FEDERAL RESERVE BANK OF DALLAS

Station K, Dallas, Texas 75222

Circular No. 84-125
December 28, 1984

TO:	All member banks and others concerned in the Eleventh Federal Reserve District
ATTENTION:	Chief Executive Officer
SUBJECT:	**Proposal to amend Regulation AA -- Unfair or Deceptive Credit Practices**
SUMMARY:	The Board of Governors of the Federal Reserve System has requested comments on a proposal to amend its Regulation AA to conform the regulation to the rules adopted by the Federal Trade Commission (FTC). The FTC now prohibits certain debt collection practices, contract obligations and misrepresentations of cosigners liabilities. The FTC's rules do not apply to commercial banks. However, the Federal Trade Commission Act requires that the Board adopt a similar regulation applicable to banks, unless the Board feels the rules adopted by the FTC prohibit acceptable banking practices. Interested parties are invited to submit comments on the proposed amendments and whether the FTC's rules should be applicable to banks. Comments, which must be received by January 28, 1985, should be directed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C., 20551. References should be made to Docket No. R-0006.
ATTACHMENTS:	Board's press release and material as published in the Federal Register
MORE INFORMATION:	Legal Department, Extension 6171
ADDITIONAL COPIES:	Public Affairs Department, Extension 6289

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FEDERAL RESERVE press release

For immediate release November 26, 1984

The Federal Reserve Board today requested comment on a proposal to amend the Board's Regulation AA -- Unfair or Deceptive Credit Practices -- to apply to banks rules substantially similar to those recently adopted by the Federal Trade Commission prohibiting certain debt collection practices in consumer credit obligations.

The Board requested comment by January 28, 1985.

The rules adopted by the FTC prohibit creditors from using certain practices:

1. A creditor may not enter into a credit contract with a consumer, directly or indirectly, that contains any of the **following**:

   --A "confession of judgment" clause, by which the consumer agrees in advance to permit the creditor to obtain a judgment in event of default without giving the debtor prior notice or an opportunity to be heard in court.

   --A "waiver of exemption" by which the consumer waives or limits state law exemptions sheltering the consumer's home or other necessities from attachment.

   --A provision by which the debtor assigns future wages to the creditor in the event of default.

   --A provision permitting creditors to repossess any of the consumer's household goods beyond those for which the creditor is extending credit.

2. In addition to the prohibited contract provisions, the FTC rules also forbid "pyramiding" of late charges, by which a charge arising from one late payment is taken out of a subsequent timely payment, and can cause a series of subsequent payments to be incomplete and subject to late charges.

3. Finally, the rules prohibit misrepresentation of a cosigner's liability and require that a creditor give a cosigner a notice informing the cosigner of the nature of the obligation and potential liability.

The FTC's action does not apply to commercial banks (or to savings and loan associations). The Federal Trade Commission Act requires that the Board adopt within 60 days of the effective date of such an FTC ruling (May 4, 1985 in this case) a substantially similar regulation applying to banks, unless the Board finds that the rules adopted by the FTC are not unfair or deceptive as engaged in by banks or that a similar regulation applying to banks would seriously conflict with essential monetary or payments policies of the Federal Reserve.

In issuing the proposal for comment the Board did not take a position on these possible exceptions, and requested comment whether the FTC's prohibitions should be applied to banks.

The Board's notice is attached.

Attachment

FEDERAL RESERVE SYSTEM

12 CFR Part 227

[Reg. AA; Doc. No. R-0006]

Unfair or Deceptive Acts or Practices; Credit Practices

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board is publishing for comment a proposed amendment to Regulation AA (Unfair or Deceptive Acts or Practices). The proposal would implement, as to banks, the credit practices rule adopted by the Federal Trade Commission. The Federal Trade Commission Act requires the Board to adopt a rule, subject to certain exceptions, that is substantially similar to the Commission's rule. This rule would prohibit banks from taking, directly or indirectly, any consumer credit contract that contains a prohibited provision, from pyramiding late charges, or from obligating a cosigner without the required notice.

DATE: Comments must be received on or before January 28, 1985.

