>> Jim Chen: Good morning, everyone. This is day 2 of the FTC's auto roundtable. And today we're starting with panel 8, which is "Fair Lending -- Interest Rates, Markups, and Payments." We have a very distinguished panel here today, I'm happy to say. And I'm just gonna give a brief introduction, just further details in the bio packet. To my right is Chris Choate, who is the Executive Vice President and CFO of General Motors Financial. Next to him is Delvin Davis from Center for Responsible Lending. Next to him is Dr. Tom Durkin, who before retirement was a senior economist with the Federal Reserve. Then we have Andy Koblenz, who's Vice President and General Counsel of the National Automobile Dealers Association. And finally Chris Kukla, also with Center for Responsible Lending. So, to get it started, I think to understand -- And, you know, some people use the term "markup." Some people use the term "dealer participation." My understanding is that those two are synonymous, so I'll use those interchangeably, unless someone tells me they're not the same. Okay? Great. To understand dealer participation, I think we first need to understand the concept of a buy rate. And since we have a representative from a finance source here today, Chris C. -- Chris, if you could tell us what is a buy rate, and how is it calculated?

>> Chris Choate: Sure, Jim. A buy rate is a wholesale rate that is offered by the financing source to a dealer. It's really comprised of several different components. And I'll walk through those just very briefly. First and foremost is what is the cost of funds for the financing source. The financing source, one way or the other has to go get that money in order to provide it to the dealer. They may obtain those funds through deposits that they raise if they're a bank. In our case and a lot of cases, they have to go to the capital markets and issue securitization bonds in order to raise the funds. So there can be varying costs of capital or funding for the funding source. That is a piece of, you know, kind of how you build up to the buy rate. A second and very critical part are the losses that are expected. How much do I expect to lose on either that loan, if you want to look on a one-on-one basis, or on a pool of loans. What are my range of expected losses? And obviously, the lower the credit tier, the higher the losses. The higher the credit tier, the lower the losses. So there's certainly some science and art in determining what are the expected losses. That goes into a calculation also of what the buy rate is. As the financing source, I'm gonna have to service that contract. I'm gonna have collectors, and, you know, ultimately some repossession expenses. I'm going to have overhead. I do have costs to underwrite the loans and fund the loans and FedEx titles

around and do all the things that it takes to service that. That is not an insubstantial part. Again, depends on the credit tier. Deeper, subprime credit is going to have a significantly higher cost of servicing than prime credit, for example, and so that component can actually be quite a significant part of overall what the buy rate is. Finally, if you're successful, you have to pay some taxes to Uncle Sam, and then there is a return objective. So, you know, financing sources don't work for free, be it a bank or a stand-alone finance company. So we expect to have a return on the money that we lend out. You kind of add all of those components together in assessing the credit risk on a deal-by-deal basis of any given consumer, and you come up with a buy rate or a wholesale rate that is quoted to the dealer.

>> Jim Chen: And my first couple questions are on the buy rate. Chris might be in the best position to answer, but if anyone wants to try, I mean, of course, please, just raise your cards. So, how is the buy-rate offer to dealers established? And what I mean is, is it purely based on credit scores, or are there other factors?

>> Chris Choate: The buy rate, at least in the case of GM Financial, is certainly largely driven by the credit profile of any given consumer, but it's also based on what is the loan structure, how much risk is reflected, not only in the credit bureau characteristics of a given consumer, but based on the financing terms being requested, be it less or more down payment, new or used vehicles. Term can certainly affect the risk exposure to the financing source. There are things of that nature that will also -- Certainly, the buy rate that a financing source offers is not unfettered by competition. So a competitive marketplace, which certainly exists now and has typically existed over the last 10 to 20 years, determines how much -- how competitive a financing source has to be. It would be nice for a financing source to just be able to toss out any buy rate, if but if they actually want to originate deals and add to their asset base, they have to have rates that are competitive in the market that will allow them to originate paper. So there are factors well beyond the credit score in and of itself.

>> Jim Chen: Andy.

>> Andrew D. Koblenz: Yeah, just one thing. In answering that way, Chris was answering how a single financial company's buy rate is established, but, of course, all of those variables that he just

described will vary from finance company to finance company.  So finance company "A" might have a cost of funds of "X."  Finance company "B" might have cost funds of "X" minus 2.  And so as you go, between different institutions, there will be variations, even on some of the things that are fixed and what Chris just said.

>> Jim Chen: Now, when you said it sounds like that, of course, I want to ask a little bit about the influence that dealers have over the buy rate now.  One of the things you said was, okay, the dealer and the consumer, of course, you know, the life of the term of the contract.  Are there other factors that the dealer has influence over that can change what the buy rate is?  Anyone wants...

>> Chris Choate: Well, again, the dealer and the consumer are sitting across from each other.  The consumer is you know, indicating a preference for a certain term, a certain payment.  They may be indicating a preference for certain additional products, such as a warranty to protect the vehicle in the event it has mechanical issues.  You know, they -- In a number of cases, consumers, come armed with, frankly, more or less information relative to what's available in the market from a bank or credit union.  So there are a number of factors and a number of discussions that are going on between the dealer and the consumer relative to what the ultimate rate will be.  You know, in the subprime space, one other thing I should add, you know, there are -- Again, there's an enormous amount of competition, and funding sources all have caps on what can be added to the buy rate, but the market really drives and there are usury limits in other states as well.  But the market really, you know, contributes a great deal to what that buy rate can be.  How many competitors, whether it's GM Financial or Santander or Cap One or others that are playing in that space, are going to have a huge determinant on what buy rates are available to the dealer.

>> Jim Chen: Chris K.

>> Chris Kukla: [ Chuckles ] We were laughing about how it could've felt like 5th grade.  If we knock each other's placards off, we couldn't speak.  Being called "Chris K."  brings me back.  The dealer does have some discretion, as well, in other parts of the deal.  Certainly we've already talked about dealer participation, dealer markup, the ability for the dealers adding to the interest rate for their compensation.  The dealer also has discretion over who they send the loan to, who they send

this particular deal to. The dealer also has discretion over which deal they show to the consumer. So while we talked about the consumer will indicate their preferences about what they might want, ultimately the dealer is deciding between a number of different loan offers, which one they're going to provide to the customer.

>> Jim Chen: Okay, so, other than, you know, the credit score, the structure of the deal, is there any other demographic information that's conveyed from a dealer to a finance source to get the buy rate? Andy?

>> Andrew D. Koblenz: Well, yeah, there's a lot. There are lengthy credit applications, and they have all sorts of -- You know, the finance sources tell the dealers what they need to know, and there's lots of information beyond the credit score. Credit score is a nice, convenient way that the market -- and efficient way the market has picked to sort of synthesize down to a quantitative number a representation of a credit history of a customer, but I don't know of any finance company -- and Chris could answer this better than I -- that looks exclusively to the credit score for the underwriting of the loan. And there's gonna be -- In fact, in the subprime area, where Chris' company operates, there will be many, many, many other things like, you know, how long have you been in your job, how long have you been in your house, and things like that. So there's all sorts of data about the borrower that is relevant to the underwriting process that the dealer is the person that they collect. They sometimes have to chase down. Sometimes it's -- You know, what was initially said was not proven to be the accurate answer, and they have to work to find out what the correct answer is and what the consequence of that correct answer is on the ultimate wholesale offer that is made. It's not, by the way -- Chris just used the word, the dealer's markup, the interest rate. It doesn't become the interest rate until an APR. It's one of the components that goes into forming the APR, and the interest rate is the wholesale rate. But it is -- Yesterday, there were a lot of comments that kind of went down this wrong path, as well. The wholesale rate is not an interest rate that people can borrow at. So it's a component that ultimately matures into one when the retail rate is agreed to by both parties. But there's a lot of data that has to be collected and sent over. And as I said, Chris can probably answer that better than I, what kind of stipulations, conditions that the finance companies will put on a loan before they'll accept it.

