The Fast and the Usurious: Putting the Brakes on Auto Lending Abuses

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The car loan market is rife with consumer abuses: inflated pricing, discriminatory lending, and a variety of deceptions and scams. These abuses all stem from the dealer-centric nature of the auto finance market that ties the vehicle purchase to the vehicle financing.

The overwhelming majority of consumers finance their purchases through the car dealer, but consumers cannot learn dealer financing terms in advance. They learn the offered financing terms only after spending substantial time and energy negotiating a car price, a trade-in price, warranties, insurance, and vehicle add-ons. At this point, because most consumers lack alternative financing options, they face a take-it-or-leave-it choice that leaves them especially vulnerable to dealer abuses.

Not only does the lack of alternative financing options deprive consumers of the protection of competition in auto loans, but competition in the dealer-based lending market also actually works against consumers. Dealers auction off loans to financial institutions based largely on which institution allows the dealer the greatest compensation in the form of a markup on the loan. These ultimate lenders compete for the dealers' business, not the consumers', which results in consumers paying supracompetitive rates because of the dealer markup. The discretionary nature of the markups also enables discriminatory lending, with minorities often charged more for car loans, as well as a number of outright frauds and scams that cannot occur with third-party financing.

This Article proposes to fix these auto lending abuses by requiring a three-business-day waiting period before delivery of the vehicle for consumers who do not have a bona fide third-party financing offer, as well as a prominently disclosed, penalty-free prepayment right for the loan during this period, and a system of mandatory data collection on auto loans to enable regulatory oversight. A penalty default waiting period would incentivize consumers to shop for financing separately from the vehicle purchase transaction, which will create positive competitive forces lowering dealers' supracompetitive markups of financing, reduce opportunities for discriminatory lending, and protect consumers from other deceptive practices.

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TABLE OF CONTENTS

INTRODUCTION 1259

I. STRUCTURE OF THE AUTO LOAN MARKET 1271

A. PARTICIPANTS IN THE AUTO LOAN MARKET 1271

1. Dealers 1271

2. Lenders 1273

B. THE AUTO LOAN 1274

C. AUTO LOAN FINANCING PROCESS 1275

1. Direct Lending 1275

2. Indirect Lending 1276

II. THE STRUCTURE OF THE AUTO LOAN TRANSACTION 1280

A. THE BUNDLED TRANSACTION 1280

B. THE UNAVAILABILITY OF ALL-IN PRICE INFORMATION *EX ANTE* 1282

C. PSYCHOLOGY OF THE SALE 1285

D. DEALER FINANCING AS AFTERMARKET TYING 1287

III. CONSUMER ABUSES IN AUTO LENDING 1289

A. SUPRACOMPETITIVE PRICING 1289

1. Competition in Indirect Lending Decreases Consumer Welfare 1289

2. Dealer Services Are Not Commensurate with the Markup 1294

3. Dealer Markup Is Not Subject to Competitive Pressure 1294

B. DISCRIMINATORY MARKUPS 1296

C. LOAN PACKING 1301

D. YO-YO SCAMS 1304

IV. THE POLICY-RESPONSE MENU 1306

A. PROHIBITIONS 1307

B. PRICE CONTROLS 1308

C. FIDUCIARY DUTIES 1309
D. DISCLOSURES 1311
1. Federal Disclosure Requirements 1311
2. State Disclosure Requirements 1313
E. CREATION OF CONSUMER RIGHTS 1314
F. TRANSACTION-STRUCTURE REQUIREMENTS 1316
1. Mandatory Data Sharing to Facilitate Refinancings 1316
2. Mandatory Auctions of Loans 1317
V. FORCING COMPETITION IN AUTO LENDING FOR CONSUMER PROTECTION . 1319
A. DE-LINKING VEHICLE PURCHASES AND FINANCING 1319
B. SPOT DELIVERY RESTRICTIONS AS A PENALTY DEFAULT RULE TO INCENTIVIZE CONSUMERS TO SHOP FOR FINANCING IN ADVANCE. . . . 1319
1. Mandatory Vehicle-Delivery Waiting Period Absent a Documented Third-Party Financing Offer 1319
2. Prominently Disclosed Penalty-Free Prepayment Right . . 1324
C. POLITICS, IMPLEMENTATION CHALLENGES, AND MARKET ADAPTATIONS. 1326
D. THE NEED FOR DATA ON AUTO LENDING 1327
CONCLUSION 1330

INTRODUCTION

Cars are ubiquitous in American life. Most housing and places of business in the United States are built on an assumption of automotive transportation. Over 95% of American households own at least one car,[1] and over 85% of Americans drive to work.[2]

Cars, however, are expensive. Cars are one of the largest single purchases most households make, other than home purchases. In 2018, the average new car sold

1. *American Community Survey: Means of Transportation to Work by Selected Characteristics*, U.S. CENSUS BUREAU, https://data.census.gov/cedsci/table?q=S0802&table=S0802&tid=ACSST1Y2017.S0802&lastDisplayedRow=116 [https://perma.cc/LL94-3SNE] (last visited Feb. 23, 2020) (listing 4.2% of population as having "[n]o vehicle available" in 2017).

2. *Id.* (including those who carpool).

for $35,608,[3] or more than half of the median family's annual pre-tax income.[4] Even used cars aren't cheap; the average used car sales price in 2018 was $20,586.[5] Accordingly, most Americans do not purchase their vehicles in cash. Instead, they finance them. Eighty-five percent of new car sales and 54% of used car sales were financed in 2018,[6] with the average new car loan being $31,454.[7] Most of the financing is in the form of loans, but over a quarter of financing for new cars is in the form of leases.[8] (Leases are rare for used cars.[9])

The sum of this lending is substantial. As of the end of 2019, there were around 116 million auto loans outstanding, with a total balance of $1.33 trillion.[10] This makes auto lending the second largest consumer credit market in terms of number of loans,[11] the third largest consumer credit market in terms of dollars outstanding,[12] and the largest private consumer credit market. Mortgage and student loans are larger markets in terms of dollars outstanding, but both markets feature substantial government involvement as insurers or direct lenders. In contrast, auto lending is a wholly private market.

Auto lending is also the fastest growing consumer credit market. From 2011 to 2019, the total balance on auto loans grew by 89% in nominal terms, a more dramatic growth than even student loans.[13] Figure 1 below shows the growth of the auto loan market in recent years.

3. NAT'L AUTO. DEALERS ASS'N, NADA DATA 2018: ANNUAL FINANCIAL PROFILE OF AMERICA'S FRANCHISED NEW-CAR DEALERSHIPS 11 (2018), https://www.nada.org/WorkArea/DownloadAsset.aspx?id=21474857318 [https://perma.cc/4NX4-U87X].

4. Median household income in the United States in 2018 was $63,179. JESSICA SEMEGA ET AL., U.S. CENSUS BUREAU, INCOME AND POVERTY IN THE UNITED STATES: 2018, at 1 (2019), https://www.census.gov/content/dam/Census/library/publications/2019/demo/p60-266.pdf [https://perma.cc/8Q4H-NXDX].

5. NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 15.

6. *Id.* at 24.

7. *See* Matt Tatham, *Auto Loan Debt Sets Record Highs*, EXPERIAN (July 18, 2019), https://www.experian.com/blogs/ask-experian/research/auto-loan-debt-study [https://perma.cc/P6NU-JWF5].

8. NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 24.

9. EXPERIAN, STATE OF THE AUTOMOTIVE FINANCE MARKET: Q1 2019, at 11 (2019), https://www.experian.com/content/dam/marketing/na/automotive/quarterly-webinars/credit-trends/q1-2019-safm-final-v2.pdf [https://perma.cc/87SS-PBQR].

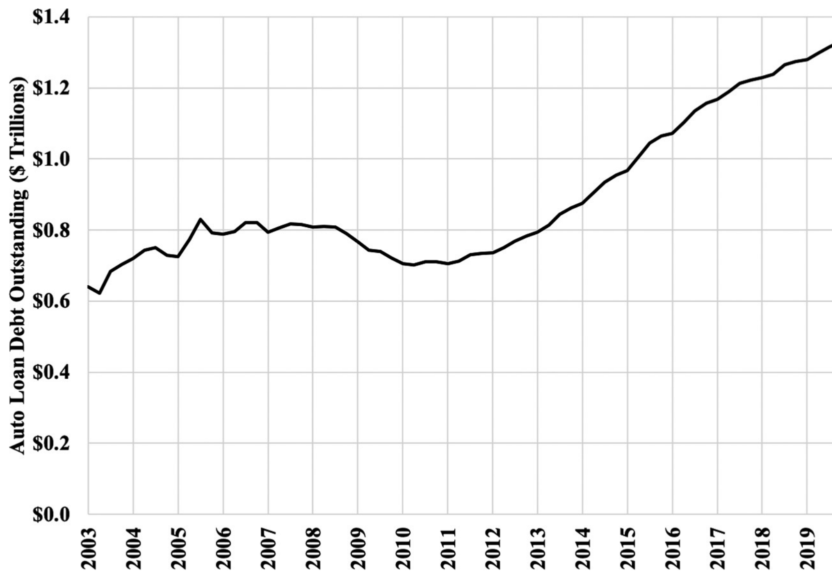
10. *Quarterly Report on Household Debt and Credit 2019: Q4 Underlying Data*, FED. RESERVE BANK OF N.Y. (2020), https://www.newyorkfed.org/microeconomics/hhdc/background.html (click "download data" under "2019 Q4"), [https://perma.cc/FR67-UBAA] (last visited Apr. 8, 2020). This implies an average outstanding auto loan balance of $11,476.

11. CTR. FOR MICROECONOMIC DATA, FED. RESERVE BANK OF N.Y., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT 2018: Q4, at 4 (2019), https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/hhdc_2018q4.pdf [https://perma.cc/2V36-38RN].

12. *Id.* at 3. "Other" is not counted as an individual market.

13. *See Quarterly Report on Household Debt and Credit 2019: Q4 Underlying Data*, *supra* note 10, at 3. On an inflation-adjusted basis using the Consumer Price Index for All Urban Consumers (CPI-U), the growth rate of auto loans was 62% during this period. *Id.* In contrast, student loans grew 80% on a nominal basis and an inflation-adjusted growth rate of 54%. *Id.*; *see also CPI Inflation Calculator*, U.S. BUREAU OF LABOR STATISTICS, https://www.bls.gov/data/inflation_calculator.htm (last visited Apr. 8 2020).

Figure 1: Growth of the Auto Loan Market, 2003–2019[14]



Auto lending is also a uniquely problematic market, both because of the structure of the loan transaction and the institutional structure of the market. Auto loans comprise nearly all purchase-money loans,[15] so they are intimately connected with the purchase of vehicles. The vehicle purchase is, in turn, almost always made through a franchised vehicle dealer.[16] And, in the vast majority of cases, the dealer also arranges the financing, which ultimately comes from another financial institution such as a captive finance company, a bank, or a credit union.[17]

A car purchase, as it happens, is a uniquely complicated transaction that has several different components. It is a materially different transaction than, say,

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14. *Quarterly Report on Household Debt and Credit 2019: Q4 Underlying Data*, *supra* note 10, at 3 (data source for nominal figures).

15. There is a small market for refinancing auto loans. *See* Press Release, Ally Financial, Inc., Auto Refinancing - A Little-Known Source for Monthly Savings (Dec. 6, 2017), https://media.ally.com/2017-12-06-Auto-Refinancing-a-Little-Known-Source-for-Monthly-Savings [https://perma.cc/N69F-UQJW] (finding that only 12% of vehicle owners had ever refinanced an auto loan). It is possible to borrow against a car title in some states, but that product, known as a vehicle-title loan or vehicle-pawn loan, is a distinct product used for short-term collateralized consumer credit.

16. *See infra* notes 55–63 and accompanying text.

17. *See* Ed Swanson, *Is Indirect Lending Really an Option Anymore?*, TCI DECISION LENDER (Jan. 26, 2017), https://tcicredit.com/blog/indirect-lending-really-option-anymore [https://perma.cc/R49J-BJST] (indicating that 87% of financing is done through dealer); *see also* NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 2 (showing F&I penetration—dealer-arranged financing or insurance products for new vehicles—is at 90%); RAJ DATE & BRIAN REED, CAMBRIDGE WINTER CTR. FOR FIN. INSTS. POLICY, AUTO RACE TO THE BOTTOM: FREE MARKETS AND CONSUMER PROTECTION IN AUTO FINANCE 4 (2009) (showing that 79% of car buyers get financing from dealership).

purchasing a sofa, which usually involves a purchase transaction and perhaps financing or a warranty, but typically nothing else. In a car purchase transaction, there is first the vehicle purchase itself. Second, there may be various physical upgrades and add-ons to the purchased vehicle—entertainment systems, floor mats, anti-theft devices, and window etching, for example. Third, there is potentially a trade-in—that is, a sale to the dealer—of the buyer's old vehicle. Fourth, there is potentially the purchase of various warranties, credit insurance products, and vehicle service contracts.[18] And fifth, there may be financing for the purchase.

Although each of these components is a separate and negotiable transaction, the pricing of one is often linked to the pricing of another. Thus, a cheaper sales price might be linked to the consumer obtaining financing from a particular source or to a particular trade-in value.[19] Altogether, a car purchase transaction amounts to what is arguably the most complicated transaction a consumer ever faces, even more so than a home purchase.

The problems in the auto lending market are not simply a consequence of the complex nature of the transaction, but are also a function of the institutional structure of the market. Almost all car purchases are done through specialized car dealerships; one cannot simply buy a car on Amazon or from Walmart.[20] Because the car financing transaction is typically connected with the car purchase transaction, the majority of auto financing is done through auto dealers; 87% of buyers finance the car through the dealership.[21]

It bears emphasis just what an unusual arrangement dealer financing is. Automobiles are the only regular major purchase that is financed primarily by the seller. Seller financing is offered for other large ticket products—electronics, furniture, jewelry—but these are products of a price that many consumers can readily finance with a credit card; the consumer has an alternative to the seller-offered financing terms. In contrast, auto loans are usually for amounts that exceed consumers' credit card limits. So, unless the consumer has lined up a third-party lender in advance, the consumer does not have an alternative financing possibility when preparing to close the transaction; the dealer is the only option.[22] This means that, in most instances, the car purchase transaction is linked to the car financing transaction.

Most financing is done through dealerships, with the dealer as the initial lender of record. The dealer is almost never the ultimate lender for new car sales,

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18. *See infra* note 102 and accompanying text.

19. *See infra* note 103.

20. *Dealer Licensing*, DMV.ORG, https://www.dmv.org/buy-sell/car-dealers/dealer-licensing.php [https://perma.cc/44R4-925W] (last visited Feb. 28, 2020) ("Every state in the country mandates specific requirements for obtaining a vehicle dealership license."); *see also* Daniel A. Crane, *Tesla, Dealer Franchise Laws, and the Politics of Crony Capitalism*, 101 IOWA L. REV. 573, 574 (2016) (noting restrictions on original-equipment manufacturers in obtaining dealer licenses).

21. *See supra* note 17.

22. Dealers also typically refuse to accept credit card payments above a certain amount because of the merchant fees on cards and risk of fraud.

though, and is frequently not the ultimate lender for used car sales.[23] Instead, in most cases, the dealer usually assigns the loan to the ultimate lender—a financial institution such as a bank, credit union, or captive finance company.[24] The assignee is known as an "indirect lender." The dealer is in effect brokering or arranging a loan for indirect lenders.

In indirect auto lending, the dealer agrees to make the loan (technically in the form of a "retail installment sales contract" that combines in one document a sales agreement and a financing agreement[25]) only after lining up an indirect lender that is willing to buy the loan. The indirect lender sets the terms on which it will buy loans, specifying the minimum interest rate required to purchase the loan (the "buy rate") and other required loan terms.

As compensation for arranging the loan, the indirect lender allows the dealer to retain part of the finance charge for the loan in the form of a markup above the buy rate, which is either paid over time out of loan payments or as an upfront flat fee. For example, if the lender's buy rate is 3.00%, the dealer might charge the consumer an interest rate of 5.50%. This 250 basis point[26] (2.50%) difference between the buy rate and the rate charged to the consumer is known as a "dealer markup," "dealer reserve," or "dealer participation." Accordingly, the loan rate (L) paid by the borrower is the sum of the buy rate (B) and the markup (M), or $L = B + M$.

23. *See* NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 25 (showing market share by lender type for new vehicles, with negligible market share for buy-here-pay-here dealers). In the used car market, dealers do sometimes provide the ultimate financing as buy-here-pay-here dealerships. *See What Is a "No Credit Check" or "Buy Here, Pay Here" Auto Loan?*, CFPB (June 8, 2016), https://www.consumerfinance.gov/ask-cfpb/what-is-a-no-credit-check-or-buy-here-pay-here-auto-loan-en-887/ [https://perma.cc/CZJ3-PHUU] (explaining what a buy-here-pay-here dealer is); EXPERIAN, STATE OF THE AUTOMOTIVE FINANCE MARKET: Q2 2019, at 12, https://www.experian.com/content/dam/marketing/na/automotive/quarterly-webinars/credit-trends/experian-auto-q2-2019-safm.pdf [https://perma.cc/2425-WVKV] (showing buy-here-pay-here dealers with negligible new vehicle market share, but substantial used vehicle market share).

24. A captive finance company, such as American Honda Finance Corporation or Ford Motor Credit, is a nonbank lender that is a corporate affiliate of an auto manufacturer. *See* Matthew A. Smith, *Brothers at Arm's Length: U.C.C. Article 2A, Captive Finance Companies, and the Close-Connection Doctrine*, 1999 WIS. L. REV. 1051, 1064. Captives are in the business of solely providing financing to facilitate the sale of the manufacturer's vehicles. *Id.* This means that captives provide both floor-plan financing to dealers to fund their inventory purchase and purchase-money financing to consumers to buy cars from dealers. *See* Mick Warshaw, *Captives, Dealers, and F&I Pay Plans*, F&I & SHOWROOM (Apr. 30, 2014), https://www.fi-magazine.com/310455/captives-dealers-and-fi-pay-plans [https://perma.cc/VK4P-6M8H]; Wayne J. Taylor, *How Do They Keep Those Showrooms Full?*, BOS. GLOBE (Sept. 6, 2016), https://sponsored.bostonglobe.com/rocklandtrust/floor-plan-lending/ [https://perma.cc/H4YD-YXGX].

25. *What Is a Retail Installment Sales Contract or Agreement? Is This a Loan?*, CFPB (June 8, 2016), https://www.consumerfinance.gov/ask-cfpb/what-is-a-retail-installment-sales-contract-or-agreement-is-this-a-loan-en-817/ [https://perma.cc/T2C2-Z2AJ].

26. A basis point is 1/100 of a percent (0.0001), meaning that 100 basis points are equal to 1% (0.01). The use of the "basis point" terminology eliminates the confusion that can arise when one refers to "percent" in the context of a change in interest rates. For example, a 25% increase in the 10% interest rate could mean either a percentage increase in the rate to 12.5% or an absolute increase in the rate to 35%. An increase of "250 basis points" would make clear that the rate had increased to 12.5%, while an increase of "2,500 basis points" would make clear that the rate had increased to 35%.

The markup is calculated in the form of an interest rate on the total loan amount, rather than a flat fee, even though it may be paid out to the dealer in a lump sum.[27] Therefore, dealer compensation for arranging the loan depends on the size of the loan (and thus, indirectly, on the price of the car and any add-ons), the size of the markup, and the length of the loan, although the dealer provides the same service, regardless of the loan's size, its length, or the ultimate interest rate.[28]

The structure of the indirect auto lending market means that indirect lenders are not competing for consumers' business; they are competing for dealers' business. The dealer is the indirect auto lender's customer, not the consumer. Indirect auto lenders compete for dealers' business primarily using the size of the dealer markup allowed, where a lower buy rate enables a greater markup. So, unlike in other markets, competition does not drive down prices in indirect auto lending. Rather than resulting in a lower loan rate for the consumer, a lower buy rate simply enables the dealer to impose a higher markup.

The primary limit on pricing is that the dealer needs to make sure the consumer will actually take the financing offer in order to get the markup.[29] If the marked-up price is too high, the consumer might balk at completing the transaction. This puts some pressure to hold down the total of the buy rate plus the markup. But, given the transactional context of auto loans, there is a high degree of consumer lock-in by the time the consumer gets to discuss financing terms. Importantly, because of the transaction structure, even if the consumer believes that the financing costs are too high, the consumer cannot readily adjust the terms of the vehicle purchase. That would require the consumer going back and negotiating the vehicle sale price again.

The financing terms are always discussed only at the end of a lengthy transactional process, following several hours of negotiations over the vehicle purchase, trade-in, and any add-ons. The transactional setting means that consumers are already emotionally committed to the transaction. It also means they are worn down and more likely to take the financing terms offered because of a sunk cost fallacy problem,[30] limited information about other financing options, and high search costs for obtaining information.[31]

The combination of the loan transaction with various sales and insurance transactions, the institutional structure of the auto lending market, and the transactional context of the financing leads to a host of consumer protection problems in

27. Although the markup is calculated as an interest rate on the loan amount, it might be paid by the indirect lender to the dealer as an upfront lump sum.

28. *See, e.g.*, Wallace P. Mors, *Recent Trends in State Regulation of Instalment Credit*, 15 J. FIN. 191, 203 (1960).

29. Lenders may also limit the total loan amount and loan-to-value ratio (LTV).

30. *See infra* note 128 (discussing behavioral science literature on sunk costs).

31. *See* Bronson Argyle et al., *Real Effects of Search Frictions in Consumer Credit Markets*, FED. DEPOSIT INS. CORP. 28 (Sept. 2017), https://www.fdic.gov/news/conferences/consumersymposium/2017/index.html [https://perma.cc/M6BB-D5QY] (demonstrating high search frictions for direct auto lending).

auto lending. Auto lending, particularly in the used car context, has long been the butt of jokes about scamming, overzealous salesmen. Indeed, the fast-talking auto salesman wearing a loud plaid jacket is a virtual trope in movies and cartoons.[32] But the consumer protection problems in auto lending are quite real. They are not simple problems of consumers being sold "lemons" but are instead problems of market and transaction structure that disincentivize competition and leave consumers vulnerable to supracompetitive pricing, discriminatory lending, forced upselling, and other abuses.

This Article focuses on four of the foremost problems in auto lending. Other issues exist, but these four are not only among the most common and serious problems but are also all connected to the unique transactional and institutional structure of the market in which the vehicle purchase transaction is linked to the vehicle financing transaction. More importantly, this Article argues that, because of this common structural cause, these four problems can all be readily addressed through the same targeted regulatory reform with few adverse consequences.

First, auto loan pricing is supracompetitive because of the difficulties in comparing costs in the context of bundled transactions. Consumers are able to readily obtain price quotes for vehicle sales but not for the all-in cost of a purchase (car, trade-in, add-ons, and financing). Given dealers' ability to shift costs between these components of the transaction, a price quote on a car is of limited use to consumers and does not in any way facilitate competitive pricing for the financing. Unless the consumer has lined up an offer of financing from a third party—something that only a minority of consumers do because consumers tend to think of the transaction as being simply a car purchase, not as a car purchase and a separate financing—the dealer markup is not subject to any real competitive pressure from comparative offers. Although indirect lending saves lenders the expense of having to prospect for consumers through advertisement and maintenance of a retail salesforce, any pass-through of those savings to consumers is offset by the competitive pressure for lenders to allow larger dealer markups.

Second, auto lending is particularly susceptible to discriminatory pricing. The extent of a markup is committed to the dealer's discretion, cabined only by any cap required by an indirect lender or, in rare cases, by state law. This means that dealers do not have one-size-fits-all markups. Instead, markups are determined on a case-by-case basis based on the dealer's estimation of the borrower's willingness to pay. The result is that minorities end up being charged larger markups such that the aggregate of markups are charged disproportionately to them.

Third, consumers face a problem of "loan packing," that is the sale of add-on products that are falsely represented as being required purchases for obtaining financing. Consumers are offered lots of add-ons by dealers, such as dealer-installed upgrades, vehicle service contracts, various insurance products, rust-

32. *See, e.g.*, CADILLAC MAN (Orion Pictures 1990); CAR DOGS (AngelShark Entertainment 2016); FARGO (PolyGram Filmed Entertainment 1996); MATILDA (TriStar Pictures 1996); SUCKERS (Neo Motion Pictures 2001); THE GOODS: LIVE HARD, SELL HARD (Paramount Vantage 2009); TRUE LIES (Lightstorm Entertainment 1994); USED CARS (Columbia Pictures 1980).

proofing, and, as made famous by the movie *Fargo*, TruCoat.[33] These are products that are rarely, if ever, purchased as standalones, indicating that consumers do not value them independently, and they are often priced at a significant markup over cost.[34] Although it is perfectly legal to sell overpriced add-ons, dealers will sometimes falsely represent that these add-ons are required as a condition of the loan or that loan pricing will increase if they are not purchased. The consumer ends up purchasing unwanted products and paying more in both sale and financing costs, including financing the unwanted add-on. The effectiveness of false representations about add-ons being required for financing depends on the consumer being reliant on the dealer for financing; if the consumer has alternative financing options, the consumer will readily recognize that the add-ons need not be purchased to obtain financing.

Fourth, the transactional framework leaves consumers vulnerable to "yo-yo" scams. In a yo-yo scam, the consumer takes delivery of the vehicle before the financing is finalized, only to receive a call from the dealer a couple days later and be told that the financing was not approved so the consumer must return the vehicle or agree to pay a higher interest rate. This type of scam extracts the additional interest rate from consumers based on the attachment they have developed to the car and their potential embarrassment at having to return it right after they have proudly showed it off to family and friends. Again, yo-yo scams are only possible with dealer financing; dealers will typically not let the car leave the lot if they do not believe that they can obtain third-party financing because the dealer will then bear the risk of the consumer making off with the car.

This Article proposes addressing all four of these consumer protection problems in the auto lending market with a relatively simple structural solution: a penalty default rule requiring a waiting period (perhaps three business days, though the particular length is a secondary concern) between the vehicle sale and the delivery of the vehicle to the consumer for all financed transactions, unless the buyer has a documented, bona fide financing offer from a third party. Such a rule could be adopted legislatively or through either Federal Trade Commission (FTC) or Consumer Financial Protection Bureau (CFPB) rulemaking.[35]

The purpose of a penalty default rule is to encourage parties to take affirmative steps to avoid being subjected to the penalty imposed by the default rule.[36] The

33. *See* FARGO, *supra* note 32.

34. *See* JOHN W. VAN ALST ET AL., NAT'L CONSUMER LAW CTR., AUTO ADD-ONS ADD UP: HOW DEALER DISCRETION DRIVES EXCESSIVE, ARBITRARY, AND DISCRIMINATORY PRICING 1 (2017), https://www.nclc.org/images/pdf/car_sales/report-auto-add-on.pdf [https://perma.cc/Q3Y8-6R3E] [hereinafter VAN ALST ET AL., AUTO ADD-ONS ADD UP]; JOHN W. VAN ALST, NAT'L CONSUMER LAW CTR., FUELING FAIR PRACTICES: A ROAD MAP TO IMPROVED PUBLIC POLICIES FOR USED CAR SALES AND FINANCING 15 (2009), https://www.nclc.org/images/pdf/car_sales/report-fuelingfairpractices0309.pdf [https://perma.cc/79SU-AAU7] [hereinafter VAN ALST, FUELING FAIR PRACTICES] (noting that consumers can pay a 100% markup on service contracts).

