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The British (Financial Regulatory Principles) Are Coming!

Law360, New York (April 11, 2014, 6:46 PM ET) -- Regulation of financial products and services in the U.S. historically has relied on rules-based regulatory policy, governing business processes including disclosures relating to terms, pricing, structure and marketing. The U.K. has been a leader in applying principles-based regulation, which governs conduct at a higher level of generality. Over the past few decades, researchers in cognitive psychology and behavioral economics have produced a body of findings that are beginning to fundamentally alter understandings of what regulation should do, particularly with respect to the design of consumer "nudges."

A nudge is a change in how a choice is presented, which leads people to make a more desired decision from a regulatory point of view.[1] Nudges relevant to regulatory policy include, for example, the presentation of disclosures and the setting of default rules (what happens if consumers do nothing). "Choice architecture," or how the options are framed, has a great deal to do with outcomes.[2]

In the United Kingdom, Prime Minister Cameron created a Behavioural Insights Team, also called the "Nudge Unit," to apply such research to government processes and policies.[3] The U.K. Financial Conduct Authority's ("FCA") Chief Executive delivered a speech in October 2013, admonishing that "check-the-box" compliance is "almost robotic," a muddle of small-print disclosures, customer inertia, and irrational financial decision-making. He rejected a "buyer beware" approach to markets for "seriously complicated financial products."[4] Accustomed to principles-based regulation, U.K. firms may take in stride an increasing application of outcomes-based regulation. In the U.S., the Consumer Financial Protection Bureau is not far behind, and the transformation in approach to regulatory policy may feel more abrupt.

Senator Elizabeth Warren, D-Mass., a central figure in the CFPB's formation, has been an advocate of principles-based regulation. In a 2010 speech, she cited with approval a 2007 report from the U.S. Financial Services Roundtable: "Instead of creating a regulatory thicket of 'thou shalt nots,' and instead of using ever more complex disclosures that drive up costs for lenders and provide little help for consumers, let's measure our success with simple questions. ... Can customers understand the product, figure out the costs and risks, and compare products in the marketplace?"

The CFPB announced in late January 2014 that it is accepting applications for its Academic Research Council (an advisory body to the Office of Research), specifying in particular a need for academics with expertise in structural or reduced form econometrics, modeling of consumer decision-making, behavioral economics, experimental economics, program evaluation, psychology, or financial choice.[5] More directly, guidance and enforcement actions — relating in particular to credit card add-on products — since mid-2012 reflect a steady trend in this direction.

11 Principles for Businesses

1. Integrity: A firm must conduct its business with integrity.
2. Skill, Care and Diligence: A firm must conduct its business with due skill, care and diligence.
3. Management and Control: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial Prudence: A firm must maintain adequate financial resources.
5. Market Conduct: A firm must observe proper standards of market conduct.
6. Customers' Interests: A firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with Clients: A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of Interest: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. 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.
10. Clients' Assets: A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with Regulators: A firm must deal with its regulators in an open and co-operative way and must disclose to the FSA anything relating to the firm of which the FSA would reasonably expect notice.

The U.K.'s Principles-Based Regulatory Policy

In September 2012, U.K. regulators initiated an enforcement action against Lloyd's Banking Group arising out of credit card add-on product marketing practices and claims processing. The Financial Services Authority ("FSA") and Office of Fair Trading ("OFT") released final Payment Protection Products (credit card add-on products) guidance in January 2013. The guidance, published in draft in November 2011, builds on the FSA's "11 Principles for Business" and focuses on four "key messages": (i) Know the law and how it applies to these products; (ii) be transparent to consumers about the "nature, price, and implications" of the products; (iii) ensure fair treatment and do not engage in "unfair or improper business practices;" and (iv) failure to observe these tenets or comply with relevant statutes may lead to enforcement action by the OFT."[6]

Shortly thereafter, in February 2013, the FSA entered into a settlement agreement with Lloyd's, which included a finding that the bank violated the FSA's third principle: "A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems." The FSA focused in particular on Lloyd's alleged failure to establish a system for processing customer claims that made effective use of technology to reduce the potential for human error. For example, the FSA found that Lloyd's process relied on the manual movement of paper tickets between white boards to track the progress of certain customer claims.

