Consumer Finance Monitor (Season 5, Episode 52): A Look at the Federal Trade Commission's Proposed Rule for Auto Dealers from the Perspective of Auto Dealers and Auto Finance Companies, with Special Guests Paul Metrey, Senior Vice President for Regulatory Affairs, National Automobile Dealers Association (NADA), and Richard Hackett, Regulatory Compliance Consultant and former Assistant Director, Consumer Financial Protection Bureau

Speakers: John Culhane, Paul Metrey, and Richard Hackett

John Culhane:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at Ballard Spahr. I'm your host, John Culhane. I'm a senior partner in the Consumer Financial Services group, and I'll be moderating today's program. For those of you who want even more information, don't forget about our blog, consumerfinancemonitor.com. We've hosted that blog since 2011 so there's lots of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or get on the list for our webinars, please visit us at ballardspahr.com. If you like our podcast, let us know. Leave us a review on Apple Podcasts, Google, or wherever you get your podcasts.

And please let us know if you have ideas for other topics that we should cover or any speakers that we should consider as guests for our show. Today I'm joined by Paul Metrey and Rick Hackett, and we'll be discussing the FTC's proposed Motor Vehicle Dealers Trade Regulation Rule released in June and published in the Federal Register on July 13. The proposed rule would impose a number of new substantive disclosure requirements on auto dealers in the car buying process. The FTC described the rule as one designed, quote, "to ban junk fees and bait and switch advertising tactics that can plague consumers throughout the car buying experience," close quote. As the impetus for the proposed rule, the FTC cited surging auto prices, high levels of consumer complaints, somewhat surprisingly, their own limited resources in terms of the staff size and other resources available to them. And then I think they placed some emphasis on their ability to get refunds under a trade regulation rule by suing under section 19 of the FTC Act.

And then lastly, they touted the rule as something that would help law abiding dealers compete in the marketplace. So let me just mention before I introduce our guests. This is actually our second podcast on this subject. Back in August, we had a podcast with two staff attorneys from the FTC Bureau of Consumer Protection who were responsible for drafting the proposed rule, and I'd recommend that as well for your consideration. So let me turn now and introduce our guests, Paul Metrey with the National Automobile Dealers Association. Paul's a senior vice president for regulatory affairs for the National Automobile Dealers Association, and in that capacity he directs a team of attorneys who represent dealer interests before federal executive branch agencies, and he also educates dealers on regulations promulgated by those agencies. Mr. Metrey is the author and editor of numerous NADA publications including their Model Dealership: Voluntary Protection Products Policy, and their Fair Credit Compliance Policy and program.

He frequently speaks to dealers, automotive trade association executives, dealership compliance professionals, and other industry groups on an array of regulatory topics. He's active in several professional organizations and serves on the governing committee of the Conference of Consumer Finance Law. Rick Hackett is probably well known to many of you. He's a former assistant director of the CFPB where he headed the markets office for automobile finance as well as for other products. Rick was also in the private practice of law for over 40 years focusing on consumer financial services regulation. He was a frequent lecturer on that subject in law schools at ABA and industry education programs and conferences, but he has now retired, sort of, from the practice of law. I'm not sure Rick will ever be fully retired. Rick consults on regulatory compliance with consumer financial services businesses and their investors as well as serving on company boards.

So with that, let's get into it. And Paul, if you don't mind, I'd like to start with you and we'll get the dealer perspective on the proposed trade regulation rule and then ask Rick to come in to provide the perspective of lenders and finance companies that might be purchasing motor vehicle installment sales contracts or otherwise originating automobile loans. So let's start this by talking about the process that the FTC engaged in. It seemed to me to be kind of an odd rule. It sort of just appeared all of a sudden and the structure is odd. There's a proposed rule and then a list of questions at the end of the rule. I think the comment letter you submitted detailed a number of flaws in the process and I was wondering if you could just highlight those for us please?

Paul Metrey:

Well, certainly John. And let just start out by saying it's a pleasure to be with you and Rick and Ballard Spahr for the podcast and to discuss this very important issue. So we do have a number of process concerns as you indicated. They are detailed in our written comments that we submitted to the commission on September 12th. Just to identify them very topically again, we dive deeper in the comments themselves, for starters, the FTC never identified this rule as being under consideration in any semi-annual regulatory agenda. So there was no advance notice of the rule coming out. Also, we had met with the commission on occasions prior to the rule coming out, there was never any mention it was coming out and certainly no discussion of any of its substantive provisions. So when this was released in late June of 2022, that was really the first we, and I believe many others, had heard about it.

