Consumer Finance 2022 Policy Outlook

Underappreciated risks and opportunities the industry will face this year

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CAPSTONE

The CFPB's Looming Regulation Ramp-up

2022 will be an inflection point for federal regulation of consumer finance companies, with large companies in the CFPB's crosshairs.

- Consumer Financial Protection Bureau Director Rohit Chopra will accelerate enforcement & rulemaking after 2021 was marked as the year the CFPB took the least action since 2018.
- Regulators will focus on equitable treatment by scrutinizing credit reporting practices, loan underwriting, and companies with significant market power.

Major Themes

Large Companies Move into CFPB's Crosshairs

Credit Reporting Agencies

Director Chopra has made clear that he will focus on the largest industry operators, especially repeat offenders, and will seek significant financial penalties to serve as a greater deterrent to illegal activity. We believe credit reporting fits squarely within his priorities at the CFPB. The industry is highly concentrated with three national credit reporting agencies (CRAs)—TransUnion (TRU), Equifax Inc. (EFX), Experian Plc (EXPN on the London exchange)—and two model developers—Fair Isaac Corp. (FICO), which is dominant, particularly in the housing market, and VantageScore, which is owned through a joint venture of the CRAs.

Credit reporting is a target of the bureau's data-driven approach as well. It annually generates the highest number of consumer complaints, including in 2021 when it accounted for more than 4x as many complaints as the next category, debt collection. Credit reporting also stands as the gatekeeper for consumer access to credit and housing, where the bureau is pursuing more equitable outcomes.

Director Chopra raised concerns with credit reporting during his time as a Federal Trade Commission (FTC) commissioner. He stated that action from the CRAs may be required to fix "debt parking," or the practice of placing fake or questionable debts onto consumer credit reports to force payments, and suggested that agencies refuse to work with furnishers with unusually high deletion rates. He also said, "The CFPB can address this problem by using its authority to define unfair, deceptive, and abusive practices by credit reporting agencies."

Capstone believes, given Director Chopra's prior comments and his focus on large operators in highly concentrated industries, CRAs will be held responsible for credit reporting errors and illegal actions by creditors and other information furnishers. We believe this could result in guidance that increases the burden on CRAs to verify information is accurate and detect illegal practices or force changes to how they respond to consumer disputes.

Large Companies Holding Consumer Data

Similarly, Chopra has expressed concern with how large technology firms collect/use consumer data, restrict product access or limit consumer choice, and protect consumers from fraud while treating each equally. In comments submitted to the CFPB

related to the large technology companies, consumer advocates noted that peer-to-peer (P2P) payment systems do not protect consumers from fraudulent transactions, or correct human or technical errors (such as entering the wrong phone number or email address). They called for clarity from the CFPB on payment providers' responsibility under the Electronic Funds Transfer Act (EFTA) for investigating and resolving consumer disputes.

In its Fall 2021 Supervisory Highlights, the CFPB found that institutions failed to conduct reasonable investigations in response to error notices from consumers who attempted to send P2P funds that were not received by the intended recipients. The bureau found the institutions reviewed only whether the transactions were processed in accordance with the sender's instructions and not whether the transfer went to an unintended recipient due to a token error.

Large Financial Institutions

Additionally, we believe large institutions will be scrutinized for bank overdraft charges, an issue that has been at the top of consumer advocate priority lists for years. In his statement alongside the CFPB's Overdraft Press Call in December 2021, Director Chopra said the bureau will "take action against large financial institutions whose overdraft practices violate the law" and "prioritize examinations of banks that are heavily reliant on overdraft."

We believe this signals risks for banks that are highly exposed to overdraft fees including Toronto-Dominion Bank (TD, 15.4% of net income), BancFirst Corp. (BANF, 12.6% of net income), Regions Financial Corp. (RF, 10.2% of net income) and Trustmark (TRMK, 10.1% of net income), and, to a lesser extent, banks that generate the most total income from overdraft, including Wells Fargo & Co. (WFC, $1.0B in overdraft fees), JPMorgan Chase & Co. (JPM, $924M in overdraft fees), Bank of America Corp. (BAC, $823M in overdraft fees), and again TD Bank ($347M in overdraft fees).

