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New CFPB and NY AG Lawsuit Could Harm Consumer Credit Markets

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Perhaps not as prominent in the national news as another relatively high-profile balloon, in its latest effort to legislate and regulate by enforcement, the Consumer Financial Protection Bureau (CFPB), together with New York's Attorney General, last month floated a trial balloon in the indirect financing space that could create a great disruption in the consumer credit markets. Specifically, the CFPB, together with the NY AG, filed a 59-page complaint against Credit Acceptance Corporation asserting UDAAP claims under the Consumer Financial Protection Act of 2010 (CFPA) and New York state law. This suit, taking direct aim at Credit Acceptance, and more broadly the entire indirect financing industry, is grounded upon industry-standard conduct specifically authorized by Regulation Z. If this cause of action is allowed to take off, it would deflate the subprime credit market and could deny credit-challenged and credit-invisible consumers valuable opportunities to lift themselves up the credit spectrum.

What is indirect financing?

Dealer-arranged or indirect financing—as opposed to obtaining a direct loan from a bank, credit union, or other lender—is a very common avenue for consumers to finance their vehicle purchases when they do not have sufficient cash on hand to purchase a vehicle outright. After the customer and dealer agree to the sale of a vehicle, they negotiate an installment contract where the customer agrees to pay the dealer for the vehicle over time. A finance company subsequently purchases that installment sales contract from the dealer. To a customer, this may look and feel like a single transaction where they sign the contract with their dealer to buy a vehicle by paying the purchase price and finance charge in monthly installments. But there are actually three distinct transactions:

The dealership and the consumer negotiate and agree on the vehicle's price and enter an agreement for the vehicle's sale, often under a buyer's order.

If the consumer desires to obtain financing through the dealership to pay for the purchase (as opposed to obtaining a direct loan from a lender and using the loan proceeds to pay for the purchase of the vehicle), they negotiate the financing terms with the dealership. If the dealership does not intend to service the financing directly (this is referred to as 'buy here, pay here'), the dealership typically sends the consumer's application to several finance companies through its Finance and Insurance (F&I) Department and uses information regarding the available financing options to finalize the financing terms with the consumer.

After the consumer and dealership enter into the retail installment sales contract, in which the dealership is the "creditor-seller," the dealership sells or assigns its rights under that contract to the finance company (assignee) based on terms agreed upon between the dealership and finance company, a business-to-business transaction. A finance company may pay the dealer less than the face value of the contract, i.e., a discount, when the consumer represents an increased credit risk.

The finance company has no direct contact with the consumer until after it purchases the retail installment sales contract from the dealer. That's what makes the financing "indirect."

Why does the CFPB and NY's complaint threaten financing opportunities for credit-challenged and credit-invisible consumers?

In their complaint, the CFPB and New York argue that it is "abusive" and "deceptive" for the dealer to record the actual vehicle sales price negotiated between the dealer and the consumer as the "cash price" in a consumer's contract. Instead, they argue that dealers across the country have been "incentivized" to inflate prices and that the "true cash price" that must be disclosed to consumers on the face of their contracts is whatever the finance company will pay to the dealer to later accept assignment of the contract, plus the customer's down payment and any trade-in value. They call this the "cash price proxy." They believe the difference between the "cash price proxy" and the selling price that the customer agreed to pay the dealership is a "hidden finance charge."

This position takes aim at the secondary market transactions where a finance company buys a contract/commercial paper at a discount and is contrary to established law. The Official Staff Commentary to the CFPB's own Regulation Z (the implementing regulation to the Truth-in-Lending Act) states "[a] discount imposed on a credit obligation when it is assigned by a seller-creditor [the dealership] to another party is not a finance charge as long as the discount is not separately imposed on the consumer.” That is, so long as the difference between the sale price and the price for which the finance company buys the paper is not paid for by the customer, the seller-creditor has not imposed a “hidden” finance charge. Put another way, if the credit customer pays the same price for the vehicle that a cash customer would, the dealership has not imposed a “hidden” finance charge and the CFPB’s trial balloon holds no air. Logic dictates that the dealership is in the best position to ensure that the discount is not imposed on a consumer. If somehow permitted to float, the CFPB and NY’s trial balloon would substantially reduce credit options for credit-challenged (consumers with a FICO of less than 620) and credit-invisible (consumers with no credit history) consumers in an already tough economy.

In a second shot to access to credit and competitive auto financing markets, the CFPB and New York argue it is abusive not to analyze the consumer’s “recurring debt obligations, rent or mortgage payment, [and] any of the other necessary expenses an individual incurs each month, including the cost of food, healthcare, or childcare” and calculate the customer’s “monthly debt-to-income ratio or residual income” when considering the customer’s ability to repay the contract. Although there are prescriptive ability-to-repay standards for certain mortgages and credit cards, there are none for auto finance. This effort to legislate through litigation avoids important aspects of the rulemaking process: giving the public and interested parties notice of a proposed action the agency has clearly articulated; inviting critical feedback from experts and those interested in the proposed rule; requiring the agency to deliberate, consider, and justify a rule’s costs, benefits, and likely impact; and allowing regulated parties to adjust their conduct ex ante based on a written rule. If they listened to and understood the impact to the consumers purportedly served by the agencies and the industry, they may find that their ‘new rule’ will cut off access to credit, harming consumers who need vehicles, and eliminates competition. Once again, the CFPB fails to recognize that the process matters.

What this means to you

This lawsuit demonstrates that the CFPB is targeting historically permissible practices in the auto finance industry. If decided in the CFPB’s favor, the case would have a chilling-effect on the auto finance industry and could effectively eliminate subprime consumers’ ability to buy a vehicle. If you or your company are involved auto financing or a similar industry, we suggest keeping your eyes to the sky (and on this case).

Contact us

We will continue to monitor the horizon for this case and assess its impact on the auto finance industry. For more information about this case or any of the CFPB’s activities or their potential impact on your business, contact Marci Kawski, Natalia Kruse or your Husch Blackwell attorney.