Consumer Finance Monitor (Season 3, Episode 18): Staying Ahead of UDAP and Fair Lending Risk to Consumer Financial Services Providers Arising From the COVID-19 Pandemic

Speakers: Alan Kaplinsky and Chris Willis

Alan Kaplinsky:

Welcome to the Consumer Finance Monitor Podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. I'm your host today, Alan Kaplinsky. I'm also the practice group leader of our consumer financial services group at Ballard Spahr, and I'm very pleased to have with me today my colleague, Chris Willis, who is the leader of our consumer financial services litigation and government enforcement team. The topic that we're going to be talking about today is related to COVID-19. However, we're going to take a different type of look at some two particular issues.

Alan Kaplinsky:

We're not going to be talking about healthcare issues, but we're going to be focused very much on potential liability that companies may have under UDAAP, either with a single A or a AA, or fair lending arising out of this pandemic. We're going to take a deeper look at some of the issues. Some of these issues we explored peripherally in a podcast that Chris and I were involved in very recently, and that hopefully all of you have already heard with Richard Cordray, former director of the CFPB, and John Roddy, a prominent plaintiff's class action lawyer. If you need more information than what we're able to provide to you today, don't forget about our blog, also known as Consumer Finance Monitor, where we have been doing the blogs since 2011.

Alan Kaplinsky:

We have a plethora of information on that blog with a particular focus these days on COVID-19, or the intersection between COVID-19 and consumer finance. Chris, first of all, welcome to the program.

Chris Willis:

Thanks a lot, Alan. I'm enjoying doing the recording with you, but of course, at a social distance.

Alan Kaplinsky:

Absolutely. We're pretty far away. Chris being in Atlanta and I'm being in the Philadelphia Area today. Chris, let's start out with this question, because I always liked to look to historical antecedents. With all the disruption that's related to the COVID-19 pandemic, where can we look for historical reference to see where UDAAP issues could arise?

Chris Willis:

Yeah, it's a great question, and I think particularly appropriate here because there's such a readily available and obvious historical example for us to look to, and that is the great recession of 2008, and it makes a very good model for us, to help learn lessons about what may happen from a regulatory standpoint on UDAAP issues now, for two reasons. First, you have a lot of parallels between the two events. They both involve very significant economic dislocation within the US economy,

people losing their jobs, people having difficulty paying their bills, and then becoming subject to collection, repossession, foreclosure activity, as a result of that.

Chris Willis:

Then you had a large outpouring of very large scale regulatory enforcement actions, many of which were UDAAP based in the aftermath of the 2008 crisis. Here, we have a similar situation playing itself out in the US economy today with massive unemployment claims, which will necessarily lead to people having difficulty paying their credit obligations. Any of the same things that happened in 2008 have the potential to happen again, so it makes a very good comparison for that reason. But the other reason that I think it's important to look closely at 2008 and its aftermath is that the memory of that event and the fallout from it, and the enforcement activity that resulted from it is still very, very fresh in the minds of regulators.

Chris Willis:

The personnel who work at the various regulatory agencies, most of them were working in the area, in this field during that time and during the aftermath of that time. In fact, the CFPB was even created because of what happened after the 2008 crisis. That was the driving force behind the passage of Dodd-Frank in 2010. So, they will be very much attentive to trying to do what they can to prevent what they perceive as consumer harms that occurred in connection with the 2008 crisis from repeating themselves in connection with this crisis. Because it will be so in the forefront of the minds of the people who work at the regulatory agencies, it makes, looking at the track record of what happens 12 and 10 and eight years ago, very instructive for us if we want to think about staying ahead of those risks in the financial services industry.

Alan Kaplinsky:

Good point, Chris, but let me push back a little on that and be curious to see what you think about what I'm going to say, and that is that the crisis of '08, I think a lot of people viewed the banking industry as being at fault, or largely at fault for that crisis. This crisis, thank goodness, the banking industry bears no fault at all. They didn't create it. It was an external event that occurred. You could say an act of God, force majeure, or what-have-you. Do you think that's going to make any difference in the way that the regulators will view it?

