The Federal Reserve Board

Staff Guidelines on the Credit Practices Rule

Effective January 1, 1986; as amended effective August 1, 1988

Introduction

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 section 18(a)(1)(B) and section 5(a)(1) of the Federal Trade Commission Act (FTC Act), 15 USC 57a(a)(1)(B) and 15 USC 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 USC 57a(f), provides that, whenever the FTC promulgates a rule prohibiting practices which it has deemed to be unfair or deceptive, the Board of Governors of the Federal Reserve System (Board) must adopt a substantially similar rule prohibiting such 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 payment-systems policies of the Board.

In April 1985, the Board adopted a rule substantially similar to the FTC's Credit Practices Rule, thereby amending the Board's Regulation AA, Unfair or Deceptive Acts or Practices (12 CFR 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 effective date of the Board's rule is January 1, 1986.

2. ***Summary of rule.*** The Board's rule applies to all consumer credit contracts other than those for the purchase of real estate. 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 contracts, and, if banks purchase contracts that contain a prohibited provision(s), banks are prohibited from enforcing the provision(s).

The prohibited provisions are: (1) a confession-of-judgment clause (also known as a cognovit or warrant of attorney), which permits a creditor to obtain a judgment based on the borrower's agreement in advance that, in the event of a suit on the obligation, the borrower waives the right to notice and the opportunity to be heard; (2) a waiver of exemption in which the consumer relinquishes a statutory right protecting his or her home and other necessities from seizure to satisfy a judgment, unless the waiver applies solely to property that serves as security for the obligation; (3) an irrevocable assignment of future wages which gives the bank the right to receive the consumer's wages or earnings directly from the consumer's employer, unless the assignment constitutes a payroll deduction plan or other preauthorized-payment plan; and (4) the taking of nonpossessory security interests in household goods, unless such goods are purchased with the credit extended by the bank.

The rule also prohibits a practice known as "pyramiding late charges." Under the pyramiding provision, a bank is prevented from assessing multiple late charges based on a single late payment that is subsequently paid.

The rule also prohibits a bank from misrepresenting a cosigner's liability and requires the

bank to give a cosigner, prior to becoming obligated in a consumer credit transaction, a disclosure notice which explains the nature of the cosigner's obligations and liabilities under the contract.

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.

4. ***State exemptions.*** The rule provides that states may seek exemptions from the requirements of the rule when the state law provides a level of protection substantially equivalent to, or greater than, the protection afforded by the rule.

5. ***Format of staff guidelines.*** The staff guidelines on the Credit Practices Rule--subpart B of Regulation AA--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 section 227.13(d). Headings are included to make it easier for users to locate questions.

Section 227.11 **Authority, purpose, and scope**

Q11(c)-1: *Penalties for noncompliance.* What are the penalties for noncompliance with the rule?

A: Administrative enforcement of the rule for banks may involve actions under section 8 of the Federal Deposit Insurance Act (12 USC 1818), including cease-and-desist orders requiring that actions be taken to remedy violations. If the terms of the order are violated, the federal supervisory agency may impose penalties of up to $1,000 per day for every day that the bank is in violation of the order.

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)-1: *Type of transaction covered.* What type of transaction is covered by the rule?

A: The rule covers credit obligations of consumers to acquire goods, services, or money primarily for personal, family, or household use. The rule does not apply, however, to loans made for the purchase of real property.

Q12(a)-2: *Business vs. consumer purpose.* How can a bank determine whether credit extensions are for business purposes and, therefore, not covered by the rule?

A: While there is no precise test for what constitutes business-purpose credit--as opposed to credit primarily for personal, family, or household purposes--banks may consider the factors described in the official staff commentary to Regulation Z (Truth in Lending, 12 CFR 226) on this issue. The factors include:

- The relationship of the borrower's primary occupation to the acquisition. The more closely related, the more likely it is to be business purpose.
- The degree to which the borrower will personally manage the acquisition. The more personal involvement there is, the more likely it is to be business purpose.
- The ratio of income from the acquisition to the total income of the borrower. The higher the ratio, the more likely it is to be business purpose.
- The size of the transaction. The larger the transaction, the more likely it is to be business purpose.
- The borrower's statement of purpose for the loan.

