The Coming Influence and Effects of UDAAP

BAI LEARNING & DEVELOPMENT WHITEPAPER

The term “UDAAP” (Unfair, Deceptive, or Abusive Acts or Practices) is one with which bankers, and not just compliance officers, will become very familiar over the coming years. It can even be said that UDAAP will govern virtually everything a bank offers when it comes to its consumer customers, due to its expansive definition and mandate.

UDAAP was introduced by the Dodd-Frank Act (in Section 1031), and the new Consumer Financial Protection Bureau (CFPB or Bureau) is directed to issue regulations designed to prevent UDAAP. The new standard builds on an existing standard known as “UDAP.” The extra “A” refers to the addition of “abusive” into the mix. “Unfair” and “deceptive” have been around for some time and their definitions and ultimate meanings have been well-established and litigated. “Abusive” is new, and coupled with the Bureau’s broad mandate for preventing abusive practices, the potential for intrusive new regulations is almost certain.

The CFPB may supervise only institutions’ consumer functions. Their mandate is consumer protection; thus, their UDAAP rules will cover only consumer products and services. The existing UDAP standard; however, covers both consumer and commercial activities.

UDAP Standard

The term “UDAP” (Unfair or Deceptive Acts or Practices) has been around for some time. It comes from Section 5 of the Federal Trade Commission Act (FTC Act). Section 5(a) of the FTC Act prohibits “unfair or deceptive acts or practices in or affecting commerce,” and this standard applies to any person or entity doing business, not just financial institutions. While the FTC has no direct enforcement authority over banks, the regulatory agencies have authority (by way of the Federal Deposit Insurance Act) to enforce UDAP rules when they find conduct in violation.

Many states also have their own versions of the FTC Act. These are sometimes referred to as “mini-FTC Acts,” as their requirements typically mirror federal law.

UDAP standards are broad. They cover any unfair or deceptive practice in business, whether directed toward consumers or businesses. Over time, the FTC and courts have developed interpretations of what constitutes an unfair or deceptive act. There are standards that exist for what is “unfair” or “deceptive”. A practice does not have to be both unfair and deceptive to violate the rule – the standards are judged independently; thus a practice can be found to be unfair or deceptive and be in violation. Traditionally the standard for deception was cited more frequently, but that seems to be changing. More practices are being judged as unfair, so it is important to understand both.

Fortunately the Dodd-Frank Act didn’t plow new ground when defining what constitutes unfair or deceptive in its new UDAAP standard. Regarding UDAAP, the Bureau has rulemaking authority, and they, along with the existing banking regulators, will enforce whatever rules are established by the Bureau.
What is UDAAP?
Dodd-Frank Act Section 1031(a) states:

The Bureau may take any action authorized under subtitle E [referring to the CFPB’s enforcement powers] to prevent a covered person or service provider from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.

First we see the UDAAP standard will apply only to consumer products and services, not those that are provided to commercial customers. However, it is necessary to understand how the terms “unfair, deceptive, or abusive” are defined to get a better idea what types of regulations the Bureau might issue.

What Makes a Practice Unfair?
There are three factors that make a practice unfair under both the FTC Act and the UDAAP standard under the Dodd-Frank Act: (1) it causes or is likely to cause substantial injury; (2) that cannot be reasonably avoided; and (3) the injury is not outweighed by any benefits. Here is a closer look at each:

1. The practice causes or is likely to cause substantial injury. The term “substantial injury” usually means monetary harm or loss. However, “substantial” does not mean each individual consumer must lose a great deal of money. If a large number of people are caused a small amount of harm (such as a small but excessive ATM fee), a substantial injury may be found. The injury could also be deemed substantial if it merely raises a risk of harm to consumers.

2. The injury cannot reasonably be avoided. The injury is unavoidable when a practice interferes with a consumer’s ability to make an informed decision. Regulators will not judge a consumer’s actual decision (under this standard, but note the “abusive” standard takes a different view); the standard is whether the practice interfered with a rational and reasonable decision-making process.

