

MILITARY PAYDAY

The Impact on Lending

BY CARL G. PRY, CRCM

ON OCTOBER 26, 2006, PRESIDENT GEORGE W. BUSH SIGNED INTO LAW THE JOHN WARNER NATIONAL DEFENSE AUTHORIZATION ACT FOR FISCAL YEAR 2007.¹ The primary purpose of this legislation is to fund national defense and various domestic and international construction initiatives, but included is Section 670, titled “Limitations on Terms of Consumer Credit Extended to Service Members and Dependents,” also called the payday lending law.² Included in the act in response to a Department of Defense (DOD) study, this provision is intended to remedy abusive practices associated with payday lending to military personnel. The provision is also known as the Talent Amendment or Talent-Graves Amendment because it was introduced by Congressman Sam Graves and sponsored in the Senate by Senator Jim Talent, both of Missouri.

The law places new restrictions and disclosure requirements on consumer credit offered to certain members of the military and their dependents. You may have seen headlines when the law was passed that the annual percentage rate on payday loans to servicemembers will now be limited to 36 percent and thought nothing more of it; perhaps you don't offer such products in your bank or have much of a military customer base. However, the application of the statute and coming regulations may be far broader than you thought and have unintended consequences that affect many types of consumer credit that you offer. Therefore it is important to understand a few specifics of the law and its potential ramifications.

One pivotal choice Congress made was selecting the DOD as the agency that will “prescribe regulations to carry out this section.”³ Although the DOD must consult with the primary banking regulators, Federal Trade Commission (FTC), National Credit Union Association (NCUA), and the Treasury Department when drafting its rules, add the DOD to the list of agencies that will now have a say in banking regulation. As this will be the DOD's first venture into drafting regulations affecting banking, the risk is that DOD's rules will not be sufficiently clear or appropriate in scope.

On December 5, 2006, the DOD issued a notice with request for comments to the public,⁴ soliciting input into its rulemaking

process (comments were due February 5, 2007). The legislation takes effect on October 1, 2007, or an earlier date the Secretary of Defense may prescribe. At this point it is unclear what would happen should final regulations not be issued by that date.

In the meantime, what should we pay attention to? Depending on how the regulations are crafted, there are aspects of the new rule that have the potential to impact many types of loans, not just traditional payday loans targeted to members of the military. During this period of uncertainty, when we do not know how the final regulations will look, be sure to consider the possibilities and plan your bank's response to the following potential issues.

What Loans Are Covered? “Consumer Credit” Must Be Clearly Defined

Much of the press coverage of the law thus far focuses on its supposed scope of “payday lending,” where that term traditionally has meant short-term loans at high rates of interest. However, the statute leaves up to the DOD the precise definition of what loans will be covered; it provides that the definition of “consumer credit” will have “the meaning provided for such term in regulations prescribed under this section,”⁵ which gives the DOD great latitude.

Without a clear and unambiguous definition of what



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precisely will be covered, banks will have no choice but to construe the term broadly. Even though the law's intent may be to restrict "payday lending," a broad definition could include credit cards, student loans, personal unsecured loans, mortgage refinancings, and even overdraft protection plans. If this happens, the result could be a reduction in the availability of these credit products and services due to the harsh penalties for violations. This would accomplish precisely the opposite of the statute's intent. The hope is that the DOD will be specific in limiting coverage to small, short-term loans.

Ideally, the DOD will rely heavily on the Truth in Lending Act (TILA)⁶ and the Federal Reserve



Board's Regulation Z' when defining "consumer credit." Reg. Z clearly defines such terms as "consumer credit" and "creditor," and bankers are familiar with those definitions. Under Reg. Z, consumer credit means "credit offered or extended to a consumer primarily for personal, family, or household purposes."⁸ Paralleling these definitions would certainly ease the compliance burden and help prevent ambiguity.

"Residential mortgage" loans are excluded from the definition of "consumer credit" in the statute. This term needs clear definition, as well. Does this mean simply a loan secured by a residence, or is it more specific? Reg. Z defines a "residential mortgage transaction" as a loan with the purpose of purchasing or constructing the consumer's primary dwelling, which is secured by that dwelling.⁹ It is not apparent in the payday lending law that only purchase money residential loans should be excluded, but this is a logical inference because the exclusion immediately following in the statute applies only to purchase money loans for automobiles or other personal property. Again, without a clear definition, many residential loan products could be unintentionally covered.

Will Existing Loans and Accounts Be Covered?

