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The New “A” in UDAAP:
What Does This Mean For Your Compliance Program?

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Agenda

- Overview of UDAAP
- Closer look at legal standards
  - “Deceptive” practices
  - “Unfair” practices
  - “Abusive” practices
- Impact on bank compliance function
- New enforcement trends: CPFB

UDAAP In Perspective

- Section 5 / FTC Act
  - Prohibits unfair or deceptive acts or practices
  - Enforced by banking regulators
  - Note: There are comparable state statutes
- Impact of Dodd-Frank Act (Title X)
  - Codified law specifically for financial institutions
  - Added the "abusive" standard
  - Bureau has rule-making authority
  - Your regulator will still enforce

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What is a “Deceptive” Practice?

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“Deceptive” Act or Practice

- Is there a
  material representation,
  omission, or
  practice
  that is likely to mislead?

- Legal standard = likelihood

“Material Representation”

- Likely to affect a consumer’s choice or conduct
  - Express (or implied) claims
  - Omitted information
- Statements related to:
  - Purpose
  - Cost
  - Performance or quality

"Reasonable Consumer"

- Focus on consumer's interpretation
- "Net impression" is key
- Target audience sets the standard

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Case: Providian National Bank Consent Order (2000)

OCC Findings

- **Providian failed to disclose adequately to consumers the limitations in a credit protection program it marketed.**
- **The bank represented to consumers that they would save money by transferring their balances to a Providian credit card, despite the fact that the interest rate on the card was higher than what many were paying with other products.**
- **The bank advertised a "No Annual Membership Fee" credit card but failed to disclose that the card required the purchase of credit protection, for which it charged $156 a year.**
- **The bank's employees were specifically instructed to provide misleading or false information to complaining customers.**

Penalty

- **Providian agreed to pay <u>at least</u> $300 million to consumers harmed by the identified practices.**

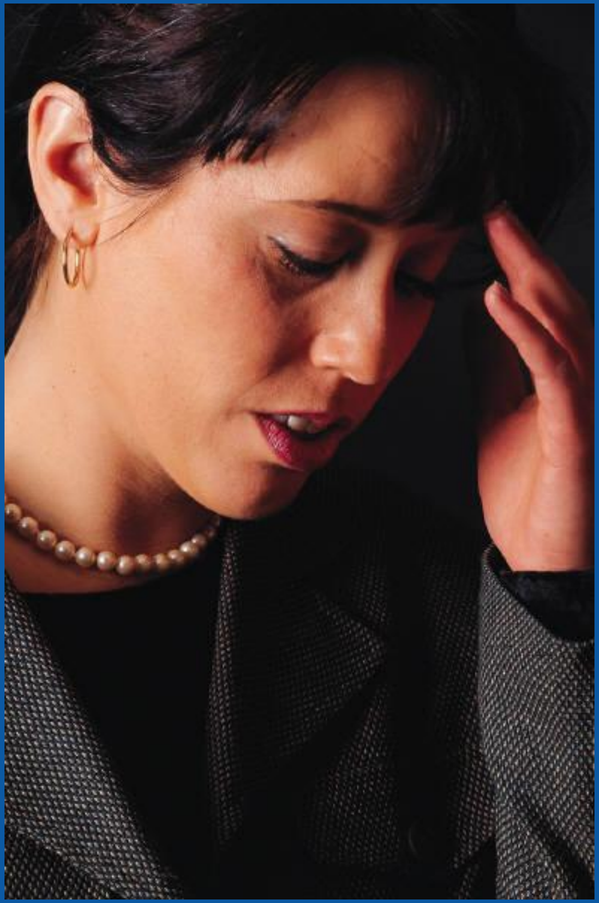
Case: Advanta Bank Corporation, a Utah Chartered Non-member Bank (2009)

- **FDIC Fact Findings: Advanta's credit card "Cash Back Reward" program advertised a percentage of cash back on certain purchases by business credit card accountholders. Due to the tiered structure of the cash back payments, however, the advertised percentage was not available for all purchases. As a result, it was effectively impossible to earn the stated percentage of cash back reward payments.**

- **The FDIC concluded that the Bank's solicitations were likely to mislead a reasonable customer and that the representations were material and that therefore, the Bank engaged in a pattern of deceptive acts or practices in violation of Section 5.**

- **Advanta agreed to an order to cease and desist, to pay restitution of approximately $14 million to businesses that used Advanta's Cash Back Reward program, and to pay a civil money penalty in the amount of $150,000 (the FDIC also alleged an unfair practice, discussed later, and the CMP is for both the deceptive practice and the unfair practice).**

What is an "Unfair" Practice?