ADDRESS: Comments should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to Room B-2223, 20th and C Streets NW., Washington, D.C. between 8:45 a.m. and 5:15 p.m. weekdays. Comments should include a reference to Doc. No. R-0006. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Steven Zeisel or Richard Garabedian, Staff Attorneys, in the Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at (202) 452-3867 or (202) 452-3667. Regarding the initial regulatory flexibility analysis, contact: Robert Kurtz, Economist, Division of Research

and Statistics, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at (202) 452-2915.

SUPPLEMENTARY INFORMATION:

(1) General

The Board is publishing for comment a proposed amendment to Regulation AA (12 CFR Part 227). The proposal would implement, as to banks, the Credit Practices Rule adopted by the Federal Trade Commission (FTC), effective March 4, 1985 (49 FR 7740, March 1, 1984). Under section 18(f)(1) of the Federal Trade Commission Act (15 U.S.C. 57a(f)(1)), the Board must adopt, subject to certain exceptions, regulations substantially similar to those adopted by the FTC under section 18(a)(1)(B) of the Act (15 U.S.C. 57a(a)(1)(B)). The Board must act within 60 days of the effective date of the FTC's rule. This rulemaking scheme was established by section 202(a) of the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 U.S.C. 57a).

The Board is not required to adopt a rule if it finds that such acts or practices of banks are not unfair or deceptive or if adoption of similar regulations would seriously conflict with essential monetary and payment systems policies of the Board. This proposal is intended to generate comment on the text of the rule and to give the Board more information on which to base a final determination of whether to adopt a rule or to make any modifications. It is not intended to suggest that the Board has decided to adopt a substantially similar rule.

The rule adopted by the FTC prohibits a creditor from including certain creditor remedies in consumer credit contracts or from purchasing contracts that contain the prohibited clauses. The rule also prohibits an accounting practice regarding late charges, prohibits misrepresentation of cosigner liability, and requires a disclosure to be given to cosigners. The prohibited contractual provisions are the following: (1) A confession of judgment clause; (2) a waiver or limitation of statutory exemption from attachment, execution or other legal process; (3) an assignment of wages; and (4) a non-purchase money security interest in household goods. The prohibited late charge practice prevents the deduction from a timely payment of a late charge applicable to an earlier payment, thus causing the timely payment to be delinquent because of non-payment in full. The cosigner rule prohibits misrepresentation of a cosigner's liability and requires that a notice be given to the cosigner to disclose the nature of the obligation.

The test used by the FTC to find an unfair act or practice requires that the injury that flows from the act or practice must be (1) substantial; (2) not outweighed by any countervailing benefits to consumers or competition that the practice produces; and (3) an injury that consumers themselves could not reasonably have avoided.

(2) Historical Overview

In 1975 the FTC was given explicit authority by the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act to adopt rules that define and prevent unfair acts or practices. On April 11, 1975, the FTC proposed the first Credit Practices Rule (40 FR 16347) that identified certain unfair and deceptive practices of creditors in consumer credit contracts and effectively prohibited such acts or practices. The Board, pursuant to its statutory mandate, published a similar rule for comment on May 5, 1975 (40 FR 19495). No final rule was ever adopted by the Board or the FTC based on the initial proposal. The FTC subsequently held hearings on the proposal and revised the rule in 1980. The rule went through further revisions until adopted by the FTC in February 1984. The final rule and the FTC's statement of basis and purpose and its regulatory analysis may be found at 49 FR 7740 (March 1, 1985). In response to this final action of the FTC, the Board is publishing a similar rule for comment.

(3) Particular Issues for Comment

The Board is required to adopt a substantially similar regulation to address the acts or practices in the FTC's rule unless it finds that (1) such acts or practices of banks are not unfair or deceptive, or (2) adoption of a similar regulation would conflict with essential monetary or payment system policies of the Board. This statutory scheme raises a list of issues on which the Board solicits comment. Since the Board can adopt the rule in part, or modify it to reflect the unique situation of banks, responses should focus separately on each of the provisions of the rule.

(1) To what extent do banks either use such practices in their own contracts or purchase contracts that contain prohibited practices?

(2) What is the burden of reviewing purchased contracts for the removal of provisions permitting such practices?

(3) Are any of the specified acts or practices not unfair as engaged in by banks?

(4) To what extent did modifications in the final rule satisfy concerns of the banking industry expressed in the rulemaking record?

