

NEW STANDARDS, EXPANDING RISKS

Don't get caught  
in the

**UDAP**

net

**“Unfair or deceptive acts or practices in or affecting commerce are hereby declared unlawful.”**

BY THOMAS G. PAREIGAT AND MEG SCZYRBA, CRCM

**THIS ONE SENTENCE, COURTESY OF SECTION 5** of the Federal Trade Commission Act [15 USC 45(a)(1)], is the statutory genesis of the rule we know fondly as “UDAP.” While

all businesses are generally covered by Section 5 of the FTC Act, federal banking regulators have the authority to cite institutions for engaging in practices that are considered unfair or deceptive.

In recent years, examining agencies have increased their UDAP-related scrutiny and stepped up enforcement activities in this area. Cease and desist orders citing UDAP violations are on the rise and by all indications will continue to grow. With the passage of the Dodd-Frank Act in 2010, supervisory focus on UDAP will become even more intense. The Dodd-Frank Act not only restates the general prohibition against “unfair or deceptive” practices, but it also adds a new standard—“abusive practices”—for which banks may soon be cited. Overall, the UDAP net has grown wider and is being cast even farther by policymakers and regulators. In the end, this means there is greater likelihood that banking practices may be caught in the UDAP net.

### **Core UDAP Concepts**

Before we delve into the most recent developments in UDAP law and enforcement, let’s review the foundational aspects of the rule. To bring clarity to the types of practices that are prohibited, the FTC developed policy statements containing key definitional elements of conduct or practices that may be considered “unfair” or “deceptive.” Over 30 years later, these general standards continue to serve as the foundation for UDAP analysis and enforcement. More than 10 years ago, when bank regulators began seriously enforcing the UDAP rule, they generally adopted the FTC standards, but built upon them with additional industry-specific guidance. Overall, bank regulator guidance provides insights into how UDAP standards will be applied to the business of banking. We get further insight into how bank regulators, state attorneys general, and even civil courts interpret and apply the “deception” and “unfairness” standards through settlement agreements and other public announcements related to UDAP cases.

### **Deceptive practices**

An act or practice is considered to be deceptive if it has the following three elements: (1) the representation, omission or practice is likely to mislead consumers (2) who are acting reasonably in the circumstances presented, and (3) the representation, omission, or practice is material.

Note that under this standard the conduct needs only to be *likely* to mislead—there is no requirement that consumers were, in fact, misled. It is also important to remember that the focus is on the “reasonable consumer,” which generally means the average person from the intended target market of the product or service. (See sidebar for examples of practices that have been deemed deceptive.)

## **Practices That Have Been Deemed Deceptive**

### **General**

- marketing practices that did not convey the whole truth or explain requirements to obtain a benefit, or that contained claims that could not be substantiated
- promises that did not materialize
- rates “as low as” or “as high as” were not available to the majority of customers
- teaser rates that did not explain the duration
- claims that could not be substantiated
- asterisks that are buried
- using the term “free” when fees could result

### **Credit cards**

- security deposits/fees for subprime cards that consumed most of the available credit

### **Home loans**

- hidden terms such as balloon payments

### **Deposit products**

- gift cards without pre-sale disclosures, especially where fees could be imposed on the balance
- ATM balances that included overdraft protection

### Unfair practices

Regulators have more recently begun to rely on the unfairness standard, which defines an unfair practice as one that

- causes or is likely to cause substantial consumer injury, where
- the injury cannot be reasonably avoided and
- the injury is not outweighed by benefits to consumers or competition

This standard generally focuses on the bank's course of conduct or business practices that result in financial harm. Here, the focus is generally on the lack of consumer choice, or situations where consumers appear to be taken advantage of—by being coerced into making a purchasing decision or by being powerless to avoid financial harm at the hands of the bank. (See sidebar for examples of practices that have been deemed unfair.)

### Remember When?

UDAP compliance standards have evolved over the years. As noted above, there was a time when UDAP compliance was primarily centered on a bank's disclosure practices—with a focus on accurate advertising copy, well-worded disclaimers, and the like. The goal was to be certain that marketing messages and other disclosures were not misleading or deceptive. In response, banks generally developed a series of compliance controls focused on the marketing function—to ensure that the bank's promotional materials and product-related statements accurately described the products' features and benefits.

