Height Research Report

31 MAY 2018

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Payday Lending

Welcome to the Golden Age of Payday Lending

THE TAKEAWAY

Despite the best efforts of former Consumer Financial Protection Bureau (CFPB) Director Richard Cordray to eliminate the payday lending industry, the business is not only alive and kicking but it is getting newfound support from the Office of the Comptroller of the Currency (OCC), National Credit Union Administration (NCUA), and CFPB Acting Director Mick Mulvaney. The regulators are taking actions that are positive for the payday and auto title lending industries as Congress' effort to overturn the CFPB's payday lending rule lacks sufficient Senate Republican support. (See our May 8 report for additional detail.) The CFPB is expected to publish its revised payday lending rule in February 2019. Payday lenders, including Enova (ENVA) and FirstCash (FCFS), will benefit from a revised or new payday rule. It is possible, but not our probable outcome, that CFPB will rescind the payday lending rule in its entirety.

"And in the master's chambers, They gathered for the feast. They stab it with their steely knives, But they just can't kill the beast."

- Hotel California by the Eagles

Conclusion. The OCC and NCUA want their supervised financial institutions to offer short-term, small dollar installment loans (STSDL) to borrowers. The regulators' actions on STSDLs represent a significant change from prior actions, which resulted in most banks exiting deposit advance loan products. Credit unions were able to offer payday alternative loans (PALs I). These actions follow the CFPB's announcement that it intends to reopen the payday lending rule for comment and revisions.

Congressional disapproval of the CFPB's payday lending rule now appears unlikely. This means that any changes to the rule will be initiated by the CFPB, a process Acting Director Mick Mulvaney announced in January. This will be a formal rulemaking process that will begin with a proposed rule, allow for a public comment period, and result in a revised final rule. The agency is scheduled to release a proposal in February 2019.

OCC payday lending bulletin. The May 23, 2018 OCC Bulletin "encourages banks to offer responsible short-term, small-dollar installment loans, typically two to 12 months in duration with equal amortizing payments, to help meet the credit needs of consumers." The bulletin includes core lending principles that national banks should

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employ when offering short-term, small-dollar installment loans. The key element included in the guidance is the concept of installment loans. The core lending principles include:

- STSDL products should be consistent with safe and sound banking practices;
- Banks should effectively manage the risks associated with STSDLs; and
- STSDLs should be underwritten using reasonable policies and practices that cover amounts borrowed, borrowing frequency, and repayment requirements.

Reasonable policies and practices include loan amounts and repayment terms based on eligibility and underwriting requirements. These policies should ensure that loan pricing conforms with state laws and generates returns based on the risks and costs associated with STSDLs (i.e. no price gouging). An institution's underwriting policy should analyze internal and external data to determine creditworthiness and manage credit risk. Product disclosures must comply with consumer protection laws and provide transparent and accurate information. Loan servicing processes should assist customers, including distressed borrowers, to avoid a continuous cycle of indebtedness and costs that are disproportionate to the amount borrowed. Banks will also report borrowers' repayment histories to credit reporting bureaus.

This bulletin provides further clarification to all national banks supervised by the OCC following the rescission of the agency's guidance for deposit advance products.

NCUA proposed rule expanding payday lending products. The NCUA proposal offers an alternative option, with different terms and conditions that credit unions (CU) can offer in addition to the payday alternative loan (PALs I). The alternative loans are labeled PALs II. The proposal modifies the minimum and maximum loan amounts and the number of loans made to a borrower in a rolling six-month period. It also permits CUs to make the loans available to borrowers that are not members of the CU and increases the maximum maturity for the loans.

The PALs II product incorporates many features of PALs I products. These features include an interest rate that is 1,000 basis points above the NCUA's established interest ceiling, a closed-end loan, and an application fee capped at $20. The PALs II loans cannot be rolled over, but the loan maturity can be extended to a maximum of 12 months. CUs cannot charge any fees for extending the maturity and may not extend additional credit. The loans must fully amortize over the term. PALs II loans are capped at 20% of a CU's net worth and CUs must implement appropriate underwriting guidelines.

