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Consumer Protection and Regulatory Changes in the Dodd-Frank Bill



By **Dr. Ethan Cohen-Cole** **Summary**

On 21 July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or “Act”). The Act is a wide-ranging set of financial reforms that make the largest change in financial regulation in decades. Among the most contentious provisions in the bill is the creation of the Bureau of Consumer Financial Protection (BCFP). The BCFP will consolidate consumer protection powers from a variety of agencies and will gain rulemaking and enforcement authority. This note will discuss key provisions of Dodd-Frank that pertain to the consumer finance industry.

Among the most important provisions of the Act is the consolidation of consumer regulatory authority in a single agency that has both rulemaking and enforcement authority. This will enable the BCFP to highlight potential consumer issues, issue new rules, and enforce them with minimal complication. The newly streamlined process will likely mean stricter rules on disclosure for retail financial products, including disclosures on product design and a greater chance of regulatory action.

Key Consumer Protection Provisions of the Act

Mandatory Arbitration

Section 1028(a) of Dodd-Frank provides for the new BCFP to restrict mandatory pre-dispute arbitration clauses between financial service companies and consumers. In advance of any new rules, the Act states:

“The Bureau shall conduct a study of, and shall provide a report to Congress concerning, the use of agreements providing for arbitration of any future dispute between covered persons and consumers in connection with the offering or providing of consumer financial products or services.”

Financial service companies have long held that mandatory consumer arbitration clauses are in the best interests of consumers. The most common argument is a cost-based one. Arbitration is typically lower cost than other legal remedies such as court adjudication; as a result, providers are able to pass on legal savings to customers in the form of better interest rates or lower fees. In addition, the faster speed of arbitration provides consumers with a quicker resolution of their concerns.

Nonetheless, consumer advocates and some legal scholars have argued against mandatory arbitration clauses on four grounds. One, they abrogate consumers’ constitutional rights.¹ Two, they force consumer agreement to provisions they may not understand or cannot negotiate.² Three, they can be cost-prohibitive to low-income borrowers. Four, they often require consumers to waive their rights to a class action settlement.

Changes to mandatory arbitration clauses are a likely outcome of the new BCFP and potentially pose the greatest litigation risk to consumer product providers.

Consolidation of Regulatory Power

The Act creates the BCFP as an independent bureau within the Federal Reserve System. Its director will be appointed by the President and will implement essentially all federal consumer financial laws through a combination of rulemaking, orders, policy statements, guidance, and enforcement.

The new bureau consolidates consumer financial laws that are currently handled by a variety of different federal agencies, including the Office of the Comptroller of the Currency (OCC), the former Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, the National Credit Union Administration, the Department of Housing and Urban Development, and the Federal Trade Commission. Most importantly, the BCFP takes authority for general oversight of consumer protection, an authority that resided with the Federal Reserve until Dodd-Frank’s passing. The alleged failure of the Federal Reserve to act on its consumer protection authority was one of the reasons for the creation of the new bureau.³

While the new BCFP will reside within the Federal Reserve System, it will be largely independent. It remains to be seen how a new system specifically designed for consumer protection will integrate with hosts that were historically more laissez-faire in their application of consumer protection. There are varied views on the reasons for the Federal Reserve's historical approach, one of which is that the safety and soundness mission of the Fed ran against the demands of consumer protection. The Federal Reserve will have only limited ability to restrict the rulemaking and enforcement of the new BCFP,⁴ but the new agency will likely rely on Federal Reserve resources, economists, and bank regulators as it quickly builds capacity.

New Rulemaking and Studies

The new Act authorizes the BCFP to write new rules to curtail deceptive, unfair, or abusive practices related to consumer financial products. However, it does not require any new rulemaking or the re-examination of inherited rules.

The Act requires that new rulemaking consider the potential benefits and costs to consumers and providers. Most importantly, it requires consideration of whether a new rule could reduce access to financial products. The concept of reduced access is hard to prove, but industry participants have long argued that any costs incurred through consumer protection or limitation of product design could result in increased costs and/or reduced access.

