Best Practices to Mitigate UDAAP Risk

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Agenda

1. UDAAP
   - History
   - Definitions

2. CFPB Expectations and Lessons Learned
   - Complaints
   - Add-On Products
   - Rewards/Loyalty Programs
   - Deferred Interest
   - Change in Terms
   - Overdraft Programs

3. Best Practices
UDAAP

- History
- Definition
What is UDAAP & Where Did it Come From?

1914 – Federal Trade Commission Act created to protect consumers from monopolies & unfair trade practices

Later amendments shifted focus to protecting consumers from deceptive advertising practices & other forms of consumer fraud

July 2010 – Dodd-Frank Act, created the CFPB, whose primary focus is entirely on consumer protection
An act or practice is unfair when:

- It causes or is likely to cause substantial injury to consumers
- The injury is not reasonably avoidable by consumers
- The injury is not outweighed by countervailing benefits to consumers or the competition
UDAAP – Standards for Determination

Unfair

Standards of review for determination of an unfair act or practice: 1) it causes or is likely to cause **substantial injury** to consumers; 2) it cannot be **reasonably avoided** by consumers; and 3) the injury that is caused is not outweighed by other benefits to consumers or to competition (requires **Cost-Benefit Analysis**).

- **Injury**: Usually involves a monetary loss, not a loss that is emotional or speculative in nature
- **Substantial**: one consumer loses a large amount of money or a small amount of money is lost by a large number of consumers

  - If the consumer can reasonably avoid being injured, the act or practice is not unfair
  - If the act or practice is deemed unfair, even avoidance of injury by the consumer will not result in a determination that the act or practice is fair

- **Avoidance Test**: Reasonable consumer

  - Injury minor compared to overall benefit to consumers- Not unfair

- **Cost-Benefit Analysis**: Consider Public Policy: Will the public benefit from the act or practice and if so, does that benefit outweigh any foreseeable harm?
  - Public benefit outweighs harm- Not unfair
  - Foreseeable harm outweighs public benefit- Unfair
UDAAP
Deceptive

An act or practice is deceptive when:

The representation, omission, act, or practice misleads or is likely to mislead the consumer.

The consumer’s interpretation of the representation, omission, act, or practice is reasonable under the circumstances, and

The misleading representation, omission, act, or practice is material.
An abusive act or practice:

Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service.

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 a consumer financial product or service; or
• The reasonable reliance by the consumer on a covered person to act in the interests of the consumer.
UDAAP – Standards for Determination

Abusive

• The Abusive prong is an evolving area of case law and regulatory procedure

• Unlike the Unfair and Deceptive prongs, there are as yet no standard developed criteria to measure an act or practice against
CFPB Expectations and Lessons Learned

• Complaints
• Add On Products
• Rewards/Loyalty Programs
• Deferred Interest
• Change in Terms
• Overdraft Programs
#1 Area Examiners Look for UDAAP Violations

**UDAAP in Complaints**

- Complaints should be reviewed by a compliance officer or committee to ensure trends are identified and changes are made.
- Complaints should be understood from a customer’s point of view.
- Have designated staff and resources devoted to complaint management.
- Track consumer indications of confusion and misunderstanding as well.

**Developing trends:**

- 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, service members, those in financial distress, those with limited English skills or education, etc.
- A statement to the effect of “I didn’t understand.”
CFPB Expectations
Add-On Products

“Sell Add-On products in a manner that limits the potential for statutory or regulatory violations and related consumer harm”

CFPB Bulletin 2012-06, July 8, 2012

• Expectations
  – Marketing materials reflect the actual terms and conditions of the product and are not deceptive or misleading to consumers
  – Ensure that employee incentives or compensation tied to add-on products do not create incentives to provide inaccurate information about the products
  – Have approved scripts for offering of add-on products
  – Cannot be required to purchase as a condition of credit approval
  – Must allow cancellations
Large Financial Institution (LFI) sold a credit protection product in which enrolled customers were required to provide sufficient personal information and consent to have their credit reports accessed.

Customers could not receive the credit monitoring services until the information and consent were submitted. However, customers were billed the full fee of the product even though not all customers were receiving the credit monitoring services.

LFI required to pay a CMP of $35 million to OCC.

LFI required to refund the full amount paid for the product along with any over the limit fees, finance charges, and interest.

LFI directed to improve its supervision of third-party vendors associated with add-on products along with developing and audit program for such products.
Rewards & Loyalty Programs

Areas of Heightened Scrutiny

• Programs that require consumers to take specific steps to earn a reward
  – if the steps are unreasonably burdensome or if few consumers actually complete the steps.