This is seen when important information is missing from an advertisement, for instance. If restrictions are omitted (minimum deposit must be maintained to receive the stated APY, for example), a consumer cannot make a rational decision regarding the product because all relevant facts are not available.

3. The injury is not outweighed by any benefits. To be unfair, the net impact of the practice is to harm the consumer. An example of a “countervailing benefit” (to use the Dodd-Frank language) could be the practice at issue allows for products and services to be more widely available. Overcoming harm is a very high hurdle, though. In most cases, any perceived benefit to consumers will not counterbalance the harm caused. A particular benefit of a product or service may be emphasized (e.g. “no annual fee”), but the reality is that other fees and charges may more than offset the “benefit” of no annual fee. The result is that the “benefit” is negated and the net effect is to harm the consumer.

Public policy considerations. Public policy, including existing laws, regulations, and judicial decisions, is a factor in determining whether a particular practice is unfair. If the practice violates other consumer protection regulations, such as Regulation DD (Truth in Savings) or Regulation Z (Truth in Lending), it is then much easier to determine the overall impact as unfair.
The themes of unfairness are already built into various laws and regulations, particularly regarding advertising. Regulation Z requires only “actually available terms” be offered in consumer loan advertisements, continuing that “only those terms that actually are or will be arranged or offered by the creditor” be stated. Regulation DD also prohibits “misleading or inaccurate advertisements,” further stating that an advertisement “shall not misrepresent a depository institution’s contract.”

The Equal Credit Opportunity Act (ECOA) and Regulation B prohibit discrimination in any aspect of a credit transaction on a prohibited basis. The Fair Housing Act (FHA) similarly prohibits discrimination in residential real estate transactions on a prohibited basis. If a particular type of loan or servicing practice unfairly targets or has a disparate impact on members of a protected class, it may also be considered unfair. In fact, fair lending problems have the potential of being institutions’ chief UDAAP concern going forward.

What Makes a Practice Deceptive?
Interestingly, Section 1031 of the Dodd-Frank Act does not expressly define what would make a practice “deceptive,” although we can rely on the FTC Act’s definition to get a clear idea. Here again there are three factors to consider whether a practice is deceptive: (1) the representation, omission, or practice misleads or is likely to mislead; (2) a “reasonable” consumer would be misled; and (3) the representation, omission, or practice is material.

1. The practice misleads or is likely to mislead. Similar to the standard for unfairness, a practice can mislead by what is unstated by the institution as well as by what is stated. For example, offering pricing and fee structures that aren’t truly available or omitting critical qualification standards are examples of misleading practices. Even if all relevant information is included and all wording is accurate, the layout or structure of a message, or the manner in which it is communicated to the consumer, may be misleading if attention is deliberately directed away from important information.

Bait-and-switch tactics are another example of a misleading practice. Promoting or encouraging a particular product or service when in reality the version provided to the consumer is vastly different is a misleading practice, because the customer ultimately will be worse off than what he or she expected.

2. A “reasonable” consumer would be misled. This standard is based on the target audience and considers how a member of that group would likely respond. The group’s “net impression” is viewed in this context, as interpretation may differ depending on the sophistication of that audience. If a product is marketed specifically to elderly or financially inexperienced consumers, for example, the potential to mislead is far greater than if targeted to a general audience. It is important to note that the consumer’s interpretation is what matters here, not what the institution intended with its message or practice.

Misleading practices cannot be “cured” by qualifying disclosures – in other words, fine print cannot explain away a misleading headline. The standard here is the likelihood of deception. If a consumer’s attention is directed toward misleading statements or claims and away from qualifying disclosure language, the likelihood of deception greatly increases.
3. The representation, omission, or practice is material. A practice is material if it is likely to affect a choice. Would the consumer be more likely to take action based on the overall impact or the practice? Information regarding cost or restrictions is almost always considered material, so if specific claims are made or products offered, they will be material. If those claims are inaccurate or misleading, the practice as a whole may be deceptive. The same applies to omissions. If information necessary to make a rational decision regarding a product or service is not included, the omission will be material.

