

# CFPB's Proposed Rule Defining Larger Participants in a Market for Auto Finance



September 2014

## Who could be a “larger participant” and how should they prepare for CFPB supervision?

### Overview

As the Consumer Financial Protection Bureau (CFPB or Bureau) prepares to release its regulation for “larger” auto finance participants, one thing is certain: the auto finance industry will soon be subject to greater regulatory scrutiny than ever before. But many questions remain — including which entities will be covered under the new rule, and what the specifics will be regarding examiners’ expectations.

***The CFPB has direct supervisory authority over large depository institutions and participants in markets for residential mortgages, private education lending loans, and payday lending. It also has direct supervisory authority over other larger participants in markets for consumer financial products and services that it identifies in an agency rule. To date, the CFPB has issued rules covering larger participants related to consumer reporting bureaus, consumer debt collectors, and student loan servicers, and has proposed a rule to define larger participants in the market for international money transfers.<sup>1</sup>***

According to the Bureau’s Spring 2014 Semi-Annual Regulatory Agenda, released February 28, 2014, “the CFPB is developing a proposed rule that would identify a market for auto lending and define “larger participants” of that market that would be subject to the CFPB’s supervisory authority.”<sup>2</sup>

The proposed rule would expand the CFPB’s supervisory authority in the area of auto lending beyond the larger banks to encompass the larger non-bank auto lenders and provide more complete oversight over the lender side of this marketplace. But the CFPB also recognizes that, while its authority generally reaches auto lenders, it does not extend to auto dealers.<sup>3</sup> The Semi-Annual Regulatory Agenda originally projected that the CFPB would issue the proposed larger participant rule in August 2014.

### Questions remain

How will the proposed rule impact auto lenders? Below, we explore three key questions that, when answered, will help industry participants prepare for increased oversight:

#### **1) Who could be considered a larger participant?**

Because this will not be the CFPB’s first larger participant rule, we can look to prior CFPB rulemakings for insight into how the CFPB might draw the lines of defining which auto lenders will be considered larger participants. For example, prior rulemaking suggests that the CFPB will look at measures of market share and

<sup>1</sup> Regulations. Consumer Financial Protection Bureau.

<sup>2</sup> Agency Rule List – Spring 2014. Consumer Financial Protection Bureau.

<sup>3</sup> Prepared Remarks of CFPB Deputy Director Steven Antonakes at the Consumer Bankers Association. April 2, 2014; Dodd-Frank Act § 1029 (“the Bureau may not exercise any rulemaking, supervisory, enforcement or any other authority, including any authority to order assessments, over a motor vehicle dealer that is predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both.”).

***“Another difficult area where we are working to mitigate harm to consumers and level the playing field is indirect auto lending. For some time now, we have expressed concern that discretionary pricing in auto finance, coupled with financial incentives to mark up interest rates—practices that are akin to the now-banned yield spread premiums in the mortgage market—create serious risks... [W]e will be moving forward with a proposal to expand our supervisory authority in this area beyond the larger banks to encompass the larger non-bank auto lenders also, providing more complete oversight over the lender side of this marketplace.”<sup>4</sup>***

***– CFPB Deputy Director Steven Antonakas***

numbers of consumers affected, and it will also likely look for natural “breaking points” in entity sizes to make it clear who does and doesn’t qualify.

In the case of auto lending, we expect the CFPB may consider annual lending dollar volume or number of loans, and that the definition will, at a minimum, cover those non-banks included in the 20 largest-volume lenders.

## **2) What could it mean to be a larger participant?**

To get an idea of what the expectations will be for an auto lending entity that’s deemed a larger participant, it’s helpful to examine historical trends. The CFPB’s supervision of non-banks in other markets with larger participant rules and its supervision of the auto lending operations of banks are good places to look for insight.

To date, all examinations of auto lending operations have been based on the CFPB’s general Supervision and Examination Manual, as no specific auto lending examination procedures have been issued. The manual cites specific examples of fair lending, truth in lending, and fair credit reporting standards for auto loans,<sup>5</sup> and this largely mirrors the CFPB’s overall regulatory focus when reviewing auto lending operations. Fair lending and “unfair, deceptive, or abusive acts or practices” (UDAAP), in particular, have appeared to be among the primary areas of focus.

