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Hot Topics in Auto Finance

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April 2018

Consumer Finance

MONTHLY BREAKFAST BRIEFING

Overview of Regulatory Issues in Auto Finance



- Recent Developments:
 - Efforts to repeal CFPB Bulletin 2013-02
 - CFPB settlement with Wells Fargo (force-placed auto insurance)
 - Will states take the lead on enforcement?
 - Mulvaney: CFPB will look to states to collaborate on enforcement
 - Creation of mini-CFPBs in select states
 - Coalition of state attorneys general
 - Indications that certain states support a more restrained approach to enforcement

Auto Finance Regulation: Change Is Here



- The prior administration expressed concerns regarding auto loan performance:
 - Richard Cordray – December 2016: “Recent reports have...found that one-in-five auto title borrowers lose their vehicles because they cannot meet the mounting payments.”
- The new administration has indicated a desire to roll back aggressive enforcement and administrative guidance impacting the auto finance market
 - Mick Mulvaney – January 2018: “The days of aggressively ‘pushing the envelope’ are over.”
 - Patrick Toomey – April 2018: “[CFPB Bulletin 2013-02 is] an ill-conceived rulemaking. Any guidance, in fact any rule-making, ultimately, should be subject to congressional review.”
 - Jeb Hensarling – April 2018: In regards to CFPB Bulletin 2013-02, “I look forward to finally repealing this harmful and flawed bulletin very soon.”

Massachusetts “Negative Equity” Loans



- New Massachusetts interpretive letter
- Requires small loan license for Massachusetts retail installment sale contracts if:
 - Lender makes or acquires loans in which trade-ins have “negative equity” and
 - Interest rate exceeds 12%
- Applies even if lender has a Mass. Sales Finance Company License
- Would also apply to securitization SPEs that acquire auto loans
- Not all finance companies can filter “negative equity” loans
- Nobody is getting licenses for securitization SPEs
- Solution: Filter out Mass. loans over 12%

LSTA Risk Retention Case



- Risk retention rules require ABS sponsors to retain 5% of the credit risk
- Definition of “Sponsor”:
 - A person who organizes and initiates a securitization transaction by **transferring assets** to the issuing entity.
- In Open Market CLOs, loans and securities are acquired directly by the issuing entity
- Feb. 9 USCA DC Circuit decision held that the Risk Retention Rules don’t apply to collateral managers in Open Market CLOs
 - No Transfer
 - “Retain,” not “obtain”

Potential Application of LSTA Case to Auto Loans



- Auto loans are typically acquired from dealers
- What if the auto loans are purchased directly by the issuing entity?
 - No “transfer” by the finance company
 - “Retain,” not “obtain”
- Some potential bad facts:
 - Finance company makes the credit decision on the loans
 - Finance company selects the assets to be securitized
 - Finance company hires the bankers, lawyers, trustees and rating agencies in the ABS deal
 - Finance company acts as servicer
 - Finance company typically gets all of the excess cash flows
- Clients must understand the very real risks that regulators might not like it and might not agree that RR does not apply.

Recent Developments: Expected Repeal of CFPB Guidance



- CFPB Bulletin 2013-02
 - Guidance for indirect auto lender compliance with fair lending requirements of Equal Credit Opportunity Act and Regulation B
 - Indirect Auto Lenders: Provide dealers ability to charge consumers more in interest and compensate dealers with a percentage of that increased interest rate in return
 - CFPB: Concern that this discretion will lead to racial disparities in interest rates for similarly situated borrowers
 - Guidance: Indirect auto lending is participation in a credit decision under ECOA/Regulation B
 - As a result of ECOA/Regulation B coverage, lenders are subject to disparate impact claims
 - Disparate impact where facially neutral policy leads to a disproportionate, adverse impact on protected group
 - Defendant can rebut claim by demonstrating that the challenged policy or practice serves a legitimate business need
 - Plaintiff can still prevail by showing less discriminatory alternative policy/practice
 - On this theory, indirect auto lenders liable for dealer practices that cause discriminatory impact on minority consumers
 - Bulletin 2013-02 is administrative guidance, but the CFPB has still enforced it as if it is a “rule” passed using Administrative Procedures Act process
 - GAO B-329129: CFPB Bulletin 2013-02 is a “rule” subject to Congressional review
 - Republicans: Bulletin 2013-02 should have been subject to notice and comment requirements

