Dodd-Frank's “Abusive” Standard: A Call for Certainty

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (hereinafter, “Dodd-Frank” or the “Act”) promises to radically transform the U.S. financial services industry. The Act was based on five objectives for financial regulatory reform articulated by the Obama Administration in a June 2009 white paper: 1) promote supervision and regulation of financial firms; 2) establish comprehensive supervision of financial markets; 3) protect consumers and investors from financial abuse; 4) provide the government with the tools it needs to manage financial crises; and 5) raise international regulatory standards and improve international cooperation.\(^2\) Given the scale of transformation involved, Dodd-Frank is the most significant financial services reform legislation since the Federal Deposit Insurance Act, the Glass-Steagall Act, and federal securities laws of the 1930s.

For banks and others in the financial services industry\(^3\) who deal primarily with consumers, the most radical change resulting from the Act is the establishment of a new agency, the Bureau of Consumer Financial Protection (hereinafter, the “Bureau”), solely

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\(^3\) This paper will generally use the term “bank” to refer to all types of entities subject to the rules of the new Bureau of Consumer Financial Protection. The universe of such entities extends far beyond banks.
dedicated to consumer financial protection. Vigorously opposed by the banking industry and other business interests during the legislative process, the Bureau will have vast rulemaking and enforcement powers over not only banks, but – with notable exclusions including securities and insurance firms – any entity that provides a “consumer financial product or service.” The Bureau will consolidate under one roof the consumer enforcement and rule-writing powers of seven different regulators. The Bureau starts its operations on the “Designated Transfer Date” of July 21, 2011 established by the Secretary of the Treasury as provided under the Act.

Particularly alarming for large banks, the Bureau will have exclusive supervisory authority over banks with assets of more than $10 billion. Set up as an independent entity within (and funded by) the Federal Reserve System, the Bureau will have relatively little oversight, as the Director of the Bureau is not accountable to a separate board, commission or council. The only non-judicial constraint on the Bureau’s rulemaking authority is the power of the new Financial Stability Oversight Council established by Dodd-Frank, by a vote of at least two-thirds of its members, to block a Bureau regulation determined to put at risk the safety and soundness of the U.S. banking system or the stability of the U.S. financial system. There is somewhat better oversight of the Bureau’s enforcement authority through a requirement of coordination with an institution’s prudential regulator and a mechanism for appeals of disagreements to an interagency panel.

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4 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, HR 4173, Title X – Bureau of Consumer Financial Protection.
5 Consumer financial protection functions will be transferred to the Bureau from the following agencies: the Board of Governors, the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Federal Trade Commission, the National Credit Union Administration, and the Department of Housing and Urban Development. Id. at §1061.
In addition to unprecedented institutional autonomy, the Act grants the Bureau broad power to take enforcement action to prevent a bank or other covered entity from engaging in an unfair, deceptive or abusive act or practice in connection with offering a consumer financial product or service, or a transaction with a consumer for such a product or service. While there are well-known standards in federal consumer law for determining whether acts or practices are “unfair” or “deceptive,” the concept of “abusive” acts or practices is not as well developed. Perhaps recognizing this, Congress has established some limits on the Bureau’s authority to declare an act or practice “abusive.” Yet the language used to create these limits creates considerable uncertainty about how the Bureau will exercise its consumer protection duties.

Section 1031 of the Act is the source of the Bureau’s broad powers to take enforcement action and engage in rulemaking regarding unfair, deceptive or abusive practices. Section 1031(d) limits the Bureau’s discretion to declare an act or practice “abusive” as follows:

The Bureau shall have no authority under this section to declare an act or practice abusive in connection with the provision of a consumer financial product or service, unless the act or practice –

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

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7 Notably, FTC Commissioner William E. Kovacic has expressed concern that the creation of the Bureau will reduce rather than enhance consumer protection in financial services. Beyond mandates for interagency coordination, there is no assurance that the Bureau will properly account for the FTC’s unfair and deceptive practices jurisprudence. Statement Submitted for the Record by Commissioner William E. Kovacic on the Proposal to Create a Consumer Financial Protection Agency to the Committee on Energy & Commerce and the Committee on Financial Services, U.S. House of Representatives, July 28, 2009. [http://www.ftc.gov/speeches/kovacic/090728stmtrec.pdf](http://www.ftc.gov/speeches/kovacic/090728stmtrec.pdf)
(2) takes 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; or
   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.