The CFPB is likely to address overdraft fees through rulemaking, even as financial institutions "self-regulate" more and move away from the fees, including a highly publicized December 1st announcement by Capital One Financial Corp. (COF) that it was eliminating overdraft charges—news that consumer advocates celebrated.

Scrutiny of large operators provides opportunities for smaller, innovative companies.

We believe the scrutiny of large operators provides opportunities for smaller, innovative companies that could challenge dominant market participants, although these companies tend to face regulatory risk from moving quickly and historically flaunting regulatory requirements.

For example, although some Democratic lawmakers criticized them, we believe companies such as Upstart Holdings Inc. (UPST), which received an updated no-action letter from the CFPB in November 2020, could present ways to reassess creditworthiness, although we are cautious on "black-box" algorithms fueled by artificial intelligence.

Similarly, we think regulators and consumer advocates could view financial institutions that present alternatives to overdraft—such as Varo and Chime or solutions such as Brigit Inc. and OportunPath from Oportun Financial Corp. (OPRT)—favorably with appropriate controls.

Increased Focus on an Equitable Recovery from the COVID-19 Pandemic

When he was appointed acting director in January 2021, Dave Uejio listed two CFPB priorities: racial equity and recovering from the COVID-19 pandemic. These concerns have carried over to Rohit Chopra, who combined the two in a cross-bureau priority titled "equitable recovery from the COVID-19 pandemic" in the Draft Strategic Plan for Fiscal Years 2022–2026.

CFPB concerns related to pandemic policies were evident in the bureau's Fall 2021 Supervisory Highlights. Among the findings, examiners noted that mortgage servicers charged delinquency-related fees to borrowers who should have been exempt based on forbearance provisions in the Coronavirus Aid, Relief, and Economic Security (CARES) Act and failed to evaluate loss mitigation applications submitted within the required 30 days while payday lenders misled customers and erroneously debited accounts that were provided loan extensions.

The findings corroborated the bureau's COVID-19 Prioritized Assessments Supervisory Highlights in January 2021 that found widespread issues where supervised entities struggled to adjust to sudden changes from the pandemic and faced significant backlogs with accommodating requests or provided inaccurate information, typically due to a combination of increased requests and staffing shortages.

Comments from CFPB leadership indicate that mortgage servicing, which the bureau formally prioritized in a memo from February 2021, will be the top concern for the pandemic recovery. Regulatory pressure will force servicers to remain cautious in pursuing foreclosures, resulting in a gradual increase (which will be further limited by broad-based home price appreciation) when the CFPB's procedural safeguards expire at the end of 2021.

Conversely, we believe regulators and consumer advocates viewed the pandemic response from certain industries favorably, relieving some regulatory concerns. While not subject to any federal requirements, most auto lenders provided voluntary accommodations to borrowers, and we believe the industry flexibility and sharp drop in delinquencies and repossessions have alleviated some concern that the CFPB would follow the trend set by many state attorneys general and allege that auto loans with a high likelihood of default are inherently unfair, although the bureau is currently investigating Credit Acceptance Corp. (CACC) and the scope of the investigation is unclear.

Likewise, we believe the large debt buyers adopted conservative business practices during the pandemic, including suspending legal collections. The companies, which are subject to the CFPB's new rules as of November 2021, benefited from high collection rates fueled by consumer stimulus, which allowed for a less aggressive approach.

Consumer Finance Opportunities in 2022

Low-Cost Consumer Lenders Benefit from Reduced Stimulus

Capstone believes low-cost consumer lenders are well-positioned against regulatory scrutiny in 2022. While our discussions indicate a decreasing likelihood the CFPB will choose to undertake rulemaking for the small dollar lending rule (which would be the third iteration), we believe the CFPB will increasingly scrutinize the payday and high-cost lending industries, which many consumer advocates believe should not exist.

However, we believe regulators will draw a sharp distinction between these lenders and

lower-cost alternatives from firms such as OneMain Holdings Inc. (OMF).

Capstone's Call at a Glance:
Small Dollar Lending Rule

We assign a 40% probability that Director Chopra will order a review of the CFPB's small dollar lending law by March 31st and a 5% probability that a new rule will go into effect during President Biden's first term.

