

## **Compliance in the Indirect Automotive Market: Key Issues in Fair Lending Analysis**

**By Arthur P. Baines and Dr. Marsha Courchane**

On March 21, 2013, the Consumer Financial Protection Bureau (CFPB) issued a bulletin on compliance with the Equal Credit Opportunity Act (ECOA) in the indirect automotive finance market. This bulletin prompted market participants to take a sharp look at fair lending compliance and analysis in their indirect automotive finance products.<sup>1</sup>

Most banks in the mortgage market have established compliance programs and analytical frameworks that meet regulatory standards. While such existing programs provide some benefit when building a corresponding program in the indirect automotive space, there are a number of important differences that must be addressed including the types of analyses performed, the methodologies employed, the interpretation of results, and any subsequent actions taken.

### *Determination of the Prohibited Basis*

One key to indirect automotive fair lending analysis is determining which applicants reflect the “prohibited basis” since banks and finance companies rarely collect this information under the “self-testing provisions of ECOA/Regulation B. As a result, the analysis must resort to using proxies based on the probability that an applicant is of a particular race, ethnicity, or gender.

Senior officials at the CFPB have suggested that they intend to issue guidance on the use of proxies and have referred practitioners to academic research that adopts the Bayesian Improved Surname Geocoding (BISG) proxy method.<sup>2</sup> BISG can be used to proxy race and ethnicity (but

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<sup>1</sup> See CFPB Bulletin 2013-02, “Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act,” March 21, 2013 at [http://files.consumerfinance.gov/f/201303\\_cfpb\\_march\\_-Auto-Finance-Bulletin.pdf](http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf).

<sup>2</sup> Elliott, Marc N. et al., “Using the Census Bureau’s surname list to improve estimates of race/ethnicity and associated disparities,” *Health Services Outcomes Research Method* 9:69-83, April 10, 2009.

not gender) and will typically increase the number of applicants in each race/ethnicity group relative to a tract-only proxy method. However, there are still high rates of false positives and negatives with BISG.<sup>3</sup> Another recent development regarding the proxy issue is the CFPB's use of continuous measures of race/ethnicity rather than a threshold-based method. Specifically, this uses the individual probability of each applicant's race/ethnicity rather than simply including applicants with probabilities above a threshold value such as 80 percent. While this has some theoretical advantages when dealing with lower application volumes, banks and finance companies should take great care in the interpretation of results derived by this method.

### *Regular Analysis of Loan Data*

Once a proxy methodology has been identified, "regular analysis of loan data" must be conducted.<sup>4</sup> The CFPB expects banks and finance companies to monitor underwriting and pricing as part of a "robust fair lending compliance management process."<sup>5</sup> While underwriting and pricing are familiar to the compliance officer, there are important nuances in the indirect automotive market that may not be well understood.

### Underwriting

Relative to mortgage lending, underwriting in the indirect automotive space is often less automated (since there is no industry standard automated underwriting model similar to those used in the mortgage lending business) and, therefore, more judgmental. Each indirect automotive finance company develops customized scorecards and underwriting criteria.

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<sup>3</sup> A false positive is defining an applicant as one race, when they are in fact a different race. A false negative is the failure to identify an applicant who belongs to a group.

<sup>4</sup> See CFPB Bulletin 2013-02, "Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act," March 21, 2013, p. 4, available at [http://files.consumerfinance.gov/f/201303\\_cfpb\\_march\\_-Auto-Finance-Bulletin.pdf](http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf).

<sup>5</sup> Ibid.

Understanding these scorecards, underwriting policies, and areas of discretion is a necessary starting point for conducting a fair lending analysis.

Also common in the automotive finance industry are counter offers, which may involve reducing the loan-to-value (LTV) or payment-to-income (PTI) ratios, shortening the term of the loan, or requiring a larger down payment. The dealership has a number of alternatives for adjusting the deal to meet the counter offer. Those may include offering a higher trade-in value, reducing the price of the vehicle, or changing the composition of add-on products. The treatment of these counter offers in fair lending underwriting models is often driven by limitations in the storage of relevant electronic data in the underwriting system.

