Supervisory Highlights

Consumer Financial
Protection Bureau

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1. Introduction

This special edition of *Supervisory Highlights* describes the Bureau's fair lending supervisory activity in the indirect automobile lending market. Promoting a fair, equitable, and nondiscriminatory auto lending market is a priority for the Bureau. In March 2013, the Bureau issued the *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act* Bulletin (*Indirect Auto Lending Bulletin*),[1] which reminded indirect auto lenders[2] of their existing responsibilities under the Equal Credit Opportunity Act (ECOA).[3] It also noted the heightened fair lending risks associated with lenders' pricing and compensation policies that allow auto dealers the discretion to increase (or "mark up") the consumer's interest rate and benefit from the increased interest revenue.

Since issuing the *Indirect Auto Lending Bulletin*, the Bureau's examination teams[4] have continued to review indirect auto lenders for ECOA compliance. These targeted ECOA reviews generally have included an examination of three areas: credit approvals and denials, interest rates quoted by the lender to the dealer (the "buy rates"), and any discretionary markup or adjustments to the buy rate.

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[1] CFPB Bulletin 2013-02 (March 21, 2013), *available at* http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf.

[2] In contrast to direct financing, which occurs when a consumer finances a vehicle directly through a financial institution, indirect auto lending occurs when a consumer secures vehicle financing through the dealer, which typically originates the loan to the consumer and arranges financing through a third-party financial institution (the indirect lender).

[3] 15 USC 1691-1691f.

[4] As used in this edition of *Supervisory Highlights*, an "examination team" generally includes personnel from multiple Bureau offices, including the Offices of Supervision Examinations, Supervision Policy, Fair Lending, and Research.

Whenever there is reason to believe that a lender's discretionary pricing policies have resulted in a pattern or practice of discrimination in violation of the ECOA, the Bureau is required to refer the matter to the U.S. Department of Justice (DOJ).[5] Where appropriate, the Bureau and the DOJ coordinate investigations and resolutions of fair lending matters. However, a referral to the DOJ does not affect the Bureau's authority to take independent corrective action.

During the last two years, multiple supervisory reviews have identified indirect auto lenders with discretionary pricing policies that resulted in discrimination against African-American, Hispanic, and/or Asian and Pacific Islander borrowers in violation of the ECOA.[6] These institutions maintained discretionary pricing policies while not adequately monitoring and controlling the fair lending risk associated with their policies. Examination and enforcement teams have already reached resolutions with several supervised institutions that will collectively pay about $136 million to provide redress for up to 425,000 consumers, an average of more than $300 per consumer. For example, together with the DOJ, the Bureau took public enforcement action against Ally Financial Inc. and Ally Bank (collectively, Ally) in December 2013, requiring Ally to pay $80 million to address harm to about 235,000 borrowers. Supervisory resolutions with several other auto lenders will account for the remaining approximately $56 million to provide redress for up to 190,000 consumers. In addition to the matters discussed above, there are additional supervisory reviews that have cited ECOA violations at other auto lending institutions, and examination and enforcement teams are actively working toward resolutions for the harmed consumers in each of these matters.

When examination teams have determined that discrimination has occurred and corrective action is necessary, the indirect auto lender was directed to pay remediation sufficient to address direct and indirect consumer harm from the examination period through the date of the resolution addressing the discrimination. To the extent that a lender has chosen to maintain discretionary pricing policies, examination teams have directed the lender to establish and

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[5] *See* Memorandum of Understanding between the Consumer Financial Protection Bureau and the United States Department of Justice Regarding Fair Lending Coordination 7 (Dec. 6, 2012), *available at* http://files.consumerfinance.gov/f/201212_cfpb_doj-fair-lending-mou.pdf [MOU Regarding Fair Lending]; *see also* 15 USC 1691e(g).

[6] As used in this document, "African American" includes "Black or African American," "Hispanic" includes "Hispanic or Latino," and "Asian and Pacific Islander" includes both "Asian" and "Native Hawaiian or Other Pacific Islander," as defined by the Office of Management and Budget. *See* Revisions to the Standards for the Classification of Federal Data on Race and Ethnicity (Oct. 30, 1997), *available at* http://www.whitehouse.gov/omb/fedreg_1997standards.

maintain strong compliance management to prevent, detect, and remediate future disparities in pricing on prohibited bases. Supervisory and enforcement resolutions have also directed indirect auto lenders to limit maximum allowable discretionary markup.

