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Trending: A Principles-Based Approach To US Financial Regs

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While the United States has traditionally utilized rules-based policies, there has been a recent trend toward integrating principles-based policies and behavioral economics in regulating consumer financial products. For a framework of applying behavioral economics- and principles-based regulations, U.S. regulators, such as the Consumer Financial Protection Bureau, need look no further than across the pond.[1]

Early adopters of principles-based and behavioral economics-guided policies have been the Financial Conduct Authority, which regulates financial products in the United Kingdom, and its jurisdictional predecessor, the Financial Services Authority. Indeed, the FSA's enforcement actions in the U.K. credit card add-on industry foreshadowed similar actions in the U.S. by the CFPB.[2] The FCA's recent regulatory proposals governing aftermarket automotive financial products, combined with the CFPB's recent investigatory focus on similar products, suggest that the U.K. experience may be instrumental in anticipating developments here.

Regulatory Principles for Financial Entities in the U.K.

Rules-based regulations generally prohibit specific conduct or prescribe certain business processes such as disclosures relating to term, pricing, structure and marketing. In contrast, regulators using a principles-based approach establish principles of conduct and investigate the outcomes of particular transactions to determine if the underlying business practices comply with the regulatory principles.[3] To that effect, the FCA has promulgated "11 Principles for Business," violations of which guide its enforcement actions. A number of those principles are evident in the manner in which U.S. regulators also operate:

Third Principle — Management and Control: A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.

Sixth Principle — Customer's Interests: A firm must pay due regard to the interests of its customers and treat them fairly.

Seventh Principle — Communications with Clients: A firm must pay due regard to the information needs of its clients and communicate information to them in a way that is clear, fair and not misleading.

Ninth Principle: Customers — Relationships of Trust: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

Eleventh Principle — Relations with Regulator: A firm must deal with its regulators in an open and cooperative way and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.

U.S. Financial Regulators Have Implemented U.K. Principles in Supervision and Enforcement

The CFPB's incorporation of principles-based regulation into its supervision and enforcement actions is evident through its bulletins and its application of the Dodd-Frank Act's prohibition on Unfair, Deceptive, or Abusive Acts or Practices (collectively, "UDAAPs").

For instance, the CFPB's Bulletin 2012-16 (July 18, 2012), on "Marketing of Credit Card Add-on Products," illustrates the principles-based approach to regulation and the focus on consumer behavior by evaluating the effectiveness of disclosures at preventing consumers from being misled based on whether the statement is "prominent enough for the consumer to notice," "presented in an easy-to-understand format," "where consumers can be expected to look or hear," at "a time when the consumer's attention is not distracted elsewhere." Moreover, the CFPB's Bulletin 2014-02 (Sept. 3, 2014), on "Marketing of Credit Card Promotional APR Offers," cautions that technical compliance with Regulation Z does not suffice and implies that compliance management must consider the effect on consumer behavior in formulating disclosures.

Specifically, the CFPB requires credit card issuers to clearly and prominently warn consumers if they will lose their grace period on new purchases when they take advantage of promotional balance transfer APR offers, even though the grace period is only associated with paying a statement balance in full and the balance transfer offer is utilized to pay a balance over time. In other words, the CFPB requires issuers to take into consideration consumers' irrational expectation that they will receive a grace period even if they do not pay in full, and therefore clearly explain to consumers the effect of promotional balance transfer offers on the grace period for new purchases. These bulletins illustrate the principles-based approach to regulation found in the FCA's sixth and seventh principles.

Similarly, the CFPB's Bulletin 2013-06 (June 25, 2013), on "Responsible Business Conduct: Self-Policing, Self-Reporting, Remediation, and Cooperation," is reminiscent of the FCA's 11th principle, describing "relations with regulators." The bulletin describes factors the CFPB will consider in exercising its discretion to bring an enforcement action and assess civil money penalties, including "prompt and complete self-reporting" by firms to the CFPB.

The CFPB has incorporated a principles-based approach in its enforcement actions as well. For example, the CFPB has recently focused on aftermarket products in the automotive industry. The CFPB entered consent orders in a pair of enforcement actions in which it alleged that a bank and its affiliate, an automobile loan program marketer and servicer, deceptively marketed the prices of a GAP insurance product and deceptively marketed the prices and scope of the coverage of vehicle service contracts.[4] While the bank did not directly market the add-on products, the CFPB alleged it was responsible for the marketing and advertising materials because it jointly developed the program with the servicer and had a contractual right to review the statements made by the servicer, regardless of whether it exercised that right.

The consent orders required the bank and the program servicer to reimburse customers more than $6.5 million in connection with loans secured through the companies' Military Installment Loans and Educational Services (MILES) auto loans program.[5] The consent orders demonstrate how the principles-based approach holds institutions to UDAAP standards in all aspects of their business, including with respect to the actions of third-party vendors if the institution participates in the endeavor and/or has supervisory authority. Consistent with this approach, the CFPB recently announced a lawsuit against a telecommunications company for permitting unauthorized third-party charges on consumers' bills, noting that it seeks to hold the company accountable for ensuring that the vendors to which it allowed access to its billing system are not treating consumers unfairly.[6]

Experiments in Behavioral Economics are Driving Principles-Based Regulation in the U.K.

