenders' pricing and compensation policies allowing auto dealers the discretion to increase (or "mark up") the consumer's interest rate and benefit from the increased interest revenue present heightened fair lending risk. The Bureau's supervisory and enforcement work has regularly found that such policies, especially when combined with inadequate controls and monitoring, result in unexplained disparities on a prohibited basis in violation of the Equal Credit Opportunity Act. Our disparity findings are based in large part on statistical analyses that use proxies for race, ethnicity, and sex, since information on such characteristics is not typically collected as part of an auto lending transaction.

**Proxy methodology white paper:** In September 2014, the Bureau published a white paper describing the Bayesian Improved Surname Geocoding Method (BISG proxy methodology that is used in fair lending statistical analysis conducted by Supervision, Enforcement, and Fair Lending and the Office of Research, along with the statistical software code used to build the proxy~~.~~

- Demographic information, such as race and ethnicity, is not collected by non-mortgage lenders, and ECOA generally forbids the collection of this kind of demographic information outside of the mortgage context. Federal regulatory and enforcement agencies have long used proxy methods in non-mortgage data analysis because demographic information is vital to assessing fair lending compliance.
- The BISG proxy integrates information associated with surname and place-of-residence to come up with the probability that a borrower belongs to each of several racial and ethnic groups, including Non-Hispanic White, African American, Hispanic, and Asian and Pacific Islander.
- ~~The paper provided a detailed description of the proxy methodology and was accompanied by the publication of the statistical software code used to build the proxy.~~
- The white paper provided an assessment of the proxy's ability to predict reported race and ethnicity for a sample of mortgage borrowers.
- The assessment demonstrated that the BISG proxy performs better than a proxy based on only surname or place-of-residence at approximating the overall reported distribution of race and ethnicity.
- We noted that while for the set of mortgage applications under review, the proxy tended to overestimate the number of minority borrowers, particularly African Americans, ~~which may be related to the fact that~~ mortgage applicants are not representative of the general population and that may account for the overestimation. ~~Overestimation may be less of a concern~~ ~~W~~when the proxy is applied to data (e.g., non-mortgage products) ~~that~~ where the applicants are more representative of the general population there may not be overestimation or it may be much less. .
- We also noted that there are various ways to use BISG probabilities in an analysis. One approach is to set a threshold and force classification into a single racial or ethnic group—thus, for example, only borrowers with an 80% or greater probability of being African American are designated as African American, only those with an 80% or greater probability of being Hispanic are designated as Hispanic, and so on. The proxy paper discussed some of the limitations of this approach, including the fact that setting a hard threshold will capture only a segment of each group. Another approach is to account for all of the BISG probabilities for each borrower, rather than assigning each borrower to only one group.
- The BISG methodology has evolved over time and will continue to evolve as enhancements are identified that improve accuracy and performance.

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As mentioned in the white paper~~ discussing the proxy methodology relied on by the Division of Supervision, Enforcement, and Fair Lending and the Office of Research~~, "the Bureau is committed to continuing our dialogue with other federal agencies, lenders, advocates, and research regarding the [BISG] methodology," and we view the AFSA policy paper as an effort to inform that dialogue. However, the AFSA policy paper does not undermine either the importance of the Bureau's anti-discrimination work in indirect auto lending or our confidence in our use of the BISG methodology.

**The AFSA policy paper** does not provide reassurance that the fair lending risk presented by discretionary dealer markup is less significant than we—and other regulators and consumer advocates—believe. Rather, the paper takes issue with the manner in which its authors think we are assessing that risk, using the BISG methodology, in order to determine whether violations have occurred. But the authors do not reject the use of a BISG methodology itself, they simply offer a variety of recommendations based on their beliefs regarding the Bureau's use of the BISG proxy. These beliefs reflect a potential misunderstanding of how we conduct our analysis, which is based on the often specific business practices of individual lenders.

The AFSA policy paper presumes the existence and knowledge of a single analytical approach that is applied to all lenders and offers specific recommendations on statistical controls, and pools across "many of the 10 largest financial institutions in the indirect automotive finance market" rather than evaluating specific lenders for potential disparities.[1] The focus of SEFL supervisory examination work and enforcement investigations is the lending outcomes for specific lenders and specific products. ~~The AFSA policy paper presumes the Bureau applies the same analysis to all lenders, in all contexts, including recommending statistical controls the Bureau should use in every case, regardless whether those controls apply to an individual lender's business model. At the Bureau,~~ ~~e~~Each supervisory examination or enforcement investigation is based on the particular facts presented. In analyzing lending data for statistical disparities on a prohibited basis, examination teams typically construct regression models based on the particular institution's specific policies and practices, which vary from institution to institution and may also vary by product and channel. For this reason, for each institution subject to review, examination teams may construct multiple regression models and tailor different models by including controls that reflect the institution's various policies, practices, products, and channels, as well as any additional factors identified by the examination team or the institution.

