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# UDAP Crackdown – A Closer Look at the UDAP Analysis Underlying New Credit Card Rules

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The Board of Governors of the Federal Reserve System ("Board"), the Office of Thrift Supervision ("OTS"), and the National Credit Union Administration ("NCUA") (collectively, the "Agencies") recently issued a joint, final rule ("UDAP Regulations")[1] under Section 5 of the Federal Trade Commission Act ("FTC Act")[2] that provides clarification to the body of law surrounding unfair or deceptive acts or practices ("UDAPs"). In adopting the regulations, the Agencies exercised specific authority granted to them under Section 18(f) of the FTC Act to prevent unfair or deceptive acts or practices engaged in by banks, savings associations, and Federal credit unions (collectively, the "Banks").[3]

In the period of time between the Agencies' adoption of the UDAP Regulations and publication of the regulations in the Federal Register, members of Congress have taken actions that could impact key terms that were thought to be solidified by the UDAP Regulations.[4] One significant aspect of the UDAP Regulations is the effective date of the new credit card provisions. Whereas the UDAP Regulations provided Banks with up to an 18-month implementation period to overhaul existing practices to ensure compliance with the UDAP Regulations, the implementation deadline could come as soon as 90 days upon enactment of the Credit Cardholders' Bill of Rights Act of 2009 ("Cardholders' Bill of Rights"). Anticipating the potentially serious and detrimental effects of an accelerated compliance date or the possibility of additional prohibitions on the practices of Banks and in particular credit card issuers, this article examines the legal analysis for Agency determinations of unfairness or deception under the UDAP Regulations. This understanding will assist Banks in anticipating regulatory issues currently and in the course of new product development.

While the credit card provisions of the final rule have received significant attention, the rule has a potentially greater impact with the reach of its UDAP authority. Generally, the significant features of the UDAP Regulations are:

- To establish, in Subpart A, the Agencies' respective authorities to regulate any unfair or deceptive acts or practices engaged in by Banks; and
- To prohibit, in Subpart C, specific acts or practices relating to credit card accounts that the Agencies have identified as "unfair."[5]

While the UDAP Regulations clearly and directly impact certain practices of credit card issuers, the articulated UDAP standards have far-reaching implications on a host of other acts and

practices engaged in by Banks. Notably, the Agencies expressly retained the right to enforce the FTC Act on a case-by-case basis for all acts and practices (not prohibited by the new rules relating to credit card accounts) engaged in by Banks.[6]

Although the effective date for the UDAP Regulations is currently set at July 1, 2010, it is important to note that existing authority of the Agencies to enforce UDAPs provides for case-by-case enforcement.[7] The legal analysis supporting the UDAP Regulations will be applicable in this context. Furthermore, because UDAPs are presently prohibited under the FTC Act,[8] if a bank is engaging in a UDAP, it can be deemed to be violating "applicable law," which, in the most extreme situation, is a ground for involuntary termination of status as an insured depository institution under Section 8 of the Federal Deposit Insurance Act.[9] Therefore, the Agencies have other sources to look to, *i.e.*, other than the recent rulemaking, to find a basis for a UDAP determination. The current standard for judging potential UDAPs is based on "the totality of the circumstances under applicable laws or regulations."[10] Generally, the eighteen month implementation period provided for by the Agencies allows sufficient time for impacted institutions to revise their current credit card practices to conform to the new requirements. In this regard, the specific acts or practices highlighted in the final rule (*i.e.*, credit card provisions) will not be subject to the UDAP Regulations until the effective date, which as discussed above, may come earlier than mid-2010 if the Cardholders' Bill of Rights regarding the same credit card practices is enacted. The Agencies have determined that, prior to the effective date, the prohibited practices are not "unfair" under the FTC Act.[11] However, Banks must act now to prepare themselves with a plan of action in case of an earlier effective date, for which compliance with new credit card rules would be required. In making such preparations, however, it is also important to keep in mind that aside from these specific acts or practices, the Agencies are presently empowered to pursue case-by-case enforcement based on the underlying UDAP analysis, *i.e.*, outside the context of the UDAP Regulations.