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“Unfair” Act or Practice

- Consumer injury
  - Substantial and unavoidable
  - Loss of “free exercise of decision-making”
  - Withholding information
  - Undue influence
- Violation of public policy
- Unethical conduct

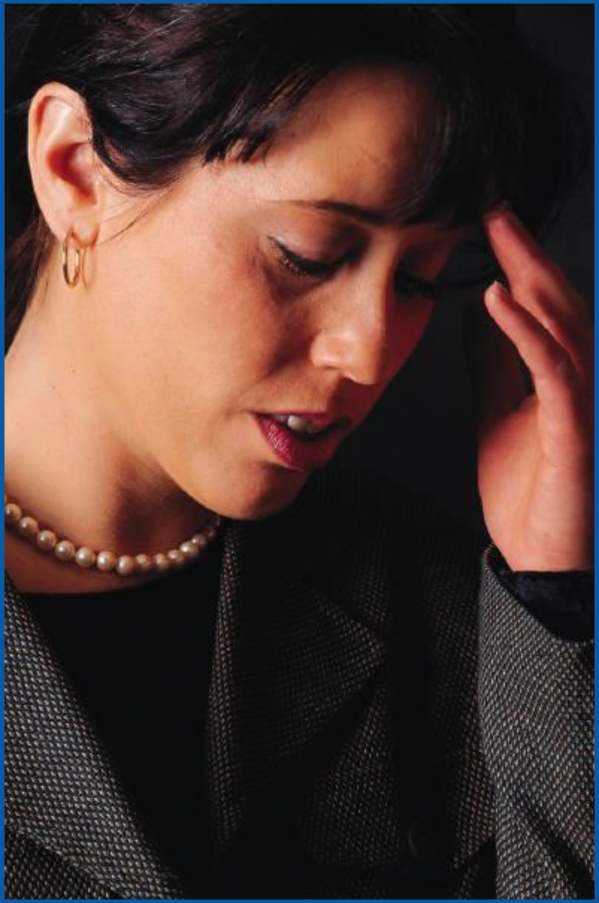
Case: Advanta Bank Corporation (2009)

- The FDIC found that numerous complaints were filed regarding Advanta's substantial APR increases on the accounts of small business owners and professionals, who had neither exceeded their credit limits nor were delinquent in making payments on their accounts.
- The FDIC determined that Advanta's rate increases had been implemented in an unfair manner, that Advanta failed to adequately notify accountholders that their APR had increased, the amount of the increase, the reason for the increase, the procedures to opt-out and the consequences of an opt-out. The repricing caused substantial injury to customers, withheld and/or provided inadequate information that could have enabled the customer to reasonably avoid the injury, and provided no benefit to the customer or competition.
- Advanta agreed to an order to cease and desist, to pay restitution of $21 million to accountholders whose accounts were repriced, and to pay a civil money penalty in the amount of $150,000 (the FDIC also alleged a deceptive practice, discussed earlier, and the CMP is for both the deceptive practice and the unfair practice).

Case: Woodforest Bank, FSB (2010)

- **The Office of Thrift Supervision (OTS) alleged that the savings association failed to impose a reasonable limit on aggregate overdraft fees assessed under an automatic-enrollment overdraft program and further failed to provide consumers overdrawn on their accounts with a reasonable opportunity to cease the imposition of additional daily fees for remaining overdrawn.**
- **The thrift was directed to deposit at least $12 million into a restitution account and to agree to pay a $400,000 civil money penalty.**

What is an "Abusive" Practice?



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“Abusive” Practices

These practices have been labeled *abusive* in other regulations:

- Prepayment penalties
- Automatic interest rate changes on default
- Balloon payments
- Negative amortization
- Failure to consider borrower’s ability to pay

New “Abusive” Standard

<u>Material interference</u> with:

- Ability of the consumer to understand a term or condition of a product or service

Key questions:

- *What acts may be considered “interference?”*
- *What is consumer’s ability to understand?*
- *Focus is on terms or conditions of products*

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Lack of Consumer’s Understanding of Risk

- Products with multiple features or changing terms
  - Is there such a thing as too much choice?
  - EW’s “tricks and traps”
- Customer agreements not in “plain language”
- Model disclosures that are not understandable
  - Will safe harbors for alphabet regulations be safe harbors for UDAAP challenge?