If the law is rewritten and goes into effect, we expect it will largely eliminate the traditional payday lending industry, forcing companies to pivot to longer-term installment loans.

*Capstone's predictions are informed by rigorously examining historical occurrences and current conditions while rooting out cognitive biases systematically. We update our probabilities often to reflect the latest information. Read more here.

It is possible the CFPB will designate larger non-bank installment lenders for supervision, which we believe the bureau has considered in the past, although it is not a high priority given the lower concern about this segment. If designated, the companies would be subject to examinations by the CFPB, which may result in a modest increase in compliance costs, although we believe the larger operators already have robust compliance management systems given the existing risk of bureau and state enforcement.

Furthermore, we believe waning federal stimulus will likely drive demand for small dollar loan originations. Federal programs in 2020 and 2021, especially direct checks through three rounds of Economic Income Payments and enhanced unemployment insurance, represented significant headwinds for loan originations.

In 2020, OneMain's total loan originations declined 23% y/y while through the first three quarters of 2021, originations were up 33% y/y, but still down 2% compared to 2019. Q3 2020 represented the first quarter of growth relative to 2019, at 5.4%. Even applying a conservative 6% growth rate to 2019 originations would result in more than 8% y/y growth in originations in 2022, and more than 44% growth compared to 2020.

We expect the proposed stimulus programs—most notably the potential extension of the advanced Child Tax Credit (CTC) through the Build Back Better Act—would be adequate to support loan performance and not severely limit loan demand. Any further delays or limitations on the advance CTC payments, which now will not be paid until February 2022 at the earliest and is at risk of not being extended at all, would generate further tailwinds for loan originations. Through the first three quarters of 2021, OneMain reported an average of 3.4% of accounts were delinquent by more than 30 days compared to an average of 3.9% in 2020 and 4.2% in 2019. While the delinquency rate is likely to increase in 2022, following the trend of deeper subprime lenders in 2021, we expect it to remain below 4%, maintaining tailwinds for lenders.

Large Debt Buyers Well-Positioned for New Debt Collection Rules

We believe debt buyers will benefit from the decrease in federal stimulus in 2022 relative to 2021, similar to originators of unsecured loans. In a conference call alongside its Q3 earnings report, Encore Capital Group Inc. (ECPG) said it sees Q3 purchases as the bottom of the cycle as credit card balances were rising alongside total consumer spending volume. Through the first three quarters of 2021, Encore reported $481 million in portfolio purchases, down 7.2% y/y and down 36.5% compared to 2019. Similarly, PRA Group Inc (PRAA) reported $384 million in portfolio purchases in the US and Australia through the first three quarters of 2021, down 7.8% y/y and 31.4% compared to 2019.

We also view the large, publicly listed companies as well-positioned for increased regulatory scrutiny from the CFPB. The

bureau's debt collection rules went into effect on November 30, 2021, and impose new requirements on market participants, including limitations on the number of call attempts and new disclosure forms. Encore and PRA were both subject to many of these provisions due to prior consent agreements with the CFPB. These companies have sophisticated compliance management programs, which we believe makes them attractive partners to creditors that are likely to be increasingly concerned with regulatory intervention.

The companies' robust compliance practices also should translate to more effective state practices. California passed its Debt Collection Licensing Act in September 2020, which for the first time requires debt collectors to be licensed with the state's Department of Financial Protection and Innovation (DFPI) by the end of 2021. The law also subjects debt collectors to examination by the DFPI. Similarly, New York recently passed legislation amending the state's approved disclosures that are delivered to debtors. We believe large companies are most able to monitor and adapt their business practices to changing state requirements.

The debt collection space is not without risk, however. We expect the CFPB will aggressively enforce the new rules, with a primary emphasis on the phone call limitations and ensuring the increased use of electronic messaging is done in a manner that is not an unfair, deceptive, or abusive act or practice (UDAAP). Given Director Chopra's prioritization of large operators and repeat offenders, PRA and Encore could be further scrutinized.

