Buckle Up!
Indirect Automotive Fair Lending Risks Ahead

Fuel up your compliance program for the journey ahead.

BY LIZA WARNER, CPA, CFSA, CRMA

FOLLOWING THE PANDEMIC, car sales and prices are surging, inventory levels are low with high resale values on used vehicles. Automotive loans are the second largest component of household debt in the United States and rising car prices means more automotive debt for consumers. Consumers began taking more loans with higher balances than ever before and making their payments in the midst of increasing inflation. There are signs that the market may be yielding to the higher costs and increased rates during the second quarter of 2022. This market is changing rapidly with the times and understanding the rules of the road will ensure your bank avoids hazards.

Rules of the Road

As the driver of your bank's fair lending program, it is critical to understand the rules of the road. The Equal Credit Opportunity Act and its implementing Regulation B prohibits discrimination against protected classes of race, color, religion, national origin, sex, marital status, age, receipt of public assistance, or good-faith exercise of any rights under the Consumer Credit Protection Act in all credit transactions, including indirect automotive lending. Ongoing enforcement actions have signaled a need to change pricing and compensation systems to substantially reduce indirect auto dealer discretion and limit the dealer markup to as low as one percent above the buy rate (https://www.consumerfinance.gov/about-us/newsroom/cfpb-and-doj-reach-resolution-with-honda-to-address-discriminatory-auto-loan-pricing/). As recent as October 2022, banks are receiving enforcement actions related to the markup charged to customers, regardless of the bank's lack of discriminatory intent. (See https://www.dfs.ny.gov/system/files/documents/2022/10/ea20221005_co_rhinebeck.pdf.) While banks do not know the demographics of a borrower involved in the indirect automotive transaction (because the dealer—not the bank—works with the borrower), the bank has a responsibility to ensure policies and practices do not violate state and federal fair lending laws. Effective fair lending programs addressing indirect automotive lending take these risks into consideration and implement appropriate policies and monitoring to ensure the program is driven defensively.

The rules of the road in automotive lending have surprisingly low guardrails, so do not expect to get off with a warning. Both bank and non-bank lenders face regulatory scrutiny surrounding the indirect automotive lending sector. Prudential regulators and the CFPB often review indirect automotive lending in both general and targeted

fair lending examinations. Historically, enforcement actions have been severe for banks that have been criticized for pricing loans to minorities higher, by as little as 20 to 59 basis points, when compared to similarly situated non-minorities.
(See https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202106291.) In addition to cautions on dealer markup practices, regulatory agencies are monitoring sales practices and are focused on identifying consumer harm and unfair lending as a result of the pandemic.

Drive Defensively by Spotting Red Flags

Avoiding tickets in indirect automotive lending means driving defensively, spotting potential accidents before they happen. The red flags or risk indicators outlined below extend beyond the markup practices of a dealership. Many aspects of a bank's compliance management system, business process, policies, procedures, and even sales practices should include risk considerations. Below are common areas that banks should closely monitor:

1. **Exceptions Rates**—elevated levels of underwriting or pricing exceptions, especially credit tier overrides and undocumented price matches.
2. **Dealership Sales Practices**—high pressure sales practices designed to increase loan volumes without regard to credit quality. This can be gleaned from BBB complaints as well as state/federal actions.
3. **Ancillary Products**—high rates of transactions with service contracts, GAP policies, wheels and tire plans, and dent-and-ding plans often charged during the finance stage of the automotive transaction and is often paid for with loan funds. However, note that some dealers may offer valuable ancillary products such as regular maintenance plans so be sure to dig in to higher numbers to see if they are explainable through available data.
4. **Documentation**—incomplete or missing application documentation, collection of prohibited basis information that is accessible to underwriters.
5. **Dealer Agreement Violations**—dealer agreements that prohibit the communication between the bank and the consumer until after the contract is obtained by the bank.
6. **Ineffective Compliance Management Systems (CMS)**—ineffective policies and procedures, and lack of periodic monitoring and testing. The tricky part is balancing the dealer's perspective with the compliance requirements so as not to lose a dealer relationship if the CMS is overly burdensome.

Steer Clear of Accidents

While spotting red flags is important, we must venture further to fully understand the risks involved. Regulatory agencies are watching closely to identify the unsafe and potentially harmful actions of poor risk management. The following six risk categories can serve as a roadmap for the journey ahead.

Risk Framework

The risk framework for a bank is the first step to identifying indirect automotive fair lending risks. A faulty framework can lead to systematic fair lending issues and widespread problems in an organization. Below are some best practices for strong risk frameworks:

- Establish a risk-based measure to establish the buy rate, the initial risk-based interest rate. Further, the policies should have clear guidelines of when discretion in adjusting the buy rate is permissible, if at all.
- Set the maximum dealer markup to limit the dealer's pricing discretion to one percent or less to align with industry best practices.
- Ensure timely adverse action notices are sent that notify the applicant of the credit decision and reason and establish a consistent procedure for ensuring all requirements are met.