## The Agencies' Formal UDAP Analysis

Primary authority of the Agencies to regulate and enforce UDAPs is derived from Section 5 of the FTC Act, which precludes unfair or deceptive acts or practices in or affecting commerce.[12] The applicable standards for unfairness and deception underlying the UDAP Regulations have long existed under the FTC Act and FTC guidance;[13] generally, these same standards are articulated in guidance and enforcement actions by the various Federal banking agencies.[14] One significant feature of the UDAP Regulations is that UDAP standards, previously applied retroactively on a case-by-case basis through enforcement actions, are now being imposed prospectively through the regulation of identified acts and practices engaged in by Banks.[15] An important aspect of the UDAP lore is that the standards for determining whether an act or practice is unfair or deceptive are mutually exclusive, *i.e.*, an act or practice violates the FTC Act when it is either unfair or deceptive, or both. The application of both aspects of the underlying UDAP analysis provides insights into future enforcement and supervisory considerations.

## Unfair Acts or Practices

Based on existing law and enforcement precedent of the Federal banking agencies and the FTC, the Agencies view an act or practice as unfair when it:

(1) causes, or is likely to cause, substantial injury to consumers;

(2) which is not reasonably avoidable by consumers themselves; and

(3) is not outweighed by countervailing benefits to consumers or to competition.[16]

Public policy considerations are relevant factors, but do not comprise an element of the

unfairness test and may not serve as a primary basis for a determination of unfairness.[17]

### *(1) Substantial consumer injury*

In general, monetary loss, *e.g.*, when a consumer incurs a fee or interest charge, that results from the consumer's use of an unfair bank product or service, will be deemed to involve substantial consumer injury.[18] Even if the monetary harm is relatively small, the injury may be deemed substantial in light of the large number of consumers affected.[19]

### *(2) Injury is not reasonably avoidable*

An injury is not reasonably avoidable when consumers are prevented from effectively making their own decisions about whether to incur that injury. The Agencies have found that "many of the practices at issue either create the complexity that acts as an obstacle to consumers' ability to make free and informed decisions or take advantage of that complexity by assessing interest or fees when a consumer fails to understand the practice."[20]

### *(3) Injury is not outweighed by countervailing benefits*

This final element balances whether an act or practice causing injury is outweighed by countervailing benefits to consumers or competition. An example of a countervailing benefit to consumers is access to a particular financial product not available without incurring the injury.[21] An example of a countervailing consideration for competition is whether prohibiting an act or practice will lead to a deterrent or chilling effect on competition, *e.g.*, compliance will cause Banks to cease engaging in the regulated activity altogether, which will serve as a detriment to consumers.

## Public Policy

Public policy is not an explicit element of the unfairness analysis, but may serve as a secondary consideration for a determination of unfairness under the FTC Act.[22] For purposes of the unfairness analysis, the Agencies note that public policy is generally embodied in a statute, regulation, or judicial decision. The Agencies acknowledge a general public policy interest in avoiding inconsistency with other laws and regulations.

## Deceptive Acts or Practices

Unlike the unfairness standards, which are codified in the FTC Act, the Agencies' standards for deception are based on FTC case law and guidance.[23] Under these standards, an act or practice is deceptive when:

(1) there is a representation or omission of information;

(2) which is likely to mislead consumers acting reasonably under the circumstances; and

(3) the information is material to consumers.[24]

Based on existing precedent, a representation or omission is deceptive if the overall net impression created is likely to mislead consumers.[25] Furthermore, if a representation is susceptible to more than one reasonable interpretation, and if one such interpretation is misleading, then the entire representation is deceptive even if other, non-deceptive interpretations are possible.[26] Determinations of deceptiveness are fact-specific and better suited for case-by-case application. Typically, these focus on the type of language or conduct used, such as in marketing or solicitation efforts.[27] This is likely the reason the Agencies focused on unfairness guidelines, *i.e.*, rather than deceptiveness, in deciding upon the five prohibitions relating to credit card accounts in Subpart C of the UDAP Regulations.