The language used ostensibly to limit the Bureau’s authority may be interpreted by banks to require compliance with dramatically higher standards for consumer product development and marketing in order to avoid Bureau enforcement against abusive practices. In particular, the language introduces radically new concepts regarding the customer’s understanding of banking products, the customer’s suitability for a banking product, and the bank’s duty to act in the interests of the consumer.

Absent clarification from the Bureau, banks may interpret Section 1031(d)(2)(A) to require them to have a much greater understanding of the “financial literacy” of each individual customer than is the case today. Previously, banks have not been required to determine whether customers actually understand the terms of banking products, much less their risks. Instead, the focus of banking regulation has primarily been on the technical adequacy of disclosures of product terms and conditions. This part of the Act introduces new, more subjective standards that appear to require banks to conduct customer-specific inquiries by obtaining information about each customer’s financial circumstances and needs, even for mass-marketed commodity products like checking accounts and credit cards. Banks will want guidance as to whether the standard that the Bureau will apply regarding customer understanding of product terms will be based on the accuracy and adequacy of product disclosures to an average, reasonable consumer or whether the Bureau
will take enforcement actions if it determines that particular consumers don’t understand a product.

Even more dramatically, Section 1031(d)(2)(B) suggests that a bank will be required to determine whether each individual customer is suitable for a product, even if there is clear and conspicuous disclosure of product terms, and even if the bank concludes that the customer understands the product. For banks to apply a suitability standard would be a radical departure from how consumer banking has traditionally been conducted. Apart from securities brokers, no other industry is obligated to determine that its customers are suitable for its products and services. A requirement for a suitability determination will add significant costs to the delivery of banking products and services, and will create incentives for banks to offer plain vanilla products with a limited menu of features. It is unlikely that many banks will want to ensure the additional training and compliance costs that would be required to enable customized, product- and customer-specific suitability determinations for what are, for the most part, commodity products.

Equally alarming is the implication under Section 1031(d)(2)(C) that banks have a duty to act in the interests of their individual customers, outside of the fiduciary contexts of trust or investment advisory settings. Traditionally, banks have not been thought to have any legal duty to act in the interests of their customers. For conventional consumer banking products – that is, deposit, payment and credit products – compliance with disclosure requirements has traditionally been enough. Yet one reading of 1031(d)(2)(C) is that there would be circumstances in which banks will be required by the Bureau to act in the interests of its customers even when providing traditional products, lest they be found to be engaged in abusive practices. This is potentially a very big change. There is considerable

It is submitted that the “reasonable reliance” concept in Section 1031(d)(2)(C) was never intended to apply to the traditional context where a consumer is directly dealing with a bank to obtain a deposit, payment or loan product. Rather, it appears that the Obama Administration had in mind the “financial intermediary” situation, that is, where the consumer has gone to a debt counselor, mortgage broker, or other advisor with the belief that he or she will get impartial advice. The Administration’s original White Paper on financial regulatory reform, Financial Regulatory Reform: A New Foundation, which preceded the submission of the legislation that become the Dodd-Frank Act a year later, offers an authoritative source for such guidance. In the White Paper, the Administration explained what it had in mind regarding the authority of a Consumer Financial Protection Agency (“CFPA”, which became the Bureau in the final Dodd-Frank Act) to impose “empirically justified and appropriately tailored duties of care on financial intermediaries”:
Impartial advice represents one of the most important financial services consumers can receive. Currently, debt counselors advise distressed and vulnerable borrowers on how to manage and reduce their debts. Mortgage brokers often advertise their trustworthiness as advisors on difficult mortgage decisions. When these intermediaries accept side payments from product providers, they can compromise their ability to be impartial. Consumers, however, may retain faith that the intermediary is working for them and placing their interests above his or her own, even if the conflict of interest is disclosed. Accordingly, in some cases consumers may reasonably but mistakenly rely on advice from conflicted intermediaries [emphasis added to original]. It is unfair for intermediaries to take advantage of that trust.