The U.K. regulators have now been experimenting with how to convert the principles into prescriptive standards by focusing on the outcome of transactions on consumers.[7] A relatively novel approach recently instituted by the FCA is the use of experiments to understand how business practices affect consumer behavior and whether those practices tend to promote outcomes unfair to consumers. Thus, the FCA conducted its first behavioral economics research experiment to investigate how the inherent structure of selling add-ons, also known as aftermarket products, impacts consumers' purchase decisions and thereby their ability to reach optimal purchase outcomes as viewed by the regulators.[8]

The experiment involved an online simulation in which consumers shopped for and purchased a primary product (e.g. a hot water heater or a laptop computer) and an associated optional insurance product to protect against a possible adverse event that would affect the value of the primary product. Participants were informed upfront of the probability of the adverse event occurring and the amount of money they would lose if it occurred. Participants were incentivized to minimize the purchase price of the primary product and the optional insurance by real-money payouts linked to a formula based on the value of the primary product minus the price paid for the primary product, optional insurance and, if the participant had decided not to purchase insurance and the adverse event occurred, minus the cost of the adverse event.

Since there was no variation in product quality, the experiment was able to explore how different transactional factors, such as the price format, access to stand-alone alternatives, and timing of offering the aftermarket product, impacted the consumer's ability to comparison-shop and select the lowest priced option. The FCA found that revealing the price of the add-on at the point of sale and not providing the option to search for stand-alone alternatives from other companies made consumers more likely to purchase a more expensive product despite the availability of comparable cheaper alternatives. Based on this experiment, the FCA concluded that selling financial produces in add-on format leads to consumers purchasing products that are of relatively poor value based on their prices and the consumers' needs.

Building on the foundation of the behavioral economics experiment,[9] U.K. regulators proposed rules restructuring the transactions with the aim of creating a more favorable result for the consumer. The FCA proposed new rules to govern the selling of add-on products, with a focus on guaranteed asset protection (GAP).[10] GAP insurance is particularly prevalent in the automotive industry to cover the gap between the insurance payout based on the value of the car and the amount outstanding on the consumer's loan to finance the purchase of the vehicle.

The FCA noted, in focusing on GAP, that the claims ratio from 2008-2012 averaged just 10 percent, substantially below other insurance products sold to consumers. Accordingly, the FCA proposes imposing a deferred opt-in so that GAP could not be sold at the point of sale of the primary product (i.e. the vehicle). The FCA also proposes banning pre-checked boxes (opt-outs) for the sale of add-ons and requiring firms to publish claims ratios for add-on insurance products.

The Effect of Behavioral Economics on Regulatory Enforcement in the U.S.

In discussing these findings, FCA Chief Executive Martin Wheatley described the use of behavioral economics by regulators as “more significant than ever to the future of the financial sector.”[11]. Indeed, Wheatley views the role of behavioral economics as a “game changer” in regulation not just for the U.K., noting the “potential importance of experimental evidence to global regulators.”[12] His remarks were indicative of the FCA’s and other countries’ regulators’ intent to intervene in the form of economic “nudges,” with consumers being encouraged, in subtle ways, to make theoretically better choices (as determined by the regulators).

In the U.S., the CFPB’s structure and practice indicate that it is incorporating behavioral economics in the manner in which it regulates financial products. The CFPB’s academic and theoretical foundations, as conceived by Sen. Elizabeth Warren, D-Mass., are rooted in behavioral economics.[13] Accordingly, the CFPB has staffed its Academic Research Council, an advisory body to its Office of Research, with experts in the field.

On the specific issue of add-ons, we are aware of the CFPB’s focus on the automotive industry. This suggests that the CFPB may follow its British counterpart in heightened scrutiny on the sale of aftermarket products in the automotive industry.[14] The CFPB is skeptical of extended warranties, telling consumers that extended warranties “can be very profitable for the dealer and expensive for you” and that consumers may find “that any additional coverage is not worth the additional cost.”[15].

Consequently, the CFPB urges consumers “to negotiate with the dealer by getting an offer from another dealer and asking them to beat that offer.”[16]. It also informs consumers that they can ask for an itemization of the amount quoted for extended warranties and that if the monthly payment doesn’t match the itemization, consumers may file a complaint with the CFPB, the Federal Trade Commission or their state attorney general.

In the U.K., the principles-based approach culminated in the proposed regulation of sales practices for add-on products, in particular GAP insurance. The CFPB has not yet followed its British counterpart by mandating deferred opt-in for ancillary products sold in connection with credit transactions. Nor has the CFPB banned pre-checked boxes (opt-outs) for the sale of add-ons.

Similarly, the CFPB is not requiring firms to publish claims ratios for add-on insurance products although it could conceivably publish such information itself. However, the CFPB is far more likely to move forward with its principles-based approach through enforcement actions. A U.S.-based company with a U.K. affiliate might even be challenged as to why it has not adopted the U.K. affiliates’ policies to the extent those are more consumer-friendly.

These enforcement actions are becoming more likely to arise from the framework of conduct principles and findings of behavioral economics. Such an approach will pose a challenge to financial institutions’ and other regulated businesses’ compliance management where following bright-line rules may no longer insulate a practice from being deemed unfair, deceptive, or abusive. Moreover, there is a substantial risk of unpredictable regulation and enforcement efforts to correct behavioral market outcomes that are deemed by the regulatory agencies as unfavorable to consumers. This paradigm shift counsels companies to review their own practices through the lenses of conduct principles and behavioral economics in an effort to stay ahead of the regulators.

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