In today's regulatory regime, regulators continue to cite and prosecute UDAP cases based on this more traditional UDAP analysis, so a bank must not lose focus on ensuring that its marketing and product promotion practices are sound. But in recent years there seems to have been a shift—or perhaps an expansion of the traditional interpretation of UDAP—beyond the realm of appropriate disclosures and into a more paternalistic pattern. We will explore this development and suggest ways to protect yourself in this ever-expanding field.

### New Directions in Enforcement

The traditional interpretation of UDAP began to shift in 2008 when regulators used it to establish a duty to protect customers and customers' customers from fraud, although there was never an allegation that the financial institution in question was the perpetrator.

### Protecting customers from fraudsters

In the MoneyGram case (July 2008), MoneyGram was tagged with a UDAP concern for failing to protect its customers from unscrupulous third parties who were using the money services business as a vehicle for fraud. In the end, MoneyGram provided an assurance of voluntary compliance. MoneyGram committed to including a warning on all person-to-person transfers to prevent fraud-induced transfers such as lotteries and other scams. MoneyGram also developed a new plat-

## Practices That Have Been Found to Be Unfair

### Predatory lending

Servicing and collections issues due to the lack of consumer choice in servicers

- posting late fees for on-time payments
- collecting unauthorized fees, e.g., for insurance that is already in place
- not quoting payoff amounts or otherwise misrepresenting the amount owed
- fees that are too high for the service received

form that automatically alerts agents to high-risk situations based on the dollar amount and destination of the funds. In these high-risk transfers, the agents are trained to ensure the customer is not the victim of fraud. Customers who believe they may have been scammed after they have sent funds via MoneyGram can reverse the transaction until the funds have been retrieved by the reputed fraudster. Finally, MoneyGram agreed to establish a \$1.1 million fund to help educate its customers on third-party risks.

The Wachovia case (April 2008) takes this new duty to protect one step further. The bank was fined \$125 million for allowing its customers to defraud their own customers (who were not necessarily Wachovia's customers). Wachovia had been servicing telemarketers and payment processors, some of whom produced remotely created checks for Wachovia to process. Four of these payment processors had high chargeback rates (up to 50 percent), causing customer complaints that the transfers had not been authorized. The bank did not act to shut down its customers. Wachovia also paid civil money penalties of \$10 million and established an education fund with \$8.9 million. Wachovia's actions were deemed unfair by virtue of the fact that it banked the payment processors, had reason to know of their unscrupulous behavior, and also profited from those relationships through fees charged.

### Expanding the bank's duty of care

The following year, as the economy started to shift downward, UDAP maintained its high profile. In addition to regulator actions, attorneys general were using state-based UDAP statutes as a sword. Many of these suits claimed that banks had a duty to protect their customers from foreclosure and therefore needed to come to workout agreements, waive their right of repayment under the initial loan terms, and strike more "fair" bargains with consumers. There were also civil suits by several municipalities that sought to create a suitability standard for mortgages—attempting to hold lenders to a higher standard of fairness and disclosure than Truth in Lending would require. Overall, there appears to be a growing

**The traditional interpretation of UDAP began to shift in 2008 when regulators used it to establish a duty to protect customers and customers' customers from fraud, although there was never an allegation that the financial institution in question was the perpetrator.**

public policy position that, based on UDAP, a bank may have a duty to forego its traditional expectation of debt repayment, collection (or realizing upon collateral), and adjust its practices based on a consumer's personal financial situation. The new paradigm suggests that in the long run, the lender will need to play a greater role in evaluating what is best for the consumer—no matter what the contract or disclosures might say.

**Alleviating unfair overdraft practices**

UDAP findings have emerged in the deposit/operations world too. New cases are firmly establishing that the new test is whether the product is deemed fair to customers, regardless of how well any product features or fees are disclosed. In the Woodforest Bank case (April 2010), the bank had appropriately disclosed

its overdraft fees and no one asserted otherwise. However, the Office of Thrift Supervision (OTS) determined that the fee was too high and therefore unfair to customers. The bank agreed to limit its overdraft fees and to set a daily cap on them. For its trouble, the bank agreed to restitution in the amount of \$12 million and a civil money penalty in the amount of \$400,000—a sizeable chunk of change for a community bank with assets of less than \$100 million.

