



FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT

November 18, 1986

DALLAS, TEXAS 75222

Circular 86-94

TO: The Chief Executive Officer of all
member banks and others concerned in
the Eleventh Federal Reserve District

SUBJECT

**Update of staff guidelines on the Credit Practices Rule --
Regulation AA**

DETAILS

The Board of Governors of the Federal Reserve System has published an update to its guidelines on the Credit Practices Rule, which applies to all banks and their subsidiaries, concerning unfair or deceptive acts or practices in the extending of consumer credit. The updated guidelines became effective November 1, 1986.

The rule applies to all consumer credit obligations except for the purchase of real property. The rule prohibits banks from using certain remedies to enforce consumer credit obligations and from imposing a late charge practice called pyramiding. It provides protections for cosigners in consumer credit transactions.

ATTACHMENTS

The material as published in the Federal Register is attached.

MORE INFORMATION

For further information, please contact Sharon Sweeney of this Bank's Legal Department at (214) 651-6228.

Sincerely yours,

William H. Wallace

12 CFR Part 227

[Reg. AA]

**Unfair or Deceptive Acts or Practices;
Update of Staff Guidelines on the
Credit Practices Rule**

AGENCY: Board of Governors of the
Federal Reserve System.

ACTION: Update of staff guidelines on
the Credit Practices Rule.

SUMMARY: The Board is publishing an update to the staff guidelines on the Credit Practices Rule, Subpart B of Regulation AA (Unfair or Deceptive Acts or Practices). The rule prohibits banks from using certain creditor remedies in connection with a consumer credit obligation, from using a late charge practice commonly referred to as pyramiding, and from obligating a cosigner prior to providing a required notice explaining the cosigner's obligations.

EFFECTIVE DATE: November 1, 1986.

FOR FURTHER INFORMATION CONTACT: Adrienne D. Hurt, Susan J. Kraeger, or Heather Hansche, Staff Attorneys, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, DC 20551 at (202) 452-3867 or (202) 452-2412; or Earnestine Hill or Dorothea Thompson, Telecommunications Device for the Deaf (TDD) at (202) 452-3544.

SUPPLEMENTARY INFORMATION:

(1) Background

On March 1, 1984, the Federal Trade Commission (FTC) adopted its Credit Practices Rule, effective March 1, 1985, pursuant to the authority granted the FTC under Sections 18(a)(1)(B) and

5(a)(1) of the Federal Trade Commission Act (FTC Act), 15 U.S.C. 57a(a)(1)(B) and 15 U.S.C. 45(a)(1). Under this statute the FTC is authorized to promulgate rules that define and prevent "unfair or deceptive acts or practices" in or affecting commerce with respect to extensions of credit to consumers. Section 18(f) of the FTC Act, 15 U.S.C. 57a(f), provides that, whenever the FTC promulgates a rule prohibiting acts or practices which it has deemed to be unfair or deceptive, the Board of Governors of the Federal Reserve System must adopt a substantially similar rule prohibiting such acts or practices by banks. The Board must adopt a rule within 60 days of the effective date of the FTC's rule unless the Board finds that such acts or practices by banks are not unfair or deceptive, or that the adoption of similar regulations for banks would seriously conflict with essential monetary and payments systems policies of the Board.

In April 1985, the Board adopted a rule substantially similar to the FTC's Credit Practices Rule (50 FR 16695), thereby amending the Board's Regulation AA, Unfair or Deceptive Acts or Practices (12 CFR Part 227). The Board modified certain provisions of the FTC's rule in order to take into account the needs and characteristics of the banking industry. The Board's rule went into effect on January 1, 1986.

(2) Summary of the Rule

The Board's rule applies to all consumer credit obligations other than those for the purchase of real property. It prohibits banks from using certain remedies to enforce consumer credit obligations. Under the rule, banks may not include these remedies in their consumer credit obligations, and if banks purchase obligations that contain a prohibited provision(s), banks are prohibited from enforcing the provision(s). The prohibited provisions are: (1) Confessions of judgment; (2) waivers of exemption; (3) wage assignments; and (4) nonpossessory, nonpurchase money security interests in household goods. In addition, the rule prohibits a certain late charge practice, and provides protections for cosigners in consumer credit transactions.