Comment [CG(1]: Taken from 11.25.14 summary document re: AFSA study

**We engage with individual lenders to better understand their policies and products.** As such, we have considered, on a case-by-case basis, many of the controls and recommendations listed in the AFSA policy paper. Many of the controls and recommendations are already incorporated into our analysis, both to test the robustness of our results and to anticipate (and respond to) lender concerns. This process is an ongoing dialogue between specific institutions and the Bureau.

**The AFSA policy paper does not reject that reliance on the proxy, rather, it provides opinions on the use of the BISG proxy in fair lending analysis.** The Bureau's own analysis demonstrates that the BISG proxy probability, which assigns an individual probability of inclusion in a prohibited-basis group, is more accurate than a geography-only or surname-only proxy in its ability to predict individual applicants' reported race and ethnicity and generally more accurate than a geography-only or surname-only proxy at approximating the overall reported distribution of race and ethnicity. An analysis of mortgage data shows that proxied race and ethnicity are highly correlated with reported race and ethnicity. The strong relationship between the proxied and reported race and ethnicity gives us confidence that disparities estimated using proxies would also be also observed if we had actual race and ethnicity data.

[1] "Fair Lending: Implications for the Indirect Auto Finance Market," AFSA policy paper, November 19, 2014, p 9.

**The AFSA policy paper highlights concerns over the accuracy of the BISG proxy based on a possible misunderstanding of the way it is generally used in our analysis.** One goal of our analysis is to identify the total number of consumers by race and ethnicity who may be impacted by potential disparities in lending outcomes. We generally rely on the BISG probability value to estimate the number of consumers by race and ethnicity. The results presented in our proxy methodology assessment paper, based on a sample of mortgage loans, suggest that the BISG probability does a good job of estimating the number of White, Hispanic, Black, and Asian and Pacific Islanders in our review. For instance, the BISG estimated number of Hispanic consumers is 11,516 compared to the reported number of 11,073, roughly a 4% overestimation.[2] Moreover, as our study suggests, the BISG proxy and reported race and ethnicity for Whites, Hispanics, Blacks, and Asian and Pacific Islanders are strongly correlated, suggesting that the proxy does accurately sort consumers into their reported race and ethnicity categories.

**The AFSA policy paper relies on auto loan data that is pooled across lenders, masking potential disparities in lending outcomes that may exist for a given lender and protected minority borrowers.** The AFSA study pools across "many of the 10 largest financial institutions in the indirect automotive finance market" rather than evaluating specific lenders for potential disparities.[3] The focus of SEFL supervisory examination work and enforcement investigations is the lending outcomes for specific lenders and specific products. In fact, our Supervisory Highlights released in September discusses how we conduct analysis in the context of the targeted ECOA review, which focuses on the lending practices of the particular lender being examined. As our Supervisory Highlights report indicates: "To date, examination teams have conducted targeted ECOA reviews at institutions that represent over 30 percent of the indirect auto lending market. Many, but not all, of these indirect auto lending examinations have revealed illegal discrimination and a need for corrective action."[4] Attempting to identify lending disparities across a pool of lenders—for which some may, d some may not, exhibit potential disparities—would mask potential disparities for a given lender.[5]

[2] For Whites: 151,832 estimated; 157,856 reported; 4% underestimation. For Blacks: 14,262 estimated; 11,871 reported; 20% overestimation. For Asian and Pacific Islanders: 9,567 estimated; 8,646 reported; 11% overestimation.
[3] "Fair Lending: Implications for the Indirect Auto Finance Market," AFSA policy paper, November 19, 2014, p 9.
[4] Supervisory Highlights, Summer 2014, p 15.
[5] Even when the data are pooled, the AFSA study reports raw disparities in dealer markup of 16.9 bps for African Americans, 9.4 bps for Hispanics, and 13.4 for Asian consumers. Even after the application of the proposed adjustments, disparities do remain.