Chris Willis:

I think it makes a marginal difference. Certainly the premise is accurate that the financial industry, and particularly the mortgage lending industry, was viewed as having a great degree of culpability in creating the real estate bubble that then burst that then got us the 2008 recession. That culpability was certainly in the minds of regulators. But the thing is, the regulators' activity in terms of enforcement, some of it was directed at the behavior that the regulators believed caused the recession. Look, for example, at the Massachusetts AG actions in Fremont and Option One, and the other things that were done in connection with the origination of mortgages. Of course, the regulatory changes like the creation of the QM rule and the ability to repay rule and the CFPB rules connected with that.

Chris Willis:

But let's not forget there was a lot of enforcement activity directed towards entities who didn't have any culpability in the real estate origination aspect of the 2008 crisis. Mortgage servicers, auto finance companies, subprime lenders like payday and auto title lenders, all of them became subject to significant regulatory attention and enforcement just because of the general economic conditions and the manner in which the regulators perceived them to respond to those, even if they had no role in making interest only mortgages or option arms, or other products that were deemed to have created the real estate bubble.

Chris Willis:

I think, yes, there is a difference there in terms of culpability of some aspect of the financial services industry, but I would expect it to have only a marginal impact on the behavior of regulators in response to what we're experiencing now.

Alan Kaplinsky:

Okay. Well, Chris, let's now move on to talk about some of the operational areas where financial institution should be wary of UDAAP issues. Where do you think these are going to arise?

Chris Willis:

I think there's three in particular that we ought to be attuned to while we're in the middle of this crisis and while it continues to play out, and those are collections, loss mitigation, or sort of hardship efforts, and the origination of new financial products. Let me talk a little bit about collections first, because it's relatively straightforward and easy and intuitive for people to understand. We have a situation now when the country is in a crisis. In fact, a declared disaster that affects the entire country. You have declarations of disaster that have been made by numerous state officials, governors, legislatures, etc.

Chris Willis:

The regulators' attitude will be the nation is in a crisis and consumers are in a crisis. For financial institutions to engage in business as usual collections efforts with respect to the obligations owed to them could be viewed as an unfair deceptive practice because there are people who've lost their jobs and who have to prioritize things like buying food and acquiring medical care, if they or a loved one happens to be sick with the coronavirus, or anything else for that matter. So, to engage in collection activity sort of in general, without a sensitivity to the economic dislocation that customers are experiencing, I think could very well lead to enforcement activity on a UDAAP basis by various regulators.

Chris Willis:

On top of that, if you think about secured credit products, for example, auto finance, where there is the possibility of repossession of the collateral, or mortgage, where there's the possibility of foreclosure on the collateral, taking those ... Or legal collections, even, with respect to an unsecured debt, suing someone for a balance on a credit card or some other unsecured debt, any of those more escalated actions that can have very long and far reaching consequences with respect to consumers, they can have their wages garnished, they can have their car repossessed, to their home taken, I think will be viewed as especially offensive by regulators if taken by financial institutions.

Chris Willis:

As a practical matter, I think there needs to be a lot of attention paid to collections in general, but especially those escalated collection steps in particular, and that any efforts toward collections or these escalated steps needs to be accompanied by a significant effort to make sure that you're not dealing with a customer who has a significant impact from coronavirus or the economic dislocation caused by it, and that you're not creating the headline, because we can all see the headline. Attorney general so-and-so takes action against company X for repossessing automobiles of victims of coronavirus, or something like that.

Chris Willis:

You can see these vignettes being told in the media or in regulatory press releases about a person who lost his or her job and then became subject to vigorous collection activity by a financial institution. We can take action to either create or prevent the creation of those headlines. I think the entities who prevent the creation of those headlines with respect to themselves will be the ones that will be spared the enforcement activity that is the fallout from it.

Alan Kaplinsky:

Okay, so collection's certainly a big area, but what about other areas?