The Board's rule applies to all banks and their subsidiaries. Institutions that are members of the Federal Home Loan Bank System and nonbank subsidiaries of bank holding companies are covered by the rules of the Federal Home Loan Bank Board and the FTC, respectively.

(3) Staff Guidelines

Staff guidelines on the Board's Credit Practices Rule were issued in November

1985 (50 FR 47036). The staff guidelines are in question and answer format. The questions are identified by hyphenated numbers. The first part of the number indicates the regulatory section; the second part, the sequential order of a particular question within that section. For example, 13(d)-1 indicates the first question in § 227.13(d). Headings are included to make it easier for users to locate questions.

The guidelines focus on material of general application that will be useful to most banks, and are expected to be the vehicle for answering questions about the rule. The guidelines will be updated annually, as necessary. This first update addresses new questions that have arisen under the rule and amends certain questions and answers that were issued in November 1985.

(4) Explanation of Revisions to Guidelines

Following is a brief description of the revisions to the staff guidelines on the Board's Credit Practices Rule:

Introduction

The last sentence of the scope and enforcement section has been changed to accurately reflect that the Federal Deposit Insurance Corporation has enforcement responsibility under the Credit Practices Rule for insured state-chartered banks that are not members of the Federal Reserve System.

Section 227.11 Authority, purpose, and scope.

Question 11(c)-2 has been added to this section.

Section 227.12 Definitions.

Questions 12(a)-10, 12(a)-11, 12(b)-1a, and 12(b)-1b have been added to this section.

Section 227.13 Unfair credit contact provisions.

Question 13-4, 13-5, 13(b)-3, 13(c)-5, and 13(d)-10 have been added to this section. Question 13-3 had been revised to address the application of § 227.13 to a renewal (as well as a refinancing) of a credit obligation entered into prior to the effective date of the rule. Language has been added to Q13(d)-5 to explain that with regard to subsequent refinancings of a purchase money loan transaction secured by household goods in which additional funds are obtained, while the rule does not require a bank to release a proportionate amount of the security interest taken in the household goods as the loan amount decreases, certain state laws (for example, in those states that have adopted the Uniform Consumer Credit Code) may impose such a requirement. Editorial changes were

also made to Q13(d)-5 with no change in substance intended.

Section 227.14 Unfair or deceptive practices involving cosigners.

Question 14(b)-13a has been added to this section. A technical amendment was made in Q14-1 to accurately reflect the provision of the rule cited in the first sentence of the answer.

The answer to Q14(b)-13 on continuing guaranties has been revised to make it clear that where a cosigner executes a continuing guaranty, a bank should modify the cosigner notice to accurately reflect the extent of the guarantor's obligation. If, for example, the guaranty applies to all future debts, the first sentence should indicate that the cosigner is being asked to guarantee not only that loan, but also the future debts of the borrower (up to a certain date or amount, as appropriate).

The answer to Q14(b)-14 has been revised to make it clear that if a cosigner is obligated under a consumer credit agreement for refinancings as well as renewals of an obligation, a bank is not required to give a cosigner notice upon each renewal or refinancing (since the cosigner is already obligated), even if the cosigner is required to execute a new note for each renewal or refinancing.

Section 227.15 Unfair late charges.

Question 15-5a has been added to this section. Question 15-2 has been revised to address partial payments as well as skipped payments; skipped payments and partial payments are treated the same way under § 227.15.

List of Subjects in 12 CFR Part 227

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

(5) Text of revisions

The revisions to the staff guidelines on the Credit Practices Rule read as follows:

Introduction

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3. *Scope; enforcement.* The Board's rule applies to all banks and their subsidiaries. Institutions that are members of the Federal Home Loan Bank System and nonbank subsidiaries of bank holding companies are covered by the rules of the Federal Home Loan Bank Board and the FTC, respectively.