Additionally, as the CFPB is likely to focus on markets that receive the most consumer complaints, the debt collection industry could be a priority (debt collection is the second most common complaint category) and for its role in credit reporting (the most common complaint). Even so, we believe the opportunities for the larger participants, under industry-friendly rules, outweigh the risks.

Consumer Finance Risks in 2022

Increased Scrutiny of 'Digital Redlining'

We expect the CFPB to prioritize racial equity in fulfilling its mission in 2022. In the bureau's draft strategic plan, released in December 2021, it acknowledged that it frequently referenced the concept of equity and added, "we will embed a racial equity lens and focus our attention on these communities, recognizing that work to protect and empower underserved people benefits all people."

Commenting on a joint enforcement action with the Department of Justice (DOJ) and Office of the Comptroller of the Currency (OCC) in October, Chopra highlighted disparate home ownership rates and pledged that "at the CFPB, we will also be closely watching for digital redlining, disguised through so-called neutral algorithms, that may reinforce the biases that have long existed." Chopra has been critical of "black box" algorithms that academic research has found could reinforce historical areas of bias, by including data such as education background, sources of credit, or more overt concerns such as ZIP codes.

We expect the CFPB's focus on racial equity to manifest in several ways, covering the full ecosystem of consumer lending. We anticipate a focus on underwriting practices and credit approval, as well as any discrepancies in when furnishers choose to report negative information to the CRAs. Additionally, we think the CFPB could renew its scrutiny of dealer markups and inconsistent pricing practices in the auto market, which it must address through auto lenders, as it does not have oversight over most dealers. Finally, similar concerns could extend to the debt collection and repossession markets where the CFPB is

likely to review different approaches or outcomes between racial demographics.

In its Fall 2021 Supervisory Highlights, the CFPB found mortgage lenders violated the Equal Credit Opportunity Act (ECOA) when it found statistically significant differences in the application of pricing exceptions for African American and female mortgage applicants. We believe the housing market, where applicants disclose their race due to the Home Mortgage Disclosure Act (HMDA), provides data that makes it easier for the bureau to identify and scrutinize potentially discriminatory practices.

State Regulators Leverage CFPB to Take More Assertive Approach

States have taken a more assertive approach to consumer protection in the past five years, primarily to offset what they viewed as a less aggressive approach by the CFPB under the Trump administration. As the CFPB realigns with priorities from Democrat-led states, we believe these states will partner with the bureau, rather than ceding oversight responsibility to the federal government.

In comments to the National Association of Attorneys General in December, Director Chopra encouraged state attorneys general (AGs) to enforce federal law, particularly when it provides greater protection than state statutes. He also indicated that the bureau is considering ways to allow states access to the CFPB's Civil Penalty Fund, which had a balance of $476 million as of September 30, 2021, in cases where the CFPB does not formally join the lawsuit.

State AGs have been active in consumer finance issues such as subprime auto lenders, which led to settlements by Santander Consumer USA Holdings Inc. (SC) with the Massachusetts and Delaware AGs and a 34-state consortium. Similarly, Credit Acceptance settled suits with Massachusetts and Mississippi, in addition to ongoing, disclosed investigations by the New York AG and a 40+ state consortium led by the Maryland AG, as well as civil investigative demands (CIDs) from the CFPB as recently as June 2021.

Capstone's Call at a Glance: Rent-To-Own
We assign a 40% probability that regulators will take enforcement action against virtual rent-to-own offerings by the end of January 2023. We assign a 70% probability that state attorneys general will file charges or agree to a settlement with Acima, which is owned by Rent-A-Center Inc. (RCII), by the end of 2024. We assign a 5% probability of enforcement action for traditional retail RTO companies by the end of January 2023. Regulator attention will likely slow virtual RTO growth, a key factor for providers carrying a higher valuation than traditional RTO companies. Additionally, negative product attention could lead to reputational damage, resulting in the termination of partnerships or difficulty obtaining new partnerships.

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More recently, in November, Rent-A-Center Inc. (RCII) disclosed that it received a letter from the Nebraska AG, representing 38 other states, initiating a multistate investigation into Acima, the company's virtual rent-to-own (VRTO) business arm. We believe VRTO presents consumer risks not captured in state laws focused on traditional rent-to-own (RTO) operations. However, the business is generally exempt from CFPB oversight, which excludes short-term leases, leaving states and the FTC with primary regulatory jurisdiction.