(5) To what extent would the cost or availability of credit be affected by the rule?

(6) What nonregulatory alternatives exist to any rulemaking?

(7) To what extent should a delayed effective date be provided for any or all of the rule that may be adopted?

(8) What is the potential impact of the rule on large and small banks, and those banks located in low- and moderate-income communities?

(9) How frequently do banks take non-purchase money security interets in household goods? In what types of obligations? What percent are "blanket" security interests? To what extent would restrictions on these security interests increase credit costs or reduce credit availability? Is there any unfairness if banks specifically itemize the household goods being taken as security?

(10) What percent of banks "pyramid" late charges? How clearly is this practice disclosed to consumers? What percent of consumers are aware of the amount due (including accumulating late charges) at each payment?

(11) Do banks inform cosigners of their liability before they sign? Do banks always see the cosigner before obtaining the cosigner's signature? How often do banks attempt to collect from cosigners? How often are cosigners obtained in default situations?

The text of the Board's proposal is identical to the FTC's rule except for editorial and organizational changes designed to adapt the rule to the format and style of the Board's regulations. In particular, the proposal clarifies that the rule does not apply to transactions for the purchase of real property. None of these changes is intended to be substantive. If the Board finally adopts the rule, some additional editorial changes may become necessary to interweave the rule with the current provisions of Regulation AA.

(4) Initial Regulatory Flexibility Analysis

A. Statement of Purpose

The FTC Act provides in section 18(f) that whenever the FTC prescribes a rule prohibiting unfair practices, the Board shall promulgate substantially similar regulations prohibiting similar practices by banks, unless the Board finds that such practices of banks are not unfair or that implementation of similar regulations with respect to banks would seriously conflict with essential monetary and payments systems policies of the Board.

This initial economic impact statement is based primarily on an examination of information in the FTC rulemaking record, which consists of quantitative studies, consumer and creditor surveys, expert testimony, and anecdotes of specific consumer injuries and creditor experience. Banks participated fully in the FTC proceeding, even though they are not under FTC jurisdiction, in anticipation of Board consideration of their coverage under section 18(f). The record is examined for differences between banks and institutions under FTC jurisdiction in their use of creditor remedies and potential injury to their customers; differences which might affect a determination of unfairness. The rulemaking record was compiled over a period of approximately 10 years. The last opportunity for the public to present its views was in June 1983, when the FTC invited prior rulemaking participants to make oral presentations. Among the participants were the Consumer Bankers Association, American Bankers Association, California Bankers Association, Independent Bankers Association, the Consumer Federation of America, and the Federal Reserve Board.

B. Background

In 1972, the National Commission on Consumer Finance (NCCF) reported the results of its examination of the consumer credit market, including an analysis of creditor remedies. In response to NCCF findings the FTC Bureau of Consumer Protection (BCP) conducted an investigation to determine whether the use of certain collection remedies was an unfair practice under § 5 of the FTC Act. Based on the BCP staff report, the FTC initiated in April 1975 a proceeding for the promulgation of a trade regulation rule designed to abolish or limit the use of 11 credit practices. In March 1984, the FTC determined that the use of six credit practices was unfair.

C. Economic Implications

1. *Theory.* Economic analysis of the loan offer function suggests that legal restrictions on creditor remedies would tend to increase loan rates. Restrictions on creditor remedies would increase creditors' per-unit cost of supplying credit in either of two ways. First, remedy restrictions may increase the risk of delinquency and default on the loan by reducing the borrower's incentive to repay. Second, creditors may respond to the increased default risk by incurring additional costs for screening applicants, monitoring and collecting loans, and for administrative activities. Consequently, creditors would offer a given quantity of credit only at a higher price, i.e., the loan supply curve would shift upward. At the same time, restrictions on creditor remedies reduce the cost of default to the consumer. Thus, consumers may be willing to pay a higher price for a given quantity of credit, i.e., the demand curve would shift upward. (It is possible that the loan could be less attractive, if elimination of a remedy raises the probability of invoking a more onerous remedy.)

Market forces discourage creditor remedy clauses in contracts when the price consumers are willing to pay creditors to restrict creditor remedies cover the cost to creditors from foregoing the remedies. However, there may be information problems that may lead to market failures in the case of creditor remedies. These problems are consumers' imperfect knowledge of the effects of creditor remedies and asymmetric information on default probabilities.