Beyond regulator actions, civil suits raising UDAP-related claims are growing in scope and severity. In the Wells Fargo class action suit (*Gutierrez v. Wells Fargo*, August 2010), the trial court determined that the bank was guilty of unfair and deceptive check processing, in violation of California law. (Wells processed checks from the highest dollar amount to the lowest

**Check out VendorINSIGHT...**

**VendorINSIGHT®**  
Risk management, simplified.

**AUDITOR APPROVED**

**The #1 Vendor Risk Management System with the Most Advanced Features**

A Serviced Solution. Much more than software.	<b>VendorINSIGHT®</b> Risk management, simplified.	Other Solutions
Designed Specifically for Financial Institutions	✓	✗
Online, Fully-Customizable Vendor Risk Assessment (VRA)	✓	✗
Daily Vendor Risk Monitoring and News Alerts	✓	✗
World Class, Acclaimed Service Team AND a Dedicated Program Administrator	✓	✗
The Most Sophisticated User Dashboard Ever	✓	✗
Fully Automated Contract Monitoring and Alerting	✓	✓
Complete Vendor Document Image Repository	✓	✓

[www.vendorinsight.com](http://www.vendorinsight.com) | 1-800-997-2674

Reach this advertiser through <http://links.aba.com>

## Clearly, there is growing momentum on the part of not only federal regulators but also state-based plaintiffs to bring actions alleging UDAP.

dollar amount rather than using sequential order, a common practice among banks.) While there was some discussion of the bank's transaction clearing policy disclosures, the arguments were more focused on the profitability of overdraft fees to the bank. The court's decision ultimately determined that the fees were excessive and therefore an unfair and deceptive business practice. The bank was ordered to pay \$203 million in restitution. The case is on appeal.

Meanwhile, 32 banks are named defendants in overdraft-related actions that have now been consolidated into a multi-district class action case venued in Florida (*In re Checking Account Overdraft Litigation*, 2009). The actions generally allege unfair or deceptive practices in connection with the imposition of overdraft fees. This massive cluster of cases will eventually run its course—but it must not go unnoticed to banks focused on UDAP risks. Clearly, there is growing momentum on the part of not only federal regulators but also state-based plaintiffs to bring actions alleging UDAP.

The OTS published guidance on overdrafts (April 2010) that encompassed lessons from both *Woodforest* and *Wells*. It recommends, in addition to what we learned from those cases, that banks explain alternatives to overdraft programs and not use the term “free” if overdraft charges are possible. Also, banks should allow customers to opt in to any overdraft program and to promptly notify customers of any overdrafts.

### UDAP-Related Rulemaking

We can glean some insight from the proposed and final rulemaking on unfair and deceptive practices related to credit cards that was finalized in three installments in 2009 and 2010. (While the banking regulators initially published the proposed rule as an extension of Reg. AA, Congress passed it as an amendment to Reg. Z. The regulators subsequently republished the proposals and final rules under Reg. Z and withdrew the Reg. AA proposal.)

The new credit card rules added requirements that limit when credit card servicers can charge late fees. As we noted earlier, one prong of the unfairness standard requires that the practice cause or be likely to cause substantial consumer injury. With that in mind, regulators focused on the timing fee imposition as a key factor that could indicate an unfair practice. In their analysis, the regulators observed that 35 percent of active credit card accounts paid at least one late fee in 2005. They concluded that the practice was injurious in that banks generally do not allow sufficient time for customers to make

their payments after receiving their statements. It appears the bar is very low for a fee-related practice to be considered unfair.

UDAP-related matters in the subprime lending area have also been of concern. The focus here raised unfairness issues based on lack of meaningful choices afforded to a subprime borrower. (Remember that the second prong of an unfairness finding requires that any injury caused by the practice cannot be reasonably avoided.) The regulators concluded that the general lack of market alternatives for subprime loans satisfied this requirement, making subprime loans potentially unfair to consumers with few other loan options.