We also believe states could become more proactive in scrutinizing new financial

offerings. For example, in 2020, California settled charges that buy now, pay later (BNPL) firms Sezzle Inc. and Afterpay operated as lenders without a license. These settlements pushed many BNPL firms to approach their products as loans, rather than retail installment sales. We believe states could scrutinize other forms of financing that are similar to loans, but may be marketed as alternatives to credit, including VRTO, earned wage access, overdraft alternatives, income share agreements, and short-term sources of liquidity with optional fees. If defined as credit, these products may be subject to licensing, certain disclosures, and state interest rate limits.

Key Questions We're Asking in 2022

Will CFPB Director Shun 'Regulation by Enforcement?'

In his confirmation hearing before the Senate Banking Committee, and subsequent testimony to Congress, Republicans regularly pressed Chopra to disavow "regulation by enforcement," or the use of enforcement actions to establish *de facto* industry rules without the more time-consuming and formal processes of regulatory guidance or rulemaking. Financial services industry groups have raised the issue. including a whitepaper from the Consumer Bankers Association. In response to congressional questions, Director Chopra indicated that the bureau would focus on "making it clear to market participants what's expected of them."

While his exact path is unclear at this time, we expect his enforcement approach will fall well short of the hopes of both the financial services industry and Republicans. We believe the bureau will use its broad UDAAP authority to establish industry compliance standards, particularly for issues on racial equity and areas such as payday lending, where rulemaking faces significant challenges, and the bureau has already released two prior rules that are entangled in litigation.

If Director Chopra avoids regulation by enforcement, we believe it would be positive for areas that are unlikely to see rulemaking, such as the politically powerful auto lending industry. While we do not see it as an immediate priority, we believe the CFPB could adopt state AG arguments that subprime auto loans with a high probability of default are inherently a UDAAP. We believe such an approach will likely play out only through enforcement, especially within any meaningful time frame.

Will Republicans Gain Control of Congress in 2022 Midterm Elections?

Democrats have been able to leverage narrow control of the House and Senate in 2021 to pass legislation through reconciliation and confirm most of President Biden's regulatory nominees relatively smoothly. However, the party of the sitting president has historically fared poorly during midterm elections. According to Gallup's polling history, presidents with an approval rating below 50%—which President Biden has averaged below since mid-August, according to FiveThirtyEight—have seen their party lose an average of 37 House seats during midterm elections. Republicans only need to net five seats to gain control of the House, given the current 221 (D) to 213 (R) makeup and net 1 Senate seat to split the 50–50 deadlock, though gaining the 60-vote majority needed to overcome the filibuster would be a much steeper feat.

While the current close margin in Congress has limited President Biden's ability to execute his agenda, Republican control of either, or both, chambers would further eliminate the ability to move Democratic legislative priorities. This would remove the Democrats' ability to rely on the reconciliation

process, which has been utilized to provide significant consumer stimulus through the American Rescue Plan (stimulus checks, enhanced federal unemployment insurance, and advance child tax credit) and the planned Build Back Better Act (proposals for extending the advance child tax credit, paid leave, and universal childcare). We currently believe legislation related to progressive consumer finance priorities is unlikely to pass, given a bloc of moderate Democrats and filibuster requirements, but Republican control would eliminate the already slim chance of passage for these bills, such as the Veterans and Consumers Fair Credit Act (H.R. 5974/S. 2508), which proposes expanding the Military Lending Act's 36% interest rate cap to all consumers.

Senate control will be particularly important for confirming any outstanding nominations, as well as replacing vacancies that arise after 2022. Notably, Jelena McWilliams' term as Federal Deposit Insurance Corporation (FDIC) chair expires in June 2023, and since her replacement would have to be confirmed by the Senate, Republican control of the chamber would significantly limit the ability of President Biden to appoint anyone other than a moderate to fill the role. Moderate leadership at the FDIC would reduce the likelihood of significant changes to the bank partnership models that many small dollar lenders rely on in states with strict interest rate limits.

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