35. *See infra* note 292. The FTC would be able to impose such a rule through regulation of dealers, whereas the CFPB would be able to do so through regulation of indirect lenders. *Id.*

36. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91, 95 (1989) (explaining that "penalty default rules" are set to what

idea behind imposing a waiting period as a penalty default rule is that it will incentivize consumers to obtain financing offers *before* shopping for a car, rather than afterwards when they are dealing with the dealer's situational monopoly. In other words, imposing a penalty default waiting period will incentivize consumers to shop for financing and thus create a market in auto financing that competes for consumers, not dealers. If consumers were to obtain financing offers prior to purchasing a car, dealers would not be able to charge supracompetitive markups on loans nor would they be able to discriminate in their markups because the consumer would have a ready alternative offer. Competition for the consumer's business would push down loan pricing and eliminate discrimination.[37]

At the same time, obtaining financing offers in advance would eliminate the ability of dealers to engage in loan packing by falsely representing that credit availability and terms are tied to the purchase of unnecessary add-on products. Lining up financing in advance would also end yo-yo financing scams that are based on delivering the vehicle to the consumer prior to financing approval.

The penalty default rule proposed by this Article would not, of course, eliminate all problems in the auto sales market or even in the auto lending market. But a mandatory waiting period for auto delivery in financed transactions would address the four most significant problems in the lending market in one fell swoop without a material adverse effect on consumer choice.

Although the penalty default rule is the Article's primary policy proposal, it makes two secondary proposals designed to buttress such a penalty default rule. First, the Article proposes mandating a right to a penalty-free prepayment period for auto loans and requiring prominent disclosure of this right, including the ability to prepay by refinancing. Alerting consumers to their ability to refinance loans would assist those consumers who do not adjust their behavior in response to the penalty default rule. Second, the Article proposes a system of auto loan data collection modeled on the Home Mortgage Disclosure Act's data collection regime. The collection and public availability of such data would help police against discriminatory lending practices in auto finance.

This Article makes three contributions to the financial regulation literature. First, it provides the first comprehensive scholarly treatment of the auto lending market, detailing the unusual structure of the market and of the auto loan transaction and the perverse incentives they create. Second, the Article identifies four distinct auto lending abuses and shows how they all relate to the unusual dealer-centric structure of the market that results in the bundling of the financing transaction with the vehicle purchase transaction. And third, the Article provides an

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parties would *not* want because they are designed to incentivize parties to contract around the default rule).

37. *See generally* Devah Pager, *Are Firms that Discriminate More Likely to Go Out of Business?*, 3 SOC. SCI. 849, 855 (2016), https://pdfs.semanticscholar.org/8352/93b0549304932e119a005a2ec70a1668bbe0.pdf [https://perma.cc/AA3T-FV86]; *see also* GARY S. BECKER, THE ECONOMICS OF DISCRIMINATION 46 (2d ed. 1971).

original and simple structural solution to that would simultaneously address all four of these abuses.

The auto lending market is the largest completely private consumer credit market in the United States, yet it has been virtually untouched by scholarship. Although the mortgage market and student loan markets are larger in terms of dollar amounts (albeit smaller in terms of number of loans),[38] the federal government is active as a market participant in both those markets. The federal government serves as a direct lender for student loans and insures both mortgages and mortgage-backed securities. In contrast, the federal government does not participate in any way in the auto lending market. Indeed, there is no specific federal regulation of auto loans beyond generally applicable consumer credit regulation, unlike mortgages, student loans, credit cards, and payday loans. Product-specific regulation of auto loans is all done at the state level, primarily through non-uniform state motor vehicle retail installment sale laws.

Despite the size of the auto lending market and its uniquely private nature, there is, surprisingly, almost no scholarship on the market in any discipline, much less a comprehensive overview of the market. There are several articles by legal scholars about vehicle *title* lending, which is a distinct and much smaller market for short-term, non-purchase money loans that are secured by title to a vehicle the consumer already owns.[39] A pair of student notes consider various aspects of regulation of the auto finance market, but lack an overall view of the market.[40]

The closest existing published work is an economics article establishing that there is a linkage between auto sale prices and the cost of automobile credit.[41] It shows that in states with lower usury caps, auto dealers shift pricing from financing to sticker pricing.[42] An unpublished economics working paper undertakes the most detailed look at the indirect lending market's structure and presents original empirical data about loan markups and consumer responsiveness to changes in vehicle and financing pricing.[43] There are also a handful of economics articles

38. *Quarterly Report on Household Debt and Credit 2019: Q4 Underlying Data*, *supra* note 10, at 3–4.

39. *See, e.g.*, Kathryn Fritzdixon et al., *Dude Where's My Car Title?: The Law, Behavior, and Economics of Title Lending Markets*, 2014 U. ILL. L. REV. 1013; Jim Hawkins, *Credit on Wheels: The Law and Business of Auto-Title Lending*, 69 WASH. & LEE L. REV. 535 (2012); Nathalie Martin & Ozymandias Adams, *Grand Theft Auto Loans: Repossession and Demographic Realties in Title Lending*, 77 MO. L. REV. 41 (2012); Todd J. Zywicki, *Consumer Use and Government Regulation of Title Pledge Lending*, 22 LOY. CONSUMER L. REV. 425 (2010).

40. *See* Chris O'Brien, Comment, *The CFPB's Endaround*, 67 CATH. U. L. REV. 365 (2018); Jennifer Pope, Note, *Preventing Predatory Practices: Indirect Auto Lending in the Motor City*, 95 U. DET. MERCY L. REV. 487 (2018).

41. *See* Brian T. Melzer & Aaron Schroeder, *Loan Contracting in the Presence of Usury Limits: Evidence from Automobile Lending* (CFPB Office of Research Working Paper Series, Working Paper No. 2017-2, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2919070 [https://perma.cc/6A8S-MZG4].

42. *Id.* at 21.

43. *See* Andreas Grunewald et al., *Auto Dealer Loan Intermediation: Consumer Behavior and Competitive Effects* (Oct. 1, 2019) (unpublished article) (on file with Mass Inst. of Tech. Dep't of Econ.), https://perma.cc/ZQ8X-FLLE.

analyzing whether there is evidence of discriminatory lending in the auto loan market,[44] as well as a parallel body of literature examining discrimination in the pricing of non-financed car sales.[45] Beyond this, there is a motley collection of economics articles that consider the impact of the 2009 "cash for clunkers" trade-in subsidization program,[46] the effect of liquidity constraints on subprime auto loan borrowers,[47] and the relative leniency of the credit terms of captive auto finance companies.[48]

There is no scholarly literature whatsoever, however, that considers the general institutional and transactional structure of the auto lending market and the failures that exist in that market other than discriminatory lending. At best, there are reports by consumer advocacy organizations that touch on some of these structural issues but they do not explore them in depth.[49] This Article represents a first

44. *See* Kerwin Kofi Charles et al., *Rates for Vehicle Loans: Race and Loan Source*, 98 AM. ECON. REV. (PAPERS & PROC.) 2008, at 315; Mark A. Cohen, *Imperfect Competition in Auto Lending: Subjective Markup, Racial Disparity, and Class Action Litigation*, 8 REV. L. & ECON. 21 (2012); Alexander W. Butler et al., *Discrimination in the Auto Loan Market* (Dec. 12, 2019) (unpublished article), http://ssrn.com/abstract=3301009 [https://perma.cc/P535-Y7SN].

45. *See* Ian Ayres, *Fair Driving: Gender and Race Discrimination in Retail Car Negotiations*, 104 HARV. L. REV. 817 (1991) (finding price discrimination again women and minorities); Ian Ayres, *Further Evidence of Discrimination in New Car Negotiations and Estimates of Its Cause*, 94 MICH. L. REV. 109 (1995) (same); Ian Ayres & Peter Siegelman, *Race and Gender Discrimination in Bargaining for a New Car*, 85 AM. ECON. REV. 304 (1995) (same); Pinelopi Koujianou Goldberg, *Dealer Price Discrimination in New Car Purchases: Evidence from the Consumer Expenditure Survey*, 104 J. POL. ECON. 622 (1996) (finding no evidence of price discrimination against women and minorities); David W. Harless & George E. Hoffer, *Do Women Pay More for New Vehicles? Evidence from Transaction Price Data*, 92 AM. ECON. REV. 270 (2002) (same); Fiona Scott Morton et al., *Consumer Information and Discrimination: Does the Internet Affect the Pricing of New Cars to Women and Minorities?*, 1 QUANTITATIVE MARKETING & ECON. 65 (2003) (finding that, although in-person minority buyers pay more than white buyers, there is no statistical evidence of discrimination).

46. *See* Mark Hoekstra et al., *Cash for Corollas: When Stimulus Reduces Spending*, 9 AM. ECON. J.: APPLIED ECON., July 2017, at 1; Atif Mian & Amir Sufi, *The Effects of Fiscal Stimulus: Evidence from the 2009 Cash for Clunkers Program*, 127 Q.J. ECON. 1107 (2012).

47. *See* William Adams et al., *Liquidity Constraints and Imperfect Information in Subprime Lending*, 99 AM. ECON. REV. 49 (2009); Orazio P. Attanasio et al., *Credit Constraints in the Market for Consumer Durables: Evidence from Micro Data on Car Loans*, 49 INT'L ECON. REV. 401 (2008); Liran Einav et al., *Contract Pricing in Consumer Credit Markets*, 80 ECONOMETRICA 1387 (2012); Liran Einav et al., *The Impact of Credit Scoring on Consumer Lending*, 44 RAND J. ECON. 249 (2013).

48. *See* John M. Barron et al., *Emergence of Captive Finance Companies and Risk Segmentation in Loan Markets: Theory and Evidence*, 40 J. MONEY, CREDIT & BANKING 173 (2008).

49. *See, e.g.*, DELVIN DAVIS, CTR. FOR RESPONSIBLE LENDING, NON-NEGOTIABLE: NEGOTIATION DOESN'T HELP AFRICAN AMERICANS AND LATINOS ON DEALER-FINANCED CAR LOANS (2014), https://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/CRL-Auto-Non-Neg-Report.pdf [https://perma.cc/6W3X-R465]; DELVIN DAVIS & JOSHUA M. FRANK, CTR. FOR RESPONSIBLE LENDING, UNDER THE HOOD: AUTO LOAN INTEREST RATE HIKES INFLATE CONSUMER COSTS AND LOAN LOSSES (2011), https://responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/Under-the-Hood-Auto-Dealer-Rate-Markups.pdf [https://perma.cc/WF2Z-SNWK]; LISA RICE & ERICH SCHWARTZ JR., NAT'L FAIR HOUS. ALL., DISCRIMINATION WHEN BUYING A CAR: HOW THE COLOR OF YOUR SKIN CAN AFFECT YOUR CAR-SHOPPING EXPERIENCE (2018), https://nationalfairhousing.org/wp-content/uploads/2018/01/Discrimination-When-Buying-a-Car-FINAL-1-11-2018.pdf [https://perma.cc/AAZ8-9A2U]; VAN ALST ET AL., AUTO ADD-ONS ADD UP, *supra* note 34; VAN ALST, FUELING FAIR PRACTICES, *supra* note 34.

step in that direction. It lays out a comprehensive overview of both the market structure and the transaction structure, and identifies a set of four serious consumer abuses that stem from these structures before proposing a discrete change to the *transaction structure* that would remedy the problems with the *market structure*.

The Article proceeds in five parts as follows. Part I walks the reader through the structure of the auto finance market and explains the difference between direct and indirect lending and the critical role played by dealers in the indirect lending market. Part II explores the structure of the auto loan transaction, which is part of a uniquely complex bundle of theoretically separate transactions. It also sets forth the psychological context of the auto loan transaction and how it discourages consumer price shopping and bargaining. Part III identifies four common consumer protection problems in the auto loan market—supracompetitive pricing, discriminatory pricing, loan packing, and yo-yo scams—and explains how they all relate to the unique structure of the car loan transaction being effectively tied to the car purchase transaction through the dealer.

Part IV considers a menu of possible policy responses to the problems in the auto lending market. It shows how many of the tools in the regulatory toolkit for addressing similar "trilateral dilemmas" in financial markets are inapposite to the auto lending market because the problems in the market have a structural origin in the linked purchase and financing transactions. A trilateral dilemma exists when consumers rely on the recommendations of a financial service provider that is incentivized to steer the consumer in a manner that serves its interests, not the consumer's.[50] The standard policy responses to trilateral dilemmas, however, do not address problems in market structure.

Part V presents this Article's policy-response proposal of a penalty default rule with a waiting period between sale and delivery of all financed vehicle purchases, unless a buyer can document a bona fide third-party financing offer. It explains that this structural change to the vehicle purchase transaction would force competition for vehicle financing, which would, in turn, substantially curtail all four of the consumer protection problems identified. It also proposes an adjunct policy response of a prominently disclosed penalty-free prepayment right for auto financing and mandatory reporting of auto financing data—along the lines of mortgage data reporting under the Home Mortgage Disclosure Act—to facilitate better policing of discriminatory auto lending and overall regulatory policy optimization.

50. Howell E. Jackson, *The Trilateral Dilemma in Financial Regulation*, *in* OVERCOMING THE SAVING SLUMP: HOW TO INCREASE THE EFFECTIVENESS OF FINANCIAL EDUCATION AND SAVINGS PROGRAMS 82, 83 (Annamaria Maria Lusardi ed., 2008) (coining the term "trilateral dilemma").

I. STRUCTURE OF THE AUTO LOAN MARKET

A. PARTICIPANTS IN THE AUTO LOAN MARKET

1. Dealers

Dealers play a critical role in auto transactions. Virtually all new cars sold in the United States are sold through dealerships. Indeed, state laws in many states prohibit direct sales of vehicles by manufacturers and require new car sales to be made through third-party dealers.[51] A majority of used cars are sold through dealerships as well. Dealers also often provide maintenance and repair service. Dealers not only sell and fix cars, but also play a key role in the financing of the purchases. Some vehicle purchases are funded through loans from third-party banks and credit unions. These third-party lenders loan directly to the consumer and are known as "direct lenders."

A majority of vehicle purchases, however, are financed through the dealer in the first instance. Dealers are generally incentivized to sell the loans they make because they do not want to have to deal with loan servicing and funding costs of the loans. Dealers themselves often have to borrow funds to purchase the cars in their inventory (known as floor plan financing).[52] They look to repay their floor plan lender from their vehicle sales, but if a dealer is itself providing the funds for the consumer to purchase the vehicle, it cannot repay the floor plan lender with the sale proceeds. Therefore, dealers sell the financing contracts to third-party lenders that are effectively providing the funding for the vehicle purchase. These third-party purchases are known as "indirect lenders."

There are three main types of dealers: franchises, independents, and buy-here-pay-here. All new car dealers are franchise dealers; they have the exclusive franchise to sell or lease a particular brand of new vehicle.[53] Franchise dealerships are independently owned entities that operate under a franchise agreement with an auto manufacturer (known as an "original equipment manufacturer" or OEM). Many franchises are family-owned.[54]

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51. Almost all states have dealer-franchise laws that effectively require new vehicles to be sold and serviced through franchised dealerships; the original equipment manufacturers (OEMs) are not allowed to sell or service vehicles directly to the public, although they may do so in some instances through temporary operation of revoked franchises. *See* Crane, *supra* note 20, at 579; *see also* Francine Lafontaine & Fiona Scott Morton, *Markets: State Franchise Laws, Dealer Terminations, and the Auto Crisis*, 24 J. ECON. PERSP. 233, 234, 239 (2010). For an example of an OEM operating a revoked franchise, see Tom Hals & Martha Graybow, *GM Bankruptcy Forever Linked to Harlem Dealership*, REUTERS (June 1, 2009, 12:33 PM), http://www.reuters.com/article/2009/06/01/us-gm-harlemdealership- idUSTRE55050V20090601 [https://perma.cc/3P3G-FP4V].

52. *See* FITCH RATINGS, GLOBAL RATING CRITERIA FOR DEALER FLOORPLAN ABS 26–27 (2016), https://perma.cc/D9A9-2BSE.

53. *See* SEAN P. MCALINDEN, CTR. FOR AUTO. RESEARCH, THE COMPETITIVE POSITION OF NEW VEHICLE DEALERSHIPS AND THEIR VALUE TO CONSUMERS 2 (2016), https://www.ftc.gov/system/files/documents/public_comments/2016/03/00495-100888.pdf [https://perma.cc/7BVB-XNUP].

54. *See* Joe DiFeo, *Why Buy from a Family-Owned Car Dealership?*, VOLKSWAGEN ST. AUGUSTINE (Aug. 10, 2018), https://www.vwstaug.com/blogs/1984/best-practices-on-buying-a-car/why-buy-from-a-family-owned-car-dealership/ [https://perma.cc/J7TH-U2LL].

Historically, OEMs sold their vehicles directly, through factory stores, by mail order, on consignment, or through retail department stores, traveling salesmen, and wholesalers.[55] By the 1950s, however, the OEMs began using franchised dealerships as a way of shifting both the cost of capital investment in sales outlets and the carrying cost of inventory.[56] The franchised dealership model also provided OEMs with a ready solution to ensure quality control over warranty support and vehicle service.[57] Franchise dealers frequently also sell used vehicles (including those they purchase as trade-ins) and have a service department in order to perform warranty and recall service. Franchise dealers will usually sell any loans that they make to unaffiliated indirect lenders shortly after making the transaction, such that they do not remain the creditor on the loan.[58]

Independent dealers are not affiliated with particular manufacturers and are limited to selling used cars. Some also operate service departments. When independent dealers make loans, they too almost always sell them to unaffiliated indirect lenders.[59]

Buy-here-pay-here (BHPH) dealers sell older, high-mileage used cars to consumers with poor credit. BHPH dealers generally retain the loans they make (hence, "pay here") or transfer them to an affiliated BHPH finance company. BHPH loans typically have short terms and high repossession rates.[60]

There are nearly 17,000 auto dealers of all stripes nationwide.[61] Many dealers are parts of chains with common ownership. (These chains may include franchises of different OEMs.) Thus, there are only around 8,000 individual dealership owners, with some chains owning over 50 dealerships.[62] The average dealership does around $60 million in annual sales, which represents perhaps 2,000 vehicle sales (new and used) per year.[63]

Dealers have outsized political power both local and nationally. There are dealerships in virtually every sizable community of and in most Congressional districts. These dealerships are small businesses, with an average of seventy employees.[64] Their owners are often civically engaged, sponsoring Little League

55. Thomas G. Marx, *The Development of the Franchise Distribution System in the U.S. Automobile Industry*, 59 BUS. HIST. REV. 465, 465–66 (1985).

56. *Id.* at 466; Gary Michael Brown, Note, *State Motor Vehicle Franchise Legislation: A Survey and Due Process Challenge to Board Composition*, 33 VAND. L. REV. 385, 387 (1980).

57. Marx, *supra* note 55, at 467–69.

58. EXPERIAN, *supra* note 23, at 12 (showing sources of financing for new vehicle loans).

59. *Id.* (showing sources of financing for used vehicle loans).

60. *See supra* note 23 and accompanying text.

61. NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 5–6 (showing the number of total dealerships in 2018).

62. NAT'L AUTO. DEALERS ASS'N, NADA DATA 2017: ANNUAL FINANCIAL PROFILE OF AMERICA'S FRANCHISED NEW-CAR DEALERSHIPS 18 (2017), https://www.nada.org/2017NADAdata/ [https://perma.cc/HW8G-FNK6].

63. *See* NAT'L AUTO. DEALERS ASS'N, NADA DATA 2019 MIDYEAR REPORT: ANNUAL FINANCIAL PROFILE OF AMERICA'S FRANCHISED NEW-CAR DEALERSHIPS 5 (2019), https://www.nada.org/WorkArea/DownloadAsset.aspx?id=21474855962 [https://perma.cc/UUH2-WTAM]. I have estimated the number of sales using a $30,000 average new and used car sale price.

64. *Id.* at 16.

teams and other community activities. These features have made auto dealers a potent political interest group, as reflected by state dealer-franchise-protection laws,[65] the unique exclusion of most non-BHPH dealers from the regulatory authority of the CFPB,[66] and a successful push for a Congressional Review Act resolution voiding CFPB guidance on discriminatory auto lending.[67]

2. Lenders

There are several sources of indirect financing for auto loans. The market is somewhat different for new-and used-car loans. Over half of new-car financing (55%) in 2018 came from captive lenders.[68] A captive lender is a financing company (which may, in fact, be a bank) that is wholly owned by the OEMs, such as Ford Motor Credit or American Honda Finance Company. By providing financing to purchasers of the associated manufacturer's cars, captives help facilitate manufacturers' sales.[69] As a result, captives often offer financing incentives to help lower the effective cost of the vehicle purchase and move excess inventory.[70]

Another 26% of new-car financing in 2018 came from banks.[71] Credit unions were the third largest source of new-car financing, with 14% of new car loans.[72] Credit union loans are made not only to existing members but also to new members who take out membership when obtaining the loan. Independent-finance companies handle another 5% of new car loans.[73]

The used car financing market looks somewhat different. Captives play little role in the used-car finance market (8%) because they are not helping OEMs sell excess production.[74] Instead, the main players in the used-car finance market are banks (35%), credit unions (28%), finance companies (17%), and dealers themselves as BHPH lenders (13%).[75]

The auto finance market overall is not concentrated. In 2015, the top twenty lenders accounted for 49% of all financing (88% of new and 39% of used), with

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65. *See* Crane, *supra* note 20, at 578–79.

66. 12 U.S.C. § 5519 (2012).

67. *See* S.J. Res. 57, Pub. L. No. 115-172, 132 Stat. 1290, 1290 (2018); David Dayen, *Car Dealers Have Their Way with Congress*, INTERCEPT (Nov. 23, 2015, 10:53 AM), https://theintercept.com/2015/11/23/car-dealers-have-their-way-with-congress/ [https://perma.cc/D5NU-EAAG] (discussing lobbying efforts aimed at a repeal of the CFPB guidance).

68. NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 25.

69. *See* Barron et al., *supra* note 48, at 185–86; James A. Wilson, Jr. & Sandra L. DiChiara, *The Changing Landscape of Indirect Automobile Lending*, FED. DEPOSIT INS. CORP. (last updated June 23, 2005), https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum05/article04_auto_lending.html [https://perma.cc/3XUG-S2LV].

70. *See* ARTHUR P. BAINES & MARSHA J. COURCHANE, CHARLES RIVER ASSOCS., FAIR LENDING: IMPLICATIONS FOR THE INDIRECT AUTO FINANCE MARKET 17 (2014), http://www.crai.com/sites/default/files/publications/Fair-Lending-Implications-for-the-Indirect-Auto-Finance-Market.pdf [https://perma.cc/P9TY-VZ4F].

71. NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 25.

72. *Id.*

73. *Id.*

74. EXPERIAN, *supra* note 9, at 12 (showing Q1 2018 data).

75. *Id.*

no single lender having more than around 6% of the total market (or 11% of the new car market or 7% of the used car market).[76] Nor do most dealers have exclusive relationships with an indirect lender. Instead, most have relationships with several (if not dozens) of indirect lenders.[77]

B. THE AUTO LOAN

The form of an auto financing agreement depends on whether the financing comes from the dealer or directly from a third-party lender. If the financing comes from the dealer, the agreement will be in the form of a "retail installment contract" (RIC). An RIC is an agreement to purchase goods through installment payments—that is payments over time—rather than through a single, upfront payment. Thus, an RIC bundles together the sale of the good and its financing into a single contract. If the financing comes directly from a third party, it is in the form of a loan and is a separate agreement from the sales agreement between the dealer and the consumer.

The distinction between an RIC and a loan is important for purposes of state law because RICs are regulated by state law under statutory schemes distinct from those regulating loans. Federal law generally does not distinguish between RICs and loans, all of which are financing agreements that fall under the rubric of "credit."[78] The distinction between an RIC and a loan is immaterial for the purposes of this Article, so this Article will use the colloquial terminology of "loan" to refer to both RICs and loans—except in instances where the transactional distinction is significant. After all, no one has ever said, "I'm behind on my motor vehicle retail installment contract." Instead, it is "I'm behind on my car loan."

Regardless of whether the financing is in the form of an RIC or a loan, it is almost always a fixed-rate, amortizing, simple-interest installment credit product. That means that the consumer will make level monthly payments over a pre-set term of months. The typical term is forty-eight or sixty months, but in recent years longer loans, such as eighty-four months, have become more common.[79] All else being equal, a longer term reduces monthly payments but results in higher total payments.

76. MELINDA ZABRITSKI, EXPERIAN, STATE OF THE AUTO FINANCE MARKET FOURTH QUARTER 2015, at 15–17 (n.d.), https://www.experian.com/assets/automotive/quarterly-webinars/experian-auto-2015-q4.pdf [https://perma.cc/NF2H-RSQD].

77. BAINES & COURCHANE, *supra* note 70, at 28, 71.

78. The Truth in Lending Act has additional disclosure requirements for RICs, 15 U.S.C. § 1638a(d) (2012), but otherwise federal law is uninterested in the distinction. *See, e.g.*, 15 U.S.C. § 1691(e).

79. *See* Ben Eisen & Adrienne Roberts, *The Seven-Year Auto Loan: America's Middle Class Can't Afford Its Cars*, WALL ST. J. (Oct. 1, 2019, 10:46 AM), https://www.wsj.com/articles/the-seven-year-auto-loan-americas-middle-class-cant-afford-their-cars-11569941215; *see also* KENNETH P. BREVOORT ET AL., CFPB, QUARTERLY CONSUMER CREDIT TRENDS: GROWTH IN LONGER-TERM AUTO LOANS 4 (2017), https://files.consumerfinance.gov/f/documents/cfpb_consumer-credit-trends_longer-term-auto-loans_2017Q2.pdf [https://perma.cc/VP65-MZ93] (noting that 42% of 2017 originations were of loans with terms of six years or longer).

Unlike many other types of consumer financial products, auto loans are typically simple interest products, meaning that interest does not compound.[80] Auto loans are always amortizing, meaning that each installment payment consists of both a principal payment and an interest payment.[81] Auto loans do not typically have prepayment penalties or yield maintenance clauses, so they are usually freely prepayable.[82] Many loans are prepaid through a trade-in of a vehicle with a new vehicle purchase; others are prepaid in cash, and some are refinanced.[83] A late fee of 5% of the payment is common in auto financing agreements, as are documentation fees. Binding mandatory arbitration clauses with class action waivers are now standard for auto loans and are a response to class action suits brought in the 2000s.

Auto financing agreements are not entirely standardized, but since the 1980s, there has been a substantial move toward state-by-state standardization of forms, particularly through the Reynolds and Reynolds LAW 553 Retail Installment Contract.[84]

C. AUTO LOAN FINANCING PROCESS

There are two basic processes by which a consumer gets financing for an auto loan: direct lending and indirect lending.

1. Direct Lending

With direct lending, the consumer applies—and gets pre-approved for—a loan separate from the vehicle purchase. Thus, the consumer might first pre-apply for a loan from a bank or finance company that advertises over the Internet, or the consumer might apply for a loan from his credit union. The consumer will submit various information to the lender and authorize the lender to pull a credit report. Based on this information, the lender will decide whether to approve the

80. *See* Carol M. Kopp, *How Interest Rates Work on Car Loans*, INVESTOPEDIA (June 25, 2019), https://www.investopedia.com/articles/personal-finance/061615/how-interest-rates-work-car-loans.asp [https://perma.cc/ZD6B-5QXY].