Recent Developments: Expected Repeal of CFPB Guidance



- Repeal Efforts
 - Repeal largely championed by trade associations
 - American Financial Services Association: “[Repeal] is in the best interests of the car-buying public.”
 - Consumer Bankers Association: “The CFPB’s 2013 Auto Bulletin was a backdoor attempt at rulemaking without notice or comment and lacked the clarity needed by lenders.”
 - Senate voted to repeal Bulletin 2013-02 on April 18th
 - House of Representatives expected to take up repeal during the week of May 7th
 - Widely expected to pass the House and be signed by President Trump

Effect of Tax Reform on Leasing Companies



- Limits on the deductibility of net interest expense in Section 163(j) under the recently passed Tax Reform Act
- Net interest expense is the amount by which interest expense exceeds interest income.
 - For a normal finance company, interest income would be expected to exceed interest expense, so every penny of interest expense would be fully deductible.
 - Leasing companies have rental income rather than interest income, so every penny of interest expense counts toward the limit.
- EBIT becomes EBITDA in three years.

Recent Developments: Wells Fargo Enforcement Action



- CFPB alleged that Wells Fargo force-placing collateral-protection insurance (Force-Placed Insurance, as defined below) on consumers' vehicles for auto loans that it originated or acquired, among other offenses.
 - Where auto used as security for a loan, Wells Fargo usually required borrower to maintain insurance to protect this security interest
 - Wells Fargo engaged a vendor to determine whether borrowers maintained this insurance and communicate with borrowers before force-placing auto insurance
 - As a result of errors in this process, Wells Fargo allegedly force-placed duplicative or unnecessary insurance on thousands of borrowers' auto loans
 - In some cases, Wells Fargo allegedly maintained this insurance on borrowers' accounts even after they obtained required insurance coverage from a third party
 - Deficiencies were allegedly due to insufficient oversight of vendor's implementation of Wells Fargo's policies and practices.
 - Wells Fargo allegedly received sufficient data from its vendor but did not have strong enough controls in place for monitoring and responding to that data

Recent Developments: Wells Fargo Enforcement Action



- Legal claim: unfair practice
 - Unfair act or practice: causes or is likely to cause (1) substantial injury to consumers that (2) is not reasonably avoidable and (3) is not outweighed by countervailing benefits to (a) consumers or (b) competition
- CFPB: Wells Fargo’s conduct caused or was likely to cause substantial injuries to consumers because it required them to pay for insurance premiums and interest that they should not have owed, to incur fees, and, in some instances, to be subject to defaults on their auto loans and repossession of their vehicles
 - Injuries were not reasonably avoidable by consumers and were not outweighed by countervailing benefits to consumers or to competition

Financing of Retained Interests



- Increased interest of sponsors in financing retained interests, particularly frequent issuers as the number of unfinanced retained interests continues to grow.
- Most difficult issue: Reconciling “recourse” requirement for sponsor or a majority-owned affiliate (MOA) with the need for a bankruptcy-remote structure for credit reasons.
 - Is borrower required to have any assets that arise outside the underlying securitization?
 - Different law firms have resolved this question in a variety of more or less conservative ways.

Titling Trusts and Collateral Agency



- Transfers of Ordinary Receivables: Bill of Sale
- Transfer of Autos (i.e., Residual Values) Requires Retitling
 - Endorse Titles
 - Application for New Title
 - Retitling Fees
 - Sales Tax
 - Odometer Readings
 - Emissions Testing
- Titling Trust Avoids the Retitling Burden and Expense

Titling Trusts and Collateral Agency



- Titling Trust will hold Vehicles and Leases
- Trust Will Issue Beneficial Interests
 - Undivided trust interest (“UTI”)
 - Special units of beneficial interest (“SUBI”)
- Trust Will Acquire Vehicles (and Leases) Directly
 - Trust will be the lessor for fleet leases
- Sponsor will be Servicer
- Works in All 50 States
- Relatively Simple, Efficient and Inexpensive
- Titling Trusts also are best solution for Syndications