One of the most critical issues is whether the regulations will exempt loans and accounts in existence prior to the regulations' effective date. The statute does not address this point, but applying the rules to existing loans and accounts would be difficult at best and impractical and unworkable at worst. First, creditors would be forced to determine whether any existing borrowers (which could number in the thousands or millions) are covered under the provisions of the law. Then creditors would be forced to make difficult decisions regarding loans held by those determined to be covered. The outcomes could vary widely, from forced modifications of existing loans to closing some accounts (due to the stringent penalty provisions, among other reasons). This would have to be accomplished before the October 1, 2007 effective date of the statute's provisions. It is even possible that existing loans, if covered, could become illegal upon the law's effective date. These outcomes surely run counter to the stated goal of the legislation, which is to make beneficial and responsible credit available to active-duty servicemembers.

It is important to remember that there are protections already in place for existing loans. Loans and accounts to active-duty servicemembers are covered by the protections of the Servicemembers Civil Relief Act (SCRA),¹⁰ which caps the interest rate on all covered extensions of credit at 6 percent during a period of active duty, provided the debt is incurred before the servicemember's period of active duty. Due to this fact and the difficulties of applying the new law retroactively, presumably the DOD will not do so. But at this point there are no guarantees.

To Whom Does the Law Apply?—"Covered Member" Must Be Clearly Defined

The payday lending law applies to both covered servicemembers and their dependents. A "covered member" is defined in the statute as "a member of the armed forces who is (a) on active duty under a call or order that does not specify a period of 30 days or less; or (b) on active

guard and reserve duty."¹¹ How will a creditor be able to determine, verify, and monitor a consumer's eligibility for the law's protections? Must the lender take a consumer's word for it or will there be a standard of proof? The statute contains no guidelines here; it is hoped that the DOD will provide a methodology for doing so.

Because the statute is also silent regarding whose duty and responsibility it should be to ascertain coverage under the law, it would make sense for a consumer eligible for the law's protections to indicate to a creditor that he or she is covered. If lenders are made responsible for asking every consumer whether he or she is currently an active duty member of the armed forces (or a dependent of one, which would entail describing what it means to be a "dependent"), a question would have to be included in every application and initial conversation between a creditor and consumer. Inquiries and applications from indirect sources (like brokers and dealers) would have to be revised. Ideally the DOD's regulations will place the responsibility to notify creditors of coverage on covered servicemembers and their dependents.

The SCRA has been on the books a long time (in 2003 it was renamed from the "Soldiers' and Sailors' Civil Relief Act of 1940") and as mentioned above, provides protections for servicemembers. To obtain the protections of the SCRA, servicemembers must present to creditors documentation (such as a copy of military orders) demonstrating active-duty status. Creditors can then confirm that information by submitting an inquiry to the Department of Defense's Defense Manpower Data Center. This also allows a creditor to monitor a consumer's continuing eligibility.

Even though there are no provisions in the payday lending law regarding verification of a consumer's claim of coverage, it would be impractical (and unreasonable) to require a creditor to accept a consumer's claim of coverage without some sort of proof. Ideally the DOD will incorporate a provision similar to the SCRA methodology into its regulations allowing for verification.

Similar challenges exist for dependents covered under the payday lending law. A covered "dependent" is defined in the statute as "(a) the member's spouse; (b) the member's child ... or (c) an individual for whom the member provided more than one-half of the individual's support for 180 days immediately preceding an extension of consumer credit covered by this section."¹² Unfortunately, the statute is once again silent regarding responsibility, notification requirements, or procedures regarding claims of dependent coverage. Again, ideally the burden should be placed on a covered dependent, as it would be extremely burdensome to require creditors to ask each consumer who is a party to a lending transaction whether he or she is a dependent of an active-duty servicemember. This would require detailed explanations of relevant terminology to consumers (such as what constitutes "support"); in some cases a consumer may be unclear as to his or her coverage status. There are no provisions for misplaced reliance on a customer's word. For instance, what happens to a loan containing terms that would violate the new regulations made to a dependent making no claim of coverage but who is in reality covered? Is the loan void? The DOD must answer these types of questions in its new regulations.

One of the statute's most controversial provisions prohibits a creditor from using "a check or other method of access to a deposit, savings, or other financial account maintained by the borrower."¹

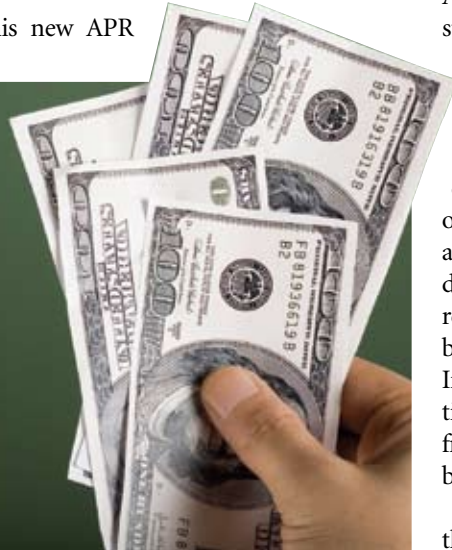
What Is the Definition of “Annual Percentage Rate”?

