

Consumer Credit

The authors argue that in light of the Consumer Financial Protection Bureau's apparently negative perception of add-on products and the way they are sold, the recent actions against auto finance companies under ECOA, and the expanded authority provided under the Larger Participant Rule, it may be inevitable that the CFPB's gaze will eventually fall on automobile ancillary products.

BNA INSIGHTS: Ancillary Products Are Anything but Ancillary for the CFPB



BY JOHN C. REDDING AND MITCHELL M. GROD

It's no secret that the Consumer Financial Protection Bureau (CFPB) has its sights set on the U.S. automobile finance industry. As evidenced by recent CFPB Bulletins and consent orders with indirect auto finance sources, the CFPB's current focus within the industry is largely on the practice of dealers marking up the whole-

sale buy rates, alleging fair lending violations under the Equal Credit Opportunity Act (ECOA).¹

Until recently, the CFPB was limited in its ability to reach nonbank automobile finance companies through its broad authority to enforce violations of certain "enumerated consumer laws" and the Unfair, Deceptive or Abusive Acts or Practices (UDAAP) standards of the

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¹ CFPB Bulletin 2013-02, *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act*, (Mar. 21, 2013); *In the Matter of Ally Financial, Inc.*; Ally Bank, CFPB Administrative Proceeding File No. 2013-CFPB-0010, (Dec. 20, 2013). Available at: http://files.consumerfinance.gov/f/201312_cfpb_consent-order_ally.pdf; and CFPB, *Supervisory Highlights - Winter 2013*, pg. 4. Available at: http://files.consumerfinance.gov/f/201401_cfpb_supervision-highlights.pdf.

Dodd-Frank Act.² On Aug. 31, 2015, the CFPB's final rule to oversee "larger participant" nonbank auto finance companies became effective, expanding the CFPB's authority to supervise all aspects of nonbank auto finance companies with at least 10,000 aggregate annual originations.³ At the same time it released the final rule, the CFPB simultaneously released its Automobile Finance Examination Procedures (Examination Procedures), which provide the first guidance specifically addressing ancillary products in the automobile industry.⁴

Long before release of the Examination Procedures, however, add-on products were on the CFPB's radar. In 2012, the CFPB issued Bulletin 2012-06 regarding the marketing of credit card add-on products, and shortly thereafter assessed significant penalties against three banks for alleged misconduct.⁵ As early as May 2013, reports surfaced that the CFPB had issued subpoenas to auto lenders concerning the sale of ancillary products.⁶ The CFPB also entered into a consent order with an auto lender in June 2013 for the alleged deceptive marketing of automobile ancillary products to service members.⁷

In light of the CFPB's apparently negative perception of add-on products and the way they are sold, the recent actions against auto finance companies under ECOA, and the expanded authority provided under the Larger Participant Rule, it may be inevitable that the CFPB's gaze will eventually fall on automobile ancillary products. Because automobile dealers are exempt under Dodd-Frank, the CFPB will likely attempt to police actions by dealers and the sale of ancillary products through indirect auto finance sources, just as it has done through enforcement actions aimed to address alleged fair lending concerns.

In attempting to predict how the ancillary product landscape may be affected by additional scrutiny from the CFPB, the automobile finance industry need look no further than recent activity by the CFPB's counterpart in the United Kingdom (U.K.), the Financial Services Authority (FSA) and its successor, the Financial Conduct Authority (FCA).

² 12 U.S.C. §§ 5481(12), (14), 5563, 5565.

³ 80 Fed. Reg. 37495.

⁴ CFPB Examination Procedures – Auto Finance at Module 9, pg. 54. Available at: http://files.consumerfinance.gov/f/201506_cfpb_automobile-finance-examination-procedures.pdf.

⁵ See: *In the Matter of Discover Bank*, Federal Deposit Insurance Corporation/CFPB Joint Consent Order, Order for Restitution, and Order to Pay Civil Money Penalty, (Sept. 24, 2012). Available at: http://files.consumerfinance.gov/f/201209_cfpb_consult_order_0005.pdf; *In the Matter of Capital One Bank*, CFPB Administrative Proceeding File No. 2012-CFPB-0001, (July 18, 2012). Available at: http://files.consumerfinance.gov/f/201207_cfpb_consult_order_0001.pdf; *In the Matter of American Express Centurion Bank*, CFPB Administrative Proceeding File No. 2013-CFPB-0011, (Dec. 24, 2013). Available at: http://files.consumerfinance.gov/f/201312_cfpb_consult_amex_centurion_011.pdf.

⁶ Robin Sidel and Alan Zibel, *Regulators Scrutinize Auto Lenders Over Add-Ons*, *The Wall Street Journal* (May 2, 2013).

⁷ CFPB, *CFPB Orders Auto Lenders to Refund Approximately \$6.5 Million to Servicemembers*, (Jun. 27, 2013). Available at: <http://www.consumerfinance.gov/newsroom/cfpb-orders-auto-lenders-to-refund-approximately-6-5-million-to-servicemembers/>.

