

**Introduction**

A Credit Practices Rule was adopted by the OTS and 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. The Rule is contained in 12 CFR 535 for savings associations, and Subpart B of Regulation AA (12 CFR Part 227) for banks. The Rule became effective on January 1, 1986.

The Rule prohibits financial institutions from using: (1) certain provisions in their consumer credit contracts; (2) a certain late charge accounting practice; and (3) deceptive cosigner practices. The Rule also requires that a disclosure notice be given to a cosigner prior to becoming obligated. Finally, the Rule prohibits financial institutions from enforcing in purchased contracts the same provisions that institutions are prohibited from including in their own consumer credit contracts.

**Scope**

The Rule applies to the consumer credit contracts of all financial institutions and their subsidiaries other than those contracts that are 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 a natural person who seeks or acquires goods, services, or money for personal, family, or household purposes. There is no monetary limitation on the coverage of the Rule.

**Prohibited Contract Provisions****Confession of Judgment**

A confession of judgment is a provision (which may also be known as a cognovit, or warrant of attorney) in which the borrower waives the right to notice and the opportunity to be heard in the event

of a suit to enforce an obligation. [§535.2 (a)(1)]

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 or given to expedite the repossession or transfer of collateral
- confessions in Louisiana for the purpose of executory process

**Waiver of Exemption**

A waiver of exemption is a provision in which the consumer relinquishes 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 with respect to property that will serve as security for an obligation. [§535.2(a)(2)]

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

**Assignment of Wages**

An assignment of wages is a provision which gives the institution the right to receive the consumer's wages or earnings directly from the consumer's employer. [§535.2(a)(3)]

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 consummation of the loan, for the purpose of making each payment
- an assignment of wages that have been earned at the time of the assignment



- garnishment

Earnings are defined as compensation paid or payable for personal services rendered or to be rendered by the consumer, whether denominated as wages, salary, commission, or bonus, including periodic payments pursuant to a pension, retirement, or disability program. [§535.1(f)]

### Household Goods Security Interests

A nonpossessory security interest in household goods is prohibited unless such goods are purchased with credit extended by the financial institution. [§535.2(a)(4)]

The following are not prohibited:

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

The term "household goods" is defined as meaning only the clothing, furniture, appliances, linens, china, crockery, kitchenware, and personal effects of the consumer and consumer's dependents. [§535.1(g)]

The following are not household goods:

- works of art
- electronic equipment (other than one television and one radio)
- items acquired as antiques (they must be over one-hundred years of age in order to be considered antiques), including such items that have been repaired or renovated without changing their original form or character
- jewelry (other than wedding rings)
- fixtures, automobiles, boats, snowmobiles, cameras and camera equipment (including darkroom), pianos, home workshops, and the like.

### Prohibited Practices

#### Pyramiding of Late Charges

"Pyramiding" of late charges is a prohibited practice. Pyramiding is an accounting method which results in the assessment of multiple delinquency charges due to a single delinquent payment. For example, when a borrower is late on a payment, the lender applies a late charge to the payment, when it is received, which then results in a short or insufficient payment. A subsequent payment is received on time, but since the previous payment is considered short a late charge is again applied. This is perpetuated until the borrower either pays the late charge separately or until the loan matures. The examiner should not confuse this with a situation 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 paid in full. [§535.4(a)]

#### Cosigner Deception

The institution may not misrepresent the nature and extent of a cosigner's liability to any person. [§535.3(a)(1)]

#### Cosigner Disclosure (§535.3(b)(1))

The 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 following statement:

##### Notice of Cosignor

*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 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.*

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.

A Cosigner is defined as (§535.1(c)):

- 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 is a cosigner whether or not designated as such in the contract.
- For open-end credit, a cosigner is 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 who 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 either in the Federal Trade Commission Act or Regulation AA, or the OTS Regulations.

## Administrative Enforcement

The regulation is to be enforced for banks through Section 8 of the Federal Deposit Insurance Act (12 USC 1818), and for savings associations through Section 5 of the Home Owners' Loan Act (15 USC 1464), Section 407 of the National Housing Act (15 USC 1730), and Section 5 (1) and 17 of the Federal Home Loan Bank Act (15 USC 1457). In addition, a supervisory agency may enforce compliance through any other authority conferred on it by law. [15 USC 57a(f) (4)]

## Examples of Prohibited Contract Provisions

### Confession of Judgment

1. 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.
2. You and any Co-Maker, jointly and severally, authorize the Prothonotary, Clerk or any attorney of any court of record to appear for you and any Co-Maker and confess judgment in our favor or in favor of any other holder of this Note. Judgment of confession may be entered either prior to or after an event of default, as often as necessary, for such sums as are or any become due on this Note, with costs of suit and 20% added as actual and reasonable attorney's fees. You and any Co-Maker agree to waive, to the extent permitted by law, all rights of appeal, appraisalment, stay of execution and exemption now or later in force. If a copy of this Note is led 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.