Nearly every CFPB examination or targeted review also includes an assessment of the entity’s compliance management system (CMS). Unfortunately, the CFPB’s 2013 Supervisory Highlights indicate that “the CFPB has found, through supervisory work, that non-banks are more likely to lack a robust compliance management system.”<sup>6</sup> This means that many entities classified as larger participants may have to make changes to their compliance management systems to meet the CFPB’s expectations. In addition, many companies will likely need to examine and modify their operational policies and procedures, tighten vendor controls, and prepare the organization for regulatory exams.

## **3) How long could larger participants have to get ready?**

Historically, the CFPB has given participants only a 60-day implementation period once the final rule is issued. For this reason, we suggest companies don’t wait until the final rule is issued to start preparing. Even if an organization begins planning when the proposed rule is issued (vs. the final rule), it will have approximately only one year to prepare.<sup>7</sup> For a company that may need to upgrade its compliance management system and prepare for CFPB examinations, this is a relatively short time frame.

<sup>4</sup> Prepared remarks of CFPB Deputy Director Steven Antonakas at the Consumer Bankers Association, April 2, 2014.

<sup>5</sup> Supervision and Examination Manual – Version 2.0. Consumer Financial Protection Bureau. October 31, 2012.

<sup>6</sup> Supervisory Highlights: Summer 2013. Consumer Financial Protection Bureau.

<sup>7</sup> The larger participant rule for student loan servicing was proposed March 28, 2013; was published as a final rule December 6, 2013; and became effective March 1, 2014. The larger participant rule for debt collectors was proposed February 17, 2012; was published as a final rule October 31, 2012; and became effective January 2, 2013. The larger participant rule for credit reporting bureaus was published February 17, 2012; was published as a final rule July 20, 2012; and became effective September 30, 2012. The larger participant rule for international money transferors was proposed January 31, 2014 and a final rule is expected in September 2014, according to the Spring 2014 Semi-Annual Regulatory Agenda.

## A deeper look

### How the CFPB could determine larger participants

#### The principles

The CFPB has historically applied three principles that govern both the definition of covered activities and the numeric threshold when determining which lenders are larger participants. These principles look to:

- Appropriately represent a lender's participation in the market
- Appropriately represent a lender's overall impact on consumers
- Be sufficiently clear so that the rule is easy to apply

#### Thresholds

Based on our review of prior rules, the CFPB appears to have historically considered the following data points when setting larger participant thresholds:

- Market share coverage: Previous rules have generally included the majority of market participants, ranging from 60% to 95% market coverage.
- Number of consumers impacted: Previous rules have generally deemed larger participants to be those entities that affect at least one million customers per year (based on whichever activities are covered for that specific market, such as loan servicing).
- Number of entities requiring supervision: The CFPB will look for natural "breaking points" by considering how many companies will be covered by the above thresholds, and determining if the cost of supervision will outweigh the benefits of coverage.

### What could this look like for auto finance?

#### Which activities could be counted against the threshold?

The first step in establishing the larger participant threshold is to determine what "covered activities" count toward that threshold. The vast majority of automotive originations are acquired indirectly through relationships with auto dealers, and these will likely be included as covered

activities. However, other origination activity that could be considered a "covered activity" may include direct consumer originations, title loans, refinancings, or originations through flow agreements with other financial institutions such as local credit unions.

#### Who might be considered a larger participant?

Applying the CFPB's prior criteria for market share, number of consumers impacted, and number of entities requiring supervision to the auto lending market is challenging because the thresholds the CFPB has previously used for each metric overlap in the auto lending sector. For example, a grouping of the top 20 overall auto lenders by origination volume would represent about 44% of the total market,<sup>8</sup> which is less than the coverage historically achieved under other larger participant rules. However, a grouping of the same top 20 lenders would also include institutions that fall below the 1 million consumer impact threshold that the CFPB has applied in other larger participant rules.<sup>9</sup> It seems the CFPB will be forced to strike a new balance between these factors. At a minimum, we believe that the larger participant rule will include at least the largest captives that are in the top 20 overall lenders, but it's hard to predict the extent to which it will also include smaller captive lenders and finance companies.