The Board has enforcement responsibility for state-chartered banks that are members of the Federal Reserve System. The Office of the Comptroller of the Currency has enforcement

responsibility for national banks. The Federal Deposit Insurance Corporation has enforcement responsibility for insured state-chartered banks that are not members of the Federal Reserve System.

Section 227.11 Authority, Purpose, and Scope.

Q11(c)-2: Industrial loan companies. Are industrial loan companies subject to the Board's rule?

A: Industrial loan companies that are insured by the Federal Deposit Insurance Corporation are covered by the Board's rule.

Section 227.12 Definitions.

12(a) "Consumer"

Q12(a)-10: Lease transactions. Are consumer lease transactions covered by the rule?

A: The rule covers only consumer credit obligations. A lease transaction would be covered by the rule only if the transaction is a credit sale as defined in Regulation Z.

Q12(a)-11: Trusts. Are extensions of credit made to a consumer through a trust covered by the rule?

A: Yes, such extensions of credit are covered by the rule, unless the credit is being extended through a nonprofit trust (as the rule does not apply to nonprofit organizations).

12(b) "Cosigner"

Q12(b)-1a: Business entities as cosigners. If a partnership or a corporation cosigns a consumer credit obligation, is such an entity a cosigner for purposes of the rule? Must the bank provide a cosigner notice?

A: No, the rule applies only to natural persons who are cosigners. Consequently, the rule does not require a bank to provide a cosigner notice when a partnership, corporation, or other business entity serves as a cosigner on a consumer credit obligation.

Q12(b)-1b: Dealer guarantee. Where a bank and an automobile dealer, for example, enter into an agreement whereby the bank purchases a consumer credit obligation from the dealer and the dealer guarantees the obligation, must the bank provide a cosigner notice to the dealer?

A: No, the rule is not intended to apply in such recourse agreement situations where the bank is purchasing dealer paper.

Section 227.13 Unfair Credit Contract Provisions.

Q13-3: Refinancings and renewals—original credit obligation entered into prior to effective date of rule. Assume that a bank entered into a credit obligation prior to the effective date of the rule and that the credit obligation contained a provision ultimately prohibited by the rule. Assume further that the credit obligation is refinanced after the effective date of the rule. May the refinanced obligation contain the prohibited provision, or is the refinancing subject to the rule? Does the same hold true or renewals of the original credit obligation?

A: There is no distinction in the treatment of renewals and refinancings for purposes of the rule. A refinancing or renewal entered into after the effective date of the rule is subject to the rule and, therefore, may not contain a contract provision prohibited by the rule.

Q13-4: Open-end account—future advances made under the plan. If a bank entered into an open-end credit obligation with a consumer prior to the effective date of the rule and that agreement contained contract provisions ultimately prohibited by the rule, may the bank enforce those contract provisions as to future advances made under the plan after January 1, 1986?

A: Yes, contract provisions ultimately prohibited by the rule can be enforced in such a situation since the advances are being made as part of an open-end agreement that was entered into before the effective date of the rule, and the rule is not intended to have retroactive effect. (See, however, Q15-8.)

Q13-5: Prohibited provisions in cosigner agreement. May a bank include any of the provisions prohibited by the rule in the documents obligating a cosigner on a consumer credit obligation (for example, in a guaranty agreement)?

A: A bank may not include any of the prohibited provisions in the documents obligating a cosigner. The agreement between the bank and the cosigner, even if executed separately, is part of the consumer credit obligation and is therefore subject to the rule's prohibitions.

13(a) Confession of Judgment

13(b) Waiver of Exemption

Q13(b)-3: Language of contract provision limiting applicability of waiver. If a bank's consumer credit contracts contain a clause that states "I

waive my state property exemption to the extent the law allows," would such a clause be permitted under the rule?

A: No, in spite of the limiting language "to the extent the law allows," the clause is an overly broad waiver and, therefore, would be prohibited by the rule. A clause in a consumer credit contract providing that the consumer waives an exemption "as to property that secures this loan," for example, would be a permissible waiver of exemption provision under the rule.