Examples of business-purpose credit include:

- A loan to expand a business, even if it is secured by the borrower's residence or personal property.
- A loan to improve a principal residence by putting in a business office.
- A business account used occasionally for consumer purposes.

Examples of consumer-purpose credit include:

- Credit extensions by a company to its employees or agents if the loans are used for personal purposes.
- A loan secured by a mechanic's tools to pay a child's tuition.
- A personal account used occasionally for business purposes.

Q12(a)-3: *Agricultural purpose loans.* What about loans made for agricultural purposes? Are they covered by the rule?

A: A loan made for an "agricultural purpose"--as that term is defined in the official staff commentary to Regulation Z--would not be a loan made primarily for personal, family, or household use and, therefore, would not be subject to the rule. An agricultural-purpose loan would include loans for the planting, propagating, nurturing, harvesting, catching, storing, exhibiting, marketing, transporting, processing, or manufacturing of food, beverages (including alcoholic beverages), flowers, trees, livestock, poultry, bees, wildlife, fish, or shellfish by a natural person engaged in farming, fishing, or growing crops, flowers, trees, livestock, poultry, bees, or wildlife.

Q12(a)-4: *Real property loan--not secured by property purchased.* Does the rule apply where a consumer obtains a loan to purchase real property but secures the loan with some other collateral, such as a savings account or other real property?

A: No, the rule would not apply since the purpose of the loan is to purchase real property.

Q12(a)-5: *Home-improvement loans.* What happens when a bank makes a home-improvement loan to a consumer and secures it with the consumer's home? Is the transaction subject to the rule?

A: Yes, the transaction is subject to the rule since the purchase of real property is not the purpose of the loan.

Q12(a)-6: *Mobile home and houseboat purchases.* Is a purchase of a mobile home or houseboat exempt from the rule as a purchase of real property?

A: The issue of whether purchases of mobile homes or houseboats are covered by the rule depends on how these dwellings are treated under state law. If the applicable state law considers them real property, as opposed to personal property, then transactions for their purchase would be exempt from the rule.

Q12(a)-7: *Construction loans.* Are construction loans and loans made to provide permanent financing exempt from the rule as purchases of real property?

A: Yes, construction loans and loans made to provide permanent financing are considered loans for the purchase of real property and, therefore, not subject to the rule.

Q12(a)-8: *Assumptions.* A bank makes a loan for the purchase of real property. The loan is assumed by a new purchaser. Would the assumption be considered a transaction "for the purchase of real property," and, therefore, not covered by the rule?

A: Yes, an assumption of a loan made for the purchase of real property is considered a transaction "for the purchase of real property," and not covered by the rule.

Q12(a)-9: *Refinancings of real property loans.* What happens if a bank refinances a loan that had been made to purchase real property and, therefore, was exempt from the rule? Is the new loan still exempt from the rule?

A: The new loan will be exempt from the rule as long as the primary purpose of the new loan is in fact the refinancing of the original debt (for example, in order to take advantage of lower interest rates). The amount outstanding on the original loan--which is now being refinanced--must represent substantially the entire amount of the new loan; any additional credit extended as part of the new loan must be incidental to the primary purpose of refinancing.

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)-1: *Cosigner--basic definition.* Who is a cosigner under the rule?

A: Any natural person who assumes liability for the obligation of a consumer (including, for example, a surety, guarantor, or other accommodation party), and who does so without receiving goods, services, or money in return for the obligation, or, in the case of open-end credit, without receiving the contractual right to obtain extensions of credit on the account, would be considered a cosigner for purposes of the rule.

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.

Q12(b)-2: *Person's signature requested as a condition to credit or as a condition for forbearance.* If a bank requests a person's signature as a condition to granting credit to another individual, or as a condition for forbearance on collection of a consumer's obligation that is in default, is that person a cosigner?