### How could larger participants be impacted?

#### Examinations

Larger participants will be subject to direct CFPB supervision as of the effective date of the final rule. Supervision may involve requests for information or records, on-site or off-site examinations, targeted reviews, and other supervisory activities. This supervision is focused on compliance with federal consumer financial law, including Title X of the Dodd-Frank Act, which prohibits unfair, deceptive, or abusive acts and practices in connection with consumer financial products and services, "enumerated consumer laws," and the implementing regulations.<sup>10</sup>

Examinations can be in-depth and tend to extend beyond simple file reviews and documentation requests. CFPB examinations focus not only on compliance with specific regulatory requirements, but also on the structures,

<sup>8</sup> Experian Automotive's State of the Automotive Finance Market, Q1 2014.

<sup>9</sup> Calculation based on application of Experian market share data to 70 million total outstanding auto loans in Q1 2014 or ~23 million annualized originations based on Q4 2013 data. TransUnion: Rising Auto Loan Debt Trend Reaches Three-Year Mark; Delinquencies Continue to Remain Low. Market Wire. May 19, 2014. Avention.

<sup>10</sup> Supervision and Examination Manual – Version 2.0. Consumer Financial Protection Bureau. October 31, 2012.

processes, and capacity of the entity to maintain compliance. That is, the CFPB focuses on each entity's compliance management system.

### *What if I'm already supervised by the CFPB?*

*Simply put, nothing changes.*

*The Bureau's supervisory authority is not limited to the products or services that qualified an entity for supervision.*

*Lenders that are already supervised by the CFPB will not have any incremental supervisory requirements, even if they exceed the threshold of the larger participant rule. This is because their auto origination and servicing operations are already within the scope of CFPB direct supervision and examination.*

A CMS consists of (1) board and senior management oversight; (2) compliance program components (e.g., compliance officer, policies and procedures, training, and monitoring and testing); (3) consumer complaints management; and (4) independent compliance audits.

As an additional consideration, the CFPB's Summer 2013 Supervisory Highlights report also notes that compliance responsibilities include not only the entity itself but also its service providers. Third-party risk management is a crucial component of an effective CMS.

Historically, non-banks have fallen short of the Bureau's CMS expectations. In the Summer 2013 Supervisory Highlights, for example, the CFPB indicated that it found many non-banks are:

- **Missing a comprehensive consumer compliance program.** CMS deficiencies noted in non-banks are generally related to the supervised entity's lacking an overarching CMS structure.

- **Lacking formal policies and procedures.** Lack of formal documentation can lead to inconsistent application of regulatory standards, which can expose consumers to potential harm (e.g., if consumers don't receive the appropriate disclosures).
- **Foregoing independent consumer compliance audits.** Without independent compliance audits, it's difficult to recognize any significant deficiencies in an institution's compliance management system.<sup>11</sup>

### **Increased emphasis on unfair, deceptive, or abusive acts or practices**

CFPB supervision and examination also focuses on identifying possible unfair, deceptive, or abusive acts or practices (UDAAP),<sup>12</sup> which is the CFPB's regulatory Swiss Army knife. That is, the CFPB can apply UDAAP to find that acts or practices are violations of law, even where they do not violate any technical requirements specified in other laws or regulations.

*CFPB supervision and examination also focuses on identifying possible unfair, deceptive, or abusive acts or practices (UDAAP).*

The “**unfair**” component of UDAAP focuses on the risk of consumer harm, and it prohibits any act or practice: (1) that causes or is likely to cause substantial injury to consumers; (2) where the consumer cannot reasonably avoid the injury; and (3) where the risk of injury is not outweighed by countervailing benefits to consumers or to competition.<sup>13</sup> UDAAP risk under this element can arise from a variety of operations or operational failures that result in consumer harm, again regardless of whether the harm is intentional.

A “**deceptive**” act or practice is any representation, omission, act, or practice: (1) that misleads or is likely to mislead the consumer; (2) where the customer's reliance was reasonable; and (3) where the misleading representation, omission, act, or practice was material.<sup>14</sup> UDAAP risk under this element can arise from any customer communication or customer-facing activity, regardless of whether the misrepresentation or omission was intentional.