In addition, there was no information gathering exercise on the front end of this very comprehensive proposal. Typically, most agencies will proceed with an advance notice of proposed rule making or perhaps a request for comment, a request for information or as we recently saw the CFPB do with regard to section 1071, an outline of proposals for which they will try to get comment. In fact, CFPB did that after they had earlier issued a request for comment on section 1071. There was no form of any type of an issuance to gather information on the front end of the process, which we think is regrettable because we think many of the substantive provisions could certainly have benefited from that. The coordination with other federal agencies in the states appears to be lacking if not nonexistent. We don't believe there was coordination with the Federal Reserve Board even though as we'll talk about a little bit later, this does get into credit disclosures, which is really in their domain at least with regard to motor vehicle dealers that are subject to or are covered by Section 1029A of the Dodd Frank Act.

And there was not stakeholder input. Again, we had opportunities to meet and we certainly enjoy the dialogue with the FTC. We always find it productive, but the type of things we're going to talk about today and particularly the specific proposals were really never on the table and not something that we could offer any meaningful insight into. Now I think, and John, I believe you alluded to this one indication of the fact that the FTC did not have sufficient information to really provide something that is likely to work in the marketplace is the extensive nature of the inquiries they made as part of the notice of proposed rule making. There were 49 questions, actually many more because several of those included sub-parts where the FTC has asked all kinds of market information. Now that's a healthy exercise. It's good that they're doing that. What's very unfortunate to us is that they did it in a proposed rule as opposed to in advance of the proposed rule so as to help inform the proposed rule.

So we really think they skipped a very important step. We think had they obtained that type of information and other stakeholder input on the front end, that would've been very important. And it's worth pointing out that there was no reason to truncate the process in this nature. There's no statutory deadline here. The FTC was not directed by Congress to do anything. That's very different from other parts of the Dodd Frank Act where agencies were directed by Congress to take certain action. If you look at other provisions, you'll see that Congress states that the CFPB shall do this, that or the other, or they have other

types of directives. This was an authorization, but it was not a directive. And so there was really no reason to dispense with due diligence or really information collection on the front end. And I think one indication of the rushed process here was the manner in which the cost benefit analysis was performed.

In terms of the cost to consumers, the FTC estimated, and of course this is all part of the Paperwork Reduction Act and Regulatory Flexibility Act, those type of analyses that always accompany this type of proposal. When they were talking about the benefit to consumers, they stated that they assume, and this assumption is based on nothing, it's not spelled out at all in the proposed rule, but they assume that this will save consumers three hours in the process to shop and ultimately purchase an automobile. They take that three hours again without any support for where that figure comes from and then they state that if you look at a person's time, it's worth a certain dollar amount. They pull a figure from the Bureau of Labor Statistics and then they take those two figures, they multiply them together, and then they multiply them by the number of purchasing, financing and lease transactions. Even though the commission has said that they believe that there's honest law body dealers out there for whom of course these type of things would not be necessary, but they take those three simplistic figures, they multiply them together, it goes north of 31 billion and they lay that out as the benefit to consumers of this particular proposal.

To say that it's not detailed would be an understatement. There's really nothing into it other than just a very quick statement. Again, another indication of how truncated this is. In addition, the reason we were very concerned about the manner in which the commission moved forward with this is the 49 questions asked a series of cost questions. What would this cost industry? What would this cost dealers? What would be the impact? Again, that's a healthy exercise. When we responded in an extension request to the commission stating that if we have additional time, we can actually get a reputable firm to help quantify what you're asking about, that request was denied. We put in requests, there were many other organizations that put in extension requests. The Small Business Administration Office of Advocacy put in a request for an extension and to us inexplicably, the commission would not grant an extension.

So on the front end, the process was truncated on the back end, it was closed off. And I would say that's in contrast to the way the commission has handled many other requests before where they put out something for comment such as the amended Safeguards Rule and then an extension request will come in. And in that case, as in many others, they will grant the extension request so you can be responsive to their inquiries or otherwise provide relevant information. Unfortunately, all of these things were precluded and there's a reason why these process elements are put in place. It is, of course, to try to produce an informed rule. When one skips basic elements, basic process requirements, of course, you greatly increase the likelihood that you're going to have a rule that is not fully informed and could create problems in the marketplace.

John Culhane:

Paul, a couple of things stood out for me in looking at the rule and considering the process that I hope you could comment on. One was the somewhat unique authority cited for this rule compared to other trade regulation rules. I believe they rely on Dodd Frank as their authority here. The second, and I hope I'm not jumbling too much together, a number of those questions seem to actually embed proposals that seem like they're going to be forthcoming in any final rule because the commission tease them up as if it's considering adding them to the rule without actually laying out exactly what it has in mind and how they would work. And then lastly, you mentioned the benefits, the costs to dealers seem to me to be remarkably truncated and optimistic in terms of the amount of time and money that would be involved in coming into compliance with a rule like this. And so I realize I've tossed a couple of things at you, but if you don't mind, if you could comment on those before we move on to other parts of the other aspects of the proposal.