To address this problem, we propose granting the CFPA authority to impose carefully crafted duties of care on financial intermediaries. For example, the CFPA could impose a duty of care to counteract an intermediary’s patent conflict of interest, or to align an intermediary’s conduct with consumers’ reasonable expectations as demonstrated by empirical evidence. The CFPA could also consider imposing on originators a requirement to disclose material information such as the consumer’s likely ability to qualify for a lower interest rate based on her risk profile. In that regard, the CFPA could impose on mortgage brokers a duty of best execution with respect to available mortgage loans and a duty to determine affordability for borrowers.8

The White Paper correctly points to problems with debt counselors and mortgage brokers, individuals whose activities were in the past not well-regulated or supervised. These individuals generally have not been employed directly by banks. By contrast, for commodity, off-the-shelf products like deposit accounts, certificates of deposit, debit cards, credit cards, home equity lines or mortgage loans, banks have not traditionally acted as, and have not held themselves out to be, impartial advisers or intermediaries. Rather, in the traditional banking industry view, it is the consumer’s job to shop for the banking product most suited to them, or that has the best terms and conditions based on all the consumer’s needs.

8 White Paper, p. 68.
Without guidance from the Bureau as to how the “reasonable reliance” concept will be interpreted and enforced, banks may conclude that they will need to provide disclaimers to their customers that their role is limited to providing a requested product or service and that the customer should not rely on the bank for advice. Disclosing a clear distinction between a bank’s role as a commodity product provider and that of an adviser or intermediary with a duty to act in the customer’s interests might be a good result from a bank customer’s perspective, but this would require a significant change in the behavior of banks and could cause banks to become very conservative in how and to whom they market products and services. It is too early to say whether the presumed gain in consumer protection will be offset by an unacceptable reduction in the availability of banking products and services as banks seek to avoid the risk of penalties for the “abusive” practice of not acting in the interests of their customers.

This paper maintains that the Bureau should proceed very cautiously in exercising its authority to pursue enforcement action, and engage in rulemaking, regarding “abusive” acts or practices. While it is clear that there have been bad practices within the consumer financial services industry that is now subject to Bureau enforcement and rulemaking, most banks are responsible players who are concerned about regulatory compliance and reputational risk, and want to do the right thing. Unless the Bureau takes early steps to clarify its enforcement intentions and create regulatory safe harbors, the likely consequences of the “abusive” standard in the Act – or more precisely, banks’ fears about how it will be enforced – could be significantly less financial product innovation, a reduction in consumer choice, and an increase in the cost of banking products to consumers. Banks may begin to limit themselves to “plain vanilla” products and services
to avoid scrutiny by the Bureau and the risk that explanations of more complex products will not be adequate under the new standards of the Act.9

Such concerns were voiced in Washington, D.C. as legislators from both sides of the aisle raised concerns regarding the potential effects of flaws in the Dodd-Frank rule-making process. House Financial Services Committee Chairman Bachus (R-Ala.) and committee member Hensarling (R-Texas) have warned the Federal Reserve that “hastily written rules may end up doing more harm than good to consumers and have negative effects on competition in the marketplace.”10 Barney Frank (D-Mass.), one of Dodd-Frank’s founding fathers, has cautioned that improperly crafted Dodd-Frank regulations “may have unintended consequences for consumer choice, the protection of consumer information and Congress’ intent to reduce the burdens on community banks, credit unions and government-benefit programs.”11 Ultimately, given that the Bureau has yet to write its own rules on the abusive standard, it may be a long time before consumers and financial institutions understand the associated regulatory and economic consequences.12

In the meantime, a lack of clarity regarding the abusive standard may have a chilling effect on the market for innovative financial products, and the unintended

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9 Experience prior to Dodd-Frank is instructive regarding the costs associated with legal uncertainty in regulations. The Truth in Lending Act, passed in 1968, requires that lenders disclose costs and terms of credit in a “clear and conspicuous manner.” Due to legal uncertainty surrounding provisions of the legislation, there were 34 official interpretations of the regulation a week before it became effective in 1969, and 10 years later the Federal Reserve had published 1500 official interpretations and more than 13,000 TILA lawsuits were filed in Federal courts. U.S. Chamber of Commerce President and CEO, Center for Capital Markets Competitiveness David T. Hirschmann Transcript of Prepared Testimony Before the House Small Business Committee Hearing on the Impact of Financial Regulatory Restructuring on Small Businesses and Community Lenders, September 23, 2009.


11 Id.

consequence of reducing access to credit for those on the economic margins and small business owners.\textsuperscript{13} There are no legal standards in existence to frame the scope and applicability of the “abusive” standard, and regulating the standard based on consumer perception will likely prove difficult.\textsuperscript{14} With such a subjective standard it’s “unclear how a lender could guarantee a customer’s understanding, or what would constitute ‘interfering’ with it.”\textsuperscript{15} Even with their best efforts banks may be considered noncompliant.\textsuperscript{16}

Importantly, underbanked or economically disadvantaged customers may suffer disproportionately from a more limited selection of banking products, as they are likely to have the most problems of understanding and suitability. The microcredit and mortgage markets illustrate the potential reduction in credit availability for high-risk consumers as a result of increased costs and risks of lending that can follow from regulatory efforts to overly proscribe lender practices.

