Regulatory: Part 2: Unraveling UDAAP in the consumer financial services industry

UDAAP's unfairness standard is a playground for subjective oversight

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This article is the second in a series of six articles concerning UDAAP. Read part one here.

According to the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Consumer Financial Protection Bureau (CFPB) can declare "unfair," and thus unlawful, any act or practice in connection with a transaction for a consumer financial product or service, or the offering of a consumer financial product or service, so long as the CFPB has a reasonable basis to conclude that:

a) the act or practice causes or is likely to cause substantial injury to consumers that they can't reasonably avoid

b) such substantial injury is not outweighed by countervailing benefits to consumers or to competition

Notably, Dodd-Frank states that "in determining whether an act or practice is unfair, the Bureau may consider established public policies as evidence to be considered with all other evidence." However, "such public policy considerations may not serve as a primary basis for such determination."

But what is unfairness? That depends, at least in part, on whether you are asking a philosophical, metaphysical or legal question. Or does it?

Random House Webster's College Dictionary defines unfairness as "not fair" and "not conforming to standards of justice, honesty, or the like." This definition of unfairness—any definition of unfairness, really—leads us to ask, "What is fair?"

"Fair," according to Black's Legal Dictionary—which, somewhat tellingly, does not even attempt to define unfair or unfairness—is defined as "having the qualities of impartiality and honesty; free from prejudice, favoritism, and self interest. Just; equitable; even-handed; equal, as between conflicting interests." These definitions provide a playground for subjectivity; someone must determine what is just, equitable or evenhanded, and that someone is going to bring her personal perspective to the adjudication. Subjectivity has many problems, particularly when it comes to the law and when contrasted with the virtues of objectivity.

Objective information is, simply put, information that is observable. You can see, touch, smell, taste or otherwise discern it. Objective information is factual in nature and often as close to the truth as we can get. When making decisions or judging people or practices under a standard, objective information is, in a word, useful.

Contrast the utility of objective information with the often destructive impact subjective information has on decision making. Subjective information is frequently not the truth. Rather, it is someone's opinion, belief, judgment or assumption. And perhaps most troubling about subjective information is that it quite frequently varies from person to person and day to day. Like a rumor, subjective information can be completely false and take on a life of its own.

With this is mind, let's examine the "unfairness" standard that now applies to all consumer financial services transactions under Dodd-Frank.

So, is unfairness objective or subjective? Well, it is arguably a bit of both, although one can quite readily take the position that it's completely, inherently subjective. Below are a series of questions related to UDAAP's "unfairness" standard, with answers derived from information the CFPB provided in version 2.0 of its Supervision and Examination Manual.

Q: What constitutes a "substantial injury"?

A: According to the CFPB, a substantial injury may or may not include monetary harm. It could be a small amount of harm to a large number of people, or perhaps even a massive harm to a single person. "Actual injury is not required in every case," as far as the bureau is concerned. Indeed, "a significant risk of concrete harm is also sufficient." Importantly, the bureau has concluded that subjective harms, such as emotional impact, will not "ordinarily" constitute substantial injury, but could in "certain circumstances." As a result of the open-ended opportunity to interject judgment and belief into the determination of whether there has been a "substantial injury" (e.g., does monetary harm or actual injury actually matter?), the bureau suggests that this term may be totally subjective.

Q: When is a substantial injury "reasonably avoidable" by consumers?

A: The bureau says that where a practice interferes with consumers' "ability to effectively make decisions or to take action to avoid the injury," a substantial injury is likely not reasonably avoidable. A key question, however, is whether an act or practice hinders a consumer's decision making. The CFPB's sole example of a substantial injury that is not avoidable because of a hindrance is not having access to important information that prevents consumers from comparison shopping, choosing desirable alternatives, and avoiding inadequate or unsatisfactory options. This hindrance is compounded, says the bureau (citing the Credit Practices Rule), if nearly the entire market is engaged in a particular practice because the incentive to search elsewhere for a better product is reduced.

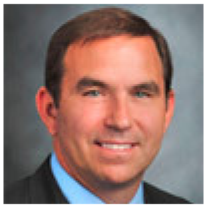
Of course the consumer must take reasonable steps to avoid the substantial injury; "hiring independent experts to test products in advance or ... bringing legal claims for damages in every case of harm [is] too expensive to be practical for individual consumers and, therefore, are not reasonable." So what is reasonable, then? The CFPB and Manual 2.0 do not help us out here, leaving the door wide open for subjective determinations.

Q: When is the injury outweighed by countervailing benefits to consumers or competition?

A: "The act or practice must be injurious in its net effects." Huh? All we can really glean from Manual 2.0 is that offsetting benefits include "lower prices to the consumer or a wider availability of products and services resulting from competition," and that the costs to prevent the injury—e.g., "the costs to society as a whole of any increased burden"—are also taken into account in determining unfairness. How could an objective inquiry ever determine this?

This simple review of Manual 2.0 reveals the innate risk of subjectivity lurking in UDAAP's unfairness standard. Given this, how can consumer financial services institutions comply? It is admittedly not an easy task. The next installment in this series will analyze UDAAP's deceptive standard. Ultimately, the series will works its way toward some holistic advice on how to manage the regulatory and compliance risks UDAAP presents, including the subjectivity the unfairness standard presents.

About the Author



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