UDAAP and How to Audit Fairness

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Background

• Section 5 of the Federal Trade Commission (FTC) Act prohibits “unfair or deceptive trade practices in or affecting commerce.” (aka UDAP)

• Bank regulators have enforcement authority under Section 8 of the Federal Deposit Insurance Act for violation of any law including Section 5 of the FTC Act and are using it increasingly against banks of all sizes.
Background (continued)

- Regulation AA prohibits a number of consumer credit practices defined as unfair and deceptive, including:
  - Misrepresenting a co-signer’s liability
  - Pyramiding of late charges
  - Confessions of judgment
  - Assignment of wages or other earnings
  - Taking a non-possessory security interest in household goods other than a purchase-money security interest
From UDAP to UDAAP

• The term **Abusive** was added by Dodd-Frank: Unfair, Deceptive or **Abusive** Acts or Practices (now known as UDAAP)

• Under the Dodd-Frank Act*, it is unlawful for any provider of consumer financial products or services or a service provider to engage in any unfair, deceptive or **abusive** act or practice.

*Title X, Subtitle C, Sec. 1036; PL 111-203 (July 21, 2010)
UDAAP and the new “Abusive” Standard

- The financial crisis and mortgage meltdown have called into question practices in the financial services industry where legislators have argued that consumers were not equipped to understand risks or complexities of banking products. The Dodd-Frank Act established that certain practices could also be **abusive** in addition to being unfair or deceptive.
UDAAP and the new “Abusive” Standard (continued)

• **An abusive act or practice:** Materially interferes with the consumer’s ability to understand a term or condition.

• Currently, there is no clear path to address the term abusive in day-to-day operations. Fundamental questions remain regarding materiality and reasonableness. Nevertheless, financial institutions (FIs) must assess practices against this new standard.
Duty to Customers under Dodd-Frank Act

- Act in the best interest of customers
- Loans must be understandable; not unfair, deceptive or abusive
- No steering toward loans that consumers cannot repay or toward loans with predatory characteristics
- May not require mandatory arbitration
- May not finance single-premium credit insurance
- First time homebuyers must receive counseling
Duty to Customers under Dodd-Frank Act (continued)

- Prohibits prepayment penalties on high-rate loans and ARMs
- If offering loans with prepayment penalty, must also offer loans without such a penalty
- Disclose total interest, aggregate fees and full amount paid for settlement
- Monthly statement showing principal remaining, interest rate, next rate adjustment, prepayment fee, description of late fee, and contact info.
UDAAP – What Has Changed?

- Established Unfairness Test
  - Cause substantial harm to consumer
  - Not reasonably avoidable by consumer
  - Practice not outweighed by benefits to consumer or to competition
UDAAP – What Has Changed? (continued)

- Established Deception Test
  - Representation, omission, act or practice that is likely to mislead
  - Act or practice would be deceptive from the perspective of a reasonable consumer
  - Representation, omission, act or practice is material
UDAAP – What Has Changed?  (continued)

• Established Abusive Test
  – Materially interferes with ability of consumer to understand a term or condition of a product or service
  – Or takes unreasonable advantage of:
    • A lack of understanding by consumer of material risks, costs or conditions of product or service
    • The inability of consumer to protect his or her interests in selecting or using the financial product or service
    • The reasonable reliance of consumer on a covered person to act in consumer’s interest
A word of caution

• An act or practice does not have to violate any other law or regulation in order to be considered unfair, deceptive or abusive.
UDAAP Trends

- UDAAP affects FIs of all sizes, including small community banks.

- Since 2008, 43% of UDAAP violations cited by the FDIC impacted banks with assets of $250MM or less.

- UDAAP applies to consumer and business-purpose products and services.

- UDAAP violations have resulted in unsatisfactory CRA ratings, downgrades in consumer compliance ratings, restitution orders and civil money penalties.
UDAAP Trends (continued)

• Fee-based products are dominating recent UDAAP enforcement actions.