FCA Influence on the CFPB

Unlike traditional rules-based financial regulations historically found in the U.S., the FCA employs principles-based and behavioral economics-guided policies, relying on the concept of "treating customers fairly." Rules-based regulations generally prohibit specific conduct or prescribe certain business processes such as disclosures relating to term, pricing, structure, and marketing.⁸ In contrast, and while there are specific conduct rules that govern interaction with customers, when considering or undertaking enforcement action, the FCA uses a principles-based view of conduct more holistically and investigates the outcomes of particular transactions to determine whether the underlying business practices comply with those regulatory principles.⁹

For example, the FCA (and the FSA before it) uses "11 Principles for Business" (Principles) as a general statement of the fundamental obligations of financial firms. These Principles require firms to, among other things:

- establish and maintain adequate risk management systems;
- maintain adequate financial resources;
- pay due regard to the interests of its customers and treat them fairly;
- communicate information to customers in a way that is clear, fair, and not misleading;
- take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment; and
- deal with its regulators in an open and cooperative way, and disclose anything relating to the firm of which such regulator would reasonably expect notice.¹⁰

The implementation of this alternative regulatory philosophy in the U.K. has coincided with a shift in the financial policies of the U.S. from a historically rules-based approach to one that is more principles-based. The transition has continued with the CFPB, relying on the academic and theoretical foundations of behavioral economics and the creation and staffing of its Academic Research Council, an advisory body to its Office of Research, with experts in the field.¹¹

The influence of these Principles can also be observed in similar mandates prescribed by the CFPB regarding the financial safety and soundness of financial firms, third-party vendor management, and most notably, UDAAP. Specifically, the Dodd-Frank Act's UDAAP provisions prohibit, among other things, acts or practices that: (i) mislead or are likely to mislead the consumer; (ii) interfere with the ability of a consumer to

⁸ Manley Williams, Nadav Ariel, and Claire Carroll, *Trending: A principles Based Approach to US Financial Regs*, Law 360, Mar. 24, 2015. Available at: <http://www.law360.com/articles/633587/trending-a-principles-based-approach-to-us-financial-regs>.

⁹ Financial Services Authority, *Principles-based regulation: Focusing on the outcomes that matter* (April 2007).

¹⁰ FCA Handbook § PRIN 2.1, available at: <https://fshandbook.info/FS/html/handbook/PRIN/2/1> (last visited Aug. 20, 2015).

¹¹ Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008); Williams, et al., *Trending: A principles Based Approach to US Financial Regs*, Law 360, Mar. 24, 2015.

understand a term or condition of a consumer financial product or service; or (iii) take unreasonable advantage of a consumer's lack of understanding or inability to protect his or her own interests.¹² Indeed, the CFPB's self-stated purpose is to "promote fairness and transparency for mortgages, credit cards, and other consumer financial products and services."¹³ This focus on fairness rather than the promulgation of rules to guide conduct represents a shift in U.S. regulatory approach consistent with that seen from the FCA.

As a result, U.S. financial regulatory activity and policy has closely tracked FCA and U.K. financial regulations. For example, one of the first actions taken by the FCA after succeeding the FSA was to conduct a market study regarding add-on products.¹⁴ The FCA examined issues surrounding the value of add-on products, potential harm to competition caused by selling the products as an add-on, and overall transparency during the sales process. In conducting the study, the FCA "used behavioural economics as a key tool during the study. We carried out both quantitative and qualitative consumer research, and undertook an innovative behavioural experiment in which we tested consumers' reactions to the add-on mechanism in a simulated environment."¹⁵

Among other things, the study found consumers typically had poor awareness regarding the purchase of add-on products or the price paid, received poor value from add-on products when sold as add-ons to the primary vehicle purchase transaction, and there was a lack of transparency and comparability. The FCA also disregarded high marks in customer satisfaction in purchasing the add-on product because customer opinions were undermined by a lack of transparency in pricing and value, potentially preventing consumers from making fully informed decisions. This illustrates the importance that principles-based analysis and policies place on the overall fairness of a transaction, as opposed to relying on broad rules-based regulations that may not provide sufficient consumer protection upon implementation.

The CFPB applied a similar approach to the sales and marketing of credit card add-on products. CFPB Bulletin 2012-06 expressed the need to assess whether additional supervisory, enforcement, or other actions may be necessary to ensure the market for add-on products functions in a fair, transparent, and competitive manner.¹⁶ The Bulletin also provided guidance regarding the marketing of credit card add-on products and further warned that statutory disclosures alone are insufficient to satisfy UDAAP scrutiny. Rather, the CFPB considers additional "factors in evaluating the effectiveness of the disclosures at preventing consumers from being misled," including whether: (i) the statement is promi-

nent enough for the consumer to notice; (ii) the information is presented in an easy-to-understand format; (iii) disclosures were provided at a time when the consumer's attention is not distracted elsewhere; (iv) the information is in a location where consumers can be expected to look or hear; and (v) the information is in close proximity to the claim it qualifies.