Under the new law, the annual percentage rate (APR) of a covered extension of credit cannot exceed 36 percent. That is simple and understandable enough. But does this APR mean what bankers traditionally understand APR to be? As defined, “the term ‘annual percentage rate’ has the same meaning as in section 107 of the Truth in Lending Act ... as implemented by regulations of the Board of Governors of the Federal Reserve System. For purposes of this section, such term includes all fees and charges, including charges and fees for single premium credit insurance and other ancillary products sold in connection with the credit transaction, and such fees and charges shall be included in the calculation of the annual percentage rate.”¹³

This definition has the potential for serious confusion. Although it begins by paralleling Reg. Z, it goes further, including “all fees and charges,” as well as “other ancillary products sold in connection with the credit transaction.” Fees excluded from the APR under Reg. Z would be included in the payday provision’s APR, resulting in two different figures. It will be important for creditors to understand exactly how to determine and calculate the APR mandated by the statute. It would be extremely helpful for the DOD to include a list of typical fees to be included in this APR (including both “charges and fees” and “ancillary products”), perhaps even with representative examples, as a guide to performing the calculation.

Simply defining how this new APR

A dual APR disclosure will surely prove confusing, rendering both essentially meaningless.



should be calculated will not be enough, however. Disclosing the APR for open-end lines of credit may present a serious problem. The statute states that the “maximum allowable amount of all fees” be “expressed and disclosed to the borrower as a total amount and as a percentage of the principal amount of the obligation, at the time at which the transaction is entered into.”¹⁴

How exactly will this be done? Among the questions to be resolved:

■ Should this be based on the total amount of credit authorized or the balance in the account at any one particular time? For lines of credit, the maximum amount of fees often can’t be determined at the time the transaction is entered into. When it can be determined, a workable solution to disclose this as a percentage of the total authorized amount could possibly be prescribed. But this must be made clear.

■ How should this be handled in light of the 36 percent cap? The maximum rate could easily be exceeded in a line of credit that carries

a low balance. For example, what would be the impact of a covered overdraft protection line that carries a low or even zero balance but is assessed a fee during a billing period? How would the APR be disclosed in that instance? To complicate matters, at times the precise percentage may not be known until the end of the billing period. Hopefully the “maximum allowable amount of all fees” will be based upon the maximum allowed amount of a line of credit.

How Will Mandatory Disclosures Be Handled?

Required disclosures to covered servicemembers must contain (a) a statement of the annual percentage rate of interest applicable to the extension of credit; (b) any disclosures required under the Truth in Lending Act; and (c) a clear description of the payment obligations of the member or dependent, as applicable.¹⁵

Disclosure of the APR mandated by the statute must be made *in addition* to that required under Reg. Z, which, as stated above, will typically be a different number. Reg. Z requires also that disclosures to consumers be “clear and conspicuous.” A dual APR disclosure will surely prove confusing, rendering both essentially meaningless. How will the competing rates be explained? Clear instructions in the DOD’s regulations to properly disclose the APR mandated by the statute along with explanations on how to differentiate between the two disclosed APRs will be necessary. In addition, the DOD ideally will clearly instruct lenders how to deliver written disclosures, as part of existing TILA disclosures or separately, for example.

The statute requires that the APR disclosure be made both “orally and in writing before the issuance of the credit.”¹⁶ It will be important for the DOD to specify the requirements for this oral disclosure, particularly regarding its timing (is there a specific meaning of “before the issuance of credit”?). It is fairly straightforward to provide an oral disclosure in a transaction where a covered servicemember or dependent has personal contact with the creditor. But how should the requirement be met where there is no personal contact between the borrower and lender (transactions conducted solely through the mail or Internet, for example) or in transactions conducted through third parties, such as brokers or agents? Ideally the DOD will provide exceptions from the oral disclosure requirement for transactions where contact between borrower and lender is impractical or impossible.

Left unaddressed is whether marketing efforts are included in the law’s coverage, although a plain reading of the statute does not specifically include them. But if the DOD decided that they were indeed covered, the dual-APR disclosure methodology will prove to be confusing here, too. It will not be clear to creditors when to include the payday lending law APR in advertisements, especially regarding products that are available but not targeted specifically to active-duty servicemembers. Must both APRs therefore be included in all consumer loan advertisements due to the possibility that a covered servicemember or dependent might respond? Ideally the DOD’s regulations will exclude marketing efforts or at least provide specific guidelines if they are included.

Limitations Placed on Covered Extensions of Credit

In the Senate, the original purpose of the military payday lending provision was narrow: cap interest rates on payday loans to military personnel. But in committee, additional limitations on certain extensions of credit were added to curb what were considered to be predatory

practices. There were no hearings or input from other Congressional committees or regulators and little public debate before the provisions were added. Thus, little consideration was given to intended or unintended consequences of these provisions.

