PUBLICATION

Was a CFPB Enforcement Action Based on "Racial Profiling and Junk Science?

Authors: Blair B. Evans
May 19, 2016

In a press release dated April 18, 2012, the Consumer Financial Protection Bureau (CFPB or Bureau) declared that it would "use all available legal avenues, including disparate impact, to pursue lenders whose practices discriminate against consumers." Shortly thereafter, the CFPB made good on its promise. On December 20, 2013, the Department of Justice and the CFPB announced a settlement with Ally Bank, formerly General Motors Acceptance Corporation or GMAC, requiring the payment of $80 million in consumer redress and $18 million to the Bureau's Civil Penalty Fund for alleged discrimination in connection with discretionary dealer markups. The settlement also articulates a "compliance plan" to which Ally is required to adhere.

While the investigation against Ally was pending, the CFPB proceeded to issue guidance to institutions whose portfolios include loans that may include dealer markups. Although enforcement actions and regulatory guidance don't have the force and effect of law, financial institutions ignore them at their own peril – lest they be on the receiving end of the CFPB's next $98 million enforcement action.

The Ally Settlement

In September 2012, the CFPB and the DOJ conducted a joint examination of Ally's indirect auto lending program for compliance with the Equal Credit Opportunity Act (ECOA). The ECOA prohibits creditors from discriminating against loan applicants in credit transactions on the basis of characteristics such as race and national origin. The result of such treatment is known as "disparate impact." To prove a disparate impact claim, the CFPB must: (1) identify a specific policy or practice adopted by a creditor; (2) demonstrate a disparate impact on a prohibited basis; and (3) show a causal relationship between the challenged practice and the alleged disparate impact.

The CFPB and DOJ's coordinated investigation concluded that Ally violated the ECOA by charging African-American, Hispanic, and Asian and Pacific Islander borrowers higher dealer markups for their auto loans than similarly-situated non-Hispanic white borrowers. Since the CFPB, DOJ and Ally resolved their differences before any adjudicative administrative proceeding, the claims by the CFPB and the DOJ were never subjected to any serious scrutiny.

Issues With Methodology

The CFPB would likely have had difficulty proving disparate impact on Ally's customer base because the methodology it used was, by its own admission, flawed. Since creditors are prohibited (outside the mortgage context) from collecting race data, the CFPB had to rely on "proxy" data. Despite alternatives, the CFPB chose to rely upon outdated census data that attempts to determine whether a borrower is a minority by looking at surnames, geographic location or a combination of both. According to a Report Prepared by the Republican Staff of the Committee on Financial Services, U.S. House of Representatives, the CFPB's process for estimating the rate of minorities affected by dealer markups has led some news outlets to refer to the CFPB's conclusions on the extent of the disparate impact of dealer markups as "racial profiling and junk science."

According to the CFPB's own reports, the CFPB's methodology overestimates the number of people categorized as ethnic, including a 20% overestimation of African Americans. Perhaps for this reason, the CFPB chose to settle its claims with Ally rather than to go forward with regulatory enforcement action. In connection with the settlement, Ally is to pay approximately $80 million in redress to approximately 235,000 consumers against whom it allegedly discriminated. Shockingly, although the CFPB and the DOJ have admitted their own methodology overestimates the number of minorities, the Bureau isn't verifying whether proposed recipients of the $80 million fund actually are minorities. As a result, in a January 19, 2016, letter to Attorney General Loretta Lynch and the CFPB, Financial Services Chairman Jeb Hensarling (R-Texas) urged the Bureau to suspend the distribution of settlement funds until all recipients verified their eligibility.

Issues With Causation

Had it not settled, the CFPB would also have had difficulty proving that Ally's dealer markups were actually caused by some perceived discrimination. In other words, the CFPB and DOJ would have needed to prove that Ally's dealer markup policies *caused* the discrimination and that the higher markups for non-whites was not the result of some other factor.

Recently, the Supreme Court of the United States stated that the mere existence of statistical disparities without a policy that actually *were the direct result of* those disparities does not give rise to liability under the disparate impact theory:

[A] disparate-impact claim that relies on a statistical disparity must fail if the plaintiff cannot point to a defendant's policy or policies causing that disparity. A robust causality requirement ensures that '[r]acial imbalance . . . does not, without more, establish a prima facie case of disparate impact' and thus protects defendants from being held liable for racial disparities they did not create.

In Ally's instance, several other factors could account for the alleged disparate impact of dealer markups. These factors include a borrower's creditworthiness, the characteristics of the vehicle, the timing, location, and structure of the deal, the composition of a creditor's portfolio, customer monthly payment constraints, competing dealer or credit offers, promotional financing or incentive campaigns, and inventory reduction considerations. The CFPB and DOJ were never required to address these flaws in their allegations because the matter was not subjected to the scrutiny of an administrative proceeding and was instead settled.

The CFPB's settlement of its claims against Ally was not made on strictly monetary terms. The settlement terms also required that Ally implement certain policies and procedures in order to ensure compliance with the ECOA going forward. Most striking is the requirement for Ally to conduct "quarterly and annual analysis of portfolio-wide retail installment contract pricing data for disparities on a prohibited basis resulting from [Ally's] dealer compensation policy that reflects the same methods and controls the CFPB and the DOJ applied in their analyses …" In other words, although the CFPB has acknowledged its methodology is faulty, it is now requiring that Ally use the same methods in analyzing its portfolio.

Although guidance and regulatory settlements of enforcement actions don't have the force of law, agency pronouncements must be taken seriously by market participants, because the cost of being subjected to a CFPB investigation, even if it does not result in a CFPB enforcement action, is enormous. In the dealer markup context, the CFPB has repeatedly promised "to ensure that the market for auto lending provides fair, equitable and nondiscriminatory access to credit for consumers." As such, indirect auto lenders ignore the Ally settlement and the March 21, 2013, guidance at their own peril, however misguided the CFPB's actions may seem.

Lenders should review their policies and procedures to show a good-faith effort in complying with the ECOA. Here's a list to get started:

- Maintain records for substantiating markups, such as borrower's creditworthiness, the characteristics of the vehicle, the timing, location, and structure of the deal, the composition of a creditor's portfolio, customer monthly payment constraints, competing dealer or credit offers, promotional financing or incentive campaigns, and inventory reduction considerations;
- Depending on the size of your institution, perform an analysis of the lender's portfolio (dealer-specific and portfolio-wide) for potential disparities on a prohibited basis in pricing, underwriting, or other aspects of the credit transaction;
- Adopt a fair lending policy statement, train employees, monitor compliance and coordinate with your regular dealers to do the same;
- Commence prompt corrective action against dealers, including termination of the business relationship, when analysis identifies unexplained disparities on a prohibited basis; and
- Provide meaningful oversight of fair lending compliance by management and, where appropriate, the financial institution's board of directors.