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Introduction:

Pursuant to the Bureau's March 2013 bulletin regarding indirect auto lending, lenders have two options for addressing the fair-lending risk inherent in compensation systems that allow dealers the discretion to mark up loans: (1) a lender can implement a rigorous compliance management system (CMS) that monitors for disparate outcomes and remediates harmed consumers or (2) a lender can adopt a non-discretionary compensation system that eliminates the risk.

The Bureau has received questions from numerous lenders regarding possible options, and in particular has been asked whether the Bureau would object if a particular lender adopted one of the proposals below.

Background of Analyses:

OFLEO, Legal, RMR (including in particular the Office of Research and Installment and Liquidity Lending Markets), and Enforcement have considered the alternatives and proposals below, analyzing the data provided by lenders as well as data from the various auto-lending exams and investigations currently in progress. Staff has determined that although there are uncertainties regarding some possible risks related to the proposals, those risks very likely are "unknowable," as it is not feasible to conduct additional research that will address those risks definitively. RMR has determined in particular that with respect to possible steering risks, additional studies (1) likely will not answer remaining questions and (2) would require valuable and limited Bureau resources for an extensive period (likely 12-18 months). In addition, as a general matter, the Bureau does not know how other interested parties (e.g., other regulators, trade associations, consumer advocates, or others) will react to any of the below.

The concerns and benefits listed below are only talking points designed to facilitate a discussion of possible objections to the various proposals. This document does not reflect the entirety of either the analyses or the discussion.

Alternatives for Resolving Examinations and Investigations

Alternative 1: Stringent Compliance Management System

Lender allows dealers discretion to mark up loans but adopts a stringent CMS that includes the following:

- o 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;
- o 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 and with specific terms of the analyses that reflect only those controls that are appropriate for a dealer markup analysis;

Comment [CC1]: These are taken from the Ally settle-or-sue draft.

Comment [CC2]: Do we need to define regular? Is that six months? Annually?

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- o 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, with appropriate cutoffs to trigger action ranging from 5-15 bps; and
- o 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, with appropriate cutoffs to trigger action ranging from 5-10 bps.

Comment [CC3]: Same question as above re frequency.

Concerns:

- The Bureau's supervisory and enforcement experience has demonstrated that discretionary markup policies in the current ranges (200-250 bps) have disparate outcomes on prohibited bases in most cases.
- If the Bureau publicly settles a matter with an order that does not require a CMS that is sufficiently stringent, specific, and concrete, it may confuse the market or send a signal to the market that lenders' current CMS (or lack thereof) are sufficient, although the Bureau would not consider them to be so (and the Bureau has seen evidence that a number of lenders have lax or no CMS in this area), or that lenders should wait until they are caught by the Bureau before taking action.
- Lenders with stringent [acceptable?] CMS are having "first-mover" problems, as dealers complain that these lenders' dealer monitoring systems are more aggressive than other lenders';
 - o [REDACTED] has stated that large dealers (including at least one with ~\$1 million/month in originations with [REDACTED]) have said that they will take their business elsewhere due to [REDACTED] CMS;
 - o Serial imposition of more rigorous CMS by lenders may exacerbate this issue for those lenders.
- CMS only captures and remediates disparate outcomes after they have occurred.
- If disparities are not lowered sufficiently, CMS could result in perpetual remediation.
- CFPB and indirect lenders will have to devote significant resources to monitor closely the exercise of discretion on an ongoing basis.
- Compensation through discretionary markup by the dealers is not transparent to consumers and may subject lenders to UDAAP liability in addition to fair-lending liability.
- Discretionary markup systems create incentives to steer consumers into longer term loans, as dealers make more from longer term loans with the same markup percentage.

Comment [CC4]: Could we include numbers? E.g., [REDACTED] exams and [REDACTED] investigations have found statistically significant disparities of a magnitude that concern the Bureau or that warrant remediation? Using whatever the current numbers are.

Benefits:

- Lenders may consider this alternative less disruptive than adopting a non-discretionary compensation system.
- Several lenders have expressed an interest in attempting to implement a more rigorous CMS rather than adopting a non-discretionary compensation systems at this time.

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- Guidance to the industry can be provided through our supervisory authority and current mechanisms (Supervisory Highlights or a Bulletin).
- Ongoing review is not uncommon in MOUs/Consent Orders.