Features that are unique to the PALs II product include a maximum loan amount of $2,000 versus $1,000 for PALs I and no minimum loan amount versus a $200 minimum for PALs I. The maximum loan term is 12 months versus six months for PALs I. The minimum term is one month, which is the same for PALs I. PALs II products do not require a minimum length of membership versus the one-month minimum membership requirement for the PALs I product. There is no limit on the number of PALs II loans that a CU can make to a borrower in a rolling six-month period; however, there can only be one loan outstanding to the borrower at any given time. This will allow CU's to extend an unlimited number of PALs II loans to borrowers with higher or lower loan amounts, but it prevents the CU from extending multiple concurrent PALs II loans to a single borrower. The NCUA is proposing these additional features to encourage more CUs to offer PALs II products.

CFPB plans to review the payday rule. In January, the CFPB announced that it "intends to engage in a rulemaking process so that the Bureau may reconsider the Payday Rule." This is the only avenue available to alter the rule materially given it appears unlikely that Congress will be able to disapprove the rule. According to the CFPB's 2018 Spring Agenda, the agency plans to issue a revised payday lending proposed rule in February 2019. We expect the CFPB's effort to revise the payday lending regulations will expand the limitation on rollovers to 10-12 rollovers, up from the current limit of two. We also expect the CFPB will make the ability-to-repay (ATR)

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requirement less restrictive. Based on the OCC and NCUA press releases, it is likely that the CFPB proposal will include STSDLs. *For our detailed outlook on a revised payday lending rule, please see our February 9 report.*

A revised rule would be positive for ENVA. In 2016, ENVA provided a business update based on the CFPB's proposed payday lending rule. ENVA stated that 60-65% of its revenues would be affected by the proposal due to the limitations on rollovers and the cooling-off period. The rule would result in a 30-40% decline in affected revenues or 18-26% of ENVA's total revenue. This was in line with our estimate of 22% of revenues. ENVA expected an outsized effect on its single pay product, which represented less than 9% of its loan portfolio. In our view, single pay loans as a percent of total loans is not a significant measure to determine the impact on ENVA's results. Management guidance indicated total revenues will decline by 18-26%. The larger effect on revenues reflects the short duration of the single pay product as well as the higher gross margin contribution. ENVA ran many simulations to assess the impact of the rule, and the results showed material differences in the products affected; however, management did not provide guidance regarding the effect on each product. The company did note that single pay will be the most affected product.

A revised rule allowing more rollovers, expanding the ATR, and reducing or eliminating cooling-off periods would benefit ENVA as it would be able to continue offering its single pay product. We are not changing our outlook for the CFPB payday lending rule revision at present, but we acknowledge the CFPB's revised rule may focus solely on STSDLs that are closed-end installment loans based on the releases from the OCC and NCUA.

The regulatory environment is becoming payday friendly. The OCC, NCUA, and CFPB are taking a lighter regulatory approach to STSDL products. This approach follows actions by the CFPB that benefited payday lenders. Earlier this year, the CFPB decided not to sue National Credit Adjusters, a payday loan collector, and considered whether to drop other actions against three payday lenders: Security Finance, Cash Express LLC, and Triton Management Group. This came among other examples of softening by the agency, which included dropping its investigation into World Acceptance Corp (**WRLD**) and lawsuits against four tribal payday lenders (Golden Valley Lending, Silver Cloud Financial, Mountain Summit Financial, and Majestic Lake Financial).

For more information on the CFPB's initiatives for the payday lending rule, please see our January 24 and January 17 reports.

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COMPANIES MENTIONED IN THIS REPORT

Enova International Inc (ENVA), World Acceptance Corp (S.C.) (WRLD), First Cash Financial Services Inc (FCFS)

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