

Client Update

CFPB Issues Final Auto Finance Larger Participant Rule and New Auto Finance Examination Procedures

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On June 10, 2015, the Consumer Financial Protection Bureau (the “CFPB” or “Bureau”) finalized its regulation to define “larger participants in a market for auto financing” (the “Final Rule”).¹ The Final Rule, which becomes effective within 60 days of publication in the Federal Register, brings certain non-bank auto finance companies under the CFPB’s supervisory authority, such that the CFPB may begin to conduct examinations at these companies to ensure compliance with federal consumer financial protection laws. Auto finance is the fifth industry the CFPB has brought under its supervision pursuant to its authority to define non-bank larger participants in consumer finance markets since opening its doors in 2011.

The CFPB also published new auto finance examination procedures (the “Exam Procedures” or “Procedures”),² which identify the aspects of an institution’s business that examiners will review during an auto finance examination. The Procedures focus on a number of areas, including underwriting, compensation, debt collection and servicing, as well as ancillary products. While the Exam Procedures mirror many of the CFPB’s other product-focused exam procedures, they also touch on a diverse set of issues based upon the variety of auto finance lender models and the fragmented nature of the industry.

¹ Defining Larger Participants of the Automobile Financing Market and Defining Certain Automobile Leasing Activity as a Financial Product or Service, CFPB 2014-0024, CONSUMERFINANCE.GOV (June 10, 2015), available at http://www.consumerfinance.gov/f/201506_cfpb_defining-larger-participants-of-the-automobile-financing-market-and-defining-certain-automobile-leasing-activity-as-a-financial-product-or-service.pdf.

² CFPB Examination Procedures, Auto Finance, CONSUMERFINANCE.GOV (June 10, 2015) available at http://files.consumerfinance.gov/f/201506_cfpb_automobile-finance-examination-procedures.pdf.

THE FINAL RULE

The Final Rule, which is almost identical to the proposed rule³ save for minor clarifying changes, has three primary functions. It defines the activities of the automobile financing market, sets out the test for determining which entities are larger participants that fall within the Bureau's supervisory authority and adds certain types of auto lease obligations to the definition of those financial products or services subject to the Bureau's regulatory authority.

“Automobile Financing” Market

The Final Rule defines the market for “automobile financing” to include the following activities: (1) granting credit for the purchase of an automobile; (2) providing automobile leases; (3) refinancing existing or previously refinanced credit obligations secured by an automobile; and (4) purchasing or acquiring any of the first three types of obligations. The Rule specifically excludes investments in asset-backed securities and purchases or acquisitions of auto loans by special purpose entities for the purpose of facilitating asset-backed securitizations.⁴ Consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), it also excludes auto dealers from qualifying as larger participants.

This definition therefore captures the activities of many types of non-bank companies, including specialty finance companies — many of which focus on financing to subprime borrowers and those with limited credit; “captive” non-banks affiliated with auto manufacturers; and “buy-here-pay-here” finance companies, which are often associated with a particular dealer, and which also frequently focus on subprime lending.

³ Defining Larger Participants of the Automobile Financing Market and Defining Certain Automobile Leasing Activity as a Financial Product or Service, CFPB 2014-0024, CONSUMERFINANCE.GOV (Sept. 17, 2014), available at http://www.consumerfinance.gov/f/201506_cfpb_defining-larger-participants-of-the-automobile-financing-market-and-defining-certain-automobile-leasing-activity-as-a-financial-product-or-service.pdf. The Bureau received approximately 30 comments on the proposed rule.

⁴ The proposed rule excluded “investments in asset-backed securities.” Some commenters urged the Bureau to clarify that this exclusion includes the purchase of loans by a securitization entity and that entity's issuance of asset-backed securities. The Bureau made this change in the Final Rule, adding to the exclusion “purchases or acquisitions of obligations by a special purpose entity established for the purpose of facilitating asset-backed securities transactions if the purchases or acquisitions are made for the purpose of facilitating an asset-backed securities transaction.”