Microcredit financial products, such as the iAdvance short-term prepaid credit option, present an opportunity for high-risk consumers to access credit and build their credit profiles. Experts speculate that the Office of Thrift Supervision’s recent shutdown of iAdvance based on “unfair or deceptive acts or practices,” with no further guidance provided on acceptable practices or products, had a “chilling effect” on the market for microcredit products. Accordingly, as a likely response to iAdvance’s fate, Think


\textsuperscript{15} Id.

\textsuperscript{16} Id.
Finance’s Elastic Card, a prepaid debit card with a $500 line of credit and fee rebates for on-time payments, was subsequently dropped from a bank partnership. According to the Center for Financial Services Innovation, a lack of clarity around how the new Bureau will handle financial products may likewise place innovation on hold.\footnote{Lepro, Sara. “Doubts Cloud the Future of Debit-Credit Products.” \textit{American Banker}, Vol 175, Issue 186, December 6, 2010.}

In terms of the mortgage market, the Act takes a “punitive approach” to innovative products “designed to fill a narrow niche of legitimate needs” by providing credit to homebuyers who otherwise could not qualify for a standard 30-year fixed-rate or adjustable-rate mortgage.\footnote{Milligan, Jack. “A Massive Overhaul.” \textit{Mortgage Banking}, Vol 70, Issue 12, September 1, 2010.} While large banks have traditionally been willing to test new consumer financial products given their ability to absorb loan losses, they will likely be unwilling to experiment for the foreseeable future.\footnote{Milligan, Jack. “A Massive Overhaul.” \textit{Mortgage Banking}, Vol 70, Issue 12, September 1, 2010. Comments by Tom Brown, president and founder of a New York-based hedge fund.} Now that the mortgage industry is forced to go beyond disclosure requirements to ask whether their products are fair, the potential risks to lenders are too great when faced with possible penalties from the Bureau including rescission of contracts, restitution, and civil penalties of up to $1 million per day.\footnote{Id.} Instead, the Act may end up shutting out borrowers with poor credit histories from the possibility of home ownership.\footnote{Id. Comments by Larry Piatt, K&L Gates.}

As an illustration of this possibility, North Carolina’s 1999 enactment of strict anti-predatory lending laws caused many responsible lenders to stop making loans in the state, with collateral damage to underserved communities. North Carolina Senate Bill 1149 was passed to institute stricter state mortgage regulations than the existing federal Home

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\footnote{Id.}
Ownership and Equity Protection Act (HOEPA), which imposed consumer protections on mortgage loans deemed “potentially predatory.”

North Carolina’s bill utilized a broader definition for high-cost loans and imposed more severe restrictions, including strict liability provisions that would penalize “even the most diligent and risk-averse lenders.” Ultimately, the law led to a reduction in the availability of high-cost loan credit in the state because legitimate lenders would not accept the compliance burdens, and the substantial legal and reputational risks. After the bill passed low-income borrowers in North Carolina collectively realized a substantial 14% decline in subprime closed-end mortgage originations with nine major national lenders, while high-income borrowers were not significantly affected.

Finally, the Act’s blunt, one-size-fits-all approach to regulation of credit products could have a detrimental effect on small businesses. The small business sector, with different needs and a higher appetite for risk than an average consumer, often relies on credit cards, home equity loans, and “fringe” consumer credit products used by individuals who own small businesses in order to meet short-term capital needs. According to

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24 Id. at 144.
25 Elliehausen, Gregory and Staten, Michael E. “Regulation of Subprime Mortgage Products: An Analysis of North Carolina’s Predatory Lending Law.” *Journal of Real Estate Finance and Economics*, Vol 29, Issue 4, pp. 429-30, 2004. Elliahausen and Staten hypothesize that it’s unlikely the declines were solely due to reduced predatory and abusive lending because North Carolina subprime lending terms were “consistent with a properly functioning market” and thus reflected loans’ risk appropriately. This is in contrast to predatory lending that involves fraud or deception rather than explicit subprime terms.
27 Id.
Thomas Durkin, a former Senior Economist with the Division of Research and Statistics at the Federal Reserve Board, the legal uncertainty and lack of precedents for guidance about how to interpret the abusive standard creates disincentives and higher costs for new financial products. Specifically, the Act creates new risks and increased costs for lenders due to the potential for regulatory fines and litigation from extending credit, which in turn creates pressure for lenders to raise prices on consumer credit products and will cause some lenders to withdraw products from the market. Notably, the Act gives states the authority to issue more restrictive consumer regulations than those adopted by the Bureau, which increases the magnitude of litigation exposure and variance in regulations possible. Industry advocates have asserted that the associated increased cost of credit for small businesses could result in slower economic growth, fewer new businesses, and a reduction in jobs.