81. Auto-loan amortization will either be under a constant payment amortization or, for loans of sixty-one months or less, under the Rule of 78s. *See* ADAM J. LEVITIN, CONSUMER FINANCE: MARKETS AND REGULATION 449 (2018). The Rule of 78s functions like a prepayment penalty, as do all front-end-loaded finance charges, because it front-loads the designation of payments as interest and backloads designation of payments as principal relative to an actuarial rule amortization. *See id.* Use of the Rule of 78s is prohibited under federal law for all consumer credit transactions with terms longer than sixty-one months, but many auto loans are forty-eight- or sixty-month loans. *Id.*; *see also* 15 U.S.C. § 1615(b) (2012); VAN ALST, FUELING FAIR PRACTICES, *supra* note 34, at 18.

82. There are exceptions. The California form of the Reynolds & Reynolds LAW 553, for example, does have a small prepayment penalty. *See* THE REYNOLDS & REYNOLDS CO., LAW 553-CA-ARB-EP 7/13: RETAIL INSTALLMENT SALE CONTRACT – SIMPLE FINANCE CHARGE (WITH ARBITRATION PROVISION) (2013), http://support.dataconsultants.com/553/LAW553_CA_ARB_0713.pdf [https://perma.cc/ABS6-GLH5].

83. Grunewald et al., *supra* note 43, at 16–17 (noting that 5.9% of prime loans are prepaid within 120 days, while 27% of prime loans are repaid between 120 days and 2 years).

84. *See Reynolds & Reynolds*, AUTO MASTER SYSTEMS, INC., https://auto-master.com/portfolio/randr/ [https://perma.cc/BF93-T2T4?type=image] (last visited Mar. 1, 2020) (describing the Reynolds & Reynolds LAW 553 RIC as "the most widely used automotive finance contract").

consumer for a loan, how large of a loan, and on what terms. Final approval of the loan depends on identification of a collateral vehicle to the contract.

The consumer is not obligated to actually take the loan offer. But having that loan offer in hand gives the consumer substantial bargaining leverage if the consumer chooses to explore the other financing processes because the consumer has an alternative financing possibility. Only a minority of auto loans—about 10–20%—are financed through direct lending.[85]

2. Indirect Lending

The second financing process is indirect lending, in which the consumer applies for financing from a dealer. In theory, the dealer could finance the purchase itself, but that is only commonly done among a subset of used car dealerships (BHPH dealerships). For new-car sales, the financing will always be funded by a third party, not the dealer, even though the dealer is the initial creditor on the financing contract (an RIC). The dealer then immediately assigns this RIC to the third-party lender, known as the "indirect lender."

In an indirect lending situation, the dealer will use a standardized information system platform, such as DealerTrack, RouteOne, or Credit Union Direct Lending (CUDL), to collect credit-application information in a single data file.[86] This system will include both information provided by the consumer and a credit report (which will enable the lender to get a credit score for the consumer) and sometimes additional income verification. The application will also include a requested loan amount and potentially a desired loan duration.

The data file is then sent out for bids to a set of potential indirect lenders with whom the dealer has relationships.[87] Indirect lenders preapprove dealers to work with them; the indirect lender must be satisfied regarding the dealer's financial and operational capacity because dealers may incur warranty liability to the indirect lender regarding the loans they sell them. When indirect lenders establish relationships with dealers, they will specify the type of loans and borrowers whose loans they are willing to finance by providing dealers with underwriting and interest rate guidelines.[88] The indirect lenders' bids will specify the minimum interest rate (known as the "buy rate") that the indirect lender will require for the loan, as well as any other loan terms required by the indirect lender.

Although one might think that the lender with the low bid—the lowest required interest rate—would win and would fund the loan, the process actually works in the opposite fashion. The buy rate is the minimum interest rate that the lender requires; it is generally not the rate that the consumer receives. Indeed, consumers

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85. *See* CTR. FOR RESPONSIBLE LENDING ET AL., COMMENTS TO THE FEDERAL TRADE COMMISSION MOTOR VEHICLE ROUNDTABLES—PROJECT NUMBER P104811, at 3 (2012), https://www.ftc.gov/sites/default/files/documents/public_comments/public-roundtables-protecting-consumers-sale-and-leasing-motor-vehicles-project-no.p104811-00071/00071-82645.pdf [https://perma.cc/PCU7-HRDD] (stating that nearly 80% of auto financing is done through the dealer).

86. Grunewald et al., *supra* note 43, at 5.

87. *Id.*; *see also* Wilson & DiChiara, *supra* note 69.

88. Wilson & DiChiara, *supra* note 69.

never even see the buy rate. The reason consumers do not generally receive the buy rate is that dealers are generally free to mark up the loan above the buy rate. Thus, if the lender's buy rate is 3.00% annual interest, the dealer might tell the consumer that the consumer is approved for a loan at 4.25% annual interest. The 125-basis-point[89] difference is a markup known as a "dealer reserve" or "dealer participation."[90]

Indirect lenders typically allow the dealer to retain some or all of the markup as compensation for having brought in the loan (a finder's fee) and processed the paperwork.[91] Indirect lenders allow dealers to keep the markup contingent upon the loan not being prepaid within a specified window (typically three to six months); if the loan is prepaid during this "clawback" window, the dealer must refund the entire markup to the indirect lender.[92] Though it is the indirect lender that allows the markup, the markup is paid by the consumer, who simply sees a higher interest rate on the loan rather than a breakdown of what goes to the indirect lender and what is kept by the dealer.

Indirect lenders will sometimes cap the markup, the loan-to-value ratio (LTV), or the loan amount. Higher markups correlate with higher rates of default and repossession,[93] and default rates on indirect loans are around twice that on direct loans.[94] The likely reason for these correlations is that higher dealer markups increase the riskiness of the loan by increasing the debt service demands on the

89. See *supra* note 26 for an explanation of basis points.

90. The terminology appears designed to obfuscate that the dealer reserve is simply a markup in the interest rate. The present terminology also conflates what were several different financing arrangements. *See* Note, *Is Control of Dealer Participation a Necessary Adjunct to Regulation of Installment Sales Financing?*, 28 IND. L.J. 641, 641 n.3 (1953). The origins of dealer reserve go back to the early days of auto finance. In the early 1920s, some finance companies started buying loans on a nonrecourse basis, which gave them a substantial competitive advantage over companies that insisted on recourse. Robert P. Shay, *The Price of New Automobile Financing*, 19 J. FIN. 205, 210 (1964). To offset this advantage, General Motors Acceptance Corporation (GMAC), which required recourse financing, came up with a dealer reserve: an account for the dealer maintained by GMAC to which a share of the consumer's interest payments was credited. *See* United States v. Gen. Motors Corp., 121 F.2d 376, 391 (7th Cir. 1941). The dealer reserve account could be used to offset recourse liability, but excess reserves could also be periodically released to the dealer. *See* Note, *Protection of Borrowers in Distribution Finance*, 60 YALE L.J. 1218, 1223, n.16 (1951). The arrangement essentially gave the dealer a participation interest in the loan, which both incentivized the dealer to ensure better quality loans and made GMAC financing more lucrative for the dealer than straight nonrecourse financing. *See* Shay, *supra*, at 210–11. Eventually, the product dropped its pretense of being a reserve account to cover recourse liability and simply became a source for compensating dealers for arranging the loan.

91. Grunewald et al., *supra* note 43, at 7 (finding that dealers keep 66% of the markup on average). The markup may be paid out to the dealer over time out of loan payments received or as an upfront lump payment.

92. *Id.* at 16.

93. DAVIS & FRANK, *supra* note 49, at 12–13 (finding that a one-standard-deviation increase in the markup correlates with a 12% higher default rate for subprime borrowers). A couple of states also cap dealer markups. *See infra* Section IV.B.

94. Press Release, Am. Bankers Ass'n, ABA Report: Consumer Delinquencies Mixed in Fourth Quarter (Apr. 11, 2019), https://www.aba.com/about-us/press-room/press-releases/consumer-delinquencies-mixed-fourth-quarter [https://perma.cc/4UB9-E356] (reporting a 1.08% default rate on direct loans, but a 2.08% default rate on indirect loans).

consumer. In contrast, higher LTVs reduce percentage recoveries upon default,[95] and higher loan amounts create more concentrated credit exposures. Additionally, captive finance companies frequently cap markups when they provide subsidized financing to facilitate manufacturer vehicle sales.[96]

Even with caps on markups from indirect lenders, however, the particular markup varies by consumer at the dealer's discretion. The amount of the dealer markup will typically be based solely on the financing and insurance (F&I) manager's estimation of the consumer's willingness to pay.

Critically, the dealer markup does not reflect the credit risk on a loan because the dealer does not assume any credit risk on the loan in a typical dealer reserve contract.[97] Instead, the risk on the loan is already reflected in the "buy rate," which is the risk-adjusted rate at which the indirect lender is willing to purchase the loan. Loans to less creditworthy borrowers will generally have higher buy rates. Those loans might also have higher markups, but they do not reflect the credit risk per se. Instead, a higher markup on the loans of less creditworthy borrowers reflects the dealer's assessment that riskier borrowers have fewer potential sources of credit than prime borrowers, and are thus more likely to accept whatever terms the dealer offers. The effect, however, is self-compounding for credit risk, because higher markups mean higher monthly payments, which put a greater strain on consumers' budgets and thus are more likely to result in defaults.

As noted above, the loan rate of the offer a consumer receives from a dealer will be an indirect lender's buy rate—a risk-based underwritten rate plus the discretionary amount of the dealer reserve markup. Expressed algebraically, the loan rate (L) that is offered to the consumer is the sum of the buy rate (B) and the dealer reserve markup (M):

$$L = B + M$$

If the consumer balks when presented with the loan terms, the dealer might lower its markup. Many consumers, however, are unaware that dealers are even allowed to mark up loans, so they would have no reason to believe that the dealer has discretion to lower the loan interest rate. Indeed, one study found that over 68% of consumers were unaware that dealers mark up loans.[98] All the consumer

95. Dealers will sometimes engage in fraudulent "power booking"—reporting to an indirect lender that the vehicle has upgrades it does not in fact have—to justify a larger loan amount from the lender and thus a higher LTV. *See* THOMAS B. HUDSON & EMILY MARLOW BECK, CARLAW III: RELOADED 466–67 (2010).

96. Grunewald et al., *supra* note 43, at 9.

97. Historically, there were varying levels of recourse to dealers for defaulted loans, but such recourse is unusual now if the dealer has accurately represented the loan to the indirect lender.

98. DAVIS, *supra* note 49, at 12. *But see* Beaudreau v. Larry Hill Pontiac/Oldsmobile/GMC, Inc., 160 S.W.3d 874, 881 (Tenn. Ct. App. 2004) (holding, without evidence in the record about the actual beliefs of reasonable consumers, that "a reasonable consumer should be aware that a for-profit retailer, in arranging for financing for a consumer, would expect to receive some sort of remuneration for its efforts [and] that the consumer is free to seek financing elsewhere if he or she is unhappy with the terms quoted by the dealer . . . .").

sees, after all, is the loan rate, not its component buy rate and dealer reserve markup.

As discussed further below, even when consumers are aware that the interest rate is negotiable with the dealer, the consumer has little leverage unless the consumer has another financing offer in hand. In other words, unless the consumer has lined up a direct financing alternative in advance, the consumer has no alternative to the dealer's financing offer except walking away. Because the consumer wants the car and has incurred substantial transaction costs in the sale process, the consumer is likely to take the loan. Consumers are averse to losing their sunk transaction costs,[99] and they have little incentive to search elsewhere because they do not believe that the outcome will be materially different at another dealer.[100]

Some financial institutions are both direct and indirect lenders, whereas others, such as captive finance companies, are only indirect lenders. The major attraction of indirect lending for financial institutions is that it saves them the costs of prospecting for customers. Instead, they are essentially bidding on a "lead" from the dealer. Because of the cost savings for indirect lenders, the buy rate they require may be lower than the "street rate" offered by direct lenders. That does not mean, however, that consumers benefit from lower interest rates on indirect loans because the comparison is between direct lenders' street rate and the dealer rate, which consists of the buy rate plus the dealer reserve markup.

Given differences in direct and indirect borrower populations, it is not possible to say empirically whether one type of lending always produces better terms for consumers. It is possible to say, however, is that competitive markets are more likely to produce better rates than noncompetitive markets, so to the extent that there is no competition for the consumer's business in indirect lending (as opposed to the dealer's business), there is reason to believe that indirect lending rates are more likely to be supracompetitive than direct lending rates.

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99. *See* discussion *infra* pp. 1287–88 and note 128 (discussing behavioral science literature on sunk costs).

100. *See* discussion *infra* pp. 1287–88 and note 128 (discussing behavioral science literature on sunk costs). PAUL ROSENBERRY & ROBERT CHRISTINI, DEALERTRACK, DIRECT OR INDIRECT–WE HAVE YOU COVERED 11 (2015), https://us.dealertrack.com/content/dam/dealertrack/landing-pages/lenders/Direct.DirecttoIndirect_Final.pdf [https://perma.cc/N3RV-25ZW]. In direct-to-indirect lending, the loan process starts the same way as with direct lending: the consumer applies for a loan directly with the lender (usually through a website). *See id.* The lender then informs the consumer of the credit application decision. *See id.* If the consumer is approved, the consumer will be given a pre-approval code, maximum loan amount and terms, and a list of lender-approved dealers. *See id.* Dealers are willing to accept lower compensation in direct-to-indirect lending because they benefit from increased business due to the reference from the lender.

The consumer then goes to an approved dealer and selects a car. The consumer gives the dealer the lender's name and preapproval code. *See id.* at 12. The dealer then uses the preapproval code to complete the loan application on the lender's website by providing additional information, particularly about the collateral vehicle. *See id.* At that point, the lender finalizes the terms of the loan offer and closes the loan. It is not clear from public documents what ability the dealer then retains to steer the lender to other financing options.

II. THE STRUCTURE OF THE AUTO LOAN TRANSACTION

A. THE BUNDLED TRANSACTION

Purchasing a car is one of the most complicated transactions a consumer can undertake because it is a bundle of several separate transactions. First, a consumer purchases a new vehicle. Second, a consumer might want to sell (or "trade in") an old vehicle.[101] Third, that consumer will likely purchase various physical add-ons to the new vehicle—floor mats, roof bars, towing hitch, window etching, protective coatings, for example. Fourth, the consumer might purchase various financial add-ons—warranties, insurance, and a vehicle service contract.[102] And finally, in most cases, the consumer will have to obtain financing of the aggregate purchase price for all of the other transactions.

Theoretically, each one of these elements is a separate and negotiable transaction. A consumer can sell a used vehicle separately from purchasing a new one. A consumer can purchase floor mats or roof bars separately from purchasing a vehicle. Likewise, an extended warranty can often be purchased separately from a vehicle purchase, as can a vehicle service contract. And financing can be obtained from a party other than the dealer.

In practice, however, all of these transactions are frequently linked.[103] In some instances, the bundling makes sense because there may be some transactional efficiencies involved. For example, selling a used car to the dealer when purchasing a new one has a transaction cost savings—the consumer is already at the dealership with the old car and does not need to take the vehicle somewhere else to be inspected before haggling over price. Bundling these purchases may also provide a tax advantage because the sales tax in many states applies only to the difference in price between the trade-in and the new car, not the full price of the new car.[104] The transaction cost savings are less apparent with financing, however, because nondealer financing can be readily obtained online. For example, Lending Tree provides lead generation for new car loans for several lenders, and major banks like Bank of

101. Many trade-in vehicles are still subject to a lien on an earlier financing and are "underwater," meaning that the amount owed on that financing exceeds the value of the vehicle. Dealers often promise to pay off the old, underwater loan, but do so by simply increasing the purchase price of the new vehicle by a corresponding amount, such that the consumer is actually the one paying for it (and then some because of the resulting larger sales tax).

102. Vehicle-service contracts are an insurance-type product that cover repairs that fall outside the manufacturer's warranty. Designation of a product as a "service contract" places the product outside of the federal regulations requiring minimum standards and terms for products termed "warranties." *See* 15 U.S.C. § 2306 (2012).

103. *See generally* Jennifer Brown & Mark Jansen, *Consumer Protection Laws in Auto Lending* 1–3 (W. Fin. Ass'n Annual Meeting, Working Paper, 2019), https://ssrn.com/abstract=3224471 [https://perma.cc/U4K6-CY7E] (finding higher auto sales prices in states where usury laws limit auto loan prices); Tom McParland, *Watch Out for Dealers Who Say the Price of the Car Depends on Your Credit*, JALOPNIK (June 26, 2018, 12:11 PM), https://jalopnik.com/watch-out-for-dealers-who-say-the-price-of-the-car-depe-1827134507 [https://perma.cc/3KU7-5WKR] (relating problem of dealers changing sales price to reflect creditworthiness); Melzer & Schroeder, *supra* note 41 (finding higher auto sales prices in states where usury laws limit auto loan prices).

104. *See, e.g.*, ILL. ADMIN. CODE tit. 86, § 130.455(b)(1) (2019) (stating that trade-in credit is deducted from vehicle sales price); MD. CODE REGS. 11.15.33.04.D(1) (2019) (declaring that the taxable price of a vehicle does not include dealer trade-in allowance).

America, Capital One, Chase, SunTrust, USAA, US Bank, and Wells Fargo all advertise online loan applications for new and used cars, as do major credit unions like Pentagon Federal Credit Union.[105]

The possibility of dealer financing, however, enables consumers to avoid searching for financing terms themselves. A range of evidence indicates a general consumer disinclination to undertake searches for better terms of financial products, resulting in substantial price dispersion in consumer financial markets.[106] Although this research indicates that limited searching plagues direct lending markets generally,[107] when a borrower obtains financing through a dealer, the borrower has engaged in even less searching because the borrower will be presented solely with whatever offer the dealer makes.

Consumers might also believe that there are savings to be gained from bundling; a dealer might claim it will offer a consumer a better price than usual on a vehicle service contract if that contract is included as part of a vehicle purchase transaction (even if the dealer sells few, if any, free-standing vehicle service contracts). Yet, such savings from bundling may well be illusory. Because of the bundled nature of the transaction, dealers are readily able to shift pricing between different components of the transaction. For example, a cheaper sales price for a new vehicle can be offset by a lower trade-in price on the old one. And the purchase of an overpriced vehicle service contract can offset a higher trade-in price. Indeed, in states where usury caps limit financing charges, dealers appear to simply offset the limitation with higher vehicle prices.[108]

Bundled transactions allow manipulative sales tactics. In a bundled market, the individual price of any component of the transaction is irrelevant; only the bundled, all-in price matters because the allocation of the components of the price is artificial, arbitrary, and wholly fungible. Thus, if the total transaction price is $30,000, it does not matter to the consumer (other than for insurance and sales tax purposes) whether the actual vehicle sales price is $22,000 or $25,000.[109]

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105. *See, e.g.*, *New and Used Auto Financing*, CAPITAL ONE., https://www.capitalone.com/auto-financing [https://perma.cc/DM84-BNA5] (last visited Mar. 3, 2020); *Our Most Popular Loan Options*, PENFED CREDIT UNION, [https://perma.cc/GX9A-G79M] (last visited Mar. 3, 2020).

106. *See, e.g.*, Victor Stango & Jonathan Zinman, *Borrowing High Versus Borrowing Higher: Price Dispersion and Shopping Behavior in the US Credit Card Market*, 29 REV. FIN. STUD. 979, 996 (2016) (finding correlation between credit-card price dispersion and intensity of search); Susan E. Woodward & Robert E. Hall, *Diagnosing Consumer Confusion and Sub-Optimal Shopping Effort: Theory and Mortgage-Market Evidence*, 102 AM. ECON. REV. 3,249, 3,262 (2012) (finding consumer reluctance to shop for mortgages); Alexei Alexandrov & Sergei Koulayev, *No Shopping in the U.S. Mortgage Market: Direct and Strategic Effects of Providing More Information* 2 (CFPB Office of Research Working Paper Series, Working Paper No. 2017-01, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2948491 [https://perma.cc/CKD9-UTM8] (finding that nearly half of consumers do not shop for mortgage loans and are often unaware of price dispersion).

107. Argyle et al., *supra* note 31, at 2–3, 34 (finding both significant price dispersion in direct auto lending and that the median borrower obtains a loan from an institution within a fifteen-minute drive of her home, such that 60% of borrowers could access better loan offers if, without cost, they could query all nearby financial institutions).

108. Brown & Jansen, *supra* note 103, at 2; Melzer & Schroeder, *supra* note 41, at 2.

109. The allocation of price matters substantially to any entity that collects sales tax based on the vehicle purchase price.

B. THE UNAVAILABILITY OF ALL-IN PRICE INFORMATION *EX ANTE*

In an ideal market, the consumer would be able to specify what elements she wants in her bundle and then shop around on the all-in bundled price. In the actual market, however, it is practically impossible to get all-in pricing absent substantial transaction costs: namely, appearing at a dealership in person and negotiating the transaction with a salesman. A consumer can ask for a quotation for an out-the-door price—the sale price including all taxes, titles, and fees—for a particular make, model, color, and trim, but the consumer will only receive a quotation for that particular model, which might not be in inventory when the consumer appears at the dealership.

In recent years, it has become possible to obtain information about vehicle pricing (including dealer price quotes) over the Internet. Although the availability of Internet price quotations has lowered vehicle pricing,[110] the information available is not always reliable. An online quote is always subject to inventory availability, and the consumer has no way of knowing if the dealer ever had the vehicle on which a price quote was given in inventory. This leaves consumers vulnerable to a simple bait and switch.

Thus, a consumer might get a price quote from a dealer about a particular make, model, color, and trim and show up to the dealership only to be told something like: "Unfortunately, we no longer have that particular vehicle in stock, but we do have a very similar vehicle that I'd like you to take a look at. I think you're going to really like it." Of course, that "similar" vehicle might have some preloaded dealer-installed add-ons already on it, such as pinstriping or an upgraded stereo system. And, because the vehicle is not exactly the same, the dealer cannot be held to the price quote. Thus, dealer price quotations are not treated as firm offers under the Uniform Commercial Code.[111]

Despite the imperfect nature of deal price quotations, the increased availability of vehicle-pricing information from multiple sources has decreased dealers' margins on vehicle sales by enabling consumers to negotiate better sales prices. Ironically, however, this may not actually benefit most consumers, as tighter margins on vehicle sales prices has put pressure on dealers to generate more profits from financing and insurance and service-contract products, which have become an increasingly significant profit source for dealers.[112] Moreover, because consumers have different price elasticities for vehicle prices versus financing prices (meaning that consumers value a dollar of vehicle pricing greater than a dollar of financing pricing),[113] a system that encourages more of the transaction price to be allocated to financing means that consumers are likely to pay more in total.

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110. *See generally* Florian Zettelmeyer et al., *How the Internet Lowers Prices: Evidence from Matched Survey and Automobile Transaction Data*, 43 J. MARKETING RES. 168 (2006) (finding that Internet price quotations lower dealer profit margins).

111. *See* U.C.C § 2-205 (AM. LAW INST. & UNIF. LAW COMM'N 1977).

112. *See infra* figs.2 & 3.

113. Grunewald et al., *supra* note 43, at 1 (finding that consumers would pay $1 in additional financing charges to reduce the price of a vehicle by 86 cents). It is unclear whether this figure accounts for the sales tax that is paid on the vehicle price but not on the financing.

Figure 2: Finance and Insurance Department and Service Department Contributions to Dealer Profits[114]

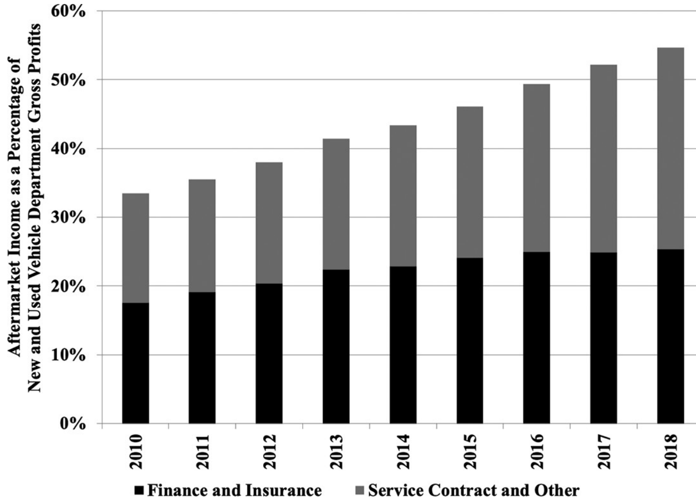
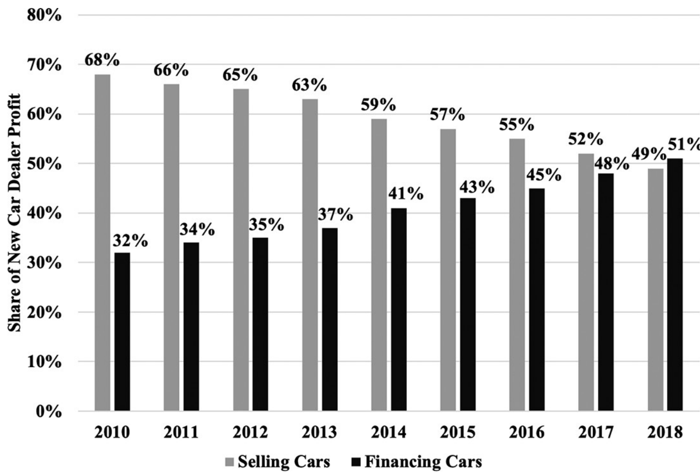


Figure 3: Source of Auto Dealer Profits[115]



But even when a dealer honors a price quote, that quote is of limited use for consumers because few consumers purchase a vehicle on its own without any

114. This chart was created based on underlying data from the 2010 through 2018 editions of the National Automobile Dealers Association, NADA Data Annual Financial Profile of America's Franchised New-Car Dealerships (data on file with author).

115. *See The Average Loan Package Markup*, OUTSIDE FIN., https://www.outsidefinancial.com/auto-loan-markup-index [https://perma.cc/43WB-XUES] (last visited Mar. 3, 2020) (source of the underlying data).

other components included in the transaction. The price quote that matters to the consumer is the all-in price, not each component price.

It is impossible for consumers to get all-in pricing in advance for a few reasons. First, the consumer may not know *ex ante* exactly what she wants in her bundle. She may know that she wants a new car, a trade-in of her old car, and financing. She is unlikely to know exactly what she wants in terms of physical or financial add-ons, though, because these products are not usually sold as standalones so there is limited advertising and information available about them.

Second, trade-in pricing requires a vehicle inspection by the dealer. The consumer can get a general idea of trade-in value from sources like the Kelley Blue Book, but that depends in part on assessments of the vehicle's condition. And third, financing terms are not offered identically to all consumers. Financing terms depend in part on individual consumer risk, so a consumer has to apply for a loan in order to get a financing offer. Dealers, however, are not set up to offer financing terms in advance of a purchase.[116] Instead, dealers offer financing terms only at the very end of the transaction process. Even then, one study using test buyers found:

> Testers faced extreme difficulty when trying to determine all of the terms of their auto loan transaction, even if they consented to a pre-approval. Testers were frequently unable to receive all five of the following pieces of information for a single pricing option: a) Price of the vehicle; b) Amount financed; c) Monthly payment; d) Interest Rate; e) Term of the loan.[117]

Dealers will generally not discuss financing with the borrower until the borrower has selected a vehicle plus any optional equipment and trade-ins.[118] This means that the consumer must first meet and negotiate with a salesman before any financing discussion arises. For dealer financing, this means that the consumer must complete almost the entire sales and financing process—picking a vehicle, negotiating the price, and negotiating a trade-in value—before finally submitting a financing application at the dealer's F&I office.[119] The sequence of

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116. *See* RICE & SCHWARTZ JR., *supra* note 49, at 21.