Consumers who do not comprehend the implications of the creditor remedies in contracts they sign, might accept unknowingly creditor remedies that they would have been willing to pay to avoid. Therefore, government restrictions on creditor remedies could result in contracts that these consumers would have selected if they had been better informed. Thus, consumers who do not understand the consequences of creditor remedies may benefit from the rule.

Consumers and creditors might not have the same information on which to evaluate deficiency and default probabilities. This asymmetric information could cause an adverse selection problem. That is, within any group of consumers that creditors judge to be equally creditworthy, there might be some misclassified individual consumers who are less creditworthy than the others. Therefore, if a creditor offers a particular group contracts containing creditor remedies less onerous than those in the contracts of competitors, the creditor is more likely than its competitors to attract the misclassified higher risk consumers who are aware of the true deficiency and default probabilities. Adverse selection would discourage creditors who are willing to eliminate particular creditor remedies from doing so.

Benefit from restrictions on creditors remedies may not be shared equally by all groups of consumers. While some individual consumers benefit, others may be harmed, e.g., credit may become unavailable to consumers who had been marginally creditworthy before restrictions were imposed.

2. *Evaluation of the FTC Rulemaking Record.* The FTC rulemaking record is a compilation of empirical evidence on the possibility that market failures occur and on the benefits and costs of restrictions on creditor remedies. It is an extensive record consisting of econometric studies measuring the impact on credit prices and availability of restrictions on creditor remedies; surveys of creditors about the prevalence and use of various creditor remedy clauses in contracts; surveys of legal aid attorneys and consumers about their experience with and attitudes toward creditor remedies; and several hundred opinions on the potential economic effects of the provisions. The considerable effort by proponents and opponents of the rule in the rulemaking procedure has not resulted in precise measurement of potential net benefits, even though the results of their effort are, perhaps, the most that can be expected. The lack of precision is due to significant methodological and data problems in the econometric studies caused by the complexity of the issue, low survey response rates, and the subjective nature of many of the potential benefits to consumers. However, some general observations are possible.

The econometric evidence in the record suggests that the overall impact on credit cost and availability from restrictions on creditor remedies may be relatively small. The major econometric study, prepared for the FTC by the Bureau of Social Science Research, concluded that the rule would increase credit costs by 19/100 of one percent. However, both proponents and opponents of the rule recognized that the shortcomings of the econometric studies were too great for decisionmakers to rely on the results for more than gross estimates of the rule's effects. The record becomes much less persuasive when it is necessary to discount econometric evidence, which tries to minimize the effect of opinion and subjective perceptions on the decisionmaking process.

Small impacts of the rule on all consumers as a group do not mean that certain subgroups of consumers would not be affected significantly. Public comments and survey opinions of legal aid attorneys suggest that the probability of injury from the subject credit remedies may be greatest for lower income, less educated consumers. These consumers may be less likely to comprehend the implications of the various contracts clauses or to

understand their rights to legal protection when they become deficient or default on a loan. On the other hand, these consumers may be adversely affected by reductions in credit availability as a result of the rule, because they have few, if any, assets to offer as collateral besides their household goods and future wages; both types of collateral are restricted to some extent by the rule.

In its determination of unfairness, the FTC considered the potential benefits to consumers from eliminating pychological injuries, such as embarrassment, humiliation and anxiety caused by the creditor remedies and practices addressed in the rule. Attempts to value these subjective benefits by estimating consumers' willingness to pay to avoid certain creditor remedies were unsuccessful. Other subjective benefits considered by the FTC include procedural due process protections, the opportunity to assert valid claims and defenses, less interference in employment relations, retaining personal possessions and household goods, and protection against coerced settlements.

There are some statistics in the record and testimony by both opponents and proponents of the rule to indicate that banks use the subject remedies less than finance companies. Consequently, the probability of injury is lower for bank customers than for others. Even though the probability of injury may be lower for bank customers, it does not follow automatically that bank customers would benefit less from the rule. It is conceivable that bank customers fear injury from particular remedies more than customers of other institutions and, therefore, more highly value the benefits of restrictions on creditor remedies.

