

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 9854
May 8, 1985]

AMENDMENTS TO REGULATION AA
Adoption of FTC Rules Prohibiting Certain
Consumer Debt Collection Practices

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

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

The Federal Reserve Board has announced a final rule amending its Regulation AA — Unfair or Deceptive Acts or Practices — that will carry out the Credit Practices Rule recently adopted by the Federal Trade Commission.

All banks except those savings banks that are members of the Federal Home Loan Bank System will be affected by the new rule.

The Board's action, effective January 1, 1986, prohibits banks from entering into any consumer credit obligation that contains a confession of judgment clause,¹ a waiver of exemption,² an assignment of future wages to the creditor in the event of default, or a security interest in the consumer's household goods other than those purchased with the credit. In addition, the rule prohibits the enforcement of these provisions in a consumer credit obligation purchased by a bank.

The rule also forbids the pyramiding of late charges. Through this practice, a creditor imposes multiple late charges based on a single late payment that is subsequently paid in full on or before the next timely payment. As the subsequent timely payments are made, and the late charge extracted, the late charges begin to pyramid. In addition, the rule requires a creditor to give a notice to cosigners informing them of the nature of their obligation and potential liability. Under the new rule, banks are given the option of either providing the notice in a separate document or including the notice in the contract document.

¹ A confession of judgment clause is a statement by which the consumer agrees in advance to permit the creditor to obtain a judgment in the event of default without giving the debtor prior notice or an opportunity to be heard in court.

² Under such a provision, the consumer waives or limits state law exemptions sheltering the consumer's home or other necessities from attachment.

Enclosed is the text of the amendments, effective January 1, 1986, which has been reprinted from the *Federal Register*. Questions regarding this regulation may be directed to our Regulations Division (Tel. No. 212-791-5914).

E. GERALD CORRIGAN,
President.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

UNFAIR OR DECEPTIVE ACTS OR PRACTICES

AMENDMENTS TO REGULATION AA

(effective January 1, 1986)

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: Final rule.

SUMMARY: The Board is publishing a final rule amending Regulation AA (Unfair or Deceptive Acts or Practices) to 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 prohibits banks from entering into any consumer credit obligation that contains certain prohibited provisions, from pyramiding late charges, or from obligating a cosigner without a required notice. The rule also prohibits the enforcement of any prohibited provisions contained in a consumer credit obligation purchased by a bank.

EFFECTIVE DATE: January 1, 1986.

FOR FURTHER INFORMATION CONTACT: Steven Zeisel, Senior Attorney or Richard Garabedian, Staff Attorney, 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 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 a final rule to amend Regulation AA (12 CFR Part 227). The rule implements, as to banks, the Credit Practices Rule adopted by the Federal Trade Commission, effective March 1, 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 Commission 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 Commission's rule. This scheme was established by section 202(a) of the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 U.S.C. 57a).

The Board published for public comment, on November 30, 1984 (49 FR 47041), a proposed rule that was substantially similar to the rule adopted by the Commission. The Board solicited public comment on issues believed to be important in assisting the Board in its determination of whether to adopt a substantially similar rule. The Board received 137 comments in response to the proposal, including comments from all the Federal Reserve Banks. About

one-half of the commenters addressed the rule as a whole, the majority of which were in opposition. Many commenters merely requested clarification of the provisions in the rule.

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. In its analysis of each of the rule's provisions, the Board has examined the record established by the Commission, the use of the practices by banks, and the concerns raised by the commenters. In so doing, the Board has concluded that neither statutory exception is applicable. Therefore, the Board is adopting a rule substantially similar to the rule adopted by the Commission. However, in promulgating a substantially similar rule, the Board has modified certain provisions, in light of the comments received, to take into account the needs and characteristics of the banking industry. These modifications are discussed under each particular provision of the rule.

The rule prohibits a bank from including certain creditor remedies in its consumer credit obligations and makes unenforceable such remedies when contained in obligations purchased by a bank. 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

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For this Regulation to be complete, retain:
1) Pamphlet effective September 27, 1976.
2) This slip sheet.