117. *Id.*

118. *See id.* ("It was difficult for testers to receive exact financing quotes, and dealers were much more likely to work to obtain better quotes for the tester if he or she committed to purchasing that same day, making comparison shopping virtually impossible.").

119. The structure of the auto purchase transaction is a form of "drip pricing"—a pricing technique where the consumer is not initially presented with the all-in cost of a transaction. MARY W. SULLIVAN, FED. TRADE COMM'N BUREAU OF ECONOMICS, ECONOMIC ISSUES: ECONOMIC ANALYSIS OF HOTEL RESORT FEES 4 (2017), https://www.ftc.gov/system/files/documents/reports/economic-analysis-hotel-resort-fees/p115503_hotel_resort_fees_economic_issues_paper.pdf [https://perma.cc/5H6F-EVHS]. Instead, the consumer is given a "headline" price, which is steadily but incrementally increased with a "drip" of various add-ons, fees, and taxes. *See id.* Once the consumer is committed to the initial headline price, the seller effectively exercises monopoly pricing power over the subsequent drips. Michael Waldman, Presentation at FTC Conference: What Do We Know About Drip Pricing? Lessons from the Aftermarkets Literature (May 21, 2012), https://www.ftc.gov/sites/default/files/documents/public_events/economics-drip-pricing/mwaldman.pdf [https://perma.cc/K6BR-EXZK] (transcript available at U.S. Fed.

this transaction is due in part to lenders' different financing terms, which are tied to the offer for a specific vehicle, such as an LTV limit. However, this transaction sequence also tremendously benefits dealers. The huge transaction costs in this process mean that consumers are often rationally unwilling to shop around for better financing prices. The costs of comparison-shopping on all-in pricing are prohibitive.

The result is that consumers cannot compare all-in pricing at different dealerships in an apples-to-apples format. To obtain an all-in price from any dealer involves substantial transaction costs for a consumer. Additionally, if the consumer were to try and replicate the process with another dealer for comparison-shopping purposes, there is no guarantee that the same deal would remain available at the initial dealer.

C. PSYCHOLOGY OF THE SALE

The auto purchase transaction is uniquely stressful for consumers, not least because of its length, which dealers use to lock in and wear down consumers. There are three basic components of the transaction. First, the consumer must determine which dealership to contact. That also means determining what make (and possibly what model) the consumer wants. The transaction is almost always done in person, not least because consumers like to test drive vehicles, which necessitates travel time. Thus, by the time the consumer walks into the dealership, the consumer has already invested substantial time in terms of research and travel.

Second, once at the dealership, the consumer deals with a car salesman. This means determining a model and trim. It often involves a test drive. The test drive gives the consumer important information about the vehicle but also gets the consumer invested in the particular vehicle. Once the consumer has figured out what model and trim, the consumer will likely negotiate the sales price with the salesman, as well as any trade-in value. The salesman will also often offer the consumer various physical add-ons, such as rubber floor mats or roof rails. Frequently, more than one salesman is involved. One treatise describes an extreme version of the process:

> [A] series of sales personnel are used to wear down a consumer. The first salesperson the consumer meets is a "liner" or "greeter" who qualifies the consumer—that is sizes up how vulnerable the consumer is and how much the dealer can take advantage of the consumer. When the consumer settles upon a car, the parties go inside, where the salesperson obtains a driver's license, keys to the trade-in, or deposit, which is given to the "desk." This prevents the consumer from leaving prematurely.

Trade Comm'n, A Conference on the Economics of Drip Pricing, at 39–48 (May 21, 2012), https://www.ftc.gov/sites/default/files/documents/public_events/economics-drip-pricing/transcript.pdf [https://perma.cc/5274-CR73]).

> At some point early in the negotiation, the consumer may be passed on to another salesperson, often called the "closer" who is specially trained to negotiate. But even the closer does not have authority to make a deal. Instead, offers are shuttled between the consumer and the "desk" for approval. The closer may not even take an offer to the desk, but just pretend to do so as part of the technique.
>
> . . . .
>
> The most abusive form of the turnover system involves the virtual imprisonment of the consumer, as teams of dealer employees relentlessly pressure the consumer for hours. The consumer is not allowed to leave the premises, and the dealer even refuses to give the consumer back the car keys the consumer used to drive to the lot.[120]

This process with the vehicle salesman alone takes one-and-a-half hours on average.[121] Few other consumer transactions take anywhere close to this long. And, when the negotiations with the salesman finish, the consumer is far from done. In 2015, the median time a consumer would spend at a dealership for a new car purchase was four hours.[122]

Once the consumer has the vehicle sale terms worked out, the consumer is then handed off to the F&I office for the third stage of the transaction.[123] The F&I manager (sometimes called the "business manager") is among the highest compensated employees at the dealership,[124] but the F&I office will usually be a windowless interior room, often with no clocks—not what one would expect for such a senior employee.[125] Thus, like a casino, the passage of time will not be readily apparent to consumers in the F&I office.[126]

In the F&I office, standard practice is to present the consumer with all products for which he qualifies. This means that the consumer will be presented with dozens of insurance, extended-warranty, "protection," and service-plan products—

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120. *See* NAT'L CONSUMER LAW CTR., UNFAIR AND DECEPTIVE ACTS AND PRACTICES § 7.3.1 (9th ed. 2016).

121. *See 2009 F&I Statistics*, F&I MAG., Dec. 2008, at 26.

122. *J.D. Power and DealerRater Report: Buying a Vehicle Takes Twice as Long as Consumers Think It Should*, PRNEWSWIRE (July 28, 2015, 1:07 PM), https://www.prnewswire.com/news-releases/jd-power-and-dealerrater-report-buying-a-vehicle-takes-twice-as-long-as-consumers-think-it-should-300119771.html [https://perma.cc/8KCN-A3ZU].

123. NAT'L CONSUMER LAW CTR., *supra* note 120, § 7.3.1.

124. *See id.*; Jackie Charniga, *Dealers Take a Hard Look at F&I Managers' Pay*, AUTOMOTIVE NEWS (Feb. 11, 2019, 12:00 AM), https://www.autonews.com/finance-insurance/dealers-take-hard-look-fi-managers-pay.

125. *See, e.g.*, ZARA MCALISTER, F&I, BETTER, FASTER, STRONGER (2015), https://www.finalcoat.com/assets/cad-march15_f-i.pdf [https://perma.cc/3NYM-M52N]; Lindsay Chappell, *Industry Turmoil Makes for a Tough Day in the F&I Office*, AUTOMOTIVE NEWS (Jan. 19, 2009), https://www.autonews.com/article/20090119/RETAIL06/301199765/industry-turmoil-makes-for-a-tough-day-in-the-f-i-office.

126. *See, e.g.*, Damien Brevers et al., *Effect of Casino-Related Sound, Red Light and Pairs on Decision-Making During the Iowa Gambling Task*, 31 J. GAMBLING STUD. 409, 410 (2015) (noting that due to a lack of clocks, casinos are able to impede players' sense of the passage of time).

all *before* the loan terms are discussed.[127] Given that the purchase of these various soft add-ons may be financed, it is necessary to determine exactly what the consumer is purchasing before turning to financing. By the time financing arises, the consumer is further worn down.

The consumer has little, if any, basis for evaluating soft add-on products on the spot. Extended warranties, for example, might have dozens of pages of disclosures detailing exactly what is covered and on what terms. Therefore, the consumer is likely to be susceptible to advice from the F&I representative and will likely not ask too many questions because she is anxious to complete the transaction and drive off with her new car. The offering of various add-on products creates an opportunity for the F&I representative to build trust while sizing up the consumer. It also imposes delay, making the consumer impatient and less likely to carefully inspect deal terms or dicker over them.

By now, the consumer just wants to leave with her new car—all that remains is some paperwork. It is at that point that the financing terms are finally discussed. The dealer will make the consumer an offer of financing. Unless the consumer has another offer, the dealer's offer is take-it-or-leave-it. If the consumer has another offer, however, then the consumer is in a position to force the dealer to negotiate, and the biggest "give" the dealer has is a reduced dealer reserve markup.

Loss aversion makes consumers reluctant to walk away from the high sunk transaction costs,[128] particularly because there is little reason for the consumer to think she will have better results at another dealership. By forcing the consumer to start with the myriad choices and negotiations for the car itself, the dealer virtually guarantees that the buyer will sign most anything to get the car by the time she goes into the F&I office. The entire sale process—from vehicle price to financing—is designed to get the consumer invested in the idea of the purchase, to make the consumer feel locked in to going through with the transaction, and to wear down consumer resistance through sheer exhaustion and exasperation.

D. DEALER FINANCING AS AFTERMARKET TYING

Linked vehicle purchase and financing presents a problem akin to that of aftermarket tying. Aftermarkets are market for follow-up sales of complementary products or services to a primary-market product. For example, ink is an aftermarket for printers; blades are an aftermarket for razors; and vehicle parts are an aftermarket for cars. Aftermarkets can also be in services—computer software updates are an aftermarket for software, and telecom services are an aftermarket for mobile phones.

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127. *See* NAT'L CONSUMER LAW CTR., *supra* note 120, § 7.2.1.

128. For academic discourse on the psychology of sunk costs, see generally Hal R. Arkes, & Catherine Blumer, *The Psychology of Sunk Costs*, 35 ORG. BEHAV. & HUM. DECISION PROCESSES 124 (1985); Brian M. Sweis et al., *Sensitivity to "Sunk Costs" in Mice, Rats, and Humans*, 361 SCI. 178 (2018); Richard H. Thaler, *Mental Accounting Matters*, 12 J. BEHAV. DECISION MAKING 183 (1999).

Firms that have market power in an aftermarket may seek to tie provision of the aftermarket good or service with purchases of the primary market good or service. Thus, suppose a firm sells both printers and ink cartridges specific to its printers. Once a consumer has purchased a printer, the consumer is substantially locked in to purchasing ink from the firm. Although there are many types of ink available, only a limited set will be compatible with the printer—potentially only the one made by the printer manufacturer. The consumer's lock-in gives the firm market power in the ink aftermarket, which allows it to charge supracompetitive rates for ink. This arrangement is known as "aftermarket tying." [129]

The auto financing market may be viewed as an aftermarket for the vehicle market. Indeed, dealers even refer to financing income as an "aftermarket income."[130] The purchase and financing markets are separate—vehicles can be obtained without financing, and financing can be obtained without a vehicle purchase. Dealers may or may not have market power in the primary market for the vehicle sale, but for most consumers, the dealer does have effective monopoly power in the aftermarket for financing.

Indeed, separating the vehicle purchase negotiations and the financing negotiations sets up a situation in which the dealer is able to extract "two rents" from consumers rather than one. Economists Meghan Busse and Jorge Silva-Risso have shown that there is a *negative* correlation between vehicle sale price and trade-in value—a higher sale price will be accompanied by a higher trade-in value and vice-versa.[131] This indicates that the sale and trade-in transactions are interchangeable, such that the total producer surplus—the profit for the dealer—is the same irrespective of the allocation of sale price and trade-in price.

Busse and Silva-Risso find a *positive* correlation, however, between sale price profits and financing profits, such that higher sale prices are not offset by cheaper financing or vice-versa.[132] This indicates that consumers face what Busse and

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129. *See generally* Eastman Kodak Co. v. Image Tech. Serv. Inc., 504 U.S. 451 (1992) (recognizing that a firm with market power in an aftermarket can violate section 1 of the Sherman Antitrust Act through a tying arrangement to a primary market in which it lacks market power).

> A tying contract is a vertical restraint that involves a conditional sale. In its simplest form, the producer of product A agrees to sell that product, but only on the condition that the buyer also purchases product B. In this scenario, product A is the *tying good* while product B is the *tied good*. The situation can be more complicated. For example, there may be a collection of tied goods rather than just one. Moreover, tying may involve services and other intangibles. It may also extend to leases as well as sales. Finally, the tying arrangement may involve third parties, i.e., the buyer of A may have to buy the tied good B from a designated third party rather than from the seller of A. In all of these scenarios, however, the essence of tying is the condition that limits the buyer's freedom to purchase the tied good(s) where he deems optimal from his own perspective.

Roger D. Blair & D. Daniel Sokol, Quality-Enhancing Merger Efficiencies, 100 IOWA L. REV. 1969, 1990 (2015).

130. NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 14.

131. Meghan R. Busse & Jorge M. Silva-Risso, *"One Discriminatory Rent" or "Double Jeopardy": Multicomponent Negotiation for New Car Purchases*, 100 AM. ECON. REV. (PAPERS & PROC.) 470, 474 (2010).

132. *Id.*

Silva-Risso refer to as "double jeopardy"—two separate and unlinked negotiations that result in the extraction of two profits from consumers.[133] If both the sale and financing markets were competitive, "double jeopardy" would not exist. Competitive pressure would force the dealer to offer the consumer the lowest aggregate cost, and the allocation of the price would be immaterial. The dealer's quasi-monopoly power in the financing "aftermarket," however, means that a "double jeopardy" structure is inherently more profitable for the dealer. The dealer gives the consumer a more-or-less competitive price on the vehicle sale, but then is able to charge a supracompetitive price on the financing.

The point here is not to cast dealer abuses as an antitrust problem, much less one best addressed through enforcement of the antitrust laws (although antitrust is a form of consumer protection regulation). Rather, it is that antitrust law's conceptual framework is useful for illustrating the *structural* nature of the problem in the auto lending market, namely that it is tied to the vehicle lending market such that problems will inevitably persist unless that tie is broken.

III. CONSUMER ABUSES IN AUTO LENDING

A. SUPRACOMPETITIVE PRICING

1. Competition in Indirect Lending Decreases Consumer Welfare

The structure of the indirect auto lending market likely results in supracompetitive pricing of auto loans. There is substantial competition in the indirect lending market, with over 1,600 indirect lenders,[134] but it is competition for dealers' business, not consumers' business. The dealer is the customer in the indirect auto lending business, operating much like a lead generator for indirect lenders. Indeed, a major attraction of indirect lending for financial institutions is that it helps them avoid the costs of prospecting for customers through general advertising and direct mail. Because consumers tend to see the transaction as only a car purchase, not also a financing, most consumers do not search for auto financing, making customer acquisition difficult for direct lenders. Indirect lending avoids this problem by piggybacking on the dealer's acquisition of the customer.

Because indirect lenders are able to obtain a consumer relationship solely through a dealer, they have to bid for the dealer's business. Indirect lenders compete on a number of dimensions: processing speed, predictability of approval, recourse requirements, buy rates, flexibility for underwriting exceptions, product ranges offered (for example, enabling the dealer to offer credit life insurance, GAP insurance or GAP waiver, or extended warranties), and floor-plan financing (for example, offering dealers a lower buy-rate if they take the lender's floor plan

133. *Id.* at 470.

134. *Is Your F&I Process Costing You Time and Profit?*, DEALERTRACK, https://us.dealertrack.com/content/dealertrack/en/f-and-i.html [https://perma.cc/CD9X-R73H] (last visited Mar. 4, 2020) (advertising over 1,600 lenders).

financing, have another commercial line of credit from the lender, or agree to submit all applications to the lender for consideration).[135]

First and foremost, however, indirect lenders compete in terms of the size of the dealer markup they allow.[136] The size of the markup allowed is determined by two factors: the buy rate and any limitation on the size of the markup above the buy rate imposed by the indirect lenders. There are four possible scenarios in terms of buy rates and dealer markup caps. In three of the four, the indirect lending market fails to get the consumer the best loan pricing and thus fails to maximize consumer welfare.

In the first scenario, there is no lender cap on the dealer markup. In such a situation, the space in which a dealer can mark up a buy rate is determined by the difference between a consumer's reserve price—the maximum price the consumer is willing to pay—and the buy rate (and at some point, the lender's maximum allowed LTV or loan amount).[137] Thus, the lower the buy rate, the larger the difference, and hence the larger the possible markup. For example, suppose that a borrower has a reserve price of 7%, meaning that the consumer will not accept the financing if the loan offer is for more than 7%. Now suppose that indirect lender *X* offers a 3% buy rate. In such a situation, the dealer can mark up the loan by 400 basis points before hitting the borrower's 7% reserve. In contrast, if indirect lender *Y* has a buy rate of 5%, then the dealer can mark up the loan by only 200 basis points before hitting the borrower's 7% reserve price. The lower the buy rate, the greater the potential markup before the borrower's reserve price is hit, and the borrower refuses to accept the financing offer. The dealer will prefer *X*'s offer, but if there is no cap on the markup, the consumer should end up paying the same price irrespective of the buy rate because the dealer will mark up the buy rate to the consumer's reserve price. Thus, the dealer, rather than the consumer, captures all of the surplus from the lower buy rate in a situation in which there is no cap on the markup.

In the second scenario, the indirect lenders impose contractual caps on the dealer markup. The caps are not identical, so both buy rates and the allowed markups differ. In this scenario, the lower buy rate (that of indirect lender *X*) goes with the lower markup allowance and vice-versa. Suppose that *X*'s buy rate is still 3%, but *X* permits only a 150-basis-point markup, whereas indirect lender *Y*'s buy rate is still 5%, but *Y* permits a 200-basis-point markup. A loan funded by *X* would result in a 4.5% loan interest rate for the consumer, whereas a loan funded by *Y* would result in a 7% loan interest rate for the consumer. The consumer's welfare would be greater with the loan from *X*, but the consumer will nonetheless inevitably end up with lender *Y*'s more expensive offer because the dealer will be compensated 50 basis points more under *Y*'s offer. It is the dealer, not the lender,

135. BAINES & COURCHANE, *supra* note 70, at 23.

136. Indirect lenders also compete on underwriting flexibility to offer dealers faster approval of loans, but this appears to be a much less important dimension of competition.

137. It is immaterial that the dealer does not actually know the borrower's reserve price; the dealer will act as if its estimate of the reserve price is the actual reserve price.

that selects which offer the consumer sees. Note that although the dealer receives differential compensation between the loan offers, the dealer performs the exact same ministerial services and arguably benefits by being able to make the sale because of the availability of financing.

In the third scenario, both the buy rates and allowed markups differ again, but now the lower buy rate (that of indirect lender *X*) goes with the larger markup and vice-versa. Suppose *X* has a 3% buy rate, but allows a 450-basis-point markup, whereas *Y* has a 5% buy rate, but allows only a 150-basis point markup. In such a situation the loan rate from *X* would be 7.5%, whereas from *Y* would be 6.5%. If the consumer's reserve price is 7%, it would seem to preclude the loan funded by *X*. But recall, now, that the dealer markup is discretionary. Even if the lender allows a 450-basis-point markup, the dealer does not have to mark up the loan by 450 basis points. Indeed, here the dealer would mark up *X*'s buy rate by only 400 basis points resulting in a 7% loan rate, which the consumer will accept. Once again, the consumer will end up with the worse loan terms, even though the loan will have the lower buy rate component. When differential markups are allowed, the dealer will always accept the buy rate that allows the largest markup under the consumer's reserve price.

Finally, consider a scenario in which the indirect lenders impose identical contractual caps on the dealer markup. In such a situation, if the ultimate loan rate would be less than the borrower's reserve price, the dealer should be indifferent between the two indirect lenders' purchase offers. This presumably results in the buyer getting the offer with the lower buy rate (and thus a lower loan rate given the identical markups) because the dealer will believe the buyer is more likely to accept the offer. If the ultimate loan rate might exceed the borrower's reserve price, however, then the dealer will not be indifferent between the indirect lenders' offers. Again, suppose that the borrower's reserve price was 7%. A 300-basis-point markup on indirect lender *X*'s 3% buy rate would result in a loan rate of 6%. The consumer would accept a 6% loan-rate offer because it is less than the consumer's 7% reserve price.

However, a 300-basis-point markup on indirect lender *Y*'s 5% buy rate would result in a loan rate of 8%, which would not be accepted by the consumer because it exceeds the consumer's 7% reserve price. In such a situation, in order to close the loan based on lender *Y*'s offer, the dealer would have to limit its markup to 200 basis points, forgoing a third of its income on the loan. Consequently, when markups are capped identically, the dealer will prefer to offer the buyer the loan with the lower buy rate, benefitting the consumer with lower price on the loan. The same would be true with a flat fee markup.

Pulling this all together, the indirect lending system results in consumers paying the highest price for the loan in all scenarios except the fourth scenario, where the markup is capped identically for all indirect lenders. This fourth scenario, however, does not actually exist in the real world. The real world is a combination of the first three scenarios. In the first scenario, the consumer might get the lower buy rate, but all of the surplus goes to the dealer. In the second and third

scenarios, the consumer ends up paying the top loan rate, irrespective of which lender has the lower buy rate. Everything is determined by the size of the markup the dealer can collect. Table 1 provides a concise summary of the situation:

TABLE 1: OUTCOMES WHEN INDIRECT LENDER *X* HAS LOWER BUY RATE THAN INDIRECT LENDER *Y*

	No Markup Cap	***X* Allows Lower Markup (*X*<*Y*)**	***X* Allows Greater Markup (*X*>*Y*)**	**Identical Markup Cap (*X*=*Y*)**
Which Indirect Lender Gets Loan?	*X*	*Y*	*X*	*X*
Welfare Outcome?	Consumer gets same loan rate, but dealer captures all surplus.	Consumer gets highest loan rate.	Consumer gets highest loan rate.	Consumer gets lowest loan rate.

In all realistic scenarios, then, the consumer ends up paying supracompetitive prices. Delvin Davis and Joshua Frank have written the only study attempting to estimate the aggregate overcharges.[138] Their study is somewhat dated (and sharply criticized by the National Automobile Dealers Association),[139] but indicates that consumers who purchased cars in 2009 paid an extra $26 billion in interest over the course of their loans due to dealer markups that averaged 101 basis points for new cars and 291 basis points for used cars.[140]

There is little reason to believe that dealer reserve markups have decreased materially during the past decade. Indeed, one financial services firm estimates

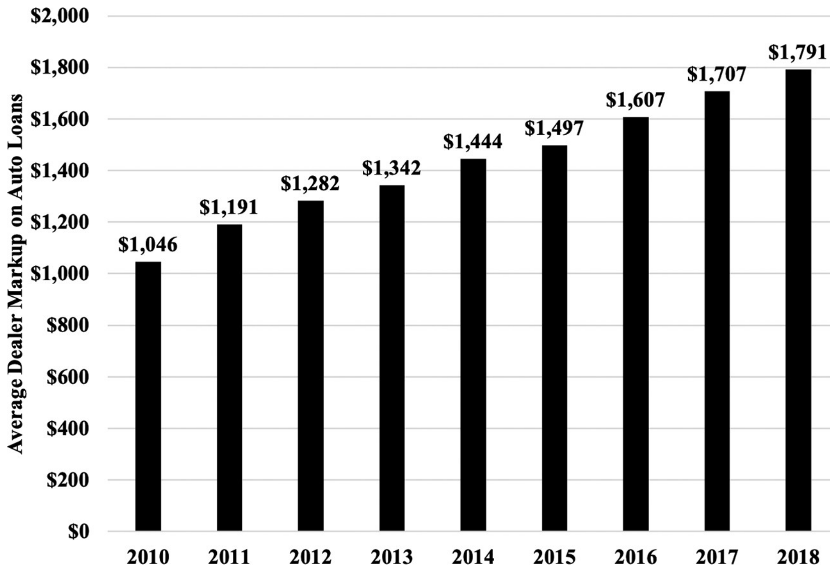
138. *See* DAVIS & FRANK, *supra* note 49.

139. The Davis and Frank study remains the only study on the extent of dealer markups. Although the National Automobile Dealers Association has criticized the Davis and Frank study, it does not release data on dealer markups, despite being challenged to do so by the Center for Responsible Lending. *See* Letter from Mike Calhoun, President, Ctr. for Responsible Lending, to Peter Welch, President, Nat'l Ass'n of Auto Dealers (June 26, 2015), https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/26june2015_nada_letter.pdf [https://perma.cc/5JD9-WSUY]. The dispute over the extent of markups underscores this Article's call for federal government data collection on auto financing. *See infra* Section V.D.

140. DAVIS & FRANK, *supra* note 49, at 2. 2018 U.S. auto sales were $1.026 trillion or 2.1 times greater than the $487 billion of sales in 2009 on which the Davis & Frank estimate was based. *See* NAT'L AUTO. DEALERS ASS'N, *supra* note 3, at 7; NAT'L AUTO. DEALERS ASS'N, NADA DATA: STATE OF THE INDUSTRY REPORT 2010, at 5 (2010). Thus, applying the same rate of overcharge to current auto loan balances suggests that there were over $54 billion in lifetime overcharges to borrowers who purchased their vehicles in 2018.

that markups have increased 71% in nominal terms between 2010 and 2018, with consumers paying on average an extra $1,791 over the life of the loan because of the markups.

Figure 4: Average Dealer Markup on Auto Loans (Nominal)[141]



A more recent economics working paper by Andreas Grunewald, Jonathan Lanning, David Low, and Tobias Salz (GLLS) finds an average markup of 108 basis points on new cars.[142] GLLS also find that nearly a quarter of loans are not marked up,[143] which most likely reflects markup restrictions on subvented loans made by captives as part of dealer financing incentives.[144] GLLS undertake a different type of analysis than Davis and Frank; one that attempts to account for the total change in consumer welfare if markups were prohibited. Their analysis accordingly accounts for responsive changes in vehicle pricing. They find that "without dealer discretion to price loans," meaning that lender buy rates are passed through to the consumer, "total prices in the market would fall and consumer surplus would increase."[145] Accordingly, GLLS find that if dealers could not markup loans, the total price of a financed vehicle purchase—accounting for dealers increasing vehicle sale prices—would drop by $350.25 on average, for an increase in annual consumer surplus of $1.78 billion.[146] Assuming that the aver

141. This chart was created with underlying data from Outside Financial. *See The Average Loan Package Markup*, *supra* note 115.

142. Grunewald et al., *supra* note 43, at 8, 19.

143. *See id.* at 8.

144. *See id.* at 9.

145. *Id.* at 35.

146. *Id.* at abstract, 34.

age auto loan is for five years, this finding translates to $8.9 billion in total savings for consumers who purchase cars in any given year.

The point here is not the precise level of dealer interest rate overcharges, only that overcharges constitute a substantial harm to consumers. Given that over seven million consumers are substantially delinquent on their auto loans—a higher number than during the Great Recession[147]—overcharges matter a lot because they may increase the likelihood of default and repossession,[148] which can have serious collateral consequences because consumers depend on their cars for getting to work, school, and childcare, and for all sorts of other personal uses.

2. Dealer Services Are Not Commensurate with the Markup

Auto dealers argue that they are performing an important service in helping consumers obtain financing and that their markups are not supracompetitive. Both of these claims are problematic.

First, the dealer is not acting *on behalf of* the consumer. If the dealer were the consumer's agent, the dealer would have the responsibility to help the consumer obtain the cheapest rate possible. But that is not the dealer's goal in the transaction. Dealers are nobody's legal agents, and economically they are acting as the lenders' agents, not consumers' agents. Therefore, it makes no sense to suggest that the markups are the price charged for a service provided to consumers.