Understanding the implications of dealers adjusting interest rates is paramount in ensuring all applicants are treated fairly. Adjusting the rate for a share of increased interest revenue presents fair lending risks if minority borrowers receive higher interest rates than similarly situated non-minority borrowers. Increases in the interest rate (above the buy rate) that may be negotiated with the applicant by the dealer are called "dealer markup." A "reserve" or "participation" is the term for the type of compensation the bank will pay the dealer based on the difference in interest revenues between the buy rate and the loan rate (actual note rate) charged to the consumer in the retail installment contract with the dealer. Flat payouts can be more problematic for smaller loans, which tend to impact lower income and minority borrowers. Generally, percentages should be utilized to ensure all borrowers receive similar treatment.

Access to Credit

Risks related to a protected consumer's access to credit can be monitored through data analysis. For example, levels of assistance can be analyzed through disparities in price matches, fee reductions, and approval overrides to ensure borrowers are treated fairly, regardless of protected class characteristics. If your bank accepts Individual Taxpayer Identification Numbers (ITIN) in place of a social security numbers and does not have consistent pricing policies for similarly situated social security number holders, there could be elevated risks with regard to pricing discrepancies. This is especially true if your bank offers subprime automotive lending. Over 20% of all U.S. car loans fall into this credit category according to Thomson Reuters/IFR and Experian studies (https://www.nytimes.com/2017/06/18/business/dealbook/car-loan-subprime.html).

Dealership Sales Practices

Beware of "power booking." Power booking is a fraudulent sales practice where the dealer falsely claims the vehicle has options or features (e.g., navigation system, performance packages, etc.) that are not actually included on the vehicle. This practice is designed to raise the value of the vehicle and influence the loan-to-value (LTV). This practice can present fair lending risks when inaccurate valuations are used for non-minority borrowers when compared to similarly situated minority borrowers as the collateral valuations will differ. Manufacturer specification sheets can be pulled for a vehicle's factory options and this can be compared to dealer documentation to compare actual factory features. Further, the bank should request complaint reporting of any transactions involving the bank to ensure that consumer concerns and issues are adequately addressed in a timely manner. If a bank has concerns about a particular dealer, it can also check BBB complaint logs.

GAP insurance and dealer-installed add-on products can present additional fair lending risks when these products are included in a transaction with bundling practices that discount the vehicle when purchased in conjunction with add-on products. This can occur when vehicle discounts are given to a non-minority borrower without the purchase of add-on products, and the similarly situated minority borrower only receives the vehicle discount when bundled with add-on products. Fair lending analyses should control for vehicle equity and purchase price to ensure the total transaction cost to the consumer is accounted for. Additionally, consumers have little time to comparison shop for these types of add-on products because they are often discussed and purchased in the dealership's finance office at the time of the contract and loan booking, which could be perceived as a potential Unfair, Deceptive, Abusive Acts or Practices (UDAAP) risk.

Finally, there is increased focus on processing timely refunds of add-on products or services not utilized, which can elevate UDAAP risk. For example, because GAP insurance is calculated based on the full life of loan, the service may not be fully utilized if a customer pays off the loan early or the car is repossessed. In those cases, be sure the bank is assisting the customer in every way possible.

Credit Risk Management

Rate competitiveness can often vary based on credit tiers (prime, super prime versus near-prime, sub-prime) and should be evaluated for override rates by tier. Negotiations are common and it is prudent to understand the override rates to offer competitive pricing. Higher override rates for non-minority borrowers compared to similarly situated minority borrowers creates fair lending risks and will often be flagged during a matched pair analysis.

Post-contract modifications may create additional legal risks to the bank and harm relationships with dealers and should generally be avoided. Likewise, dealers should avoid contract term modifications after assignment, which impacts the bank.

First payment defaults should also be monitored for the impact on a consumer. This typically happens when the bank finances vehicles in an amount that exceeds the vehicle's market value and leaves borrowers with a loan that they are unable to repay. Overleveraged minority borrowers with high first payment defaults could indicate predatory lending practices that result in consumer harm when borrowers cannot meet the loan repayment requirements. The CFPB released a compliance bulletin in March 2022 that detailed the increased risk of improper repossessions by lenders, services, and investors within the automotive industry (files.consumerfinance.gov/f/documents/cfpb_bulletin-2022-04_mitigating-harm-from-repossession-ofautomobiles.pdf). Recent conduct observed during examinations and enforcement actions included illegal seizure of cars, poor recordkeeping, unreliable balance statements, and ransom demanded for borrower's personal property collected during the repossession (https://www.consumerfinance.gov/about-us/newsroom/cfpb-moves-to-thwart-illegal-auto-repossessions/).