## UDAP Analysis Underlying the New Credit Card Rules

The following chart outlines the considerations and rationale the Agencies applied in concluding that five identified acts or practices relating to

credit card accounts are "unfair"[28] under UDAP standards and, therefore, prohibited under the FTC Act. Generally, these prohibitions inform the rationale upon which the new rules and related requirements are based.[29] The chart identifies *what* is prohibited, and *why*.

| Regarding… | Prohibited Act or Practice | (1) Substantial consumer injury | (2) Injury is not reasonably avoidable | (3) Injury is not outweighed by countervailing benefits | Public Policy |
|---|---|---|---|---|---|
| Time to make payment | Treating a payment on a consumer credit card account as late for any purpose (other than expiration of a grace period), unless the consumer has been provided a reasonable amount of time to make that payment | Late fees, APR increases on the account as a penalty, or negative reporting to a credit reporting agency, all of which are caused, or likely to be caused, by a Bank's failure to provide the consumer a reasonable amount of time to make payment | Factors beyond a consumer's control, such as mail service delay, travel or other circumstances, can cause the consumer to not receive a statement in time or not have enough time to review it | Injury: (i) Longer time to make payment could result in add'l finance charges for consumers who do not get a grace period; (ii) Banks may incur costs in altering their systems to comply with rule, but costs are not outweighed by benefit to consumers<br><br>Benefit: No direct benefit to consumers from receiving too little time to make payment | Addressed possible inconsistency created by the 21-day safe harbor with policy underlying current Regulation Z, which provides that periodic statements must be mailed at least 14 days in advance of the expiration of a grace period |
| Allocation of payments | Allocating amounts paid by consumers in excess of the required minimum periodic payment in a manner that does not apply a significant portion of the amount to the balance with the highest annual percentage rate | Higher interest charges than would be incurred if some or all of the excess payment were applied to balances with higher rates<br><br>Loss of receiving the full benefit of a promotional rate or deferred interest plan if consumer uses the | Generally consumers have no control over an institution's allocation of payments<br><br>Disclosures may not enable consumers to sufficiently understand the effects of payment allocation - even if they did, injury is not deemed avoidable since Banks almost | Injury: May reduce Banks' revenue received from interest charges, which could in turn cause Banks to increase rates generally<br><br>Benefits: (i) Prohibited practice does not appear to create benefits for consumers or competition; (ii) Prohibiting the practice would enhance transparency in payment | Addressed possible inconsistency with statements in Congressional testimony and OCC guidance suggesting that concerns regarding payment allocation should be addressed through disclosure rather than substantive regulation |

| Regarding… | Prohibited Act or Practice | (1) Substantial consumer injury | (2) Injury is not reasonably avoidable | (3) Injury is not outweighed by countervailing benefits | Public Policy |
|---|---|---|---|---|---|
| | | credit card account for other transactions | uniformly apply payments first to balance with lowest interest rate<br><br>Not reasonable to expect consumers to avoid injury by paying off balance in full each month, since many are unable to do so | allocation process and allow consumers to better assess the cost of credit; (iii) Prohibiting the practice would enhance rather than harm competition because Banks offering rates that reflect costs would no longer be forced to compete with Banks offering artificially reduced rates | |
| Increases in APR | Increasing the APR applicable to an outstanding balance on a consumer credit card, except under limited circumstances; and, increasing an APR that applies to a consumer credit card account during the first year after account opening, except under limited circumstances | Additional interest charges assessed on the consumer's account | Consumers lack control over many circumstances under which Banks increase rates, *e.g.*, changes in market conditions affecting the cost of borrowing, universal defaults, or using most but not all of available credit | Injury: Possible increased costs or reduced credit availability (due to reduced interest revenue) for consumers generally<br><br>Benefits: (i) Substantial benefits to consumers of avoiding significant unanticipated increases in the cost of completed transactions; (ii) Enhances competition by creating add'l incentives for Banks to ensure that rates offered to consumers fully reflect the risks presented by both consumers and market conditions | Addressed possible inconsistency with testimony, guidance, reports, and advisory letters from Federal banking regulators, stating or suggesting that risk can be effectively managed by adjusting interest rates on outstanding balances and new transactions |