To avoid these adverse consequences, the Bureau should consider taking steps to provide more certainty regarding its approach to enforcement and supervision of the “abusive” standard by providing safe-harbor guidance. A useful early action for the Bureau would be guidance applicable to specific categories of consumer practices regarding acts or practices that it will not consider to be abusive, or that will be considered abusive only under certain defined circumstances. The Bureau could also provide guidance about what processes banks should put into place to ensure that consumers understand product risks and costs, and whether a particular product meets the consumer’s needs. Such

28 Id.
29 Id.
30 Id.
31 Id.
guidance should make it clear that if banks follow these processes, they will not be second-guessed by the Bureau.


One part of the Guidelines lists specific mortgage lending practices which national banks are told to avoid altogether. A second part sets out loan terms, conditions and features that “may, under particular circumstances, be susceptible to abusive, predatory, unfair or deceptive practices, yet may be appropriate and acceptable risk mitigation measures, consistent with safe and sound lending, and benefit customers under particular circumstances.” The Guidelines state that “heightened diligence” should be exercised when offering loans with this second type of feature (e.g., negative amortization) to consumers who are elderly, substantially indebted, not financially sophisticated, have language barriers, have limited or poor credit histories, or have other characteristics that limit their credit choices. By providing a great deal of specificity regarding which particular product features are never acceptable and which might be acceptable under certain circumstances,

33 Id. at 6330, Footnote 3.
the Guidelines offer a useful template for the Bureau to follow for other types of consumer products.

An example of helpful “process” guidance that could guide the Bureau is OCC Bulletin 2004-20 entitled Risk Management of New, Expanded, or Modified Bank Products and Services.\(^{34}\) This bulletin sets forth a number of factors that national banks should consider as part of their product development process. The Bureau could reduce industry fears and more effectively leverage its influence by issuing similar guidance applicable to consumer products. Such guidance could provide that banks should consider the Section 1031(d) factors for both new and pre-existing consumer products. By requiring that banks explicitly consider consumer protection requirements in their own internal processes, the Bureau is likely to achieve more positive changes in consumer products than through selective enforcement of particular cases. The Bureau in its supervisory capacity, and other supervisory agencies that adopt the same guidance on an interagency basis, would be able to examine the adequacy of product review processes. Banks that have adopted robust processes could be provided appropriate assurances that their decisions would not be second-guessed through Bureau enforcement. Unless banks have some reasonable certainty in this area, they are likely to over-correct and become unnecessarily cautious both as to product innovation and the types of customers to whom new products are marketed.

The Bureau should also provide advisory guidance regarding the limited nature of the “reasonable reliance” concept that was intended by the proponents of the Act. Specifically, the Bureau could issue guidance to the effect that it will generally enforce the

Section 1031(d)(2)(C) prong of the “abusive” standard only in situations where a bank is acting as a “financial intermediary”, providing concrete illustrations of those situations, as well as situations where a bank is not so acting, and thus will not generally be challenged by the Bureau.

Regulation of consumer financial products and services in the United States has never before been attempted on the scale as is about to be undertaken by the Bureau. The Act provides the Bureau with unprecedented powers to regulate and supervise much of the financial services industry through enforcement of existing federal consumer financial laws, in addition to sweeping new authority to prevent abusive practices. The Bureau’s acts, and the threat of its power to act, will have benefits and costs that are hard to measure. In order to achieve the maximum benefits of reform and minimize costs and unintended consequences, the Bureau should focus its resources to provide the financial services industry with as much certainty as possible, as early as possible, regarding how it will enforce its new authority. Absent this certainty, the industry may freeze up and remain very cautious about product innovation and wide availability of banking products, to the detriment of consumers and the economy. The Bureau should act quickly to avoid this unnecessarily adverse result of financial services reform.