Building on principles-based regulation and enforcement, an "outcomes-focused approach" is next up in the U.K., says Veronique Marquis, partner in the Financial Institutions Group of London-based Eversheds LLP. Such an approach draws heavily from behavioral economics and studies consumer behavior to evaluate whether product design, marketing and sales processes lead consumers to make poor financial decisions.[7]

In the October speech mentioned above, the FCA Chief Executive said that regulators could use their power and expertise to require testing of different disclosures, with the goal of leading customers to better outcomes. He reported that, in an FCA trial of letters advising consumers they were due a refund, consumers responded at higher rates to a letter with behavioral economic “nudges,” including less text, information presented in bullet points, and a pledge that responding would take only five minutes. The FCA also sees potential in regulatory initiatives influenced by behavioral economics to reduce the complexity of financial products and deter marketing appeals to consumers’ biases rather than their judgment.

Regulated entities in the U.K. are doing their best to keep up. For example, on June 7, several banks voluntarily agreed to set up a “retry system” to help consumers avoid NSF charges. These banks will “retry” in the afternoon any transaction that would have resulted in an NSF charge early in the day, and will assess the NSF charge only on consumers with insufficient funds on the second try. The initiative is not based on any rule, statute, or enforcement action, but rather on FCA concerns that deductions (including direct debits) tend to hit accounts first thing in the morning, while new credits, payments, and cleared checks appear later in the day.

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

It is clear that strands of the approach are gaining hold in the U.S., largely through the application of the Dodd-Frank Act’s prohibition on Unfair, Deceptive, or Abusive Acts or Practices. In Bulletin 2012-06 (July 18, 2012) on “Marketing of Credit Card Add-on Products,” the CFPB incorporated principles from the FSA’s draft guidance, requiring, among other things, that marketing materials accurately state product terms and conditions. By declining to prescribe specific words or phrases, the CFPB signaled that it will look more broadly at the application of principles and outcomes to assess deceptiveness.

As it issued this guidance, the CFPB simultaneously initiated a series of actions to enforce it. Of particular interest here, the CFPB’s October 2012 consent order condemns an issuer’s use of the word “enroll” in telemarketing credit card add-on products. Notably, comments to Regulation Z state that asking a customer if he or she wishes to “enroll” in an add-on product “would not be considered misleading.” The CFPB found, however, that the word insufficiently conveyed “the material fact that enrollment or membership constituted an agreement to purchase the product.”

Bulletin 2013-06 (June 23, 2013) is similarly reminiscent of the FCA’s eleventh principle, describing “relations with regulators.” Entitled “Responsible Business Conduct: Self-Policing, Self-Reporting, Remediation and Cooperation,” the bulletin describes factors the CFPB will consider in exercising its discretion to bring an enforcement action and assess civil money penalties. The bulletin outlines steps that firms can take to exhibit “responsible conduct” in managing their businesses, during an investigation or enforcement action, and afterward.

Reminiscent of the FSA’s acknowledgement in the Lloyd’s matter, the CFPB noted in a June 27, 2013, consent order requiring a bank and its affiliate to refund more than $6.5 million to military servicemembers allegedly injured by its auto lending practices, that it did not impose a civil money penalty in part due to cooperation. In the Lloyd’s agreement referenced above, the FSA stated that the size of the penalty was reduced by 30 percent in view of cooperation.

These trends are not unique to the CFPB. For example, in amending Regulation Z to comply with the

CARD Act, the Federal Reserve Board of Governors “not[ed] that [its] approach is consistent with the conclusions reached by the United Kingdom’s Office of Fair Trading in a statement of the principles that credit card issuers must follow in setting default charges.” 75 Fed. Reg. 37526, n. 34 (June 29, 2010).