| Regarding… | Prohibited Act or Practice | (1) Substantial consumer injury | (2) Injury is not reasonably avoidable | (3) Injury is not outweighed by countervailing benefits | Public Policy |
|---|---|---|---|---|---|
| Two-cycle billing | Assessing interest charges on balances for days in prior billing cycles when such charges are imposed as a result of the loss of a grace period | Greater interest charges as the result of the loss of a grace period when a consumer pays a balance in full one month but not the next month | Disclosures may be ineffective in helping consumers avoid the effects of two-cycle billing<br><br>Once consumers use their cards, they have no control over the methods used by Banks to calculate finance charges on their accounts<br><br>Because the intended purpose of credit is to finance purchases over multiple billing cycles, it may be unreasonable to expect consumers to pay their balance in full each month | Injury: Reduction in revenue for Banks that use two-cycle billing method, which may be passed on to consumers through higher APRs or fees<br><br>Benefit: Ultimate benefit to consumers in the form of more transparent pricing that allows consumers to make informed decisions about the use of credit | Addressed possible inconsistency with policy underlying Regulation Z, which lists two-cycle billing as a common method that may be described by name |
| Security deposits and fees | Charging security deposits or fees that exceed applicable limits on a consumer credit card account for the issuance or availability of credit | High upfront fees; diminished use of available credit; high interest charges | Subprime cards are typically marketed to financially vulnerable consumers with limited credit options, so improved disclosures would be unhelpful | Injury: (i) Diminished value to consumers where security deposits and fees consume majority of credit limit; (ii) Higher risk to Banks because of subprime consumers' greater risk of default | No contrary public policy found – rather, OCC guidance indicates that high-fee subprime credit card accounts increase risk of default and therefore |

| Regarding… | Prohibited Act or Practice | (1) Substantial consumer injury | (2) Injury is not reasonably avoidable | (3) Injury is not outweighed by countervailing benefits | Public Policy |
|---|---|---|---|---|---|
| | | | | Benefit: Consumer access to credit card products that they otherwise generally would not be able to obtain | present safety and soundness concerns |

## Conclusion

While UDAP standards have long existed under the FTC Act and related laws, as well as in FTC and Federal banking agency guidance, the unsettling effect of the final rule is the widespread, prospective application of UDAP standards (rather than retroactive application through enforcement actions) to certain acts or practices relating to credit card accounts engaged in by Banks. In light of recent developments with the change in Administration and the pending Cardholders' Bill of Rights, an accelerated effective date for compliance with the new credit card rules, along with increased prohibitions, are possibilities that Banks should be prepared to address. It is reasonable to expect that other acts or practices will be subject to similar UDAP analyses, as outlined above. In this regard, the Agencies' final rule warrants a renewed look at, and thorough understanding of, the UDAP analysis going forward with respect to other existing products and new product development efforts. An understanding of the UDAP analysis may prove to serve Banks well, especially in light of the fact that the Agencies have expressly retained the right to regulate other acts or practices on a case-by-case basis through enforcement actions.

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[1] 74 Fed. Reg. 5498 (Jan. 29, 2009). The final rule amends Parts 227, 535, and 706 of title 12 of the Code of Federal Regulations, which contain the rules promulgated by the Board, OTS, and NCUA, respectively. The Agencies' adoption of the final rule was first announced in December 2008, and the press release is available at http://www.federalreserve.gov/newsevents/press/bcreg/20081218a.htm (Dec. 18, 2008).

The OCC and FDIC were not directly involved in promulgating the UDAP regulations, as they were not specifically granted with the rulemaking authority under the FTC Act, *see* 15 U.S.C. § 57a(f)(1); however, they remain responsible for enforcement of such regulations under 15 U.S.C. § 57a(f)(2).