11 Supervisory Highlights: Summer 2013. Consumer Financial Protection Bureau.

12 See Dodd-Frank Act, §§ 1031, 1036.

13 See Dodd-Frank Act, § 1031(d); see also CFPB Examination Manual, UDAAP 1-5 (version 2, Oct. 2012).

14 See Dodd-Frank Act, § 1031(c); see also CFPB Examination Manual, UDAAP 5-8.

Finally, the “**abusive**” standard prohibits any act or practice in connection with a consumer financial transaction that: (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service, or (2) takes unreasonable advantage of consumers.<sup>15</sup> The CFPB’s Risk Assessment tool suggests that targeting a product or service, perhaps an extended warranty or GAP product in certain circumstances, to certain types of vulnerable populations, and particularly the targeting of multiple categories of such populations, “may be of particular concern.”<sup>16</sup>

### **All consumer financial activities become subject to CFPB supervision**

Larger participants’ broader activities also become subject to supervision. For example, a lender that is subject to direct CFPB supervision under the automotive finance larger participant rule is also subject to direct CFPB supervision in all of its other activities involving consumer financial products and services, such as lending or servicing activities in the marine, recreational vehicle (RV), or unsecured credit card industries. For this reason, larger participants need to be sure that their compliance management system for federal consumer financial laws is well-controlled across all asset classes, products, and services.

### **How frequently could lenders be examined and what will it cost?**

Although the Bureau offers limited guidance into examination scheduling, it prioritizes supervisory activity based on risk, taking into account factors such as “the size of each entity, the volume of its transactions involving consumer financial products or services, the size and risk presented by the product market in which it is a participant, the extent of relevant State oversight, and any [complaints or other] information that the Bureau has on the entity.”<sup>17</sup> Based on the CFPB’s estimates used to calculate the cost of supervision in previous larger participant rules, the largest participants can expect to be reviewed every other year. For example, the Debt Collection Final Rule projected that the 16 largest participants would be reviewed every other year, while other larger participants may expect to be reviewed,

on average, up to once every five years.<sup>18</sup> However, in some cases targeted exams may be initiated more frequently and individual entities may be simultaneously subject to multiple exams.

Lenders may incur significant costs in order to effectively prepare for and respond to examination requests. The cost of an examination is not limited to the cost incurred during the exam itself, due to the high level of documentation gathering and exam preparation required. This is especially true for lenders without a robust CMS. Additionally, lenders should keep in mind that examinations can be just the tip of the iceberg when it comes to costs, as any findings that require remediation and restitution are likely to be far more costly. With this in mind, lenders should consider developing a formal exam management function, as well as a robust CMS to help identify, assess, control, monitor, and report on compliance risks. Although the costs of developing these functions may be significant, the potential savings from the ability to demonstrate compliance and avoid significant examination findings can be sufficient.

In the end, the exact impact for auto lenders will likely vary greatly, depending on their individual size and risk profiles.

### **What about industry participants that are not considered larger participants?**

Although smaller entities that do not qualify as larger participants will not become subject to supervision, it’s important to recognize that all entities are expected to comply with consumer financial law, regardless of their covered status. The CFPB’s ability to supervise industry participants is likely to provide information to the broader marketplace with regard to consumer protection concerns, and could lead to increased scrutiny regardless of whether an entity is considered a larger participant. While non-larger participants will not be supervised, they remain subject to potential CFPB enforcement actions and should maintain sufficient compliance structures, processes, and controls to ensure compliance with consumer financial laws, and carefully monitor any findings from CFPB examinations as potential leading indicators of increased industry scrutiny.

15 Dodd-Frank Act, § 1031(e). Includes taking unreasonable advantage of (a) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service; (b) the inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or (c) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer. See also CFPB Examination Manual, UDAAP 9-10.

16 See CFPB Supervision and Examination Manual, Risk Assessment Template, p. 5 (listing the following populations: Students or young adults; Elderly; Minorities; Immigrants; Consumers of certain national origins; Members of specific religious groups or denominations; Military service members or former service members; Consumers with limited education; Consumers with limited English proficiency; Low-income consumers or consumers on limited fixed incomes; Consumers receiving any type of public assistance; Consumers with limited experience with financial products or services; Consumers in or who have recently experienced financial distress; Consumers with low credit scores (e.g., FICO below 620); or Consumers of a certain gender or marital status). While these populations may not necessarily be vulnerable to abuse, the list provides some insight into the CFPB’s views on risks to consumers.

