

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 7622]
May 2, 1975]

PROPOSED REGULATION REGARDING
UNFAIR OR DECEPTIVE PRACTICES BY BANKS

*To All Banks, and Others Concerned,
in the Second Federal Reserve District:*

Following is the text of a statement issued April 24 by the Board of Governors of the Federal Reserve System:

The Board of Governors of the Federal Reserve System today published for comment a proposed regulation prohibiting the use by banks of certain credit practices the Federal Trade Commission has proposed to declare unfair.

The Board's proposed regulation would apply to banks. It parallels a proposed Unfair Credit Practices Rule applying to nonbanks published for comment by the Federal Trade Commission on April 9. The Board's action is based on recent legislation which requires the Board to adopt, with certain exceptions, Federal Trade Commission regulations respecting unfair or deceptive acts or practices within 60 days of the adoption of such rules by the Commission.

The Board's proposed regulation, like the Commission's, would prohibit the use of specified collection practices and the incorporation in credit contracts of provisions considered by the Commission to be unfair. The proposed regulation would also require that specific disclosures be made to cosigners to inform them of the legal ramifications of agreements they sign.

The Board published the FTC proposals virtually unchanged, except to apply them to banks, so as to elicit bank comment as promptly as possible in view of the limited time allowed by statute for Board action after the FTC adopts final rules. It is hoped that publication of the proposal will focus attention on any operational problems the proposed rules might create for banks.

Comment may be sent to the Federal Reserve Board (with a copy to the Federal Trade Commission) in Washington through June 10, 1975.

Enclosed is a copy of the proposed regulation. Comments thereon should be submitted by June 10, 1975, and may be sent to our Bank Regulations Department.

Additional copies of this circular and the enclosure will be furnished upon request.

ALFRED HAYES,
President.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[12 C.F.R. PART 228]

UNFAIR OR DECEPTIVE ACTS OR PRACTICES

Notice of Proposed Rulemaking

The Federal Reserve Board is considering the issuance of regulations with respect to unfair or deceptive credit practices by banks. These regulations would be issued pursuant to the authority of Section 18(f) of the Federal Trade Commission Act (15 U.S.C. § 41 et seq. as amended by Public Law 93-637). That Act gives the Board authority to develop such regulations on its own initiative or in response to rules promulgated by the Federal Trade Commission. It provides that whenever the Federal Trade Commission prescribes a rule prohibiting unfair or deceptive acts or practices, the Board shall within 60 days thereafter promulgate substantially similar regulations prohibiting substantially similar acts or practices of banks, unless the Board finds either that such acts or practices of banks are not unfair or deceptive or that implementation of similar regulations with respect to banks would seriously conflict with essential monetary and payments systems policies of the Board.

The Federal Trade Commission has proposed a rule prohibiting the use of certain contractual terms frequently included in consumer credit contracts and certain practices often employed by creditors to aid in the collection of unpaid debts. The proposed rule would also require disclosures to cosigners which clearly inform them of the ramifications of the obligations to which they agree.

Failure to conform with the terms of the rule would be considered an unfair or deceptive act or practice prohibited under § 5(a)(1) of the Federal Trade Commission Act (15 U.S.C. §41 et seq.).

In order to assure that potentially affected banks are aware of the proposed rule and to have the benefit of their suggestions on such matters, the Board is publishing for comment a substantially identical rule as well as a substantially identical version of the Commission's Statement of Reason for the Proposed Rule. The only alterations made by the Board to the Commission's proposal are those conforming the sectional designations to 12 C.F.R. part 228 and certain definitional changes, e.g. substituting "banks" for "lenders within the jurisdiction of the Federal Trade Commission."

Accordingly, the Board hereby publishes for comment a proposed rule potentially applicable to banks:

Sec.

228.1 Definitions.

228.2 Unfair credit practices.

AUTHORITY: The provisions of this Part 228 issued under 38 Stat. 717, as amended, 15 U.S.C. § 41, et seq.

§ 228.1 Definitions.

(a) Lender. Any bank within the jurisdiction of the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, or the Comptroller of the Currency.

(b) Retail instalment seller. A person who sells goods or services to consumers on a deferred payment basis or pursuant to a lease-purchase arrangement.

(c) Person. An individual, corporation or other business organization.