A: Yes, if such a person is asked to sign as a condition to granting credit to another individual, or as a condition for forbearance on collection of an obligation that is in default, such a person would be a cosigner, provided that the person assumes liability for a consumer's obligation without receiving goods, services, or money in return. If the person who is asked to sign the credit obligation (for example, for the purchase of an automobile, or for an open-end credit card account) decides that he or she wishes to be reflected on the title to the automobile being purchased, or to have access to the credit card line, that person is not a cosigner for purposes of the rule.

Q12(b)-3: *Joint applicants.* What happens when two people visit a bank to apply for a loan and appear to be applying jointly? Can the bank assume that they are applying as joint applicants, or does the rule require the bank to determine if both of the applicants will actually be "receiving goods, services, or money in return for the obligation"?

A: Where two people visit a bank to apply for a loan and appear to be applying jointly, the rule does not require a bank to conduct a detailed inquiry into the extent to which both persons are "receiving goods, services, or money in return for the obligation." In the great majority of situations, individuals applying together will be co-borrowers and will not be covered by the rule. The cosigner provision would not apply, for example:

- If two people apply together for a loan to purchase items for their shared use or to be owned jointly.
- If two people apply jointly for a credit card account and both have the contractual right to draw on the account, even if one of the applicants eventually chooses not to use the account.

The cosigner provision would apply, for example:

- If a consumer applies for a loan with a friend or relative and during the application process it becomes apparent to the loan officer that the purpose of the loan is such that the friend or relative will not receive any benefit from the loan and that the friend or relative is applying with the consumer solely to aid the consumer in obtaining credit (for example, where the proceeds of the loan are to be used to pay the consumer's dental expenses, or to buy furniture for the consumer's home or apartment).

Q12(b)-4: *Signature to perfect security interest--relationship to Regulation B.* The rule does not consider a spouse whose signature is required on a credit obligation to perfect a security interest pursuant to state law, to be a cosigner. Does this affect a creditor's obligation under the signature rules of Regulation B (Equal Credit Opportunity, 12 CFR

202), which limit the circumstances in which a creditor may require a cosigner?

A: No, the rule in no way permits a creditor to obtain the signature of a nonapplicant spouse, or any person, in violation of Regulation B. The rule merely addresses whether a bank must give a cosigner notice when a person's signature is required on the credit obligation in order to perfect a security interest; whether a bank is in fact permitted to obtain such a signature, however, is controlled by Regulation B.

Q12(b)-5: *Hypothecating security.* Is a person who hypothecates security for another's obligation a cosigner?

A: No. A person who merely offers security for a loan, and in so doing signs a security agreement--but not the note, contract, or other document that would render the cosigner liable on the underlying obligation--is not a cosigner under the rule.

12(d) "Household Goods"

Q12(d)-1: *Basic definition of household goods.* What is included in the term "household goods"?

A: "Household goods" includes clothing, furniture, appliances, linens, china, crockery, kitchenware, and personal effects of the consumer and the consumer's dependents. The term does not include works of art, electronic entertainment equipment (other than one television and one radio), items acquired as antiques, and jewelry (except wedding rings).

Q12(d)-2: *Duplicates of household goods.* Can duplicate items of household goods be used to secure a consumer credit obligation?

A: The definition of "household goods" includes one television and one radio, but it does not similarly limit furniture or any of the other items included in the definition. Consequently, duplicates of any items included in the definition--other than duplicates of a television or a radio--are covered by the prohibition.

Q12(d)-3: *Personal effects.* What are "personal effects" for purposes of the "household goods" definition?

A: The term "personal effects" is to be narrowly construed and is limited to those items that an individual would ordinarily carry about on his or her person and possessions of a uniquely personal nature. This includes items such as personal papers, family photographs, or a family Bible. It does not include musical instruments, typewriters, firearms, bicycles, smowmobiles, cameras and camera equipment, sporting goods, and stamp and coin collections.

