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Financial Services and Consumer Loan ABS – US

CFPB Push to Widen Access to Class-Action Suits Creates Risks

Summary

On 5 May, the Consumer Financial Protection Bureau (CFPB) released a proposal[1] to end the use of clauses in US financial-product contracts that prevent consumers from taking part in class-action lawsuits, a rule that would create new risks for financial services companies and US asset-backed securities (ABS) tied to consumer loans.

» The fact that the proposed rule would not affect contracts outstanding before it is finalized would lessen its effects initially, as well as over the longer term for contracts on products that typically have long lives such as credit cards.

» Nevertheless, if adopted, the rule would expand legal risks for banks and other financial companies, and could adversely affect some securitizations. Some of the negative effects, however, would be offset if the rule leads to improved borrower credit quality by ending practices that weaken consumers' finances.

Proposed regulation would create risks for financial services companies and securitizations, but immediate impact is likely limited

The proposed regulation that the CFPB released last week to prohibit clauses in US financial contracts that prevent consumers from taking part in class-action lawsuits would create new risks for financial services companies and some securitizations tied to consumer loans. (For our earlier discussion of these issues, see "CFPB Effort to Remove Hurdle to Class-Action Lawsuits Would Create Risks for Consumer Lenders and Related ABS," 3 November 2015.)

However, because only contracts entered into after the rule's compliance date would be subject to the regulation, the rule – if adopted in its current form – would likely have no immediate material effect on potentially affected parties such as US banks, finance companies and securitizations. The CFPB will accept comments on the proposed rule for 90 days after its publication in the Federal Register. Under the proposal, the regulation would cover only contracts entered into beginning 211 days after the publication of a final rule.

The grandfathering of existing contracts would be particularly meaningful for products such as credit cards and bank accounts that customers typically use over long periods. The CFPB's proposal states explicitly that amendments or modifications to pre-existing contracts would not require the provider to insert language into the agreements allowing consumers to pursue class-action lawsuits.[2] However, the agency sought comment on whether that approach was too narrow, so it could change in a final rule.

Banks and finance companies face higher litigation risk and potential reputation damage over time

Over time, the rule would expose banks and finance companies to an increasing risk of litigation and settlements with customers, as well as potential reputational damage. The impact would depend on the size and success rate of class-action lawsuits. Nevertheless, the rule would also expand future legal risks for banks when bank profitability is constrained and their regulatory and litigation risks continue to be elevated. US-based global investment banks set aside $139 billion in litigation provisions between 2008 and 2014 and continue to face outstanding legal actions related to US mortgages and other matters.[3]

In turn, if companies negatively affected by lawsuits play key roles in securitizations, a weakening of their financial position could also weaken the credit quality of the transactions in certain cases, especially if the companies already have weak credit profiles. Lawsuits could also have other negative credit effects on securitizations. Such effects could occur, for example, if legal and/or regulatory settlements require that loan servicers alter their collection practices;[4] if representations and warranties by securitization sponsors fail to cover challenged payment terms or practices; or if sponsors are unable to honor obligations to repurchase impaired loans.

However, providing consumers with greater legal recourse would carry some offsetting positive effects on the credit quality of securitizations to the degree that it strengthens borrowers' finances. Settlements or court rulings that require consumer-friendly adjustments to lender or servicer practices can be more important in this regard than the often small monetary awards that individual consumers win through class-action litigation.

Overview of the CFPB Proposal

The CFPB's 5 May proposal to bar clauses in US financial contracts that prevent consumers from taking part in class-action lawsuits follows the agency's completion of a three-year study required under the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 on the use of arbitration agreements. In October, the CFPB signaled publicly it would seek to create such regulation.

Although earlier regulation mandated by Dodd–Frank banned any type of mandatory arbitration clauses in the US residential mortgage market, such clauses remain very common in credit cards, auto loans, private student loans and bank accounts. These arbitration clauses, which the CFPB says affect hundreds of millions of consumer contracts, often include the language that prevents customers from participating in class actions that the CFPB is now seeking to prohibit.

Under the CFPB proposal, the agency could also collect information on arbitration proceedings on an ongoing basis. On top of the information that the CFPB said in October that it would seek, the new proposal would also allow it to gather correspondence from arbitration administrators regarding the non-payment of arbitration fees or failure to adhere to an arbitration forum's standards of conduct.

The CFPB proposal could affect a large array of contracts, which is underscored by the strong objections to the proposal by the US Chamber of Congress and other groups. The earlier CFPB study also suggests that the proposal's scope could be broad. The study found that arbitration clauses are in 53 percent of credit card loans outstanding; 92 percent of examined prepaid cards; 86 percent of a sample of private student loan contracts; and 99 percent of the storefront payday loan market.[5]

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Endnotes

1 See CFPB press release and proposal.

2 The CFPB also explicitly said in its commentary on the proposal that new charges on a credit card would not be considered to trigger the need to insert language in account agreements allowing for participation in class-action cases.

3 See "Global Investment Banks: Litigation Charges Put Shock Absorbers to the Test and Pose Franchise Risk," 17 November 2015.

4 For one example of a settlement weakening performance, see discussion of changes to Consumer Portfolio Services servicing practices in "Amid a Weakening Trend, Subprime Auto ABS Performance Varies by Lender," 6 April 2016.

5 See page 8 of outline of planned proposal.

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