Alternative 2: Stringent CMS with a step-down mark-up provision

Lender allows dealers discretion to mark up loans but adopts a stringent CMS that includes the components from Alternative 1 as well as requirements that:

- The lender reduces its mark-up caps by 25 – 50 bps immediately;
- If disparities remain above 10 bps after ____ [6 months?] and originations remain at least ____ [90%?] of the prior period (as adjusted for seasonal differences and any market-wide changes), the lender must reduce its caps by another 25 – 50 bps;
- The lender must monitor its portfolio every ____ [6 months?] thereafter and lower its caps by 25 – 50 bps if the two conditions above are met;
- The lender may provide non-discretionary compensation to dealers in addition to the discretionary markup to maintain the dealers' current level of compensation.

Concerns:

- This alternative has the same concerns as the stringent CMS alternative, although the signal to the market likely will be much clearer.
- It is likely that one (or more) of the following will occur:
 - The lender will lose share as transactions at the high-end of its previous cap—which it previously had captured—would go to another lender that will pay more for those transactions;
 - The dealer will—overall—receive less compensation than under the current system, because a significant number of loans are at the current markup caps and if the dealer does not choose a different lender, it will have to accept less compensation for those deals; or
 - The lender will have to develop some non-discretionary supplemental fee structure to ensure that dealers' overall compensation remains the same.
- People may argue that the Bureau is dictating dealers' compensation, which is both untrue and in contrast to the Bureau's prior statements.
- This alternative could create an unlevel playing field (e.g., create a first-mover problem) in the following ways:
 - If this provision is not included in the resolution of all Bureau matters where actionable disparities have been found (i.e., the Bureau will have required some lenders to lower their caps but not others);
 - If the Bureau requires lenders to set their caps at different levels (e.g., one lender at 175 bps and another at 200); or
 - If lenders who are not currently the subjects of Bureau action, or who do not have actionable disparities, retain higher caps.
- If an unlevel playing field develops, it may take a significant amount of time for the differences to even out.
- People may argue that the Bureau is dictating winners and losers, especially if it requires or allows different lenders to set different caps.

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- Is there a possibility that this alternative could get stuck, wherein disparities remain high but caps are not lowered further because business shifts to other lenders who have not lowered their caps?
- Industry actors may perceive this alternative as punishing lenders who currently have lower caps, despite the fact that the Bureau might consider those lenders to have been more proactive about addressing disparate outcomes.
- This alternative has not been discussed with lenders, and lenders may be resistant to adopting a compensation structure that could put them at a competitive disadvantage over the short term (by requiring them to have caps lower than the market norm).
- This alternative could allow disparities to continue for a long time.
- This alternative could create the perception that some discriminatory outcomes are acceptable if fixing them would cause a lender to lose too much business.

Benefits:

- This alternative requires change (the lowering of the cap) if the CMS does not reduce the disparities, thereby ensuring either the effectiveness of the CMS or further corrective action.
- Given that there appear to be a significant number of transactions at the current caps, this alternative would provide an immediate decrease in markup that likely would decrease the lenders' markup disparities.
- Lenders may prefer this alternative to adopting an entirely new compensation system, as it limits the risks to their market share and requires change in small doses.
- If other lenders do not adopt this structure, the potential negative impact on the market share of a lender that does adopt this structure should be limited.
- Over the long run, if enough lenders reduce their caps, it seems likely that either the disparities will reduce to below 10 bps or the discretionary markup will be eliminated.

Possible ways to ameliorate concerns:

- Set a schedule of steps that would apply evenly across the industry, although this would not address differences due to lenders not having disparities or not being reached by the Bureau.
- Make explicit in orders and MOUs that lenders can provide non-discretionary compensation in addition to the markup.

Alternative 3: Either stringent CMS or the adoption of a non-discretionary compensation system

Lender has the option of adopting a stringent, concrete, and specific CMS (either Alternative 1 or 2) or an unspecified non-discretionary compensation system, including possibly any of the systems discussed below.

Concerns:

- This alternative has the same concerns as the other CMS alternatives.

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- This alternative may not provide much concrete guidance to industry regarding non-discretionary systems to which the Bureau would not object (even if the principles were explicitly stated).

Benefits:

- This alternative could provide at least limited guidance (e.g., the principles) to industry regarding non-discretionary systems to which the Bureau would not object.
- This alternative could be structured in a way that would allow lenders subject to consent decrees or MOUs to propose the adoption of a non-discretionary compensation system at a later date that would relieve them of the costs associated with maintaining a stringent CMS.
- This alternative likely would give the Bureau additional time to consider proposals from industry regarding non-discretionary systems and would give industry time to evaluate the costs and benefits of continuing with CMS versus adopting a non-discretionary system.
- There appear to be no downsides including this option in any decree or MOU that provides for stringent CMS, but it also seems likely that the ultimate outcomes will be the same as either Alternative 1 or 2 (depending on which is specified in the decree or MOU).