Already, as a result of these supervisory actions, some lenders are more stringently monitoring dealers and, when monitoring reveals evidence suggesting discrimination, implementing additional limits to discretionary pricing adjustments or taking other appropriate action to manage or reduce the lender's fair lending risk. Further, supervisory resolutions will result in prompt remuneration of affected consumers when pricing analysis reveals unexplained disparities on a prohibited basis. Although approaches vary, some lenders are instituting remuneration of affected consumers as frequently as monthly by adjusting interest rates to address emerging disparities, in addition to regular compliance management that includes annual analysis of portfolio pricing.

Supervisory experience suggests that significantly limiting discretionary pricing adjustments—for example, imposing limits of 100 basis points, rather than the more common limits of 200 or 250 basis points—may reduce or even effectively eliminate pricing disparities.[7] An institution that implements significant limits on discretionary pricing may find that it can significantly reduce certain compliance management activities, such as dealer-specific monitoring and discipline, to which the institution would otherwise need to devote significant attention and resources.

Alternatively, the indirect auto lender could choose to adopt non-discretionary dealer compensation policies. Since publication of the *Indirect Auto Lending Bulletin*, several indirect auto lenders have chosen to fully implement or pilot policies that do not rely on discretionary markup to compensate dealers.

As with all lending products, fair lending examination teams expect indirect auto lenders to use underwriting and risk-based pricing practices that appropriately take into account objective factors, including borrower creditworthiness, the characteristics of the collateral, and the terms of the transaction. The supervisory focus on indirect auto lending, however, has been primarily concerned with the fair lending risk created by lenders' policies that compensate dealers by

[7] 250 basis points equal 2.5 percentage points. Basis points often denote interest rate variations.

allowing them the discretion to mark up each consumer's interest rate *after* the lender has already underwritten the consumer's loan application and generated a risk-based price.

Given the fair lending risk associated with discretionary pricing policies affecting dealer compensation, indirect auto lending remains a significant focus of supervisory reviews, especially for indirect auto lenders that maintain discretionary markup policies and have not yet been subject to a fair lending review. Examination teams will continue to review lenders for compliance with Federal consumer financial law, and take supervisory action as appropriate to reduce fair lending risk and to promote a fair and competitive auto lending market for consumers.

Questions or comments can be directed to CFPB_Supervision@cfpb.gov.

2. Supervising indirect auto lenders – authority, methods, and procedures

In the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),[8] Congress gave the Bureau the authority to supervise larger depository institutions with more than $10 billion in assets, and their affiliates.[9] These institutions include a number of indirect auto lenders. The Bureau is also authorized to supervise nonbanks that are larger participants in other markets, as defined by a Bureau rule.[10] To provide more complete oversight of the auto financing market, the Bureau has proposed a rule to define larger participants in this market.[11] In addition to its supervisory authority, and subject to certain exceptions, the Dodd-Frank Act also gives the Bureau enforcement authority over both banks and nonbanks in the auto lending market, including "captive" auto lenders.[12]

Consistent with the jurisdiction granted by the Dodd-Frank Act, the Bureau uses both supervisory and enforcement tools to ensure compliance with Federal consumer financial laws,

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[8] Pub L No 111-203, 124 Stat 1376 (2010) (codified at 12 USC 5301 *et seq*.).

[9] *See* 12 USC 5515.

[10] *See* 12 USC 5514(a)(1)(B), (b).

[11] Defining Larger Participants of the Automobile Financing Market (proposed Sept. 2014) (to be codified at 12 CFR Parts 1001 and 1090), *available at* http://files.consumerfinance.gov/f/201409_cfpb_proposed-rule_lp-v_auto-financing.pdf.

[12] *See* 12 USC 5563, 5564. Captive auto lenders are indirect auto lenders that are directly affiliated with a particular automobile manufacturer.

including the ECOA. The ECOA and its implementing regulation, Regulation B, make it illegal for a "creditor" to discriminate against any applicant 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.[13] Consistent with statements by the Interagency Task Force on Fair Lending,[14] the Bureau has indicated that it will consider evidence of disparate treatment and disparate impact in identifying lending discrimination under the ECOA.[15]

As noted in the *Indirect Auto Lending Bulletin*, the ECOA applies to indirect auto lenders that, in the ordinary course of business, regularly participate in the credit decision.[16] Supervisory reviews have revealed that indirect auto lenders' standard policies and practices related to underwriting and pricing often constitute participation in a credit decision.[17] The following section addresses what indirect auto lenders can expect of a targeted ECOA review and the methodologies that examination teams employ in evaluating ECOA compliance in this context.