Paul Metrey:

I think, John, these are all very good observations. I think what you said about the 49 questions, certainly a number of them do envision potentially addressing additional topics beyond what is in the proposed rule itself so that it appears to be a possibility. And the concern is, of course, that no one has offered comment on those other than in the form of these questions. And in terms of actually fashioning a proposal that would make sense and one can really look at how it interacts with other areas of the law, we think would be very difficult to do that. So that is a concern.

As for the cost, we have very, very significant concerns about the cost. When we talk a little later about the substance of the rule, I'll try to flag some of those, but certainly even just in the area of record keeping, we think it could be very, very

significant. So the cost elements we do think could be very, very high. It's something that we're attempting to quantify. Unfortunately, the comment period has been closed. It's not part of the record, but nevertheless, we are trying to get a handle on what this would involve for the members and that becomes very important consideration and certainly is something that in any cost benefit analysis, we would hope that the commission would be focused on.

John Culhane:

Let's move on and talk about some other aspects of the proposal. Your comments were very critical of the support the commission cited for issuing the proposed rule and basically the citations seemed to be to different enforcement actions that they had pulled out as if they were representative of everything going on in the automobile industry. Could you say a little bit more about that and give us a sense of how the support for the rule is lacking?

Paul Metrey:

Certainly. There are four main areas of support that the commission has put forward for the proposed rule, the motor vehicle round-tables that the commission conducted in 2011 in the aftermath of the enactment of section 1029 of the Dodd-Frank Act, qualitative research that was conducted in 2017 and was released in 2020, complaint data and enforcement actions. And I think a few comments about each of those should indicate why we're concerned that they did not provide adequate support for the rule. With regarding the motor vehicle round-tables. The whole purpose of them now these were conducted in 2011, was to try to determine whether or not a UDAP type of rule, a trade regulation rule would be warranted. And so the commission wanted to take a look at the marketplace, bring people in and discuss it and that certainly occurred. There were 21 panels that occurred. It generated over 500 pages of written transcripts that involved 58 panelists and over and over and over the commission asked the question about whether or not there was credible data to demonstrate that there are prevalent problems in the marketplace.

They focus on prevalence. Now this was post enactment of Dodd-Frank. They focus on prevalence as something that would be very important because, of course, today to the extent there's a UDAAP violation, the commission does have enforcement authority to address it. If there's going to be a rule of broad applicability, prevalence does become very important. So that inquiry was made, and of course we know that in the last decade the commission has not taken any action in the aftermath of what are now very dated round-tables. So a record was not generated to demonstrate that there was credible evidence of prevalent problems that required additional rules, and yet the motor vehicle round -tables are somehow supported as support for that exercise. So we really think it cuts in the other direction. With regard to the qualitative research right out of the gate, the name of that should suggest that there's a problem in relying on it.

It's qualitative research, not quantitative research, but let's be clear on how much the commission referenced this in the notes of proposed rule making. It was alluded to over 30 times. If you look at the joint statement of the commissioners that voted in support of the Motor Vehicle Trade Regulation Rule, they identify this most prominently as a source of support and there are many problems with it even before you get to the manner in which it was used. The design and execution of it had a number of flaws. We pointed those out at the time in the comments. And also we had a market research expert, Dr. John Vidmar, who has actually done work for federal agencies, including the FTC as well as others on survey design. And he found numerous areas of potential bias and other areas that could produce inaccurate results. He also indicated the 2020 reports that were put out were intermingling findings with other reports that had nothing to do with this exercise to give it an air of legitimacy.

And that's typically not something that's done when you create a report based on survey research and, of course, its use is most problematic. A qualitative study is designed as a precursor to inform a quantitative study to make sure that when you do want to measure the prevalence of something in an industry or to the extent to which there's some scientific basis for concluding that there's a problem, you are doing it in a manner that is statistically valid that really comports with survey design principles. In this instance, the quantitative research step was skipped. The qualitative research was used as a means to support this exercise. These were 90-minute interviews with 38 consumers from one market back in 2017, 19 that purchased new vehicles, 19 that purchased used vehicles. That's all that consisted of. There was nothing further and yet it's being relied on in this fashion.

And I should note that the report itself indicates, the 2020 reports that summarized this qualitative research, that it's not suitable for generalizable conclusions and yet a rulemaking we know by its very nature is an exercise in applying generalizable

conclusions. And that's what's happened here. So really that qualitative research should not have been a factor in this rulemaking that supported it and yet it is very, very prominently alluded to. With regard to the complaint data, we think the numbers offered by the commission, unfortunately, are very inflated. They refer to over a hundred thousand auto-related complaints in each of the last three years. That sounds like it's a very significant problem until you really break it down. First, many of the subcategories of complaints have nothing to do with the subject matter of what we're talking about or there are vague subcategories where they could refer to dealers, but they could refer to misconduct by other entities as well.