D. Provisions of the Rule

The provisions of the rule include a disclosure requirement, and prohibit an accounting practice and four contract clauses.

1. Consigners. This provision requires that, before the contract is signed, creditors provide cosigners with a disclosure document explaining cosigners' obligations. There are few jurisdictions with statutes requiring creditors to make such disclosures. Legal aid attorneys asserted in a National Consumer Law Center survey that 80 percent of cosigners who use legal aid service do not understand the nature and extent of their obligation; some cosigners believed they were merely acting as a reference for the principal debtor. Relatively few of the legal service clients obtain bank credit.

Testimony in the record based on creditor experience suggests that the cost of providing cosigners with the required disclosures would not be great. Most creditor concerns about cost focused on cosigner provisions proposed but not adopted into the final rule. The concept of informing cosigners of their obligations was not a major concern, because disclosure does not cause serious inconvenience to creditors in making cosigner loans nor significantly affect credit availability to inexperienced borrowers, who must depend on cosigners.

2. *Late Charges.* This provision prohibits a bank "pyramiding" late charges, i.e., assessing multiple late charges based on a single late payment that is subsequently paid in full on or before the next timely payment. The late change subtracted from the next timely payment causes that payment to be short, hence delinquent. The process continues with each subsequent payment. The cumulative impact of repetitive late charges can be substantial.

The extent of pyramiding cannot be ascertained from the current record. Pyramiding is prohibited in the states that have adopted the Uniform Consumer Credit Code. The problem is most serious in situations where the debtor becomes aware of pyramiding late charges only when the final payment is made. For example, some consumers are given a book of coupons at the time credit is extended rather than a periodic statement. Bank customers usually are given periodic statements indicating the amount of late charges as they accrue. No banks who participated in the FTC proceedings defended the use of pyramiding late charges.

3. *Confessions of Judgment (Cognovits).* A confession of judgment is a legal device whereby a debtor agrees in the loan contract to a judgment against himself in the event of default. The debtor waives the right to notice and the opportunity to be heard in court before judgment is entered. Such a waiver is constitutional, if the waiver is made voluntarily, knowingly, and intelligently. Therefore, the benefit of the provisions accrues to those consumers who waive their rights to due process out of ignorance or inability to effectively shop for credit on the basis of contract clauses. The record contains statements by legal aid groups that lower income consumers, especially, are unaware of the legal implications of the cognovit clause, partly because it conflicts with the common understanding of basic due process rights.

Few creditors and consumers would be affected by the provision, because most states restrict the use of confessions of judgment. The use of this creditor remedy is limited almost entirely to Ohio, Illinois, Pennsylvania, and Louisiana. The record does not provide a precise measurement of the extent cognovit clauses appear in contracts. The Consumer Bankers Association (CBA) surveyed its membership and found that 20 percent of the respondents included cognovit clauses in a majority of their contracts, where permitted by law. An NCLC survey of legal aid attorneys indicated that cognovit clauses were used, where permitted by law, in 16 percent of bank contracts, 21 percent of finance company contract, and 300 percent of contracts over all. Cognovits may reduce costs somewhat because it is more costly for the creditor to file suit in the event of default, than to file a confession of judgment.

4. *Wage Assignments.* A wage assignment is a contractual transfer by a debtor to a creditor of the right to receive wages directly from the debtor's employer. A wage assignment clause can be invoked in the event of default and the creditor is not required to obtain a prior court judgment, as is the case with wage garnishment. Most states prohibit or restrict the use of wage assignments in order to provide consumers some protection. However, the protections often fall short of providing the consumer with a hearing and an opportunity to assert defenses or counterclaims.

Small loan and finance companies are the primary users of wage assignments. The NCCF reported that wage assignments were included in 13 percent of personal loan contracts of finance companies and 3 to 4 percent of bank contracts.

Garnishment is a more costly substitute for wage assignments because of court cost. The increased cost could make the smallest loans to marginal consumers unprofitable. However, bank associations stated in the record that they do not anticipate significant impact from a prohibition on wage assignments.