Chris Willis:

Well, the second area that I mentioned was sort of hardship or loss mitigation programs. Here, the mentality of industry and what we've been seeing in our clients activities is that many of them are really rolling out hardship programs and widely

publicizing them and making them readily available to their borrowers, which is a good and responsible thing for them to do. The attitude of industry, when they're doing things like that, is probably, hey, we're doing a service for consumers, we're making life easier for them in a time of difficulty for them, and so like we're doing the right thing, and indeed they are.

Chris Willis:

But let's not lose sight of the fact that there have been two CFPB consent orders that deal with sort of forbearance type programs. One of them involved an auto finance company and the other involved a mortgage servicer, and where there are costs or consequences to those hardship or forbearance programs, the CFPB took enforcement action against two different entities for failing to adequately disclose the costs and terms and conditions of those. Both of those consent orders involved daily, simple interest lending products, where people were given deferments and told, "Hey, you don't have to make a payment for one month or two months."

Chris Willis:

The financial institutions involved, I'm sure, thought that they were doing those consumers a favor, but yet, the Bureau alleged, in two different enforcement actions and consent orders, that because the consumers weren't adequately informed of the accrual of interest during the period of the deferment, the consequences to interest accrual and a pay down of principal and the extension of the time of the credit obligation, that, that was a UDAAP violation. Here, what we have is a situation where industry is rolling out hardship and forbearance and deferment and other loss mitigation type programs at a record pace. They need to do it quickly to make them meaningful for their customers who were affected by the crisis.

Chris Willis:

When you do something in a hurry, it's easy to forget that, when there are costs or detriments associated with taking advantage of those programs, and sometimes there are to the consumer, that a failure to adequately disclose those terms and to make sure consumers understand them could be cited later as a UDAAP violation by the CFPB or by a state attorney general along the exact same lines of these two previous CFPB consent orders. The takeaway there is the industry should do what it is doing and roll out those hardship programs and make them as available as possible, but just to make sure that we very accurately describe the terms, conditions and potential detriments of taking advantage of those hardship programs to consumers who enroll in them.

Alan Kaplinsky:

You had mentioned there were three areas. Let me make a guess. It must have something to do with originating the credit, right?

Chris Willis:

It does. Correct. There's two things that I wanted to highlight there, and both of them come out of experiences that we had in 2008. First off, if you happen to be a subprime lender that charges high interest rates in connection with your products, and there's certainly a whole segment of the market that is that way and it's a necessary segment of the market, what you saw in response to the 2008 crisis was allegations that high interest rate lenders were "predatory lenders." The theme that you will see from regulators here, and as we saw in 2008, was that this was an example of predatory lenders taking advantage of people in a time of need to charge them extortionately high interest rates.

Chris Willis:

Anyone who's involved in these high interest rate loan products, like payday and auto title loans, or other similar things with triple digit interest rates needs to be especially mindful of their marketing and of their origination, and particularly, I think of the ability to repay aspect of their origination activity during a crisis like this, because those that don't pay attention to those, I think will be the easiest targets for these sort of predatory lending type of UDAAP actions by regulators. That's one segment of the industry. The other segment of the industry, if you think about sort of more mainstream, more prime leaning types of

products, there's the possibility that financial institutions will roll out products that are tailored to assist people who are affected by the coronavirus pandemic.

Chris Willis:

Imagine people who are unemployed because their restaurant that they worked with is closed right now, their hours have been cut so their income has been cut, or any kind of person for whom the lender thinks there is a temporary interruption in their income, but that it's likely to be resolved once the country can go back to work again. It's possible that financial institutions will design new products solely to cater to people who are experiencing that sort of a problem, which again, is a good thing. It should be helpful to consumers, but there's the opportunity again, to roll out those products where, either the advertising or other communications about the terms and conditions and various aspects of those products aren't adequately communicated.