Alternative 4: Adoption of a stringent CMS that meets explicit criteria or a mandatory change to a non-discretionary compensation system

Lender has a set period (e.g., three months) in which to adopt a stringent CMS that meets concrete and specific criteria described in the decree or MOU; if it fails to do so, it must adopt a non-discretionary compensation system.

- The lender would propose a non-discretionary system that satisfies the principles;
- That system would not have to be specified in the decree or MOU.

Concerns:

- If a lender is required to adopt a non-discretionary compensation system, it may lose market share (the first-mover concern), although some industry insiders have stated that any such loss could be managed and non-discretionary systems can be revenue-neutral to the dealers (i.e., their compensation would be the same as it is now), which should mitigate any loss in share.
- People likely would argue that this alternative is a shift from the guidance given in the bulletin and that the Bureau was forcing adoption of a particular compensation system (although such arguments are made now).
- If the lender adopts a CMS, this alternative has the same concerns as the other CMS alternatives.

Benefits:

- This alternative gives lenders who are interested the opportunity to adopt a stringent CMS, but it also imposes an immediate consequence on those lenders who fail to take their obligations seriously.

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- This alternative has the same benefits as the other CMS alternatives, including in particular sending a strong, clear market signal on what type of CMS the Bureau expects.
- This alternative creates incentives to adopt stringent CMS now for those who want to do so, and it creates disincentives for lenders to take a wait-and-see approach (e.g., to do little or nothing until examined or investigated).
- If the lender adopts a CMS, this alternative has the same concerns as the other CMS alternatives.
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Alternative 5: Mandatory adoption of a non-discretionary compensation system

Lender is required to change to a non-discretionary compensation system in order to address significant disparities.

- The lender would propose a non-discretionary system that would not have to be specified in the decree or MOU but that would have to satisfy the principles.

Concerns:

- This alternative likely would be construed as conflicting with the Bureau's previous guidance.
- This alternative would require the Bureau to take an immediate position on a proposed non-discretionary system.
- This alternative would have the same first-mover concerns as above, and it seems extremely unlikely that a lender will want to adopt such a system alone.
- This alternative would subject the Bureau to claims that it was forcing lenders to eliminate markup.

Benefits:

- A lender that agreed to this alternative would encourage others to adopt similar systems and would work to demonstrate the benefits of such a system to other lenders and to dealers.
- This alternative would send a strong signal to the industry.

Possible Non-Discretionary Compensation Systems

None of the above alternatives would require interested lenders to adopt a particular non-discretionary compensation system. However, Alternatives 2, 4, and 5 do require the Bureau to be prepared in the near term to object or not object to non-discretionary compensation systems that may be proposed by lenders. Further, unless the Bureau is prepared to take a position, it will not be able to react quickly in response to market events (e.g., a public enforcement action or a lender that adopts a voluntary pilot program) that generate interest in the adoption of non-discretionary systems.

There is an internal disagreement as to whether research into whether protected classes that are harmed by the current practices are disproportionately represented in the shorter-term or lower-amount-financed loans would be useful in evaluating these proposals.

- If they are disproportionately represented, those persons might face higher cost loans under Proposal A or B.

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- However, assuming that is true, the fact that a given class was disproportionately affected may not be indicative of fair-lending liability, as there may be legitimate business needs justifying the disparate outcomes (e.g., as with the use of FICO score in underwriting).

Characteristics of discretionary markup:

- Dealers are paid more for longer term loans (all other things being equal).
- Compensation varies by markup rate, term, and amount financed.

Proposal A: Flat dollar amount per transaction

A lender would pay dealers a flat dollar amount (e.g. \$650) for each contract financed. A lender likely would set the amount to pay compensation comparable to what the dealer is paid under the current system for the most desirable type of loan for its portfolio, whether that be the “average” loan in its portfolio or loans with a particular term or amount financed (the “target loan”).

Concerns:

- Because the lender can set only a single dollar amount for all loans, the lender will pay more than the current system for loans with shorter terms or lower amounts financed than the target loan. As a result, APRs offered to consumers for such loans likely will be higher than they are currently, although dealers may have incentives nonetheless to offer those higher loans to consumers because the lender will be paying higher compensation than the industry norm.
- Conversely, the lender will pay less than the current system for loans with longer terms or higher amounts financed than the target loan. As a result, APRs for those loans likely will be lower, although again the dealers may have incentives to steer consumers to higher-cost loans offered by other lenders who pay more.
- Because the lender can set only a single price, the lender likely will have to solve either for the average, for a particular term, or for a particular amount financed. For example, if a lender sets the fee to capture 60-month loans, because those are the bulk of its portfolio, it may not be able to compete effectively for very short term loans—that it might want in its portfolio due to the high average credit tier and lower LTV characteristic of those loans—because the APR it can offer will be too high for those consumers.
- There is a risk that lenders will compete for loans on the basis of compensation paid rather than on lower buy rates.
- There is a risk that the market may bifurcate into low-cost, low-compensation lenders and high-cost, high-compensation lenders.
- Although this system may address the discrimination problem, it will not solve the underlying problems in the auto lending market caused by lack of transparency.

