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NY Revives Fair Lending Risks For Indirect Auto Lenders

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The recent rollback of Obama-era fair lending enforcement does not mean that fair lending risk has disappeared. Many states are stepping up to fill in where the Trump administration's Consumer Financial Protection Bureau, also known as the Bureau of Consumer Financial Protection, or BCFP, has backed off. For example, on Aug. 23, 2018, the New York Department of Financial Services issued a guidance document expressing the department's position on the application of New York state's fair lending law[1] to indirect auto lending. The key takeaways are:

- The guidance looks a lot like the now-rescinded March 2013 indirect auto lending bulletin;
- Although it does not use the term "disparate impact," the guidance implies that the DFS will apply the disparate impact theory to indirect auto lenders that grant auto dealers discretion to mark up buy rates; and
- The guidance sets out specific measures that the DFS expects indirect auto lenders to include in their fair lending compliance programs, including both within-dealer and cross-portfolio monitoring and consumer restitution for unexplained interest rate disparities.

A more detailed discussion follows.

Background

In March 2013, under the leadership of former Director Richard Cordray, the BCFP published the Indirect Auto Lending Bulletin, a guidance document announcing the bureau's position on the fair lending risks associated with dealer markups in indirect auto lending transactions. Among other things, the BCFP bulletin stated that, as assignees of retail installment contracts, indirect auto lenders typically qualify as "creditors" subject to the anti-discrimination provisions of the Equal Credit Opportunity Act and Regulation B. The BCFP bulletin indicated that indirect auto lenders "may be liable" for pricing disparities both within a particular dealer's transactions as well as across different dealers in their portfolios "under the legal doctrines of both disparate treatment and disparate impact." The indirect auto bulletin offered recommendations for how indirect auto lenders could mitigate the fair lending risks associated with dealer markup policies and reiterated earlier BCFP guidance describing the features of a strong fair lending compliance program.

The BCFP's fair lending policy position, analytical methods and enforcement activity against the indirect auto lending industry prompted heated criticism from Congress and other parties.[2] Nevertheless, the Cordray-led BCFP, usually in conjunction with the U.S. Department of Justice, entered into settlements with several indirect auto lenders that allegedly had portfolio-wide disparities in dealer markups that were adverse to African-American and/or Hispanic consumers. To avoid having to face BCFP and DOJ enforcement, many indirect auto lenders lowered their markup caps or eliminated discretionary markups altogether. These measures mitigated fair lending enforcement risk but often proved harmful to business, and some indirect auto lenders have reverted back to allowing dealer markups.

In November 2017, Cordray resigned, and President Donald Trump installed Mick Mulvaney, an ardent critic of the bureau's aggressive consumer protection efforts and overall existence, as the BCFP's acting director. On May 21, 2018, under the auspices of the Congressional Review Act, Trump signed a congressional resolution revoking the BCFP bulletin.[3] Democratic state attorneys general and banking regulators have expressed significant concern over Mulvaney's drastic scaling back of the bureau's enforcement activities.[4] The DFS' decision to issue the guidance was likely prompted at least in part by these concerns.

Summary of NY Guidance

The NY guidance states that the DFS is concerned about discretionary dealer markups and that lenders permitting dealers to mark up buy rates "are potentially liable for pricing disparities on a prohibited basis." To mitigate this risk, the department recommends that lenders do the following:

- Learn about dealers before entering into an origination relationship and periodically evaluate the relationship to determine if it should be revised or terminated;
- Review dealers' policies for arranging financing and advise the dealers on weaknesses or concerns;
- Regularly review their own and their dealers' product marketing and advertising strategies for fair lending compliance;
- Limit or eliminate dealer markup discretion;
- Conduct both portfolio-level and dealer-specific monitoring; and
- Take corrective action on any pricing disparities, including limiting or eliminating markup discretion, terminating dealer relationships and paying restitution to consumers.

The NY guidance "consolidates, streamlines and reinforces" previous fair lending guidance issued by DFS' predecessor, the New York State Banking Department, including the state's fair lending plan requirement and fair lending plan guidelines. Like the BCFP's compliance management system guidance, New York's fair lending compliance materials indicate that a lender's board of directors and senior management are responsible for developing and ensuring compliance with a fair lending plan. The DFS states that fair lending plans should include compliance monitoring, semi-annual training, second reviews of all declined and withdrawn applications, and fair lending oversight of third-party originators (i.e., dealers).