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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 provision prohibits misrepresentation of a cosigner's liability and requires that a notice disclosing the nature of the cosigner's obligation be given to the cosigner, either in a separate document or in the credit obligation.

(2) *Scope.* The rule applies to all banks and their subsidiaries, except savings banks that are members of the Federal Home Loan Bank System.

(3) *Definitions. Consumer.* As the definition of consumer makes clear, the rule does not apply to credit extended for the purchase of real property. Dwellings such as mobile homes and houseboats are not considered real property under this definition if they are deemed to be personal property under state law.

Cosigner. A cosigner includes any person who renders himself or herself personally liable, in any capacity, for the obligation of another person without receiving goods, money, or services. It does not include a person who only pledges collateral for the obligation of another person. Thus, any sole or joint owner of property who merely gives a security interest without personal liability is not a cosigner.

The definition of cosigner has been clarified for open-end accounts. It has been modified from the proposal to exclude any consumer who has the contractual right to draw on an open-end credit obligation, such as a credit card account. This clarification was made in light of concerns raised by the commenters that a bank will not know, at the time that account is opened, whether a consumer will ever draw on the account and therefore not be considered a cosigner.

Household goods. The term "household goods" includes only those items specified in the regulation. Thus, other items of personal property that are not household goods are not subject to the rule's prohibition against taking

nonpurchase money security interests. The term does not include such items as fixtures, automobiles, boats, snowmobiles, cameras and camera equipment (including darkroom equipment), pianos, home workshops and the like. As used in the definition of household goods, the term "personal effects" is intended to have its commonly accepted meaning. Items that are clearly personal effects are those which a person would ordinarily carry about on his or her person and possessions of uniquely personal nature, such as family photographs.

(4) *Unfair Credit Contract Provisions.* The first sentence of § 227.13 makes clear that it is an unfair act or practice for a bank either to enter into a consumer credit obligation containing any of the prohibited provisions or to seek to enforce any of the prohibited provisions contained in a consumer credit obligation purchased by the bank. This is a modification from the proposal which prohibited the purchase of an obligation containing a prohibited provision. The Board believes, in light of the comments received and further analysis, that making such provisions unenforceable will achieve the goals of the rule without imposing undue compliance burdens on banks.

Confession of Judgment. This provision prohibits only confessions of judgment that involve anticipatory waivers of procedural due process in the context of credit obligations. It does not prohibit confessions of judgment executed after an action has been instituted on the underlying obligation or after the consumer's default. The rule also does not prohibit powers of attorney given in a mortgage loan obligation or deed of trust for purposes of foreclosure, and the rule does not prohibit powers of attorney given to expedite the transfer of pledged securities, to expedite the disposal of repossessed collateral, or to allow prompt cancellation of insurance in an insurance premium finance contract.

Waiver of Exemption. This provision prohibits the contractual waiver of a property exemption that is provided to a consumer under state law. However, a waiver is permitted if it relates to property which is specifically given as security in connection with the obligation.

Assignment of Wages. This provision prohibits the assignment of wages but allows payroll deduction plans,

assignments that are revocable by their terms, and assignments of earned wages. Payroll deductions plans are permitted whether revocable or irrevocable.

Blanket Security Interests. This rule prohibits nonpossessory security interests in household goods, as defined in the rule, in nonpurchase money transactions. Because the rule only prohibits certain nonpossessory security interests, it will not affect a consumer's right to pledge or pawn any household goods.

The rule also does not prohibit nonpurchase money security interests in stocks, bonds, and other non-household goods assets. In addition, it does not prevent consumers from borrowing on the equity in their homes. If a purchase money loan is refinanced or consolidated, the household goods collateralizing the prior loan can continue to secure the new loan, even if the new loan is for a larger amount or is in other respects a nonpurchase money loan.