Data Integrity

One challenge with assessing and monitoring indirect automotive lending risk is the quality of application data. Application data should be accurate and retained in accordance with applicable data retention policies. Additional pointers include:

- Take special care when the dealership utilizes paper applications as they can be more prone to data errors, particularly when transcribed to a digital format.
- Ensure accuracy of the consumer address and surname. This data is important as these fields will be utilized in applying proxy methodology for disparity analysis based on protected class.
- Communication logs between banks and dealerships are critical during the file review to adequately document the transaction and provide reliable data for research in the event a fair lending comparative file review is conducted.
- Disparity analysis should be performed, documented, reviewed, and analyzed regularly for differences in treatment.

Pricing Exceptions

Issues can arise when it is unclear why, how, and how often exceptions to standard pricing are made. An exception may create fair lending risk when minority applicants are not given similar exceptions to similarly situated non-protected applicants. Banks often lack detailed exception documentation at the point the exception is made making tracking and analyzing of exceptions difficult. Examples of exceptions may include:

- Waiving, reducing, or increasing fees; and
- Pricing analysis objectives (differences in APRs).

Safe Navigation

Whether you are behind a wheel, or driving a compliance program, safety is a top concern. In this case, controls act as safety features for your bank. Controls should be both preventative (headlights at night) or detective (a check engine light) to help structure a strong risk mitigation environment.

Similar to a car's numerous safety features, risk management involves layer upon layer of controls. For example, board of directors and senior management involvement in the development and oversight of a fair lending program is key to setting the tone at the top. Additionally, management should monitor implementation, monitoring, and enforcement of the program and how the bank adheres to the policies and procedures related to application, underwriting, pricing, refinancing, and collection/servicing processes. Training programs should include both new hires and current employees for both frontline and management personnel. Withdrawn or denied applications should undergo a timely second review process with adequate managerial oversight. Written agreements with dealers should certify the dealer's commitment and responsibilities with fair lending requirements and be updated regularly as necessary. Lastly, the bank's compliance program and related fair lending plan should be periodically reviewed and updated with proper oversight by senior management to ensure alignment between policies and practices.

Examples of controls in indirect automotive lending may include:

- Conducting analysis to detect discrimination in markup monitoring practices. Policy should also dictate how to handle dealers that were found to discriminate and the point at which the dealer should be moved to a flat rate fee.
- Reviewing internal memos, internal or external audits, internal compliance reviews, or observations by bank employees involving discrimination allegations and unfair treatment.
- Ensuring automobile lending policies establish specific underwriting guidelines that encompass objective criteria, such as credit scores, debt-to-income ratios, interest rates, amortization periods, loan-to-value ratios, and diversification standards and that the guidelines are consistently followed. It is also beneficial to document the order in which applications will be processed from the queue.
- Performing due diligence on a dealership and its business practices before entering a third-party loan origination agreement and ongoing evaluation of the relationship. Provisions should be included in the dealer agreement that allows the bank to evaluate the dealer's compliance procedures, including fair lending efforts.
- Verifying collection procedures and the repossession process are independent of any bank personnel involved in originating the loan and ensuring bank-financed repossessions are identified and tracked.
- Reviewing indirect automotive oversight and the control environment to identify situations where loan officers may manipulate delinquency and net loan loss figures through a repossession cycle.

Driving a Successful Indirect Auto Program

Whether it is lending or driving, there is one common thread: responsibility. Banks should always consider what responsibility and accountability means to both the institution and consumers. Driving a successful indirect auto program starts with accountability and the desire to make a positive impact for consumers through fair and responsible lending practices. This becomes more evident as fair lending risks in indirect auto continue to emerge. The economy faces new challenges with inflation and supply chain issues that may limit inventory, which increases prices paid by consumers. These price fluctuations must be closely monitored to ensure similarly situated minority borrowers are being treated equally to their non-minority counterparts.

In the end, indirect auto lending is often a high-speed and competitive process. The pressure to remain competitive will continue to drive differences in rates on a daily basis for many dealerships and banks alike. Because of these challenges, banks must take the necessary steps to prevent discrimination in lending and follow the rules of the road. ■

The author would like to thank Daniel Johnson for his assistance with this article.

…

ABOUT THE AUTHOR

LIZA WARNER, CPA, CFSA, CRMA, is a partner and managing director at CrossCheck Compliance LLC and a bank internal audit, compliance, and risk management executive with over 30 years of experience in the financial and professional services industries. Previously Liza was the chief compliance and operational risk officer for a mid-size regional bank and has consulted with banks of all sizes on their regulatory compliance, fair lending, and internal audit needs. She is a CPA, a Certified Financial Services Auditor (CFSA), and she holds a Certificate in Risk Management Assurance (CRMA). You can reach Liza at lwarner@crosscheckcompliance.com.

ABA MEMBER RESOURCES

ABA Recorded Webinar—New Frontiers in Combatting Redlining: https://www.aba.com/training-events/online-training/new-frontiers-in-combating-redlining

ABA Training—Fair Lending: https://www.aba.com/training-events/online-training/fair-lending

Fair Housing Act: aba.com/banking-topics/compliance/acts/fair-housing-act