Comments and Recommendations

As was the case with the BCFP's indirect auto bulletin, the NY guidance does not answer one of the key fair lending compliance questions confronting indirect auto (and other) lenders: When is a pricing disparity large enough to present legal risk and/or warrant corrective action? Regulators are understandably hesitant to offer clear direction on this point because pricing practices are complex and vary across institutions; a statistically significant 10-basis-point disparity at one lender may indicate potential discrimination, whereas at another lender, it may merely reflect the fact that statistical models cannot always account for all of the legitimate factors affecting pricing outcomes. Furthermore, all else equal, whether a statistically significant pricing disparity is material enough to warrant enforcement has varied over time depending on the policy inclinations of the regulators in charge.

Notwithstanding this continued uncertainty over when a disparity is large enough to prompt enforcement, the NY guidance does offer some direction on how indirect auto lenders can calibrate risk. First, like most regulatory guidance addressing fair lending risks, the NY guidance focuses on the discretionary portion (i.e., the dealer markup) of the overall contract rates charged across borrower groups. If an indirect auto lender is comfortable that its buy rates are set consistently using commonly accepted risk factors,[5] it may want to consider focusing its price monitoring efforts on markups.

Second, consistent with the BCFP bulletin, the NY guidance emphasizes that indirect auto lenders should monitor for disparities both across its portfolio and on a dealer-by-dealer basis. Liability for portfolio-wide disparities has and will continue to cause great consternation because most indirect auto lenders do business with hundreds or thousands of dealers, each of which typically send the lender a fairly low volume of loans. Many industry participants believe it is unfair to hold lenders responsible for the pricing activity of independent, third-party dealers, especially when liability can arise even if no dealer has disparities within its own originations. Notwithstanding these criticisms, the DFS makes clear in the guidance that it expects both within-dealer and portfolio-wide monitoring.

Third, the guidance states that "[l]egitimate reasons for differences in interest rate include ... demonstrable differences in business climate at the time of the offers." This statement is important because it suggests that the DFS is open to the theory that differences in market conditions can justify price differences across borrower groups. Note, however, that the guidance states that differences in business climate must be "demonstrable."

Finally, although the NY guidance does not mention the term "disparate impact," by stating that lenders "are potentially liable" for disparities in third-party markups, the DFS appears to be signaling that it intends to use the disparate impact theory[6] in assessing indirect auto lenders' fair lending compliance. Although a discussion of disparate impact is beyond the scope of this article, lenders should be aware that there are significant legal limitations to how the theory can be applied.[7] Although indirect auto lenders may choose to monitor for and remediate portfolio-wide disparities to keep their regulator(s) happy, those facing fair lending challenges to dealer markups should consider raising these important legal defenses.

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Indirect auto lenders have enjoyed significant relief from the BCFP's vigorous, Cordray-era fair lending enforcement activity but should be aware that states such as New York may pick up where the bureau left off.

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[1] N.Y. Exec. L. § 296-a prohibits discrimination in any credit transaction on the basis of race, creed, color, national origin, sexual orientation, military status, age, sex, marital status, disability or familial status.

[2] See, e.g., Unsafe at Any Bureaucracy: BCFP Junk Science and Indirect Auto Lending, Report Prepared By the Republican Staff of the Committee on Financial Services, US House of Representatives, 114th Congress, First Session (November 24, 2015) available here.

[3] See BCFP statement here.

[4] See Dec. 12, 2017 letter from 17 state attorneys general to Trump, available here.

[5] This use of alternative data in credit underwriting and pricing may present a different type of fair lending risk (e.g., if an “alternative” factor has a disparate impact on a protected class, the lender using that factor should consider taking steps to ensure that the factor is predictive of credit risk in a way that could not be served by an alternative factor having a lesser impact).

[6] Although the BCFP’s indirect auto bulletin states that lenders with markup disparities may be liable under both the disparate treatment and disparate impact theories of liability, it is difficult to imagine how a lender could be liable under the disparate treatment theory for the acts of an independent third party.

[7] For example, the Supreme Court has established rigorous pleading requirements that a plaintiff must satisfy when bringing a disparate impact claim under the Fair Housing Act. See. e.g., Texas Department of Community Affairs v. Inclusive Communities Project Inc., 135 S. Ct. 2507 (2015). The court also has cast doubt on whether the granting of discretion can serve as the basis for such a claim. Wal-Mart v. Dukes, 131 S. Ct. 2541 (2011). It remains to be seen whether courts will apply these holdings to disparate impact claims brought under the Equal Credit Opportunity Act and/or state law, but lenders facing fair lending challenges to dealer markup practices should be aware of the limits the Supreme Court has placed on the application of disparate impact.