17 See final rule: Defining larger participants of the Student Loan Servicing Market, 78 FR 73383, 73402 (Dec. 6, 2013) (Final Student Loan Servicing Rule).

18 See final rule: Defining larger participants of the Consumer Debt Collection Market, 77 FR 65775, 65794 (Oct. 31, 2012).



## What can you do to prepare?

### Responding to the proposed rule

Consider submitting a comment letter or working with a trade association or other industry partners to craft a response. The CFPB has shown in its previous larger participant rules that it is open to incorporating industry feedback, particularly if it's factual and operational. By participating in the comment period, companies may be able to help inform the CFPB's thinking as it determines what, if any, changes it makes in the final rule.

Lenders should expect to remain involved in the Bureau's rulemaking efforts over the long-term. Customarily, rulemaking efforts are targeted to address the more common, widely publicized issues that broadly impact consumers. As the Bureau's understanding of auto finance expands, however, supplemental guidance may be proposed and lenders will have to make sure it is promptly integrated into their compliance risk framework.

### Preparing for supervision – begin now

The CFPB's consumer financial protection regulations apply to auto lenders, regardless of whether they're subject to direct CFPB supervision. Therefore, the Bureau expects new larger participants to already be in compliance with the applicable federal consumer financial laws.<sup>19</sup> Consistent with that expectation, the most recent larger participant rules provided about 60 days from final rule to effective date.<sup>20</sup> Lenders should begin preparing now — before the final rule is issued; the entire process from proposed rule to effective date generally has taken less than a full year.<sup>21</sup>

#### *Prepare your CMS*

With the CFPB emphasis on examining an entity's CMS, it will be important for organizations likely to be designated as larger participants to start assessing the adequacy (or existence) of their CMS. Generally speaking, a CMS is how a supervised entity: (1) establishes its compliance responsibilities; (2) communicates those responsibilities to its employees; (3) incorporates the responsibilities for meeting requirements into business processes; (4) reviews operations to be certain responsibilities are carried out and legal requirements are met; and (5) takes corrective action and updates tools, systems, and materials as necessary. The next page depicts key CMS elements.

A key question auto lenders should ask is whether their CMS includes all the necessary components. For example, does it include a process for managing and responding to complaints (including conducting root-cause analysis)? Is it an integrated system, or is it fragmented? Is it supported by a comprehensive inventory of laws and regulations? Is there a robust monitoring and testing program? Does the internal audit department conduct compliance audits with sufficient frequency?

#### *Examine policies and procedures*

Auto lenders also should plan to update policy and procedure documentation and accurately depict the activities carried out by the institution's employees. Make sure to:

- Include applicable federal consumer protection regulations in policy and procedure documentation
- Integrate ongoing compliance training and monitoring programs into the organization for consistent interpretation by management and staff

#### *Include vendor oversight*

Lenders should enhance their oversight of and assume accountability for third-party relationships, especially those third parties that have direct contact with consumers. Vendors, especially those that conduct "higher-risk" activities such as collections and repossessions, and entities with access to customer data should be held to the same standard and review frequency as in-house functions. Begin with developing a vendor risk assessment framework in order to conduct an inventory of higher-risk vendors, and ensure your vendor onboarding conforms to that framework. Then, implement a comprehensive, ongoing due diligence and monitoring oversight program which prioritizes those higher-risk entities. Also consider creating a consumer feedback loop, contingency planning, and corrective action process to enable the immediate termination of unsatisfactory relationships.

#### *Conduct practice exams*

Finally, prospective larger participants may find it helpful to conduct a mock examination as part of their CFPB-readiness transition. This exercise can help prepare for supervision and identify deficiencies that can be remediated before supervision begins.

<sup>19</sup> Defining larger participants of the Consumer Reporting Market, 77 FR 42873, 42876, July 20, 2012.

<sup>20</sup> See final rule: Defining larger participants of the Student Loan Servicing Market, 78 FR 73383, 73402 (Dec. 6, 2013) (Final Student Loan Servicing Rule).