Conceptually, counter offers can be thought of as two applications. The first, as submitted by the dealership, may be considered a declined application. The second may be considered as the terms upon which the bank or finance company was willing to purchase the contract. How these are analyzed depends on which data fields the underwriting system stores. Optimally, an underwriting system stores all of the relevant information submitted by the dealership.

Once the appropriate treatment of counter offers has been determined, a fair lending analysis of underwriting can be conducted to identify meaningful differences correlated with race, ethnicity, gender, or age. If regression analysis is used, the factors included in a regression model should be based on the bank's underwriting policies and procedures. Common controls include deal specific attributes (e.g., age of vehicle, LTV, PTI, rebate), applicant credit worthiness and stability (e.g., FICO/customer credit score, payment history, time in job, own versus rent), and

dealership specific attributes (e.g., recourse versus non-recourse,<sup>6</sup> relationship with bank, performance of contracts previously assigned to the bank).

Where statistically significant differences exist, manual file reviews of “matched pairs” are often used to further analyze the circumstances surrounding the applications in question.<sup>7</sup> Often, the manual file review identifies relevant information that was not available electronically and could not easily be incorporated in the regression model.

Underwriting analysis should also consider the risks associated with custom scorecards. The highly competitive auto market has led to the desire to obtain better credit predictions. Numerous third parties are marketing sophisticated, predicative tools that may include non-traditional credit factors. When these are used as a “black box,” with the bank having little, if any, information on how the models were developed and which factors they include, fair lending risks increase when expressly prohibited attributes or factors highly correlated with prohibited basis are factors within the “black box.”

### Pricing

The CFPB’s March 21, 2013 bulletin has focused attention on the pricing of indirect automotive contracts. The use of judgmental or discretionary pricing by the dealership or the finance company presents heightened fair lending risk, with many issues unique to the pricing of indirect automotive contracts. The contract rate paid by the buyer is a combination of two components: the wholesale rate and the dealer reserve. The CFPB’s analytical framework examines these two components separately.

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<sup>6</sup> Dealerships with non-recourse agreements are subject to credit and prepayment risk for a limited period after origination, while dealerships with recourse agreements are subject to credit and prepayment risk for the life of the contract.

<sup>7</sup> Matched pairs are applications from the relevant groups with similar attributes but different underwriting outcomes.

The wholesale rate is commonly called the “buy rate” and represents the minimum rate at which the finance company is willing to purchase the contract. It is generally agreed that the buy rate is a risk-based price,<sup>8</sup> meaning that fair lending analyses will include controls for the credit worthiness of the buyer. In order to apply the correct analytical framework, one must first understand the process by which the bank established the buy rate. In the indirect automotive market, there are a number of ways to establish buy rates. Many finance companies publish rate sheets for the dealerships from whom they purchase contracts. These rate sheets outline buy rates available to the dealership for different types of contracts and often vary by credit score ranges, age of vehicle, length of contract, LTV, and loan amount, as well as dealership specific factors. For example, dealerships that have a floor plan line or other commercial loan arrangement with the bank or finance company may receive lower buy rates.

In some cases, the rate sheet reflects set rates, but in others they represent the starting point for a negotiation between the dealership and the finance company. Once this process is understood, a regression analysis may be completed to look for any meaningful differences in buy rate correlated with a prohibited basis. The controls included in a buy rate regression should reflect the key factors used to set the buy rate as reflected in the bank’s rate sheets and other documentation. Statistically significant differences may be further analyzed using a manual file review of matched pairs. This may be particularly relevant when the bank used a relatively judgmental process to establish the buy rate. For example, additional analyses may examine the extent to which buy rate exceptions were granted by race or ethnicity.

Unexplained differences in buy rates correlated with a prohibited basis may be interpreted by regulators as disparate impact created by pricing models and/or the unfair application of

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<sup>8</sup> See CFPB Bulletin 2013-02, “Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act,” March 21, 2013, p. 1, available at [http://files.consumerfinance.gov/f/201303\\_cfpb\\_march\\_-Auto-Finance-Bulletin.pdf](http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf).

discretion. While the CFPB may be focused on dealership discretion, it is important to remember that regulators may believe that the bank received direct financial benefit from the unfair application of its discretion in establishing the buy rate, and that such discretion could be indicative of disparate treatment.