>> Jim Chen: Okay. So given what Andy just said, how, okay, we've got the credit score, we've got the deal structure, we've got a whole bunch of other data, like how long you've been in your job, so forth, so on. Just in terms of the buy rate, is there any concern over fair lending, other fair lending concerns raised with respect to the establishment of the buy rate? Okay. We can move on, then.

>> Andrew D. Koblenz: I guess I -- I mean --

>> Jim Chen: Go ahead, Andy.

>> Andrew D. Koblenz: The Equal Credit Opportunity Act governs, you know, anyone who is extending credit. It governs, you know, both dealers and the financial companies with whom the dealers operate. You say, are there concerns? I don't think there are concerns. I don't think there are -- I think that the market is operating very well, that they are not broad-based. Anecdotally, there are gonna be issues out there. But it's not that the Fair Lending Equal Credit Opportunity Act considerations aren't floating through there. I just don't think there are -- We don't have any crisis or problem in this country now in auto lending. That doesn't mean that ECOA doesn't govern and that there aren't -- You know, it doesn't apply.

>> Jim Chen: Chris K.

>> Chris Kukla: I would say that -- We can say that there's no fair-lending problem, but there's no way for anyone to independently verify that. There's no publicly available database that gives you the kind of information that allows anyone in the public to make that determination, unlike in, say, the mortgage market, where HMDA has a lot of data that's available that gives you a sense of what's going on in the marketplace. By no means is HMDA perfect, but certainly HMDA at least gives you a good snapshot of what's going on in that marketplace. In auto lending, there is no such comparable database. So in terms of saying there's no fair-lending problem, you also have to take the lender's and dealer's word for that.

>> Jim Chen: Andy, did you want to say more?

>> Andrew D.  Koblenz: I don't.

>> Jim Chen: Okay.  And building up what Chris K.  just said, are there certain pools of data that would be useful to analyze to determine whether there are fair-lending concerns with respect to buy rates?

>> Chris Choate: Well, one thing I want to add, maybe it's a bit of an extension to the last comments from Andy and Chris K., you know, the amount of discretion -- And there are good data sources.  Some of them are private.  You know, others of them -- CNW I know is a data source.  There are others such as J.D.  Power PIN data that do track the amount of dealer participations paid.  And that data is coming directly from you know, the dealer's DMS systems.  So it's not a self-reporting, fill out a form.  It's an automated reporting tool that gets data out there.  Now, it certainly does not append the amount of participation, to my knowledge, by any other protected classes or other ECOA, you know, protections.  That said, ECOA, my understanding -- I'm a recovering attorney, but the ECOA, really, in the auto-finance sector prohibits, frankly, the capturing of data that would allow finance sources or others to report that relative to auto credit.

>> Jim Chen: Chris K.

>> Chris Kukla: In terms of data sources, there are data sources out there, as Chris has indicated.  Those are not, you know, necessarily publicly available.  J.D.  Power PIN database is a great database.  We've tried to get access to it.  We've been told no.  And it's also very expensive.  The average, you know, person can't just go and buy a subscription to J.D.  Power database or any other one.  There is no truly publicly available data out there that really captures this in the way that in other industries it is captured.

>> Jim Chen: So, I'm gonna move on now to the second part of interest rates, which would be the markup or dealer participation.  Now, at the first roundtable in Detroit, we learned that the dealer participation is an amount that can be added to buy rate that compensates the dealer for their role in providing dealer-assisted financing.  Have I a accurately stated that?  Agree?  Okay.  Great.  So,

starting with a more broad question, what kind of discretion do dealers have in deciding how much of a markup or dealer participation is added to the buy rate to get to the ultimate contract rate that's offered to a consumer? Andy.

>> Andrew D. Koblenz: Yeah. Well, Jim, as you said, this was discussed extensively in Detroit. And for many transactions, dealers negotiate the rate with consumers. The fact of the negotiability of this is smack on the front of every contract -- This is, for those who watched the panel that we were on in Detroit, this is -- Went through it all. It's a big piece of the consumer education that we were talking about yesterday. From our perspective, the fact that you can negotiate the rate, it's -- You know, Terry O'Loughlin was on the panel from Reynolds and Reynolds yesterday, and his company produces an awful lot of the contracts that are used in the retail installment sales contracts in all 50 states, And we've looked at it, and we can confirm every one of them has the disclosure of negotiability so that -- And the rate is negotiable. That doesn't mean that it's always negotiated. There are many instances where there are some rates, there are special programs, and there are other significant market constraints that limit, that sort of put that negotiation into a narrow band. Chris alluded to the fact that every major lender in this country, has in place, dealer participation compensation caps that are fairly, fairly narrow. They range between 2 -- depending on the term of the loan, 2% and 2.5%. They're fairly significant. Those are across-the-board caps. In addition, and Chris alluded to this as well, there are dealer deal-specific constraints, whether or not there's an overall broad cap at that particular lender, the underwriting of this particular loan, they'll say that because of the ratios elsewhere in the transaction, they have to be within certain parameters, there are going to the constrains on what participation can be included in the ultimate APR. And then finally, there's a strong constraint imposed by the marketplace. Jeremy Anwyl yesterday talked about the narrowing of not only the prices of the vehicles. He said the standard deviation had over time contracted, but also of financing. And there's a very robust and efficient marketplace operating, which also constrained. And I know Chris may be able to expand on some of those -- the significance of some of those market constraints.

>> Jim Chen: Chris K.?

>> Chris Kukla: There's a few things wrapped up in this that Andy pointed out. I think that the first, and I think something that we discussed a lot yesterday was when does the consumer actually see that disclosure that your rate is negotiable? Are they seeing that before they enter into the deal, or are they seeing it when those papers are handed to the customer at the end of the deal? And what we at least heard yesterday is that in most cases, those papers are handed to that person at the end of the deal, not at the beginning. In North Carolina, for instance, there is a -- the state law requires that there's a sign that has to be posted in the dealership that says, "Your rate can be negotiated, and we reserve the right to increase the interest rate for compensation." I went to my local Honda dealer to actually try to find that sign. The first time I went in, it was conveniently placed between the bathrooms. So I'm not sure people were gonna spend a lot of time looking at the sign. The second time I came in, interestingly enough, I was pushing the door open on the front door and I noticed that there was something on the window underneath the door handle, and I noticed that it was the sign that said, "You may negotiate your interest rate." If my 3-year-old had been with me, he could have maybe pointed it out to me. But my niece saw it. I probably wouldn't have. And I think most people walking into the dealership are not looking underneath the door handle to see that. So I think there's a real question about when is the customer actually made aware of the fact that this interest rate's negotiable? And I would argue that it's toward the end of the transaction. We've done polling in North Carolina where we've asked the question, "Were you aware of this practice?" And 85% of people in two polls that were done in two separate counties, and then another poll that was done statewide, the numbers were very consistent. 85% of people said they had absolutely no idea that this process occurred. We can talk about this being a consumer-education aspect, but the fact is that there are still a significant number of people who have absolutely no idea that there's this practice of -- hat the dealer's compensation is tied into the rate. Then there's also the question of how do you effectively negotiate. If you can get your financing elsewhere and bring it in with you, that's the best way to do it, because then you have at least one option that you can compare with this other rate. But what if you don't have a lot of access? We talked a lot about competition with prime customers, and folks who have good credit have a lot of options available to them. If you have blemished credit, and a vast majority of people in this country right now do, it's difficult to find a financing source, especially a direct one. And if you go into certain neighbors in Durham and elsewhere, there aren't a lot of brick-and-mortar institutions that are out there asking for your business. Now, we've also heard that you can go

online and try to find a source that way.  But we also heard yesterday a lot of hair-raising stories, about things like the Romanian mob putting up Websites that look like edmunds.com to make it look like you could buy a car for cheap.  We've told people that you shouldn't send out your personal and sensitive financial information online, and yet we're telling subprime consumers that's exactly what we want you to do.  So if we're saying it's negotiable, we have to be really honest about how negotiable is it and how easy is it for somebody to be able to really unpack this deal and say, "This part of it is related to the risk that I present, and this part of it is related to the compensation that the dealer's gonna get."  And I don't think -- It's not an easy task.