Collateral Agency



- Collateral Agency arrangements increasingly common
- Reasons for liens on certificates of title:
 - Pension Plans: Risk of ERISA/PBGC liens
 - Lenders often want liens on vehicles, not just on SUBI
- SPE Collateral Agent
 - Owned by independent service company
 - Under master collateral agency agreement, collateral agent holds liens on specified assets for specified creditors
 - Sponsor manages Collateral Agent
 - Manager can be replaced for particular assets upon certain events (e.g., default)
 - No need to change lienholder when refinancing with different parties

Auto Finance: Representative Federal Cases



Company	Date	Agency	Restitution	Penalty	Alleged Violation
Wells Fargo	4/20/2018	CFPB, OCC	n/a	1 B	Administered a mandatory insurance program related to its auto loans that resulted in borrowers paying thousands of dollars for unnecessary insurance.
California Auto Finance (complaint filed)	3/28/2018	DOJ, California	n/a	n/a	Lender violated SCRA by repossessing a servicemember's car on her first day of military service after she failed to make payments.
BMW Financial Services	2/22/2018	DOJ	2 M	n/a	Company violated SCRA by failing to refund portions of up-front lease payments made by servicemembers who terminated their leases early due to military obligations.
CarMax (complaint filed)	3/22/2017	FTC	n/a	n/a	Alleged misrepresentations in advertisements regarding rigor of pre-sale inspections without disclosing that cars may be subject to open recalls at time of sale.
Asbury Automotive, Coggin Automotive, Crown Automotive (complaint filed)	12/14/2016	FTC	n/a	n/a	Alleged misrepresentations in advertisements regarding rigor of pre-sale inspections without disclosing that cars may be subject to open recalls at time of sale.
General Motors (complaint filed)	12/8/2016	FTC	n/a	n/a	Alleged misrepresentations in advertisements regarding rigor of pre-sale inspections without disclosing that cars may be subject to open recalls at time of sale.
Toyota Motor Credit Corp.	2/2/2016	CFPB, DOJ	21.9 M	n/a	African-American, Asian-American, and Pacific Islander borrowers paid more for auto credit without regard to their creditworthiness due to discretionary interest pricing policies.
Herbies Auto Sales	1/21/2016	CFPB	.7 M	.1 M	Utilized abusive financing schemes, hid auto finance charges, and misled consumers with regard to such charges.
CarHop, Universal Acceptance Corporation	12/17/2015	CFPB	n/a	6.465 M	Furnished damaging, inaccurate information to credit reporting agencies.
BMW Financial Services (complaint filed)	10/21/2015	FTC	n/a	n/a	Violations of Magnuson-Moss Warranty Act with regard to conditions on vehicle maintenance that require use of branded parts and repair facilities.

Auto Finance: Representative Federal Cases



Company	Date	Agency	Restitution	Penalty	Alleged Violation
Westlake Financial Services, Wilshire Commercial Capital	9/30/2015	CFPB	n/a	4.25 M	Illegal debt collection practices.
Fifth Third Bank	9/28/2015	CFPB, DOJ	18 M	n/a	Discriminatory auto loan pricing impacting African-American and Hispanic consumers through policies permitting dealers discretion to quote borrowers interest rate.
America Honda Finance Corporation	7/14/2015	CFPB, DOJ	24 M	n/a	Discriminatory auto loan pricing impacting African-American, Hispanic, and Asian and Pacific Islander borrowers through policies permitting dealers discretion to quote borrowers interest rate.
Security National Automotive Acceptance Company	6/17/2015	CFPB	2.28 M	1 M	Illegal debt collection practices.
National Payment Network	5/4/2015	FTC	.949 M	2.475 M	Failure to disclose material information about fees and about biweekly loan program effects.
Auto Fare	2/10/2015	DOJ, North Carolina	.225 M	n/a	Discriminatory auto loan pricing impacting African-American, Hispanic, and Asian and Pacific Islander borrowers through policies permitting dealers discretion to quote borrowers interest rate.
Southeastern Auto Corporation	2/10/2015	DOJ, North Carolina	.225 M	n/a	Discriminatory auto loan pricing impacting African-American, Hispanic, and Asian and Pacific Islander borrowers through policies permitting dealers discretion to quote borrowers interest rate.
DriveTime	11/19/2014	CFPB	n/a	8 M	Illegal debt collection practices and furnishing of harmful and inaccurate information to credit reporting agencies.
First Investors Financial Services Corp.	8/20/2014	CFPB	n/a	2.75 M	Furnishing of harmful and inaccurate information to credit reporting agencies.
Ally Financial Inc.	12/20/2013	CFPB	80 M	18 M	Discriminatory auto loan pricing impacting African-American, Hispanic, and Asian and Pacific Islander borrowers through policies permitting dealers discretion to quote borrowers interest rate.
U.S. Bank	6/26/2013	CFPB	6.5 M	n/a	Deceptive auto loan marketing and lending practices targeting active-duty military.