Q12(d)-4: *Appliances as fixtures.* What happens when appliances are considered "fixtures" under state law? Do they still come within the "household goods" definition?

A: No. Under some state laws, appliances are considered fixtures, and, as such, they become part of the realty. A bank that takes a security interest in realty in such cases would not violate the rule's prohibition against taking a security interest in household goods.

12(e) "Obligation"

Q12(e)-1: *Transactions over $25,000.* Is a credit transaction exceeding $25,000 excluded from the rule's requirements?

A: Unlike Regulation Z, the credit practices rule does not have any dollar amount cutoff for determining if a transaction is covered by the rule. However, the dollar amount of a transaction is one of the factors that can be considered in determining whether a transaction is for a business or a consumer purpose. (See Q12(a) -2.)

Section 227.13 **Unfair credit contract provisions**

Q13-1: *Retroactive effect--bank's own contract.* If a bank entered into a contract with a consumer prior to the effective date of the rule, and that contract contained a provision ultimately prohibited by the rule, may the bank enforce the provision?

A: Yes, the rule is not intended to have retroactive effect. (See, however, Q15-8.)

Q13-2: *Retroactive effect--purchased paper written before effective date of rule.* What happens if, after January 1, 1986, a bank buys paper from a third party that was written prior to the rule's effective date that contains a provision ultimately prohibited by the rule? May the bank enforce the provision?

A: Yes, the bank could enforce the provision since, at the time the paper was written, the provision was not prohibited.

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?

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.

13(a) Confession of Judgment

Q13(a)-1: *Basic definition; coverage.* What is a confession of judgment provision?

A: A confession of judgment is a contract clause in which the debtor consents in advance to allow the creditor to obtain a judgment against the debtor without giving the debtor prior notice or an opportunity to be heard in court. Such provisions are sometimes referred to as "cognovit" provisions. The Board's rule prohibits confessions of judgment that involve anticipatory waivers of procedural due process in the context of consumer credit obligations. It does not prohibit a debtor from acknowledging liability, or from otherwise entering into a negotiated settlement, after a legal action has been instituted.

The confession-of-judgment provision also does not affect a power of attorney in a mortgage loan obligation or deed of trust for purposes of foreclosure; nor does the provision affect a power of attorney given to expedite the transfer of pledged securities or the disposal of repossessed collateral, or to allow the prompt cancellation of insurance in an insurance-premium finance contract.

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.

13(b) Waiver of Exemption

Q13(b)-1: *Basic definition.* What is a waiver-of-exemption clause?

A: A waiver-of-exemption clause is a contract provision under which the debtor agrees to waive a property exemption provided by state law. Generally, state-property exemptions protect the debtor's home and other necessary items, such as furniture and clothing, from attachment or execution in order to satisfy the judgment debt. Under the rule, a waiver is permitted if it applies solely to property which was given as security in connection with the consumer credit obligation.

Q13(b)-2: *Non-purchase-money transactions.* Does a waiver of a state homestead exemption for a non-purchase-money security interest (such as a second trust or a home equity line of credit) violate the rule if the waiver applies only to the property that is subject to the security interest?

A: No, the waiver of homestead exemption provision in the rule is not violated in the non-purchase-money security interest situation, as long as the waiver only applies to the property that is in fact securing the transaction.

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)-1: *Basic definition.* What is an assignment-of-wages clause?

A: Under an assignment-of-wages clause the debtor assigns future wages to the creditor in the event of default. Unlike a garnishment, a court judgment is not required. Typically, once a debtor defaults, the creditor presents the assignment of wages to the debtor's employer, who then pays the agreed portion of the employee's wages directly to the creditor.

Q13(c)-2: *Exceptions.* Are there any exceptions to the assignment-of-wages prohibition?

A: Yes, the following types of wage assignments are permitted under the rule:

- assignments that are revocable at the will of the debtor;
- payroll deduction plans regardless of revocability;
- revocable preauthorized-payment plans (governed by the Electronic Fund Transfer Act, 15 USC 1693 et seq.) for electronic fund transfers to accounts from wages; and
- assignments of wages already earned at the time of the assignment.