2.1 The targeted ECOA review

Bureau examination teams rely on the *Interagency Fair Lending Examination Procedures*[18] and the Bureau's *ECOA Examination Procedures*[19] in conducting a targeted ECOA review.

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[13] *See* 15 USC 1691(a); 12 CFR 1002.2(z), 1002.4.

[14] *See* Policy Statement on Discrimination in Lending, 59 Fed Reg 18,266 (Apr. 15, 1994), *available at* http://www.occ.treas.gov/news-issuances/federal-register/94fr9214.pdf.

[15] *See* CFPB Bulletin 2012-04 at 2 (Apr. 18, 2012), *available at* http://files.consumerfinance.gov/f/201404_cfpb_bulletin_lending_discrimination.pdf [Lending Discrimination Bulletin].

[16] *See* Indirect Auto Lending Bulletin, *supra* note 1, at 2-3 (citing 15 USC 1691a(e); 12 CFR 1002.2(*l*)).

[17] *See also* Indirect Auto Lending Bulletin, *supra* note 1, at 2-3.

[18] Interagency Fair Lending Examination Procedures (Aug. 2009), *available at* http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.

[19] ECOA Examination Procedures (Oct. 2012), *available at* http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.

Examination teams evaluate ECOA compliance in light of a particular lender's business model, the product type, and other unique facts and circumstances. The typical targeted ECOA review of an indirect auto lender includes a review of the lender's relevant policies, procedures, and fair lending compliance management. As mentioned above, examination teams also typically consider statistical analyses of three areas: credit approvals and denials, buy rates, and any discretionary markup or adjustment to the buy rate.

The first step in a targeted ECOA review is to identify areas of fair lending risk. One indicator of fair lending risk is policies and procedures that allow for broad discretion in underwriting, pricing, and compensation decisions.[20] When a review identifies lender policies that allow broad discretion without appropriate monitoring and controls, examination teams may evaluate whether such policies result in violations of the ECOA and Regulation B.

Regarding the indirect auto lender's compliance management, previous editions of *Supervisory Highlights* have indicated the importance of strong compliance management in adhering to consumer financial laws, including, for lenders, strong fair lending compliance management.[21] Key components of such systems are preventative measures—such as limits on discretionary markups—and self-monitoring, which often includes statistical analyses to identify disparities on a prohibited basis. In the context of a lender's discretionary pricing policies, self-monitoring—and appropriate corrective action if potential discrimination is detected—is important to managing the fair lending risk inherent in such systems. Accordingly, targeted ECOA reviews of indirect auto lenders will generally review mechanisms for prevention, monitoring, corrective action, and other aspects of the lender's compliance management.

Examination teams may also conduct statistical analyses of lending data to identify evidence of discrimination. Such analyses may include the use of regression models to test whether a specific policy results in unlawful differences based on race, national origin, or other prohibited basis characteristics. In analyzing lending data for statistical disparities, 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 product

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[20] *See* Interagency Fair Lending Examination Procedures, *supra* note 18, at 15.

[21] *See* Supervisory Highlights: Fall 2012 at 6, *available at* http://files.consumerfinance.gov/f/201210_cfpb_supervisory-highlights-fall-2012.pdf.

characteristic. 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, and products, as well as any additional factors identified by the examination team or the institution.

A regression model to detect disparities on a prohibited basis in the buy rate that the lender quotes the dealer, for example, typically must control for characteristics appropriate to setting the buy rate. In general, such a model will consider creditworthiness factors, such as credit scores and debt-to-income ratios; characteristics of the collateral; and terms of the deal, such as the amount financed, down payments, the existence of a manufacturer discounted rate, and the term of the loan, as these factors are typically taken into account by lenders in arriving at the appropriate buy rate.

Controls that may be appropriate to a statistical analysis of buy rates may not be appropriate in an analysis of dealer markup, however. Such controls may not be appropriate to a dealer markup analysis because, when the dealer considers applying a discretionary markup, the indirect auto lender's underwriting and pricing systems have often already considered risk-based factors related to creditworthiness, the characteristics of the collateral, and the terms of the transaction. Absent a showing of a legitimate business need, it is generally not appropriate to consider such factors for a second time in conducting an analysis of dealer markup to identify disparities on a prohibited basis.

2.2 The use of proxy methodology in supervision

Regulation B generally prohibits a creditor from inquiring "about the race, color, religion, national origin, or sex of an applicant or any other person in connection with a credit transaction,"[22] with a few exceptions, including for home mortgages covered under the Home

[22] 12 CFR 1002.5(b).