(d) Consumer. A natural person who seeks or acquires goods, services or money for personal, family or household use.

(e) Obligation. An agreement between a consumer and a lender or retail instalment seller.

(f) Creditor. A lender as defined in § 228.1(a)

(g) Debt. Money which is due or alleged to be due from one to another.

(h) Co-signer. A natural person who, by agreement and without compensation, renders himself liable for the obligation of a consumer.

(i) Household goods. Clothing, furniture, appliances, linens, china, crockery, kitchenware, and personal effects of the consumer and his dependents.

(j) Personal loan. A loan of money to a consumer as distinguished from a sale of goods or services on a deferred payment basis or pursuant to a lease-purchase arrangement.

(k) Collecting a debt. Any activity other than the use of judicial process which is intended to bring about or does bring about repayment of all or part of a consumer debt, except:

(1) Inquiry to locate a consumer whose whereabouts are genuinely unknown to the creditor; and/or

(2) Inquiry to determine the nature and extent of a consumer's wages or property;

Provided That, in these two instances, no specific mention is made of the alleged indebtedness.

(1) Other definitions. Words defined in the Uniform Commercial Code retain their UCC definitions for the purposes of this part.

§ 228.2 Unfair credit practices.

In connection with the extension of credit to consumers in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is an unfair act or practice within the meaning of Section 5 of that Act for a lender directly or indirectly:

(a) To take or receive from a consumer an obligation which:

(1) Constitutes or contains a cognovit, confession of judgment, warrant of attorney, power of attorney or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon;

(2) Constitutes or contains a waiver or limitation of exemption from attachment, execution or other process on real or personal property held, owned by or due to the consumer;

(3) Constitutes or contains an assignment of wages;

[Alternate subparagraph (3):

(3) Constitutes or contains an assignment of wages unless the amount of the obligation is three hundred dollars (\$300.00) or less and no other security interest is taken with respect to the obligation;]

(4) Constitutes or contains a security interest other than a Purchase Money security interest, EXCEPT, where the proceeds of a

personal loan are NOT to be PRIMARILY applied to the purchase of consumer goods, the lender may take a security interest in OTHER THAN household goods;

(5) Encumbers goods purchased on different dates from a retail instalment seller on a deferred payment basis, unless the contract provides that payments made by the consumer will be credited in full to the earliest purchase to release the goods from encumbrance in the order acquired;

(6) Fails to enumerate and specifically identify each individual item of property encumbered by it;

(7) Fails to provide that if the creditor retakes encumbered property from the consumer, the fair market retail value of the property so taken will be credited toward the balance due under the obligation;

(8) Constitutes or contains a provision requiring the payment of attorney's fees or any other costs incident to the collection of the obligation;

[Alternate subparagraph (8):

(8) Constitutes or contains a provision which:

(1) With respect to a consumer loan in which the finance charge calculated according to the actuarial method is more than 18 percent per year, provides for payment by the consumer of attorney's fees:

(A) if the loan is not pursuant to open-end credit and the amount financed is \$1,000 or less; or

(B) if the loan is pursuant to open-end credit and

the balance of the account at the time of default
is \$1,000 or less;

(ii) With respect to any other consumer credit transaction,
provides for payment by the consumer of attorney's fees unless
(A) such fees do not exceed fifteen percent of the unpaid debt
at the time of default and (B) such fees become due only after
actual referral of the obligation to an attorney who is not a
salaried employee of the creditor;]

(9) Provides for charges for late or extended payments which exceed
the amount derived from application of the annual percentage rate
governing the transaction to the payment or payments late or extended;
or

(10) Fails to provide that the creditor shall not, in the course
of collecting a debt, communicate or threaten to communicate with the
consumer's employer or any agent of the employer or any other person
not liable for the debt other than the spouse or attorney of the
consumer, except as permitted by order of a court.

(b) To obligate a co-signer other than the spouse of the consumer
on any obligation unless:

(1) The co-signer is furnished with a separate statement, at
least three days prior to his becoming obligated, which shall contain
in ten point bold face type the following information with such limita-
tions as necessary to conform to applicable State law and no other:

NOTICE TO CO-SIGNER

(Date)

BY SIGNING THIS CONTRACT YOU ARE AGREEING TO
PAY [Amount of Contract] TO [Name of Lender],
IF [Name of Principal Debtor] DOES NOT.