For example, if you talk about something like vehicle financing, is that a problem by the dealer on the front end of the transaction or is that a consumer complaint about servicing, about collections, about a repossession? We just don't know. It's not that granular. They also relied on input from foreign sources. In fact, the FTC said the third largest data contributor to their most recent data set was the Australian Competition and Consumer Commission. Presumably the complaints that they have reported have nothing to do with US based motor vehicle dealers and on and on. There's also concerns about double counting. A consumer can list more than one complaint category and of course all of these unverified. So there are real problems with the way that these have been categorized. But the biggest problem is the lack of context. We've got to look at the complaints in the context of the market in which they occur.

So every year typically there are over 40 million deliveries by new and independent motor vehicle dealers to consumers. Now those are actually consummated deliveries. There are obviously many more interactions beyond that and if you pull the service department into it, you get incredibly high numbers. So the FTC here has focused on the numerator. They have not focused on the denominator. So we even have problems with the numerator, but you put the denominator in there, which is a massive number of transactions and other interactions with consumers and you find that this is a very, very small percentage in what's happening in the marketplace. With regard to enforcement actions, we also think that unfortunately it's overstated. The commission uses the phrase that more than 50 have been taken. Now 16 of those, nearly one third, do not even involve motor vehicle dealers. So one would have to ask why is there a reference to more than 50 if it's not applicable to this exercise?

Of the enforcement actions related to add-on products, which of course are a very significant part of this proposed rule, only three of the 37 complaints that involve motor vehicle dealers pertain to add-on products. That's a rather thin record to base a rulemaking if indeed that is being offered as support for it. So there's also other things that could be said. Most of these enforcement actions are in the area of advertising. We know that this proposal is much broader than just advertising. And even within the realm of advertising, if we got more granular, we'd see that many of those actions do not even pertain to the subject matter of what's being addressed here. So a lot of concerns are there. We believe that the support that is offered really does not serve as support for the rule making. And this is one of the reasons why we have suggested in our comments that the commission hit the reset button and really study this issue further before they decide how to move forward.

John Culhane:

You mentioned advertisements, I think that's a good opportunity for us to segue into the substance of the rule since it does deal with advertisements, but it also imposes a lot of additional disclosure requirements, places limitations and restrictions on dealer charges. And there's a fair amount of record keeping required here as well. Could you maybe tease out some of the more salient, substantive flaws that you've identified with the FTC's proposals?

Paul Metrey:

Certainly, and one thing I would just offer to any listener is that our comments that we submit to the commission are 140 pages. And we do talk about the substitute concerns in depth there and we provide examples as well. So for anyone that wants to do a deeper dive, it is available there. I'll just make a couple general comments. Again, more details providing the comments. First though, a threshold matter is that there's no regulatory hole to fill here in the sense that typically a rulemaking exercise, you are trying to make sure that consumers have some type of remedy when problematic conduct does occur. Now we know that problematic conduct can and does occur, and certainly there need to be consumer remedies for addressing those, but they already exist in each area that the commission has addressed in the Notice of Proposed Rulemaking.

And that's in contrast to some other areas of the law. When we think about areas even like privacy, when we think about all the advances that have been made in communications and what Congress and some of the agencies have tried to do to keep

pace with that, we see that they want to make sure that consumers have a remedy, they have some protection when some problem occurs. But with regard to some of the salient areas, let me focus on a few of them.

They first have to do with new disclosure requirements, second with websites and third with record keeping. Now with regard to new disclosures, what the commission has really done has come up with new triggering terms. If something comes up, you have to provide certain information. So for example, as it relates to any time that a consumer would raise a specific vehicle or a monetary obligation or a financing term, the dealer would have to go ahead in the first response and provide the offering price of the vehicle. Now that is defined really as the price of a vehicle except for governmental fees. Now again, that's on the first response and one has to really look at the practical application of that to determine how helpful would that be. Now let's take a look at how this could arise in the context of a dealer consumer set of interactions.

A consumer could inquire about a vehicle on the showroom floor. They could make an inquiry during a test drive. They could do it on a chat box on the homepage of a website or a dealership. It could come up in a text, it could come up in an email, it could come up with a salesperson at some offsite location. They could be bowling, they could be doing any number of things. You have to, in the first response, provide the offering price. At that point, typically, you're not going to know what benefits the consumer could avail themselves of to try to bring down what would otherwise be an offering price. For example, is it a recent college grad or a member of the military or perhaps they qualify for some loyalty rebate because they're purchasing a vehicle that they purchased in the past from the same manufacturer.

Or there could be a myriad of other rebates or incentives that could be beneficial to them. But you don't know enough about the consumer circumstance to go ahead and factor that into whatever it is you're going to quote for. So you have an offering price that you put out there, presumably you default to something like the MSRP. And if you're allowed to offer a lower price, when you learn more about the customer circumstances, one has to ask what is the purpose of that offering price disclosure? And from a training standpoint, in trying to make sure that this type of thing occurs, particularly with these heightened penalties that the FTC would confer upon themselves with this proposed rule, one can see how that would be a concern, not just in terms of is it providing consumers with meaningful information, but is also creating some type of liability trap for anyone that has to comply with it.