Auto Finance Regulation: Will States Take the Lead?



- Mick Mulvaney: CFPB will be looking for “much more collaboration and much more leadership” from states when deciding which enforcement cases to bring
- Establishment of mini-CFPBs in certain states (Maryland, New Jersey, Pennsylvania, etc.)
- Creation of coalition of state attorneys general after Mick Mulvaney takes control of the CFPB (Led by New York; also includes: California, Connecticut, Hawaii, Illinois, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Mexico, North Carolina, Oregon, Vermont, Virginia, Washington, and the District of Columbia)
 - Formed in response to earlier letter in support of more restrained CFPB from attorneys general in West Virginia, Texas, Alabama, Arkansas, and Oklahoma

Auto Finance: Representative State Enforcement



- Delaware and Massachusetts – 2017: Indirect lender’s subprime installment contracts were unfair and deceptive because the lender failed to consider borrowers’ ability to repay loans.
 - Mississippi also engaged outside counsel to examine possibility of using this theory of liability in 2017.
- Massachusetts, New Jersey and New York – 2017: Illegal bundling of credit repair, identity theft protection, and other services into installment contracts, sometimes for subprime borrowers.
- Florida – 2017: Major car dealership, its financing arm, and its president engaged in misleading business and sales practices related to finance charge advertisements.
 - Dealership allegedly used devices to track hundreds of vehicles purchased by customers without customers’ knowledge or consent. It later used the tracking devices to repossess vehicles, with some repossessions purportedly occurring even when consumers were current on payments.
 - Dealership also allegedly created fake online profiles using customers’ data, without their knowledge, in order to post positive comments online about the dealership.
- Arkansas – 2016: Buy-here, pay-here auto dealerships financed cars at “exorbitant” interest rates and subsequently used illegal debt collection practices when borrowers could not pay these rates.
- FTC and Various States – 2015: Operation Ruse Control: Partnership with state attorney generals. Enforcement efforts included a range of deceptive advertising charges, criminal automotive loan application fraud, odometer fraud, deceptive add-on fees, and deceptive marketing of car title loans.
- Ohio – 2012: Enforcement push against buy-here, pay-here used car dealers alleging improper disclosure of finance charges.

LIBOR – The Problems



- Continued decline of confidence in the LIBOR market
 - Declining degree to which banks fund themselves in the London interbank market
 - Concerns about insufficient trading volume and liquidity to support the use of LIBOR as a benchmark interest rate
 - Pending and potential litigation
 - LIBOR spreads have widened compared to other benchmarks
- UK FCA obtained agreement of each of the LIBOR panel banks to continue providing LIBOR quotations through the end of 2021, at which time UK FCA will no longer require LIBOR submissions

LIBOR - U.S. Regulators Response



- Federal Reserve Board and the Federal Reserve Bank of New York convened a joint committee (Alternative Reference Rates Committee – the “ARRC”) to identify a replacement rate
- Committee wanted a “risk-free” rate – a theoretical rate of return on an investment with no risk of financial loss
- The ARRC has identified the Secured Overnight Financial Rate (“SOFR”), which is the cost of overnight loans that use U.S. government obligations as collateral

Observations about Changing from LIBOR



- Legacy deals
 - Lots of deals can't be amended without unanimous consent
 - Do investors have much incentive to push for a different benchmark in legacy deals?
 - It's economically good for investors if LIBOR spreads widen. LIBOR spread over overnight swaps has widened in recent months.
 - It's terrible if interest rates increase but their deals convert to a fixed rate.
 - Some current LIBOR definitions in existing securitizations may result in fixed rate transactions
 - Many deals refer to LIBOR being "unavailable" – What if LIBOR is still quoted, but does not represent actual trades?
 - Probably will need spread adjustments if we move to SOFR – How can we amend to make that happen?
 - Will there be any effects on ratings in a shift to SOFR? For example, are past LIBOR assumptions correct for volatility and basis risk for underlying assets?
 - Need CFTC and IRS regulatory help to avoid amendment triggering clearing and margin, tax recognition