[2] 15 U.S.C. §§ 41-58, as amended.

[3] 15 U.S.C. § 57a(f). In exercising their authority under the FTC Act, the Agencies recognize that state-chartered credit unions and any entities providing consumer credit card accounts independent of a depository institution are within the FTC's jurisdiction and are not within the authority granted to the NCUA under the FTC Act. While such entities are not subject to the UDAP Regulations, they are still subject to UDAP standards, as implemented by the FTC.

[4] On January 14, 2009, U.S. Senators Charles Schumer and Mark Udall introduced Senate bill S. 235, which is based on U.S. Representative Carolyn Maloney's bill, H.R. 5244, known as the "Credit Cardholders' Bill of Rights Act of 2008," which was passed by the House in the 110th Congress, but failed to gain sufficient votes in the Senate. On January 22, 2009, Representative Maloney reintroduced the bill in the House as H.R. 627. The legislation overlaps to a large extent with the UDAP Regulations, but proposes more comprehensive and restrictive limitations on credit card practices than the UDAP Regulations, and is expected to take effect 90 days after its enactment, thereby imposing an accelerated implementation timeline for compliance by credit card issuers. The text of the Senate bill (S.235) is available at http://www.thomas.gov/cgi-bin/query/z?c111:S.235: and the text of the House bill (H.R.627) is available at http://www.thomas.gov/cgi-bin/query/z?c111:H.R.627: The authors expect to follow up shortly with an article discussing the key provisions of the pending legislation.

[5] The Agencies identified five specific practices relating to credit card accounts and declared such practices to be unfair and therefore unlawful under the FTC Act. In finding such practices unlawful, the Agencies approved rules and related requirements that effectively ban the practices. The five rules pertaining to credit card accounts relate to (1) time to make payments; (2) allocation of payments; (3) interest rate increases; (4) two-cycle billing; and (5) financing of security deposits and fees. 74 Fed. Reg. 5498 (Jan. 29, 2009). Highlights of these new rules can be found at: http://www.federalreserve.gov/newsevents/press/bcreg/20081218a.htm. An overview of the new rules is the subject of another Paul Hastings article, entitled "Congressional Agenda Could Accelerate Banking Agency Rules on Unfair Credit Card Practices and Consumer Disclosures – Understanding the New Rules."

[6] 12 C.F.R. § 227.1(b) (effective 7/1/2010); 12 C.F.R. § 535.1(b) (effective 7/1/2010); and 12 C.F.R. § 706.1(b) (effective 7/1/2010).

[7] Each of the appropriate Federal banking agencies, including the OCC and FDIC, are currently able to enforce UDAPs on a case-by-case basis because current Part 227 of the Board's regulations already consists of UDAP regulations applicable to all banks and their subsidiaries (except savings banks that are members of the Federal Home Loan Bank System). Current Regulation AA outlines procedures that consumers can follow to report any acts or practices that they deem to be unfair or deceptive. 12 C.F.R. § 227.2.

[8] 15 U.S.C. § 45.

[9] 12 U.S.C. § 1818.

[10] 74 Fed. Reg. 5498, 5548 (Jan. 29, 2009). "Compliance with the provisions of the final rule is not required before the effective date. Accordingly, the final rule and the Agencies' accompanying analysis should have no bearing on whether or not acts or practices restricted or prohibited under this rule are unfair or deceptive before the effective date of this rule." "[A]cts or practices occurring before the effective date of the final rule will be judged on the totality of the circumstances under applicable laws or regulations. Similarly, acts or practices occurring after the rule's effective date that are not governed by these rules will continue to be judged on the totality of the circumstances under applicable laws or regulations."

[11] 74 Fed. Reg. 5498, 5502 fn.9 (Jan. 29, 2009).

[12] 15 U.S.C. § 57a(f). Additionally, the OTS derives secondary authority to regulate unsafe and unsound banking practices under the Home Owners' Loan Act. 12 U.S.C. § 1461 *et seq*.