5. *Security Interests in Household Goods.* This provision prohibits the use of nonpossessory security interests in household goods, other than a purchase money security interest. Consumers are not prevented from borrowing on the equity in their homes or pledging stocks, bonds, liquid financial assets, or certain other valuable assets excluded from the definition of household goods, if the

assets are specifically encumbered in the contract. The prohibition is to protect debtors from the threat of losing or the actual loss of property deemed essential for a minimum standard of living. Nearly all concern expressed in the record by proponents of the rule focused on blanket liens on household goods. Repossessions seldom occur. Legal aid attorneys have asserted that their clientele have been injured by "psychological harassment" in the form of threats to repossess household goods. The anecdotal information includes cases in which consumers have agreed to economic arrangements, such as debt refinancing, only out of fear of losing all their household goods.

Most states have enacted statutes restricting installment sellers to a lien on the goods sold, but few states have similar restrictions on consumer loan transactions. There appears to be widespread use of non-purchase money household goods as collateral by finance companies, especially small loan companies, which are licensed to lend no more than a few hundred dollars. A National Consumer Finance Association survey of some 10,000 consumer accounts held by finance companies showed that household goods were taken as collateral in over 60 percent of personal loans. Although there are no statistics in the record, there is agreement between proponents and opponents of the rule that banks use this creditor remedy to a much lesser extent than finance companies. Moreover, unlike finance companies, banks seldom engage in the practice of taking blanket security interests in household goods, according to testimony from the American Bankers Association (ABA).

Creditors confirmed in the record that household goods usually have little resale value. Therefore, taking a security interest in household goods is unlikely to reduce creditors' losses in the event of default. However, because of the significant value consumers place on their own household goods, such collateral functions as a deterrent to default and as a signal to creditors of a potential borrower's good faith. Creditors perceive that the potential economic and psychological cost to debtors of losing their houehold goods is an effective deterrent to default. Consequently, it is consumers who have nothing other than household goods to pledge as collateral, who are at risk of losing access to credit from finance companies and banks or paying higher prices for unsecured personal loans.

6. *Waivers of Exemption.* There are statutes in most states that exempt certain real or personal property from judicial seizure in the event of default, in order to allow debtors and their families to retain basic necessities. This provision of the rule would prohibit the use of contract clauses waiving such protective rights, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation.

The prohibition of waiver of exemption clauses is likely to encourage the taking of security interests in property, to the extent permitted by the "household goods" portion of the rule. Creditors can seize secured property without obtaining a judgment; unlike unsecured property. Therefore, to the extent security interests are encouraged, collection costs might be reduced.

Apparently, some creditors find waiver of exemption clauses to be an effective tool in preventing default, if the debtor is unaware of what property is exempt from judgment under state law and incorrectly assumes that basic necessities may be lost. The record shows that some creditors include waiver of exemption clauses in contracts even when state law makes the clause unenforceable.

E. Potential Impact on Small Banks

The evidence in the record does not indicate that the rule will have a disproportionate effect on smaller banks. In 1977, the ABA surveyed its members in order to establish a profile of consumer credit practices used by banks. The ABA reported the results from over 800 banks in testimony before the FTC. The ABA testified that the survey results were similar for small and large banks, where small banks were defined as those with less than $100 million in deposits. However, the results about small banks were not as reliable statistically, because the response rate was only 18 percent, compared to 48 percent for large banks.

F. Summary and Conclusions

Banks participated fully in the FTC rulemaking proceedings, in anticipation of Board consideration of a similar rule for banks, as required by section 18(f) of the FTC Act. The rulemaking record is extensive. However, the considerable effort by proponents and opponents of the rule has not resulted in precise measurement of potential net benefits. The lack of precision is due to significant methodological and data problems in the econometric studies, low survey response rates, and the subjective nature of many of the potential benefits to consumers.

The rule restricts creditors from taking or receiving from consumers obligations that constitute or contain a confession of judgment or an assignment of wages, primarily in order to assure consumers of legal due process protection of a hearing and an opportunity to assert defenses or counterclaims. In addition, restrictions are imposed on creditors regarding waivers of exemptions and nonpossessory security interests in househould goods other than a purchase money security interest, primarily to protect delinquent debtors from losing or from the threat of losing goods considered to be basic necessities. Finally, the rule prohibits the accounting practice of "pyramiding" late charges and requires creditors to disclose cosigners' rights and obligations.