The dealer is the original creditor of the consumer on the RIC, but that contract will almost always be assigned to an indirect lender.[149] The economic reality is that the loan is underwritten and funded by the indirect lender, not the dealer. Thus, the real service the dealer provides is minimal and ministerial; it collects the consumer's loan application data and submits it through a computer program in order to obtain offers from a stable of indirect lenders. For most consumers, the level of service the dealer provides has no relationship to the ultimate loan terms; the service is the same for all consumers, irrespective of which lender ultimately funds the loan.[150] Yet the dealer is compensated with an interest-only slice of the loan rather than with a fixed fee.

3. Dealer Markup Is Not Subject to Competitive Pressure

Dealers also contend that their rates, even with the markups, are still cheaper than the rates consumers can obtain from third-party lenders. The National Association of Auto Dealers (NADA) claims:

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147. Andrew F. Haughwout et al., *Just Released: Auto Loans in High Gear*, *Liberty Street Economics*, FED. RES. BANK N.Y. (Feb. 12, 2019), https://libertystreeteconomics.newyorkfed.org/2019/02/just-released-auto-loans-in-high-gear.html [https://perma.cc/85TQ-8BRW].

148. DAVIS & FRANK, *supra* note 49, at 12–13 (finding a correlation between rate markups, defaults, and repossessions for subprime borrowers). For further discussion of the likely causal relationship between markups and defaults, see *supra* Section I.C.2.

149. *See* NAT'L CONSUMER LAW CTR., AUTOMOBILE FRAUD § 4.1.2 (6th ed. 2018) ("In the credit marketplace, the dealer can always find a buyer for the installment loan. The only question is whether the dealer will sell the loan at a loss, break even, or make a profit.").

150. Note, however, that for consumers with poor credit, the dealer may need to work harder to structure the deal.

> Because dealerships can shop a customer's credit application to dozens of lenders, dealerships are usually able to offer their customers better interest rates than consumers can find on their own. Local dealerships can also discount interest rates for their customers to meet or beat a competing offer from another lender, such as a bank or credit union.[151]

NADA's claim is problematic. First, no data supports its empirical claim that dealers can usually offer better rates than consumers can find from third parties. Indeed, to be meaningful, data would have to control for borrower characteristics because the pool of direct-loan applicants differs from the pool of indirect loan applicants. That data does not exist.

Second, recall that the rate a consumer pays on an indirect loan (L) is the sum of the buy rate (B) and the dealer markup (M), or $L = B+M$. The question is not whether the buy rate (B) is lower than the street rate offered by direct lenders (D). The buy rate is almost assuredly lower than the street rate ($D>B$), because a direct lender must spend on advertising to acquire customers and maintain a retail sales force to interact with customers whereas indirect lenders do not. That cost is therefore likely reflected in direct lending rates. Moreover, captive finance companies—which are only indirect lenders—sometimes offer subsidized rates (known as subvented loans) as a way of facilitating their manufacturing affiliates' sales.[152] Captive subsidies will push the buy rate (B) even lower.[153]

The problem here is that it is irrelevant whether the direct lending street rate exceeds the buy rate ($D>B$). Instead, what matters is whether the street rate is greater than the indirect loan rate ($D>L$). Given that there is competitive pressure on the direct lending street rate (D) but not on the dealer markup (M), it seems unlikely that the street rate would exceed the indirect loan rate ($D>B+M$) if one controlled for borrower characteristics and the additional risk created by the dealer markup in the form of greater monthly payment requirements for the borrower.

Third, many of the institutions that are direct lenders also compete as indirect lenders. Why would the rates obtainable on an indirect loan would be lower for such a lender, particularly given that indirect loans have a dealer markup that direct loans do not? NADA notes that dealers can "discount" rates to "meet or beat" direct lenders' offers,[154] but this merely means that dealers are forgoing *some* of the markup because the dealer only gets a markup on an indirect loan. The discount situation flagged by NADA really has nothing to do with whether

151. *Dealer-Assisted Financing Benefits Consumers*, NAT'L ASS'N OF AUTO DEALERS, https://www.nada.org/auto-financing/ [https://perma.cc/L3PG-Y73H] (last visited Mar. 4, 2020).

152. *See* Wilson & DiChiara, *supra* note 69 ("It has become more difficult for banks to compete safely in a market dominated by captives, which establish lending criteria that are influenced by manufacturing decisions rather than the risk/return trade-off of each financial transaction"); *see also* Barron et al., *supra* note 48, at 185–86.

153. Markups are often prohibited or restricted on subvented loans. Grunewald et al., *supra* note 43, at 9. As a result, dealers shift their pricing to vehicles, with the result that total consumer costs may be higher. *Id.*

154. *Dealer Assisted Financing Benefits Consumers*, *supra* note 151.

indirect lending rates are lower than direct lending rates. In fact, it indicates that they are not, even though they could be. The only reason the dealer is reducing its markup in the discount scenario would be because of a *cheaper* competing direct lender offer. Absent such a competing offer in hand, the dealer would not give the discount, and the indirect loan would have had a higher rate than a potential direct loan. NADA's dealer discount scenario just takes us back to the core problem in the auto finance market: the lack of competition for the consumer's business once the consumer steps into the F&I office.

B. DISCRIMINATORY MARKUPS

Dealer markups are discretionary (and subject to any cap imposed by the indirect lender). This means that dealers charge markups to some consumers but not others, and that they do not always charge the same markup, either in terms of basis points or percent of the buy rate. Dealers are, presumably, attempting to charge a markup that maximizes the borrower's willingness—rather than ability—to pay.[155] The decision about the markup is entirely in the hands of the F&I manager who must size up the borrower and determine the largest markup that will get the deal closed. The discretionary nature of dealer markups means that there is substantial room for bias to affect the decision, whether deliberately or subconsciously.

Discrimination in dealer markups would translate into discriminatory terms of credit for borrowers. The Equal Credit Opportunity Act (ECOA) and Regulation B thereunder prohibit discrimination in any aspect of a credit transaction based on the loan applicant's race, color, religion, national origin, sex, marital status, age, or income from public assistance.[156] Courts have interpreted ECOA's prohibition as applying not only to disparate treatment but also to disparate impact claims.[157]

An ECOA disparate impact claim does not require any intentional discrimination. Instead, it requires only a disparate impact on a protected class and a connection to a policy or practice that causes the disparity.[158] A disparate impact claim can be overcome, however, with a business justification for the practice if it cannot be accomplished in a manner that would not produce the disparity.[159]

155. Maximizing the dealer markup will raise interest rates and thus monthly payments, and this may result in higher default rates. Dealers' liability for defaulted loans varies based on the contractual relationship with the indirect lender, but there is not usually recourse to dealers if there were no inaccuracies in the loan information provided to the indirect lender. To the extent that the dealer is exposed to credit risk, the dealer might not be as aggressive with the markup.

156. 15 U.S.C. § 1691(a) (2012); 12 C.F.R. § 1002.6(2), (8)–(9) (2019).

157. *See, e.g.*, Miller v. Am. Express Co., 688 F.2d 1235, 1239–40 (9th Cir. 1982); Ramirez v. GreenPoint Mortg. Funding, Inc., 633 F. Supp. 2d 922, 926–27 (N.D. Cal. 2008).

158. *See* Tex. Dep't of Hous. & Cmty. Affairs v. Inclusive Cmtys. Project, Inc., 135 S. Ct. 2507, 2518, 2523 (2015) (explaining requirements for a disparate impact claim under the analogous prohibition on discrimination in the Fair Housing Act).

159. *See id.* at 2518.

Critically, ECOA and Regulation B apply to "creditor[s]."[160] That term is defined to include not just the party that makes the loan in the first instance but also any assignee of the original creditor that participates in the underwriting decision.[161] That means both dealers and indirect lenders are creditors for the purposes of ECOA and Regulation B. Dealers are creditors because they are the party that first enters into the RIC with the borrower. The indirect lender is also a creditor because the indirect lender has participated in the underwriting decision by dictating the buy rate and other mandatory terms such as the LTV or loan amount. The dealer would not enter into the RIC without knowing that it had an indirect lender lined up as a purchaser of the contract. Thus, if an indirect lender permits dealers to engage in discretionary markups and purchases loans with such discriminatory markups, the indirect lender may be liable for discrimination in those markups even though the indirect lender did not itself engage in direct discrimination.

There is substantial evidence indicating that dealer markups may, in some cases, be discriminatory. Academic studies have found that minorities pay higher rates for auto financing, even controlling for other borrower characteristics.[162] In particular, a 2019 study found that not only are black and Hispanic loan applicants 1.5% less likely to have their loans approved than white applicants, controlling for creditworthiness, but that the interest rates on loans approved for minority borrowers are seventy basis points higher than those for comparable white borrowers.[163] In addition, a 2018 study undertaken by the National Fair Housing Alliance found that nonwhite test shoppers were quoted higher financing rates 62.5% of the time, with their average total payment being $2,662.56 higher than that of white testers with equivalent or worse credit profiles.[164] Further, during the late 1990s, numerous class action suits were brought against the major auto finance companies alleging discriminatory markups. None of these cases resulted in a disposition on the merits, but they instead resulted in a series of substantial settlements that included an agreement from the finance companies to temporarily cap dealer markups.[165]

Fourth, the CFPB and Department of Justice (DOJ) have brought a number of enforcement actions against indirect lenders and dealers for discriminatory markups. The CFPB entered into consent orders with four indirect auto lenders for failing to take adequate steps to prevent dealers from charging discriminatory

160. 15 U.S.C. § 1691(a); 12 C.F.R. § 1002.1(a).

161. 15 U.S.C. § 1691a(e).

162. Charles et al., *supra* note 44, at 319; Cohen *supra* note 44, at 23.

163. Butler et al., *supra* note 44, at 4, 16–17.

164. RICE & SCHWARTZ JR., *supra* note 49, at 5, 15. Nonwhite testers had higher creditor scores in all cases and had higher incomes in seven of eight cases, but in all cases had a lower debt-to-income ratio. *Id.*

165. *Id.* at 8; *see also* DAVIS & FRANK, *supra* note 49, at 15 (summarizing key terms of dealer-markup class action settlements).

markups.[166] The DOJ has also brought four suits against indirect lenders and dealers for discriminatory markups,[167] and filed an amicus brief in a private litigation.[168] The scale of the alleged discrimination is staggering. DOJ and the CPFB have alleged that between April 2011 and December 2013, approximately 235,000 car buyers of color were charged higher markups by just a single company: Ally Financial, Inc.[169]

Additionally, the CFPB[170] and regional Federal Reserve Banks[171] have issued regulatory guidance warning about the possibility of discriminatory markups, and the National Credit Union Administration has advised federally chartered and insured credit unions to limit dealer markups on indirect auto loans.[172] Although these settlements and guidance are not conclusive evidence of discriminatory markups in indirect lending, they show that a number of regulators believe there is a serious and widespread problem.

Indeed, a 2019 study found a substantial decrease in the spread of auto loan rates between racial minorities and comparable white borrowers between 2013 and 2018,[173] the period in which the CFPB was active in scrutinizing discriminatory markups. The decline occurred primarily in areas where indirect auto lending is most prevalent.[174] The decline in the spread of the rate by race in the face of regulatory scrutiny is suggestive of racial discrimination in auto lending.

166. *See* Stipulation and Consent to the Issuance of a Consent Order, *In re* Toyota Motor Credit Corp., CFPB No. 2016-CFPB-0002 (Jan. 29, 2016); Consent Order, *In re* Fifth Third Bank, CFPB No. 2015-CFPB-0024 (Sep. 28, 2015); Consent Order, *In re* Am. Honda Fin. Corp., CFPB No. 2015-CFPB-0014 (July 14, 2015); Consent Order, *In re* Ally Fin., Inc., CFPB No. 2013-CFPB-0010 (Dec. 19, 2013).

167. Complaint, United States v. Evergreen Bank Grp., No 1:15-cv-04059 (N.D. Ill. May 7, 2015); First Amended Complaint, United States v. Nara Bank, No. 2:09-cv-07124-RGK-JC (C.D. Cal. Mar. 18, 2010); Complaint, United States v. Springfield Ford, Inc., No. 2:07-cv-03469-PBT (E.D. Pa. Aug. 21, 2007); Complaint, United States v. Pacifico Ford, Inc., No. 2:07-cv-03470-PBT (E.D. Pa. Aug. 21, 2007).

168. Brief of the United States as Amicus Curiae in Support of Plaintiffs' Opposition to Defendant's Motion for Summary Judgment, Cason v. Nissan Motor Acceptance Corp., No. 3-98-0223 (M.D. Tenn. July 31, 2000).

169. Consent Order, *In re* Ally Fin., Inc., CFPB No. 2013-CFPB-0010 (Dec. 19, 2013).

170. CFPB, CFPB BULLETIN 2013-02, at 1 (2013), https://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf [https://perma.cc/8N7V-Y4V4]. This guidance was voided by S.J. Res. 57, Pub. L. No. 115-172, 132 Stat. 1290 (2018). Regarding the effect of the Congressional Review Act, see Adam Levitin, *Congressional Review Act Confusion: Indirect Auto Lending Guidance Edition (a/k/a the Fast & the Pointless)*, CREDITSLIPS.ORG (Apr. 17, 2018, 10:40 PM), https://www.creditslips.org/creditslips/2018/04/congressional-review-act-confusion.html [https://perma.cc/H65T-5WTV].

171. Tim Melrose & Karin Modjeski Bearss, *Indirect Lending*, *Banking in the Ninth*, FED. RES. BANK MINNEAPOLIS (Dec. 4, 2014), https://perma.cc/T44X-57CE ("The primary fair lending risk with this type of arrangement is that, without proper controls, individuals with similar credit and other characteristics may receive different rates because of this discretion in pricing at the dealer level.").

172. *NCUA Report: What to Look for When Managing an Indirect Lending Program*, NAT'L CREDIT UNION ADMIN., https://www.ncua.gov/newsroom/Pages/ncua-report/2017/second-quarter/what-to-look-out-for-managing-indirect-lending-program.aspx [https://perma.cc/4FGE-LK9T] (last visited Mar. 4, 2020) (advising credit unions to limit dealer markups on indirect auto loans).

173. *See* Butler et al., *supra* note 44, at 5 (noting a drop in racial interest rate spread from eighty-four basis points to thirty-five basis points).

174. *Id.*

It is important to recognize where discrimination likely occurs in auto lending. Such discrimination likely occurs at the dealer level, not the indirect lender level. Indirect lenders' policies may enable discriminatory conduct by dealers, however, and indirect lenders may still bear liability for the discrimination, even if it is done by the dealer.

It is unlikely that indirect lenders themselves are engaged in the discriminatory conduct for three reasons. First, indirect lenders compete intensely with each other for dealers' businesses. Such competition is likely to drive out discrimination;[175] a lender that wishes to charge minority borrowers higher rates will have a higher buy rate, which makes it less likely its offer to purchase the retail installment sale contract will be accepted by the dealer.

Second, indirect lenders are corporate entities that have no apparent motivation to engage in discriminatory lending. Perhaps individual employees have animus toward protected classes, but it is unlikely that such animus infects an indirect lender's policies or overall business. Third, indirect lenders never see borrowers and do not receive any information on borrowers' race or gender. Although indirect lenders could use borrower characteristics like name and ZIP code as proxies for race and gender, their underwriting systems are substantially automated.

Automated underwriting systems can have biases or accidental proxies for protected classes in their coding. Thus, factors that correlate with race may end up being used as proxies for credit risk by indirect lenders. At the same time, however, automated underwriting systems may be less likely to discriminate than in-person lending because of the lack of ability to observe borrower characteristics.[176]

In contrast, dealers' markups are not subject to the sort of competitive pressures that discourage discrimination in the buy rate. Likewise, the markup decision at a dealership is made by an individual—the F&I manager—so individual animus could be an issue in some cases. Most importantly, the dealer is able to directly and physically observe the borrower. This is important because the dealer could use race, gender, or ethnicity as a proxy for willingness to pay in the face of limited information.[177] (Most borrowers will not reveal their true reserve price.)

Recall that the dealer does not assume the credit risk on the RIC; that risk is assumed by the lender and is reflected in the buy rate. The only question for the

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175. BECKER, *supra* note 37, at 46.

176. Robert P. Bartlett et al., *Consumer-Lending Discrimination in the Fintech Era* (Nat'l Bureau of Econ. Research, Working Paper No. w25943, 2019), https://ssrn.com/abstract=3405130 (finding less discrimination in mortgage lending by FinTechs using automated underwriting than by in-person lenders); *see also* Fiona Scott Morton et al., *Consumer Information and Discrimination: Does the Internet Affect the Pricing of New Cars to Women and Minorities?*, 1 QUANTITATIVE MARKETING & ECON. 65, 91 (2003) (finding that the pricing disparity between white and minority in-person auto buyers disappears in online sales).

177. *See* KENNETH J. ARROW, SOME MODELS OF RACIAL DISCRIMINATION IN THE LABOR MARKET 22 (1971); Edmund S. Phelps, *The Statistical Theory of Racism and Sexism*, 62 AM. ECON. REV. 659, 659 (1972).

dealer is how much the borrower is willing to pay, which indicates how high the dealer can push the markup above the buy rate.

F&I managers have to make on-the-spot determinations about the willingness of a borrower to pay. When making that determination, F&I managers have relatively limited information about the borrower beyond perhaps his credit score, credit report, and income level. F&I managers might, therefore, turn to stereotypes about race, gender, and ethnicity as proxies for willingness to pay and likelihood that the borrower will dicker over the offer. If the F&I manager believes that minority populations, for example, are less likely to have alternative sources of financing, the manager is more likely to quote a rate with a larger markup. Alternatively, if the manager perceives that a consumer is from a group that the manager believes is more likely to haggle, the manager might propose a lower markup (or, perhaps strategically, a higher markup, expecting to be bargained down).

Thus, the likely locus of discrimination in auto lending is by dealers in the form of the markup. The discretionary nature of the markup, the in-person decisionmaking by the F&I manager, the on-the-spot nature of that decision, and the ability of the F&I manager to observe the physical characteristics of the borrowers are all factors that make discrimination more likely.[178]

Indeed, dealer markups are analogous to "yield spread premiums" charged by mortgage brokers prior to 2010.[179] In these arrangements, mortgage brokers connected mortgage borrowers and mortgage lenders.[180] Mortgage brokers were compensated by lenders, and traditionally their compensation was in the form of a yield spread premium: a piece of the interest on the mortgage loan (typically paid in a lump sum).[181] Mortgage brokers were given larger premiums for placing borrowers in more expensive loans, so brokers were incentivized to steer borrowers towards more expensive loans.[182] Mortgage brokers also worked in person with borrowers and had substantial discretion regarding which lender's loan to propose, and there is evidence that black and Hispanic borrowers paid higher mortgage prices as a result, even controlling for other borrower characteristics.[183]

There are a number of unresolved legal questions regarding determination of discriminatory markups, such as whether the issue should be evaluated on the dealer level or across the portfolio of an indirect lender,[184] but the basic point

178. Whether such discrimination reflects racial animus or whether race is being used as a proxy by dealers for borrowers' alternative credit possibilities and willingness to take an offer is beyond the scope of this Article.

179. *See generally* Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J. L. BUS. & FIN. 289 (2007) (discussing the problem of yield spread premiums).

180. *Id.* at 291.

181. *See id.* at 289.

182. *Id.* at 291–92.

183. *See id.* at 295–96.

184. *See* Peter N. Cubita et al., *Auto Finance and Disparate Impact: Substantive Lessons Learned from Class Certification Decisions*, 18 CONSUMER FIN. SERVS. L. REP., May 1, 2015, at 6, 10.

remains: the discretionary nature of dealer markups, particularly when combined with the in-person evaluation of the borrower, creates circumstances in which the size of the markup could be affected by either deliberate or unconscious bias. Even states that cap dealer markups do not require uniform markups for all consumers, leaving room for disparate treatment. The lack of a competitive market check on markups means that competition will not squeeze out discrimination in the long run. The dealer-centric indirect lending model is more structurally prone to discrimination than third-party lending.

C. LOAN PACKING

Another problem in auto financing is loan packing, the practice of upselling the consumer on various add-on products. This includes: "hard adds," namely dealer-installed physical upgrades like spoilers, racing stripes, and upgraded wheels and tires; "soft adds," which are financial contracts, such as vehicle service contracts,[185] GAP insurance,[186] GAP waiver,[187] credit life insurance,[188] and credit disability insurance;[189] and products that combine "hard" and "soft" features, such as "etch" protection[190] and rust-proofing.

Consumers do not purchase these products as stand-alone products; they would only ever consider them in the context of a vehicle purchase. These products are sold at a significant markup over their wholesale cost so they tend to be high-profit-margin products for dealers.[191] Soft adds tend to be sold as bundled packages, which disguise individual items' actual cost and makes comparison shopping difficult. (Remember that the consumer is only offered the soft adds products once in the F&I office so there is no comparison shopping really possible even in the first place). Moreover, add-on products tend to be offered in terms

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185. *See supra* note 102 and accompanying text.

186. GAP insurance covers the gap between the amount the consumer owes on the auto loan and the amount paid by the consumer's insurance—usually the market value of the car—if the car is stolen or totaled. *See* N.Y. State Ins. Dep't., General Counsel Opinion Letter No. 08-03-07 (Mar. 11, 2008) https://www.dfs.ny.gov/insurance/ogco2008/rg080307.htm [https://perma.cc/K3F9-H2K4].

187. GAP waiver is an agreement in which the creditor agrees to waive the borrower's obligation for the difference of the loan amount and the market value of the car. It may not be considered insurance depending on the terms. *See id.*

188. Credit life insurance pays off any remaining balance on the loan in the event of the consumer's death.

189. Credit disability insurance pays off any remaining balance on the loan in the event of the consumer's disability.

190. Window etching or etch involves the etching of the vehicle identification number (VIN) on one or more of the car's windows. This supposedly deters theft and makes vehicle recovery easier because the parts are traceable. Some etch products include an insurance feature so that if the vehicle is stolen and not recovered, the consumer receives a payment. THOMAS B. HUDSON, CARLAW: A SOUTHERN ATTORNEY DELIVERS HUMOROUS PRACTICAL LEGAL ADVICE ON CAR SALES AND FINANCING! 368 n.2 (2006); VAN ALST ET AL., AUTO ADD-ONS ADD UP, *supra* note 34, at 7–8.

191. VAN ALST ET AL., AUTO ADD-ONS ADD UP, *supra* note 34, at 6; VAN ALST, FUELING FAIR PRACTICES, *supra* note 34, at 15 (noting markup on service contracts may be double actual cost); *see also The Average Loan Package Markup*, *supra* note 115 (giving typical VSC markup of $800, GAP markup of $400, tire and wheel package markup of $400, appearance contract markup of $300, and etching markup of $150).

of monthly payments, rather than total cost. Price quotation in monthly payment form is a form of partitioned pricing that makes the cost of the add-on products seem smaller and also separate from the total cost of the deal.

Loan packing is not inherently illegal—it is simply upselling. When loan packing happens through deception, however, it is a different matter because then it violates state and federal statutes prohibiting unfair and deceptive acts and practices (UDAP) and may also constitute common law fraud.[192] Sometimes finance managers will falsely represent to consumers that certain add-on products must be purchased as a condition of the loan, or that the cost of the financing will go up if an add-on is not purchased, when in fact the buy rate is unrelated to the purchase of the add-on, and the dealer has already maxed out its allowed markup.[193]

Other times, if the consumer is focused on the monthly payment amount, the finance manager will quote a monthly payment amount that is larger than the amount actually due on the loan.[194] Thus, a $25,000 loan at 3% for sixty months should have monthly payments of $449. But, if the borrower is quoted $499 per month, what else is included for the extra $50 per month? Likely some sort of add-ons are included without the consumer having selected them.[195] Loan packing appears to be a frequent enough occurrence that several state attorneys general and the FTC have brought litigation over it.[196]

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192. Terry O'Loughlin, *The Return of the Leg*, PROVIDERS & ADMINS. (Nov. 18, 2015), https://www.providers-administrators.com/348368/the-return-of-the-leg [https://perma.cc/S7Y7-MKWQ] ("Does anyone in the car business not know that payment packing is illegal?").

193. *See* Complaint at 20–21, FTC v. Universal City Nissan, Inc., No. 2:16-cv-07329 (C.D. Cal. Sept. 29, 2016).

194. NAT'L CONSUMER LAW CTR., *supra* note 120, § 7.2.2 ("Many salespeople will . . . 'guesstimate' a monthly payment for the car and provide that to the consumer," even though the financing terms have not yet been worked out so no monthly payment can actually be determined. "In fact this [guesstimated] monthly payment may be the only amount discussed and the cash price of the car may never be mentioned. There might also be no mention of the term or length of the finance period and corresponding number of payments. In many cases this estimated monthly payment that the salesperson provides will exceed what might be required to pay for the car. Instead, the estimate will be inflated to allow the payment to be packed.").

195. *See* HUDSON, CARLAW, *supra* note 190, at 368. This practice is specifically prohibited by statute in California. CAL. VEH. CODE § 11713.19(a)(1) (West 2019).

196. *See, e.g.*, Complaint at 4–5, FTC v. Universal City Nissan, Inc. (alleging deceptive loan packing); Complaint at 10, People v. S.G. Hyland Motors Corp., No. 450921/2016 (N.Y. Sup. Ct. July 27, 2016) (same); Complaint at 5, People v. Koeppel Nissan, Inc., No. 150454/2016 (N.Y. Sup. Ct. Jan. 19, 2016) (same); Verified Petition at 10, Schneiderman v. Paragon Motors of Woodside, Inc., No. 452024/2015 (N.Y. Sup. Ct. June 16, 2015) (same); Complaint at 4–5, 7–8, State v. Res. Dealer Grps., Inc., No. 9702015754-4-SEA (Wash. Super. Ct. June 24, 1997) (same); Complaint for Injunctive and Additional Relief Under the Unfair Business Practices – Consumer Protection Act, Chapter 19.86 RCW at 4–5, State v. Universal Underwriters Life Ins. Co., No. 97-2-15752-8SEA (Wash. Super. Ct. June 24, 1997) (alleging aiding and abetting of deceptive loan packing through teaching dealers how to disguise the pack); *see also* HUDSON & BECK, *supra* note 95, at 450 (detailing a deceptive loan packing settlement between the Oregon Department of Justice and an auto dealer); News Release, Wash. State Office of the Att'y Gen., State Takes Action to Stop Deception in Auto Industry (Sept. 18, 1997), https://www.atg.wa.gov/news/news-releases/state-takes-action-stop-deception-auto-industry [https://perma.cc/72XM-FGP6] (describing settlements over deceptive loan packing that did not involve litigation); Press Release, N.Y. State Office of the Att'y Gen., A.G. Schneiderman Announces $1.6 Million Settlements with Auto Dealerships that Illegally Charged Thousands of Customers for Hidden Purchases (Dec. 8, 2016),

Yet another version of loan packing involves the dealer telling the consumer that they will not be charged for an add-on product or that an extended warranty is included, which it is, but for an additional cost, meaning that the consumer could purchase the vehicle for less without the optional extended warranty.[197]

Other scams include failing to honor consumer requests to cancel the add-on products for a refund after offering that option within a specified time.[198] This sort of misrepresentation is clearly prohibited by state and federal UDAP statutes and may also be common law fraud.