>> Jim Chen: Delvin.

>> Delvin Davis: Kind of piggy-backing on the issue about disclosures, the thing that's interesting about that is not necessarily what the disclosure says, but what it does not say.  Nowhere does the disclosure say definitively, "Your rate has been marked up," if so, by how much, and if the consumer was just knowledgeable enough somehow to know that there was a particular markup on that rate and what you directly ask the dealer, "How much is on my rate?"  the disclosure does not legally mandate that the dealer tell them.  Lots of dealers are trained to kind of reiterate that this is the best rate that is available right now or, "This is the best that we can do for you," or, "This is what we're offering."  But that disclosure is not to necessarily empower the consumer at the negotiating table, but more or less to cover the dealer's behind.

>> Jim Chen: I do want to let everyone make their points on this point, but I was trying to get more at what factors go into a dealer's, you know, determination of a markup.  Like, for instance, do they have kind of formal written or underwriting guidelines?  Basically, how does the dealer decide, okay, the markup on this is gonna be, you know, 1% or 1.5% or 2%, what have you?  But, Andy, if you'd like to close out?

>> Andrew D.  Koblenz: I was going to respond to a couple things from the previous comments. You know, Chris says that, you know, the signs may not be -- in the dealership that he looked -- may not have been the most opportune.  I mean, I've never seen a sign in a direct-lending institution that say the rates are negotiable.  Although there's nothing that prevents the rates from being

negotiable, and they can and I've heard that they are in some direct-lending institutions, that they're negotiable. And Delvin continues the notion that there's, again, a fixed -- that there is a buy rate for which the customer qualifies to borrow, is simply not the case. And that the direct-lending institution, for example, has an internal buy rate, effectively, and if you pull the loan distribution costs out of the APR that a direct-lending institution offers, that will reveal the same thing and no one is talking about disclosing to the consumer how much direct-lending institution is marking up its internal buy rate. So, the -- And we even sit there saying, "That doesn't even make sense." And that's right. It's not a particularly important number. So the notion that this should be disclosed would only lead to confusion in the marketplace, something that, as we discussed the last time, has been established by a couple of the government agencies, including the Federal Trade Commission. That's what I wanted to add on that.

>> Jim Chen: Chris C.

>> Chris Choate: Yeah, just another item or two on the competitive environment in the market forces and dealers' incentive relative to rate participation. We may get into later on the panel the impact of rate participation on credit performance for which we really, at GM Financial, don't really see any correlation, but there is a correlation, that we observed -- I think most finance companies would observe. I understand that dealers would observe this. That, you know, if the rate participation is marked up too high, that there is a competitive force kind of after the fact. There are re-fi opportunities out there. There are some lenders that engage even more specifically in the subprime segment in attempting to basically pick off recently originated loans and re-fi those down for a lower rate. And that lower rate a lot of times presents its opportunity, if there was too high of a rate participation marked up by the dealer, allows some room for someone to do a prescreen on a credit bureau, come in, pick those off. We've seen instances where, you know, a consumer, to save 20, 30 bucks a month, which would be sort of representative of around a 1% type participation, if a third-party finance company can come along and do a prescreen mailing and capture that, that is a back-end protection on a dealer overcharging for participation and frankly, in that scenario, makes that dealer look very bad. The consumer gets it at that point, that the dealer has effectively done something that, you know, wasn't good for them. And that's not somewhere dealers want to be in trying to build life-long customers.

>> Jim Chen: Chris, did you want to add?

>> Chris Kukla: The original question was how much discretion does the dealer have in deciding markup? Absent a cap from the finance source -- And, you know, we've said that some finance sources have caps. We know that there are some finance sources that don't. Ultimately, the dealer has pretty significant discretion in deciding how much of -- how much dealer participation or dealer markup they're going to add to that deal. We talk about the competitive forces. Those -- There are really two parts of this deal. One is determining the borrower's risk to the lender. So how -- What's their risk of default, of late payment, of, you know, being a good paying customer versus one that's not a great payer. Then there's the second component that has everything to do with what can I get this customer to pay? Whether -- It's really a question of that customer's ability to negotiate, that customer's wherewithal if they come in with other financing, versus walking in blind. That's gonna determine whether or not -- What the level of markup is going to be for that customer. So, there is a wide amount of discretion when we talk about fair-lending issues. Whenever you have discretionary pricing, when you have someone who's sitting across the table from someone else, and the determination that they get to make on the price has nothing to do with the risk that the borrower presents and everything to do with how much compensation am I going to get out of this transaction, you start to really -- You start to have some real issues there.

>> Jim Chen: Okay. Delvin had his card up next.

>> Delvin Davis: Two points I wanted to make. About the market being able to naturally kind of price out the dealer participation model, you can't assume that refinancing can save everybody, especially with the subprime mortgage crisis that we just came out of. If only the subprime borrowers were able to refinance their way out of their underwater homes, then the foreclosure rates that we're seeing even right now would be much less than they are. Even with what used to an appreciating asset if you're mortgaging your home, it's hard enough to re-fi. But with a depreciating asset with your car loan, it's even harder, especially if you are a subprime customer, again, subprime customers having less options to go to. That lack of options makes it harder to refinance or even get a loan. Your first loan -- With the subprime customer knowing that they're

less likely to shop around... [ Speaks indistinctly ] ...and stick with that, yes. So once they get in, they kind of stay in. You can't really assume that once you get into a subprime product that it's a natural step up into prime credit on down the road. And least data and other [indistinct] have declared that. And secondly, as far as what the dealership -- the kind of metrics or methodology that they use to determine what the markup is -- A few years ago, when all of the class-action lawsuits were going down against the lenders, there is testimony from, at least from one particular dealer from Texas, that is representing -- It was in the Primus case. He said blatantly that -- I'll quote here -- "The markup on loans was unrelated to credit worthiness for other borrower, [indistinct] on the vehicle, time spent negotiating the loan, make or model of the vehicle." So it kind of lends itself to being a much more subjective and random process. So it's -- I'm not really sure how to answer the question about, how do they come to a decision of who gets marked up and who doesn't, how much markup is? Kind of put on the people that are marked up. You know, it could be rock, paper, scissors, for all we know. It's very random.

>> Jim Chen: Andy?

>> Andrew D. Koblenz: Yeah, I -- With respect to the opportunities to re-fi, Chris Choate previously, I believe, explained how, in his company, there's a significant re-fi -- actual real-world on the ground, consequence of the possibility of refinancing, and the impact that that has -- the disciplining impact that has on the rates that are charged in the indirect loans that his company does. So, I mean, we can speculate about it, but Chris talked about real-world experience and the existence of a -- of the re-fi situation. With respect to the rest of the comments from Chris K. and Delvin, I guess I would ask them a question. If two groups of borrowers who have identical characteristics -- credit and circumstantial characteristics -- one goes through a direct-lending source, and the other group goes through an indirect-lending source, and they have -- They get the same APR. Is there a fair-lending issue? Is there an overcharge issue? Is there any issue of -- So I guess I would ask whether or not, when you have a similarly situated group that goes to an indirect source without regard to the dealer participation, but the APRs are identical, is there differential treatment? And if the answer to that question, I got to believe, is no, that there's no overcharge, there's no differential treatment, then what we're gonna find is that it's the marketplace that is going to be the source of that discipline, and that the -- The dealers, on an anecdotal basis, are constantly

telling me that they are -- What they are doing is responding to the marketplace. They're very aware and knowledgeable of the rates -- the prevailing rates -- in their marketplaces, and they are basically competing against that, and that is where -- what is dictating where they go. And if we get into the data, we'll see that the -- that the dealer participations are very -- are not anywhere near as broad as some people seem to think they are, and that is because of all of those natural constraints that I've previously identified.