Q13(c)-3: *Retroactivity.* Does the rule's prohibition against wage assignments apply to a loan agreement entered into by the bank prior to the effective date of the rule?

A: No. The rule does not invalidate or prevent enforcement of any wage assignments that were executed prior to January 1, 1986, the effective date of the rule, even through such wage assignments may cover wages payable or earned after the effective date.

Q13(c)-4: *Payment plans entered into after transaction begins.* What happens if, sometime after entering into a credit transaction, a consumer decides that he or she would like to make payments by payroll deduction or by having the payments deducted from wages and electronically transferred to the bank as payment on an account. Would this be considered a prohibited wage assignment under the rule?

A: While most consumers authorize payroll deduction plans and preauthorized-payment plans at the commencement of the credit obligation (as is contemplated by the rule), a consumer's enrolling in a payroll deduction plan or preauthorized-payment plan after the obligation has begun is permissible under the rule as long as it is done voluntarily by the consumer and at the consumer's request.

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)-1: *Definition of type of security interest prohibited.* What type of security interest is prohibited by the Board's rule?

A: The Board's rule specifically prohibits banks from taking nonpossessory security interests--other than purchase money security interests--in items defined as household goods. The purpose of the rule is to prevent consumers from losing basic necessities, which usually have little resale value to the creditor. The Board's rule does not prohibit a security interest in real property, a security interest in items not defined as household goods, or a possessory security interest (for example, a pawn or pledge) in a consumer's household goods.

Q13(d)-2: *Voluntary offerings of household goods.* What happens if a consumer voluntarily offers household goods as collateral on a non-purchase-money loan? Is the bank allowed to accept them?

A: No. The bank is prohibited from accepting household goods as collateral even if offered voluntarily.

Q13(d)-3: *Refinancings--original loan purchase money.* Assume that a bank entered into a loan transaction with the consumer--either before or after the effective date of the rule--that involved the taking of a purchase-money security interest in household goods. Assume further that the loan is refinanced. May the bank retain its security interest in the household goods? Does it make a difference if the new loan is for a larger amount? What if the loan is refinanced more than once?

A: The bank may retain its security interest in household goods even if the new transaction is for a larger amount, and without regard to how many times the loan is refinanced.

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.

Q13(d)-4: *Cross-collateral and future-advances clauses.* Does the rule prohibit a cross-collateral or future-advances clause in a security agreement for household goods which provides that the household goods would serve as security for other loans--both current and future--that the bank makes to the debtor?

A: A cross-collateral or future-advances clause would violate the rule's prohibition on taking a security interest in household goods where the clause is so broad in its applicability that it goes beyond loans that are refinancings or consolidations of the original loan (which contained the purchase-money security interest in household goods) and extends to other loans--whether current or future--that the bank makes to the debtor.

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)-6: *Bill-consolidation loans.* May Bank A, in making a bill-consolidation loan,

secure its loan with the security interest in household goods taken in the original credit transaction with Bank B (which was a purchase-money credit transaction) and which will be paid in full by the bill-consolidation loan?

A: Yes, no distinction is made under the rule between a consolidation loan made by a creditor who already holds the purchase-money security interest and a consolidation loan made by a different creditor.

Q13(d)-7: *Refinancing by sales contract vs. direct loan.* May a purchase-money security interest in household goods that is acquired by a sales contract be retained if that sales contract is consolidated or refinanced by a direct loan instead of another sales contract?

A: Yes, a bank may retain the security interest in the household goods even though the sales contract is consolidated or refinanced by a direct loan.

Q13(d)-8: *Documentation of purchase-money loan.* How is the purchase money nature of a loan to be documented?

A: The rule contains no specific documentation requirements. For purposes of evidencing compliance, however, the creditor may, for example, place a note or statement in the loan file attesting to the purchase-money nature of a loan; include a check-box in the contract which would indicate whether the transaction was a purchase-money loan; or reserve a place in the contract for indicating the purpose for which the proceeds will be used.