At perhaps the most extreme, consumers might simply be asked to sign documents that commit them to purchasing add-on products without being told that they were making a purchase or were even signing blank documents—classic fraud in the factum.[199] The proliferation of e-signature solutions such as DocuSign has exacerbated the problem because consumers can effectively just click in order to initial or sign each page without even having the opportunity to read. As an FTC complaint alleges:

> Information about the add-on products is often included in a stack of lengthy, complex, highly technical documents presented at the close of a long financing process after an already lengthy process of selecting a car and negotiating over its price. Consumers report that Defendants' employees, in numerous instances, have rushed consumers through the closing process and have simply indicated to consumers where to sign.[200]

Loan packing is sometimes encouraged by the third-party providers of add-on products. As one treatise notes:

> Third-party providers of credit insurance and other back-end products aggressively compete for dealership accounts, and will provide significant financial incentives, training, and marketing assistance to dealers to get business. One of the principle techniques they teach is the "pack," and as a result, this practice has become widespread in the automobile dealership industry.[201]

https://ag.ny.gov/press-release/ag-schneiderman-announces-16-million-settlements-auto-dealerships-illegally-charged [https://perma.cc/MJY8-DZWL] (detailing deceptive loan packing settlements); Press Release, N.Y. Office of the State Att'y Gen., A.G. Schneiderman Announces Lawsuit Against Staten Island Auto Dealerships for Alleged Deceptive Practices that Illegally Inflated Car Prices (July 28, 2016), https://ag.ny.gov/press-release/ag-schneiderman-announces-lawsuit-against-staten-island-auto-dealerships-alleged [https://perma.cc/V6JA-HCMC] (detailing deceptive loan packing settlements with nine dealership groups); Press Release, N.Y. State Office of the Att'y Gen., A.G. Schneiderman Announces Settlements with Four Auto Dealer Groups for Deceptive Practices that Resulted in Inflated Car Prices (Apr. 21, 2016), https://ag.ny.gov/press-release/ag-schneiderman-announces-settlements-four-auto-dealer-groups-deceptive-practices [https://perma.cc/22Q9-3DG4] (announcing loan-packing settlements with four dealership groups).

197. *See* Complaint at 20, FTC v. Universal City Nissan, Inc.

198. *See id.*

199. *See id.* at 19–20.

200. *Id.*

201. NAT'L CONSUMER LAW CTR., *supra* note 120, § 7.2.2.

Indeed, the Washington state attorney general sued and entered into a consent decree with a firm that specifically trained auto dealers in the "pack."[202]

Loan packing may also be done on a discriminatory basis. Minorities are targeted more for add-ons than other car buyers,[203] and the average markup on the add-ons was higher for Hispanics than for non-Hispanic whites and blacks in forty-four states, a figure that suggests an even larger markup relative to non-Hispanic whites.[204]

D. YO-YO SCAMS

Consumers are often eager to complete the car purchase transaction and leave the dealer lot with their new car. One might think that a dealer would not let a consumer drive off until and unless the car had been paid for, meaning that all financing was complete and in place. Dealers, however, often allow "spot delivery," meaning that the consumer is allowed to take possession of the car before financing is finalized. Sometimes this is done with an explicit statement (known as a "MacArthur statement") that ownership is contingent on financing approval.[205]

This practice leaves consumers vulnerable to so-called yo-yo scams, also known as "spot delivery," "take-back," "Gimme-back," "bushing," or "fronting," scams, or the "MacArthur" (based on the general's famous admonition "I shall return!").[206] In a yo-yo scam, the consumer drives off with the car before financing is finalized, often with the dealer's assurances that everything will be fine and that there is just a little final paperwork to be received from the lender.[207] A few days later, however, the dealer then contacts the consumer to say that the loan was not approved, so the consumer will have to return the car unless the consumer will agree to different and more onerous loan terms. Sometimes this is because the original loan was not in fact approved by the lender, but it can also simply be an opportunity for the dealer to increase its markup. Indeed, the dealer may not have actually even submitted the loan for approval by an indirect lender.[208]

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202. Consent Decree, State v. Res. Dealer Grp., Inc., No. 97-2-15754-4 SEA (Wash. Super. Ct. May 22, 1998), https://www.nclc.org/images/pdf/unreported/52057.pdf [https://perma.cc/MVM4-3EL2]; Wash. State Office of the Att'y Gen., *supra* note 196.

203. DAVIS, *supra* note 49, at 14–15.

204. *See* VAN ALST ET AL., AUTO ADD-ONS ADD UP, *supra* note 34, at 29.

205. NAT'L CONSUMER LAW CTR., *supra* note 120, § 4.1.2.

206. *Id.*

207. *See, e.g.*, Ericson v. Landers McLarty Olathe KS, LLC., No. 17-2087-DDC, 2017 WL 4573309, at *1 (D. Kan. Oct. 13, 2017) (alleging a yo-yo scam); Salvagne v. Fairfield Ford, Inc., 794 F. Supp. 2d 826, 829 (S.D. Ohio 2010) (finding consumers who signed a dealer's spot delivery form were subsequently contacted by the dealer and required to sign a new contract with different terms to keep their cars); Complaint at 23, FTC v. Universal City Nissan, Inc., No. 2:16-cv-07329 (C.D. Cal. Sept. 29, 2016) (same); s*ee also* HUDSON, *supra* note 190, at 396; THOMAS B. HUDSON, CARLAW II: STREET LEGAL 283–85 (2008) (detailing a spot-delivery suit).

208. Failure to submit the loan for approval might itself be a violation of the ECOA and Fair Credit Reporting Act's adverse action notice requirements. *See, e.g.*, 15 U.S.C. § 1681m (2012); HUDSON & BECK, *supra* note 95, at 425. Alternatively, it might be a violation of the Fair Credit Reporting Act's prohibition on obtaining consumer reports on false pretenses. *See* 15 U.S.C. § 1681q. Additionally,

A number of states have addressed yo-yo scams legislatively or through regulation.[209] For example, Colorado law explicitly provides that it is a deceptive trade practice for a dealer to represent that financing is certain when it is not,[210] whereas Washington law prohibits "bushing," but defines it as occurring more than four days after the vehicle sale.[211] In contrast, North Carolina explicitly allows conditional motor vehicle sales.[212] Likewise, some states limit the ability of the dealer to resell the trade-in before the transaction is finalized or require a refund of the trade-in value before the consumer must return the vehicle.[213] Although these statutes are potentially helpful to consumers, they are not self-executing, and consumers often lack the financial wherewithal and sophistication to attempt to vindicate their rights through the courts or to complain to a regulatory agency.

Yo-yo scams work because the consumer is already emotionally invested in the car. The consumer may have shown off the car to friends and family and faces embarrassment if he must return the car.[214] The consumer may also have no other transportation options because of the trade-in that was done with the sale; the dealer may claim that the trade-in is actually a separate transaction or that it cannot be unwound because the trade-in vehicle has already been sold to someone else.[215] Although there are short-term transportation options such as ride-sharing, car rental, and public transportation, a consumer who gets yo-yo'd is likely to have poor credit and may have difficulty getting another car (and will incur substantial transaction costs as part of the process). If a consumer decides to return the car rather than take out a different loan, the dealer may sometimes refuse to return the down payment or may charge wear-and-tear fees on the vehicle. Although these actions are likely illegal, few consumers are likely to fight them, and they put pressure on the consumer to accept the new loan terms in order to save the down payment or avoid additional charges. Alternatively, if the

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failure to submit the loan for approval might be a UDAP violation or common law fraud, depending on the representations made.

209. *See, e.g.*, ALASKA STAT. § 45.25.610 (West 2019); ARIZ. REV. STAT. ANN. § 44-1371 (2019); CAL. CIV. CODE § 2982.7(a) (West 2019); COLO. REV. STAT. ANN. § 6-1-708 (West 2019); CONN. GEN. STAT. ANN. § 14-62(h) (West 2019); 815 ILL. COMP. STAT. ANN. 505/2C (2019); LA. STAT. ANN. § 32:1261(A)(2)(f) (2019); NEV. REV. STAT. § 482.554 (2019); N.H. REV. STAT. ANN. § 361-A:10-b (West 2019); TEX. FIN. CODE ANN. § 348.013 (West 2019); UTAH CODE ANN. §§ 41-3-401, 41-3-401.5 (LexisNexis 2019); VA. CODE ANN. § 46.2-1530 (West 2019); WASH. REV. CODE ANN. § 46.70.180(4) (2019). In other states yo-yo scams are not specifically prohibited but run afoul of unfair and deceptive acts and practices statutes and also potentially various federal statutes. *See* NAT'L CONSUMER LAW CTR., *supra* note 149, §§ 4.1.3, 4.5.1.

210. COLO. REV. STAT. ANN. § 6-1-708(1)(a)(I).

211. WASH. REV. CODE ANN. § 46.70.180(4).

212. N.C. GEN. STAT. ANN. § 20-75.1 (West 2019).

213. *E.g.*, ARIZ. REV. STAT. § 44-1371 (2019); COLO. REV. STAT. § 6-1-708(1)(a)(II)–(III) (2019); 815 ILL. COMP. STAT. 505/2C; UTAH CODE ANN. § 41-3-401(2)(b), (3); VA. CODE ANN. § 46.2-1530 (12).

214. NAT'L CONSUMER LAW CTR., *supra* note 149, § 4.1.2.

215. *See id.* at § 4.5.1; *see also* NAT'L CONSUMER LAW CTR., *supra* note 120, § 7.3.3 (discussing the practice of "unhorsing").

consumer refuses to return the car or take out a new loan, the dealer might even threaten the consumer with prosecution for theft.[216]

It is impossible to say how common yo-yo scams are, but they have been the subject of FTC enforcement actions[217] and numerous complaints to state attorneys general,[218] and are generally considered one of the leading auto finance scams.[219]

Again, yo-yo scams are feasible only because of dealer financing. If the financing were from a third-party direct lender, the dealer would have a harder time credibly claiming that the financing fell through; the consumer could verify this with the third-party direct lender and would know if she had received a monthly invoice from the third-party lender. Moreover, if the financing had fallen through, the consumer would not necessarily assume that new financing had to go through the dealer.

IV. THE POLICY-RESPONSE MENU

A common phenomenon in financial services is what Professor Howell Jackson has termed the "trilateral dilemma."[220] The dilemma is that consumers often rely on the recommendations of financial service providers, but these providers are frequently incentivized to steer the consumer in a manner that serves the provider's interest, not the consumer's.[221] In particular, the provider might be compensated more for recommending a particular product that is more expensive or less suitable for the consumer. Professor Jackson identifies numerous trilateral dilemmas across consumer credit, insurance, and investment markets.[222] Although indirect auto lending is not among them, it fits the description to a tee. The consumer relies on the dealer to arrange financing, but the dealer's incentives are not aligned with the interests of the consumer.

Professor Jackson also mapped out a set of general policy responses to trilateral dilemmas. These are: (a) prohibitions on certain financial service provider compensation, (b) price controls on compensation, (c) imposition of fiduciary duties on providers, (d) generalized or individualized disclosure rules, (e) assignment of rights to consumers, and (f) requirements regarding the structuring of transactions.[223] Professor Jackson's catalog of the typology of policy responses provides a useful framework for considering potential policy responses to the problems in the auto lending market.

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216. NAT'L CONSUMER LAW CTR., *supra* note 149, § 4.5.2.

217. *See, e.g.*, Complaint at 10, FTC v. Universal City Nissan, Inc., No. 2:16-cv-07329 (C.D. Cal. Sept. 29, 2016).

218. *See* MARCELINE WHITE, MD. CONSUMER RIGHTS COAL., RISKY BUSINESS– BUYING A CAR IN MARYLAND: AUTO FRAUD AND POLICY CHOICES 10 (2013), https://perma.cc/9F42-92CR.

219. NAT'L CONSUMER LAW CTR., *supra* note 120, § 7.3.10.

220. Jackson, *supra* note 50, at 83.

221. *Id.*

222. *Id.* at 84–99.

223. *Id.* at 99–100.

This section considers a menu of potential policy responses in light of Professor Jackson's typology. It shows that most of the approaches are inadequate because they fail to address the root cause of the problems in the auto lending market—the market structure in which vehicle purchases are effectively tied with vehicle financing. This structural problem speaks to the need for a market structure solution, which is not in Professor Jackson's catalogue of policy-response categories.

A. PROHIBITIONS

A simple and direct way to address the consumer protection problems in auto lending is to prohibit bad practices. Thus, several consumer organizations have proposed prohibiting dealer markups.[224] Discriminatory lending prohibitions already exist,[225] as do general prohibitions against fraud; unconscionable behavior; and unfair, deceptive, and abusive acts and practices. The only two reported cases to consider the legality of dealer reserve arrangements under state UDAP law have both held that they are not unfair,[226] and those courts' reasoning is suspect because it was predicated on a questionable factual assumption that consumers understand that the dealer can markup the loans. In any case, one could imagine specific prohibitions against dealer markups, loan packing, and yo-yos.

A limitation on outright prohibitions is that they are not self-executing. For example, loan packing and yo-yos are already unconscionable; fraudulent; or violations of general prohibitions on unfair, deceptive, and abusive acts and practices.[227] Still, these schemes persist. Likewise, the fact that there are fair lending laws on the books does not necessarily prevent discriminatory lending. In order to prevent such, substantial information about lending and borrowers should be available to public enforcement authorities and private litigants, much as the Home Mortgage Disclosure Act does for mortgage lending and (the not yet implemented) section 1071 of the Dodd–Frank Wall Street Reform and Consumer Protection Act should do for small business lending.[228] Similarly, the effectiveness of specific prohibitions on loan packing and yo-yos likely depends on the extent of public and private enforcement.

A prohibition on loan markups would also be ineffective because of a substitution effect. If markups are prohibited, dealers will simply move financing costs to other unregulated areas, resulting in, for example, higher vehicle sale prices or

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224. *See* DAVIS & FRANK, *supra* note 49, at 17–18 (calling for flat-fee dealer compensation); RICE & SCHWARTZ JR., *supra* note 49, at 26 (calling for elimination of dealer markups); VAN ALST, FUELING FAIR PRACTICES, *supra* note 34, at 14 (same).

225. 15 U.S.C. § 1691(a) (2012).

226. *See* Beaudreau v. Larry Hill Pontiac/Oldsmobile/GMC, Inc., 160 S.W.3d 874, 881 (Tenn. Ct. App. 2004) (finding that dealer reserve is not a deceptive practice); Kunert v. Mission Fin. Servs. Corp., 1 Cal. Rptr. 3d 589, 606 (Cal. Ct. App. 2003) (finding that dealer reserve is not an unfair, unlawful, or fraudulent business practice).

227. *See* 12 U.S.C. § 5536 (2012) (prohibiting unfair, deceptive, and abusive practices in consumer finance); 15 U.S.C. § 45 (prohibiting unfair, deceptive, and abusive practices affecting interstate commerce).

228. 15 U.S.C. § 1691o-2.

higher markups on add-ons (and more loan packing). The linked nature of the purchase and financing markets undermines the effectiveness of a prohibition on loan markups.

B. PRICE CONTROLS

Rather than prohibit transaction fees, another regulatory move sometimes used to address trilateral dilemmas is to allow the transaction fees but regulate their price terms. At least one consumer organization has called for allowing but capping dealer markups.[229] A cap could be either a percentage limit or a fixed dollar amount. Price controls are an incomplete solution to the problems in the auto lending market. Price controls could not address yo-yos or loan packing, only the dealer markup of the loan.

It is also important to recognize that despite the abuses of dealer markups, dealers are still providing a ministerial service when they arrange for an indirect loan, and they deserve to be compensated for it. Thus, a pair of states currently allow but cap the size of dealer markups in percentage terms. In 2004, Louisiana began to require that dealers disclose in writing that they may be participating in the finance charges and also capped the difference between the contract rate and the buy rate at 3%.[230] Likewise, since 2006, California has limited dealer markups to 2% of the purchase amount for contracts with terms of over sixty months and 2.5% of the purchase amount for contracts with terms of sixty months or less.[231] Historically, four other states—Indiana,[232] Michigan,[233] Ohio,[234] and

229. VAN ALST, FUELING FAIR PRACTICES, *supra* note 34, at 14–15 (also calling for consumers to all be charged the same markup).

230. *See* LA. STAT. ANN. § 32:1261A(2)(k)(i)–(ii) (2019).

231. CAL. CIV. CODE § 2982.10 (West 2019). The average markup of between 1% and 2% is approximately industry standard, so California's limitation is unlikely to affect most dealers. Grunewald et al., *supra* note 43, at 8.

232. The Indiana Retail Instalment Sales Act was adopted in 1935. IND. CODE §§ 58-906, 58-910, 58-926 (Supp. 1943). It authorized the Indiana Department of Financial Institutions to set a limit on dealer financing markups. *Id*. The Department limited dealer participation in finance charges to 2% to 5%. 2 IND. ADMIN. CODE 58-926-1 (1941). The statute was struck down in 1952 as violating the general preamble of the Indiana state constitution. Dep't of Fin. Insts. v. Holt, 108 N.E.2d 629, 637 (Ind. 1952). Even after Indiana's statutory limitation was voided, the Indiana Department of Financial Institutions attempted, unsuccessfully, to use an anti-monopoly provision in the same statute to prevent one of the largest auto finance companies from offering 20% participations in order to drive its smaller competitors out of business. Dep't of Fin. Insts. v. Universal C. I. T. Credit Corp., 146 N.E.2d 93, 96 (Ind. 1957).

233. Section 31(c) of the Michigan Motor Vehicle Sales Finance Act, No. 27, 1950 Mich. Pub. Acts 43, *amended by* Act of Jun. 2, 1955, No. 102, 1955 Mich. Pub. Acts 153, 154, allowed a service fee of 2% of the principal amount financed on motor vehicles not more than one year old and 3% of the amount financed on other vehicles, plus an additional amount not exceeding 1/12 of the amount paid to the seller for each month the principal amount is financed in beyond 12 months but for not more than 24 months. The restriction was repealed in 1995. Act of Oct. 9, 1995, No. 167, 1995 Mich. Pub. Acts 1690, 1695.

234. The relevant provision of the Ohio Retail Installment Sales Act limited dealer markups to 2%. Ohio Retail Installment Sales Act, 1949 Ohio Laws 77, 82. The law was upheld when challenged, Teegardin v. Foley, 143 N.E.2d 824, 833 (Ohio 1957), but was repealed in 2001, Act of Oct. 17, 2001, 2001-2002 Ohio Laws 6436.

Wisconsin[235]—also restricted dealer markups. The current state laws restricting markups appear to be responding to the numerous suits alleging discriminatory markups that settled during the 2000s.[236] In contrast, other states implicitly authorize markups.[237]

Simply capping the size of the markup in percentage terms is a poorly tailored solution to the problem, however, because although dealers deserve to be compensated for their services, the value of the dealer's service does not depend on the size of the loan or the borrower's characteristics.[238] Dealer compensation for arranging a loan should be a flat fee, not a percentage cut. Yet if that flat fee is not also capped, then it could still be supracompetitive, even if it could no longer have discriminatory variation.

But what is an appropriate cap? If the cap is too high, it will allow dealers to continue to charge supracompetitive prices; if it is too low or eliminated, dealers will simply move financing costs to other, unregulated areas, as they would with an outright prohibition on markups. Thus, studies suggest that when faced with usury caps, dealers simply charge more for the sales price of the vehicle.[239] Because of the bundled nature of the auto purchase and financing transaction, regulating one aspect of the price (whether capping or prohibiting outright) will inevitably result in a substitution to another area of the price. Price controls are an inadequate solution because they do not de-link the auto purchase and auto financing markets.

C. FIDUCIARY DUTIES

Fiduciary duties also present an unsatisfactory response to the trilateral dilemma in indirect auto lending. As a starting matter, fiduciary duties are not self-enforcing; they are a standard that require litigation to enforce. They are also a poor conceptual fit with auto lending. Fiduciary duties generally exist in contexts where one party is acting as the other's agent or where one party recognizes the other as being a mere transaction broker. Neither characterizes the consumer-auto-dealer relationship. The dealer is the consumer's counterparty on the sale and also, as far as the consumer knows, on the financing because the loan will originally come through the dealer. True counterparties are not fiduciaries or else every seller would have to get the buyer the best price. Thus, the two reported cases regarding whether there is a common law duty to disclose dealer markups

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235. The Wisconsin Motor Vehicles Sales Finance Act, 1935 Wis. Sess. Laws 748, 755, was adopted in 1935 and was upheld when challenged, Gen. Motors Acceptance Corp. v. Comm'r of Banks, 46 N.W.2d 328, 329 (Wis. 1951), but was repealed in 1953. Act of June 17, 1953, Ch. 302, 1953 Wis. Sess. Laws 280. For a discussion of the statute's unusual and complex operation, see Marvin Holz, *The Regulation of Consumer Credit*, 1943 WIS. L. REV. 449, 529–50.

236. John L. Ropiequet & Nathan O. Lundby, *Dealer Rate Participation Class Actions Under the ECOA: Have We Reached the End of the Road?*, 62 BUS. LAW. 663, 668–71 (2007).

237. *See, e.g.*, MINN. STAT. ANN. § 53C.08 subdiv. 2(6) (West 2019); TEX. FIN. CODE ANN. § 348.301 (West 2019).

238. Mors, *supra* note 28, at 203.

239. *See* Brown & Jansen, *supra* note 103, at 6; Melzer & Schroeder, *supra* note 41, at 2 (finding that LTV ratios increase when usury caps bind, which is consistent with higher sale prices).

have both held that there is no such duty because the dealer is not the borrower's agent.[240]

Even if one thought a fiduciary duty were appropriate, however, what would such a duty be? In other transaction contexts, there may be a duty of best execution or a duty of suitability or duties of care and loyalty, but none of those fits auto lending well. For example, securities brokers are subject to a duty of best execution.[241] This is not a duty of individualized best execution but of best execution for customer orders in aggregate. This means that the broker does not need to consider the idiosyncratic preferences of an individual customer when determining what is the best execution for the transaction.

The same is not true for an auto dealer. There is no aggregate best execution for auto loans. Instead, it is a question of individualized preference. And an auto loan has multiple variables—most importantly interest rate, down payment, and term. How is a dealer supposed to evaluate the trade-off between a lower rate and a longer term? Or between a lower rate and a larger down payment? If indirect lender *A* offers 3.99% over seven years and indirect lender *B* offers 5.99% over five years, which is the best deal for the consumer? The dealer cannot know individual consumer preferences in this regard except as the consumer reveals them, which will, in turn, depend on the deals offered.

Likewise, securities and commodities brokers are subject to a duty to recommend only "suitable" investments to clients.[242] This does not mean that the broker must put the client's interests above his own, although it does entail eschewing excessive transaction fees or unnecessary transactions (known as "churning").[243] Instead, it is primarily a duty to make recommendations consistent with the client's profile and objectives.[244] The suitability concept also fits auto lending poorly. Suitability does not prohibit a markup, only an excessive one, but at what level is a markup excessive? Nor does it give the dealer any guidance regarding which indirect loan offer should be given the consumer as between the offers of indirect lender *A* and indirect lender *B*, above.

240. Balderos v. City Chevrolet, 214 F.3d 849, 853–54 (7th Cir. 2000) (no fiduciary duty to disclose dealer markup); *Ex parte* Ford Motor Credit Co., 717 So.2d 781, 787 (Ala. 1997) (no common law duty to disclose dealer markup).

241. *See, e.g.*, *In re* Merrill Lynch Sec. Litig., 911 F. Supp. 754, 760 (D.N.J. 1995), *rev'd on other grounds*, Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266 (3d Cir. 1993).

242. *2111.Suitability*, FINRA, https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111 (last visited Mar. 5, 2020) (listing FINRA rule 2111(a)). There is no equivalent suitability requirement for commodities brokers. Some states have suitability requirements for sale of life insurance and annuities. *See* NAT'L ASSOC. OF INS. COMM'RS, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 11–15 (2000), https://www.naic.org/store/free/SOS-LI.pdf [https://perma.cc/BT7C-3H8R].

243. *2111.Suitability*, *supra* note 242 (listing FINRA rule 2111.05(c)). *But see* Jonathan Macey et al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789, 828 n.220 (2009) (discussing whether churning is a separate doctrine from suitability). Churning is a Commodities Exchange Act antifraud violation despite the statute's lack of a suitability requirement. *See, e.g.*, Gilbert v. Refco, Inc., CFTC No. 87-R223, Comm. Fut. L. Rep. (CCH) ¶ 25,081 (June 27, 1991).

244. *2111.Suitability*, *supra* note 242 (listing FINRA rule 2111(a)).

Similarly, standard fiduciary duties of care and loyalty make no sense in the context of a credit sale. Although investment advisors are prohibited from putting their interests above the client's,[245] such a duty of loyalty is incompatible with a credit transaction that is bundled with a sales transaction where the dealer is not acting as the consumer's agent but as a principal counterparty. Because of the interplay between car price and financing terms, a duty of loyalty on the financing would either be ineffective (because the dealer would simply shift price from the financing term to the vehicle term) or would also have to operate as a duty of loyalty for the sales terms, meaning that the dealer would have to forgo all profit on the deal. There would be no auto dealers on those terms.

D. DISCLOSURES

Another response to trilateral dilemmas is disclosure on the theory that if intermediaries' fees are disclosed, then competition will help protect consumers. For example, if dealers were to disclose markups, consumers could decide whether the dealer's services in arranging the financing were worth the cost. Accordingly, some consumer advocates have called for greater disclosures in auto lending.[246]

It is unlikely that the problems in auto financing can be addressed through disclosure requirements, however, because the source of the problem is not primarily information failure, but rather dealers' market power over financing once the car purchase terms are concluded.

1. Federal Disclosure Requirements

Federal law does not appear to require any sort of disclosure of the dealer markup. Regulation Z under the Truth in Lending Act (TILA) requires the itemized disclosure of "[a]ny amounts paid to other persons by the creditor on the consumer's behalf."[247] This provision has never been applied to dealer markups. Instead, its usual application is retention of commissions on insurance contracts.[248] But nothing in the language of Regulation Z would impede the application of the itemization requirement to dealer markups.

Nonetheless, the few reported cases have all held that there is no duty to disclose the markup under TILA or Regulation Z. [249] A factor for some of these

245. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–92 (1963); *see* 15 U.S.C. § 80b-6 (2012).

246. VAN ALST ET AL., AUTO ADD-ONS ADD UP, *supra* note 34, at 42 (calling for up-front disclosure of add-on costs); VAN ALST, FUELING FAIR PRACTICES, *supra* note 34, at 15 (same); DAVIS & FRANK, *supra* note 49, at 18 (calling for disclosure of markup amounts).

247. 12 C.F.R. § 1026.18(c)(1)(iii) (2019).

248. *See Comment for 1026.18 - Content of Disclosures*, CFPB, https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/Interp-18/#18-c-1-iii-Interp [https://perma.cc/6E67-X88L] (last visisted Mar. 5, 2020) (paragraph 1026.18(c)(1)(iii)).

249. Mendoza v. Lithia Motors, Inc., No. 6:16-cv-01264-AA, 2018 WL 1513650, at *4 (D. Or. Mar. 27, 2018); Guinn v. Hoskins Chevrolet, 836 N.E.2d 681, 695 (Ill. App. Ct. 2005); Geller v. Onyx Acceptance Corp., No. 7285614, 2001 Cal. Super. LEXIS 543, at *16 (Cal. Super. Ct. Nov. 13, 2001).