Benefits:

- The proposal would reduce significantly the fair-lending risk as compared with the current system.
- The compensation system would be easier for consumers to understand than the current system.

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- Because dealers likely make higher profit margins from other sources (e.g., add-ons or trade-ins), they may have incentives to offer the lowest available APR to the consumer even if they could have earned more from another dealer by offering a higher APR.

Proposal B: Fixed Percentage of Amount Financed

Pay dealers a fixed percentage of the loan amount (e.g., 3%) for each loan financed. This proposal allows compensation to vary by rate (the percentage paid) and amount financed, two of the three determinants of current compensation.

Concerns:

- Because the lender can set only a single percentage for all loans, the lender will pay more than the current system for loans with shorter terms and less for loans with longer terms (depending on where the percentage is set), as with Proposal A.
- The data suggests that shorter-terms correlate with lower amounts financed, which suggests that this proposal also would put upward pressure on the costs of loans for lower amounts financed, as with Proposal A, although perhaps to a lesser extent.
- There is a risk that lenders will compete for loans on the basis of compensation paid rather than on lower buy rates.
- There is a risk that the market may bifurcate into low-cost, low-compensation lenders and high-cost, high-compensation lenders.
- Although this system may address the discrimination problem, it will not solve the underlying problems in the auto lending market caused by lack of transparency.

Benefits:

- The proposal would reduce significantly the fair-lending risk as compared with the current system.
- The compensation system would be easier for consumers to understand than the current system.
- Because dealers likely make higher profit margins from other sources (e.g., add-ons or trade-ins), they may have incentives to offer the lowest available APR to the consumer even if they could have earned more from another dealer by offering a higher APR.

Proposal C: Percentage of Amount Financed Based Upon Loan Term

Pay dealers a percentage of the amount financed based on the loan term (e.g. 1.70% for terms of 25 -36 months, 2.50% for terms of 37-48 months, 2.75% for terms of 49-60 months, 3.2% for terms of 61 months and longer).

Concerns:

- There is a risk that dealers will steer consumers into longer-term loans in order to earn higher compensation; however,
 - That incentive exists in the current system;

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- That incentive exists regardless of the compensation structure, as it is easier to sell various lucrative products (e.g., add-ons) with longer-term loans because many consumers are focused on the monthly payments;
- That risk may be ameliorated by (1) requiring no pre-payment penalties so that consumers could prepay longer-term loans if they changed their minds (although there is some internal disagreement regarding the likely efficacy of this approach) and (2) requiring lenders to monitor for possible steering.
- This proposal potentially would allow lenders to compete for loans of a given term by increasing the percentage paid for that term alone; under the current system, the lender can only compete by lowering the buy rate for a given term, and under the other proposals the same is true once the amount or percentage is set.
- There is a risk that lenders will compete for loans on the basis of compensation paid rather than on lower buy rates.
- There is a risk that the market may bifurcate into low-cost, low-compensation lenders and high-cost, high-compensation lenders.
- Although this system may address the discrimination problem, it will not solve the underlying problems in the auto lending market caused by lack of transparency, and this proposal may be less transparent to consumers than the other proposals.
- People may argue that this proposal is at odds with the rationale underlying the MLO Comp rule.

Benefits:

- The proposal would reduce significantly the fair-lending risk as compared with the current system.
- The proposal allows lenders to adopt a non-discretionary compensation system that produces compensation that most closely mirrors the compensation currently received for similar loans (e.g., shorter-term loans cost less and are compensated at lower rates than longer-term loans).
- The proposal allows lenders to pay more for loans that are more valuable for its portfolio (e.g., by paying more for longer-term or higher amount-financed loans that generate higher finance charges).
- The compensation system would be easier for consumers to understand than the current system, although likely not as easy as the other proposals.

Proposal D: Nondiscretionary Markup

Lenders would, in essence, mark up the loans themselves, by offering dealers a contract rate that cannot be reduced, but which represents a buy rate plus a set percentage (e.g., the average current markup under the discretionary mark-up system or 1%) and dealers would receive the amount of the set percentage.

Concerns:

- Because compensation under this method changes with term and amount financed, the concerns are very similar to those of Proposal C, although unlike

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with Proposal C, lenders could not alter the compensation for a single term bucket without altering the compensation for all of the term buckets.

Benefits:

- It is not clear what benefits this proposal has as compared with Proposal C.