Q13(d)-9: *Appliances as fixtures.* When a bank takes a security interest in realty and, under state law, fixtures are part of the realty, does the bank violate the prohibition against taking a security interest in household goods?

A: No. See Q12(d)-4.

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**

Q14-1: *State-required cosigner notice.* If a state law also requires that a notice be given to a cosigner, how should a bank handle the dual requirement? Can the state-required notice substitute for the federal notice?

A: No, a state notice cannot be substituted for the federal notice, unless a state has obtained an exemption from the federal cosigner provision as provided for in section 227.16 of the rule. In those instances in which state law requires that a notice be given to cosigners, the bank may give both notices. The bank could, for example, include both notices in the documents evidencing the credit obligation or on a separate document, unless such would be prohibited by state law. (See Q14(b)-7 on how to handle language in the federal notice that is inconsistent with state law provisions.)

Q14-2: *Record retention.* Must a bank retain a copy of the cosigner notice it gives its

customers?

A: As a general matter, the rule does not contain any record-retention requirements. A bank should be able, however, to demonstrate that it has procedures in place that ensure that the cosigner notice is provided as required by the rule. (See Q14(b) -9, which discusses the inclusion of acknowledgment statements and signature lines on the cosigner notice.)

14(a) Prohibited Practices

Q14(a)-1: *Retroactivity of cosigner provision.* If a bank has entered into a loan transaction prior to January 1, 1986, in which a cosigner was involved, but at which time the cosigner notice was not required, can the bank attempt to collect against the cosigner after January 1, 1986, should the debtor default?

A: Yes, the bank can attempt to collect from the cosigner, since the rule does not apply retroactively to obligations entered into before the rule's effective date.

Q14(a)-2: *Purchase of third-party paper.* What happens if a bank, after January 1, 1986, purchases an obligation in which a cosigner notice should have been given under the rule, but was not? Would a bank's purchase of the obligation violate the rule? Would the bank's attempt to collect from the cosigner in such a situation violate the rule?

A: A bank that purchases an obligation in which the cosigner notice was not given would not be considered to have obligated the cosigner in violation of the rule. The purchasing bank would violate the rule in such a case, however, if it attempts to collect the debt from the cosigner.

14(b) Disclosure Requirement

Q14(b)-1: *Timing of cosigner notice.* At what point in the transaction must the cosigner notice be given?

A: The cosigner notice must be given to the cosigner before the cosigner becomes obligated on the transaction. This means that the cosigner should receive the notice prior to the event that makes the cosigner liable. In the case of open-end credit, the cosigner should receive the notice before becoming obligated for any fees or transactions on the account.

Q14(b)-2: *Oral vs. written notice.* May the cosigner notice be given orally to a cosigner?

A: No, the cosigner notice must be in writing.

Q14(b)-3: *Form of cosigner notice.* Does the cosigner notice have to be given in a form that the cosigner can keep?

A: No, the rule does not require that the cosigner notice be in a form that the cosigner can keep.

Q14(b)-4: *Acknowledgment of receipt.* Must the cosigner notice be signed by the cosigner?

A: The rule does not require that the cosigner sign the cosigner notice, or otherwise acknowledge its receipt. (See, however, Q14(b)-9 on permissible additions to the cosigner notice.)

Q14(b)-5: *Type-size, format requirements.* Does the cosigner notice have to be in a particular type size or format?

A: No, the rule does not specify a particular type size, style, or format. The rule does require, however, that the notice be clear and conspicuous.

Q14(b)-6: *Clear and conspicuous.* What is meant by the rule's requirement that the cosigner notice be "clear and conspicuous"?

A: A cosigner notice is clear and conspicuous if it is noticeable, readable and understandable. In those instances in which the notice is included in the body of the documents evidencing the obligation, special attention should be given to ensure that the cosigner notice is prominent or distinctive--that is, to ensure that it is noticeable and readable. Any modifications or additions to the notice should not jeopardize its clarity.