• In 2012, cases totaled over $400 million in sanctions.
  – $200m Consent Order & Civil Money Penalty against Discover for deceptive marketing practices (CFPB & FDIC)
  – $11.2m Consent Order & CMP against Higher one Inc. & The Bancorp Bank in Wilmington, DE for unfair & deceptive practices involving student debit card fees (FDIC)
  – $210m Consent Order & CMP against Capital One Bank for unfair & deceptive sale of credit card “add-on products” (CFPB & OCC)
UDAAP – Advertising

- Is the ad readily understandable by target audience?
- Do the people to whom the ad is targeted have a reasonable chance of qualifying for and obtaining the product/service as advertised?
- Is fine print used to correct other information in the ad?
- Is there anything about the ad that indicates there is a “bait and switch” going on?
- Does the ad suggest any features or benefits that might not really be available?
FTC Recommendations for Advertising

**DO**

- Format ads to direct attention to key information
- Present information clearly and conspicuously
- Disclose all decision-impacting information near most highly promoted features and place any qualifiers near claim it is qualifying

**DO NOT**

- Use small font to hide costs, critical terms or conditions
- Use pop-up windows or hyperlinks to display key information
- Bury information at the end of a long Web page
- Use a fast-moving “scroll” on Websites
Clear & Conspicuous Disclosures

FDIC’s four “Ps” of deception:

• PROMINENCE: Is it big enough for consumers to notice and read?

• PRESENTATION: Is wording and format easy for consumers to understand?

• PLACEMENT: Is it where consumers will look?

• PROXIMITY: Is it near the claim that it qualifies?
UDAAP - New Product Development

• Do you have a new product development process that includes all key stakeholders including the Business Units, IT, Compliance and Legal (as applicable)?

• Before rolling out new products and services, does your organization consider potential UDAAP issues?
UDAAP – Consumer Complaints

• This is one area where “more is better.”
• Not only do you want to capture and track true consumer complaints regarding regulatory matters, but you also want to track indications of consumer confusion and misunderstanding.
• Loan servicing and collections are two of the biggest areas for consumer complaint intake.
• It takes a great tracking system to get those “inquiries” and “inklings of confusion” into the system for review. Call center supervisor escalations may be an early indication of UDAAP issues.
UDAAP – Consumer Complaints (continued)

• What procedures or processes does the FI have in place to aggregate complaints and misunderstandings from all sources across the organization?

• Don’t forget the comments and complaints that may show up on digital media sites such as Twitter and Facebook.

• What procedures or processes are in place to watch for developing trends?
UDAAP Triggers in Complaints

- Accusation of misleading or false statements
- Missing disclosures or information
- Undue or excessive fees
- Inability to reach customer service (or a live person)
- Undisclosed or unauthorized charges
- Products geared toward the “vulnerable” – students, elders, servicemembers, those in financial distress, those with limited English skills or education, etc.
- A statement to the effect of “I didn’t understand”
UDAAP – Vendor Management

• Review actual vendor and third-party contracts to determine whether the FI is protected at all from the risk of the vendor engaging in unfair, deceptive or abusive acts or practices.

• Remember that consumers will associate any wrongdoing with your FI rather than the vendor.

• Reputation risk cannot be contracted away or insured against.
UDAAP – Training

• Has the Board, Management and Staff been trained on UDAAP?

• Have internal courses and computer-based training modules been updated as appropriate to incorporate UDAAP considerations?
Potential UDAAP Triggers

- Advertising ODP on “free” deposit accounts
- Rewards Programs:
  - Stating customers must “make” transactions within certain timeframe when what bank really means is that transactions must “post” within a certain timeframe.
  - Stating “month” if bank really means “qualification cycle.”
  - Stating customer must “receive” electronic statements if bank really means “view” electronic statements.
  - Stating “ATM transactions” if bank really means “debit card purchases.”
UDAAP – Best Practices

- Risk Assessment
- Training
- Ad Review Process
- Customer Agreements
- Consumer Complaint Administration
- New Products and Services
- Vendor Management
- Error Resolution Process
- Monitoring
The Key to UDAAP

• Is it fair to the consumer?

