FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
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DALLAS, TEXAS 75222

October 21, 1988

Circular 88-72

**TO:** The Chief Executive Officer of all member banks, bank holding companies and others concerned in the Eleventh Federal Reserve District

## SUBJECT

**Slip sheet with amendments to the Staff Guidelines on Regulation AA, Subpart B -- The Credit Practices Rule**

## DETAILS

The Board of Governors of the Federal Reserve System has published amendments in slip-sheet form to Regulation AA, Subpart B, effective August 1, 1988. The new slip sheet should be inserted in Volume 2 of your Regulations Binders.

## ENCLOSURES

The slip sheet is enclosed.

## MORE INFORMATION

For more information, please contact Dean A. Pankonien at (214) 651-6228.

Sincerely yours,

William H. Wallace

Board of Governors of the Federal Reserve System

# Amendments to the Staff Guidelines on Regulation AA, Subpart B, The Credit Practices Rule*

*Effective November 1, 1986, the following questions and answers have been added or amended:*

## INTRODUCTION

3. *Scope; enforcement.* * * * 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

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).

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 for renewals of the original credit obligation?

* The complete guidelines, as amended effective August 1, 1988, consist of—
- the pamphlet dated January 1986 (see inside cover) and
- this slip sheet.

A: 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.

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.

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.

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, by 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 non-purchase-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 purchase-money transaction for purposes of the rule.

## 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.*

Q14(b)–13: *Continuing guaranties.* When must a bank give the cosigner notice to a guarantor who has executed a guaranty not only for 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 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 or the partial payment?

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

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.

*Effective August 1, 1988, the following questions and answers have been added:*

## SECTION 227.13—Unfair Credit Contract Provisions

Q13(a)–2: *Language limiting confession-of-judgment provision.* If a bank uses multipurpose credit contracts, may the bank include a confession-of-judgment clause with qualifying language indicating that the clause is not applicable in a consumer-purpose loan—such as, "You confess judgment to the extent the law allows," or "This clause applies only in business-purpose loans"?

A: No. Given the public-policy purpose of the rule, a bank may not have a confession-of-judgment clause in a consumer credit contract, even with limiting language. Therefore, when a multipurpose form is used for a consumer-purpose loan, the bank must cross out, blacken in, or otherwise indicate clearly the removal of the prohibited clause from the loan document.

Q13(d)–3a: *Refinancing (new creditor)—original loan purchase money.* On the same facts as those detailed in Q13(d)–3, assume that the consumer refinances the loan with a different bank. May that bank acquire the security interest of the purchase-money lender in household goods without violating the rule?

A: Yes, the bank may acquire the security interest of the purchase-money lender without violating the rule.

## SECTION 227.16—State Exemptions

Q16(b)–3. *Exemptions granted.* What states have been granted an exemption from the Board's rule?

A: The state of Wisconsin was granted an exemption from all provisions of the Board's rule effective November 20, 1986, for transactions of $25,000 or less. The state of New York was granted an exemption from the cosigner provisions of the Board's rule effective January 21, 1987, for transactions of $25,000 or less. In both Wisconsin and New York, transactions over $25,000 are subject to the Board's rule, but compliance with state law is deemed compliance with the federal law. The state of California was granted an exemption from the cosigner provisions of the Board's rule effective August 1, 1988. These exemptions do not apply to federally chartered institutions.