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Non-Direct Auto Lending: Is the CFPB Asserting Jurisdiction over the Capital Markets?

U.S. Consumer Financial Services Alert

By: Laurence E. Platt

The capital markets should look closely at the proposed rule of the Consumer Financial Protection Bureau (the "CFPB") to supervise certain larger non-bank automobile finance companies because of the CFPB's assertion of broad authority over large purchasers of auto loans and auto leases. The CFPB's interest in indirect auto lending is not new. The proposed rule, however, purports to give the CFPB jurisdiction over any large purchaser of auto loans and auto leases, regardless of whether the purchaser had any direct involvement with the lender or reasonably could be construed to be the indirect originator. In its defense, the CFPB would stop its jurisdiction at the door of securitization, but any purchases up to that point may be fair game. The logic underlying this position could be extended by the CFPB to mortgages, credit cards, and virtually any other type of consumer product or service. Interested parties may want to comment by the December 8, 2014 due date.

The CFPB issued a proposed rule on September 17, 2014, to give the CFPB authority to supervise nonbank larger participants of certain financial product and service markets for compliance with federal consumer laws (the "Proposed Rule").[1] It issued the Proposed Rule pursuant to its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] As described in our prior alert,[3] the Proposed Rule will be significant for several reasons, including:

- It will be the first time that nonbank auto finance companies will be federally supervised, meaning that, among other matters, they will be subject to CFPB examination;
- Nonbank auto finance companies will be expected to establish and implement compliance management systems that are appropriate for their size and complexity; and
- The institutions covered by the rule will include not only entities that make auto finance loans and automobile leases, but also those who purchase them, although investors in asset-backed securities are not included in the coverage.

With certain nuances not relevant here, the CFPB has jurisdiction over a non-depository purchaser only if the purchaser engages in offering or providing a consumer financial product or service.[4] The CFPB issued the Proposed Rule in an attempt to establish supervisory authority over certain "larger participant" non-bank covered persons participating in the market for automobile financing. To be a larger participant in the automobile financing market (and thereby subject to CFPB supervisory authority), a non-bank and its affiliates must "originate" more than a specified amount of automobile finance transactions and "purchases or acquisitions" to fall within the definition of "originations."[5] However, the Proposed Rule begs the question of how a purchaser of auto loans and leases can be deemed to be offering or providing automobile financing.

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The CFPB deftly co-mingles the concepts of "offering or providing," on the one hand, with a "consumer financial product or service," on the other hand. Note that the statute itself includes "acquiring" or "purchasing" in the definition of "financial product or service," as follows: "The term financial product or service means *extending credit* and servicing loans, *including acquiring, purchasing*, selling, brokering or other extensions of credit…."[6] (emphasis added) Importantly, though, the illustrative examples of "acquiring" and "purchasing" qualify the phrase "extending credit" and, thus, are not stand-alone components of the statutory definition. In other words, if purchasing or acquiring consumer products or services cannot reasonably be construed to constitute an extension of credit, engaging in such transactions would appear to be beyond the CFPB's purview.

The Proposed Rule does not define the phrase "purchasing or acquiring," and it does not explicitly link the phrase to "extending credit" like the statute itself does. Read literally, a remote purchaser of auto paper, which is several purchases removed from the origination of the loan, could still be deemed to be engaged in providing or offering a consumer financial product. To its credit, the CFPB recognizes that there must be some limitation on this concept. As discussed in our prior alert, the CFPB is not proposing to include the securitization of auto loans and leases in the calculation of "aggregate annual originations," explaining that it would exclude "investments in asset-backed securities." According to the preamble, the "asset-backed securities are investment vehicles [that] . . . do not generally alter the contractual obligation between the consumer and the entity that granted the credit or services the loan," and, thus, the CFPB does not believe that "such transactions" should be covered by the rule. It asked for comments on this position. Although use of the term "such transactions" suggests that the CFPB may intend to exclude the entire securitization process, the text of the preamble only excludes "investments." Since the Proposed Rule intends to otherwise cover purchases of auto finance loans, trusts or other investment vehicles that purchase such loans and issue securities based on and backed by them might be intended by the CFPB to be covered.