Larger Participant Test

The Final Rule provides that any non-bank firm that engages in automobile financing will be considered a larger participant subject to the Bureau's supervision if it has at least 10,000 "aggregate annual originations," which is calculated as the sum of the annual originations of the non-bank, as defined by the auto financing activities above, and those of each affiliate of that non-bank. The Bureau does not require entities to undertake this calculation themselves, but they can do so should they wish to contest the Bureau's assertion of supervisory authority.

The Bureau received several comments urging that the threshold for the definition of larger participant be increased to 50,000 aggregate annual originations, rather than a 10,000 threshold. The Bureau rejected this suggestion and noted that using a 50,000 figure would lead to supervision of just 15 entities and 86% of the market. Under the Final Rule, the Bureau will supervise about 34 entities and their affiliated companies, which constitute approximately 91 percent of the activity in non-bank automobile financing.

Leasing

The Final Rule expands the definition of "financial product or service" for purposes of Title X of the Dodd-Frank Act to include certain automobile leases that are not already included in the definition of "financial product or service." This expansion means that these leases will qualify as "annual originations" for purposes of determining which entities meet the larger participant test. Although this provision of the Final Rule is unchanged from the proposed rule, the Bureau spends a great deal of space in the Supplementary Information section responding to comments received and explaining its reasoning.

"Functional Equivalents." The Bureau makes clear that it believes that most auto leases already are covered by the Dodd-Frank Act's definition of "financial product or service." In particular, the Act provides that the term "financial product or service" includes extending or brokering leases of personal property that are "the functional equivalent of purchase finance arrangements" and that meet other requirements (the leases must also be non-operating — *i.e.*, the consumer, not the lessor, is responsible for the vehicle's maintenance — and have a term of at least 90 days).⁵ The phrase "functional equivalent of purchase finance arrangement" is not defined in the Act, and the Bureau takes the position that it should be interpreted from the perspective of a consumer to include most

⁵ 12 U.S.C. § 5481(15)(A)(ii).

automobile leases, given that the leasing process is in many ways the same for consumers as the financed purchase of an automobile. For instance, both require making periodic payments over time, and the consumer is responsible for the upkeep of the vehicle. Consumers also often are able to purchase the vehicle at the end of a lease.

With respect to this view, commenters urged that the Bureau's interpretation is inconsistent with that of other regulators and other federal and state laws, and that functional equivalency requires transfer of ownership. The Bureau rejected these arguments, restating its belief that most auto leases are the functional equivalent of purchased finance arrangements, and that the phrase must be interpreted in light of the Bureau's "unique mission" of consumer protection. Thus, the Bureau argues, the Dodd-Frank Act already subjects most leases to the Bureau's jurisdiction.

Other "financial products and services." In order both to capture any other types of leases not already covered by the Dodd-Frank Act as "functional equivalents" and to make the larger participant rule more straightforward to administer, the CFPB in the Final Rule defines, for purposes of Title X of the Dodd-Frank Act, certain other leases as "financial products or services": (a) those leases that are full pay-out leases, where the lessor expects to realize the full cost of the vehicle and (b) net leases with a term of at least 90 days.

Commenters challenged that the Bureau failed to provide a proper record for promulgation of the expanded definition. In particular, they asserted that to add to the definition of "financial product or service," the CFPB must show that the proposed additional products or services (i) are permissible for banks to offer and (ii) have, or likely will have, a "material impact" on consumers.⁶ In response to these challenges, the Bureau reiterated that the leases to be covered may be offered by banks and have a "material impact" on consumers. On this latter point, the Bureau emphasized the growth in reliance on leasing and the fact that access to vehicles is of critical importance to consumers' financial well-being.