(5) *Unfair or Deceptive Practices Involving Cosigners.* Section 227.14 (a)(1) prohibits a bank from misrepresenting a cosigner's liability to any person. Section 227.14(b)(1) requires that a disclosure notice be given to the cosigner, prior to becoming obligated, either on a separate document or on the documents evidencing the consumer credit obligation. In either case, the notice must be substantially similar to the specified notice and be clear and conspicuous. In order to be clear and conspicuous, the notice must be distinctive. A notice in the contract might be, for example, in slightly larger type or set off from the contract language. If the notice is on a separate document, additional information may be placed on the document, such as the bank's identity, the identity of the debt in question, the cosigner's acknowledgment of receipt, the date, and any state notice that is required. The alternative of including the notice in the contract documents—suggested by a number of commenters—was adopted to take into account the needs and characteristics of the banking industry. If the underlying contract is in a foreign language, the notice should be provided in the same language.

A "substantially similar" standard has been adopted to allow banks to modify the notice to take into account, for

example, such variations as conflicts with state law, default situations, state notice requirements, and loans in which the bank cannot identify the cosigner. In addition, language may be deleted if it is either inapplicable or inaccurately reflects the agreement.

In the case of open-end credit obligations, the notice must be given before the cosigner becomes obligated for any fees or transactions on the account. This modification from the proposal, which required the notice to be given before execution, was added in response to the concerns of commenters that the point of execution may be uncertain in open-end obligations that are consummated through the mail. Requiring the notice before any obligation is incurred will provide sufficient protections.

If state law requires that a notice also be given to cosigners, the bank may include both notices in the credit obligation or on a separate document (either on the same side or on opposite sides), until an exemption is granted.

(6) *Unfair Late Charges.* This rule only prohibits the imposition of a late charge resulting from the failure to pay an earlier late charge. For example, if a consumer makes the January payment 15 days late, but makes the February payment on time and in full, the bank may not cause the latter payment to be considered delinquent by extracting the late charge applicable to the January payment. The rule does not prohibit late charges from being assessed for every period that a payment remains not fully paid. For example, if a consumer fails to make the January payment and then makes the February payment on time, the bank may continue to assess a late charge until the January payment is made; the rule is not intended to permit a consumer to skip a payment and unilaterally extend the term of the loan.

(7) *Regulatory Flexibility Analysis.* The Board's Division of Research and Statistics has prepared a regulatory flexibility analysis. A copy of the analysis may be obtained from Publications Services, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at (202) 452-3245.

List of Subjects in 12 CFR Part 227

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

PART 227—[AMENDED]

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 is amending Regulation AA, 12 CFR Part 227, by redesignating the current provisions as Subpart A and adding a new Subpart B, as follows:

Subpart A—Consumer Complaints

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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 section 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 defines unfair or deceptive acts or practices of banks in connection with extensions of credit to consumers.

(c) *Scope.* This subpart applies to all banks and their subsidiaries, except savings banks that are members of the Federal Home Loan Bank System. 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 Board of Governors of the Federal Reserve System, in the case of banks that are members of the Federal Reserve System (other than banks referred to in paragraph (c)(1) of this section); and

(3) The Federal Deposit Insurance Corporation, in the case of banks insured by the Federal Deposit

Insurance Corporation (other than banks referred to in paragraphs (c)(1) and (c)(2) of this section).

§ 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 of 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, or, in the case of an open-end credit obligation, without receiving the contractual right to obtain extensions of credit under the account.

(2) "Cosigner" includes any 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 pension, 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 a creditor.

(f) "Person" means an individual,

corporation, or other business organization.

§ 227.13 Unfair credit contract provisions.

It is an unfair act or practice for a bank to enter into a consumer credit obligation that contains, or to enforce in a consumer credit obligation purchased by the bank, 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 of attorney, or other waiver of the right of 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) *Pronhibited 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) A clear and conspicuous disclosure statement shall be given in writing to the cosigner prior to becoming obligated. The disclosure statement shall be substantially similar to the following statement and shall either be a separate document or included in the documents evidencing the consumer credit obligation.

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 increase this amount.

The bank can collect this debt from you without first trying to collect from the borrower. The bank 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 cosigner becomes obligated for fees or transactions on the account.

(3) A bank that is in compliance with this paragraph may not be held in violation of paragraph (a)(2) 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 delinquency 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 intended 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, April 23, 1985.

William W. Wiles,

Secretary of the Board.

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