The Act also requires the bureau to conduct three large, comprehensive market studies. The first, discussed above, is related to the impact of mandatory arbitration clauses.

The second, outlined in Section 1076, requires the bureau to conduct a study on reverse mortgages. In general, the Act directs the bureau to evaluate the nature of disclosures and limitations on reverse mortgages to determine if any practice is "unfair, deceptive or abusive." It further directs the bureau to provide an "integrated disclosure standard and model disclosures for reverse mortgage transactions."

The third is a study on credit scores. This study, from Section 1078, requires the bureau to evaluate the "nature, range and size of variations" between the information sold to consumers in the form of credit reports and to creditors in the form of marketing information. The goal of this study is to determine whether these differences disadvantage consumers.

Each of these three studies is likely to produce both new disclosure standards and new rules on the provision of financial products and/or the sale of credit information.

Exclusions and Limitations

The Act included a widely debated set of exclusions on the purview of the BCFP. Three significant exclusions were included.

The first excluded retailers, merchants, and sellers of non-financial goods or services that provide credit for the sale of retail products.

The second excluded a specific set of other entities that provide financial products of some type. These included auto dealers, real estate brokerage activities, accountants and tax preparers, lawyers engaged in the practice of law, persons regulated by state insurance regulators, manufactured home retailers and modular home retailers, employee benefit and compensation plans, persons regulated by state securities commissions, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, and activities related to charitable contributions.

Finally, the Act excluded from BCFP oversight insured depository institutions and credit unions with assets of \$10 billion or less. Oversight of these entities remains under the control of their primary regulator.

These exclusions will likely have a broad impact. First, rules and regulations laid out by the BCFP for larger entities, particularly standard disclosure forms, could end up being used as a default by many smaller banks and credit unions. Second, the exclusion will likely lead to a proliferation of non-traditional financial products in unregulated and/or small entities. Third, products sold by a non-regulated entity under contract with a larger bank, or later sold to a larger bank introduce unresolved legal issues that will likely end up being resolved within the legal system. For example, does a mortgage underwritten by a large bank but sold through a mortgage broker require the same disclosure as a loan offered by the bank directly?

Card Act

In 2009, Congress passed the Credit Card Accountability, Responsibility and Disclosure Act (Card Act) that curtailed many practices regularly used by credit card providers and mandated new disclosure rules. The creation of the BCFP consolidates enforcement of the Card Act in a single agency. The likely impact will be stronger and more comprehensive enforcement of its provisions.

FTC Authority

Under Section 1061(b)(5) of the Act, along with the Federal Reserve, the OCC, and the FDIC, the Federal Trade Commission (FTC) has lost authority to prescribe rules, issue guidelines, conduct studies, or issue guidelines related to consumer protection for financial service products. This provision will grant the BCFP authority to make rules that impact the FTC Act and grant the BCFP authority enforce and interpret existing component of the FTC Act. While the BCFP will gain rulemaking and enforcement authority over financial service products, the FTC will remain responsible for non-bank entities.

Given the potential overlap, Dodd-Frank also calls for the BCFP and the FTC to negotiate an operating agreement related to rulemaking which requires consultation between the two agencies.

Potentially the largest substantive change appears in Section 1031. It expands the language of the FTC Act by specifying "abusive" practices. Dodd-Frank will permit the BCFP to:

- 1) issue rules or go to court to prevent “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.”

It also defines unfair practices as:

“an A) act or practice [that] causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and

B) such substantial injury is not outweighed by countervailing benefits to consumers or to competition.”

It also defines “abusive” practices as those that:

(1) Materially interfere with the ability of a consumer to understand a term or condition of a consumer financial product or service; or

(2) Take 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.

Implications for Litigation

The BCFP will likely have a number of impacts on consumer protection litigation. One, in the places where regulation has been consolidated efforts in a single place, it will make cross-institution comparisons and data collection more viable. This will enable the BCFP to both impose civil fines and to support the Department of Justice in criminal actions. Indeed, the Department of Justice has indicated that it will seek greater enforcement of fair lending laws.⁵

Two, the three studies mandated by Dodd-Frank could lead to a round of new litigation. For example, new rules around mandatory arbitration could permit class action filings on a range of new matters. Perhaps more notably, the large-scale studies on reverse mortgages and credit scoring could bring to light patterns of lending that contribute to current liability.