Commenters also argued that the Dodd-Frank Act already defined which leases are consumer financial products and services and that leases already are sufficiently regulated. In response to these arguments, the Bureau noted that the fact that Congress defined certain leases as financial products and services is not an indication that Congress intended to limit the CFPB's authority to define other leases – and that its authority is properly applied here, regardless of how

⁶ 12 U.S.C. § 5481(15)(A)(xi)(II).

many leases already are covered. Finally, the Bureau concluded that although there is existing regulation of leases, this framework best protects consumers when used in conjunction with the Bureau's authority.

Ultimately, the inclusion of certain leases in the proposed rule has an effect not just on which entities will reach the threshold to become supervised as larger participants, but also on the Bureau's other regulatory authority as well. For instance, these leases now will be subject to the Bureau's prohibition on unfair, deceptive and abusive acts and practices. The Bureau also will be permitted to prescribe rules with respect to these leases that affect disclosure obligations and access to information, as well as to monitor offering and servicing of these leases for risks to consumers.

As noted, the Final Rule as a whole is largely unchanged from the proposed rule. In addition to the clarifying change to asset-backed securitizations noted above, the Bureau made clear that refinancings must be secured by an automobile, and that "automobile financing" means both "providing" and "engaging in" the transactions identified. It also made a technical correction regarding aggregation of receipts for affiliated companies in the consumer reporting and consumer debt collection markets.

THE CFPB AUTO FINANCE EXAMINATION PROCEDURES

As described below, the Exam Procedures cover a number of areas within auto finance, including origination, advertising and marketing, collections, consumer complaints and servicing, as well as the assessment of an institution's compliance management system ("CMS"). The CFPB's Procedures will be applicable to banks and non-bank auto finance companies, and thus all Bureau-supervised institutions engaged in auto lending activities should consider these procedures in preparing for an auto finance examination. Supervised entities also should continue to review the Bureau's overall examination procedures, as certain substantive sections, such as fair lending, unfair, deceptive or abusive acts or practices ("UDAAP") or debt collection, will be used as a reference in any CMS or targeted examination.

Overview of the Exam Procedures

The Procedures describe the lenders subject to the Final Rule, which include those lenders engaged in indirect lending, direct lending, auto leasing and buy-here-pay-here financing. Based on the diverse business models of these lenders, the Procedures cover a number of consumer financial laws applicable to the auto finance market, including the Truth in Lending Act ("TILA"), the Electronic Fund Transfer Act ("EFTA"), the Fair Credit Reporting Act ("FCRA"), the Fair

Debt Collection Practices Act (“FDCPA”), the Equal Credit Opportunity Act (“ECOA”), the Gramm-Leach-Bliley Act (“GLBA”), the Servicemembers Civil Relief Act (“SCRA”), the Consumer Leasing Act and the Dodd-Frank Act’s prohibition on UDAAPs. This broad coverage demonstrates that the CFPB plans comprehensive supervision of the auto finance industry in a manner that resembles its supervision of the mortgage industry.

Requested Information. The Procedures indicate that the CFPB will request a significant amount of information from auto finance institutions they examine. As with other product-focused procedures, the CFPB will ask for CMS-related information, such as materials related to the business’s organization structure, board minutes, annual reports, policies and procedures, audit and compliance reports, training programs, advertisements and consumer complaints.

However, the CFPB also has included a list of reviewable items directly applicable to auto finance companies. These items include: compensation policies; structure and bonus programs for employees and dealers; rate and fee sheets; loan and lease applications and other documentation; dealer agreements; underwriting guidelines and servicing-related policies and procedures (including payment posting and allocation). Lenders also should expect CFPB examiners to interview management, staff and customers to the extent necessary or to further investigate any areas identified as potential concerns. Furthermore, depending on the scope and type of exam, lenders may be required to supply data necessary for examiners to perform transaction testing — either through the use of a judgmental or statistical sample.