We see with monthly payments, that's another thing that would create an effect, a triggering term where you'd have to provide additional information. Now this is a concern because it intrudes on the province of the Federal Reserve Board. That is the agency that Congress really, since TILA was enacted, they have entrusted the Federal Reserve Board with coming out with the content, the form and the timing requirements for important credit disclosures to help consumers make informed purchasing decisions when it comes to credit. The FTC has placed this additional disclosure obligation onto dealers apparently with no coordination with the Federal Reserve. And that is a big concern in terms of is it going to be beneficial to consumers or is it going to be something that is disruptive? Obviously the Federal Reserve has put in a lot of time and attention to determining what would be helpful and what would not in the process of shopping for consumer credit.

And we also know that one thing the commission would require in the proposed rule is up to four additional written forms involving the sale of any, quote-unquote, "add-on product". Now this is a little bit confusing to understand when the commission states that a huge goal here is to really cut down on the dense paperwork that is currently present in the vehicle transaction process, certainly the time it takes. We talked about that previously. Adding four forms that would have to be executed or up to four forms is a concern but also the contents of those forms are a concern. If you look at even items like cash price and how that relates to the definition of cash price that is disclosed under TILA. And the fact that oftentimes dealers are asked to explain these things that are in the written disclosures, and how does a consumer walk away with an enhanced understanding?

And that really leads to a broader issue with these disclosures, which is there's no indication whatsoever that any of them have been consumer tested. A critical aspect of any disclosure regime is to ensure that it is going to benefit consumers and not confuse consumers. And we see this all the time. In fact, the Federal Trade Commission has a lot of experience with this. One quick example I think helps to point that out. In 2002, HUD had proposed a mortgage broker compensation disclosure. The FTC Bureau of Economics in early 2004 put out a report in which they studied the proposal and it was based on quantitative research of over 500 consumers. And what they concluded was, this is very well intentioned, it certainly tries to promote transparency, but what they had found was that many consumers were selecting more expensive mortgages because that mortgage broker compensation disclosure was present.

So while it was intended to benefit consumers, they were walking away paying more for credit than they otherwise might have paid and that certainly is not to their benefit. So more is not necessarily better and in some cases it has an adverse effect. But either way, you don't know that until you've done consumer testing like what the Bureau of Economics did in that context back in 2004. So we think all these disclosure requirements, not benefiting from consumer testing, it's really a stab in the dark as to whether or not they're going to be beneficial in the marketplace. And it's one more indication of how this has just moved out in a very truncated process that does not benefit from due diligence that can really make sure that these are going to be helpful to consumers.

The other areas, real quickly, John, are websites. A big concern here is that add-on products, if you look at the definition of them, it is exceedingly broad. So an add-on product is really anything that the dealer is offering to a consumer beyond the vehicle itself. And it's also anything that is not being placed on the vehicle or sold by the motor vehicle manufacturer. So that means not just items like service contracts, not just gap waiver, prepaid maintenance, those type of products, but really any individual parts that a dealership might sell with the vehicle. And many may not be aware of just how voluminous that is. So we spoke to one GM dealer that sells Chevrolet vehicles and learned that on one model of one pickup truck, the Silverado, they offer 599 separate parts that each have their own price. That's one model of one vehicle. The average franchise has 12 models of vehicles. The average dealership rooftop has 1.9 franchises. When you think about everything a dealership would have to disclose to comply with the website requirement, and by the way, it's not just websites, it's mobile devices. It's any online service.

But dealers would have to post thousands if not tens of thousands of items. Again, how would that help consumers? And is that really what the FTC intended? We wish we could have discussed that with them on the front end so they could have taken another look at that. Also, they talk about the need to level the playing field, but here they decidedly have not done that because we know direct sellers like Tesla and Rivian and others, they, of course, offer these type of products. They offer parts of their vehicles and those type of things, but by definition they do not offer add-on products the way that definition is structured. So you have motor vehicle dealers, franchise dealers that are subject to these requirements and you have direct sellers that are in the same marketplace, offering the same types of products that are excused from them.

Again, we don't think the FTC necessarily intended that, but a little bit of discussion on the front end we think could have avoided that result. With regard to record keeping, we think it is extremely broad, would be very cumbersome. I'd invite the listeners to really look at the eight categories of records that dealers would have to keep, many of which they do not currently keep. Things like all ads, sales scripts, training materials, marketing materials, regarding price, finance or lease of a motor vehicle, or add-on list and remember how extensive that can be. Any documents describing add-ons, any written communications between the consumer and the dealer regarding the same, consumer complaints, inquiries and responses, gap waiver calculations, which we've not even gotten into, and a slew of other items. It would be very onerous. They would have to keep it for 24 months and really to capture all the communications that go on, particularly in light of the offering price we talked about and some of those other applications would be very, very burdensome.