>> Jim Chen: Delvin.

>> Delvin Davis: A couple of points there. [ Speaks indistinctly ] With the few data points that we do have from J.D. Power, that we have access to at CRL -- Comparing direct lending to indirect lending, the people that get direct loans are getting APRs up to 100 basis points cheaper than people at the indirect field. So it's -- They're using those savings to purchase a little more car. And just to -- I'm just wondering -- The scenario that Andy just put across with two similarly situated credit borrowers -- one going to a direct lender, one going to an indirect lender. I was wondering if you have data or any kind of independent research that kind of supports that claim or if you can cite that from somewhere.

>> Andrew D. Koblenz: I was just asking a hypothetical as to whether or not if a group of 100 borrowers went to an indirect lender and got "X," you know, APRs on their 100 loans of "X," whatever they were, and a group of identical consumers went to a direct lender and got the exact same APRs, whether you would say there's an overcharge there, because the indirect lenders paid a dealer participation. That's was the question I was asking.

>> Jim Chen: Chris K., did you want to respond to that?

>> Chris Kukla: It's a nice hypothetical, and, certainly, if you've got two people who are getting the same rates, it's not a question of, are they getting the same rate from different lending sources. Are two similarly situated borrowers walking into the same lender getting the same price for that credit. Is there something else that's getting in the way? And the answer to that is, it's hard to tell. There is no publicly available data that allows us to look and see whether or not that's actually

occurring.  We do know -- I mean, I know there are cases from 10 years ago that showed a strong correlation between race and the amount of markup that was put in place.  Whenever you have discretionary pricing, whenever you have someone that can sit in front of a borrower and make a decision independent of their credit risk -- When they can look at that borrower and make a determination, that it takes in all of their biases, all of their past background, anything that they're got rattling around, you always run the risk of a fair-lending problem, because you're giving that person the ability to change the price based on whatever they want to change -- whatever they want to use as their criteria.

>> Jim Chen: Tom?

>> Thomas Durkin: Yeah, I just want to mention something about that, that it's always easy to get a correlation on something when you're correlating one variable with another, but you need to take a lot of other things into account when you do those sorts of correlations.  That kind of analysis is called a multivariable or, using regression analysis, for example, a multiple regression.  In some of those studies that you're referring to, there have been significant statistical criticisms of those studies, and I just raised that issue, if you're interested, or, Delvin, as the analyst, if you're interested in some of these studies, I brought a paper or two along that you can take a look at if you'd like.

>> Jim Chen: Tom, could you briefly tell us what kind of concerns have been raised with respect to studies?

>> Thomas Durkin: Yeah, omitted variables -- that if you correlate race with rate or anything else, practically anything else, I mean, probably, I'm going to talk off the top of my head here, but if you correlated race with age of population, average age of the population, with location of residence, with education levels, with wealth, with income, it correlates with all of those things, but it doesn't mean that race explains those things.  There's other things.  I mean, education, for example, may be associated with income, and income is associated with race, but it's not because of race, it's become of income -- or, education that the income may be lower.  I mean, you have to study these things, and so you need a multivariate relationship.  And if you don't properly specify the multivariate relationship, you're going to get biased results.  Now, one paper in particular that I'm talking about,

and maybe you guys have seen this, was by -- criticizing some of the statistical methodology was by James Heckman of the University of Chicago, and he was specifically referring to some problems in the econometric evidence. I would listen to James Heckman seriously. Now, this may sound like an appeal to authority of some sort, but you got to start somewhere. James Heckman won the Nobel Prize for his contributions to econometrics, and so it's somebody that's certainly worth listening to.

>> Jim Chen: Chris C.?

>> Chris Choate: My comment is decidedly less scholarly than Tom's comment, but I'd like to sort of maybe disabuse the notion that when a dealer marks up the buy rate or there's a yield spread, that it's purely subjective based on, you know, what they can get away with. We've talked about market constraints, we've talked about ratios inside the deal, competitive factors and all that limit that, but it also certainly bears noting that there is much more than zero amount of work or effort and risk on the dealer's side that goes into originating that loan. And, again, I'm not trying to get as completely off the path that we've been on with the last few comments, but particularly in the subprime space, it is -- it is not always an easy task to get the funding source satisfied with the conditions that are called stipulations -- proof of income, proof of residency, you know, show up with paychecks and other things that the dealer has to help accommodate along. That can take a fair number of days, in many instances, during which the dealer is out that liquidity. They are potentially out some financing costs to help float that. You know, in other words, financing sources can be relatively difficult to deal with in order to get something accomplished. Secondly, there is the risk of not getting the deal funded whatsoever. We at GMF kick back a decent percentage of the deals that come in the first time through that have to go back to the dealer for some further processing. There's always a risk those won't be ultimately fundable. There is risk down the road with the reps and warranties that dealers make to us in connection with each contract that we will ultimately seek recourse or put that thing back to the dealer. So, there is a fair amount of work. And there is a decent amount of risk the dealers take, and it seems to me entirely appropriate that they would be compensated for that. And it's not simply a matter of, you know, I think I can get more from this person across the table than I can get from the person earlier this morning.

>> Jim Chen: Andy?

>> Andrew D. Koblenz: Yeah, and just to echo and build on what Chris just said, those -- that amount of work varies dramatically deal to deal. There's CNW out there that says that, on the average prime deal, the dealer shops 2.8 lenders, on average, where, when you get to the subprime area, that number jumps to 7.9. So, they're shopping to more lenders. The close rate for prime deals is around 90% -- again, I'm citing CNW data -- whereas the close rate in the subprime is 57% or 58% so that you have a lot of differential between deals relative to the amount of work. And I note in passing, in the study that Chris and Delvin's organization published, there's a kind of a teasingly attractive analysis of trying to calculate the dealer compensation on an hourly basis and saying that, "Well, they only spent 45 minutes -- a half an hour, 45 minutes, something like that -- and that translates out using some numbers." We actually have a lot of concerns about the actual data and mathematics in the study, but they actually spend $1,000 an hour or something like that. But they conveniently omit from there all the work that goes on not in the presence of the customer in this deal. They conveniently omit all of the work that goes on in the failed deals that don't result in transactions going forward. They conveniently omit all the training time that goes on in the F&I office. They conveniently omit all the overhead costs that have to be loaded onto everything so that you get to these very large numbers and they're startlingly, strikingly large numbers, and they say, "Wow, that's a cause for concern." But when you actually peel back the onion and realize that there are all the variations and all of the work that goes in, the numbers, stipulations -- as Chris says, his company can be very difficult to deal with at some of the credit-challenged people. Because of all the work that has to be done to chase down the stipulations, to make sure they're satisfied, there's an awful lot of real-world functionality and real-world activity driving that compensation number which varies deal to deal to deal.

>> Jim Chen: Chris K.

>> Chris Kukla: Well, certainly, if there's data that people want to make available, we'd be glad to see it. We've used the data that we have available to us. If there's other data that is out there that folks want to put out into the field, we would be glad to take a look at it. I think there's something going on. I think we're taking -- we're taking two things and putting them together. There's a

discussion about should the dealer be compensated, and I don't think there's any disagreement that the dealer -- if the dealer is working to arrange the financing, that the dealer should get compensated. I think there's a question about how does the dealer get compensated that's at issue. And so, I mean, we can argue about whether or not dealers should get compensated, and I think it's a red herring. Nobody has said dealers should not get compensated for the work that they do. I think the real question is how should the dealer get compensated? And I think that's the place where we're racing concerns, not in the argument about whether or not -- Nobody is saying a dealer should be working for free.