One final example of changing supervisory thinking relates to how banks allocate payments received for credit card balances, especially when those balances are subject to different rates. In their analysis, rulemakers concluded that substantial injury occurs because customers are paying more interest and could potentially lose their promotional rates. The injury is not avoidable because consumers have no control over allocation and disclosures are typically not sufficient. Finally, the regulators determined that there is no countervailing benefit, as consumers do not benefit from banks' increased profits.

### Expanding the UDAP standard: abusive practices

In addition to the UDAP-related changes in Reg. Z's credit card rules, the passage of the Dodd-Frank Act casts an even wider net. Title X of the act creates yet another standard that may result in a UDAP violation: abusive acts or practices. This term appears in two separate sections: Section 1036 makes it unlawful for banks to engage in an unfair, deceptive, or abusive acts or practices, and Section 1031 empowers the new Consumer Financial Protection Bureau (CFPB) to write regulations governing these practices.

Under the Dodd-Frank Act, the CFPB is empowered to declare an act or practice abusive if it

- materially *interferes with the ability of a consumer to understand* a term or condition of a consumer financial product or service, or
- *takes unreasonable advantage of*
  - a *lack of understanding* on the part of the consumer of the material risks, costs, or conditions of the product or service
  - the *inability of the consumer to protect his or her interests* in selecting or using the financial product or service
  - the *reasonable reliance by the consumer on a covered person to act in the interests of the consumer*

While the scope of this new standard has not yet been tested or interpreted by any court or banking agency, it clearly widens the UDAP risks banks face. The new abusiveness standard codifies and further expands the expectation that banks must do more than provide disclosures and be clear in their marketing and advertising. Instead, it clearly creates the expectation that banks must be ready to proactively protect consumers from their own bad choices—and affirmatively engage in what appears to be a greater duty of care.

Under the Dodd-Frank Act, the CFPB has, and will most certainly exercise, rulemaking authority. In some respects, formal rulemaking may be useful from a compliance perspective. Because of UDAP's subjective nature, a clearer list of do's and don'ts could provide greater clarity to the industry. Plus, with formal rulemaking, banks will have a chance to better understand this new UDAP (or more accurately, UDAAP) paradigm—which puts them in an active role in monitoring consumer behavior and preventing consumers from engaging in conduct that may not be in their best interests.

### Practical Implications for Bankers

We don't have a crystal ball to predict where UDAP might be heading next. However, with UDAP-related issues clearly on the rise, consider the following recommendations and action steps to beef up your UDAP awareness in this new UDAAP world:

**1. Renew your focus on consumer complaints.** UDAP-related risks may be lurking in areas where you have a greater number of consumer complaints or inquiries. In the spirit of customer service, many bankers tend to focus on complaint resolution as the primary goal. While timely resolution of consumer complaints is essential, your UDAP analysis should not end there. You should also delve into the root causes of consumer dissatisfaction. Look for trends in complaints, and re-evaluate the product from a UDAP perspective.

- Are the terms and conditions clear? Do customers understand the product features? Is the product properly positioned from a marketing perspective? Remember that you could be in full compliance with consumer disclosure rules and still have a serious UDAP problem. (For example, Reg. DD permits the use of the term “free” in relation to accounts where overdraft fees may apply, while the OTS’s guidance finds the use of that term inappropriate from a UDAP perspective.) To the extent that consumer complaints focus on fees, the timing of services, or other technical terms, be sure that all product messaging accurately describes the product or service—both benefits and drawbacks.
- Is the product (and the way it is offered) useful and beneficial to consumers—or is the product itself the problem? In today’s environment, regulators are beginning to determine that bank products (or a bank’s operational practices) must

# ...and check risk off your list!



*"Set up was simple and fast. We were up and running in two weeks."*

*"Our examiner LOVED this solution!"*

*"Our VendorINSIGHT program administrator saves us a lot of time and effort."*




**VendorINSIGHT®**  
Risk management, simplified.

**Find out more and sign up for a free demonstration at [www.vendorinsight.com](http://www.vendorinsight.com)**

[www.vendorinsight.com](http://www.vendorinsight.com)