And the last quick comment I would just make on that, John, is that when you consider the desire to try to protect the honest dealer, the law abiding dealer, one has to wonder if this was really well thought out. The commission has brought an average of under four enforcement actions against dealers over the last 10 years, none of which, I believe, have suffered from inadequate documentation in terms of the ability to bring the action. And here what they're going to do to try to foster the ability to bring successful enforcement actions is to require an entire industry of nearly 17,000 franchise dealers, and that's before you get to independents to have to retain this massive cache of documents. That really is something where when you look at the cost and you look at the burden, it does not seem to be in sync. So those are just some of the many substantive concerns that we have.

John Culhane:

Rick, we've talked a lot about the implications of this rule for dealers. We didn't get into detail about all of the rules on add-ons, the requirement that add-ons provide a benefit, the documentation around disclosures of add-ons, lists of add-ons, express informed consent, there seems like an awful lot here and obviously it raises concerns for dealers and the auto retailing industry. Should the finance industry be concerned about this? And if so, why?

Rick Hackett:

Well, first of all, thanks John. It's great to join you again at a table albeit at virtual and it's great to see Paul again, on the same side of the table for a moment. This is absolutely a problem for this proposal. It's absolutely a problem for the auto finance industry. The back-up of 50,000 feet, much of what Paul was talking about in the substance of the rule is activity that takes place verbally, activity that takes place far, far away from the financing transaction, nothing a lender would have any reason to know about. But as you and I both know, the FTC Holder Rule requires that all indirect paper, which the vast, vast majority of paper, virtually all paper originated at a dealership, have a notice on it that says that any holder of this consumer credit contract, that's going to be the lender, is subject to all claims and defenses, which the debtor, that's the consumer, could assert against the seller of goods or services, that's the dealer, obtained pursuant hereto.

So essentially if something happens at the dealership's conduct or documentation or advertising that creates a claim or violation under the FTC rule as proposed, well that infects, if you will, the contract in the hands of the ultimate as the auto finance company. And for that reason, AFSA and CBA, the two leading trade associations filed a comment letter pointing out this liability and their complete inability to control for it. And this potential liability exists not only because of a defense the consumer might raise, but because under state, many FTC Acts, both attorneys general and consumers can affirmatively assert the alleged violations by the dealer against the holder of the contract, the auto finance company. This creates an undiscoverable and unquantifiable risk for the finance industry. I can just imagine how the ABS industry would react to knowing that there's the potential for massive defenses and/or liability in those contracts behind the securitization. It's not a manageable risk from a lender's perspective and it is substantial.

So how do they propose to manage this? The comment letter from the asset and CBA left most of the heavy lifting, which was well managed by NADA on the substance and procedural flaws in the rule to NADA and the F&I or add-on product manufacturers and instead said, look, we should only be held to what we can see and what we control. And what they specifically asked for was a safe harbor similar to what exists under Truth in Lending and/or one that exists under the civil liability provisions of other federal consumer laws. So if in Truth in Lending, if there's a Truth in Lending violation, the assignee is not liable for that unless the violation is apparent on the face of contract.

Similarly, if there's an assertion of civil liability for a Title violation and other violations and other federal consumer financial laws, if it results from a bona fide error not withstanding the maintenance of procedures reasonably adapted to avoid such error, well then there's no liability. And so what the industry has said essentially, "Look, we're already looking at the deal jacket. If it's in the deal jacket, we can see it on the face of the deal jacket" – that's the paperwork that comes with the contract – “well then we should have some responsibility, but otherwise we should be in the safe harbor."

John Culhane:

Is a face of the contract rule, Rick, going to be enough to cover the issue if something like this proposal is adopted and obviously those remedies that you mentioned, or those processes that you mentioned are conspicuously absent from the proposal?

Rick Hackett:

Well yes, I don't think that the FTC... Paul's pointed out many things they didn't think about. They certainly didn't think about the downstream effects on availability of credit for auto purchases. It's a good to start by the finance industry to zero in on the narrow range of what they could possibly be responsible for. But I do think still there's a huge burden and they may have underestimated the scope of what's in the, quote, "face of the contract". So burden wise, I think that it's possible the FTC could give them a face of the contract safe harbor but if that included matching up the add-on product disclosures with the add-on product pricing that ended up in the contract or other things that in theory could be within the deal jacket, that could be a massive amount of time consuming work. And there is a subtle, and I think, more important reason, which is the very complexity of the contracts involved when you're dealing with add-on products.