While the Procedures do not specifically reference fair lending disparate impact analysis, lenders should expect the CFPB to request similar information as during a fair lending targeted examination, as well as considerable data to assess an institution’s compliance with ECOA. Such a data request will likely be separate from any transaction testing conducted by examiners on-site, as the Bureau will conduct its disparate impact analysis off-site with the assistance from the CFPB’s Office of Research.

Areas of Exam Focus

In addition to the areas listed above, the CFPB Procedures spend a considerable amount of time discussing three particular areas: ancillary products, use of service providers and certain collection practices. The CFPB has scrutinized each of these issues in other contexts, and their inclusion in the Procedures signals that auto finance companies are likely to face regulatory oversight similar to that of other types of firms.

Optional Products. The CFPB identifies three particular types of ancillary products that may pose a concern: guaranteed asset protection insurance; extended warranty and vehicle add-ons (including lo-jack systems, vehicle identification number etching and paint protection). In addition, the CFPB will review add-on products, such as payment protection, credit protection, debt cancellation or debt suspension products.

The Procedures instruct examiners to evaluate consumer-facing communications and materials related to the financing of ancillary or add-on products. Further, for those firms that offer or finance add-on products or services, the CFPB will review whether the firm uses a service provider and how it monitors those optional products offered and administered by the third-party. Other areas of review will include whether the consumer has explicitly authorized the purchase of optional products, which has been the subject of enforcement actions related to credit card ancillary products and whether a consumer's request for cancellation of the optional products is processed in a timely manner.

The CFPB's concerns with these products appear to be similar to those identified in its 2012 Bulletin on credit card add-on products.⁷ In particular, the CFPB's Procedures indicate that a primary concern is the manner in which these products are marketed and serviced with respect to consumers. Thus, in preparing for a CFPB examination, a lender should focus on whether its marketing and servicing of such optional products may lead to any potential UDAAPs or other consumer-facing concerns.

Service Providers. The Procedures also address the use of third-party service providers by auto finance companies. Auto finance companies likely will have to take similar steps to those outlined in the Bureau's April 2012 Bulletin on service provider oversight⁸ to review service provider policies, procedures, internal controls and training materials to assess compliance with federal consumer financial laws. In particular, the Procedures place significant emphasis on the type of due diligence and monitoring the entity takes with respect to the service providers it uses.

Firms are expected to review the debt collection practices of their third-party service providers, including the conduct of service providers with respect to repossession of a customer's vehicle. In addition, institutions should consider the

⁷ CFPB, Bulletin 2012-06, *Marketing of Credit Card Add-on Products* (July 18, 2012).

⁸ CFPB, Bulletin 2012-03, *Service Providers* (Apr. 13, 2012).

ways in which affiliates, such as an affiliate engaged in vehicle manufacturing, may be viewed as third-party service providers, particularly in cases where the affiliate engages in marketing or advertising on behalf of the supervised affiliate.

Collection, Repossession and Bankruptcy. The Procedures discuss in considerable detail the areas examiners should focus on with respect to customers in default or bankruptcy, and those whose vehicles have been repossessed or are in the process of repossession. Each of these issues has been under much scrutiny by state regulators and the press, particularly as the subprime auto loan industry continues to grow. Through examination procedures that focus on these activities, the CFPB appears to be taking a close look at how auto lenders treat borrowers in distress, including whether they provide opportunities for such borrowers to work out alternative solutions.

In reviewing these practices, CFPB examiners will determine whether a servicer permits debt restructuring to borrowers in default or at risk of default, including through forbearance, alternative repayment plans or loan modifications. Further, the CFPB will review policies and procedures with respect to repossessions, and the use of payment assurance devices, which may limit the ability for the consumer to start a vehicle if a payment is past due. As noted above, firms not only will have to take the additional step of reviewing their policies and procedures with respect to borrowers in distress, but likely also will have to review those of their service providers or dealers that directly interact with consumers in default or delinquency.

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Please do not hesitate to contact us with any questions.