What Will Make a Practice “Abusive”? “Abusive” is defined in Section 1031(d) as an act or practice that:

(1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
(2) takes unreasonable advantage of—
   (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
   (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
   (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

Material interference. This focuses on the consumer’s ability to understand a term or condition or the product or service. Disclosure becomes paramount here. Does the wording of promotional material, disclosures, or conversations and representations made by bankers convey clear information to the consumer, so an educated decision can be made? If not, arguably there is interference.

Clear and complete understanding is paramount. What might interfere with a clear understanding of what a consumer is getting himself or herself into? There are some danger areas, including products with multiple features, some more beneficial to the consumer than others. Products with frequently changing terms are also at risk, especially if those changes are not communicated clearly.

There is a temptation to rely on model disclosure forms provided in various regulations, including Regulations E, P, Z, CC, DD, RESPA, and others. However, this may not be enough if the consumer still can’t understand the complexities of a particular product or service, even though there is a strong push by the agencies to make model disclosure forms “plain language” documents. These “safe harbor” forms might not be as safe as the industry assumed them to be in the past. Additional information and documentation might be needed to ensure the level of understanding to withstand a UDAAP challenge.

Taking unreasonable advantage. This tracks fairly closely to the second element of deceptive practices, where the target audience’s interpretation of information is considered. Offering certain products or services to consumers having a low level of sophistication, who clearly do not fully understand banking and financial concepts, is an example of abuse.
This factor is not limited only to the disclosure process, though. Institutions may take unreasonable advantage of a consumer’s lack of sophistication if they fail to prevent overuse of certain services that generate fees. Overdraft is an obvious example, and the FDIC’s recent guidance suggests this to be the case. One FDIC suggestion: “if a customer overdraws his or her account on more than six occasions where a fee is charged in a rolling twelve-month period, [the institution is to] undertake meaningful and effective follow-up action.” Failure to follow this is not abusive per se, but it is easy to connect the dots and see where the CFPB could issue overdraft rules that could make such failures explicitly abusive.

In the interests of the consumer. This piece of the definition is arguably the most critical: subsection (2)(C) states an act or practice may be considered abusive if it takes “unreasonable advantage of...reasonable reliance by the consumer on a covered person [a financial institution] to act in the interests of the consumer.” This sounds almost like a fiduciary duty, placing a burden on institutions to act in consumers’ best interests rather than their own.

The devil is in the details, of course, or in this case, the devil is in the definitions. What will the “interests of the consumer” be considered to be, and how far will they go? In other words, must profitability be sacrificed in the name of the consumers’ interests? Arguably the answer is already yes when considering Dodd-Frank rules such as the Durbin Amendment’s limitations on interchange fees, along with the regulators’ recent proclamations on overdrafts.

Consider the intent of Title X of the Dodd-Frank Act itself, which created the CFPB – the sole purpose of creating this new body was to protect consumers and ensure products and services are principally in their interests, not the institution’s. It’s not a far leap to imagine some fairly restrictive regulations coming in the near future.

But what do financial institutions need to be aware of today? Clear disclosure and informed choices are key priorities. Ensuring institutions aren’t steering consumers toward products and services that generate excessive fees when a less-expensive alternative for which they would qualify is available is one example. But what can an institution do when a consumer insists on an alternative that might be more expensive or not in the consumer’s best interests according to a neutral view? The best choice here, if the more-expensive alternative is in fact sold, is to ensure that clear evidence is retained that the less-expensive alternatives, costs, and risks were presented, and they were rejected by the consumer. This evidentiary standard will be critically important.

Examples of UDAAP and Protecting Customer’s Interests in Dodd-Frank
Section 1031 is not the only place within Dodd-Frank where evidence of a duty of care to consumers is found. There are multiple Dodd-Frank provisions that require or relate to some degree of duty to consumers. Some of these can be read even as specific examples of UDAAP, especially regarding mortgage loans. These include:

- Section 1402, amending TILA: “Consumers [must be] offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive or abusive.” Implicit in this section is that not considering the consumer’s ability to repay could be considered abusive, since a consumer being able to repay his/her loan is certainly in their interest.
• Section 1403, also amending TILA, requires “regulations to prohibit mortgage originators from steering any consumer to a residential mortgage loan that the consumer lacks a reasonable ability to ... or has predatory characteristics or effects (such as equity stripping, excessive fees, or abusive terms”; and requires “regulations to prohibit abusive or unfair lending practices that promote disparities among consumers of equal credit worthiness but of different race, ethnicity, gender, or age.”