IF FOR ANY REASON [Name of Principal Debtor]
DOES NOT PAY THIS [Amount of Contract] OR ANY
PART OF IT WHEN IT IS DUE, YOU MAY BE REQUIRED
TO PAY THE AMOUNT WHICH HAS NOT BEEN PAID OR
ANY PART OF IT. HOWEVER, BEFORE YOU CAN BE
HELD LIABLE FOR THE DEBT, [Name of Lender]
MUST FIRST DILIGENTLY ATTEMPT TO COLLECT THE
DEBT FROM [Name of Principal Debtor].

YOU MAY BE SUED ON THIS CONTRACT IF [Name of
Principal Debtor] DOES NOT PAY AS AGREED
FOR ANY REASON. IF [Name of Lender] WINS A
SUIT AGAINST YOU IN COURT, IT MAY TAKE A PART
OF YOUR WAGES EACH WEEK UNTIL THE DEBT IS PAID
IN FULL; IT MAY TAKE YOUR SAVINGS OR REAL OR
PERSONAL PROPERTY WHICH YOU OWN TO PAY THIS
DEBT; AND IT MAY USE OTHER LAWFUL MEANS TO COLLECT
THIS DEBT FROM YOU.

YOU MAY BE SUED EVEN IF [Name of Principal Debtor]
IS NOT SUED IF HE HAS NOT PAID AS AGREED, BUT YOU
MAY SUE HIM TO COLLECT ANY MONEY YOU HAVE PAID ON
HIS BEHALF.

THIS NOTICE IS NOT THE CONTRACT YOU WILL BE
ASKED TO SIGN. YOU MUST BE GIVEN A COPY
OF THAT CONTRACT AND OF THIS NOTICE.

(Signature of Co-signer)

(2) Three days or more after receiving the NOTICE TO CO-SIGNER, the co-signer signs a document evidencing the obligation which discloses the full amount he may be asked to repay;

(3) The co-signer is furnished with a completed copy of every document that he is asked to sign or that is furnished to the consumer; and

(4) Any document evidencing the obligation contains the following notice;

No co-signer or surety of this obligation shall be liable thereunder except after the lender or retail instalment seller has employed due diligence in attempting to collect the obligation from the principal debtor.

No co-signer or surety of this obligation shall be liable thereunder for more than the total of payments for which the principal debtor is liable at the time that the co-signer becomes obligated.

No co-signer or surety of this obligation shall be liable thereunder unless promptly notified in writing of any default by the principal debtor.

The following is a statement by the Federal Trade Commission of the reasons for the proposed rule:

STATEMENT OF REASON FOR
THE PROPOSED RULE

It is the Commission's purpose, in issuing this statement, to set forth its reason for proposing this rule with sufficient particularity to allow informed comment. The precise format of such

statements may vary from rule to rule depending on the complexity of the issues involved. In this proceeding, we have determined that meaningful comment by the public will be best facilitated by presenting (1) a statement describing the basic factual and legal premises upon which the Commission has determined to propose the rule, and (2) a series of questions designed to draw to the public's attention matters which the Commission presently deems particularly pertinent and on which comment is especially solicited.

The Commission emphasizes that neither the statement of factual and legal premises nor the questions should be interpreted as designating disputed issues of specific fact. Such designations shall be made by the Commission or its duly authorized presiding official pursuant to the Commission's Rules of Practice.

Statement

The Commission has reason to believe that many creditors, as that term is defined in the proposed rule, utilize form contracts in consumer credit transactions which constitute or contain: a cognovit provision (also known as a "confession of judgment" and "warrant of attorney"), a waiver of statutory property exemptions, a wage assignment, a provision creating blanket security interests, a requirement that the consumer reimburse the creditor for attorney fees when the contract is referred to an attorney, and provisions imposing late charges and extension fees; that these provisions are included in form contracts without regard to the actual risk of non-repayment borne by the creditor in a given case; that these remedies

injure consumers; and that consumers receive no substantial benefit in exchange for the above-listed creditor remedies.

The Commission has reason to believe additionally that many creditors abuse the deficiency judgment mechanism by selling repossessed goods at prices substantially below their fair market retail value.

