Regulation AA

Unfair or Deceptive Acts or Practices: Credit Practices Rule

Background

The Credit Practices Rule, which was adopted by the Federal Reserve Board under section 18(f)(1) of the Federal Trade Commission Act (15 USC 45) in response to a similar rule adopted by the Federal Trade Commission, is contained in subpart B of Regulation AA.[1] It became effective in January 1986.

The rule prohibits banks and their subsidiaries from using (1) certain provisions in their consumer credit contracts, (2) a late-charge accounting practice known as pyramiding, and (3) deceptive cosigner practices. It also requires that a disclosure notice be given to a cosigner prior to the cosigner's becoming obligated. Finally, the rule prohibits banks and their subsidiaries from enforcing in purchased contracts the same provisions they are prohibited from including in their own consumer credit contracts.

Scope of the Rule

The Credit Practices Rule applies to consumer credit contracts other than those for the purchase of real estate. Dwellings such as mobile homes and houseboats are not considered real estate if they are considered personal property under state law. A *consumer* is defined as a natural person who seeks or acquires goods, services, or money for personal, family, or household purposes. There is no monetary limit on the coverage of the rule.

Prohibited Contract Provisions

In general, banks are prohibited from entering into credit contracts that contain any of the provisions described in the following paragraphs.

Confession of Judgment

A *confession of judgment* is a contract clause (sometimes also known as a cognovit or a warrant of attorney) in which the borrower waives the right to notice and the opportunity to be heard in court in the event of a creditor-initiated lawsuit to enforce an obligation.

The following are not prohibited:

- Confessions executed after default or the filing of a suit on the debt
- Powers of attorney contained in a mortgage or deed of trust for foreclosure purposes
- Powers of attorney given to expedite the disposal of repossessed collateral or the transfer of pledged securities
- Confessions in Louisiana for the purpose of executory process

Waiver of Exemption

Under a *waiver of exemption*, a consumer relinquishes the right granted under state law to protect his or her home (a right known as the homestead exemption), possessions, or wages from seizure to satisfy a judgment. Under the rule, a waiver is permitted if it pertains solely to the property given as collateral in connection with a consumer credit obligation.

Any other types of waivers (for example, waivers of demand, presentment, protest, notice of dishonor, and notice of protest) are not prohibited.

Assignment of Wages

An *assignment of wages* is a contract provision that gives banks the right to receive the consumer's future wages or earnings directly from the consumer's employer in the event the consumer defaults on the loan.

The following are not prohibited:

- An assignment that by its terms is revocable at will by the consumer
- A payroll deduction or preauthorized-payment plan (whether or not revocable by the consumer) commencing at loan consummation and authorized for the purpose of making periodic payments on the debt
- A revocable preauthorized-payment plan (subject to the Electronic Fund Transfer Act) for electronic fund transfers to accounts from wages
- An assignment of wages already earned at the time of the assignment
- Garnishment

Earnings are defined as compensation paid or payable to an individual, or for the individual's account, for personal services rendered or to be rendered by the consumer, whether in the form of wages, salary, commission, or bonus, including periodic payments pursuant to a pension, retirement, or disability program.

1. The Office of Thrift Supervision has a rule for savings banks identical to the Federal Reserve's rule for state member banks and their subsidiaries.

Security Interest in Household Goods

A nonpossessory security interest in household goods is prohibited unless such goods are purchased with credit extended by the financial institution.

The following are not prohibited:

- Security interests in household goods not purchased with credit extended by the bank if the goods are placed in the bank's possession
- Security interests in all other real and personal property of the consumer other than household goods as defined in the rule

Household goods include the clothing, furniture, appliances, linens, china, crockery, kitchenware, and personal effects of the consumer and the consumer's dependents. The following are not household goods:

- Works of art
- Electronic equipment (other than one television and one radio)
- Items acquired as antiques, including such items that have been repaired or renovated without changing their original form or character (To be considered an antique, an item must be more than 100 years old.)
- Jewelry (other than wedding rings)
- Automobiles, boats, snowmobiles, cameras and camera equipment (including darkroom), pianos, home workshops, and the like

Examples of Prohibited Contract Provisions

Confession of Judgment

- *If you fail to carry out the terms of this notice, you appoint ________ or ________ as your attorney-in-fact for the purpose of confessing judgment against you, and you authorize either of them to confess judgment against you in favor of us in the Clerk's Office of the City/County of Powatan, Virginia, or in any other court of proper jurisdiction for the unpaid balance of this Note plus costs, expenses, and attorney's fees as provided on the reverse side of this Note.*
- *You and any CoMaker, jointly and severally, authorize the Prothonotary, Clerk, and any attorney of any court of record to appear for you and any CoMaker and confess judgment in our favor or in favor of any other holder of this Note. Judgment by confession may be entered either prior to or after an event of default, as often as necessary, for such sums as are or may become due on this Note, with costs of suit and 20 percent added as actual and reasonable attorney's fees. You and CoMaker agree, to the extent permitted by law, to all rights of appeal, appraisement, stay of execution, and exemption now or later enforced. If a copy of this Note is filed in connection with the entry of judgment, it shall not be necessary to file the original Note as a Warrant of Attorney, if the copy is verified by affidavit.*