Mortgage Disclosure Act.[23] For this reason, information on race, ethnicity, and sex is typically not collected as part of an auto lending transaction or a transaction involving other non-mortgage consumer lending products. In the context of discussing comparative file reviews, the *Interagency Fair Lending Examination Procedures* provide that when direct evidence of a particular prohibited basis characteristic is not otherwise available, "[a] surrogate for a prohibited basis group characteristic may be used to set up a comparative analysis with control group applicants or borrowers."[24] Similarly, when analyzing lending data for prohibited disparities, Bureau examination teams, other federal supervisory and enforcement agencies, and many lenders use a proxy methodology to differentiate among consumers based upon race, national origin, and sex. The concept of using proxies for unavailable data is a mathematical and statistical approach used across disciplines.[25]

When utilizing a proxy, examination teams are using a borrower's name and geographic information to match data that are publicly available from the Social Security Administration and the United States Census Bureau. In general, the proxy methodology used depends on the characteristic being proxied. For example, to proxy for sex, examination teams are relying on a first-name database from the Social Security Administration that reports counts of individuals by sex and birth year for first names occurring at least five times for a particular sex in a birth year.[26] In such a case, the proxy method assigns a probability that a particular applicant is female based on the distribution of the population across sex categories (male or female) for the applicant's first name.

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[23] *See* 12 CFR 1002.5(a)(2), 1002.13. For the Home Mortgage Disclosure Act and its implementing regulation, Regulation C, see 12 USC 2801-2810 and 12 CFR Part 1003. For the Regulation B provisions concerning requests for information generally, see 12 CFR 1002.5.

[24] Interagency Fair Lending Examination Procedures, *supra* note 18, at 19.

[25] *See* Marc N. Elliott et al., *Using the Census Bureau's Surname List to Improve Estimates of Race/Ethnicity and Associated Disparities*, Health Services & Outcomes Research Methodology 69-83 (June 2009); Using Publicly Available Information to Proxy for Unidentified Race and Ethnicity: A Methodology and Assessment (Sept. 2014), *available at* http://files.consumerfinance.gov/f/201409_cfpb_report_proxy-methodology.pdf [Proxy Methodology and Assessment].

[26] Social Security Administration, Beyond the Top 1000 Names (Sept. 12, 2014, 3:01 pm), http://ssa.gov/oact/babynames/limits.html.

There are several methods that can be used to proxy for race and national origin. One common method for proxying the probability that an applicant is Hispanic or Asian is to use the surname database published by the Census Bureau.[27] Another method to proxy for race and national origin—typically referred to as "geocoding"—uses the demographics of the census geography (e.g., census tract, block group, or block) in which an individual's residence is located, and assigns probabilities about the individual's race or national origin based on the demographics of that area. This method may be used, for example, to proxy the probability that an applicant is African-American, Hispanic, or Asian or Pacific Islander.

To proxy for race and national origin in the non-mortgage context, examination teams are using a proxy method that integrates both the surname and geographical approaches described above, called Bayesian Improved Surname Geocoding (BISG).[28] The BISG method combines the respective probabilities generated by the surname and geographical proxies. Published academic research has found that the integrated approach produces proxies that correlate highly with self-reported race and ethnicity data and are more accurate than using surname or geography alone.[29] 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.[30] The BISG methodology has evolved over time and will continue to evolve as enhancements are identified that improve accuracy and performance.

There are proxy methods for race and national origin that use nonpublic information, such as proprietary databases developed in the private sector matching first or middle names to certain racial or ethnic groups. However, for the purpose of conducting supervisory work, examination teams use proxy methods that rely solely on public data so that lenders can, if they choose,

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[27] United States Census Bureau, Genealogy Data: Frequently Occurring Surnames from Census 2000 (Sept. 12, 2014, 3:02 pm), http://census.gov/genealogy/www/data/2000surnames/index.html.

[28] *See* Proxy Methodology and Assessment, *supra* note 25.

[29] *See* Elliott, *supra* note 25.

[30] *See* Proxy Methodology and Assessment, *supra* note 25.

replicate these proxy methods without the need to recreate or purchase proprietary databases as part of their own fair lending compliance management. There may be other proxy methodologies that would also be appropriate in particular circumstances, and examination teams consider analyses based on such methodologies when provided by lenders.