Included are prohibitions against most types of refinancings done by the same creditor, such as where the same creditor “rolls over, renews, repays, refinances, or consolidates any consumer credit extended to the borrower.”¹⁷ Of course this excludes certain residential mortgages and secured automobile and personal loans (per the statutory definition of consumer credit). This could limit many beneficial products traditionally made available to servicemembers and their dependents. Offers to renew or consolidate credit obligations in order to avoid penalties or to avoid repossession or foreclosure would be precluded, for example. It is also not clear whether this prohibition is intended to bar workout arrangements or other types of loans intended to assist a borrower in recovering from a difficult financial position. It is hoped that the DOD carefully considers the impact of prohibitions on covered servicemembers and their dependents and applies fair regulations to allow beneficial extensions of credit to them.

Prepayment fees or penalties are also prohibited, which could have an unintended adverse effect. Products are often offered with penalties for prepayment as a trade-off for a lower interest rate or fee structure. Again, the SCRA already provides protections for active-duty servicemembers, particularly for residential loans. This prohibition will ideally be carefully crafted in the regulation to protect beneficial consolidations to covered servicemembers and their dependents.

One of the statute’s most controversial provisions prohibits a creditor from using “a check or other method of access to a deposit, savings, or other financial account maintained by the borrower.”¹⁸ It is common for a creditor to offer a rate discount in return for the borrower’s utilizing automatic payment from a deposit or other account at the same bank. These auto-debit provisions benefit both borrower and creditor, and it seems contrary to the statute’s intent to disallow these types of features under the guise of protecting servicemembers and their dependents.

Severe Penalty Provisions Could Limit Availability of Products and Services

The payday lending law imposes strict penalties for violations, including misdemeanor fines and potential imprisonment for knowingly violating the law. These types of penalties are rarely present in consumer lending laws and regulations; banks will be extremely sensitive to the risks and as a result may pull back their offerings to covered members of the military.

The law further provides that “any credit agreement, promissory note, or other contract prohibited under this section is void from the inception of such contract.”¹⁹ This is different from a voidable provision penalty, where only the offending part of the agreement is eliminated; voiding the entire loan agreement for even a small technical violation is a harsh penalty (as well as a safety and soundness risk), so compliance with the new regulations will be critically important.

Again, the ultimate result may be banks’ erring on the side of caution. Some creditors may choose to restrict their offerings or simply not offer products and services at all to servicemembers and their dependents to avoid the risk of having an offending provision void the entire loan agreement. The hope is that the DOD will carefully delineate what violations will result in what specific penalties and pos-

sibly provide some relief in the form of corrective action procedures for unintentional or minor violations.

Preemption Provisions Are Unclear

According to the statute, any inconsistent state or federal law, rule, or regulation, including any state usury law,²⁰ that is inconsistent with the provisions of the payday lending law is preempted. This sounds simple, but there are some issues that must be resolved. One is exactly which state’s usury law is preempted, depending on the situation. For example, if a covered servicemember is stationed domestically in a state different from his or her residence, does preemption apply to the state of the servicemember’s given address, the state of the servicemember’s actual location, or both? The hope is that the DOD will specify these preemption principles in detail in its regulations so that lenders clearly understand their responsibilities and limitations regarding interest rates and other loan characteristics.

If you think this discussion sounds like a wish list or a series of pleas to the Department of Defense, you would be correct. Many of these comments (and more) have been made to the DOD in the form of comment letters from the ABA and others in the industry. It is hoped that the DOD responds to these suggestions responsibly and crafts appropriately narrow regulations. But if it does not, the key will be to be prepared for how the changes will impact your bank, your customers, and your products. BC

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Endnotes

¹Public Law 109-364

²To be codified in 10 U.S.C. Ch. 49, Section 987

³10 U.S.C. 987(h)(1)

⁴71 FR 70512; December 5, 2006

⁵10 U.S.C. 987(i)(6)

⁶15 U.S.C. 1601

⁷12 C.F.R. 226

⁸12 C.F.R. 226.2(a)(12)

⁹12 C.F.R. 226.2(a)(24)

¹⁰U.S.C. App. Section 501 et seq.

¹¹10 U.S.C. 987(i)(1)

¹²10 U.S.C. 987(i)(2)

¹³10 U.S.C. 987(i)(4)

¹⁴10 U.S.C. 987(h)(2)(C)

¹⁵10 U.S.C. 987(c)(1)

¹⁶*Id.*

¹⁷10 U.S.C. 987(e)(1)

¹⁸10 U.S.C. 987(e)(5)

¹⁹10 U.S.C. 987(f)(3)

²⁰10 U.S.C. 987(d)(1)