1-800-997-2674

Reach this advertiser through <http://links.aba.com>



**By all indicators, we are not far from the day when banks will need to delicately guide or redirect consumers to financial products that conform to their financial habits, rather than allowing consumers to make those choices on their own.**

not in any way be detrimental to the consumer—even if the consumer’s actions are the cause of the detriment. There is growing public sentiment that banks should not charge for all of their services—at least not all the time. To the extent that customer complaints emanate from the product itself—or how it is used by the consumer—it’s time to step back and evaluate whether the product needs to change in order to prevent UDAP risks from surfacing, even when the product or service has traditionally been within industry standards.

**2. Evaluate your revenue streams.** While safety and soundness standards require banks to maintain strong earnings, recent enforcement trends suggest that bank products or services with long and profitable shelf lives can be ripe for UDAP findings. In today’s UDAP-focused environment, optional services typically offered for the convenience of customers may now be viewed through a different lens. While some level of fee imposition is generally acceptable, banks now have an affirmative duty to intervene on behalf of customers who are overusing a particular service, especially when their financial habits are outside the norm of acceptable customer behavior. The Dodd-Frank Act codifies this new public policy proposition—terming it an abusive practice if financial services providers do not step in and save consumers who do not protect their own interests when selecting or using products or services.

**3. Consider the suitability of your products for your customers.** By all indicators, the concept of product suitability is making its way into bank compliance practices, with UDAP as the entry point. Without question there is a growing sense that banks must actively evaluate the propriety of their products for the specific customer. While it would be unthinkable for a restaurant owner to size up a patron and deliver a salad rather than the requested cheeseburger and fries, the same is not true in the financial services industry. (Remember that the initial CFPB proposal called for all banks to offer only plain-vanilla products and straying from that would have required permission.) By all indicators, we are not far from the day when banks will need to delicately guide or redirect consumers to financial products that conform to their financial habits, rather than allowing consumers to make those choices on their own. Evaluate your product lines and consider how they may need to change to accommodate this emerging UDAP standard. In the end, UDAP

compliance may require creating products with features and services that are directly tied to acceptable consumer conduct so as to avoid the imposition of fees. In the end, the bank’s operational systems, rather than the consumer’s own judgment, may need to dictate which account best fits the consumer. This will mean creating products that give the bank the contractual right to remove or eliminate certain product features based on undesirable consumer behavior—all in the name of consumer protection.

There is no question that when it comes to UDAP compliance, the tide of regulatory risk is rising. Recent enforcement actions indicate greater confidence among regulators in pursuing a UDAP claim by expanding the traditional interpretations of UDAP compliance. Public policy standards are also shifting, placing less value on consumer responsibility and greater accountability on the banking industry to monitor and curtail consumer behavior. And, with the passage of the Dodd-Frank Act, a new era of increased rulemaking will soon be upon us—potentially giving rise to a new set of rules that prohibit unfair, deceptive, or abusive acts or practices. ■

#### **ABOUT THE AUTHORS**

**THOMAS G. PAREIGAT** is a banking attorney with more than 25 years of consumer protection and regulatory compliance experience. He serves as general counsel of The Bancorp, Inc., headquartered in Wilmington, Del., where he oversees the legal and compliance management function. He previously served as a partner at the Minneapolis law firm of Lindquist & Vennum PLLP, where he advised banks on emerging legal and regulatory risk issues and represented banks in supervisory proceedings including UDAP-related enforcement actions. Reach him by e-mail at [tpareigat@thebancorp.com](mailto:tpareigat@thebancorp.com) or by telephone at (612) 371.2030.

**MEG SCZYRBA, CRCM**, works for PayPal as the director, regulatory compliance. She is very involved in the industry, including regular speaking, training, and writing on various compliance topics, including UDAP. She sits on several ABA boards and committees, including the ABA Compliance School Board and the ABA Bank Compliance editorial advisory board, and is a former member of the CRCM Advisory Board and the Compliance Executive Committee. She graduated from the University of Missouri–Columbia with degrees in psychology and law. Reach her at [mssczyrba@paypal.com](mailto:mssczyrba@paypal.com) or (408) 967-4567.