In 2010, Congress prohibited payments to mortgage loan originators based on the terms of the mortgage. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1403, 124 Stat. 1376, 2139–41 (2010) (codified at 15 U.S.C. § 1639b(c) (2012)). This prohibition outlawed the

courts is that in 1977, the Federal Reserve Board adopted an official interpretation of Regulation Z that dealer markups do not need to be broken out in the itemization of the finance charge.[250] The Board also proposed but withdrew an amendment to Regulation Z specifically requiring disclosure of the existence (but not the amount) of a dealer markup.[251] The Board's official interpretation was repealed without comment in 1982, however, as part of a general reorganization of Regulation Z,[252] a fact not mentioned by any of the courts that rely on the 1977 interpretation.[253]

In any case, the CFPB's current official interpretation of this itemization requirement shields from TILA liability parties that in good faith merely make a generic disclosure of the possibility of a markup.[254] There is no liability under TILA for a party that relies in good faith on a CFPB official interpretation of the statute.[255] The CFPB's current official interpretation notes that:

> Given the flexibility permitted in meeting the requirements of the amount financed itemization (see the commentary to § 1026.18(c)), the creditor in such cases may reflect that the creditor has retained a portion of the amount paid to others. For example, the creditor could add to the category "amount paid to others" language such as "(we may be retaining a portion of this amount)."[256]

A dealer or indirect lender (depending on who was the original creditor) that provides a generic disclosure of the possibility of a markup could reasonably shelter in compliance with the official interpretation. Parties that make no disclosure whatsoever cannot shelter in the official interpretation, but it is still not clear that they have any liability under TILA because of lack of certainty about whether there is a duty to disclose. As it stands, however, the CFPB has the ability to require disclosure of the markup through rulemaking.[257]

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payment of yield spread premiums to mortgage brokers, a practice analogous to the payment of dealer reserve by indirect lenders. *Cf.* Jackson & Burlingame, *supra* note 179, at 291–92. Courts applying the law as it was before Dodd–Frank, however, have similarly held that there was no duty under TILA to disclose the yield spread premium. *See, e.g.*, Willis v. Bank of Am. Corp., No. ELH-13-02615, 2014 WL 3829520, at *16 (D. Md. Aug. 1, 2014); Hernandez v. Downey Sav. & Loan Ass'n, No. 08cv2336-IEG (LSP), 2009 WL 704381, at *7 (S.D. Cal. Mar. 17, 2009).

250. Interpretation on Disclosure of Amount of Dealer Participation, 42 Fed. Reg. 19,124 (Apr. 12, 1977). There is no liability under TILA for a party that relies in good faith on an official interpretation. 15 U.S.C. § 1640(f) (2012).

251. Interpretation on Disclosure of Amount of Dealer Participation, 42 Fed. Reg. at 19,124.

252. Revised Regulation Z, 46 Fed. Reg. 20,892 (Apr. 7, 1981); *Comment for 1026.18 - Content of Disclosures*, *supra* note 248.

253. *See* Guinn, 836 N.E.2d at 695 (relying on Federal Reserve Board interpretation without noting repeal of interpretation); Geller, 2001 Cal. Super. LEXIS 543, at *15–16 (same).

254. *Comment for 1026.18 - Content of Disclosures*, *supra* note 248.

255. 15 U.S.C. § 1640(f) (2012).

256. *Comment for 1026.18 - Content of Disclosures*, *supra* note 248.

257. The CFPB has no authority to undertake a rulemaking regarding auto dealers that routinely assign nondefaulted loans to unaffiliated third parties. 12 U.S.C. § 5519(b) (2012). This includes rulemakings under TILA/Regulation Z. The CFPB does, however, maintain rulemaking authority over

2. State Disclosure Requirements

State law, too, rarely requires disclosure of even the *possibility* of a markup, much less the actual markup. Since 2004, Louisiana has required disclosure of the possibility of a markup,[258] and since 2005 Texas has included in its model motor vehicle installment sale forms a generalized disclosure of the possibility of a markup.[259] Some lawyers have been advising dealers to do this prophylactically.[260] At the same time, Texas law makes clear that there is no duty to disclose the amount of markup or the terms on which the indirect lender acquires the contract.[261]

Even if a consumer were to read a generalized disclosure alerting the consumer to the possibility of a markup, it would be of little use because the consumer would not know if there actually is a markup and how large it is. The disclosure informs the consumer that it *might* be wise to shop around. But, without knowing the size of the potential savings, a consumer cannot rationally decide whether it is worthwhile to shop for a better deal. The Federal Reserve expressed a similar sentiment when it withdrew its proposed amendment[262] to Regulation Z—which required dealers to disclose the existence (but not size) of any markup—concluding that such an anodyne disclosure would not significantly enhance the consumer's ability to shop for credit.[263]

The Illinois Attorney General proposed requiring disclosure of actual markups in 2004.[264] Although nothing came of the Illinois proposal, even individualized disclosures showing the actual markup on the loan would be of little help to consumers because these disclosures would come too late to matter. By the time the consumer learns of the markup, the consumer has already sunk in time negotiating other terms and lacks an alternative other than walking away and risking getting worse terms elsewhere.

Perhaps disclosures could address loan packing—a disclosure might inform the consumer that loan terms do not depend on the purchase of add-ons—but

indirect lenders as "covered persons," 12 U.S.C. § 5481(6) and assignees are liable under TILA/Regulation Z for facial violations of the statute, 15 U.S.C. § 1641(e)(2). Whether a facial violation could exist given the lack of rulemaking authority over the assignor dealer is unclear. The CFPB could, alternatively, undertake a disclosure rulemaking applicable to indirect lenders under its UDAP power to prohibit deceptive acts and practices. 12 U.S.C. § 5531(b).

258. *See* LA. STAT. ANN. § 32:1261(2)(k) (2019).

259. 30 TEX. REG. 5329 (Sept. 2, 2005) (codified at 7 TEX. ADMIN. CODE § 84.808(45)(C) (West 2019)). Use of forms other than the model forms requires regulatory approval. 7 TEX. ADMIN. CODE § 84.802(a) (2019).

260. Kenneth J. Rojc & Sara B. Robertson, *Dealer Rate Participation Class Action Settlements: Impact on Automotive Financing*, 61 BUS. LAW. 819, 826 (2006).

261. TEX. FIN. CODE ANN. § 348.301 (West 2019).

262. Proposed Amendment on Disclosure of Dealer Participation, 42 Fed. Reg. 1268 (proposed Jan. 6, 1977).

263. Interpretation on Disclosure of Amount of Dealer Participation, 42 Fed. Reg. 19,124–25 (Apr. 12, 1977).

264. Al Swanson, *First Truth-in-Financing Auto Law Proposed*, UNITED PRESS INT'L (Jan. 29, 2004, 4:56 PM), https://www.upi.com/Defense-News/2004/01/29/First-truth-in-financing-auto-law-proposed/92751075413393/ [https://perma.cc/BXV4-N6LJ].

such a disclosure could easily be buried in the mound of information presented to the consumer in the F&I office. More importantly, given the auto loan transaction structure, disclosures are unlikely to prevent supracompetitive or discriminatory pricing, and in no case would they affect yo-yo scams.

E. CREATION OF CONSUMER RIGHTS

The trilateral dilemma can also be addressed by giving consumers rights that let them insist on certain transaction terms or avoid other terms. For example, some consumer groups have proposed a right of rescission for auto *purchase* transactions with an eye to addressing yo-yo scams.[265] Thus, John Van Alst of the National Consumer Law Center has proposed requiring a cooling-off period or rescission right for motor vehicle RICs,[266] and a bill introduced in the House in 2009 would have directed the FTC to consider adopting such a rescission right.[267] Such a right would seem to rescind both the vehicle sale and the financing—for the sale is done through an RIC that bundles the financing with the sale in a single contract. As such, a right of rescission does not let the consumer purchase a car with dealer financing and then shop for better financing after leaving the dealer during the rescissory period. In order to allow formal rescission of only the financing, it would be necessary to require that the sale and the financing be under separate contracts—a sales contract and a loan contract, rather than an integrated RIC. Such separation would enable the rescission of the financing, but such rescission would require repayment of the loan (such as through refinancing), because the consumer would still owe payment under the sales contract.

Rights of rescission already exist for certain types of sales[268] and credit contracts in much of the developed world, including in the United States for certain

265. *See, e.g.*, VAN ALST, FUELING FAIR PRACTICES, *supra* note 34, at 12–13; WHITE, *supra* note 218, at 18–19.

266. VAN ALST, FUELING FAIR PRACTICES, *supra* note 34, at 12.

267. Consumer Credit and Debt Protection Act, H.R. 2309, 111th Cong. § 2(b)(2)(B) (2009).

268. Rescission rights exist in other commercial contexts. For example, there is a mandatory three-business-day cancellation period for door-to-door sales. 16 C.F.R. § 429.1 (2019) (requiring door-to-door sales contracts to have a provision allowing for consumers to cancel the contract without penalty within three business days of the transaction date). Some states have similar statutes that sometimes also cover telephone and mail sales. *See, e.g.*, 815 ILL. COMP. STAT. ANN. § 505/2B (West 2019) (requiring three-business-day, penalty-free cancellation for sales at the consumer's residence); MINN. STAT. ANN. § 325G.08 (West 2019) (same); OHIO REV. CODE ANN. § 1345.30(D) (West 2019) (hearing aid or timeshare sales); WIS. STAT. ANN. §§ 423.201, 423.202 (West 2019) (three-business-day, penalty-free cancellation for telephone, mail, and door-to-door sales); 13 N.Y. COMP. CODES R. & REGS. tit. 13, § 24.3 (Oct. 2, 2019) (seven-business-day cancellation for time share plans).

Similarly, outside of the United States, one can find rescissory periods for a range of purchase transactions. For example, the EU requires its member states to have a fourteen-day right of rescission for all distance and off-premises contracts. Council Directive 2011/83, art. 9, art. 10, art. 14, 2011 O.J. (L304) 11–14 (EC) (fourteen-day right of rescission (or up to one-year if not adequately disclosed) for all distance and off-premises contracts but liability for costs of return and diminished value in goods). The fourteen-day right of rescission supplants an earlier seven-day right of rescission. *See* Council Directive 97/7, art. 6, 1997 (EC) (seven-day right of withdrawal for distance contracts); Council Directive 87/577, art. 5, 1985 O.J. (L144) 22 (EC) (seven-day right of withdrawal for off-premises contracts).

mortgage loans,[269] in Europe,[270] New Zealand,[271] Singapore,[272] South Africa for all consumer credit,[273] and some Canadian provinces for payday loans.[274] There is a functional right of rescission in the United States for auto loans (including those done in RIC form) because they are generally freely prepayable, meaning that the borrower can pay off the loan at any time without incurring an additional charge. This means that a consumer can often "rescind" the loan simply by refinancing it, although the consumer will not be reimbursed any finance charges or other fees she has already been charged. If the loan is in the form of an RIC, refinancing enables the consumer to rescind solely the financing component of the contract without rescinding the sale component. Indeed, there appears to be a small subset of consumers who refinance their initial auto loans within days of closing.[275]

Nonetheless, it appears that few consumers ever refinance their auto loans. A 2017 poll found that only 12% of vehicle owners had ever refinanced an auto loan.[276] This may be, in part, due to lack of awareness about the ability to get better terms. The same 2017 poll found that less than half of U.S. adults were aware that it is even possible to refinance auto loans.[277] It may also have a behavioral explanation—consumer think they are done with the auto transaction, are exhausted from it, and do not want to reopen the transaction. Indeed, we see a failure to rationally refinance in the mortgage market as well.[278]

The ability to refinance an auto loan can theoretically help consumers avoid supracompetitive markups, discriminatory markups, and yo-yo scams. But it does not help with loan packing because the consumer has already financed the add-on products in the original loan. The consumer would need to be able to separately

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269. 15 U.S.C. § 1635 (2012).

270. Council Directive 2008/48, art. 14, 2008 O.J. (L 133) 79 (EC).

271. Credit Contracts and Consumer Finance Act 2003, s 27 (N.Z.) (five-business-day right of cancellation for all credit contracts in New Zealand).

272. Consumer Protection (Fair Trading) Act (Ch. 52A, 2009 Rev. Ed.), § 11 (Sing.); Consumer Protection (Fair Trading) (Cancellation of Contracts) Regulations (S65/2009) regs 3(h), 4 (Sing.) (five-day cancellation period, excluding financial services, only if there is a separate cancellation rule under Monetary Authority of Singapore regulations).

273. National Credit Act 34 of 2005 § 121 (S. Afr.) (five-business-day right of cancellation for off-premises credit contracts in South Africa).

274. Payday Loans Act, S.O. 2008, c. 9, s. 30 (Can.) (two-day payday loan cancellation period in Ontario); Payday Loans Regulation, B.C. Reg. 57/2009, s. 14.2 (Can.) (two-day payday loan cancellation period in British Columbia); Cost of Credit Disclosure and Payday Loan Act, R.S.N.B. 2002, c. C-28.3, s. 37.29 (Can.) (two-day payday loan cancellation period in New Brunswick); The Payday Loans Act, S.S. 2007, c. P-4.3, s. 22 (Can.) (two-day payday loan cancellation period in Saskatchewan).

275. *As Auto Shopping Season Heats Up, It's Clear that Some Consumers Refinance Their Loans Within Days of Purchase*, TRANSUNION (Aug. 9, 2018), https://newsroom.transunion.com/as-auto-shopping-season-heats-up-its-clear-that-some-consumers–refinance-their-loans-within-days-of-purchase/ [https://perma.cc/CU8K-LS2B].

276. *See* Press Release, Ally Financial, Inc., *supra* note 15.

277. *Id.*

278. *See* Yoon-Ho Alex Lee & K. Jeremy Ko, *Consumer Mistakes in the Mortgages Market: Choosing Unwisely Versus Not Switching Wisely*, 14 U. PA. J. BUS. L. 417, 424–26 (2012).

rescind those add-ons to the purchase contract, which is not always possible for hard-adds that are physically part of the vehicle.

F. TRANSACTION-STRUCTURE REQUIREMENTS

A final approach for addressing trilateral dilemmas is to impose requirements on the transaction structure as opposed to the terms of the transaction itself. Although the transaction structuring requirements identified by Professor Jackson are similar to requirements for the use of a certified computer model for investment options for a pension plan,[279] one can think of transaction-structure requirements as a broader category that mandates particular steps in a transaction. Transaction-structuring requirements can be used to encourage greater competition in markets. This section considers two possible transaction-structure requirements: mandatory sharing of loan data to enable direct lenders to make refinancing offers and mandatory auctions of loans by dealers.

1. Mandatory Data Sharing to Facilitate Refinancings

One possibility of a transaction-structure requirement would be a requirement that dealers collect consumer contact information and submit it to a central database that third-party lenders could use to contact consumers for refinancing. Indeed, state departments of motor vehicles already collect some consumer contact information, such as addresses, as part of their regular record maintenance of vehicle titles and liens,[280] although that information may not be readily available to third parties, except when searching for known borrowers or lenders.

In theory, this approach would enable consumers to more easily refinance to lower cost loans and thus put downward pressure on dealer markups. Accordingly, it would help limit supracompetitive pricing and discriminatory markups. It would not address loan-packing, however, because the marked-up add-ons would be in the principal balance being refinanced. It would also not affect yo-yos, because the nature of a yo-yo scam is that there is no loan (or, technically, RIC) ever actually made, so the consumer's data would never be entered into a database.

Putting aside consumer privacy concerns, this approach is likely to be effective on a large scale only if consumers pay attention to refinancing solicitations from third-party financiers. This seems unlikely for two reasons. First, consumers would not think of themselves as being in the auto loan market—they already bought a car and obtained financing that they were happy enough with—so they are unlikely to pay attention to auto loan solicitations. Second, consumers have low take-up on direct mail, email, and phone campaigns generally.[281] Indeed,

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279. Jackson, *supra* note 50, at 15, 28.

280. *See, e.g.*, CONN. GEN. STAT. ANN. § 14-171 (West 2019) (laying out what needs to be included in an application for title, like name and address).

281. *See, e.g.*, *20 Direct Mail Statistics You Need to Know for 2019*, DATA TARGETING SOLUTIONS (Mar. 7, 2019), https://perma.cc/AE47-R2DX (noting a 5% response rate for direct mail and a 1% response rate for emails).

there is relatively little third-party refinancing of auto loans.[282]

2. Mandatory Auctions of Loans

An alternative transaction structure approach has been suggested by Professor Ian Ayres. Professor Ayres has proposed mandating dealers to auction loans on an open-access auction website if the finance contract has more than a specified markup level.[283] Professor Ayres's proposal does not specify the details of how this auction would work—does the consumer get the rate offered by the low-bidder, meaning the dealer loses any markup, or would that be the base rate above which there would be a dealer markup?

Regardless of the details, Professor Ayres's proposal moves in the right direction of encouraging a market for financing separate from the market for the vehicle purchase. Professor Ayres's proposal is as much one regarding market structure as transaction structure. Nonetheless, it has several important limitations.

First, Professor Ayres's auction requirement kicks in only after a certain markup level. This design is similar to the price-cap approach discussed above, meaning dealers will be incentivized to limit the markup to just under the trigger level. Indeed, Professor Ayres specifically praises California's price-cap approach and recommends it to other states.[284] Unfortunately, this means that Professor Ayres's approach has all the problems of a price-cap approach, including the lack of an appropriate cap level and the substitution problem.

Second, Professor Ayres's proposal deprives the consumer of the right to choose the lender. Although most consumers will prioritize low costs, that may not be their only consideration. Indeed, Ayres's auction system rewards lenders with the lowest bid, encouraging them to cut costs at the expense of service quality.[285] The consumer may therefore receive a cheaper loan but problematic loan servicing.

Third, Professor Ayres's proposal seems to assume that the interest rate would be the only basis for competition in the auction. If so, other key terms of the loan—down payment, total loan amount, LTV, and length—would be set between the dealer and the indirect lender. However, many consumers are concerned about getting the lowest monthly payment rather than the lowest total payment. Lowest monthly payment is a function not just of interest rate but also of down payment and contract length. The consumer may not, in fact, get the best overall deal in terms of lowest monthly payment by virtue of getting the lowest interest rate. For example, if a consumer has a $25,000 with a 3% interest rate for sixty months, monthly payments would be $449 and the total payments

282. Interview with Sonia Steinway, CEO, Outside Fin. (July 11, 2019) (on file with author).

283. Ian Ayres, *Guess How Much Cheaper Your Auto Loan Would Be if Dealers Had to Play Fair*, WASH. POST (June 26, 2019, 3:48 PM), https://www.washingtonpost.com/opinions/2019/06/26/guess-how-much-cheaper-your-auto-loan-would-be-if-dealers-had-play-fair/.

284. *See id.*

285. *See id.*

would be $27,348. If, however, the term were only forty-eight months and the interest rate were 2%, the consumer's monthly payments would be $542. The shorter term more than offsets the lower rate.

Likewise, if a consumer were concerned about total payments, the lower rate would not necessarily guaranty the lowest total payment. The total payment for the 3% loan over sixty months is $27,348, but at a higher 4% rate over forty-eight months, the total would be $27,095. Again, the longer term offsets the lower rate. Under Professor Ayres's proposal, which focuses solely on the interest rate, the consumer never gets the ability to select the combination of loan terms that matches his preferences. Professor Ayres's proposal would require an up-front agreement on all terms of the loan other than the interest rate, but a consumer might want to see the possible trade-offs before making a commitment.

Fourth, for Professor Ayres's proposal to work, auto loans would need to be completely standardized in terms of documentation. They currently are not standardized as a de jure matter in most states,[286] even though they are largely standardized as a de facto matter through the widespread use of the Reynolds & Reynolds LAW 553 RIC form.[287] Although *consumers* may be interested primarily in rate, down payment, contract length, and monthly payment, lenders may be concerned about particularities of loan documentation or rights in the event of a default. For example, is there a binding mandatory arbitration clause? How is it drafted? Is there a forum selection clause? Where is that forum? What do the provisions on acceleration and attorneys' fees say?

These boilerplate terms in the aggregate have value to lenders. Lenders do not want to assemble a hodge-podge of differently drafted contracts with non-standardized rights because that substantially raises their contract enforcement costs by requiring them to investigate their rights for each specific loan. For auto loan pricing to be commoditized as Professor Ayres rightly seeks, the boilerplate and fine-print language needs to be standardized.

Finally, Professor Ayres does not address who would run the auction. Unless a governmental entity ran the auction (and what entity would do that?), there could be multiple private-auction platforms that would compete for business. That competition would again be for the dealer's business, just recreating the markup problem. And the platforms might themselves be owned by dealers or lenders creating a set of conflict of interests that could undermine any consumer cost savings.

Despite these limitations, Ayres's proposal moves in the right direction by delinking the financing from the vehicle purchase. The next Part considers an alternative, original transaction structure solution that would more effectively de-link the vehicle purchase and financing markets and expose the financing market to greater competition.

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286. One exception is that Texas promulgates model forms and requires regulatory approval to use other forms. 7 TEX. ADMIN. CODE § 84.802 (West 2019). Lenders may choose which clauses to include in model forms, so not all Texas auto loan contracts are necessarily identical.

287. *See supra* note 84.

V. FORCING COMPETITION IN AUTO LENDING FOR CONSUMER PROTECTION

A. DE-LINKING VEHICLE PURCHASES AND FINANCING

To recap, this Article has argued that the four frequent auto lending abuses it identifies all share a common structural origin—the effective tying of financing to the vehicle purchase. The linked nature of the financing transaction means that it is not subject to normal competitive pressures. Instead of lenders competing for the *consumer*'s business, they are competing for the *dealer*'s business. This structure results in inflated loan pricing, the opportunity for discriminatory markups, the ability to deceive consumers into purchasing add-ons, and the ability to yo-yo consumers with contingent financing. Accordingly, a solution to the problems in the auto lending market lies in de-linking the purchase and financing transactions so there is more robust competition for consumers' financing business. Extending Professor Jackson's typological catalogue, what is needed is less a transaction-structure response than a market-structure response.

The next section presents a pair of policy proposals that would de-link auto sales and financing. First, it proposes a penalty default rule of a mandatory vehicle-delivery waiting period absent a documented, bona fide third-party financing offer. This is the main policy proposal of the Article. Second, as an adjunct proposal, it proposes a penalty-free prepayment right that would be required to be prominently disclosed to alert consumers to the possibility of refinancing. These proposals are followed by sections that address implementation issues, including the politics of reform, and the need for better public data collection on the auto finance market for optimal regulation. In particular, this Part concludes with a call for expanding Home Mortgage Disclosure Act-type data collection to the auto lending market as a tool to combat discriminatory lending.

B. SPOT DELIVERY RESTRICTIONS AS A PENALTY DEFAULT RULE TO INCENTIVIZE CONSUMERS TO SHOP FOR FINANCING IN ADVANCE

1. Mandatory Vehicle-Delivery Waiting Period Absent a Documented Third-Party Financing Offer

This Article's proposal to address the structural problem in auto lending is a penalty default rule that incentivizes consumers to shop for financing *before* shopping for a vehicle.[288] Specifically, this Article proposes requiring a waiting period for delivery of any financed vehicle unless the borrower can document a bona fide financing offer from a third party that is unaffiliated with the dealer, that is, a direct loan offer.[289] In keeping with current law on assignee liability under the FTC's Holder Rule, [290] both the dealer and an indirect lender that lends without adequate measures to ensure compliance with the waiting period would

288. *See* Ayres & Gertner, *supra* note 36, at 91 (explaining the concept of penalty default rules).

289. The dealer would also be required to take the third-party financing absent a good-faith basis for believing it to be fraudulent.

290. 16 C.F.R. § 433.2 (2019). The ECOA also provides for liability for indirect lenders that are involved in the decision to extend credit. 15 U.S.C. § 1691a(e) (2012).

incur liability if delivery of an indirectly financed vehicle were made without the waiting period or a bona fide direct financing offer.[291]

Implementation of such a penalty default rule could be done legislatively by Congress (or by state legislatures if on a state-by-state basis). It could also, in theory, be implemented without legislation through regulation by either the FTC (under its power to prohibit unfair or deceptive acts and practices in interstate commerce) or the CFPB (under its power to prohibit unfair, deceptive, or abusive acts in consumer finance), although there are potential issues with the scope of these agencies' regulatory authority.[292] Although such a penalty default rule would be resolutely opposed by dealers and indirect lenders, it would likely have off-setting political support from various direct lenders that would see it as a way to increase their market share.

A mandatory waiting period for delivery—perhaps three business days—would address all four leading consumer protection problems identified by this Article. It would not address all possible consumer protection problems in auto lending, but it would be a major advance.

First, a mandatory waiting period would encourage competition for financing terms. Buyers want their cars and they want them now. Consumer impatience would be channeled into forced loan shopping—a consumer who wants immediate delivery would have to shop for financing before getting the car. As a result, a

291. The precise measure of liability is beyond the scope of this Article's consideration, but one possibility would be standard Truth-in-Lending Act damages. *See* 15 U.S.C. § 1640. Such a measure would treat the difference between the best obtainable direct financing offer rate and the indirect lender's rate as damages.

292. The FTC has rulemaking and enforcement jurisdiction over most new car dealers, 12 U.S.C. § 5519(c), but not over indirect lenders that are insured depository institutions (banks and credit unions), 15 U.S.C. § 45(a)(2). The FTC is also authorized to undertake UDAP rulemakings regarding auto dealers through the Administrative Procedures Act notice-and-comment process, 12 U.S.C. § 5519(d) (2012), rather than under the substantially more burdensome Magnusson–Moss adversarial procedure usually required of the FTC. *See* Jeffrey S. Lubbers, *It's Time to Remove the "Mossified" Procedures for FTC Rulemaking*, 83 GEO. WASH. L. REV. 1979, 1982–85 (2015) (discussing the difficulties with Magnusson–Moss rulemaking).

The CFPB, in contrast, generally lacks authority over new car dealers that regularly assign their retail installment contracts to unaffiliated third parties, 12 U.S.C. § 5519, but has regular Administrative Procedures Act rulemaking and enforcement authority over indirect auto lenders as well as supervisory authority over those that fall under its "larger participant" rulemaking, 12 U.S.C. § 5514(a)(1)(B)–(C) (authorizing designation of entities for CFPB supervision through "larger participant" rulemakings); 12 C.F.R. § 1090.108 (2019) (defining larger participants in the automobile finance market). In other words, CFPB jurisdiction over dealers is generally limited to BHPH dealers, although it is unclear whether an assignment to an indirect lender counts as an assignment for purposes of the statute if the assignment is made with recourse. In such a situation, the dealer still bears the credit risk on the loan, such that it would not be meaningfully economically distinguishable from the dealer simply obtaining financing secured by the loan.

Thus, the FTC could implement a delayed delivery rule through its authority over dealers, whereas the CFPB could do so through its authority over indirect lenders. Although either the FTC or CFPB could proceed alone, joint FTC-CFPB rulemaking would be necessary for maximum effect. Whether a penalty default rule as proposed by this Article could be supported under the FTC's power to prohibit unfair or deceptive acts and practices or the CFPB's power to prohibit unfair, deceptive, or abusive acts and practices is beyond the scope of this Article.

consumer who comes into the F&I office would have an alternative offer to the dealer's proposal, putting considerable downward pressure on dealer markups.

Second, this same mechanism would reduce opportunities for discriminatory markups by dealers. As noted above, discrimination in auto lending appears to occur on the dealer markup—not on the buy rate—because only the dealer can directly observe the physical characteristics of the borrower (race and gender, for example), and because the dealer has more incentive to discriminate than indirect lenders do.[293] In contrast, direct lenders cannot physically observe the borrower and lack dealers' motivations for discrimination, although it is possible that direct lenders could discriminate through use of proxy variables, such as ZIP Code or name. If direct lending is less likely to result in discriminatory rates—and there is reason to think that would be the case—it will impose competitive pressure against discriminatory markups by dealers.