• Redemption requirements that make it unreasonably difficult for consumers to redeem their rewards, such as reward minimums, blackout periods, and redemption fees.

• Unilateral changes to the rewards program after enrollment that are detrimental to consumers

• Failure to adequately disclose all features of a rewards program, including when rewards may be forfeited or reinstated from other sources

• Failure to keep adequate records regarding rewards earned and redeemed by consumers
Rewards and Loyalty Programs

Problem Areas and Suggestions

- **Marketing the dollar-value equivalent of points-based schemes**: Review all marketing collateral to make sure that it is clear to the cardholder how to earn points and the value of the points.

- **Misrepresenting bonuses in promotional materials**: Compliance review of all marketing material with an eye towards unfair, deceptive, or abusive practices.

- **Overpromising on benefits**: Avoid promoting unattainable benefits. Promote the benefit level the average cardholder would earn.

- **Failing to make rewards disclosures clear and transparent**: Compliance and audit review of rewards program disclosures.
Rewards & Loyalty Programs

Financial Institutions Should:

Evaluate rewards program materials to determine whether ads and disclosures are clear, accurate, and create reasonably attainable expectations on the part of the consumer.

Review and monitor rewards programs offered by any third-party vendors to ensure that the actual practices of the vendor in administering the program are consistent with the disclosures provided.

Monitor all rewards-related complaints to assess whether any aspect of the program is consistently problematic for consumers.
Deferred Interest

• Deferred Interest Means Finance Charges Accrued on Balances that a Consumer Is Not Obligated to Pay if Those Balances Are Paid In Full by a Specific Date

• Advertising Provisions:
  – Acceptable Terms for Deferred Interest
    • No interest
    • Deferred interest
    • Same as cash
  – If State “No Interest” Must Also State “If Paid In Full” by Date Certain
    • Immediate proximity
    • Must also state in a prominent location closely proximate
      – Interest will be charged from the date of the transaction if not paid in full by a certain date; and
    • Interest will be charged from the date of the transaction if the account is in default before the end of the deferral period

UDAAP Violations Can Occur Along with Reg Z violations
Deferred Interest

• Allocation of Payments (Section 1026.53)
  – Excess amount (above minimum payment) allocated first to balance with highest APR then any remaining portion to other balances in descending order based on the APR.
  – If there is a deferred interest program, excess payments allocated in above manner except that during the two billing cycles immediately preceding the deferred interest period, the excess must first be allocated to the deferred interest program or in the manner requested by the consumer.

• Periodic Statement Requirements (Section 1026.7)
  – If there is a deferred interest program, the creditor must disclose the date by which the outstanding balance must be paid in full in order to avoid paying finance charges on the deferred interest program.
  – This disclosure must be on the front page of the periodic statement and substantially similar to Sample G-18(H) in Appendix G.
Change In Terms

UDAAP Violations Can Occur Along with Reg Z violations

• Significant change in terms includes:
  – Changes required to be disclosed under 1026.6(b)(1) and (2)
  – An increase in the required minimum periodic payment
  – A change to a term required to be disclosed under 1026.6(b)(4)
  – Acquisition of a security interest

• Written notice required
  – Forty-five (45) days prior to the effective date of the change
Overdraft Program

Common Overdraft Solutions

1. **AUTOMATED PROGRAM**
   - Assumptions

2. **TRANSFER CAPABILITIES**
   - Line of Credit, Credit Card, Linked Deposit Accounts

3. **AD HOC**
   - Review Overdrawn Items (Typically Checks) Next Business Day
   - Pay/No-Pay Decision is Judgmental
   - Consistent Process Challenges

4. **DEBIT CARD ACTIVITY**
   - Opt-in Functionality
   - Preauthorized Transactions and Amounts

5. **DI MINIMIS**
   - Small Overdraft without a Fee Charged
### Common Elements of an Automated Program

- Core vs Third-Party
- “Limit” – Dynamic or Static
- Customer Scoring
- All Transaction Types *(excluding debit cards)*
- All Transaction Types with Debit Cards
- Loss Mitigation/Collection Efforts
- Ad Hoc
Overdraft Program