The second component of contract pricing is the dealer reserve or “dealer markup.”<sup>9</sup> Banks and finance companies have historically allowed the dealership to establish the contract rate at a level above the buy rate. The difference determines the dealer reserve. While most banks and finance companies place limits and other controls on how much the contract rate may exceed the buy rate, the CFPB has identified this as a lending policy that creates “significant risk.”<sup>10</sup>

The CFPB has been clear in its bulletins and public statements—a robust compliance monitoring program includes monitoring and analysis of dealer reserve at the portfolio and dealership levels. It is challenging to reach accurate conclusions regarding potential pricing disparities based on dealership discretion. Much of the challenge results from the structure of indirect automotive transactions (see sidebar). In particular, attempting to isolate a single pricing component from a transaction where multiple prices are concurrently established raises difficult economic and analytical questions. These challenges are exacerbated by limitations when using proxies.<sup>11</sup>

Additionally, the CFPB views dealer reserve as a non-risk-based price. This has two important implications. First, it mandates that dealer reserve be analyzed separately from the buy rate. Second, it suggests the CFPB may not find convincing an analysis of dealer reserve that includes controls for the buyer’s credit worthiness. This view may persist even when dealerships are exposed to charge backs of the dealer reserve due to credit and prepayment risk for some number

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<sup>9</sup> See CFPB Bulletin 2013-02, “Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act,” March 21, 2013, at [http://files.consumerfinance.gov/f/201303\\_cfpb\\_march\\_-Auto-Finance-Bulletin.pdf](http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf).

<sup>10</sup> Ibid.

<sup>11</sup> These rates can be measured by applying these proxy methods to the bank’s HMDA filing where race and ethnicity are known.

of months after contract origination and, in more limited cases, for the life of the contract. For the compliance officer, these issues greatly increase the fair lending risk associated with dealer reserve.

Quantifying meaningful differences in dealer reserve across the portfolio and at specific dealerships requires several analytical steps. However, before any analyses can be undertaken, one must decide how to measure dealer reserve. Basis points (bps) at origination and dollars paid to the dealership are commonly used, but other options may be used. This fundamental issue becomes complicated when the bank allowed the dealership to choose among different payment plans or when some dealerships are non-recourse, while others are not.<sup>12</sup> At the portfolio level, the next step is to understand the average difference in dealer reserves faced by each prohibited basis group (or “raw” differences as they reflect no controls). Generally, two raw metrics should be considered: the frequency of and the extent (level) of the dealer reserve for each prohibited basis group. The frequency metric identifies the percentage of contracts with a non-zero dealer reserve. The level metric measures the average amount of dealer reserve. Just as in underwriting, the identification of raw differences is not the end of the analysis, but rather the beginning.

The next step requires the analysis of portfolio level dealer reserves while controlling for relevant factors. Most of the factors will not be discernible from bank policies or practices. The dealer reserve is a factor in arriving at the contract rate established by the dealership and the vehicle buyer as part of the negotiation of the overall transaction. Unlike the factors dictating underwriting decisions or buy rates, the dealership’s supply function and the buyer’s demand function are not to be found in the bank’s records.

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<sup>12</sup> Dealerships with non-recourse agreements are subject to credit and prepayment risk for a limited period after origination, while dealerships with recourse agreements are subject to credit and prepayment risk for the life of the contract.

Understanding these purchase-related factors that emerge from the traditional economics of supply and demand is important to the portfolio level analysis of dealer reserve. While there are numerous unobservable dealership and buyer attributes that contribute to the transactions (including the motivations of supply and demand), proxies for some attributes may be developed from the bank's transaction records. A regression analysis may analyze the portfolio level dealer reserve and control for factors that can be observed or inferred. To the extent that statistically significant differences are identified, it is important to understand that manual file reviews may be of limited value due to the general lack of relevant information in the files.

