



The New “A” in UDAAP: What Does It Mean for Your Compliance Program?

ABA Telephone Briefing

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Agenda

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



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
 - Eliminated Fed UDAP rule-writing
 - Added the “abusive” standard
 - Bureau has rule-making authority
 - Your regulator will still enforce



1985 UDAP Rule = Regulation AA

- Consumer Credit not purchase of RE
- Cosigner Liability and Notice
- Contract protections:
 - No confession of judgment
 - Waiver of exemption
 - Assignment of wages
 - Security interest in “household goods”
- Prohibits pyramiding late fees

What has happened to Regulation AA after DFA?



What is a “Deceptive” Practice?

- Is there a material representation, omission, or practice that is likely to mislead?
- Legal standard = likelihood, not certainty



“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





Deceptive Practices, cont'd

- Deceptive representations
 - Express misrepresentation
 - Implied misrepresentation
 - Omit material information
- Fine print cannot cure misrepresentations in headline or text
 - More than technical regulatory requirements



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.

Penalty

- Providian agreed to pay at least \$300 million to consumers harmed by the identified practices.



Enforcement Actions—Deceptive Practices

Examples of Implied Misrepresentations

- Net credit line case (FNB Brookings)
 - Range of credit lines available in card solicitation
 - Majority or “high percentage” of applicants get lower line
 - Fees reduce net available credit “substantially”
 - Promoted uses inconsistent with net available credit
- Implication of “Annual” Fees
 - Bank A: Did not inform applicants that portfolio was liquidating and card would not be useable in less than year.
 - Bank B: No annual fees—but requirement for monthly fees!



Enforcement Actions—More Deceptive Practices

- **Undisclosed Loan Add-ons
(Stewart Financial—FTC)**
 - Loan payment quoted without disclosing AD&D premiums
 - Closing documents obscure presence of add-ons
- **Misleading Mortgage Terms
(Mortgages Para Hispanos.com—FTC)**
 - Promised particular term, rate or payment in Spanish
 - But documents in English did not deliver promised terms
- **ATM Balance Availability
(FDIC Supervisory Position)**
 - Balance misrepresented real funds v. overdraft line



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?

- Now codified in DFA 1031(c)(1)
- Bureau must have a reasonable basis to conclude that
 - “Likely to cause substantial injury to consumers”
 - “Not reasonably avoidable by consumers”
 - “Not outweighed by countervailing benefits to consumers or to competition”



What Makes an Act or Practice Unfair?

- Consumer injury
 - Substantial and unavoidable
 - Does bank's behavior create unreasonable obstacle to free choice?
 - Loss of “free exercise of decision-making”
 - Withholding information
 - Undue influence
- Violation of public policy--DFA 1031(c)(2)
 - May not serve as primary basis



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).



Enforcement Actions—Unfair Practices

- **Predatory Sub-prime Lending**
 - Tax-relief Loans with fees 22% - 123% of principal
 - Fees charged where services not performed or “clearly in excess” of value for services.
- **Unfair Servicing Practices (Fairbanks—FTC)**
 - Failure to post payments timely incurred late fees
 - Collected unwarranted or non-contractual fees



What Makes an Act or Practice Unfair?

- Unfairness case examples often look like contract breaches.
 - Implication for handling of consumer complaints?



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?

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



“Suitability” Standard

- NASD Rules of Conduct
 - Recommended purchase is suitable based on revealed financial situation and needs
 - Reasonable inquiry of financial status, tax situation, investment objectives & other relevant context
 - Professional judgment of licensed personnel
- Not fiduciary – instead fair treatment
- 2310-2(b)(5) = Financial ability to meet commitment → Credit parallel = ability to pay



Increased complexity of products and choices

“Nobody has the time or cognitive resources to be completely thorough and accurate with every decision, and as more decisions are required and more options are available, the challenge of doing the decision making correctly becomes ever more difficult to meet.”

Barry Schwartz, [The Paradox of Choice](#), 2004



Draft G20 Principles on Consumer Protection

“Renewed policy and regulatory focus on financial consumer protection results from the increased transfer of opportunities and risks to individuals and households as well as the increased complexity of financial products and rapid technological change.... In light of these issues,... *it is essential to protect **consumers’ rights** while also recognizing the fact that these rights **do come with consumer responsibilities.***”

--Draft Framework of Draft G20 High Level Principles (8/1/11)



Responsible Customers?

“American families aren’t looking for a free ride. They **expect to be held responsible** for the purchases they make. If they don’t keep up with payments on their credit cards, car loans and mortgages, they expect to face the consequences. They also expect to pay for the services they receive. They know that businesses need to make a profit, and “free” usually means that the real costs will eventually show up somewhere. **They aren’t look for a free ride, but they are looking for an honest marketplace.** They want to know the costs up front, before something gets added that they never knew was coming.”