2.3 What to expect if the examination reveals potential violations

If the examination team finds statistically significant disparities on a prohibited basis or other evidence of possible discrimination, the Office of Fair Lending will send a letter stating its preliminary findings and inviting the institution to provide additional information for consideration in determining whether the institution has violated the ECOA. In appropriate circumstances, the Office of Fair Lending's notification may now include the unique, custom computer code or scripts used to prepare analytical data and perform statistical analyses, including regression modeling. Additionally, the Office of Fair Lending notifies the institution that if the potential legal violations constitute a pattern or practice of lending discrimination, the Bureau is required to refer the findings to the DOJ.[31] Resolutions arising from supervisory findings are based on a case-by-case assessment to determine the appropriate corrective action, including supervisory or enforcement resolutions.[32]

In addition, if the Bureau is required to refer the lender to the DOJ based on a pattern or practice of discrimination, the DOJ may elect to open an investigation, initiate a civil action, or defer resolution to the Bureau.[33] Findings of disparities in discretionary markup in an indirect auto lender's portfolio typically constitute a pattern or practice of discrimination if the disparities cannot be justified by "a legitimate business need that cannot reasonably be achieved

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[31] *See* MOU Regarding Fair Lending, *supra* note 5, at 7; *see also* 15 USC 1691e(g).

[32] For information on the factors that the Bureau considers related to responsible business conduct, see CFPB Bulletin 2013-06 (June 25, 2013), *available at* http://files.consumerfinance.gov/f/201306_cfpb_bulletin_responsible-conduct.pdf.

[33] *See* MOU Regarding Fair Lending, *supra* note 5, 7-9.

as well by means that are less disparate in their impact."[34] Where both the Bureau and the DOJ determine that they will take actions related to the potential violation, they seek to coordinate that action in a consistent and complementary manner.[35] However, a referral to the DOJ does not affect the Bureau's authority to take independent supervisory or enforcement action.

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[34] 12 CFR 1002, Supp I, 1002.6, 6(a)-2. *See also* Lending Discrimination Bulletin, *supra* note 15, at 2-3.

[35] *See* MOU Regarding Fair Lending, *supra* note 5, at 8.

3. Supervisory observations

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. Examination teams found that indirect auto lending policies that allow discretionary markups affecting dealer compensation often resulted in disparities in dealer markup based on race and/or national origin. Examination teams generally determined that these disparities could not be explained by a legitimate business need that was not reasonably achievable as well by means less disparate in their impact. In many instances, these disparities persisted across the institution's entire indirect auto lending portfolio. In other cases, disparities were limited to certain products or programs and did not exist in other areas of the institution's auto lending business.

Examination teams also observed that indirect auto lenders often limit discretionary dealer markup to between 200 and 250 basis points. Yet examination teams found that indirect auto lenders often do not otherwise engage in significant monitoring and internal control of the fair lending risk related to their discretionary pricing policies and practices. In contrast, supervisory activity identified some auto lending products that significantly limit, by policy, discretionary dealer pricing adjustments. Supervisory experience suggests that where these significant limits on discretionary pricing have been in effect, they may result in considerable reductions or effective elimination of markup disparities for the particular product or business line subject to the limit. Thus, supervisory experience suggests that significant limits on markup, such as a limit of 100 basis points, may reduce fair lending risk and significantly reduce the need for certain compliance management activities. When institutions did not implement significant controls on discretionary pricing adjustments and did not engage in strong compliance management, fair lending examination teams have generally identified statistically significant disparities in dealer markup.

3.1 Remedial action involving indirect auto lenders

Examinations of indirect auto lenders have found disparities in dealer markup and have resulted in supervisory resolutions with some institutions and an enforcement resolution against Ally Financial Inc. and Ally Bank. Thus, examination and enforcement teams have already reached resolutions with several institutions that will collectively pay about $136 million to provide redress to up to 425,000 consumers. Redress directed by such resolutions has included damages for direct and indirect harm to affected consumers. As a result of these supervisory actions, some lenders are more stringently monitoring dealers and, when monitoring reveals evidence suggesting discrimination, are implementing additional limits to discretionary pricing adjustments or taking other appropriate action to manage or reduce their fair lending risk. As noted in the April 2014 *Fair Lending Report of the Consumer Financial Protection Bureau*[36] and *The Attorney General's 2013 Annual Report to Congress Pursuant to the ECOA Amendments of 1976*,[37] discrimination in auto lending continues to be an area of focus for the Bureau and the DOJ.