<sup>21</sup> The larger participant rule for student loan servicing was proposed March 28, 2013; was published as a final rule December 6, 2013; and became effective March 1, 2014. The larger participant rule for debt collectors was proposed February 17, 2012; was published as a final rule October 31, 2012; and became effective January 2, 2013. The larger participant rule for credit reporting bureaus was published February 17, 2012; was published as a final rule July 20, 2012; and became effective September 30, 2012. The larger participant rule for international money transferors was proposed January 31, 2014 and a final rule is expected in September 2014, according to the Spring 2014 Semi-Annual Regulatory Agenda.

## Compliance management system elements

Board & senior management oversight responsibilities	Compliance program components	Consumer complaints data mining and management	Independent compliance testing
<p>Ultimately responsible for:</p> <ul style="list-style-type: none"> <li>Developing &amp; administering a compliance management system</li> <li>Communicating clear expectations to employees &amp; third-party service providers</li> <li>Allocating resources commensurate with firm's size and complexity</li> </ul>	<ul style="list-style-type: none"> <li>Experienced &amp; qualified chief compliance officer</li> <li>Formal, written policies &amp; procedures</li> <li>Training</li> <li>Risk assessment</li> <li>Monitoring &amp; corrective action</li> </ul>	<ul style="list-style-type: none"> <li>Recorded &amp; categorized</li> <li>Addressed &amp; resolved promptly</li> <li>Escalate matters triggering legal issues, e.g., UDAAP</li> <li>Reporting &amp; analysis</li> <li>Evidence of corrective action</li> </ul>	<ul style="list-style-type: none"> <li>Independent of compliance function &amp; consumer-related business unit(s)</li> <li>Reports to board</li> <li>Reviews compliance with internal policies and external regulations</li> </ul>

## How can PwC help?

Any auto lender that could be considered a larger participant subject to CFPB supervision would benefit from the assistance of someone who both understands their business and understands the culture and expectations of supervision, particularly CFPB supervision. PwC can provide perspective and insight regarding examinations, and can help determine if your current CMS and overall compliance program are sufficiently mature and ready for the increased scrutiny.

We've helped many entities prepare for supervision and work through adverse regulatory events. Through our deep experience helping industry leaders, PwC can:

- Assist clients with CFPB examination readiness, including conducting practice exams
- Evaluate companies' compliance management systems and help them address weaknesses to meet regulatory expectations

- Help clients structure and enhance third-party risk management programs
- Help lenders develop fair lending statistical models and develop dealer monitoring programs
- Conduct independent third-party statistical analysis and other reviews to determine current fair lending risks and the state of fair lending controls
- Help banks and captives comply with new and changing regulatory requirements and increasing supervisory expectations
- Assist in-house counsel and compliance officers as they manage adverse regulatory actions

Contact any of the leaders below to discuss a range of options specific to your institution's needs.

**[www.pwc.com/consumerfinance](http://www.pwc.com/consumerfinance)**

**[www.pwcfinancialservices.com/regulatory](http://www.pwcfinancialservices.com/regulatory)**

### PwC Consumer Finance Group

<b>Peter Pollini</b> <i>Principal</i>	peter.c.pollini@us.pwc.com 207 450 9036
<b>Martin Touhey</b> <i>Principal</i>	martin.e.touhey@us.pwc.com 206 790 8751
<b>Doug Ekizian</b> <i>Senior Manager</i>	douglas.c.ekizian@us.pwc.com 949 517 8220
<b>Craig Schleicher</b> <i>Manager</i>	craig.w.schleicher@us.pwc.com 415 531 8728

### PwC Financial Services Regulatory Practice

<b>Jeff Lavine</b> <i>Partner</i>	jeff.lavine@us.pwc.com 703 918 1379
<b>Ric Pace</b> <i>Principal</i>	ric.pace@us.pwc.com 703 624 3314
<b>Anthony Ricko</b> <i>Managing Director</i>	anthony.ricko@us.pwc.com 978 985 1749
<b>Bruce S. Oliver</b> <i>Director</i>	bruce.oliver@us.pwc.com 703 918 6990

**Follow us on Twitter @PwC\_US\_FinSrvcs**