Chris Willis:

If consumers get into those products and experience negative outcomes from them, and the regulator believes that it could have been resolved by better disclosure or better advertising of the product on the front end, then you might expect UDAAP claims to follow that situation. Again, the practical lesson for financial institutions is make sure if you're going to roll out a product like that, to be very clear and very upfront about what the terms and conditions are. When does interest start accruing? When do you have to repay it? What are the terms? Etc. Particularly, if you have a product that has a delayed onset of repayment or smaller payments at the beginning followed by larger payments later, when the person has presumably returned to work, just remember the analog from the 2008 crisis of things like adjustable rate mortgages, or teaser rate mortgages, where you had low payments to start with and escalating payments later.

Chris Willis:

Regulators took offense to those because they would create payment shocks for consumers in the minds of regulators. So, we have to be attentive to those kinds of risks if we have products that share some of those features.

Alan Kaplinsky:

Chris, let me circle back for a minute to the area of loss mitigation. You focus your attention on things that companies develop in order to help consumers, where they might restructure a mortgage or another type of loan, creating a moratorium on payments while the emergency lasts. But what you were referring to were voluntary efforts by companies to do that, and then an ensuing failure by the company to let the consumer know about the availability of a particular mitigation device that might be used. What I'm wondering about is whether you think that you could conjure up a situation, where a regulator could say that you committed a UDAAP because you were callous to the consumer.

Alan Kaplinsky:

The consumer called you, told you that he or she was unemployed, or laid off, or furloughed, and that, making the story even worse, he or she came down with the virus, or got hospitalized. There's no way I can make that mortgage payment this month. Is it a UDAAP violation for a company to just say, "Well, I feel sorry for you, Mr. Smith, but it's a contractual obligation and you're going to have to figure out a way to make the payment or you're going to be in default?"

Chris Willis:

I think that companies that behave in that manner are exposing themselves to significant risk. Here's how I think the regulatory enforcement action would play out. I don't think that the regulator would assert that the failure to offer voluntary Loss mitigation is a UDAAP violation, but think about it this way. Let's say the scenario is exactly as you described it, where you have a borrower who either has lost his or her job, or is indeed sick with coronavirus and having to deal with battling the virus, and the creditor just simply continues collection efforts as usual.

Chris Willis:

The Fair Debt Collection Practices Act and lots of other state debt collection statutes say that it's an unfair, deceptive practice to engage in collection activity when the effect of it will be to harass the recipient of the collection activity, in this instance, the debtor. It's very easy for a regulator to say, once the consumer tells you that he or she has lost his or her job, or that they're ill with the coronavirus and can't make a payment to continue calling them to continue insisting on payment, or to take further action has no effect other than to harass them. There, you have a very, sort of easy, straightforward UDAAP claim that's rooted very strongly in the language of a statute that seems like a relatively easy one for a regulator to bring.

Chris Willis:

I don't think the regulator has to stretch and make up a new legal theory about failure to offer loss mitigation in order to punish a creditor that behaves in the manner that you suggested.

Alan Kaplinsky:

Yeah. Okay. Let's turn now to fair lending. At least at first glance, to me, Chris, I don't see how the COVID-19 virus raises any particular fair lending issues, but I'm sure, since you suggested that we talk about that today, you are concerned about something.

Chris Willis:

I am concerned about something, and you're right. The crisis doesn't obviously raise a fair lending issue except in the very narrow sense that if being infected with the virus constitutes a disability, there are some anti-discrimination statutes that reached disability discrimination, and so you could see enforcement around that, but that's not really what I was thinking about. What I was thinking about is the fact that financial institutions right now are struggling to cope with the reality that the coronavirus pandemic has created, because it's disrupted the lives of everybody in the country, including the operations of financial services companies who rely, for their existence, on people making payments on their loan obligations, for example.