Most comments in the FTC rulemaking record received from the banking industry addressed provisions which have been eliminated or modified in the final rule. FTC modification of the security interest provision satisfied many of the economic objections expressed by creditors by permitting purchase money security interests and security interests in other than household goods. However, bankers' associations still express concern about this provision. A potential benefit of the provision is the elimination of the "psychological" injury experienced by delinquent debtors who lose or are told by creditors that they might lose household goods considered to be basic necessities. Bankers' associations argue that the FTC exceeded its authority when it considered "psychological" injury in its determination that taking non-purchase money security interests in household goods is an unfair practice. In addition, some bankers are concerned that their lower income consumers with no collateral to pledge other than household goods will be restricted to more expensive, smaller, unsecured personal loans, if they qualify for credit at all. Banks generally do not take non-purchase money security interests in household goods, according to ABA testimony given to the FTC in 1978. Nearly all comments in the record about the potential costs and benefits of restrictions on security interests focused on blanket security interests, where *all* of a debtor's household goods are subject to seizure and the potential impact is greatest. The ABA testified that, unlike finance companies, banks in general seldom take blanket security interests. Evidence in the records not indicate whether there are subcategories of banks, e.g., small or rural banks, which depend on taking blanket security interests to a significant extent.

The record suggests that the probability of injury from creditor remedies and practices addressed by

the rule is lower for bank customers than for customers of finance companies. Finance companies are the most frequent users of the creditor remedies that would be prohibited by the trade regulation rule. In general, banks use the subject remedies less. Furthermore, bank customers may better comprehend contract terms and may be more knowledgeable of legal protections, if we assume that their greater educational attainment, incomes, and assets lead to more financial sophistication.

List of Subjects in 12 CFR Part 227

Banks, Banking, Consumer protection, Credit, Federal Reserve System, Finance.

(5) Text of Proposed Revision

Pursuant to the authority granted in section 18 of the Federal Trade Commission Act (15 U.S.C. 57a), the Board proposes to amend Regulation AA, 12 CFR Part 227, by adding a Subpart A consisting of the current provisions and adding a new Subpart B, as follows:

PART 227—UNFAIR OR DECEPTIVE ACTS OR PRACTICES

Subpart A—Consumer Complaints

* * * * *

Subpart B—Credit Practices Rule

Sec.
227.11 Authority, purpose, and scope.
227.12 Definitions.
227.13 Unfair credit contract provisions.
227.14 Unfair or deceptive practices involving cosigners.
227.15 Unfair late charges.
227.16 State exemptions.

Authority: 15 U.S.C. 57a.

Subpart A—Consumer Complaints

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Subpart B—Credit Practices Rule

§ 227.11 Authority, purpose, and scope.

(a) *Authority.* This subpart is issued by the Board under § 18(f) of the Federal Trade Commission Act, 15 U.S.C. 57a(f) (section 202(a) of the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, Pub. L. 93-637).

(b) *Purpose.* Unfair or deceptive acts or practices in or affecting commerce are unlawful under section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45(a)(1). This subpart is intended to define unfair or deceptive acts or practices of banks in connection with extensions of credit to consumers.

(c) *Scope.* This subpart applies to any bank that is insured or eligible to become insured under the Federal Deposit Insurance Act (12 U.S.C. 1811 *et seq.*). Compliance is to be enforced by:

(1) The Comptroller of the Currency, in the case of national banks and banks operating under the code of laws for the District of Columbia;

(2) The Federal Deposit Insurance Corporation, in the case of state banks that are not members of the Federal Reserve System; and

(3) The Boards, in the case of state banks that are members of the Federal Reserve System.

§ 227.12 Definitions.

For the purposes of this subpart, the following definitions apply:

(a) "Consumer" means a natural person who seeks or acquires goods, services, or money for personal, family, or household use other than for the purchase or real property.

(b) (1) "Cosigner" means a natural person who assumes liability for the obligation of a consumer without receiving goods, services, or money in return for the obligation.

(2) "Cosigner" includes any such person whose signature is requested as a condition to granting credit to a consumer, or as a condition for forbearance on collection of a consumer's obligation that is in default. The term does not include a spouse whose signature is required on a credit obligation to perfect a security interest pursuant to state law.