3. You and any Co-Maker, jointly and severally, authorize the Prothonotary, Clerk and any attorney of any court of record to appear for you and any Co-Maker 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% added as actual and reasonable attorney's fees. You and Co-Maker agree to the extent permitted by law, all rights of appeal, appraisal, stay of execution and exemption now or later enforce. 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**

1. I waive my homestead exemption.
2. In consideration of the credit extended, Mortgagor waives and relinquished, 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, 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 which 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.
3. 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.

4. 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.

### **Examination Objectives**

To determine if the institution has established an effective system to ensure that it:

- does not originate, acquire, or enforce contracts which contain prohibited provisions
- does not "pyramid" late charges
- does not engage in deceptive cosigner practices
- provides the required disclosure to cosigners prior to becoming obligated.

To determine whether the institution's contracts contain prohibited provisions in their originated or purchased credit contacts.

To determine whether the institution used impermissible late charge accounting practices.

To determine if the institution advised cosigners prior to becoming contractually liable of the nature and extent of their liability.

To determine if the institution provides the required notices to cosigners prior to becoming obligated, or in case of open-end credit plans, prior to the time the cosigner becomes obligated for fees or transactions on the account.

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 institution in extending con-

sumer credit for the following prohibited contract provisions:

- a. Confessions to Judgment - which is a waiver of the right to notice and the opportunity to be heard in the event of a suit on the obligation. [§535.2(a)(1)]
  - b. Waiver of Statutory Property Exemption - which is a provision that waives the consumer's statutory right to protect his or her home (known as the homestead exemption), possessions, or wages unless given solely on property that will serve as security for the obligation. [§535.2(a)(2)]
  - c. Assignment of Wages - which is a provision that gives the institution the right to receive the consumer's wages or earnings directly from the consumer's employer. [§535.2(a)(3)] However, such an assignment is permitted if:
    - It is revocable, at will, by the consumer.
    - It is a payroll deduction plan or preauthorized payment plan (whether or not revocable by the consumer), commencing at consummation, for the purpose of making loan payments.
    - It applies only to wages or earnings already earned at the time of the assignment.
  - d. Blanket Security Interest in Household Goods - which is a provision which allows the institution to hold as collateral the clothing, furniture, appliances, and the personal effects of the consumer's dependents. [§535.2(a)(4)]
2. Determine through discussions with management and staff if the institution attempts to enforce confessions of judgment, assignments of wages, security interests in household goods, or waivers of exemption in originated or acquired contracts.
  3. Review the institution's collection policies, procedures, and practices to ensure that staff members are not using an assignment of wages except where permissible. [§ 535.2(a) (3)]
  4. Judgmentally sample an adequate number of loan files to ensure that prohibited contract provisions are not included in contracts (or related documents) originated, 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 assignments of wages. [§535.2(a)(3)]
  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. [§535.4(a)]
  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 in loans it originated or acquired. [§535.3(a)]
  8. Determine through discussions with management and staff if there is evidence that the institution engages in prohibited cosigner practices (i.e., misrepresentation of a cosigner's liability and contractually obligating cosigners prior to informing them of their liability).
  9. Determine through discussions with management and staff of the institution, whether the nature and extent of a cosigner's liability is properly represented to cosigners prior to the time signatures are obtained. [§535.3(b)]
  10. Judgmentally sample the documents evidencing the credit obligation for the required notice to cosigners. [§535.3(b)(1)]
    - 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.

- If the notice to cosigners is contained in a separate document also:
  - Interview applicable employees to determine if they are aware that the notice must be provided prior to the cosigners becoming obligated.
  - Review the institution's policies, procedures, and practices to ensure that staff members are aware that cosigners must be provided with the notice prior to becoming obligated.

**References***Laws*

15 U.S.C. 41 Federal Trade Commission Act et seq.

*Regulations*OTS Regulations:

12 C.F.R. Part 535 Prohibited Consumer Credit Practices