Chris Willis:

There's two particular areas where I think there are opportunities for financial institutions to sort of miss a fair lending issue and subject themselves to enforcement later. That's what I wanted to mention on today's episode of the podcast. First of those is loss mitigation or workout or hardship options. The practical takeaway for lenders is that they of course, should roll out these hardship programs, but just make sure that their availability is widely made known to the consumer base as a whole, and that the criteria for qualifying people to participate in them is simple and objective and easy for employees to apply rather than involving a lot of fact finding or discretion on the part of employees.

Chris Willis:

The second area that I am concerned about from a fair lending standpoint has to do with lenders response in models to what's going on with coronavirus. I think everybody anticipates that there will be an increased incidents of fraud during this time of economic dislocation. Lenders, of course, have a duty to try to avoid identity theft and protect themselves from fraud, not just a business duty, but a duty under the Fair Credit Reporting Act.

Chris Willis:

So, there's going to be a lot of pressure to make those fraud models as predictive as possible. The worry that I have in that regard is that financial institutions will feel tempted to use protected characteristics or close proxies for protected characteristics and fraud models in circumstances where regulators will not view them to be solely targeted at fraud, not narrowly targeted enough to fraud.

Chris Willis:

So, there's an opportunity for financial institutions to run afoul by trying to quickly respond to emerging fraud patterns by straying too far into the use of protected variables in fraud models. Then, if we look at the underwriting side, all the regulators

seem to have been encouraging financial institutions to use alternative data in underwriting models. For example, in the joint inter-agency statement about the use of alternative data and underwriting that came out several months ago, there definitely is a line there that can be crossed.

Chris Willis:

If financial institutions start to think that they can use close proxies or other very sensitive characteristics in underwriting models, and that doing so will help them predict credit risk better in a coronavirus disrupted economy, they can still stray into an area where they would be subject to fair lending enforcement by the CFPB or some other regulator. Again, what we need to do as a practical matter on models is to make sure that any changes that we make to models, any new models that we roll out that may need to take into account the new economic or new fraud realities of coronavirus are subject to the same kind of fair lending screening, and review and variable validation and business justification processes that we would have applied under business as usual for any other fraud or underwriting model.

Chris Willis:

If we skip those steps because we're in a hurry, then we do put ourselves, I think, at greater risk of fair lending enforcement later. Remember, the Statute of Limitations under the Equal Credit Opportunity Act is five years.

Alan Kaplinsky:

Right. Okay, Chris, before we conclude, I'm wondering if you have any concluding remarks that you want to share about the topics that we talked about today.

Chris Willis:

Yeah. I think the main takeaway that I would have, the main message that I want to send to our community, which is the financial institution community is, I've been very impressed by everything that the community has done to rise to the occasion, to try to make things easier for borrowers, and to behave in a socially responsible way during this time of crisis. I've also seen that the demands of this situation and having to adapt to it have really put a strain on the resources of financial institutions. Entities are in a hurry to get things done, get them rolled out quickly for the best of intentions. But when we do things in a hurry, we can overlook things like the topics that we discussed in today's podcast, and that may come back to bite us later.

Chris Willis:

What I would say is, when you're in the middle of trying to adapt to a crisis, if we can just pause briefly for reflection and make sure we've considered the kinds of risks that we've talked about in today's program and the kind of experience that we all remember from the 2008 crisis, we'll be able to think for the long-term, and not just live in the moment and think for the short term. If we do that, we'll protect ourselves much better against potential UDAAP and fair lending issues that may come about months or even years after this crisis has passed. That's what I'd urge our community to do.

Alan Kaplinsky:

Okay. Well, Chris, thank you very much for being a part of our episode today. Also, want to thank everybody who took the time to download our podcast today. Make sure you visit our website, www.ballardspahr.com, where you can subscribe to the show. You can also subscribe to the show on Apple Podcasts, Google Play, Spotify, or whatever your favorite podcast platform may be. As I indicated at the beginning of our show, don't forget to check out our blog, consumerfinancemonitor.com, for daily insights about the consumer financial services industry, particularly now during this time of great stress. If you have any questions or suggestions for our show, please email us at podcast@ballardspahr.com, and stay tuned each Thursday for a new episode of our show.