Similarly, CFPB Bulletin 2014-02 on the "Marketing of Credit Card Promotional APR Offers" suggests that technical compliance with Regulation Z does not provide a safe harbor for possible UDAAP violations to the extent disclosures are not sufficiently prominent or fail to clearly explain all terms, risks and costs.¹⁷

United Kingdom GAP Product Regulations

Perhaps the most influential finding in the FCA's add-on market study was that guaranteed asset protection (GAP) products sold in connection with an automobile produced significantly worse results for consumers than other products. The study concluded that GAP add-on distributors had a clear impact on consumer behavior by exploiting biases affecting decision-making and weakening engagement in the purchasing process. Further, the FCA noted that add-on buyers were less informed, less likely to shop around, less effective when they do shop around and less sensitive to price.

As a result, the FCA issued a "Competition Remedy" regulating the manner in which GAP products may be sold.¹⁸ The aim was to produce better customer outcomes through more informed purchasing decisions and improved competition between add-on and stand-alone distribution channels. Beginning Sept. 1, 2015, firms distributing GAP products as an add-on product in the U.K. will be required to (i) provide customers with prescribed information to help them shop around and be more engaged when making decisions about purchasing the product, and (ii) introduce a deferral period, which prohibits firms from introducing and selling GAP products on the same day.

GAP Disclosures

Under the FCA Competition Remedy, prior to executing a GAP contract, a seller must provide the consumer with the following information:

- the total premium of the GAP contract, separate from any other prices;
- the significant features and benefits, significant and unusual exclusions or limitations, and cross-references to the relevant policy document provisions;
- whether the GAP contract is sold in connection with vehicle finance;
- that GAP contracts are sold by other distributors;
- the duration of the policy;
- whether the GAP contract is optional or compulsory;
- when the GAP contract can be concluded by the firm; and
- the date the foregoing information is provided to the customer.

In addition, the required information must be communicated in writing, and in a clear and accurate man-

¹² 12 U.S.C. § 5531(d); CFPB Exam Manual at UDAAP 5.

¹³ Federal Register Agency Summary, *Consumer Financial Protection Bureau*. Available at: <https://www.federalregister.gov/agencies/consumer-financial-protection-bureau>.

¹⁴ FCA Market Study MS14/1, *General Insurance Add-Ons: Final Report – Confirmed Findings of the Market Study*, (July 2014). Available at: <https://www.fca.org.uk/static/documents/market-studies/ms14-01-final-report.pdf>.

¹⁵ FCA, *General Insurance Add-Ons Market Study*, (Jun. 10, 2015). Available at: <https://www.fca.org.uk/news/general-insurance-add-ons-market-study>.

¹⁶ CFPB Bulletin 2012-06, *Marketing of Credit Card Add-on Products* (Mar. 21, 2013).

¹⁷ CFPB Bulletin 2014-02, *Marketing of Credit Card Promotional APR Offers*, (Sept. 3, 2014).

¹⁸ FCA, PS15/13: *Guaranteed Asset Protection insurance: Competition Remedy* (June 10, 2015).

ner accessible to the customer. The seller must specifically call the customer's attention to the disclosures and identify them as key information. Consistent with other principles-based regulations, the Competition Remedy requires a seller consider the information needs of its customers and determine whether it would be in the customer's interest to receive the disclosures again before completing the sale of the GAP product.

Deferral Period

After providing the disclosures, a seller may not execute an add-on GAP contract until at least three days later. Customers wishing to purchase add-on GAP products during this waiting period may do so by initiating the sale with the seller themselves, provided the consumer confirms they understand the restrictions in the disclosures. Customers also have the ability to buy stand-alone GAP products any time. Although not part of the Competition Remedy, consumers also have the right to cancel without cause or penalty within 30 days of the contract.¹⁹

Potential Effects on the U.S. Ancillary Product Market

These U.K. regulations represent significant changes to the sale of add-on GAP products and could be applied to other automobile add-on products as well. Recent U.K. financial regulatory activity has influenced

CFPB action, and both the FCA and CFPB have expressed increased interest in the automobile industry as a whole, both in the U.K. and U.S. The CFPB has already articulated concerns regarding other add-on products such as vehicle services agreements (often erroneously referred to as "extended warranties") due to perceived high profitability for sellers and lower value to consumers.²⁰

In light of the parallels between the regulatory course of the FCA and CFPB, and the CFPB's apparent skepticism toward the value of add-on products, together with the results of the FCA's add-on market study and GAP Competition Remedy, it appears that automobile add-on products may soon be an area of increased focus by the CFPB.

Further, the ongoing shift from rules-based to principles-based regulation will likely continue to pose compliance management challenges for automobile dealers and finance companies. As evidenced by recent CFPB activity and opinions, adhering to bright-line rules in a mechanical fashion without considering the context of the transaction or consumer behavior will likely be insufficient to insulate auto finance companies from UDAAP scrutiny. In today's regulatory climate, automobile dealers and finance companies in particular would be well served to evaluate add-on practices and procedures from the perspective of fairness, clarity, and value.

¹⁹ FCA Handbook § ICOBS 7.1.1, available at: <https://fshandbook.info/FS/html/FCA/ICOBS/7/1>.

²⁰ <http://www.consumerfinance.gov/d/askcfpb/825/what-difference-between-warranty-and-extended-warranty.html>.