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Policies, Profits and Pacifico

BY GOING TO FLAT FEES, BANKS AND FINANCE COMPANIES MAY SHIFT REGULATORY PRESSURE AWAY FROM THEMSELVES — AND ONTO DEALERS.

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By Jim Ganther

In the months that have passed since the National Automobile Dealers Association (NADA) published its Fair Credit Compliance Policy and Program, much ink has been spilled debating its merit. Reasonable minds can differ — and have — on its necessity and practicality. Group 1 Automotive, for example, announced its intent to implement the NADA policy. Penske Automotive has taken a "wait-and-see" posture. And countless dealers across the country are wondering what their obligations actually are.

In my last article on this topic ("Dealers, Dollars and Disparate Impact," April 2014, Page 20), I explained the concept of disparate impact as the basis of the Consumer Financial Protection Bureau (CFPB)'s scrutiny of dealer reserve. In this article, I will give some deep background on the NADA's approach to help dealers understand that program and make an informed decision on how to move forward.

United States v. Pacifico Ford Inc.

In the beginning was the Pacifico case. In 2007, the U.S. Department of Justice sued Pacifico Ford, a Philadelphia car dealership, alleging that Pacifico routinely charged African-Americans higher interest rates than non-African-American customers in violation of the Equal Credit Opportunity Act.

Pacifico denied it had violated the ECOA or engaged in any discriminatory practices against any car buyers, regardless of their race. Pacifico cooperated fully with the DOJ's investigation, which preceded the lawsuit.

Two interesting facts about this case: first, Pacifico had a policy of permitting discretionary markups over the buy rate of up to 400 basis points (4%); second, the DOJ did not allege Pacifico discriminated against any minority groups other than African-Americans. So there was no allegation of discriminatory practices against Hispanics, Asians, Native Americans, women, or any other protected class.

Ultimately, Pacifico voluntarily entered into a consent order in 2007 to avoid the substantial cost and uncertainty of defending the government's charges. (A consent order is an agreement whereby a defendant doesn't admit liability but undertakes certain corrective actions and the government drops its lawsuit.)

Pacifico's consent order contributed greatly to the NADA Fair Credit Compliance Policy and Program. While consent orders are specific to the parties and facts involved and thus have little precedential value, they do provide a pretty clear idea of what the government considers to be legal compliance. Thus they are taken seriously for purposes of guidance.

So here's what Pacifico agreed to do to come into what the Department of Justice considered a compliant ECOA process:

- Be enjoined from engaging in any discriminatory practice on the basis of race or color.

- Limit dealer reserve to 2.5% for loans (sic — apparently the DOJ doesn't understand the difference between a "loan" and an "installment sale contract") with a term of 60 months or less, and 2% for loans with a term over 60 months.

- Develop and implement formal, written "Guidelines for Setting Dealer Reserves." Note that this element included documentation and management review requirements that ultimately provided the DNA for the NADA policy.

- Post public notices of nondiscrimination throughout the dealership — as well as a notice that APR is negotiable — and provide hard copies of those notices to customers that make it as far as the F&I office.

- Create an ECOA training program. Covered employees get this training upon hire and annually thereafter.

- In addition to the above, Pacifico agreed to deposit $363,166 in an escrow account as a settlement fund to compensate aggrieved customers.

The Guidelines for Setting Dealer Reserves contained the process of establishing a standard dealer reserve and permitting downward adjustments for a limited number of documented reasons. The reasons included:

- Dealer reserve limited by financing source
- Customer stated payment constraint
- Customer stated competing dealer offer
- Customer stated competing credit offer
- Dealer promotional financing program
- Subvened interest rate
- Dealer employee incentive program
- Documented inventory reduction considerations

If you've made it this far, congratulations! By adopting — and following — the NADA Fair Credit Compliance Policy and Program, you will have the comfort of knowing you are following the DOJ's guidance set forth in Pacifico. That assumes (reasonably, I believe) that the DOJ's approach will satisfy the CFPB. Will that be enough to eliminate the potential for dealership liability? Perhaps not. Read on.

The move toward flat fees fails to address the scenario of two banks competing for the same contract. F&I managers could be forced to choose between a higher flat for their dealership and a lower APR for their customer.

Going Flat

BMO Harris Bank recently announced that, in response to CFPB pressure and in the absence of any safe harbor guidance, it will eliminate discretionary markups and compensate dealers with a flat fee. That fee (3% of amount financed) may appear to satisfy the CFPB's concerns, but looks can be deceiving. Flat fees get the bank off the hook but moves the regulatory focus to the dealer.

This is so because BMO Harris has a 3% flat fee. Other banks will have a different fee, or none. Dealers will have to shop rate, as always. So now the question becomes not why is the mark-up different for different classes of customers (if there is a difference) but why did the dealer choose one finance source over another? And these are factors Pacifico does not address.

A hypothetical example may help. Say BMO Harris offers a flat fee equal to 3% of amount financed and an APR of 7.25%. Another bank may offer 2.75% of amount financed and an APR of 7%. Does the F&I manager go for the higher flat, increasing the dealership's income as well as the customer's cost? Or does she save the customer money at the expense of her employer? Is it illegal to maximize profit?

In either event, the finance sources are no longer in the CFPB's crosshairs, as their policies remove any dealer discretion that could create the appearance of discrimination. Those crosshairs are now squarely centered on you, the dealer.

This would be the case even if every finance source went to flats — even if they went to the same flat. Why? Because buy rate and dealer participation are now combined into one APR for the consumer. But if buy rates differ now, they will continue to differ even after a flat dealer participation is added.

Underwriting factors will continue to vary from bank to bank as well. Shopping for rate will go on, and with it the possibility of creating an appearance of discrimination.

So who wins in all this? From where I sit, the banks. By going to flats, they preserve their profit margins and shift the regulatory attention to dealers. And by eliminating negotiation over rate, consumers are actually hurt, for negotiation creates downward pressure on prices.

The NADA wants to see finance reserve remain a viable source of dealership income. In order to do so, it seeks to help dealers avoid the appearance of discrimination by ensuring there are no undocumented deviations from a standard dealership participation rate. That is at the core of the NADA policy, and it is a reasonable approach. What is unreasonable is basing regulatory enforcement on the mere possibility of adverse impact in an area of commerce where adverse impact analysis has never been approved by any court. In short, the CFPB's war on dealer reserve may well be a solution in search of a problem.

James S. Ganther, Esq., is the co-founder and CEO of Mosaic Compliance Services. He is a legal and compliance expert and a prolific writer and speaker.
JGanther@AutoDealerMonthly.com

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