>> Andrew D. Koblenz: In fairness, Chris, your organization has, over the years, put out communications that say 100% of the dealer compensation's an overcharge. And an overcharge is something that shouldn't be charged, so your organization has said 100% -- Said, "Here's the buy rate. Everything above it is in extra charge." It's in the most recent study that this is an additional charge that Americans pay by going to the dealership that they don't have to pay elsewhere. And your organization is the one that said dealers shouldn't get paid anything.

>> Chris Kukla: No, we said that the dealers are getting -- that this is what goes towards dealer compensation and that it's built into the rate and that most people don't know about it instead of saying that none of it should be compensated.

>> Andrew D. Koblenz: I think, candidly, in response to some of the facts we've pointed out, you've, in recent -- in the last couple weeks or months, you've shifted slightly your argumentation. But we have lots of statements from CRL and from some of the other organizations saying that this is a 100% overcharge -- 100%. The $20 billion allegation that was present during the debate over the Consumer Financial Protection Bureau legislation shifted to $25 billion i the current report. As your calculation goes, it's 100% of the dealer compensation.

>> Jim Chen: Okay, I do want to get into some questions about compensation, but before we get to that, Delvin, you had your flag up. You wanted to say something?

>> Delvin Davis: Yeah. A couple points I wanted to make. One, using the CNW data to kind of gauge how well prime customers shop as opposed to subprime customers, I wouldn't necessarily consider that shopping if the subprime customer has to go to several lenders in order to finally get that financing that we're looking for. They're probably getting told no a considerable amount of times before they get to that "yes," and once they get to that yes, they stick with it, as bad as it might be. Secondly, again, we're not saying that dealers aren't putting in a certain amount of effort to arrange the loan, find whatever many opportunities that are available for whatever customer they might have, but it should be noted that there is work that goes into all of the loans that are dealer-arranged, but there is not a markup on every loan that is dealer-arranged. I think that's pretty significant to say and speaks to the -- again, the randomness or the subjectivity and the methodology that goes into what actually establishes the dealer markup and dealer participation rate. And, lastly, getting back to the -- I guess -- Well, there's a large body of not just our paper but the other paper that CRL put out, but there are other reports, also. Marc Cohen, Ian Ayers -- they've also, in past years, put studies out there that have taken issue with how rates are being established with different customers, some of them establishing racial disparities, as well. But Heckman -- It's interesting that Heckman had his rebuttal but didn't offer any additional data or analysis that would kind of counter what Cohen and others put out in the past. We're recognizing that there is a void there in research, that you need more variables to control for all of the different things that might impact the interest rate. Then the industry should, being that they have -- You would think that they would have access to their own data, that they could possibly put out a study that would address that and the variables that are necessary to have the multivariate progression and, you know, have superior research combat the "inferior research."

>> Jim Chen: Tom?

>> Thomas Durkin: Yeah, that's an interesting point. If you look in Heckman's paper, as a matter of fact, he specifically addresses that, and he says he wasn't asked that question. You have to remember that Heckman is not an automobile finance specialist or a consumer credit specialist. He's a specialist in econometrics, and he was asked questions about econometrics, and so it's not especially surprising that he didn't spend the rest of his life gathering the necessary data and so forth to do this. And, you know, speaking of data and that kind of thing, you know, I didn't realize

when I came down here, I guess, that I was, as it turns out, literally in the middle of an argument between analysts. And, you know, I'm sitting here looking around the room, and I notice that I'm the oldest person in the room. I suspect that that would go without any challenge by anybody, and it brings me back to the point that I wondered about yesterday when I was coming down here on the plane, looking out at the thunderheads and so forth, and I was thinking, "What exactly am I -- Where am I going and what am I doing there?" And so, if you don't mind, Jim, I would like to get back to your original question to me, if we could. And that is, you asked me if I would comment on the CRL Auto Report. I would be happy to get do that.

>> Jim Chen: I want to get at that by determining what studies are out there.

>> Thomas Durkin: I would like to do that and how would I do that? The CRL report, as I read it, is what I would characterize as an advocacy report. There's nothing wrong with an advocacy report. Other people make advocacy reports. It happens all the time. When I was in the Federal Reserve, we used to see these things all of the time. We tended not to read them very carefully, unless we had to, such as they came in under the Administrative Procedures Act or something like that that caused us to have to read them. I would like to put that report, in this case, into the class of an academic paper and respond as I might to an academic paper. That's the kind of thing that people with gray hair in the profession do all of the time. In fact, the last couple times I was in San Antonio, I came here specifically to make comments at an academic meeting, and these do go on all the time -- every day at the Federal Reserve, but there was one going on at the hotel where I'm staying. I'm not sure what the feud was, but you can tell by riding up the elevator when they're talking about progression coefficients and things that it must have been some kind of an academic. And as I say, this paper is an advocacy paper, but I would like to approach it as an academic paper. And the purpose of an academic meeting is to have somebody who has some experience, maybe a little gray hair, maybe not, but has a little bit of experience to comment on that paper and to try to help the authors in an early stage so that the paper can be improved and published in a reputable academic journal. What I would like to do for a few moments, if I could, is put on my academic hat, and we at the Federal Reserve think of it as simply the largest academic economic department in the Federal Reserve's Research Division. So, it's something all of us have done all the time. So, let me point out, then, a couple of things that I see with the CRL report, again, hoping to help the

authors to produce a better second draft that then can lead to publication in the academic or economic literature, that there's a few things that advocacy reports normally exhibit, and this one, I think, exhibits all of them.  One is that advocacy reports tend to start with the conclusion, and then they try to marshal evidence and data and so forth to support this conclusion.  I'm not questioning the intellectual integrity of doing that.  That actually is a well-established methodology in the field of law.  That's what lawyers do all the time.  They establish a conclusion.  The client is guilty or the client is not guilty.  And they marshal all of the evidence that they can to support that.  And they tend, unfortunately to ignore evidence that doesn't agree with that "hypothesis" or that conclusion.  So, sometimes that leads to a lack of transparency in the work itself.  And I think that that unfortunately appears to be true in the CRL report.  You cannot really tell how they used the data.  So, for instance, one of the first things I do when I look at a study is look at the second labeled "methodology."  Many studies have this.  In this study, the methodology is about four paragraphs long.  It begins on the bottom of page 9 and goes on to page 10.  I would suggest that maybe it's because the thing is so short that I defy you to tell me what exactly is going on with the data there.  They're not well described.  There's no tables of statistics, the data, and there's no discussion of how waiting was used or how it was -- how the data simply were organized in their own analysis.  There are some questions, and I could read some specific sentences there that are particularly disturbing, but there were adjustments.  It used the word "adjustments" a number of times.  It's not clear what those adjustments were, and so, simply, Delvin, if you would, take those data that you have, walk us through how you got from point "A" to point "B" to point "C" To point "D" and then all the way through point "Z."  Then at the bottom of page 7, there's a number that springs.  It's 2.47, is the proportion of that percent.  That's a proportion of the dealer participation relative to the size of the average loan.  That number may be right, but I can't derive that from the paper.  It's simply not there, you can't do that, and so to an analyst, it's an assertion.  You made an assertion.  It's 2.47.  You cannot derive that from the body of the paper.  An analyst is supposed to be skeptical.  I am skeptical.  That's the nature of an academic analyst and somebody commenting on the paper.  And so you've got to spell it out a little bit where this came from.  Now, another thing that needs to be done that tends not to be done in advocacy papers is a specified hypotheses, and so this paper and many others unfortunately seem to specify conclusions rather than hypotheses.  What you do is you specify something from theory or previous experience and knowledge seems to be true, and then you study that more.  Do you have new evidence to suggest it's not true?  So in other words, you can deny the hypothesis.  In this case, it seems like the paper has two parts.  And the hypotheses in one of them is specified better than the other, but in one of them, the hypothesis seems to be that the cost of dealer credit is higher than the cost of direct credit.  Now, I'm not aware of evidence that suggests that.  In fact, the Federal Reserve, which has data that addresses that slightly, although it's not well defined and so forth --

>> Jim Chen: I'm sorry.  I don't mean to cut you off.  I want to try and tie it a little bit more to the topic of whether there are studies -- if your all's study is one of these that examine how interest rates and markups are charged different subgroups of consumers.