13(c) Assignment of Wages

Q13(c)-5: Offer of a commission as security. Is the rule's prohibition against a bank's taking an assignment of a consumer's future wages violated if a bank takes as security for a loan a consumer's commission (for example, a real estate agent's commission) that has been earned but not yet received by the consumer?

A: No, this would not be a prohibited wage assignment since the consumer's commission has already been earned at the time of the assignment; the fact that it has not yet been received by the consumer does not affect its treatment under the rule.

13(d) Security Interest in Household Goods

Q13(d)-5: Refinancings—releasing a portion of security interest. When a bank has entered into a purchase money loan transaction secured by household goods and then advances additional funds to the consumer in subsequent refinancings of that transaction, is the bank required to release a proportionate amount of the security interest in the household goods, as the original loan amount decreases?

A: The rule does not require a proportionate reduction of the security interest as the original loan amount decreases; such may be required, however, under state law.

Q13(d)-10: Security interest in substituted household goods. Does a bank violate the rule by retaining a security interest in household goods that have been substituted by the consumer for household goods in which the bank originally had a permissible purchase money security interest?

A: A security interest in substituted household goods would violate the rule's prohibition on taking a nonpurchase money security interest in household goods unless the goods were substituted pursuant to a warranty; as such, the

goods would be considered part of the original money transaction for purposes of the rule.

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Section 227.14 Unfair or Deceptive Practices Involving Cosigners.

The reference to section 226.16 in the answer to Q14-1 should be changed to section 227.16.

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14(b) Disclosure Requirement

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Q14(b)-13: Continuing guaranties. When must a bank give the cosigner notice to a guarantor who has executed a guaranty for not only the original loan, but also for future loans of the primary debtor? Must a cosigner notice be given to the guarantor with each subsequent loan to the primary debtor?

A: The cosigner notice should be provided before the guarantor becomes obligated on the guaranty—that is, at the time the guaranty is executed. The cosigner notice need not be given to the guarantor with each subsequent loan made to the primary debtor, since the cosigner is already obligated under the original contract to guarantee future indebtedness. However, since the guarantor is being asked to guarantee not only the original debt, but also the future debts of the primary obligor, the cosigner notice should be modified to accurately reflect the extent of the guaranty obligation. For example, the first sentence of the cosigner notice could read "You are being asked to guarantee this debt, as well as all future debts of the borrower entered into with this bank through December 31, 1987."

Q14(b)-13a: Continuing guaranties—open-end plan. If a cosigner executes a guaranty on an open-end credit plan (that is, one guaranteeing all advances made under the plan), does the bank have to modify the cosigner notice to indicate that all advances made under the plan are being guaranteed?

A: No, the bank is not required to modify the cosigner notice since the future advances are all being made as part of the same open-end credit plan.

Q14(b)-14: Renewal or refinancing of credit obligation. What happens when a credit obligation involving a cosigner is renewed or refinanced? Must a bank give the cosigner another notice at the time of the renewal or refinancing?

A: If under the terms of the original credit agreement the cosigner is obligated for renewals or refinancings of the credit obligation, a bank would not be required to give another cosigner notice at the time of each renewal or refinancing.

Section 227.15 Unfair Late Charges.

* * *

Q15-2: Skipped and partial payments. What happens if a consumer misses or partially pays a monthly payment and fails to make up that payment month after month? May the bank assess a delinquency charge for each month that passes in which the consumer fails to make the missed or "skipped" payment or to pay the outstanding balance of the partial payment?

A: Yes, the rule does not prohibit the bank from assessing a delinquency charge for each month that the skipped or partial payment remains outstanding.

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Q15-5a: Allocation of excessive payment. Assume that beginning in January a consumer's payment on an installment loan is \$40 a month. The consumer pays only \$35 of a \$40 January payment and a late charge of \$5 is imposed on the account. If the following month's payment is for \$45, may the creditor use the extra \$5 to pay off the late charge and impose another late charge since the previous month's payment is still deficient \$5?

A: If a consumer's payment could bring the account current except for an outstanding late charge, no additional late charge may be imposed.

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Board of Governors of the Federal Reserve System, October 24, 1986.

William W. Wiles,
Secretary of the Board.

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