There are two issues here. First, steering most certainly will be seen as an abusive practice, as steering consumers to products for which they would pay more than they might involves several of the elements in the abusive definition, including taking unreasonable advantage of a lack of consumer sophistication, as well as reliance on the institution to put the consumer into the right (meaning less expensive) product.

Second is the mention of promoting disparities, which is fair lending terminology. Here it is easy to see how almost any fair lending issue could also be categorized as UDAAP. In short, fair lending compliance is likely to become more difficult.

• Section 1414 contains several of these requirements, each of which could be read as a specific example of an abusive practice, including:
  – Prohibitions against mandatory arbitration;
  – Prohibitions against financing single-premium credit insurance;
  – A requirement that first-time homebuyers receive homeowner counseling; and
  – Restrictions and outright prohibitions on prepayment penalties on certain types of mortgage loans, including a requirement to offer loans with no prepayment penalties as an offset to loans that have prepayment penalties.

Along with these requirements is the implicit assumption that not following these requirements would not only be considered a violation of the particular regulation that will contain the requirement, but could also be considered a UDAAP and a violation of Section 1031.

Potential Targets: What Might the CFPB Declare as UDAAP?
It’s not only possible that the CFPB will prescribe regulations to ban practices and activities they see as unfair, deceptive, or abusive, it’s virtually guaranteed. Section 1031(b) states:

The Bureau may prescribe rules applicable to a covered person or service provider identifying as unlawful unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. Rules under this section may include requirements for the purpose of preventing such acts or practices.

Notice the extremely broad scope of this mandate. Although there are other mentions of “unfair, deceptive, or abusive” in Dodd-Frank, the language above gives the Bureau nearly unlimited discretion to proclaim whatever regulations it sees fit to issue. The Bureau is to “consult with the Federal banking agencies, or other Federal agencies, as appropriate, concerning the consistency of the proposed rule with prudential, market, or systemic objectives administered by such agencies.” However, this doesn’t appear to be a high hurdle to clear.
This is not new with the Dodd-Frank Act. Other Acts and regulations have deemed various practices to be abusive or otherwise forbidden. These include such mortgage practices as automatic interest rate changes upon default, balloon payments, and negative amortization.

On what products or services might the Bureau focus when it starts issuing regulations? Here are a few examples of what may be considered “abusive,” based on a reading of the language of the Dodd-Frank Act and recent rulemakings from the agencies:

- **Paying items from high-to-low.** Although currently not a violation of Regulation CC, Regulation E, or anything else, FDIC guidance (FIL-47-2010) on overdraft fees, as well as recent litigation, suggests that current thought is that this practice exists only to increase fee income (which is obviously not in consumers’ best interests) rather than protect customers from having larger payments (such as mortgage and car payments) bounce. The FDIC guidance states that banks should “not process transactions in a manner designed to maximize the cost to consumers.” This seems like an ideal candidate for early Bureau rulemaking.

- **Overdraft fees.** The recent Fed Regulation E amendments on ATM and debit card overdraft opt-ins as well as the same FDIC guidance referenced above (which even refers to UDAP) specifically target overdraft fees. It is likely only a matter of time before the Bureau adopts the FDIC’s “supervisory expectations,” including honoring requests to opt out of other overdraft programs and taking “meaningful and effective action to limit use by customers,” to formulate a regulation.

- **Yield spread premiums.** Limitations on these types of payments are already upon us. The Fed last year issued a final Regulation Z rule (with accompanying Press Release titled “final rules to protect mortgage borrowers from unfair, abusive, or deceptive lending practices…”) to severely restrict compensation practices that are based on most loan terms. However, Section 1403 of the Dodd-Frank Act amends the Truth in Lending Act to virtually prohibit them outright. Regulation Z will therefore be amended to prohibit them as a UDAAP.

