CONSUMER FINANCE PODCAST: CFPB-NEW YORK AG LAWSUIT ANALYSES AGAINST SUBPRIME AUTO FINANCER
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Chris Willis:

Welcome to the Consumer Finance Podcast. I'm Chris Willis, the co-leader of Troutman Pepper's Consumer Financial Services Regulatory Practice. And today, I'm going to be sharing my thoughts about a recent and very aggressive lawsuit filed by the CFPB and the New York Attorney General in the subprime auto finance industry. But before I start talking about that, let me remind you to visit and subscribe to our blog at consumerfinancialserviceslawmonitor.com, where you can see all of our daily updates about everything happening in the world of consumer finance. And check out our other podcasts. We have the *FCRA Focus* all about credit reporting, *The Crypto Exchange* about all things crypto, and our privacy and data security podcast called *Unauthorized Access*. All of those are available on all the popular podcast platforms. And if you like this podcast, let us know. Leave us a review on your podcast platform of choice, and let us know how we're doing.

Now, as I said, today I'm going to be talking about a very unprecedented and unusual lawsuit filed jointly by the Consumer Financial Protection Bureau and the New York Attorney General recently against a subprime auto finance company. And I wanted to talk about the very unusual claims that were made in that case, what I think some of the flaws in the legal theories being asserted are, and what the potential implications are for the rest of the auto finance industry, especially the subprime part of the auto finance industry, because here we have the regulators taking really unprecedented positions in a lawsuit that could potentially be big news for the rest of the industry. So let's talk for a second about each of the claims that's been asserted by these two regulators together and what they might mean for the rest of the industry.

There are three basic claims that are asserted in the lawsuit. First, the regulators allege that there was a practice of the auto dealers inflating the purchase price of the automobiles that were then financed by this company. And that because of that practice as well as the allegation that the finance company used a dealer discount model, which I'll explain in just a second, that there were hidden finance charges in the transactions. That is a disguised cost of financing that wasn't reflected in the interest rate. And the CFPB asserts that's a UDAP violation, and the New York Attorney General asserts it's a violation of the New York Usury Law. Interestingly, even though the case is all about alleged finance charge disclosures, the CFPB doesn't cite or even mention the Truth in Lending Act as part of its complaint, and there's a reason for that. The reason is that the idea of a dealer discount, which is alleged in this complaint and which is a practice that occurs in various places in the consumer finance industry, is one that is very closely analogous to something that is specified in Regulation Z as not being a finance charge.

If you look at the section of Reg Z that defines what is and what isn't a finance charge, there's a provision called seller's points that says that if there is a charge levied on a non-creditor merchant or seller of goods or services by the lender, that is not part of the finance charge. And the official commentary to Reg Z says that it's not a finance charge even if that amount is then passed onto the consumer as part of an increased sale price of whatever it is that's being sold. Now, that provision doesn't directly apply to indirect auto finance because the dealer is the originator of the retail installment contract. So it's not a non-creditor seller, but nevertheless, you have an incredibly closely analogous provision in Reg Z that flat out says, "This is not a finance charge." And the complaint doesn't even mention, let alone try to distinguish this aspect of the Truth in Lending Act that's been in the regulation for, I believe, a very long time.

And so the idea here that underlies this claim of a hidden finance charge is unprecedented and frankly contrary to our understanding of the established law, as I've mentioned it in the Truth in Lending Act, but also unprecedented because it seeks to hold a finance company liable for the pricing behavior that is the price of selling automobiles of completely unrelated and unaffiliated dealers. And that to me, when I first read the complaint, seemed like an incredible stretch. And the regulators try to get around that by alleging that there was encouragement or facilitation by the finance company that caused the dealers to be able to or to increase the sale price of the vehicles. But at the end of the day, there's only one party that's in charge of the pricing of the vehicle, and it's the auto dealers, the ones who are completely exempt from the CFPB'S authority under Dodd-Frank and who are very much independent actors from any financing source in the automotive industry.

And so it struck me as an incredible stretch to make this hidden finance charge claim, ignoring the Truth in Lending Act, and not even citing it into the complaint, but then trying to hold a finance company liable for the pricing decisions of independent dealers. We'll talk in a minute about what the implications of that might be for the rest of the industry. But first, let me talk about the other claims that are asserted in this complaint by the two regulators. The second allegation that's made is that there was an inadequate analysis of the applicant's ability to repay. And in this respect, the allegations made by the two regulators in this case follow a pattern that we've seen in the subprime auto finance industry from several state attorney general enforcement actions over the last few years. There have been a number of these from the Massachusetts Attorney General, and then in the spring of 2020, there was a 34-state attorney general settlement with a large subprime auto finance company all predicated on this idea of ability to repay.

The idea was that there were certain applicants among the customer base who were predicted to be not that likely to repay the amount financed or the full amount of the loan, and that it's a UDAP violation to make credit available to those people because they will inevitably default, suffer negative credit reporting, incur fees, lose their car, et cetera. Now, the thing about this theory, and this I think is the very first time that the CFPB has adopted this theory in the context of auto finance, is that it ignores the fact that the subprime market needs transportation. People need a car to go to work, to take their kids to school, to just live in this country, and making credit available to buy cars facilitates that incredibly important social objective. And even if you have a model that suggests that someone is riskier from the standpoint of their potential to default on a credit obligation, you don't know which of the population is going to default and which is going to perform perfectly fine.