Inability to Protect Oneself

- Offering products to customers who do not understand financial concepts
  - Vulnerability as a low level of financial sophistication
- Failure of bank to prevent customers from over-using a fee-based service
  - What does frequent use indicate? Knowing acceptance of impact on interests or Inability to protect one's interests?

Consumer's Reasonable Reliance on a Banker?

- Failure of bank in not ***steering*** consumer to product that is "best" for that consumer
  - I see you are LMI. Have we got a product for you!
- Banks who allow consumers to make their own choice and fail to guide or advise the customer
  - Paternalism v. Libertarian paternalism?

UDAAP Impact on Bank Compliance: Lessons Learned

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Lessons Learned: Our Experience

- Exam focus and enforcement is increasing
  - Dodd-Frank Act and CFPB provide momentum
  - Prudential regulators are active
  - State AG offices will become more active
  - Legal elements of proof often disregarded

- Concept of "consumer protection" is shifting
  - Full and accurate disclosures are not enough
  - Even "legal" practices can violate UDAAP (???)
  - Banks as "bartenders"—you must cut customers off

- Dawn of the era of consumer "paternalism"?
  - Enhanced scrutiny of products and services targeted towards lower-income consumers and those who have experienced previous financial problems
  - Willing to hold institutions liable for the informed decisions of their customers if the agency concludes that such decisions were not, in its opinion, in the customers' best interest
  - Despite the clear standards and criteria articulated by the FTC, federal banking agencies have taken an expansive reading of "unfair" and "deceptive," providing loose or even incomplete analysis under the required elements of the tests.

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Impact on Compliance

- New "*abusive*" standard casts a "wider net"
  - Compliance risk is increased
  - Trend toward consumer "paternalism"
  - Bank must be sure customer understands everything
  - Liability on bank for customer's bad choices
  - New "duty of care"—what is *best for this customer*?
    - Product steering / suitability?
- Key UDAAP risk triggers
  - Consumer complaints
  - Areas of high fee income

UDAAP and The Bureau

Consumer Financial Protection Bureau

What can we expect?

CFPB and UDAAP Compliance

CFPB as "one voice" on UDAAP

- *Will CFPB provide greater clarity for the industry?*
  - *Does the old view that UDAP can trump the Alphabet regs still hold?*
  - *Should we expect UDAAP rules anytime soon?*
- *What are the prospects for prudential regulator or AG enforcement of UDAAP?*
- *Can best practices change the UDAAP landscape?*
- *Will Bureau authority over non-bank financial services providers level the playing field?*

Prudential Regulators' Consumer Protection Mission

- **FDIC's New Division of Depositor and Consumer Protection**
  - **"complement the activities of the new [BCFP]"**
  - **"Safe" financial products initiative**
    - **Small Dollar Loan Product Template**
    - **Transaction and Savings Account Templates**

"Safe" from What?

Never lose a penny.

The more you know, the safer your money. FDIC

Stay within FDIC limits and your deposit accounts are 100% safe and secure.

The more you know about FDIC insurance, the safer your money.

For more than 75 years, the FDIC has been protecting the money depositors put in banks. And in all that time, no one has ever lost a penny of insured deposits.

But like any type of insurance, you must understand how it works and stay within the coverage limits in order to be fully protected. There are many facts about FDIC insurance that every depositor should know. We call them the Depositor's Bill of Rights. They're listed on the back of this brochure. For more information, visit www.FDIC.gov/EDIE.

The more you know, the safer your money. FDIC

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FDIC Sign = Consumer Safety Seal?

- **"Every one of your branches prominently displays the FDIC seal. It is a symbol of public confidence that assures the public that their money is safe if your institution should fail. *But that seal also carries with it the expectation of your customers that they will be treated fairly and protected from unsuitable loan products and hidden service charges.*"**
  - **Chairman Sheila Bair, March 16, 2011**

Safe from What?