The Commission further has reason to believe that many creditors utilize form contracts in consumer credit transactions which fail to include provisions limiting contacts with third parties, as specified in [§ 228.2(a)(10)] of the proposed rule, and which fail to place certain limitations on the liability of co-signers, as specified in [§ 228.2(b)] of the proposal; that these provisions are omitted without regard to the actual risk of non-repayment borne by the creditor in a given case; that consumers are injured by said third-party contacts and co-signers are injured by failure to place said limitations on co-signer liability; and that consumers receive no substantial benefit in exchange for the absence of said limitations on third-party contacts nor do co-signers receive a substantial benefit in exchange for the absence of said limitations on their liability. The Commission has further reason to believe that many creditors fail to provide co-signers of consumer obligations with necessary information, as specified in [§ 228.2(b)(1), (b)(3)] and the last paragraph of the notice in (b)(4) of the proposed rule and that consumer contracts are generally co-signed in an atmosphere of high pressure.

The Commission determined that it has reason to believe the above assertions after it was presented with information compiled by the staff during a two-year investigation of the character and use of collection remedies associated with consumer credit agreements throughout the United States. In the course of this investigation the Commission staff has received documentary evidence on these remedies in thousands of actual cases. It has obtained official corporate statements concerning collection procedures and strategies and copies of form contracts. In addition, the staff has evaluated pertinent state statutes and judicial rulings, interviewed many persons with an interest in the matter, and examined the findings of the National Commission on Consumer Finance. The Commission has not adopted any findings or conclusions of the staff. All findings of fact in this proceeding shall be based solely on matter in the rulemaking record.

The Commission's authority to examine and prohibit unfair practices in or affecting commerce has been analogized to the jurisdiction of an equity court. ^{1/} Thus, where one party to a transaction enjoys substantial advantages with respect to those with whom he deals, it is appropriate for the Commission to conduct an inquiry to determine whether that party uses an overabundance of market power in an inequitable manner. Accordingly, the Commission is proceeding

^{1/} Sperry and Hutchinson v. F.T.C., 405 U.S. 233, 244 (1972).

upon the theory that relief of the variety proposed in certain subparagraphs of [§ 228.2] ^{2/} is mandated by Section 5 of the Federal Trade Commission Act if:

(1) The creditor imposes upon consumers contracts of adhesion (i.e., the credit customers cannot bargain over the particular contract provisions) which contain provisions disadvantageous to consumers or the creditor fails to include in the contracts of adhesion provisions beneficial to consumers, all to the consumers' detriment; and

(2) This detriment to consumers is not offset by a reasonable measure of value received in return.

The Commission additionally believes that the relief specified in [§ 228.2(a)(7)] is merited if the deficiency judgment mechanism is abused through the sale of repossessed secured property at prices substantially below the property's fair market retail value.

The Commission further believes that Section 5 requires the relief specified in [§ 228.2(b)(1) and (b)(3)] and the last paragraph of the notice in (b)(4) if the failure to provide co-signers with the information specified in said paragraphs denies co-signers adequate information about the nature of the cost of credit, the extent of the co-signers' obligations or events which may substantially affect their interests.

^{2/} (a)(1) (pertaining to cognovits), (a)(2) (pertaining to waivers of statutory property exemptions), (a)(3) (pertaining to wage assignments), (a)(4), (a)(5), (a)(6) (all pertaining to blanket security interests), (a)(8) (pertaining to attorney fees), (a)(9) (pertaining to late charges and extension fees), and (a)(10) (pertaining to contacts with third parties), and the first two paragraphs of the notice in (b)(4) (pertaining to liability of co-signers).

Finally, it is the Commission's belief that Section 5 requires the relief specified in [§ 228.2(b)(2)] if considerable pressure generally attends the transactions in which consumers co-sign consumer obligations.

Questions

1. Are the contracts used in consumer credit transactions drafted by creditors in standardized form and presented to consumers on a "take it or leave it" basis under circumstances that preclude meaningful bargaining over the terms thereof? If these contracts are drafted and presented in this manner, the Commission would be interested in receiving comments on why this is the case. The Commission would also be interested in whether or not such form contracts vary significantly from lender to lender in such a way that consumers could choose, if they so desired, by picking one lender as opposed to another, between contracts with different remedial provisions.
2. In the accompanying preliminary statement the Commission has outlined its tentative approach to unfairness in the context of creditors' remedies. It is interested in analysis supporting or opposing this theory and in other theories of unfairness under Section 5 (15 U.S.C. § 45 (1970)) and how they might apply to the area.
3. Economic theory suggests that in a freely functioning credit market the remedies contained in credit contracts would represent an equilibrium between the costs and benefits of the transaction as a whole to consumers and creditors. The Commission is interested in comment on whether (due to lack of information, collusion, (tacit or

explicit) government regulation, or some other cause) the market fails to reach this equilibrium with respect to creditors' remedies.