Dealership-level analysis of dealer reserve is further complicated by low contract volume at many dealerships from which a bank purchases contracts. A common approach is to establish a minimum volume level before including a dealership in the analyses. For example, include only dealerships that assigned to the bank 10 minority, 10 non-minority, and 30 total contracts in a year. For each dealership that meets the 10/10/30 screen, raw frequency and level metrics, as well as statistical tests, may be calculated and compared across protected group contracts at the dealership. More complex analyses, such as regressions, are generally not possible at the dealership level due to the low numbers of contracts assigned by a dealership.

#### *Bank Participation in Dealer Reserves*

Finally, there is additional fair lending risk related to the dealer reserve that has received limited attention recently—bank participation in the dealer reserve. Prior to extensive dealer reserve litigation in the early 2000s, many indirect automotive finance companies shared financially, or “participated,” in the dealer reserve. As these cases settled, most banks and finance companies stopped participating in the dealer reserve. Paying the dealership the full dealer reserve creates



two potential fair lending risks—one perceived and one actual. To understand these risks, one must understand the mechanics of these payments to the dealership and risks accepted by the dealership and bank.

When the dealership assigns the contract to a bank or finance company and the contract rate exceeds the buy rate, the basis point difference between the two rates can be calculated and converted into dollars of dealer reserve. However, that dollar amount is based on the assumption the contract will be repaid as agreed and will not pay off early or default. Of course, many buyers refinance, sell the vehicle, or experience a total loss in an accident prior to the end of the contract. At the origination of the contract, neither the dealership nor the bank knows how many of the originally scheduled payments will be paid and, consequently, how much of the dealer reserve will materialize. Most dealerships do not want to wait months or years to receive payment of the materialized dealer reserve. To deal with these conflicting priorities, dealerships choose among a number of dealer reserve payment programs offered by banks and finance companies. Often, dealerships elect to receive less than the full reserve payment at the time of contract origination. In return, the dealership is subject to chargebacks of the reduced dealer reserve for a relatively limited period of time, commonly 90 to 180 days. The reduced dealer reserve payment is typically 70 percent to 80 percent of the calculated dealer reserve at origination.

This reduction percentage is commonly called the dealer reserve “split,” and that term can be the source of considerable confusion. Some industry professionals describe the 20 percent to 30 percent reduction as “retained” by the bank. However, on average, the 20 percent to 30 percent never materializes due to prepayment and default of contracts. When the split is set at or above a certain point, on average, no payment stream associated with the dealer reserve is actually

retained by the bank. Fair lending analysis should consider whether the bank's actual prepayment and default experience supports the split. This fair lending risk is heightened when a bank has an explicit policy of not participating in the dealer reserve, and its actual prepayment and default experience indicates that it is, in fact, retaining a portion of the dealer reserve.

### *Conclusion*

We have identified some of the key fair lending compliance issues associated with indirect automotive finance and methodologies that may assist with the identification of any disparities resulting from underwriting or pricing of automotive finance contracts. In particular, we have identified the circumstances that make the “regular analysis of loan data for potential disparities on a prohibited basis” in indirect automotive finance different from the corresponding analyses in the mortgage lending arenas.<sup>13</sup> This area of regulatory scrutiny continues to evolve, and modifications to the focus or methodologies suggested will certainly change over time.

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<sup>13</sup> Consumer Financial Protection Bureau, Supervisory Highlights: Fall 2012, October 31, 2012, at <http://www.consumerfinance.gov/reports/supervisory-highlights-fall-2012>.

## **About the Authors**

Arthur P. Baines, vice president at Charles River Associates, has more than 20 years of diversified business, economic, and quantitative analysis experience. He is a leading expert in the retail automotive industry, consumer finance, and indirect lending. He has assisted numerous banks, automobile manufacturers, captive finance arms, and other automotive lenders respond to regulatory investigations and litigations. Baines has assisted numerous clients in the design, implementation, and monitoring of governance and compliance programs related to fair lending, conflicts of interest, financial disclosure, and various consent decrees.