• Because compliance has traditionally been focused on meeting technical requirements, the new fairness challenge requires FIs to rethink the old way of doings things when rolling out new products and services.
UDAAP Lessons Learned

• Refer to Handout:
  “UDAAP Cases & Enforcement Actions”
CFPB Supervision and Examination Manual

- Initially released in October 2011
- Version 2 was released in October 2012
- Contains three sections covering UDAAP
- Explanation of the Bureau’s interpretation of “unfair,” “deceptive” and “abusive”
- UDAAP Examination Procedures
- Risk Assessment template
CFPB Exam Procedures

• To identify potential UDAAP issues, examiners will review the following:
  – Board and Management Committee Meeting Minutes
  – Written policies and procedures including those related to servicing and collections
  – Training materials
  – List of products and services, including descriptions, disclosures and fee structure
  – Internal control monitoring and auditing procedures
  – Compensation agreements, including employee and third party incentive programs
CFPB Exam Procedures (continued)

• To identify potential UDAAP issues, examiners will also review:
  – Documentation related to new product development
  – Marketing programs, advertisements and other promotional materials
  – Scripts and recorded calls for telemarketing and collections
  – Organizational charts including those of affiliates
  – Agreements with affiliates and third parties that interact with consumers on the FI’s behalf
  – Consumer complaint files
  – Documentation related to software development and testing
CFPB Exam Procedures (continued)

• Management and Policy-Related Examination Procedures
  – Identify potential UDAAP concerns by reviewing relevant written policies and procedures, customer complaints, internal and external audit reports, management and examination reports
  – Through discussions with management and review of documentation, determine whether internal controls are adequate to prevent UDAAP issues
  – Perform a high level assessment of the FI’s products, services and customer base to identify areas for potential transaction testing
CFPB Exam Procedures (continued)

• Transaction-Related Examination Procedures
  – Marketing and Disclosures
  – Availability of Terms or Services as Advertised
  – Availability of Actual Credit to the Consumer
  – Employees and Third Parties Interacting with Consumers
  – Servicing and Collections
  – Interviews with Consumers (as deemed appropriate)
UDAAP Audit Components

- Compliance Management
  - Policies, procedures, agreements
- Advertisements & Promotional Items
  - Written, electronic, radio, television, digital media
- Disclosures & Agreements
- Loan Servicing & Collections
  - Loan Modifications; Servicemembers Civil Relief Act
- Third Party Oversight
- Consumer Complaints
- Training
- Relevant State Laws
Summary of Important Laws and Regulations

• **Section 5 of the Federal Trade Commission Act**
  Prohibits “unfair or deceptive trade practices in or affecting commerce.”

• **Dodd-Frank Wall Street Reform Act**
  Unfair is defined similarly to the FTC Act; Deceptive is defined by the CFPB similar to FTC Act; Defines abusive as material interference with the consumer’s ability to understand…or takes unreasonable advantage…

• **Regulation AA**
  Prohibits unfair credit contract provisions, unfair or deceptive cosigner practices, and unfair late charges, among other things.
Summary of Important Laws and Regulations (continued)

• **MGL Ch 93A**
  Prohibits unfair and deceptive acts and practices “in the conduct of any trade or commerce.” Includes a debt collection provision.

• **Conn. Gen. Stat. §§ 42-110a through 42-110q**
  Connecticut Unfair Trade Practices Act

  Unfair Trade Practices Act
Summary of Important Laws and Regulations (continued)

  Consumer Protection Act

  Unfair Trade Practice & Consumer Protection Act
Summary of Important Laws and Regulations (continued)

• **N.Y. Exec. Law § 63 (12) (McKinney)**
  Allows AG to bring suit in case of “repeated fraudulent or illegal acts,” defined to include “unconscionable contract provisions.” The provisions enforceable by consumers, however, only prohibit deceptive acts.

Resources

• CFPB – www.consumerfinance.gov

• FDIC, Overdraft Payment Programs and Consumer Protection, Final Supervisory Guidance, FIL 81-2010, November 24, 2010

• FTC Policy Statement on Deceptive Acts and Practices

• FTC Policy Statement on Unfairness
Resources (continued)


Thank you for your attention

May I address any further questions?