The cost of making a UDAP claim that says if someone is too risky, you may not approve them, is to cut off access of credit, not only for those that would have defaulted, but also those who wouldn't have defaulted. And therefore, to draw just a big line across the country and say, "Anybody who's below this line cannot buy a car." That seems to me to be an incredibly socially undesirable result. And of course, the very definition of unfair under the CFPB'S UDAP statute requires the court to consider countervailing benefits to consumers, which I don't feel like the CFPB did very much in connection with bringing this case or making these allegations. But this is a litigated case. It's not a consent order. And so the party that's been targeted by these allegations will have every opportunity to showcase to the court how socially destructive and what a mistake from a policy standpoint, a claim based on ability to repay of this nature would be because it would simply cut off credit availability to a segment of the population that needs it the most.

Again, we'll talk about implications in just a minute, but this is another theory that has been brewing for a while at the state level and now has been adopted by the CFPB, but that I think has profoundly negative effects on the availability of credit to people who need it. Now, the final claim that's asserted here, and again, this is another first for the CFPB, has to do with the sale of optional products. And the allegations in the complaint are that this finance company has its own optional products, and the assertion by the two regulators is that there are incentives for dealers to sell those products and that, consequently because of that, there's a very high rate of adoption of those products by customers whose auto purchases are financed by this company. And so the CFPB and the New York Attorney General essentially alleged that these optional products are being forced on consumers who don't really want them, and that consumers are being told essentially that they are mandatory products and that they're not supposed to be. That's the basic theory of the complaint.

Now, of course, this is also a very novel claim by the CFPB for a couple of reasons. We haven't ever seen the CFPB take the position that dealer sales practices with respect to optional products are subject to its enforcement power. This is the first time it's done so because, remember, dealers are wholly exempt from the CFPB's authority under an exemption in Dodd-Frank that's been there since the statute was passed. But like this hidden finance charge claim that I talked about a moment ago, this claim relies solely on the idea that the finance company can be held liable for the behavior of dealers in the manner in which they interact with customers with the finance company not present, and not part of the conversation at all, at the point of sale of the automobile in the dealership and in the finance office of the dealership where these contracts end up getting signed and consumers make the election to buy or not buy these products.

The point is, this is directly trying to make finance companies liable for dealer behavior as the hidden finance charge claim is, but now in the context of optional products, and it's the first time that the CFPB has ever taken such a position. So what we have here is a collection of very aggressive claims, unprecedented claims that represent significant stretches in terms of the legal and factual theories being asserted. And of course, as I said, this is a complaint. None of it has been proven yet, and the defendant will surely have the opportunity to present its side of the case over the time that the case is litigated. So we don't know obviously how it's going to come out, but we'll be watching it closely. But I think the question that we have to ask ourselves now is, what does this mean for the rest of the industry?

And the thing is, you could look at the complaint and read the various factual allegations that are there, and be of the opinion that perhaps this is a situation where the claims being asserted by the regulators were motivated by what they perceived as the specific set of facts that they believe to exist with this particular company, and that this is really kind of a one-off aberration that doesn't really have much to do with the rest of the auto finance industry, especially the subprime auto finance industry. On the other hand, we don't know that that's the case, and we might worry, for example, that the CFPB intends to take the position that dealer discounts are always hidden finance charges, or that any credit scoring model that has gradations of applicants, some of whom are more likely to default and some of whom are less, can be used as the basis for a UDAP violation anytime a creditor extends credit to anybody except the absolute most likely to repay segment of a particular consumer population.

And obviously if the CFPB were to adopt those provisions, then the damage to the credit markets in the United States would be even greater because it would cut off even more credit availability to even more people, and it would be something that would be even more unprecedented and I think incorrect in terms of an interpretation of the prevailing laws, even for a law that is so elastic and malleable as the Dodd-Frank UDAP provision. And of course, at this point, we don't know how the litigation's going to come out, and we don't know whether these theories will be generalized to the rest of the industry, but I think industry participants need to be thinking about what their defensive position would be if the CFPB or another regulator came to them with these theories. And I think there are lots of arguments to be made in favor of the industry and perhaps particular industry participants in connection with these issues.

But the point of the podcast is really to let everyone know that this is a possibility and we need to be prepared for it. And of course, we're going to be watching this case carefully along with the rest of the industry. And if anything significant happens in connection with it, we'll of course be reporting on it and paying attention to it to advise the rest of the industry. I think the closing thought here is let's watch this case. Let's hope that the CFPB's overreach is corrected through the litigation process here, and let's also hope that the CFPB and the New York Attorney General view this as a special circumstance and not legal theories that are sort of blanket applicable to the rest of the consumer credit world, because that would be a very significant negative development both for the industry and for the availability of credit throughout the United States.

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