Third, by encouraging consumers to come to dealers armed with third-party financing offers, a mandatory waiting period eliminates dealers' ability to engage in loan packing by claiming that add-ons are tied to loan terms. The consumer can decline the add-ons and would still have financing from a third party. Again, competitive pressure would protect consumers from an abusive practice.

Finally, a mandatory pre-transaction waiting period would eliminate spot delivery prior to financing and therefore help eliminate yo-yo scams. Yo-yo scams depend on spot delivery prior to financing. If a consumer took the dealer's financing, the consumer could still be yo-yo'd, but the consumer would also know that she could go to a third-party company to get financing, even if the dealer claimed that the dealer-loan was not ultimately approved.

The idea of a mandatory waiting period is not particularly radical. Mandatory pre-transaction waiting periods ("cooling-off periods") are a common regulatory device to allow parties time to consider their actions before committing to them irrevocably.[294] Mortgage loans have a built-in seven-day mandatory cooling-off period between the disclosure of loan terms and the closing of the loan.[295] Federal law requires a mandatory delay between issuance of a registration statement and sale of certain securities.[296] Some states

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293. *See supra* note 176 and accompanying text.

294. Waiting periods are also mandated by law for other purposes. For example, federal law mandates waiting periods for certain corporate mergers to allow sufficient time for regulatory review. 15 U.S.C. § 16(b) (sixty-day period for public comment regarding consent judgments under the antitrust laws, which includes divestiture agreements as part of mergers); 15 U.S.C. § 18a(b)(1) (merger review period of thirty days generally and fifteen days for cash tender offers). Likewise, medical and dental insurance contracts frequently have mandatory waiting periods before coverage becomes effective to prevent consumers from purchasing insurance just before undergoing a medical procedure. *See, e.g.*, Mila Araujo, *Dental Insurance Waiting Period*, BALANCE (Oct. 31, 2019), https://www.thebalance.com/dental-insurance-waiting-period-2645722 [https://perma.cc/RL75-NWZD]. Federal law limits these waiting periods in group health-insurance plans to no more than ninety days. 42 U.S.C. § 300gg-7 (2012).

295. 12 C.F.R. § 1026.19(e)(1)(iii). This is distinct from the right to rescind certain mortgage transactions post-closing. *See* 15 U.S.C. § 1635.

296. 17 C.F.R. § 230.424(h)(1) (2019).

require delayed delivery for firearms.[297] Some states have mandatory waiting periods before they will grant a marriage license[298] or for the wedding after a license has been granted,[299] and most states require a mandatory waiting period prior to granting a divorce.[300] Likewise, many states have some form of mandatory waiting periods prior to getting an abortion.[301]

The motivations for these statutory cooling-off periods vary, but they are designed to let the consumer think about the consequences of a potentially impactful decision: a large financial transaction, a major life choice about marriage or children, obtaining weapons that could be used in a fit of rage. In the age of Amazon Prime's same-day delivery and streaming video, the idea of delayed gratification for anything might seem anathema. That is precisely the point. If consumers want their cars and want them now, they will be incentivized to line up financing in advance.

Indeed, anecdotally, spot delivery appears to be important to at least a subset of consumers. For example, one industry participant explains, a dealer might tell

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297. From 1994 to 1998, there was a five-day waiting period for handgun sales under the Brady Handgun Violence Prevention Act, Pub. L. No. 103-159, § 102(a)(2), 107 Stat. 1536, 1537–38 (1993). The law provided, however, that beginning in 1998, the waiting period would be replaced with a computerized background check. *Id.* § 103(b). Under current federal law, a dealer may transfer a firearm to a purchaser as soon as the purchaser passes a background check, and if the check is not completed within three business days, the transaction may nonetheless proceed. 18 U.S.C. § 922(t)(1) (2012). Currently nine states and the District of Columbia have firearms-purchase waiting periods, which range from seventy-two hours to fourteen days. CAL. PENAL CODE §§ 27600, 27540(a), 26815(a) (West 2019) (ten-day waiting period); D.C. CODE ANN. § 22-4508 (West 2019) (ten-day waiting period); FLA. STAT. ANN. § 790.0655(1)(a) (West 2019) (waiting period of the longer of three days or the time required to complete a background check); HAW. REV. STAT. ANN. § 134-2(e) (West 2019) (fourteen-day waiting period); 720 ILL. COMP. STAT. ANN. 5/24-3(A)(g) (West 2019) (seventy-two-hour waiting period); R.I. GEN. LAWS ANN. §§ 11-47-35(a)(1), 11-47-35.2 (West 2019) (seven-day waiting period).

298. Waiting periods can be between application and receipt of marriage licenses or between receipt of a license and the marriage itself. No state has both, and the total waiting period is never more than five days. *See, e.g.*, WIS. STAT. ANN. § 765.08(1) (West 2019) (five-day waiting period for marriage license after application).

299. *See, e.g.*, 13 DEL. CODE ANN. tit. 13, § 107 (West 2019) (license must be issued at least twenty-four hours before ceremony); 750 ILL. COMP. STAT. ANN. § 5/207 (West 2019) (one-day waiting period after license is issued); IOWA CODE ANN. § 595.4 (West 2019) (three-day waiting period after license is issued).

300. Some states require a couple to live separately without sexual relations for a period of time before they are eligible for at least certain types of divorce. *See, e.g.*, ARK. CODE ANN. § 9-12-301(b)(5) (West 2019) (requiring eighteen months of continuous separation without cohabitation for no-fault divorce). Additionally, some states impose a waiting period between a divorce filing and the finalization of the dissolution of the marriage. *See, e.g.*, CAL. FAM. CODE § 2339(a) (West 2019) (requiring six-month waiting period before finalization of a divorce after the earlier of service or appearance of the respondent).

301. Thirty-four states require pre-abortion counseling. *Counseling and Waiting Periods for Abortion,* GUTTMACHER INST., https://www.guttmacher.org/state-policy/explore/counseling-and-waiting-periods-abortion [https://perma.cc/2FQN-LNLZ] (last updated Mar. 1, 2020). Fourteen of those states require the counseling to be in-person, which imposes an unspecified delay based on scheduling availability for counseling. *Id.* Additionally, twenty-seven of the states requiring counseling also require a waiting period between the counseling and the abortion procedure. *Id.* The waiting periods range from eighteen to seventy-two hours, but with weekends and state holidays excluded from the waiting period in one of the seventy-two-hour waiting period states). *Id.*

a consumer, "If you go with the financing from your credit union, we will have to wait for the check to clear before we can give you the vehicle. That might be as long as a week. You can drive away with the car today if you take our financing offer."[302] This suggests that a penalty default rule proposed by this Article would be effective at shaping consumer behavior.

Vehicle sales are often for more than half of median annual household income, and vehicles are a long-term purchase, so the consumer welfare implications are strong enough to merit an intervention such as this Article proposes. Although the penalty default rule proposed could impose a delay in vehicle delivery to consumers who do not want to shop for financing, it is also quite easy for consumers to avoid the penalty default position. All a consumer need do is apply and be approved for a financing offer from a direct lender.

Many consumer lending products are based on automated underwriting which allows for near real time decision-making after the consumer has submitted all loan application data. For example, Quicken Loan's Rocket Mortgage enables consumers to apply and be pre-qualified for a home mortgage loan in around eight minutes.[303] Likewise, LightStream by SunTrust Bank promises same day funding for auto loans.[304] Presumably, other direct auto lenders will develop similar, if not faster products, such that a consumer who wants to drive off the dealership lot with their new car on the same day would still be able to do so simply by obtaining financing in advance. Given the approval speed of many contemporary consumer loan products with automated underwriting, this is not a substantial imposition.

One existing complication is that the terms of an indirect lender's financing offer will depend on the vehicle used as collateral.[305] In particular, indirect lenders have LTV and loan-amount caps that will vary with collateral.[306] This means that the precise amount a lender will lend and on what terms cannot be guaranteed before a vehicle is identified in the contract by vehicle identification number (VIN). A mere category of vehicle—such as a "2020 model Ford F-150"—will not suffice, because the value of a 2020 model Ford F-150 can vary significantly depending on trim and features. Indeed, a problem lenders face is dealers that "power book" sales—that is fraudulently represent the presence of features on

302. *See* Interview with Sonia Steinway, *supra* note 282.

303. Alexandra Mondalek, *You Can Now Be Approved for a Mortgage in 8 Minutes*, MONEY (Dec. 1, 2015), http://money.com/money/4129146/quicken-loans-8-minute-mortgage/ [https://perma.cc/V5KK-9TS8].

304. *See Drive the Car You Want*, LIGHTSTREAM, https://www.lightstream.com/auto-loans [https://perma.cc/5ESA-VPTA] (last visited Mar. 5, 2020).

305. Direct lending does not appear to rely on information about the vehicle make and model for underwriting. Instead, underwriting is based on the borrower's credit score and down payment. SUMIT AGARWAL ET AL., FED. RESERVE BANK OF CHI., DETERMINANTS OF AUTOMOBILE LOAN DEFAULT AND PREPAYMENT 17 (2008).

306. *See* VAN ALST ET AL., AUTO ADD-ONS ADD UP, *supra* note 34, at 37; Tom Herald, *The Three "C's" of Finance*, AUTO DEALER TODAY MAG. (July 1, 2007), https://www.autodealertodaymagazine.com/308579/the-three-cs-of-finance [https://perma.cc/2N3Z-UFRT].

vehicles that do not exist in order to facilitate greater financing for consumers and thus higher sale prices and dealer participation.[307]

This problem can be addressed through technology: lenders could preapprove a borrower for a loan up to a particular dollar amount, use an online platform to identify the particular vehicle used as collateral, and then direct deposit the money into the dealer's account, enabling faster clearing than a check payment. Thus, avoiding the penalty default will be a minor inconvenience for most consumers, and even for those who fail to obtain third-party financing offers, delayed delivery should be only a minor inconvenience because consumers in urgent need of transportation have a range of other options than a vehicle purchase—public transit, rental, taxis, and ride-sharing. The cost of utilizing any of those modes of transportation for three business days is likely to be substantially outweighed by the savings on the financing.[308]

Indeed, it is important to recognize the extremely targeted nature of the intervention proposed by this Article. This proposal would not require a consumer to finance a vehicle purchase. Nor would it require the consumer to either seek or take a third-party financing offer. Instead, it merely delays delivery of the vehicle to consumers who have not sought and successfully obtained third-party financing. Thus, if a consumer cannot obtain third-party financing or does not want to bother with doing so, the consumer can still buy a car with dealer financing, only the vehicle delivery will be delayed.

Likewise, this Article's proposal does not prevent dealers from offering to arrange financing or from being compensated for their services. Instead, it subjects dealer financing offers to greater competition from direct lending offers. Thus, although some commentators have proposed restricting dealer compensation to a flat fee,[309] this Article suggests another approach that gives more leeway to market rates: allowing dealers to price in market implications while simultaneously exposing the dealers to increased competition in auto financing as a check on dealer compensation.

2. Prominently Disclosed Penalty-Free Prepayment Right

Of course, not all consumers can be expected to obtain bona fide third-party financing offers in advance. Therefore, the benefits of a limitation on spot delivery could be extended by also having a penalty-free prepayment right for the period between transaction closing and vehicle delivery, and by requiring that dealers

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307. Thomas B. Hudson, *The Coming Crackdown on Dealer Fraud*, HUDSON COOK (June 1, 2017), https://www.hudsoncook.com/article/the-coming-crackdown-on-dealer-fraud/ [https://perma.cc/RR9N-CPJH]. In contrast, mortgage lenders will not disburse funds until after a property has been identified and appraised because it is not possible to take a security interest in after acquired realty. *See* BAINES & COURCHANE, *supra* note 70, at 33 (noting that spot delivery does not exist in the mortgage market).

308. For example, Ally Financial claims that its online refinancing platform helps consumers save on average $112 per month. *See* Press Release, Ally Financial, Inc., *supra* note 15. *See also* Anthony Giorgianni, *Should You Refinance Your Car Loan?*, CONSUMER REPS. (Aug. 31, 2017), https://www.consumerreports.org/car-financing/should-you-refinance-your-car-loan/ [https://perma.cc/N3JW-TYRV] (giving scenarios with monthly savings of $10 and $56).

309. DAVIS & FRANK, *supra* note 49, at 17–18.

provide consumers with prominent notice of such a right and explain the right to prepay through refinancing from third-party lenders. Auto loans are often freely prepayable,[310] but there is no general right to prepay without penalty; it is a matter of contract, such that market practices could easily change. A mandatory, penalty-free prepayment period would give a consumer a chance to shop around for better financing offers outside of the high-pressure sales environment of the dealership. If the consumer found a better rate, the consumer could refinance with the new lender without having to return the vehicle.

This proposal contrasts with the right of rescission proposed by some consumer groups.[311] In the case of an RIC, a right of rescission would mean having to rescind the entire RIC—the vehicle sale and the financing—which would necessitate the return of the vehicle. A penalty-free prepayment right would protect those consumers who, for whatever reason, fail to obtain a third-party financing offer in advance. Requiring prominent notice of the right to prepay, including through refinancing, would also help overcome one obstacle to refinancing—lack of consumer awareness that it is even an option.[312]

A mandatory waiting period for consumers without bona fide third-party financing offers, combined with a penalty-free prepayment period, would make auto lending more like mortgage lending. A consumer cannot purchase a home and apply and close on the financing on a mortgage loan on the same day; federal regulations require that the lender give the consumer certain disclosures a number of days prior to loan closing.[313] These disclosures must indicate both loan terms and closing costs, including which closing costs are mandatory, which are optional, which can be obtained from third parties, and which must be obtained from the lender.[314] This enables consumers to shop around to avoid marked-up prices. Likewise, there is an absolute right to rescind certain mortgage loans for three business days,[315] and prepayment penalties are restricted on mortgages.[316] Given that a car purchase is often the next largest consumer transaction after a home purchase, it is reasonable to adapt the protections that exist in the mortgage market to the auto finance market.

It is important to note, however, that a penalty-free prepayment right will be substantially less effective at protecting consumers than a penalty default rule limiting spot delivery because it does not put competitive pressure on the financing offer at the time it is made. To the extent that a prepayment right puts pressure on the terms offered by a dealer, it is only based on the dealer's fear of a consumer refinancing with a third party, but dealers know based on current practice that such refinancing is unlikely.

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310. *See supra* note 82 and accompanying text.

311. *See supra* note 265 and accompanying text.

312. *See supra* notes 276–77 and accompanying text.

313. 12 C.F.R. § 1026.19(e)(1)(iii) (2019).

314. *Id.* § 1026.19(a)–(b).

315. 15 U.S.C. § 1635 (2012). Because the mortgage loan is not typically from the seller, the mortgage loan can be rescinded separately from the sale of the home.

316. 12 C.F.R. § 1026.43(g).

A penalty-free prepayment right is hardly a substitute for a structural reform like a penalty default rule limiting spot delivery when the borrower does not have an alternative bona fide third-party financing offer. Those consumers who are concerned about financing costs are more likely to shop for financing in advance and therefore have less reason to refinance; those consumers who most need to refinance are precisely the ones least likely to do so. Nonetheless, creating such a right and coupling it with a disclosure requirement might encourage more consumers to take advantage of refinancing.

C. POLITICS, IMPLEMENTATION CHALLENGES, AND MARKET ADAPTATIONS

This Article does not address the politics of implementing a spot delivery restriction or the challenges in implementing such a restriction. These issues are beyond the scope of this Article, but it is important nevertheless to acknowledge them. Dealers and indirect lenders represent obvious and potent sources of political opposition. Moreover, incentives for dealers to game the system and the market's ability to adapt to regulation present inevitable implementation challenges to spot delivery restrictions.

At the same time, however, it is important to note that there are also constituencies that might favor a spot delivery restriction, helping facilitate compliance. A spot delivery restriction would open up auto lending markets to greater competition from direct lenders, particularly "fintechs"—nonbank financial services companies that operate primarily through online interactions with consumers. These direct lenders could offset the opposition of dealers and indirect lenders. Indeed, some indirect lenders (banks and credit unions) also engage in direct lending. To the extent that this Article's proposal shifts business from their indirect to direct lending operations, they might welcome it or be neutral.

Similarly, regulation may incentivize parties such as indirect lenders, insurers, and floor plan lenders to ensure dealer compliance. For example, if indirect lenders were liable for loans made in violation of a spot delivery delay, they would be incentivized to ensure dealer compliance.[317] Likewise, both consumers' insurers and dealers' insurers would be incentivized to prevent illegal spot deliveries. It would, however, be difficult for a regulator to tell if a dealer made a spot delivery without a bona fide third-party loan offer if the dealer claimed that there was delayed delivery, particularly if the dealer were to delay paperwork filings relating to title transfer by a few days. But if there was an auto accident during the gap period when possession and title did not match, the *consumer*'s auto insurer might pounce on this as a means of denying claims or of bringing claims for contribution.

317. *See* Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. REG. 143, 194–96 (2009) (explaining the "hydraulic regulation" strategy of regulating consumer markets through placement of liability "upstream" on the ultimate funders). In this manner, the CFPB could effectively implement a delayed-delivery rule through its power to regulate indirect lenders.

Moreover, *dealers*' insurers are likely to be concerned about the possibility of consumers driving around cars for which the dealer has liability.[318] Dealers' insurers might respond with their own programs to ensure dealer compliance or with policy exclusions such that the dealer would have to self-insure for the gap period. Whether a dealer would find it worthwhile to self-insure for the gap period in order to make spot delivery is unclear, but at the very least it would make illegal spot delivery less attractive economically.

The same is true for dealers' floor plan lenders. Floor plan lenders finance the dealers' purchase of inventory from the original equipment manufacturers. The dealer's inventory secures the floor plan loans. The last thing a floor plan lender wants is for its collateral to be outside the dealer's control because, if the dealer were to default, it would be much more difficult to repossess vehicles (still owned by the dealer) that have been illegally spot delivered to consumers. Already, a vehicle sold with spot delivery may be "out of trust," for a floor plan lender.[319] Thus, floor plan lenders' existing compliance programs might be leveraged to prevent illegal spot delivery.

Because of the existence of constituencies naturally inclined to favor spot delivery restrictions, and the secondary parties who have incentives to ensure dealer compliance, political and implementation challenges for a spot delivery restriction are real but hardly insurmountable.

D. THE NEED FOR DATA ON AUTO LENDING

This Article has identified four distinct abuses in the auto lending market, associated them with particular unique features of the auto lending transaction and market structure, and proposed a regulatory response that addresses all four problems simultaneously. Critics might question whether the primary response—a penalty default rule of a three-business-day delay on auto delivery for financed vehicles if the borrower has not obtained a bona fide third-party financing offer—is overkill, particularly if the abuses are infrequent. After all, spot delivery is a common feature in the U.S. auto market and something consumers appear to like.[320]

This criticism points to an empirical problem: there is scant reliable public data on the auto lending market, including on all four problems raised by this Article. For example, there is little data on the extent of dealer markups. And the only existing data has been heavily criticized by the NADA, which has notably failed

318. *See* HUDSON, *supra* note 190, at 403 (finding dealer's insurer liable for uninsured driver's accident where state law required dealer to insure the vehicle until financing approved).

319. April Wortham, *Spot Deliveries: Slippery Slope for Dealers*, AUTOMOTIVE NEWS, (Dec. 29, 2008, 12:00 AM), https://www.autonews.com/article/20081229/RETAIL07/312299896/spot-deliveries-slippery-slope-for-dealers.

320. *See* Stergiopoulos v. First Midwest Bancorp, 427 F.3d 1043, 1044 (7th Cir. 2005) (noting the "common scenario" and "routine nature" of spot delivery). One reason that spot delivery is common is that dealers do a substantial share of business on weekends when consumers have the time to do car shopping, but indirect lenders are often closed or thinly staffed on weekends, complicating loan approvals.

to produce its own data.[321] Likewise, indirect lenders have vigorously contested allegations of discriminatory lending, taking particular issue with the statistical methods for racial identification of borrowers.[322] Although loan packing and yo-yos are known to be problems, there is no empirical evidence of the scope of these abuses. Complaints to regulators provide some measure,[323] and indicate that these are not isolated problems, but it is likely that many defrauded consumers fail to complain (and may not even know of the problem in the case of loan packing), so that the problem is underreported.

Not only is there no reliable data source on these issues, but there also is little in the way of reliable, public data even on the auto sales and lending markets generally. The federal government collects almost no data on auto sales or loans. The Federal Reserve Board collects data on commercial bank interest rates on forty-eight-and sixty-month new car loans, but commercial banks are limited players in the market, so the data collected is narrow. For example, it does not reflect the trend of increasingly long terms on auto loans.[324] Likewise, the Federal Reserve Bank of New York collects aggregate data from a consumer credit reporting bureau, but it tells little beyond the total amount of auto loans outstanding and delinquency rates.[325] The publicly available data is not sufficiently granular to allow more detailed investigation. Notably, this is just credit data. There is no central source that connects auto sales, add-on data, and auto lending data, much less on a comprehensive national basis.

Absent data, it is near impossible to evaluate the scope of possible problems in the auto lending market and that complicates evaluation of policy responses. Given that there is prima facie evidence of a range of non-isolated problems throughout the auto lending market, more comprehensive data would be a first step to determining the scope of the problems. There are some costs to data collection, but they are quite discrete because dealers are already generating almost all the data that is likely to be collected, so its collection could be readily automated as an adjunct to the lending process.

In particular, data collection is important for addressing discriminatory lending. The Home Mortgage Disclosure Act of 1975 (HMDA) has long required mortgage lenders to collect data on borrower characteristics, including race and

321. *See* Letter from Mike Calhoun to Peter Welch, *supra* note 139.

322. REPUBLICAN STAFF OF H. COMM. ON FIN. SERVS., 114ST CONG., UNSAFE AT ANY BUREAUCRACY: CFPB JUNK SCIENCE AND INDIRECT AUTO LENDING 28 (2015), https://financialservices.house.gov/uploadedfiles/11-24-15_cfpb_indirect_auto_staff_report.pdf [https://perma.cc/T749-39V3]; James Rufus Koren, *Feds Use a Rand Formula to Spot Discrimination. The GOP Calls It Junk Science*, L.A. TIMES (Aug. 28, 2016 3:00 AM), https://www.latimes.com/business/la-fi-rand-elliott-20160824-snap-story.html; Press Release, American Financial Services Association, AFSA Study Finds Significant Bias and High Error Rates in CFPB Proxy Methodology (Dec. 8, 2015), https://perma.cc/6353-3HH4.

323. *See* WHITE, *supra* note 218.

324. Eisen & Roberts, *supra* note 79.

325. *See, e.g.*, *Quarterly Report on Household Debt and Credit 2019: Q4 Underlying Data*, *supra* note 10.

gender.[326] The purpose of this data collection is to enable policing of racial discrimination in the home mortgage market. Thus, HMDA data is made publicly available and is also scrutinized by federal regulators searching for patterns of disparate impact in mortgage lending. The Dodd–Frank Wall Street Reform and Consumer Protection Act created a similar data collection requirement for small business loans,[327] although even a decade later, no regulatory implementation has yet occurred.

It is time to extend the HMDA data collection system to auto loans. Like mortgage lending, there are sufficient indicia of discriminatory lending in the auto loan market to call for proactive policing. The particular data that needs to be collected for auto loans is, of course, different than for mortgages, but making data publicly available would enable better enforcement of the ECOA in auto lending by leveraging private researchers' capabilities as well as providing data for federal agencies to evaluate. In particular, a HMDA-type data collection system for auto loans could include borrower racial self-identification, which would eliminate concerns about borrower racial identification methodology that dealers and indirect lenders have raised[328] in response to the CFPB's reliance on Bayesian Surname Improved Geocoding, which attempts to use borrowers' surnames and addresses as a statistical proxy for race.[329]

Currently Regulation B under ECOA actually prohibits the collection of information on race, color, religion, national origin, or sex, except in narrow circumstances.[330] But merely changing the regulation would likely be insufficient because it would not create a mandate for data collection. It is questionable whether ECOA itself creates sufficient authority to mandate data collection, particularly in light of the Paperwork Reduction Act's limitation on agencies demanding data from more than nine persons.[331] It is likely necessary to proceed through legislation to mandate collection of demographic data in auto financing transactions.

This Article's proposal for demographic data collection on auto lending is not new—the National Consumer Law Center has made such a proposal previously,[332] and a resolution was put forward to the American Bar Association House of Delegates calling for the ABA to urge such a policy.[333] But the data that should be collected goes beyond demographic data and encompasses the terms of

326. *See* 12 U.S.C. § 2803 (2012).

327. *See* 15 U.S.C. § 1691(b) (2012).

328. *See supra* note 322 and accompanying text.

329. *See generally* CFPB, USING PUBLICLY AVAILABLE INFORMATION TO PROXY FOR UNIDENTIFIED RACE AND ETHNICITY: A METHODOLOGY AND ASSESSMENT (2014).

330. 12 C.F.R. § 1002.5(b) (2019).

331. 44 U.S.C. § 3502(3)(A)(i) (2012).

332. VAN ALST ET AL., AUTO ADD-ONS ADD UP, *supra* note 34, at 43.

333. *See* AM. BAR ASS'N., REPORT TO THE HOUSE OF DELEGATES, RESOLUTION 115G (2019), https://www.americanbar.org/content/dam/aba/images/news/2019/08/am-hod-resolutions/115g.pdf [https://perma.cc/95PN-SS4W] (proposing that the ABA urge Congress to amend ECOA to require collection of data on auto loan race, gender, and national origin). The resolution was ultimately withdrawn.

the loans themselves because such data are useful for regulatory policy beyond policing discrimination. Data is a precondition to designing optimal regulation and data helps pave the way politically for implementing regulation. Implementation of any regulatory reforms in the auto lending market will face challenges. Indeed, even something as seemingly anodyne as data collection will likely face vigorous opposition from both dealers and the auto lending industry precisely because of the political power of data.

CONCLUSION

Purchasing and financing a car is one of the most complicated transactions consumers will undertake. These types of transactions are also rife with opportunities for various forms of abuse and fraud, including supracompetitive pricing, discriminatory lending, sharp sales practices, and even outright fraud and scams. Consumers' vulnerability to such misbehavior regarding the auto purchase and finance transaction is, in substantial part, due to few consumers having financing alternatives to the indirect lending offers they receive through the dealer. The combination of the auto financing transaction with the auto purchase transaction is, in part, to blame for the lack of financing alternatives. The consumer thinks of the transaction as buying a car and may do substantial research on different cars while ignoring the financing side of the transaction, only to be caught in an effective dealer monopoly on financing.

Structural reform is the best approach to this problem. This Article has proposed a targeted regulatory intervention to de-link auto purchase and auto financing transactions through a penalty default rule that would restrict spot delivery of financed vehicles to consumers who have bona fide third-party financing offers in hand. Such a penalty default rule would not bind consumers to accepting a third-party financing offer but would instead incentivize them to shop for financing in advance of the vehicle purchase. Equipping consumers with these financing offers *before* negotiating with the dealer will create competition in auto lending for the consumer's business rather than the current competition among indirect lenders for the dealer's business. Greater competition for the consumer's business would help drive down auto loan pricing, prevent discriminatory loan rates, reduce deceptive upselling, and thwart yo-yo scams. For this reason, de-linking auto financing from auto purchases through a penalty default rule is essential to ending auto financing abuses and making it a fairer and more efficient market.