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State Regulator Pursues Disparate Impact in Auto Finance

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Players in the auto finance industry have been watching the Consumer Financial Protection Bureau ping-pong over the last several years regarding disparate impact theories under the Equal Credit Opportunity Act. The disparate impact theory allows for discrimination claims when a law, policy, or procedure appears neutral on its face but, when applied, results in adverse effects on members of protected classes.

In 2013, the CFPB issued guidance stating that creditors that allow dealers to add their own finance charges on top of creditor-established buy rates at the dealer's discretion are at significant risk of fair lending violations under the ECOA, under a disparate impact theory. Several large players in the auto finance industry found themselves subject to enforcement activity under this guidance.

The CPFB's guidance did not go through the rulemaking process, and, in 2018, a Congressional Review Act disapproved it, relying on a Government Accountability Office review stating that it was a rule in disguise. The CRA erased the guidance, telling the CFPB that it could not recreate a substantially similar rule without specific congressional authorization. Understandably, dealers and finance sources celebrated the end of the guidance, even as the CFPB stated that it would continue to vigorously enforce fair lending laws.

However, federal enforcement from the CFPB is not an auto finance provider's only worry. State regulators have continued to act under a disparate impact theory, as a recent pair of settlements showed.

Two banks chartered in New York, Adirondack Trust Company and Chemung Canal Trust Company, were subjects of investigation by the New York Department of Financial Services regarding dealer markup. Both banks agreed to consent orders that came with hefty penalties.

According to the consent orders, Adirondack Trust allowed dealers to impose additional finance charges on retail installment sale contracts of up to 2% above its buy rate between January 1, 2016, and November 1, 2017. From January 1, 2016, to August 31, 2020, Chemung Canal Trust permitted an increase of 2.5% for contract terms up to 69 months and 2% for shorter terms. Neither bank controlled the dealer's markup for creditworthiness or other objective criteria and instead allowed the pricing to be set at the dealer's sole discretion.

New York performed a Bayesian statistical analysis as a proxy to investigate disparities in the dealer markup rates and found that, for financing originated by Adirondack Trust, buyers who were identified as Black, Asian, and Hispanic via the analysis paid a statistically significant higher rate than non-Hispanic white credit buyers. The DFS analysis of Chemung Canal Trust's finance contracts showed that buyers who were identified as Hispanic paid a higher finance charge than non-Hispanic white buyers.

The penalties are significant. Adirondack Trust will pay $275,000 to the state and $50,000 to community development organizations, and Chemung Canal Trust will pay the state $350,000. Both banks are required to find the affected non-white buyers and make restitution. Adirondack Trust voluntarily ended its indirect auto finance program in 2017, and Chemung Canal Trust has pledged to increase its monitoring efforts and prevent future discrimination.

The lesson here? Don't rely on the CFPB's limited ability to pursue discrimination claims related to dealer markup to relax standards related to potential discrimination in credit pricing. Your state regulators can also enforce fair lending compliance. Further, even though the CFPB guidance was revoked, smart creditors might dig up a copy and give it a read. The leadership of the CFPB and Congress can shift like the wind, and it's a lot better to be prepared to comply than it is to be prepared to settle an enforcement action.

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7037 Ridge Road, Suite 300, Hanover, Maryland 21076
410.684.3200

hudsoncook.com