3.1.1 Non-public supervisory actions

When appropriate, the Office of Fair Lending and the Office of Supervision have reached non-public supervisory resolutions with institutions to address identified discrimination on a prohibited basis across indirect auto lending portfolios. As a result, supervisory resolutions have directed indirect auto lenders to pay about $56 million to provide redress for up to 190,000 consumers. Corrective action in the supervisory context in many ways mirrors corrective action in the public enforcement context. Supervisory resolutions have, to date, directed remediation sufficient to address consumer harm for past disparities in dealer markup, based on a methodology that is appropriately designed to distribute funds to harmed consumers. In addition, examination teams directed the supervised institutions to address the aspects of their businesses that gave rise to the fair lending risk. Consistent with the enforcement resolution with Ally, supervisory resolutions have not required institutions to adopt a single compliance

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[36] Available at http://files.consumerfinance.gov/f/201404_cfpb_report_fair-lending.pdf.

[37] Available at http://www.justice.gov/crt/about/hce/documents/ecoareport2013.pdf.

alternative. Instead, institutions have the choice to adopt compliance mechanisms that suit their particular business structure, provided that the institution addresses the policies and practices that resulted in the disparities in dealer markup. A discussion of some compliance options follows in Section 3.2.

The institutions also were directed to remunerate harmed consumers on a prospective basis if compliance mechanisms do not eliminate disparities in dealer markup in the future. Supervisory actions will result in prompt remuneration of affected consumers when pricing analysis reveals unexplained disparities on a prohibited basis. Although approaches vary, some lenders are instituting remuneration of affected consumers as frequently as monthly by adjusting interest rates to address emerging disparities, in addition to regular compliance management that includes an annual analysis of portfolio pricing. Unlike enforcement resolutions, supervisory resolutions do not include the possibility of civil money penalties.

3.1.2 Public enforcement activity

On December 20, 2013, the Bureau and the DOJ announced an enforcement action and concurrent consent orders that required Ally to pay $80 million to establish a settlement fund to provide redress to consumers who were harmed by Ally's discretionary pricing policy between April 2011 and December 2013.[38] The policy resulted in illegal discrimination against approximately 235,000 African-American, Hispanic, and Asian and Pacific Islander borrowers. In addition, the consent orders required Ally to hire a settlement administrator to distribute funds to harmed borrowers identified by the Bureau and the DOJ. The administrator must be accessible to victims on a cost-free basis and ensure that impacted borrowers receive compensation. In addition, Ally was directed to pay an $18 million civil money penalty.

Pursuant to the consent orders, Ally will monitor discretionary dealer markups to prevent future discrimination or may choose to eliminate discretionary dealer markup policies altogether. Ally is required to implement a compliance program to prevent future discrimination, including: dealer education, dealer monitoring and prompt corrective action against dealers when there are dealer-level disparities in loan pricing, and portfolio-wide analysis of pricing data for disparities

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[38] *See* CFPB and DOJ Order Ally to Pay $80 Million to Consumers Harmed by Discriminatory Auto Loan Pricing (Dec. 20, 2013), *available at* http://www.consumerfinance.gov/newsroom/cfpb-and-doj-order-ally-to-pay-80-million-to-consumers-harmed-by-discriminatory-auto-loan-pricing/.

and consumer remuneration if Ally detects disparities. In the alternative, Ally can decide to move away from discretionary pricing affecting dealer compensation to a non-discretionary dealer compensation structure, which would eliminate Ally's obligation to monitor the fair lending risk of its policy permitting discretionary dealer markups and reduce Ally's overall fair lending compliance responsibilities. The Bureau is currently engaged in additional enforcement investigations involving other indirect auto lenders.

3.2 Mitigating fair lending risk

When addressing discrimination in indirect auto lending, a key component of supervisory resolutions has been to direct the lender to adopt policies and practices that effectively mitigate fair lending risk. Supervisory and enforcement experience has identified three possible methods of mitigating the fair lending risk associated with auto lending policies that allow discretionary pricing adjustments; however, there may be other methods, and examination teams recognize that the appropriate program will vary among financial institutions. One alternative is to monitor and, if necessary, correct disparities through a strong compliance management system. Another alternative is to implement policies that limit the maximum discretionary pricing adjustment to an amount that significantly reduces or eliminates disparities and fair lending risk. This option may significantly reduce but will not eliminate compliance activities related to discretionary pricing. A third alternative is to eliminate discretionary dealer adjustments to risk-based buy rates altogether and fairly compensate dealers using a non-discretionary mechanism that does not result in discrimination. By eliminating dealer pricing discretion, the lender eliminates the need for monitoring of discretionary dealer pricing adjustments. Each of these three options is discussed in detail below.