(3) A person who meets the definition in this paragraph is a "cosigner" whether or not the person is designated as such on the credit obligation.

(c) "Earnings" means compensation paid or payable to an individual or for the individual's account for personal services rendered or to be rendered by the individual, whether denominated as wages, salary, commission, bonus, or otherwise, including periodic payments pursuant to a pensions, retirement, or disability program.

(d) "Household goods" means clothing, furniture, appliances, linens, china, crockery, kitchenware, and personal effects of the consumer and the consumer's dependents. The term "household goods" does not include:

(1) Works of art;

(2) Electronic entertainment equipment (other than one television and one radio);

(3) Items acquired as antiques, that is items over one hundred years of age, including such items that have been repaired or renovated without changing their original form or character; and

(4) Jewelry (other than wedding rings).

(e) "Obligation" means an agreement between a consumer and creditor.

(f) "Person" means an individual, corporation, or other business organization.

§ 227.13 Unfair credit contract provisions.

In connection with the extension of credit to consumers, it is an unfair act or practice for a bank to enter into or purchase a consumer credit obligation that conbtains any of the following provisions:

(a) *Confession of judgment.* A cognovit or confession of judgment (for purposes other than executory process in the State of Louisiana), warrant or attorney, or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon.

(b) *Waiver of exemption.* An executory waiver or a limitation of exemption from attachment, execution, or other process on real or personal property held, owned by, or due to the consumer, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation.

(c) *Assignment of wages.* An assignment of wages or other earnings unless:

(1) The assignment by its terms is revocable at the will of the debtor;

(2) The assignment is a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction, in which the consumer authorizes a series of wage deductions as a method of making each payment; or

(3) The assignment applies only to wages or other earnings already earned at the time of the assignment.

(d) *Security interest in household goods.* A nonpossessory security interest in household goods other than a purchase money security interest.

§ 227.14 Unfair or deceptive practices involving cosigners.

(a) *Prohibited practices.* In connection with the extension of credit to consumers, it is:

(1) A deceptive act or practice for a bank to misrepresent the nature or extent of cosigner liability to any person; and

(2) An unfair act or practice for a bank to obligate a cosigner unless the cosigner is informed prior to becoming obligated of the nature of the cosigner's liability.

(b) *Disclosure requirement.* (1) To prevent the unfair or deceptive acts or practices defined in this seciton, a disclosure statement shall be given to the cosigner prior to becoming obligated. The disclosure statement shall consist of a separate document that contains the following statement and no other:

Notice to Cosigner

You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.

You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increases this amount.

The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of your credit record.

This notice is not the contract that makes you liable for the debt.

(2) In the case of open-end credit, the disclosure statement shall be given to the cosigner prior to the time that the agreement creating the cosigner's liability for future charges is executed.

(3) A bank that is in compliance with this paragraph may not be held in violation of paragraph (a) of this section.

§ 227.15 Unfair late charges.

(a) In connection with collecting a debt arising out of an extension of credit to a consumer, it is an unfair act or practice for a bank to levy or collect any deliquency charge on a payment, when the only delinquency is attributable to late fees or delinquency charges assessed on earlier installments, and the payment is otherwise a full payment for the applicable period and is paid on its due date or within an applicable grace period.

(b) For the purposes of this section, collecting a debt means any activity, other than the use of judicial process, that is inteded to bring about or does bring about repayment of all or part of money due (or alleged to be due) from a consumer.

§ 227.16 State exemptions.

(a) *General rule.* (1) An appropriate state agency may apply to the Board for a determination that:

(i) There is a state requirement or prohibition in effect that applies to any transaction to which a provision of this subpart applies; and

(ii) The state requirement or prohibition affords a level of protection to consumers that is substantially equivalent to, or greater than, the protection afforded by this subpart.

(2) If the Board makes such a determination, the provision of this subpart will not be in effect in that state to the extent specified by the Board in its determination, for as long as the state administers and enforces the state requirement or prohibition effectively.

(b) *Applications.* The procedures under which a state agency may apply for an exemption under this section are the same as those set forth in Appendix B to Regulation Z (12 CFR Part 226).

By order of the Board of Governors of the Federal Reserve System, November 26, 1984.

William W. Wiles,

Secretary of the Board.

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