Observations about Changing from LIBOR



- New deals

- Nobody seems willing to make changes to their LIBOR definition – fear of adverse pricing if they do anything interesting
- We’ve seen some corporate deals with a Calculation Agent concept – Calculation Agent has discretion to make changes
- Probably a good idea to try to avoid unanimous consent for a change from LIBOR to another index if the interest rate does not decrease; add exculpatory language

Observations about Changing from LIBOR



- SOFR will be an overnight rate. Market participants are generally assuming that market forces will develop into a “one month SOFR rate” and a “three month SOFR rate”
- Chicken and Egg Problem: Interdependence of different markets
 - Investors need to be able to hedge – Waiting for issuers and derivatives market to change
 - Issuers waiting for investors
 - Benchmarks for underlying assets need to match benchmarks used in financing
 - Derivatives are a hedge, and won’t change until the underlying instruments change

Auto Finance: Other Potential Issues



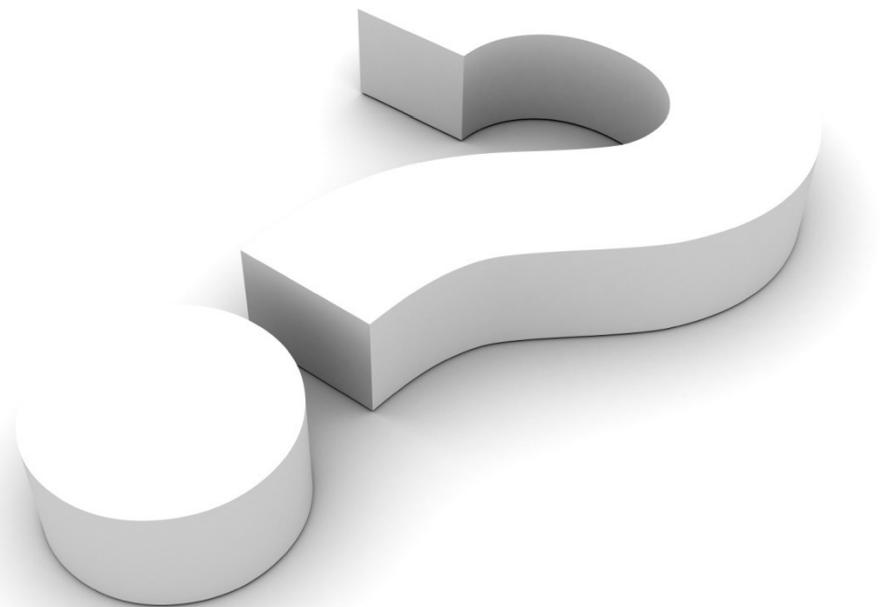
- FTC Used Car Rule
 - Came into effect January 28, 2018
 - Requires dealers to use FTC’s revised window sticker, known as the “Buyers Guide,” on all used vehicles offered for public sale
 - Subject to FTC’s September 2017 Guidance: Answering Dealers’ Questions about the Revised Used Car Rule
- DOJ has been the most active federal enforcement agency as of late and has focused on Servicemembers Civil Relief Act claims
 - Applies to loans made before a borrower enters active duty military service
 - “Active duty” occurs at different times for reservists as opposed to full-time military members
 - 6% interest cap
 - Limit on repossessions
 - State mini-SCRA laws may lead to state enforcement in this area

Current Expected Credit Loss (CECL)



- Accounting Change Adopted June 2016, Effective 2020
- Recognize allowance for expected credit losses
 - No longer just the amount that is a “probable” loss and “capable of reasonable estimation”
 - Considers forward looking information, including discounted cash flow projections
 - Allowance is deducted from the asset value on Day 1, and updated quarterly
- Banks and finance companies are “freaking out” about CECL
 - Volatility of earnings
 - Potential effect on Stress Tests
- EHRI and CECL loss projections will need to be consistent
- Expect more finance companies and banks to desire off-balance sheet treatment or risk transfers

QUESTIONS?



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