1 Overdraft Fee
   Daily Cap (Number of Items per Day or Dollar Amount per Day)

2 Non-Sufficient Fund (NSF) Fee
   Daily Cap (Number of Items per Day or Dollar Amount per Day)

3 Continuous Overdraft Fee
   Timeframe for Assessing
   Assessed After 5 Days (Business or Calendar) Overdrawn

4 Transfer Fees
   Linked Deposit Account
   Linked Credit Account

Disclosures VS. System Parameters?
Regulatory Enforcement - Overdraft Program

Consumer Financial Protection Bureau

WHEN
August 2015

WHAT
Overdraft Fees
Customer did not “opt-in”

PENALTY
Consent Order
Fine - $7.5 Million Fine

FIXES
Policy & Procedures
Training
Monitoring
Audit
If the consumer does not opt in, banks may either allow or decline the transaction, but cannot charge a fee if they decide to cover any overage.

"Overdraft Practices ~ Regulation E"
Current Hot Topics

Balance Definitions
- Available Balance
- Ledger Balance

Fee-on-Fee Concerns
- Overdraft Fee due to Other Account Fee

Business Day vs. Calendar Day
- Continuous Overdraft Fee

Preauthorized Debit Card Transactions
- Opt-In
- How the Transaction Affects Balance Methodology

Disclosures
- Clear-and-Conspicuous Expectation
- Content = System Setup Parameters
### Current Hot Topics

Posting using Available Balance

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Available Balance</th>
<th>Ledger Balance</th>
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<tbody>
<tr>
<td><strong>Day 1</strong></td>
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<tr>
<td>Opening Balance</td>
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<td>$100</td>
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<tr>
<td>Signature Debit Authorized</td>
<td>&lt;$80&gt;</td>
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<td>$100</td>
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<tr>
<td><strong>Day 2</strong></td>
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<tr>
<td>Check Posted</td>
<td>&lt;$40&gt;</td>
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<td>Overdraft Fee</td>
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<td>&lt;$50&gt;</td>
<td>$30</td>
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<tr>
<td><strong>Day 3</strong></td>
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<tr>
<td>Signature Debit Posted</td>
<td>&lt;$80&gt;</td>
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<tr>
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<td>&lt;$80&gt;</td>
<td>&lt;$80&gt;</td>
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Source: Outlook Live Webinar November 9, 2016
System Configuration

System Parameters vs. Disclosures?
System Configuration

Order of Presentment

![Diagram of order of presentment]

- **Comingled High to Low**
  - Bank Adjustments (cannot cause OD fee)
  - All other debts

- **Sub-batched High to Low**
  - Pre-authorized debits & bank adjustments (some can cause OD fee)
  - Signature POS debit
  - Online transfers, teller withdrawals, on-us checks, PIN POS, ATM
  - Off-us and converted checks

- **Chronological & Serial Order**
  - Bank adjustments (cannot cause OD fee)
  - Wire, teller withdrawal (cannot cause OD fee)
  - POS debit, ACH, ATM
  - Checks

Source: CFPB
System Configuration

Overdraft Limit

Static

Same Limit

Unique Limit

Monitoring and Loss Mitigation

Dynamic

Scoring

Monitoring & Customized Loss Mitigation
Quick Recap

In Summary:

- Overdraft Programs/Sources of Funds
- Fee Structure
- Balance Methodology Considerations
- System Parameters and Settings
- Ownership and Accountability
- Proactive Management
- Enforcement Actions
Compliance Management System

Managing Compliance Risk

Compliance Risk

Reputational Risk

Product Development
Product Advertising
Product Offerings/Changes to Product Offerings
Servicing
Proactive Management
Function/Framework

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<tr>
<th>Function/Framework</th>
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<tbody>
<tr>
<td>• Due Diligence</td>
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<tr>
<td>• New Product/Service On-Boarding</td>
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<tr>
<td>• Change in Terms</td>
</tr>
<tr>
<td>• System Release Updates</td>
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<tr>
<td>• New Technology</td>
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<tr>
<td>• New Product Development</td>
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<tr>
<td>• Core – Available Settings</td>
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<tr>
<td>• Fee Structure</td>
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<table>
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<tr>
<th>Committee</th>
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<tbody>
<tr>
<td>• Which lines of business are represented?</td>
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<table>
<thead>
<tr>
<th>Ownership &amp; Accountability</th>
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<tr>
<td>• How is it defined?</td>
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<th>Regulatory Environment</th>
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<td>• Presentations, Alerts, Enforcement Actions</td>
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<th>Testing/Validation/Confirmation</th>
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<tbody>
<tr>
<td>• System Configuration</td>
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<th>Third-Party Vendor Management</th>
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