>> Thomas Durkin: I think it's an important point I'm making, though, that the 2.47 is not a number that's derived in the study itself.  It's asserted there.  It's much higher -- again, the gray hair -- it's much higher than any number I've seen before.  I think it needs to be better established.  Also, I would comment a little bit about the statistical procedures.  The relationship there clearly is a multivariate relationship, and it does not seem, for a variety of statistical reasons, that the multivariate relationship is carried through and analyzed.  Let me mention what some of these are.  Maybe these are the reasons why the multiple regression doesn't show up.  One is overfitting.  I have a paper on that.  Another one is multifamiliarity.  That word is used a couple times but never employed, really.  Another is heteroskedasticity.  The data clearly show that.  There's non-normal dependant variable, and so multiple regression of a normal kind is probably not the way to go anyway.  And there's no discussion of any proper specification of a functional form.  That would have to be done as well.  And so you can't use a multiple regression, and they don't.  What happens, then, is rather than using a regression that has a single dependent variable and six independent variables, or the six they mention, there instead is six univariate relationships specified, each one with one variable.  What happens is if you use one variable, as I mentioned before with the race example, all of the error, then, or all the variation is assigned to a single variable.  That is never correct in a multivariate relationship, and so, very simply, I don't think that you can properly say that you have found something, and, as a matter of fact, in the examples there, which the authors seem to like pretty well, because they are in six or seven different tables and charts, that there's really only one relationship there, and that is that rate is related to risk.  The others are what we call proxy variables -- the size of the loan, whether it's subprime finance company, all of those things.

Those need to be introduced as separate variables to the extent that you can apart from the multivariate problem I mentioned.

>> Jim Chen: I know that this is a very complex topic. We need to move on a little bit.

>> Thomas Durkin: Yeah, and I will finish up. I do have some suggestions for the author at the end that I would make for improving the paper, but just let me specify. Rather than going through that -- I think they're useful and would be helpful to the authors as well. But let me just say that there's one last problem, and that is that it appears that the data in the regressions that are used have what's called an outlier problem. They should be studied, and this would involve specifying the equation in different ways, because what's going on right now -- and I can give you an example that would show you exactly what I'm talking about in more detail. And in the interest of keeping Jim happy, I wouldn't do that. But it's going to twist the regression line, and it could not be duplicated, I think. And so I would not rely upon any of those regression coefficients for either of those reasons. They are probably biased because of an outlier problem and all of the variation is assigned to too few variables.

>> Jim Chen: Okay. I want to get to a point that was started being discussed before we got into a discussion of the data points, and that was the compensation for dealers and how the markup reflects some compensation given to dealers for arranging the financing. There are some instances where financing is arranged with no markups, is that right? Can someone answer that? Andy?

>> Andrew D. Koblenz: Yeah, I can answer that. But at some point, come back, because there was one thing from the Cohen study that we should come back to. But to answer that direct question, yes, there are situations where there's no markup because there are subventions, there are special deals, and there are some times that the market is so competitive that the dealer opts on this transition to place the financing without any compensation, just like there are times when the dealer opts to sell a vehicle at the cost of goods sold. There are some of those.

>> Jim Chen: In instances where there is no markup, how is a dealer compensated?

>> Andrew D. Koblenz: Retailers do loss leaders all of the time. You can go to a clothing retailer and they might sell below their cost to clear their inventory. Dealers have other interest in this transaction. This came out yesterday. Dealers are not merely trying to sell financing. They are first and foremost trying to sell a car, and this may be a very good customer. This may be a customer who they know is very loyal in terms of using their service department. Coming back, this may be a customer who has three or four siblings or family member who they also they know because they're a local, community-based businesses. They know their families and they know they are going to be back. So, there's all sorts of reasons why a dealer might, in a given situation, opt to lower the level of compensation that they have down to zero. Actually, this may surprise you. There are times when a dealer will write the APR at a number that is less than the buy rate. I think Chris can tell you that, that they will actually, on behalf of the customer, buy down the interest rate to help them get into the loan, not out of a -- And these are businessmen who are making a profit, but there are other aspects of the overall customer relationship that might make that variable one that they would actually sell the financing at below cost.

>> Jim Chen: Chris K., did you want to comment on compensation issues?

>> Chris Kukla: I did. I also understand in some of these programs, the dealer also can receive a flat fee, or it's not that there's no compensation, so to say that the dealer participation or the dealer markup is the only way to do compensation is not necessarily the case.

>> Andrew D. Koblenz: Absolutely. In fact, in the NAF data, the National Automotive Finance Association, which is a lot of the data that the first part of the CRL report is based, if you actually look at the NAF data, which we've done, there are in their description of dealer reserve, there are actually six models of dealer reserve. So, we've been talking about one, which is probably the one that's the most prevalent, which is where the dealer is compensated by a differential between the APR and the discount rate at which the finance company acquires the loan, but there are many others. Chris has mentioned one. There's flat-fee arrangements. There are the ones that I was describing, where the dealer actually takes no compensation on the deal, but if you peel back the NAF data, you'll see there's a whole bunch of different ones in the marketplace, and that's great.

There's all sorts of different compensation schemes between the dealer and the finance company operating. And they are driven by the market imperatives of those different situations.

>> Jim Chen: Chris K.?

>> Chris Kukla: Sorry. I'm going to jump back to a previous thing. We were treated to Dr. Durkin's opinions and feelings about our paper. I don't want to step the next 15 minutes having Delvin wow you with his knowledge of multivariate regression analyses and things like that. But I do wonder if we're going to -- Given the fact that our paper has been criticized in this panel, if we're going to have an opportunity to rebut or discuss whether or not Dr. Durkin's opinions or thoughts on our paper we think are correct or whether --

>> Thomas Durkin: I wouldn't call anything I said a criticism. They are just comments of a normal academic sort to try to attempt to help the authors improve the paper, and in that context, I hope that that's how they are taken. I also did assemble a list of 16 experts in Washington, and, Jim, this was for you, so you don't have to go elsewhere if you want to talk about automobile financing and so forth. Of the 16 experts, 15 of them were better econometricians than I am, and so I would -- and Delvin, you and your coauthor -- I would be more than happy to try to set up a seminar at the Federal Reserve where you could present the paper.

>> Chris Kukla: Given the context, I think it's fair to say that I one just global point that I'll make is we've run into this before in other contexts when we've had research papers on mortgage lending, where we've been treated to long discourses about how our papers wrong and then there's no data on the other side to show anything other than what we've said. So, if we're going have this discussion, I think it's fair to say we've put out the data that we have available and our analysis of that available data. If there's other data available, we'd be glad to see it.

>> Thomas Durkin: No, my point is that --

>> Jim Chen: We've got -- Sorry. One at a time here. Andy, you wanted to make a point?