Add-on products, in some cases, are literally part of the contract± so I'll focus for a moment on gap, which is the product that covers the consumer if a total loss is insured at ACV and that actual cash value is less than was in the contract, the gap. And that's usually documented as a amendment to the finance contract that waives any deficiency. Well, I work on those in my business and there are literally hundreds of gap providers and there are 50 different states, most of them with different laws

and state laws govern all these contracts when you're talking about indirect paper. So in order to track what's on the face of the contract, there's literally potentially thousands of forms for large finance laws. Why do we care what's in those forms? Well, one of the obligations under the rule is not to sell an add-on product that provides no value. And in particular, the commission is focused on how gap can provide no value.

And the NADA has done an excellent job of describing how that's an almost impossible prognosticatory effort because when you're looking at loan value ratios, then you also have to look at depreciation and the various points in the life of the contract. And you really, you can't know, well, each individual deal that might become the lender's responsibility because it is apparent, the data you need to know that is apparent from the face of the contract.

In addition, and equally or perhaps more straightforward, given the breadth of the gap industry, which is provided by people who are not auto dealers, they're third parties, who're basically the insurance business, there's a huge plethora of different approaches to the content of gap contracts. And it's quite possible to write a contract that has limited or illusory value if only because the number of exclusions end up being material to the consumer, not to mention that if the gap provider is insolvent, it's an illusory benefit. So all those things may be apparent on the face of the contract and I therefore think that the safe harbor might have a few minds floating around in it.

John Culhane:

So what should lenders and financing companies do? Should they be more actively involved in opposing the rule if there's no real easy resolution here?

Rick Hackett:

Well, a couple of things. I think that AFSA and CBA might want to talk to Paul, but that's a strategic decision on their part. There are other approaches to mitigating this risk some of which exist and I think are necessary today. There are literally dozens of finance companies who proactively manage the risk of at least the content of the add-ons that they're financing, I mean, regardless of the adoption of this rule. And on the servicing side, if you don't know what you are financing for an add-on product. On the servicing side, you don't know what, for example, refunds might be available if there's a total loss or if there's repayment.

One finance source recently agreed to pay $50 million to settle a civil class action for failure to properly provide gap refunds. And I'm familiar with a technology solution that many finance companies use, dozens of them, basically saying to the finance company saying to its dealers, we won't finance a particular add-on product, contractual F&I add-on product, unless it's going through our gatekeeper who's looking at questions like is there value to this product? Is it got lurking UDAAPs and, by the way, does it comply with 50 different states of disclosure and so on. So there are ways to reduce that risk, but it's not inexpensive. It is something that I think is currently increasing in visibility due to the activity of other regulators. And we'll talk about that some more when we have time.

John Culhane:

Well, that actually leads me to the question that I think is logical follow up is a concern about the content of these voluntary protection products contracts really new in this ecosystem?

Rick Hackett:

Well, not at all. One of the great learning opportunities for me in reading the whole comment letter from the NADA was to come across the part of the appendix that was, as you pointed out earlier, Paul's effort in writing the NADA model policy for add-ons or VPPs as we like to call them. And it suggests pretty strongly that the dealership have knowledge of what's in the add-on product and think about it in terms of its coverage and suitability for particular customer profiles. It also asks a very important question, can this provider pay? Because most of these contracts are promises and a promise without solvency or in this industry, a contractual liability insurance policy, could well be a product of no value and dealers have no interest in selling products of no value. And so there's been an awareness for many years that this is an area that, while it's important to the

consumer and profitable to the dealer, requires some diligence on the part of the folks who are selling products and I would argue on the part of the people who are financing that sale.

John Culhane:

So we've been focusing on the Holder Rule as a large part of the discussion here. Are there other possible issues for lenders and financing companies beyond the Holder Rule concerns?

Rick Hackett:

I have a strong suspicion based on my experience at CFPB and I have three reasons to think about that. First, there is a current and historical supervisory activity focused on add-on products at the CFPB. Second, I can speak to my experience with an overall suspicious attitude at CFPB about add-on products. And third, we have a history of CFPB using leverage over the finance companies to try to influence dealer behavior. Of course, all these concerns might go away because the CFPB might evaporate in the Supreme Court and Paul and I can take a long vacation, but let's assume it sticks around.

John Culhane:

So could you elaborate about that a little bit, concerned about supervisory activity and attitude at the CFPB?

Rick Hackett:

Sure. So CFPB is currently focusing on add-on product cancellation refunds. So this is servicing of these finance contract that includes financing for add-on products. And in spring of 2022, under the heading of, quote, "overcharging for add-ons," unquote, very neutral charge, the bureau focused on that in the repossession context. Back in 2018, they focused in the Santander case and found a UDAAP in gap products that did not in fact provide coverage in some circumstances. And most recently, just in November of 2022, they expanded the scope of the concern that lenders have to have with the add-on contracts to essentially say that every auto finance company needs to know the exact refund provisions of any product that if the contract terminates early, will stop providing value and instead trigger a refund.