Innovation and experience may provide other effective alternatives to mitigating fair lending risk in indirect auto lending. Further, no one alternative is necessarily exclusive of the others and hybrid approaches may effectively mitigate fair lending risk. For example, a combination of tighter limits on discretionary pricing and compliance management may significantly reduce fair lending risk. Alternatively, adopting a non-discretionary dealer compensation program or imposing strict limits on discretionary pricing may significantly reduce an institution's fair lending risk, thereby requiring fewer resources for compliance management.

3.2.1 Fair lending compliance management systems

In prior issues of *Supervisory Highlights*, the Bureau has identified the following common features found at financial institutions with well-developed fair lending compliance systems:

- 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 loan originator 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 statistical analysis of loan data for potential disparities on a prohibited class 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.[39]

Elaborating on these elements, the *Indirect Auto Lending Bulletin* identified a number of features of a strong fair lending compliance program that may be effective in mitigating fair lending risk for indirect auto lenders.[40] Supervisory and enforcement experience provides further guidance. Institutions that choose to permit discretionary pricing affecting dealer compensation after an examination revealing discrimination on a basis prohibited by the ECOA have been directed to take the following corrective actions to ensure strong fair lending compliance management:

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[39] Supervisory Highlights: Fall 2012, *supra* note 21, at 6.

[40] *See* Indirect Auto Lending Bulletin, *supra* note 1, at 4-5.

- Maintaining appropriate limits on maximum rate spread between the institution's buy rate and the contract rate of the auto loan;
- Sending regular 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 discretionary pricing policies, including:
  - using only controls that reflect legitimate, nondiscriminatory, demonstrated factors when analyzing the discretionary pricing adjustments (as discussed above, controls appropriate in analyzing the lender buy rate may not be appropriate in analyzing subsequent discretionary pricing adjustments); and
  - applying a reasonable proxy when analyzing loans for disparities based on race or ethnicity (see Section 2.2 for a discussion of proxy methodologies);
- Commencing prompt corrective action against dealers, when analysis identifies unexplained, statistically significant disparities on a prohibited basis, including:
  - providing dealer education and training, as well as assisting the dealer in developing a strong fair lending compliance management system;
  - restricting or eliminating the dealer's discretion to adjust the buy rate; or
  - excluding dealers from future transactions when the disparities cannot be corrected or explained by a legitimate, nondiscriminatory, and demonstrated factor;
- Promptly remunerating affected consumers—including issuing checks, providing account credits, or adjusting interest rates—sufficient to address consumer harm, when unexplained disparities on a prohibited basis are identified by an institution across its portfolio using a regression model and proxy method that are appropriately designed to identify harmed consumers.

Supervisory experience has identified an array of possible approaches to dealer monitoring and corrective action. Effective dealer monitoring programs generally set a reasonable minimum volume requirement to identify dealers with sufficient transactions with the indirect lender to permit effective statistical analysis for prohibited basis disparities. At the same time, any approach to dealer monitoring should ensure broad coverage of dealers conducting business with the indirect lender to maximize risk mitigation. Supervisory experience suggests multiple approaches to setting this minimum volume requirement, but the approach chosen should consider sufficient information for a large enough pool of applicants to permit sound statistical analysis of the prohibited basis groups identified for testing. Supervisory experience suggests such an analysis may be difficult or may result in statistical anomalies when a dealer has limited transactions with the indirect lender. A strong dealer monitoring program will appropriately weigh this consideration while also ensuring broad coverage of participating dealers. Such minimum volume requirements would only apply to dealer-specific monitoring, rather than the portfolio-level analyses.

Robust processes to monitor and correct for potential discrimination resulting from discretionary pricing policies can be critical to ensuring compliance with the ECOA. Supervisory experience is that the scope of the monitoring regime may appropriately vary based on the nature, size, and complexity of the institution's auto lending operations. However, examination teams have observed that implementing a compliance management system that includes most of the above elements can reduce disparities or quickly address them, thereby significantly mitigating fair lending risk.

In general, if a lender involved in an examination is not sure whether its compliance management system or corrective actions adequately address potential fair lending risk, the lender can contact the Office of Fair Lending or the Office of Supervision for input on specific questions by emailing CFPB_Supervision@cfpb.gov.