[13] The standards for finding an act or practice *unfair* are codified in Section 5(n) of the FTC Act. By contrast, the standards for finding an act or practice *deceptive* are embodied in FTC guidance such as the "FTC Policy Statement on Deception," available at http://www.ftc.gov/bcp/policystmt/ad-decept.htm.

[14] *See* Board and FDIC, *Unfair or Deceptive Acts or Practices by State-Chartered Banks* (Mar. 11, 2004) (available at http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040311/attachment.pdf); OCC Advisory Letter 2002-3, *Guidance on Unfair or Deceptive Acts or Practices* (Mar. 22, 2002) (available at http://www.occ.treas.gov/ftp/advisory/2002-3.doc); and FDIC Supervisory Insights, From *the Examiner's Desk: Unfair and Deceptive Acts and Practices: Recent FDIC Experience*, at 21-31 (Winter 2008) (available at http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/si_win08.pdf).

[15] Note however, that the Agencies' regulation of UDAPs and consumer credit practices is not new. *See* 12 C.F.R. Parts 227, 535, and 706. Present UDAP prohibitions on consumer credit practices are extremely limited in scope, relating to contract provisions, cosigner rights, and late charges based on earlier late charges. The final rule supplements these existing provisions.

[16] 15 U.S.C. § 45(n).

[17] *Id.*

[18] *See* FTC Policy Statement on Unfairness, at 3 (Dec. 17, 1980) (available at http://www.ftc.gov/bcp/policystmt/ad-unfair.htm).

[19] OCC Advisory Letter 2002-3, *supra* note 14, at 4; FDIC Supervisory Insights, *supra* note 14, at 28.

[20] 74 Fed. Reg. 5498, 5503 (Jan. 29, 2009).

[21] For example, the Agencies applied this balancing test to the act or practice of subprime credit cards. *Id*. at 165. "While the final rule may result in some subprime consumers who are currently eligible for high-fee subprime credit cards not having access to a credit card, this outcome does not outweigh the benefits to subprime consumers generally of receiving credit cards that provide a meaningful amount of available credit."

[22] *See* 15 U.S.C. § 45(n).

[23] *See* FTC Policy Statement on Deception (Oct. 14, 1983) (available at http://www.ftc.gov/bcp/policystmt/ad-decept.htm); and *see, e.g.*, *FTC v. Tashman*, 318 F.3d 1273, 1277 (11th Cir. 2003).

[24] 74 Fed. Reg. 5498, 5504 (Jan. 29, 2009), citing FTC Policy Statement on Deception, *supra* note 13, at 1-2 (specifically noting that "[t]he FTC views deception as a subset of unfairness but does not apply the full unfairness analysis because

deception is very unlikely to benefit consumers or competition and consumers cannot reasonably avoid being harmed by deception.”).

[25] 74 Fed. Reg. 5498, 5504 (Jan. 29, 2009), citing *FTC v. Cyberspace.com*, 453 F.3d 1196, 1200 (9th Cir. 2006); *FTC v. Gill*, 265 F.3d 944, 950 (9th Cir. 2001); and *Removatron Int'l Corp. v. FTC*, 884 F.2d 1489, 1497 (1st Cir. 1989).

[26] *Id.*, citing FTC Policy Statement on Deception, at 3.

[27] *See, e.g.*, FDIC Supervisory Insights, *supra* note 14, at 22-27.

[28] It was unnecessary for the Agencies to apply the standards applicable to finding an act or practice to be *deceptive* because as discussed above, the standards for determining whether an act or practice is unfair or deceptive are mutually exclusive, *i.e.*, an act or practice violates the FTC Act when it is either unfair or deceptive, or both.

[29] *See* 74 Fed. Reg. 5498 (Jan. 29, 2009). An overview of the new rules is the subject of another Paul Hastings article, entitled “Congressional Agenda Could Accelerate Banking Agency Rules on Unfair Credit Card Practices and Consumer Disclosures – Understanding the New Rules.”