Again, historically this was not something that finance companies and banks thought was their province. Clearly with respect to gap, which is part of their own contract, they needed to be on top of it. This clearly applies to credit, life, health and accident insurance, all of which go away on prepayment. And the concern I have, and I think there's an argument based on what the CFPB has said, that even vehicle service contracts which might be refundable on total loss is something that has to be monitored. And the implication of the publication and the highlights was this is something you need to say, not just when you're chasing repos, default collections, you need to include this calculation in your computation of a payoff.

So attitude, I think that the focus on servicing of add-ons and in the Santander case, the misrepresentation of add-ons is the tip of the iceberg. And I'd like to call out a historical coincidence that's going on here that leads me to have some concern. My former colleague and at the time friend, Director Chopra, was at the FTC until eight months before the rule dropped in June of 2022 as a commissioner. And then as we know, Director Chopra went over to take over the CFPB. In my experience, in the rulemaking process, it takes more than eight months to put together a rule that's complicated. Now this rule was going on at the Federal Trade Commission at the time that Director Chopra was one of the leaders of that organization would have socialized and had some input to at least informally where this effort was going.

So he, at least theoretically, has a view of add-on products that might be similar to the view taken in the FTC proposal. Leaving aside the historical coincidences of personnel swaps, the bureau has shown antipathy toward, quote-unquote, "ancillary products" in credit card lending, installment lending, and in their educational pronouncements, auto finance. And when I was at the bureau, there was basic concern about the lack of transparency or the opacity to the consumer of the value of an add-on product. Like what does it do, and what's a reasonable price? The value is something that most dealers clearly explain, but is based on a lot of complex language in a contract. So it's not as clear as say, the value of a bottle of Tide on a shelf in the grocery store. And the price, as we know, is variable. It depends upon the wholesale price, the knowledgeability of the consumer, the negotiating capabilities of the F&I salesperson, who by the way gets a commission that grows with the price of the product and, of course, any payment limitations in the overall contract.

And the bureau has historically had hostility toward variable price of financing and variable price of products involved in financing generally. And the NADA model policy very, very wisely anticipates the variable pricing issue by saying, you should do with this what we did to protect ourselves from uninformed salesperson behavior in the fair lending side, which is set a target price for your add-on product, and then only vary that where there's a documented approved reason to do so, like a competing offer and put a slip in the file. So in other words, the dealership management sets policy, not the F&I salesman sets policy on what's the reasonable price for the product. That ecosystem where you have opacity of value in price, combined with the fact that, for example, the gap premium is technically a finance charge for ECOA purposes has always been a concern, at least was a concern in 2011, 2012, 2013, that underlay the CFPB attitude, at least the market staff attitude toward ancillary products.

John Culhane:

So let me ask you one more question and then I think we'll wrap up here and maybe the answer to this question is obvious from what you just said, but given the fair lending context, it seems to me that I should ask, do you see the CFPB leaning on lenders as a way of policing dealer conduct or compliance with the FTC rule and broader concerns here where we see Director Chopra, former Commissioner Chopra now Director Chopra at the CFPB basically trying to get both ends of the process here within his jurisdiction?

Rick Hackett:

Well, I think that as Paul knows, the CFPB has never accepted fully the political intent and policy intent of section 1029, which is the shield that protects auto dealers from any of the CFPB tools. And in the fair lending context in 2013, the bureau attempted to poke its camel's nose under the tent of 1029 by leaning on lenders to impact the behavior of dealers. If in fact it turns out that there's a whole list of UDAPs with one A that dealers may be accused of, and if in fact they affect to one degree or another the finance contract itself, well, I certainly can see the CFPB applying its 1031 UDAAP with two As authorities to lenders under any number of theories whether it's designating with some question, in my mind, the dealer as a service provider to the origination of the gap contract or using section 1036 aider and abettor theory, or simply imposing a much greater supervisory effort to track any consumer complaints about add-on products on the finance company.

Any one of those coming out of the supervisory or enforcement system could be used to, again, try to stick the camel's nose under the 1029 tent, all of which brings us back to maybe there won't be a CFPB in 2024, which is the earliest I think we might ever see an FTC rule. So we all have to come back to this podcast and find out what happened.

John Culhane:

I'd like to thank Paul and Rick for some really thoughtful comments and dissection of a very significant proposed rule by the FTC and thank our listeners as well. To make sure you don't miss our future episodes, subscribe to our show on your favorite podcast platform, Apple Podcasts, Google, Spotify, wherever you listen. Don't forget to check out our blog, consumerfinancemonitor.com for our daily insights on the consumer financial services industry. And if you have any questions or suggestions for the show, please email podcast@ballardspahr.com. Stay tuned each Thursday for a new episode, and thank you for listening.