So where does one draw the line between purchasers that may be covered by the Proposed Rule and those that may not? In the absence of definitive language in the Proposed Rule, one can only speculate as to the position the CFPB will take. However, the preamble provides an indication of the CFPB's mindset. As noted above, the CFPB disclaimed jurisdiction over investment vehicles involving asset-backed securities because the contractual obligation between the consumer and the entity that granted the credit or serviced the loan generally is not altered by the arrangement.

Contrast that approach with the CFPB's treatment of indirect auto lending. The CFPB asserted in the Proposed Rule that auto dealers generally collect basic information regarding the consumer applicant and then forward that information to prospective "indirect auto lenders" for evaluation. After evaluating the applicant, according to the preamble, the "indirect auto lender" may provide eligibility criteria to the dealer for the purchase of the debt, which may include a "risk-based buy rate," establishing a minimum required interest rate to be eligible for purchase. The dealer then closes the transaction with the consumer and sells the resulting retail installment sales contract to the purchaser, which may compensate the dealer for arranging the indirect financing. The CFPB defines this type of a purchase as an "origination."

We believe that indirect lending of the type described above is this limited type of purchase that the Proposed Rule is intended to capture. Indeed, while characterizing these purchases

as indirect lending or origination is not without criticism, the CFPB's approach has its roots in other federal laws. One example is the Equal Credit Opportunity Act's definition of "creditor," which means a person who, in the ordinary course of business, regularly participates in a credit decision, including setting the terms of the credit.[7] Another example is the Real Estate Settlement Procedures Act's exclusion from its coverage of bona fide transfers of loans characterized as "secondary market transactions;"[8] determining whether a transfer rises to the level of a "secondary market transaction" is based on consideration of "the real source of funding and the real interest of the funding lender" and explicitly excludes "table funded" sales and the first assignment of a dealer loan or dealer consumer contract.[9]

In other words, in other regulatory contexts, the applicable consumer credit laws and their regulations may blur the line between origination and purchase, but invariably it is only the initial purchaser that is close to the underlying credit transaction that risks re-characterization. Under the Proposed Rule, all purchasers up to the point of investment in a securitization seem to be treated the same as an offeror or provider of a consumer financial product solely as a result of its purchase of the debt obligation. The logic of this analysis is not necessarily limited to auto financing and deserves clarification.

Capital market participants may want to consider providing written comments to the effect that subsequent purchases or acquisitions of auto loans or leases should not be subject to the final rule where such transactions do not have the indicia of "indirect lending."

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[1] Defining Larger Participants of the Automobile Financing Market and Defining Certain Automobile Leasing Activity as a Financial Product or Service, 79 Fed. Reg. 60762 (Oct. 8, 2014) (to be codified at 12 C.F.R. Parts 1001 and 1090).
[2] The CFPB has authority to supervise all nonbank residential mortgage, private education, and payday lenders. It also has the authority to supervise nonbank "larger participants" in other consumer financial product and services markets, as defined through rulemaking. 12 U.S.C. § 5514(a)(1)(B). If adopted, the Proposed Rule will be the Bureau's fifth larger participant rulemaking.
[3] K&L Gates, *Start Your Compliance Engines: CFPB Proposes Rule to Supervise Larger Nonbank Auto Finance Companies* (Oct. 8, 2014) by Melanie Brody and Anjali Garg, *available at* http://www.klgates.com/start-your-compliance-engines-cfpb-proposes-rule-to-supervise-larger-nonbank-auto-finance-companies-10-08-2014/.
[4] 12 U.S.C. § 5481(6).
[5] The Proposed Rule at 108(a).
[6] 12 U.S.C. § 5481(15)(A)(i).
[7] 12 C.F.R. § 202(l).
[8] 24 C.F.R. § 3500.5(b)(7).
[9] *Id.*

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