Waiver of Exemption

- *I waive my homestead exemption.*
- *In consideration of the credit extended, Mortgagor waives and relinquishes, with respect to the Property and all other property now or hereafter owned by Mortgagor, the benefit of any and all stay and extension laws, and further expressly waives notice and delay accorded by Louisiana Code of Civil Procedure Articles 2331, 2639, and 2722 and La. R. S. 12:4363–4366, including, but not limited to, any and all homestead and other claims to exemption from seizure that under existing or future laws might be asserted against enforcement of payment of the indebtedness secured hereby, and consents to the immediate seizure, advertisement, and sale of said property in the event of institution of executory or other legal proceedings.*
- *Debtor hereby acknowledges express intent to hereby waive and abandon all personal property exemptions granted by law upon the goods, which are the subject of this Agreement. Notice: By signing this Agreement, Debtor waives all rights provided by law to claim such goods exempt from process.*
- *I waive (to the extent permitted by law) certain rights I might otherwise have. All exemptions in and to any of the property are hereby waived.*

Prohibited Practices

Pyramiding of Late Charges

Pyramiding is an accounting method that results in the assessment of multiple delinquency charges as a consequence of a single delinquent payment for the current month. For example, when a borrower's payment is received late, the lender deducts a late charge directly from the payment received, which then results in an insufficient payment. Although the next payment may be received on time, because the first payment was considered insufficient, a late charge is again applied. This continues until either the borrower pays the late charge separately or the loan matures. The examiner should not confuse this situation with one in which a payment is missed and never made up, triggering late charges each month until the entire payment is made and the account is brought entirely up to date or is paid in full.

Cosigner Deception

The institution may not misrepresent the nature and extent of a cosigner's liability to any person.

Disclosures to Cosigners

A financial institution must provide, either in a separate document or in the credit obligation, a clear and conspicuous notice that is substantially similar to the example below. This notice must be given to the cosigner prior to the time he or she becomes obligated. In the case of open-end credit plans, the notice must be given prior to the time the cosigner becomes obligated for fees or transactions on the account.

Sample 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 the debt 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 may 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 or garnishing your wages. 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.

A *cosigner* is defined as

- Any person who assumes personal liability, in any capacity, for the obligation of another consumer without receiving goods, services, or money in return for the obligation. This includes any person whose signature is requested to allow a consumer to obtain credit or to prevent collection of a consumer's obligation that is in default.
- A person who meets the above definition, whether or not he or she is designated as such in the contract
- For open-end credit, a person who signs the debt instrument but does not have the contractual right to obtain credit under the account

A cosigner is not

- A spouse whose signature is required on a credit obligation to perfect a security interest pursuant to state law
- A person who does not assume personal liability, but rather only provides collateral for the obligation of another person
- A person who has the contractual right to obtain credit under an open-end account, whether exercised or not

Civil Liability

There is no express provision for civil liability in either the Federal Trade Commission Act or Regulation AA.

Administrative Enforcement

Regulation AA is to be enforced for banks through section 8 of the Federal Deposit Insurance Act (12 USC 1818). In addition, the Federal Reserve may enforce compliance through any other authority conferred on it by law (15 USC 57a(f)(4)).

Examination Objectives and Procedures

EXAMINATION OBJECTIVES

1. To determine if the financial institution has established an effective system for ensuring that it
   a. Does not originate, acquire, or enforce contracts that contain prohibited provisions
   b. Does not ‘‘pyramid’’ late charges
   c. Does not engage in deceptive cosigner practices
   d. Provides the required disclosure to cosigners prior to their becoming obligated
2. To determine whether the credit contracts originated or purchased by the institution contain prohibited provisions
3. To determine whether the institution used impermissible late-charge accounting practices
4. To determine if the institution advised cosigners prior to their becoming contractually liable of the nature and extent of their liability
5. To determine if the institution provides the required notices to cosigners prior to their becoming obligated or, in the case of open-end credit plans, prior to the time they become obligated for fees or transactions on the account
6. To determine if the institution has attempted to enforce prohibited provisions in contracts it has originated or acquired