Q14(b)-7: *Modifying the cosigner notice; inconsistency with state law provisions.* Must a bank give a cosigner notice that is identical to that set forth in the rule, or can the bank modify the notice? What if language in the federal notice is inconsistent with state law provisions?

A: Under the rule, a bank must give a cosigner notice that is substantially similar to the one set forth in the rule; the notice does not have to be identical. Language in the notice may be deleted or modified to take into account the rights and responsibilities of cosigners under applicable state law. Language may be deleted or modified if it is inapplicable or if it inaccurately reflects the agreement with the cosigner. For example, the federal cosigner notice states that a bank can collect from a cosigner without first collecting from the borrower. It also states that a bank can garnish a cosigner's wages. If either of these statements is inaccurate under state law, then the inaccurate language may be deleted or modified. In addition, minor editorial changes can be made to the notice, such as changing the word "borrower" to "accountholder," or changing the word "debt" to "account," as appropriate.

Q14(b)-8: *Guarantee language in cosigner notice.* The cosigner notice in the rule states "You are being asked to guarantee this debt." If a bank does not consider the cosigner a guarantor, may the bank modify the notice?

A: The word "guarantee" is used in the cosigner notice in its generic or colloquial sense merely as a way to describe the fact that the cosigner has an obligation to repay the debt. The underlying contract--not the notice--is what defines or determines a cosigner's liability. However, if use of the term conflicts with or causes confusion under state law, language such as, "You are being asked to become liable on this debt" can be substituted.

Q14(b)-9: *Additional information included on notice.* If the cosigner notice is given on a separate document, may a bank place additional information on the document? May the bank print the notice on its letterhead?

A: Yes, a bank may print the notice on its letterhead. The bank may also include additional information on the document such as:

- the date of the transaction
- the loan amount
- name(s) and addresses
- the account number and other information describing or identifying the debt in question

acknowledgment of receipt language
- a signature line

As a general rule, any additional information should be concisely written so as not to detract from the notice's message. Moreover, care should be taken not to add unnecessary information to the notice.

Q14(b)-10: *Cosigner notice on credit application.* May the cosigner notice be placed on a credit application form?

A: Yes, the cosigner notice may be placed on a credit application form.

Q14(b)-11: *Documents of principal debtor vs. those of cosigner.* What happens if the document obligating the cosigner is separate from that obligating the principal debtor? May the cosigner notice be included in the document obligating the cosigner?

A: Yes. Where the cosigner is required to sign a separate document that obligates the cosigner, the cosigner notice may be included in that document.

Q14(b)-12: *Multiple cosigners.* What happens if there are two or more cosigners involved in a transaction? Must each one receive the cosigner notice?

A: Yes, each cosigner must be given the cosigner notice. However, since there is no requirement in the regulation that the cosigner notice be given in a form that the cosigner can retain (see Q14(b)-3), each cosigner does not have to receive his or her own notice. One notice that serves to notify all cosigners is sufficient.

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.

Q14(b)-15: *Placement of cosigner notice above signature line.* When the cosigner notice is included in the documents evidencing the consumer credit obligation, does the notice have to be located above the place reserved for the cosigner's signature?

A: The regulation does not specify the location of the cosigner notice when it is contained in the documents evidencing the consumer credit obligation. Since a bank must, however, provide the notice to the cosigner prior to the cosigner's becoming obligated on the consumer credit transaction, placement of the notice above the cosigner's signature line would seem wise.

Q14(b)-16: *Foreign language translation.* May a foreign language translation of the cosigner notice be provided?

A: Yes, a foreign language translation of the cosigner notice may be provided.

Q14(b)-17: *Contract in foreign language.* What if the underlying contract is in a foreign language? Must the cosigner notice be in the same language?

A: Yes, the cosigner notice should be provided in the same language as that used in the underlying contract.

Section 227.15 **Unfair late charges**

Q15-1: *Basic definition of unfair-late-charges prohibition.* What does the rule prohibit with regard to the imposition of late charges?

A: Under the rule banks are prohibited from levying or collecting 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.