Elizabeth Warren, September 29, 2010



New “Abusive” Standard

Material interference 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*



New “Abusive” Standard

or Taking unreasonable advantage of:

- Lack of understanding of consumer regarding risks, costs, or conditions of product or service
- Consumer’s inability to protect his/her interests in selecting or using the product or service
- Reasonable reliance by the consumer that bank will protect his/her interests

How might this be happening at your bank?



Lack of Consumer's Understanding of Risk

*Taking unreasonable advantage of:
Lack of understanding of consumer regarding
risks, costs, or conditions of product or service*

- 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"
 - Complexity and contingencies obscured
- Model disclosures that are not understandable
 - Will safe harbors for alphabet regulations be safe harbors for UDAAP challenge?



Inability to Protect Oneself

*Taking unreasonable advantage of:
Consumer's inability to protect his/her interests
in selecting or using the product or service*

- 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?

*Taking unreasonable advantage of:
Reasonable reliance by the consumer that
bank will protect his/her interests*

- 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?



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



Lessons Learned: Our Experience

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



Lessons Learned: Our Experience

- 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 and passed into DFA, 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.



Impact on Compliance—Red Flags

Key UDAAP risk triggers

- Consumer complaints that evidence communication disconnect or disappointed expectations about what would happen in using product
- Compensation incentives that reward aggressive practices over honestly informative pitches
- Targeting less sophisticated customers with messages that down-play contingencies and consequences
- Areas of high fee income or penalty revenue especially in connection with otherwise “free” products



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?*



CFPB in its own words....

- [CFPB is working to ensure] that **consumers** get the information they need to **make the financial decisions *they believe are best*** for themselves and their families—that prices are clear up front, that risks are visible, and that nothing is buried in fine print.
- “In a market that works, consumers should be able to make direct comparisons among products and ***no provider should be able to build, or feel pressure to build, a business model around unfair, deceptive, or abusive practices.***”
 - CFPB Website at <http://www.consumerfinance.gov/the-bureau/>



Prudential Regulators' Consumer Protection Mission

- Where do prudential regulators get UDAAP authority after DFA?
 - DFA 1026(d) enforcement of Federal consumer financial laws—but 1002(14) excludes FTCA
- Banking Agency UDAP Exam Procedures
- 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



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
 - Offense to Norms of Unfairness
 - High Costs
 - Disadvantages that outweigh Advantages
 - Increased Risk of Financial Distress
 - Inability to repay or perform
 - Secondary effects on borrowing and wealth
- } Deceptive
- } Unfair
- } Abusive

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Managing Marketing or Sales Practice Risks

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

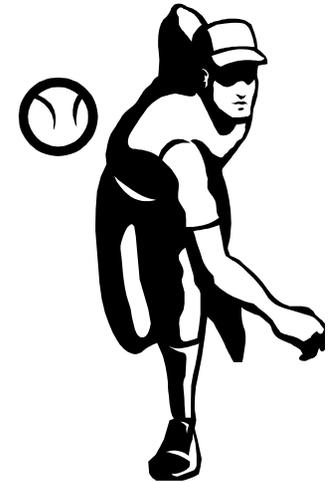
- Legal standard is applied to your intended **target** market
- Know the characteristics of your “reasonable consumer”
 - Education/Sophistication
 - Risk Appetite
 - Vulnerabilities
 - Capacity to perform
 - Credit (ability to pay)
 - Deposit/Investment ?!



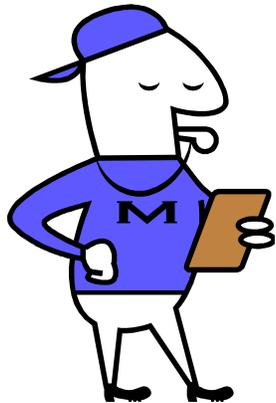


Step 2 – Match Product with Pitch

- **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 promotion and contract with operations**
 - Do products work the way you say they will?



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 expectations 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?
- Are promises made delivered?

Monitor performance

- Supervise the players
- Review complaints and remedy problems

Audit the results

- Hold marketing and business lines accountable





Obama Proposal for Reform

“Taken together, we are proposing the most ambitious overhaul of the financial system since the Great Depression. But I want to emphasize that these reforms are rooted in a simple principle: we ought to set clear rules of the road that promote transparency and accountability. That’s how we’ll make certain that markets foster responsibility, not recklessness, and reward those who compete honestly and vigorously within the system, instead of those who try to game the system.”

President Obama’s remarks at Federal Hall, September 14, 2009



Honesty in Business

- “ I sometimes think that when all is said and done at our Commission, the main conclusion we may come up with is that top management should be honest and insist that everyone in the organization be the same.”
 - James Treadway, quoted by Professor Manuel Tiggos about the COSO Compliance Framework, The CPA Journal, May 2003.
- A bank’s compliance policy will not be effective unless the board of directors promotes the values of honesty and integrity throughout the organization.
 - Basel Paper 113, April 2005, Paragraph #14
- “American families... aren’t looking for a free ride, but they are looking for an honest marketplace..”
 - Elizabeth Warren, September 29, 2010