>> Andrew D. Koblenz: In fairness, one of the crucial charts -- and Tom mentioned it and he questioned it -- he said this 2.7 number comes up, but this is figure one. It cited the key citations to the NAF data. It has numbers in a line called "average markup per loan" of 494, 780, and 714. That's very interesting, but on pages 19, 20, and 21 of the NAF report that is cited here, there are -- average markup per loan is listed as 477, 280, and 330, significantly lower. So, one question I would have, which also translates, based upon the NAF data, into average markups of 7, 1 and .9, where the CRL data is at 2.91 and 2.47. I think there's a mixing of apples and oranges going on in this chart, but the very core data that the CRL cites for these figures is itself facially inconsistent with it, and there's no explanation. It's cited. So, I take all of Tom's -- I'm not a statistician, I'm not an economist, and I can't -- I don't know a coefficient from a regression analysis, but I will tell you that I can read the NAF data, and there are absolute inconsistencies between the very data that they cite for that chart and the report upon which they rely.

>> Jim Chen: Okay. I'm sorry. We really need to move on, because we've only got a little bit of time left. I just want to talk a little bit more about -- more on closer to fair lending concerns. Andy mentioned that there are several different models of compensation for dealers. Do any of those models have an increased or decreased risk of fair lending concerns? Have you adopted one or the other? Andy, go ahead.

>> Andrew D. Koblenz: This is the comment I wanted to make with respect to the experience with the litigation in the early part of the decade. There was one piece of analysis done on data that was collected after the caps were put in place, and that was in the Primus case, and there was 12 months of post-cap data. And applying, even though, for the reasons Tom Durkin has said and some of the other experts that were present during the -- during that litigation, there was a lot of criticism of Dr. Cohen's methodologies at the time. Dr. Janet Thornton wrote a lengthy paper, and I'm not proposing to relitigate the disagreement, and the one litigated case, Primus, took an awful lot of shots at Dr. Cohen's analysis, and it never got to final adjudication. The case was settled. But there was one effort to analyze the post-cap data using the methodologies that Dr. Cohen had employed. And when that was done, it was 12 months' worth of data. It was determined that there was no statistically significant differential from zero of the spreads that were present at that point, so that there is an affirmative piece of data that, in that case, in that instance, there was no fair lending

concern presented by the model that is the most prevalent model that we've been talking about, namely the dealer spread model.

>> Jim Chen: Tom, did you want to make a comment about the compensation?

>> Thomas Durkin: Yeah, just simply that I think, Chris, you missed my point. I don't have better data, and I'm not saying your data are wrong. I'm just saying that you have to explain what they are, and you can't get that from the paper. That is a request to the author to clarify that in ways that any analyst -- and let me say that I'm the only one, I guess it's safe to say, that, as they say in Washington, doesn't have a dog in this hunt or a horse in this race or something like that. I'm just a skeptical analyst, and so you got to show me where these things come from. I don't have an opinion about them. I was just asking a question.

>> Jim Chen: Chris, do you have a comment on the dealer compensation and how that would relate to fair lending concerns?

>> Chris Kukla: He keeps steering me away from this. I didn't realize that half this panel is about our paper, which is great. And we stand behind it. I think on the compensation issue, we can take our experience both within this industry but also in other places where similar compensation systems were in place -- in particular, in the mortgage market, where there was a very similar, if not almost exactly the same, kind of compensation system available. And what was found is that there were fair lending risks associated with that kind of compensation system. I go back to the point that I made earlier. Anytime that you give one person the discretion sitting in front of the borrower to decide what that rate is going be that's independent of other variables like risk, where it's their decision of how much they're going to put onto this loan, you can talk about competitive forces, you can talk about, "Well, you can't mark it up too high, because if you mark it up too high, they're going to get a loan somewhere else." That may be true. But, again, you're putting on a piece of that -- no matter how big it is, you're putting a piece onto that interest rate that is determined by what you think is appropriate in that situation but also what you think that person is willing to live with, and when you have that situation, you could have two people with very similar backgrounds, very similar credit scores, very similar risk profiles paying a different interest rate, not because of

the risk that they present but because one person may have walked in with financing from a direct lending source versus someone who walked in blind, and that has nothing to do with risk-based pricing. That has everything to do with that person sizing up that customer and making a decision about what they think they should charge.

>> Jim Chen: Andy.

>> Andrew D. Koblenz: That's not unfair lending. Let's be very clear. There is nothing that says discretionary pricing in any segment of the marketplace is unfair. The ability to reduce down from an amount down to a -- to meet the market is not unfair lending. There is no evidence that it is problematic. There's evidence that it's not problematic that I just alluded to. So that we -- that does not necessarily lead to the concerns that Jim is asking about, and, as we've explained, you said that you analogize the mortgage arena, but there are many, many, many differences between the auto market and mortgage market. There are many differences between the role that the auto dealer plays in the creation of dealer-assisted financing versus what a mortgage broker might do. For one, this actually came up during the debate on the Consumer Financial Protection Bureau legislation that led to that, and one of the participants in the debate explained that one very notable difference, and this would have to be run through the kind of analysis that Tom Durkin was talking about -- was that dealers carry inventories. They have this other interest. There is another set of incentives and interests that are driving their behavior, that this makes them distinctive and distinguished from mortgage brokers, and the person who said that during the Dodd-Frank discussions was Barney Frank.

>> Jim Chen: Delvin, do you want to make a comment? And then I want to hit one more topic before we open up for questions.

>> Delvin Davis: Yeah. One point I wanted to make about the compensation that I think we had mentioned before -- Competition here, the market naturally would drive down prices if there was pure and perfect competition, but here the competition is not pure per se. It would be understandable if the dealers, or, rather, the lender, third-party lenders, were competing directly for the business of the customer, but there is that middle man, the dealer, and it's not the lenders that

are competing for the business of the customer but the lenders that are competing for the business of the dealer.  If it was the former, competing for the business of the customer, then prices would be driven downwards because the customer will be able to choose directly from a wide source of -- wide range of sources, what the APRs could be, but the dealer is not going out, getting four or five quotes, and then turning around and giving all four or five quotes to that consumer and saying, "Hey, pick which one you like the best."  They are picking the one rate quote that is most advantageous to them from the lender.  So, the lender, if they want to stay up to a certain market share in the business, they have to compete for the business of the dealer, which would -- It's a reverse-competition kind of model where prices are driven upwards but never downwards.

>> Jim Chen: Okay, Andy.  If you could briefly --

>> Andrew D.  Koblenz: Yeah, just one question.  But, Delvin, if the APRs and the direct lending space were higher or equal to -- let's just say equal to -- then it doesn't matter, right?  That's all interesting, but if it costs more to go to the one that doesn't have this heinous component to it, it doesn't matter, right?

>> Delvin Davis: J.D.  Power doesn't say that.

>> Andrew D.  Koblenz: I'm sorry?

>> Delvin Davis: J.D.  Power does not say that.

>> Jim Chen: Okay.  If I can move just one last point -- Sorry, Chris.  I actually want to rope Chris C.  back into this conversation, because we had a little bit of discussion about subvened rate or also heard it call subvented rate.  My understanding is that's where a finance source subsidizes a rate given to a customer.  Is that right?

>> Andrew D.  Koblenz: That's not right.

>> Jim Chen: I'm sorry.

>> Andrew D. Koblenz: I'm sorry. It's not the finance source that's doing the subsidization in the subvened rates. It's generally the manufacturers.

>> Jim Chen: Oh, I'm sorry.

>> Chris Choate: It is the manufacturer that is helping the consumer buy down the rate by providing funding to the finance source.

>> Jim Chen: Okay. Now, do dealers have discretion over who is offered this subvened rate?