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## **SIDEBAR: Automobile Dealerships Differ from Mortgage Brokers**

Comparisons of indirect automotive financing to wholesale mortgage lending must recognize that franchised automobile dealerships are not brokers.<sup>14</sup> A mortgage broker's relationship with the home buyer is limited to the arrangement of financing, and it usually ends at the closing table. The dealership's relationship with the vehicle buyer can be multi-faceted. The dealership stocks an inventory of new and used vehicles for sale, combines multiple products in each vehicle purchase, may purchase the customer's used vehicle, and provides warranty and repair work after the sale.

Collectively, the new vehicle inventory of dealerships in the U.S. included approximately 3.1 million vehicles as of Jan. 1, 2013, which is roughly a two-month supply.<sup>15</sup> Industry statistics suggest that approximately 50 percent of new-vehicle customers trade in a vehicle as part of the transaction. Additionally, dealerships sold 17.1 million used vehicles in 2012.<sup>16</sup> JD Powers Associates estimates that approximately 79 percent of new-vehicle financing is arranged through the dealership.<sup>17</sup> In addition to arranging customer financing, dealerships' finance and insurance (F&I) departments sell consumers warranty and insurance products and service contracts. Some dealership groups report the average transaction includes 1.4 F&I products.<sup>18</sup> For example, group 1, a publically traded company that owns automobile dealerships, recently reported nearly 40 percent of its new-vehicle sales included an extended service contract, and 22 percent of such sales included Guaranteed Auto Protection (GAP) insurance.<sup>19</sup> As a result, automotive dealerships, unlike mortgage brokers, have multiple potential revenue streams associated with each vehicle transaction and incur significant hard- and soft-dollar costs in the operations of the business.

Dealerships employed (on average) 55 people and maintained an employee payroll of almost \$51.6 billion in 2012.<sup>20</sup> State law and manufacturer franchise agreements commonly require a dealership to have the capability to service vehicles. Dealerships make investments in facilities, tools, and computers to service these vehicles. In 2012, dealerships maintained a \$5.3 billion inventory of vehicle replacement parts.<sup>21</sup> Additionally, franchise agreements commonly require dealerships to maintain certain levels of capitalization, sales penetration, profitability, and facility investment. As a result, dealerships require a significant amount of capital to fund physical facilities, inventory, payroll, and working capital. This differs significantly from a typical wholesale channel mortgage broker.

The fundamental role of the automobile dealership creates a challenge for a bank, which attempts to isolate and analyze a single component of the transaction, the financing, from the other components of the transaction. As the CEO of Asbury Automotive Group recently commented when asked about the possibility of shrinking dealer reserves, "It's like a balloon, if you push on it on one side, it bulges out on the other side."<sup>22</sup> This is the market in which the bank's indirect automotive finance product competes. Any fair lending analysis of the indirect automotive finance product must consider the role of the dealership and the structure of these transactions.

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<sup>14</sup> See "Automotive Finance—Will dealership finance reserve go the way of mortgage yield spread premiums?", March 2013, at: <http://www.crai.com/Publications/listingdetails.aspx?id=16084&pubtype=All%20Type>.

<sup>15</sup> *Automotive News*, January 24, 2013, p. 36.

<sup>16</sup> NADA DATA 2013, p.11, <http://www.nada.org/Publications/NADADATA/2013/>.

<sup>17</sup> Delvin Davis and Joshua M. Frank, "Under the Hood: Auto Loan Interest Rate Hikes Inflate Consumer Costs and Loan Losses," Center for Responsible Lending, April 19, 2011.

<sup>18</sup> "Public Group's Dual Focus: Car Sales, F&I," *Automotive News*, August 3, 2011.

<sup>19</sup> "Weekly F&I Report," *Automotive News*, November 14, 2012.

<sup>20</sup> NADA DATA 2013, p. 14.

<sup>21</sup> *Ibid*, p. 12.

<sup>22</sup> "Public retailers report higher F&I results, downplay CFPB impact," *Automotive News*, July 24, 2013.