- **ATM fees.** The idea of limiting the assessment and/or amount of ATM fees is periodically discussed in Congress, but this highlights consumers’ feelings that these fees are unfair or even abusive in and of themselves. They are seen as penalizing customers for accessing their own funds rather than covering the costs of convenience and ATM upkeep. It would not be a surprise if they are curtailed by the Bureau, with excesses being declared as abusive.

- **Punitive mortgage loan provisions.** Many of these were stated previously and are included in Dodd-Frank language, including negative amortization and prepayment penalties. But with the CFPB’s broad mandate, other standard practices could be at risk, such as certain variable rate features and even balloon payments. Congress’ attitude toward these “exotic” features is apparent when mortgage loans containing them cannot be considered “qualified” under Dodd-Frank’s new standards for presumptive compliance with TILA’s revised ability-to-pay provisions and risk retention requirements.

- **Credit life.** Dodd-Frank prohibits creditors from financing single-premium credit life, either directly or indirectly in connection with any residential mortgage loan or HELOC. This might be a first step toward further restrictions or an outright ban.
Preparing for UDAAP Regulations

There are several takeaways from all of these - items on the to-do list which financial institutions can examine right now. These include:

• Be sure customer understands absolutely everything. Your disclosures must be crystal clear to the point of blatant obviousness. Do not assume that model forms in regulations fit the bill and need no supplement. This does not mean changing model forms, but additional explanatory documents or communications may be in order, particularly when various alternatives exist for various products with different fee structures. Consider acknowledgment forms where consumers sign or initial that they understand the consequences of their choices. Again this is not a get-out-of-jail-free card, but it is better than not being able to respond to an accusation of abuse.

• Enhance scrutiny of your products and services targeted towards low-income consumers and those who have experienced financial problems. These customers typically qualify as those with a lesser degree of financial sophistication. It stands to reason that the standard of understanding will be higher. Ensure you are clear and complete in your disclosures and communications with these customers, especially if they select or insist upon a fee-intensive product or service.

• Understand the target audience for your products and services – their level of education, financial sophistication, risk appetite, vulnerabilities, financial position, etc. This is a product-by-product determination as well as an overall institution determination.

• Pay attention to the terms discussed in this article, including suitability, steering, and alternatives. Are your consumer customers given the choice of products and services? How is the selection process handled? Are alternatives pointed out and pursued? What happens, if anything, if newer and more beneficial products are introduced after more expensive ones are already on the market and utilized by consumers?

• Pay close attention to your customer complaints. On an industry level, these will drive many of the Bureau’s future rulemakings, so whatever level of information is made publicly available by the CFPB, study it carefully. Also pay equal attention to the complaints received at your own institution. You can be certain your examiners will.

• Look to where your institution’s fee income is generated. Indeed, the whole income statement of the bank is potentially subject to review by the CFPB to determine if income was earned abusively. If you have a disproportionate degree of income coming from overdrafts, prepayment penalties, and the like, you should take a closer look at your practices.

• Watch your compensation models that could encourage risk-taking, especially on the consumer mortgage side. Regulation Z and RESPA have clear rules now enforced by the CFPB, and Dodd-Frank provisions will only add more teeth to them.
• Be aware that the Bureau and prudential regulations may still choose to hold you liable for the choices of your customers, despite the best of intentions and clearest of communications, if the agencies conclude that those decisions were not in the customers’ interest. Of course that standard has yet to be determined, so exactly what is in the customer’s interest and what is not is unknown at present, and in the future is likely to be a floating target. In the meantime, consider situations where consumers select products and services that are clearly not in their best interests and examine the decision-making, disclosure and communication processes to determine if different choices (forced or not) can be made. This may include refusing certain products and services for certain consumers.

The UDAAP mandate given to the Bureau by Congress is an unprecedented blank check, one the Bureau is sure to exercise. Perhaps the compliance professional’s greatest responsibility in preparation for future rules is to educate senior management, and even the Board of Directors, of the scope and magnitude of this seemingly small part Dodd-Frank. It may have the largest impact on financial institutions when all is said and done.