EXAMINATION PROCEDURES

1. Obtain and review blank notes (contracts) and disclosures (including those furnished to dealers) used by the financial institution in extending consumer credit for the following prohibited contract provisions:
   a. Confession of judgment—A waiver by the consumer of the right to notice and the opportunity to be heard in court in the event of a suit on the obligation (§ 227.13(a))
   b. Waiver of statutory property exemption—A waiver by the consumer of the statutory right to protect his or her home (known as the homestead exemption), possessions, or wages from seizure to satisfy a judgment unless the waiver is given on property that will serve as security for the obligation (§ 227.13(b))
   c. Assignment of wages—A provision giving the bank the right to receive the consumer’s wages or earnings directly from the consumer’s employer (§ 227.13(c)). However, such an assignment is permitted if
      i. It is revocable at will by the consumer
      ii. It is a payroll deduction plan or a preauthorized payment plan (whether or not revocable by the consumer), commencing at consummation, for the purpose of making loan payments
      iii. It applies only to wages or earnings already earned at the time of the assignment
   d. Blanket security interest in household goods—A provision that allows the institution to hold as collateral the clothing, furniture, appliances, and personal effects of the consumer’s dependents (§ 227.13(d))
2. Determine through discussions with management and staff if the institution attempts to enforce confessions of judgment, waivers of exemption, assignments of wages, or security interests in household goods in originated or acquired contracts.
3. Review the bank’s collection policies, procedures, and practices to ensure that staff members are not using an assignment of wages except where permissible. (§ 227.13(c))
4. Judgmentally sample an adequate number of loan files to ensure that prohibited contract provisions are not included in contracts (or related documents) originated by, or enforced in contracts acquired by, the institution.
5. Judgmentally sample an adequate number of overdue loans to determine if the institution collects or attempts to collect overdue payments through assignment of wages. (§ 227.13(c))
6. Judgmentally sample an adequate number of overdue loans to determine if the institution collects or attempts to collect a late charge on a timely payment because of the consumer’s failure to pay a late charge attributable to a prior delinquent payment. (§ 227.15))
7. Determine through a review of procedures, policies, and practices whether the institution takes steps to prevent its staff from engaging in prohibited cosigner practices on loans it originated or acquired. (§ 227.14(a))
8. Determine through discussions with management and staff if there is evidence that the institution engages in prohibited cosigner practices (for example, misrepresenting a cosign-

er's liability or contractually obligating cosigners prior to informing them of their liability).

9. Determine through discussions with management and staff whether the nature and extent of a cosigner's liability is properly represented to cosigners prior to the time signatures are obtained. (§ 227.14(a))
10. Judgmentally sample the documents evidencing the credit obligation and determine if they contain the required notice to cosigners. (§ 227.14(b))
    a. If the notice to cosigners is contained in the note or disclosure, it must be clear, conspicuous, and substantially similar to that provided in the regulation and must be provided before the cosigner becomes obligated.
    b. If the notice to cosigners is contained in a separate document, also
        i. Interview applicable employees to determine if they are aware that the notice must be provided prior to the cosigner's becoming obligated.
        ii. Review the institution's polices, procedures, and practices to ensure that staff members are aware that cosigners must be provided with the notice prior to their becoming obligated.

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Examination Checklist

1. Do the consumer contracts originated by the bank contain any of the following prohibited provisions?
   a. Confession of judgment (§ 227.13(a)) Yes No
   b. Waiver of statutory property exemption (unless the waiver applies solely to the property that will serve as security for the loan) (§ 227.13(b)) Yes No
   c. Assignment of wages or other earnings (except where permitted) (§ 227.13(c)) Yes No
   d. Blanket security interests in household goods (§ 227.13(d)) Yes No
2. Does the bank acquire loans originated by other creditors? Yes No

   If so, does it attempt to enforce any of the following prohibited practices?
   a. Confession of judgment (§ 227.13(a)) Yes No
   b. Waiver of statutory property exemption (unless the waiver applies solely to the property that will serve as security for the loan) (§ 227.13(b)) Yes No
   c. Assignment of wages or other earnings (except where permitted) (§ 227.13(c)) Yes No
   d. Blanket security interests in household goods (§ 227.13(d)) Yes No
3. Does the bank take a nonpossessory security interest in household goods (as defined in section 227.12(d)) not purchased with the loan proceeds? (Review bank security agreement forms.) Yes No
4. Has the bank attempted to enforce any prohibited practices with respect to the consumer credit contracts it has originated? (§ 227.13(a) or 227.13(b)) Yes No
5. Does the bank collect or attempt to collect a late charge on a timely payment because of the consumer's failure to pay a late charge attributable to a prior delinquent payment? (§ 227.15) Yes No
6. Has the bank engaged in any prohibited cosigner practices (for example, misrepresenting the cosigner's liability or obligating cosigners prior to providing the required notification)? (§ 227.14(a)) Yes No
7. Does the bank provide to each cosigner, prior to his or her becoming contractually obligated, the required notice or one that is substantially similar (whether separate or contained in the credit documents)? (§ 227.14(b)) Yes No