Still, the CFPB has kept up a robust rulemaking schedule, and regulators clearly have not relaxed the rules-based framework. In Bulletin 2012-06, for example, the CFPB said that it not only expected regulated entities to comply with its general principles but also to “ensure compliance with ... [all] applicable Federal and state consumer financial protection laws and regulations.” In its consent orders, the CFPB made other allegations that, if true, would support a finding that the regulated entities violated both applicable rules and principles.

Financial Institutions Should Expect Their Practices to be Filtered Through Conduct Principles and Findings of Behavioral Economics

Two of the central findings of behavioral research figure prominently in the CFPB add-on product enforcement actions.[8]

First, default rules can have large effects on outcomes. In a frequently cited example, simply giving people access to retirement savings plans will produce low participation rates, but requiring them to opt out greatly increases participation. CFPB’s concern about two-step enrollment processes for identity theft protection and credit monitoring services, which require post-enrollment registration with a third party, and “trial periods” that require a customer to take an affirmative step to cancel, have been common remedial themes.

Second, framing and presentation influence the choices consumers make. For example, studies have demonstrated that salience or vivid displays (for example, in public health messages) are more effective in guiding behavior than explanations of statistical risks. Researchers have found that “add-on” costs are not as salient as purchase prices, and that consumers may not be attentive to them.[9]

With respect to salience, the CFPB’s focus on the use of the word “enrollment” in the offering debt cancellation or other add-on products is instructive, as is its prototype penalty fee box — a disclosure proposed in February 2012 that would appear on a consumer’s checking account statement to highlight the amount overdraft and the fees charged.

More and more, consumer financial regulatory initiatives in the U.K. and in the U.S. are likely to focus on these and other components of choice architecture, with enormous potential effects on financial institutions’ compliance management. Jurisdiction over consumer credit, including credit cards and short-term unsecured loan products, transferred from the OFT to the FCA on April 1, 2014.

It should go without saying that regulators may be just as prone to errors as consumers themselves, and there is a real risk that more and/or unpredictable regulation and enforcement efforts to correct purported behavioral market failures could lead to unfavorable consumer outcomes. But there can be no dispute that many consumer financial products and services viewed unfavorably by regulators — perfectly legal, with terms and features disclosed consistent with relevant law — enjoy enormous popularity in the market. It is difficult to predict how the application of principles will disrupt them where rules cannot, but it appears to be simply a matter of when. It is clear, however, that those still asking where in the laws or regulations they are required to do (or are prevented from doing) something may find themselves blindsided by regulatory action.

—By Manley Williams, Valerie L. Hletko and Leslie L. Meredith, BuckleySandler LLP

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[1] Thaler, R.H., and Sunstein, C.R. (2008). Nudge. New Haven: Yale University Press.

[2] Cass R. Sunstein, Empirically Informed Regulation, 78 U. Chi. L. Rev. 1349 (2011).

[3] "Human Face of Regulation," a speech by Martin Wheatley at the London School of Economics, October 4, 2013, available at http://www.fca.org.uk/news/speeches/human-face-of-regulation.

[4] Id.

[5] https://www.federalregister.gov/articles/2014/01/29/2014-01607/academic-research-council-solicitation-of-applications-for-membership

[6] Treating Customers Fairly (TCF) involves six retail consumer protection outcomes as listed in the Financial Conduct Authority's July 2013 report, "The FCA's Approach to Advancing its Objectives," online at http://www.fca.org.uk/static/documents/fca-approach-advancing-objectives.pdf. At the heart of the TCF initiative is "getting a fair deal for consumers."

[7] "Human Face of Regulation," a speech by Martin Wheatley at the London School of Economics, October 4, 2013, available at http://www.fca.org.uk/news/speeches/human-face-of-regulation.

[8] Cass R. Sunstein, Empirically Informed Regulation, 78 U. Chi. L. Rev. 1349 (2011).

[9] Id.