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 of 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.

Q15-3: *Multiple late charges assessed on payment subsequently paid.* Assume the following: A consumer's payments are $40 a month. The consumer makes his or her February payment in full, but makes it late. The bank assesses a $5 late charge. The consumer makes the March payment of $40 on time, but fails to pay the $5 late charge. The bank uses part of the March payment to pay off the outstanding late charge, and then considers the March payment deficient. May the bank then assess another late charge?

A: No, the bank cannot assess another late charge since the March payment was made in full and on time.

Q15-4: *Subsequent payment made late.* Assume the same facts as those detailed in Q15-3, but that the consumer makes the March payment of $40 late. May the bank assess another late charge?

A: Yes, the bank may assess another late charge since the consumer failed to make the March payment on time.

Q15-5: *Partial payment short more than amount of outstanding late fee.* Assume the same facts as those detailed in Q15-3, but that the consumer only pays $20 of the $40 March payment. May the bank assess another late charge?

A: Yes, the bank may assess another late charge since the consumer failed to make the March payment in full.

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.

Q15-6: *Open-end credit plans.* Does the rule's late-charges provision come into play in an open-end credit plan that involves a periodic statement that reflects a late charge upon its imposition, as well as a minimum payment amount that serves to inform the consumer of the full amount due to remain current on the account?

A: No, in an open-end credit plan where the bank discloses late charges to the consumer as they are imposed and informs the consumer of the full amount that the consumer must pay for the applicable period in order to remain current on the account, the rule's provision on late charges does not come into play.

Q15-7: *Interest limitations.* Does the rule prohibit a bank from imposing interest on an unpaid late fee?

A: The rule does not address the issue of whether interest may be imposed on unpaid late fees.

Q15-8: *Retroactivity of unfair-late-charges prohibition.* Does the unfair-late-charges prohibition reach obligations entered into prior to the rule's effective date?

A: Yes. Unlike the other provisions in the rule which do not affect obligations entered into prior to the rule's effective date, the unfair-late-charges prohibition applies to all outstanding consumer credit obligations regardless of when they were entered into.

Section 227.16 **State exemptions**

Q16-1: *Applicability of exemption granted by another agency.* If the FTC grants an exemption from a provision(s) of its rule, are banks, which are subject to the Board's rule, able to take advantage of that exemption or must the state apply to the Board for an exemption?

A: Exemptions that are granted by the FTC apply only to those creditors that are covered by that agency's rule. The state agency would have to apply to the Board for an exemption for banks under the Board's rule.

16(a) General Rule

Q16(a)-1: *Who may request an exemption.* May a private individual or a bank apply for an exemption?

A: No, neither private individuals nor banks may apply for an exemption from the rule's provisions. The rule provides that "an appropriate state agency" may apply for an exemption.

Q16(a)-2: *Criteria for exemption.* When may a state agency apply for an exemption?

A: A state agency may apply for an exemption from the rule's provisions:

- when there is a state requirement or prohibition in effect that applies to any transaction(s) to which a provision of the rule applies; and
- when the state requirement or prohibition affords a level of protection to consumers that is substantially equivalent to, or greater than, the protection afforded by the rule's provision.

16(b) Applications

Q16(b)-1: *Board guidelines on exemption applications.* Does the Board have guidelines for applying for an exemption from the rule?

A: Yes, a state agency applying for an exemption should use the procedures set forth in appendix B to Regulation Z. These procedures indicate: where an application should be filed; what should be contained in the application; what types of supporting documents should accompany the application; factors on which the Board bases its determination; the consequences of favorable and adverse Board determinations; and the procedures involved in revoking an exemption.

Q16(b)-2: *Deadline for exemption application.* Is there a time by which a state agency must submit its exemption application in order to receive consideration? Must it be submitted by the effective date of the rule?

A: There is no deadline for submitting an exemption application. Applications can be submitted anytime before or after the effective date of the rule.

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. open-end credit, the cosigner notice must be given before the cosigner becomes obligated for any fees or transactions.