- **Confusion/Misunderstanding**
- **Errors in Decision-making**

Deceptive

- **Offense to Norms of Unfairness**
- **High Costs**

Unfair

- **Disadvantages that outweigh Advantages**
- **Increased Risk of Financial Distress**
  - **Inability to repay or perform**
  - **Secondary effects on borrowing and wealth**

Abusive

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Direct Express and Safety

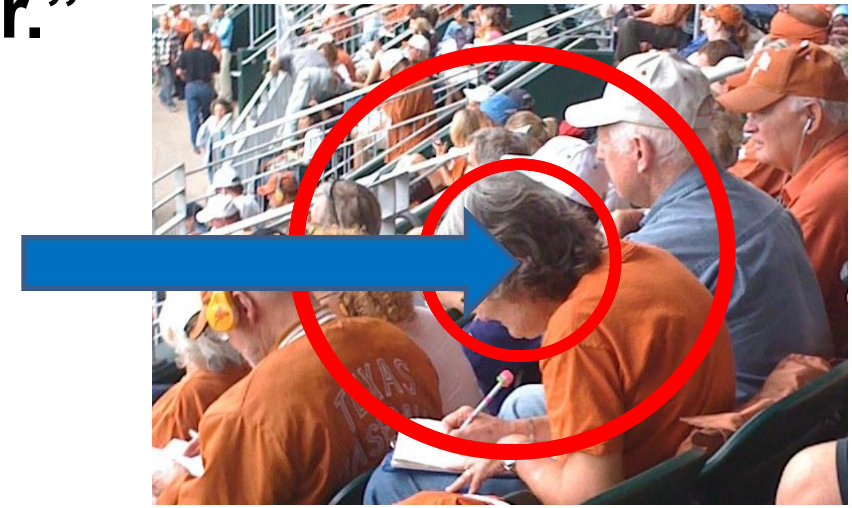
Pitching in the Financial Ballgame

- "**Pitch** … to sell or advertise especially in a high-pressure way …"
  - Webster's New Collegiate Dictionary

- "Advertising is the science of arresting human intelligence long enough to get money from it."
  - Stephen Leacock, The Perfect Salesman, (1924)

Step 1 – Understand Your Target Market

- **Legal standard is applied to your intended target market**
- **Know the characteristics of your "reasonable consumer."**
  - Education/Sophistication
  - Risk Appetite
  - Vulnerabilities
  - Capacity to perform
    - Credit (ability to pay)
    - Deposit/Investment ?!



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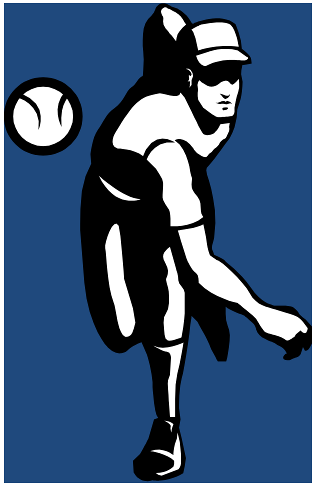
Step 2 – Match Product with Pitch

- **Identify special standards** (e.g., Debit Overdraft)
- **Unilateral changes that increase costs or reduce value are suspect**
  - Are "fixed" rates really fixed?
  - Does consumer conduct change pricing?
  - Do "hidden triggers" make a perk disappear?
- **Scrutinize promotional "hooks"**
  - Duration and conditions must be clear
- **Conform contract with operations**



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Step 3 – Manage Message Content

- **Consider all forms of media (and interaction or impact)**

- **Ask these questions**:
  - *Is the message complete and accurate?*
  - *Is there a representation likely to mislead the **targeted** customer?*
  - *Is there an explanation that is missing—given how we operate or given the <u>expectations</u> of the **target** market?*
- **Compose carefully some words present greater risk:**
  - *Limited time…pre-approved…guaranteed…lifetime rate*
  - *Free…Free trial period…Up to…as low as…*
- **Must be able to back it up with *"meaningful numbers"***

Step 4 – Control the Delivery

- **Review format and layout**
  - *Headlines, font, footnotes, graphics and images*
  - *Words may be true—but does the layout mislead?*
- **Train staff to deliver balanced message**
  - *Out front and behind the scenes*
  - *Avoid inducing customer's unwarranted reliance*
- **Watch the bench -- third party due diligence**:
  - *What is the vendor's reputation?*
  - *What is consumer complaint track record?*
  - *What monitoring and audit reports?*
- **Avoid compensation incentives that could lead to abusive or deceptive sales practices**

Step 5 – Evaluate the Results

Review the pitch

- Is the "main message" on **target**?
- Are disclosures compliant & readily understandable?
- Does impression conflict with fine print?

Test the delivery

- Does staff know their roles and scripts?

Monitor performance

- Supervise the players
- Review complaints and remedy problems

Audit the results

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