If the market has failed in some way, the Commission wishes to know how it has failed, the causes of such failure, and appropriateness and adequacy of the proposed rule as a remedy for any such failure.

4. The Commission wishes to know the effect of the proposed rule on the costs of and/or restrictions on the availability of credit and whether these costs or restrictions, if any, would fall on particular groups and, if so, the characteristics of these groups. In connection with this question the Commission particularly desires analysis based on specific data and experience.

5. Do consumers receive any substantial benefit or quid pro quo for acceding to the practices that would be proscribed by the proposed rule?

6. The Commission seeks comment on all aspects of the interaction of the proposed rule with state laws governing credit and creditors' remedies.

7. For each of the individual rule provisions, the Commission desires comment on the nature and extent of any consumer injury associated with the practice being restricted, and of any benefits flowing to consumers from the practice which might offset such injury.

8. The Commission wishes to know whether any injury which may be associated with practices restricted by the rule may be eliminated without eliminating the practices entirely. That is, are there other

and better ways of achieving the results which the rule seeks to achieve?

9. The Commission requests comment on the prevalence of the challenged practices.

10. The Commission also seeks comments evaluating the economic effect of the rule on small business.

11. Are there any unfair or deceptive consumer credit practices not covered by the proposed rule which might appropriately be included?

12. Two provisions of the rule are stated in the alternative. As to these, the Commission is specifically interested in comment on which alternative is preferable.

(a) Wage assignments. Wage assignments may have deleterious effects on consumers by depriving them of the opportunity to assert legitimate defenses and by causing loss of employment or the threat of such loss. Some commentators suggest, however, that wage assignments are such an important remedy in small loan transactions for which no other security is available that forbidding their use would cause a significant diminution in the availability of such loans or a significant increase in the cost of such loans. The Commission is interested in information on a possible exemption from the prohibition of wage assignments for certain small loan transactions, and on the optimum amount for any such exemption.

(b) Attorney's fees and collection costs.

Provisions allowing creditors to collect attorney's fees and other costs from debtors may be abused. These charges may not

bear any direct relationship to actual or reasonable costs borne by the creditor in collecting a debt. On the other hand, a creditor should be able to recover such actual reasonable costs as are incurred. The Commission is interested in receiving comment as to the differing effects of an absolute prohibition of inclusion of attorney's fees provisions in consumer obligations; or, alternatively, of a limitation of the amount of such fees expressed as a percentage of the obligation with a minimum obligation amount below which no such fees could be collected. Comment as to appropriate amounts to be allowed is also solicited.

END OF COMMISSION'S STATEMENT

Comments regarding the proposed rule's general applicability are invited. The Board would be particularly interested in specific comments directed to any reason why such rule should not apply to banks.

This notice is published pursuant to § 553(b) of Title 5 United States Code, and § 262.2(a) of the Rule of Procedure of the Board of Governors of the Federal Reserve System (12 C.F.R. § 262.2(a)). To aid in consideration of these matters by the Board, interested persons are invited to submit relevant data, views, or arguments in writing to the Office of the Secretary, the Board of Governors of the Federal Reserve System, Washington, D.C. 20551, to be received not later than June 10, 1975. Such material will be made available upon request, except as provided in 12 C.F.R. § 261.6(a) of the Board's Rules Regarding Availability of Information.

Since the Board may be required to issue regulations substantially similar to the rule ultimately promulgated by the Federal Trade Commission, it is recommended that copies of comments also be sent directly to the Commission for consideration. Such comments should be addressed to the Special Assistant Director for Rulemaking, Federal Trade Commission, Washington, D.C. 20580.

By order of the Board of Governors, April 21, 1975.

(signed) Theodore E. Allison
Theodore E. Allison
Secretary of the Board

[SEAL]