3.2.2 Limits on maximum allowable discretionary pricing adjustments

Based on supervisory experience, indirect auto lenders may also substantially mitigate fair lending risk by significantly limiting the maximum allowable discretionary pricing adjustment that a dealer can make for a loan financed by the lender. For example, fair lending reviews to date have found no actionable disparities associated with certain auto lending products or business lines that limit, by policy, discretionary pricing adjustments to significantly less than 200 or 250 basis points (for example, limits of 100 basis points). Imposing such limits on discretionary pricing adjustments does not completely eliminate all fair lending risk, though it can effectively mitigate such risk. Strict limits on discretionary pricing adjustments may result in significant reductions in portfolio-level disparities in dealer markup and ease reliance on compliance management alone to address disparities. For example, an institution that implements significant limits on discretionary pricing may find that it can significantly reduce certain compliance activities, such as dealer-specific monitoring and corrective action, to which the institution would otherwise need to devote significant attention and resources. As with any policy that limits but does not eliminate discretion, limits on discretionary pricing adjustments require ongoing monitoring of fair lending risk at each stage of the transaction across the lender's portfolio. Yet, if successful in reducing or eliminating disparities, limits on discretionary pricing reduce or eliminate the need for portfolio-level remediation.

3.2.3 Dealer compensation not based on discretionary markup

The Bureau remains concerned about indirect lending programs built around discretion and financial incentives that create fair lending risks. As described above, when a lender allows for discretionary pricing affecting dealer compensation, the lender should employ strong controls or engage in robust compliance management to address the potential for discrimination. The *Indirect Auto Lending Bulletin* also noted that lenders may choose to adopt alternative pricing policies as a method of addressing fair lending risks.[41]

During the last year, supervisory experience has revealed that some entities have chosen to develop dealer compensation policies not based on discretionary markup. In addition, industry participants have identified several possible models of non-discretionary dealer compensation. One model compensates dealers using the same fixed amount for each loan (sometimes called a "flat fee"). Under another model, dealers are paid a fixed percentage of the amount financed. Alternatively, a lender could develop a multiple-criteria system in which compensation is tied to both the amount financed and the duration of the contract. Both of these latter approaches are non-discretionary compensation systems that allow for differences in compensation based on loan amount and potentially term and hence differ from a flat fee approach. These are a few examples of potential non-discretionary compensation systems, which could vary in design and sophistication, depending on the needs of an individual lender's business. There could be many other possibilities, and the Office of Fair Lending welcomes their creation and development, so long as they appropriately mitigate fair lending risk and do not adversely impact consumers.

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[41] *See* Indirect Auto Lending Bulletin, *supra* note 1, at 4.

For example, BMO Harris Bank publicly announced in April that it has eliminated dealer compensation for discretionary markups.[42] BMO Harris publicly stated that it will instead pay dealers three percent of the amount financed, up to a fixed dollar figure.[43] As CFPB Director Richard Cordray stated at the time, BMO Harris's new policy represents "a proactive step to protect consumers from discrimination."[44] This institution's approach is an example of but one option to limit fair lending risk in indirect auto lending.

As a general matter, the Office of Fair Lending expects that lenders consider a variety of factors in designing a dealer compensation system, including the extent to which the system mitigates fair lending risk, whether the system would create new risks of discrimination or other consumer harm, and the system's economic sustainability.

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[42] *See Bank Eliminates Dealer Markup, Cites CFPB Guidance*, F&I and Showroom (Apr. 24, 2014), *available at* http://www.fi-magazine.com/channel/f-i-products/news/story/2014/04/bank-eliminates-dealer-markup-cites-cfpb-guidance.aspx.

[43] *See Bank Eliminates Dealer Markup*, *supra* note 42.

[44] Statement of CFPB Director Richard Cordray on BMO Harris Auto Lending Policy (Apr. 30, 2014), *available at* http://www.consumerfinance.gov/newsroom/statement-of-cfpb-director-richard-cordray-on-bmo-harris-auto-lending-policy/.

4. Conclusion

Supervisory and enforcement experience reveals that significant discrimination often results from indirect auto lending policies that compensate dealers based on discretionary markup. Supervisory and enforcement resolutions have directed institutions to pay remediation sufficient to address consumer harm, engage in ongoing robust compliance management, and consider the option of adopting compensation and pricing policies not based on discretionary markup. Through the supervisory process, the Bureau will continue to conduct regular examinations to ensure that indirect auto lenders comply with the ECOA and Regulation B, and to promote fair and equal access to credit in the auto lending market.

To avoid risking liability for violations of the ECOA, indirect auto lenders should take proactive steps to mitigate fair lending risk. Supervisory and enforcement experience suggests that maintaining strong compliance management, imposing strict caps on discretionary pricing adjustments, and/or adopting non-discretionary dealer compensation models may limit fair lending risk. Innovation and experience may reveal other compliance options.