Three, because the BCFP has the ability to conduct investigations and issue adjudications, including civil fines, financial product providers could find themselves having to manage additional legal matters. BCFP decisions are subject to review by the Federal Appellate courts. While remedies do not include punitive damages, findings by the BCFP could well be used by private parties seeking additional compensation. The BCFP can directly require rescission or reformation of contracts, restitution, payment of damages, and injunctions barring future violations.

Four, the assumption of FTC responsibilities and the inclusion of new language on the definition of abusive practices are almost certain to result in either direct enforcement action or consumer legal challenges. The boundaries of “abusive” practices will require some time to fully establish and will likely be defined in part by the outcome of legal action.

Suggestions for Consumer Financial Product Providers

We encourage financial service providers of all types, including those that may be excluded from direct oversight, to be aware of the regulatory changes. This will ensure that the intent of the law is followed in protecting consumer rights, and will also limit legal liability going forward. Indeed, the BCFP is authorized to expand its own authority by rule. It can extend its reach to so-called non-depository persons (e.g., persons who offer or provide origination, brokerage, or servicing of loans secured by consumer homes). Providers should:

One, evaluate whether your organization is regulated by the BCFP and/or subject in some fashion to its new rulemaking or enforcement authority. Given some oversight of your business, determine the portions, or your business that are impacted.

Two, review your organization’s internal compliance program. An understanding of consumer financial behavior and financial literacy will facilitate this process. It should be augmented and developed to ensure that it meets the requirements of Dodd-Frank both now and in an ongoing fashion. Because the agency will have a singular focus, there is an increased likelihood of on-going changes to consumer protection laws.

Three, be aware of new rulemaking. In the next 12-24 months, the BCFP will likely issue a range of new rules that will require active changes to internal compliance and lending programs. The notice and comment rulemaking process is an opportunity for affected firms to place on the public record factual information about compliance costs or alternative means of meeting BCFP objectives. Contributing to the public record is important not only for assisting the BCFP in their deliberations, but also for assisting judges who may be asked to review the record for rules that are challenged in court.

Four, develop new standards for examination preparation. These examinations will likely be conducted by individuals with prior training in examinations from another regulatory agency, but will be closely targeted to consumer issues and disclosure. These issues may have been less central to examinations in the past.

Five, your organization should be prepared for investigations by the BCFP either as a result of examinations or based on other information. The BCFP is authorized to investigate *suspected* violations with full civil investigative power including administrative hearings and adjudications. These decisions are subject to review by the Federal Appellate courts, so preparation in a matter similar to SEC investigations is appropriate.

Six, your organization should be cognizant of the new definitions of “abusive” practices and be prepared to defend your specific practices to both the BCFP and a court.

Note

¹ Public Citizen’s campaign on this issue: http://www.citizen.org/congress/article_redirect.cfm?ID=7332.

² See for a discussion on the topic: “Creeping Mandatory Arbitration: Is It Just?” by Jean R. Sternlight, *Stanford Law Review*, Vol. 57, 2005.

³ See <http://www.washingtonpost.com/wp-dyn/content/article/2009/09/26/AR2009092602706.html>. Barney Frank was quoted in late December 2007 as saying ““If I was going to list the top 87 entities in Washington in order of the history of their efforts on consumer protection, the Fed would not make it.” <http://www.washingtonpost.com/wp-dyn/content/article/2007/12/14/AR2007121401875.html>.

⁴ Only provisions that endanger the safety and soundness of the financial system can be restricted by the Federal Reserve.

⁵ <http://www.justice.gov/opa/pr/2010/April/10-crt-462.html>. The Department of Justice indicates that it is currently investigating major lenders for redlining, reverse-redlining, and pricing discrimination.

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