>> Chris Choate: Well, typically a subvention program is, "A," going to be available for new vehicles, not used, because it's generally dollars coming from the manufacturer, and they're interested in selling new vehicles, and, by and large, dealers are eager to see subvention programs available because it helps them sell cars. It helps get the consumer into -- I think Delvin used the phrase "a little bit more with the savings." Generally, it's available on this vehicle or that vehicle but perhaps not on this vehicle. Subvention dollars are nothing more than a marketing spin by the manufacturer given vehicles they're looking to try to move. They may have a little more inventory of this this time of year, for example, where there's the model-year changeover. There can be subvention dollars placed on the outgoing models. Dealers are typically eager to see those subvention programs come around because it helps them move those vehicles off the lot.

>> Jim Chen: Okay. I'm going to let Chris K. speak, then Andy, and then I want to take some quick questions, and I really want to kind of get at whether there's any way it's been sure that these subvened rates are being given to all that qualify.

>> Chris Kukla: That's an interesting point. I think it would be very interesting to see the data that's available on that, because that's not something that we can see, and that's one thing I want to point out. I do want to just quickly respond to Andy's point about -- that discretionary pricing is not in and of itself unfair lending. Discretionary pricing has a distinct risk of unfair lending that other forms of compensation doesn't have. Again, we have someone sitting across the table bringing

their own biases into the transaction.  You run a greater risk of fair lending issues than you do elsewhere.  If you have an F&I salesperson who is, for whatever reason, charging women more than men in markups or giving higher markups and more markups to women than men, you've got a fair lending problem.  If you've got the same thing with other protected classes, I think that's the point of it, not that, you know, in a vacuum, it's not unfair lending.  It lends itself to unfair lending in a way that other compensation practices simply don't.

>> Jim Chen: Andy, Go ahead.

>> Andrew D.  Koblenz: Excuse me.  I'll answer Jim's question.  We're running out of time to answer that one.  Maybe we'll have other forums to do it.  But with respect to the subvened rates, let's start with the fact that the purpose of these subvened rates is to encourage the sale.  They are advertised massively by the manufacturers that offer them, and they are out there, so, in a sense, they are offered to everybody.  Do they have qualifications associated with them?  Absolutely.  Are those qualifications based on credit worthiness?  Some of them are.  But there are other qualification requirements.  As Chris mentioned, there's the vehicle that it might be on.  They may be be regional.  Manufacturers have inventory issues at the wholesale level that they're trying to push through.  I'm also, among my many other talents that I don't have, because I'm not a marketing expert, as to when you're going to do it, but there are marketing experts at the manufacturer's who are trying to drive traffic in particular areas, to move particular vehicles, to move them at different times, to clear it out because there's another shipment coming on the ship from Japan or Germany or coming off the factory in Detroit.  And there are all sorts of special qualifications, but there's no secret to these rates.  They're out there, and the market is driving people.  They want to get them because it allows them to more readily sell the car, which is the primary business that the dealers are in.

>> Jim Chen: Any questions from the audience?

>> Female Speaker: Hi.  This is a question for Chris.  I was wondering what percentage of loans do you put back to dealers and under what circumstances.

>> Chris Choate: Well, I'm not going to give an exact percentage. I've alluded to the fact that we can be -- As a subprime lender, we're going to be very, very careful in verifying proof of income. It's going to be a very big one. Proof of employment, so not only do you have a job -- Not only do you have an income, you showed up with a paystub, a recent paystub or a tax return, but also that you still, in fact, have the job. Proof of residency. Again, at certain tiers in subprime, you really need to be able to know where the consumer and the collateral is going to be. Some of those things differ for prime. They may not be quite as important. But, certainly, we'll have 10% or so of our business when it initially comes in the door that just is not fundable within some reasonable period of time. There'll be a back and take on most of that with the dealer, and we will ultimately find another decent percentage of that 10% or so that we're not able to fund up front.

>> Male Speaker: Mr. Davis, you said That J.D. Power had data showing indirect lending and 100 basis points, I think you said, over direct lending. And I thought I heard Dr. Durkin start to say that the Fed data is different. Dr. Durkin, what does the Fed data show on that basis?

>> Thomas Durkin: The Fed data is not well defined. You'd have to go there and ask them exactly what's in there, so I wouldn't want to make too much of it, but what it says is that lending at banks is less expensive than -- Excuse me, the other way around -- that lending at finance companies is less expensive than automobile lending by banks, and this has been -- it's not always been true, but it's been true for at least 15 years.

>> Male Speaker: Does this data also include credit unions?

>> Thomas Durkin: No, the Federal Reserve is not a regulator of credit unions, and so it doesn't have that information, but it has simply the bank and the finance companies. It's been releasing this in the G19 statistical report for decades.

>> Andrew D. Koblenz: In 2010, the commercial-bank number that Tom is alluding to -- It's a 40-month new car all tiers average interest rate. Interest rates are annual percentage rates as specified by Reg Z. New car loans, personal loans, simple unrated averages at 6.21. We have some data from J.D. Power saying that the comparable all banks, all tiers is 4.4. So, there's obviously some

disagreement as to what the reality is.  I'm not sure how J.D.  Power is getting direct-lending data, but, obviously, that's something to look into.

>> Jim Chen: Last question over here.

>> Male Speaker: Yeah, yesterday we focused on the military consumer, and bringing that idea to the work that the dealer must do to sell a credit contract to the buyer of that credit contract and the comment about having to chase down stipulations -- When a military consumer is buying a car credit from a dealer local to a bank, local to a base, other than the car data itself, the Consumer Reporting Agency data, and that servicemember's rank, what else does the buyer of that credit contract need to know to agree to buy that credit contract?

>> Chris Choate: I can't answer you specifically as to what other stipulations there may be.  Again, we're looking at a Credit Bureau file.  You mentioned the credit report.

>> Male Speaker: Right.  So, there's all of the data on the credit report.

>> Chris Choate: And you're going to look at the deal structure.  I don't know if you mentioned that in your question.  That's an important part of how we assess the credit, is going to be what's the cost of the vehicle, what's the down payment, is there a trade-in?  All of the deal structure is going to be an important component that we're going to assess.  It would seem to me relevant that, if a guy's in the military, that he's going be leaving the military within "X" amount of time, or has he been -- What's the duration that he's been in the military, which may have something to do with rank?  Has he been in the military for three months?  Has he been in the military for three years?  Is he going to be there for some period of time?  He's locked into a term.  I mean, there are other factors that would go into that assessment.  Beyond that, I can't be more specific.

>> Male Speaker: I was just wondering if there's anything other than what's known at the time that that military consumer is in the finance office that needs to be chased down later.  What else would need to be chased down later?

>> Andrew D. Koblenz: Some of his past credit experiences. There might be some issues, factual issues, relative. Did he have two bankruptcies, one bankruptcy, zero bankruptcies? There are other variables in the credit application that may have to be --

>> Male Speaker: All that information is on the consumer reporting data, though. Other than the consumer reporting data, for the military consumer, what needs to be chased down later? Why can't you deliver a funding decision at that time to the military consumer?

>> Chris Choate: Well, again, the funding decision at that moment in time is for the dealer to deliver. The funding source is going to have these other attributes that they are going look at, such as prior credit history, deal structure. There are a number of other things that really aren't that dramatically different than any other consumer. Again, in the military, we know this guy is stationed -- man or female is stationed -- at a particular base. We know they have pretty good stability where they're going to be, at least with that vehicle initially, but I don't know that there's anything dramatically that much different from underwriting the loan.

>> Jim Chen: Okay. Thank you very much to our panel. We went over a little bit, but we'll have a short break, and if we could reconvene at 10:00 a.m. Thank you.

>> Chris Choate: Thanks very much. You did a great job.

>> Jim Chen: Thank you.

>> Thomas Durkin: [ Speaking indistinctly ]

>> Delvin Davis: No, I appreciate it. [ Speaking indistinctly ]

>> Thomas Durkin: I hope you didn't feel offended.

>> Delvin Davis: Thank you. Appreciate it. Give you my card. [ Indistinct conversations ]