

DOD Credit Rule May Limit Lending To Service Members

Law360, New York (January 22, 2015, 2:20 PM ET) --

In late September last year, the U.S. Department of Defense proposed sweeping changes to its rule that implements the Military Lending Act. The proposed rule would significantly expand the scope of the DOD's current regulation by applying the MLA to new types of creditors and credit products, including open-end credit with special rules for credit cards. The comment period ended on Dec. 26, 2014, and the DOD received more than 500 comment letters from industry, consumer groups, service members and others. Given the wide range of views expressed on the proposed rule, the DOD will have difficult decisions to make in sorting out the best approach to take in the final rule.

Background

The MLA was enacted in 2006 and established new provisions governing credit extended to active duty service members and their dependents and spouses ("covered persons"). In broad terms, the MLA: (1) established a maximum annual percent rate of 36 percent (including fees and charges) that can be charged to covered persons for consumer credit transactions; (2) prohibits the use of arbitration or other "onerous legal notice provisions" when disputes arise; (3) provides that any credit contract that contains provisions prohibited under the law is void at inception; and (4) requires that certain disclosures be given orally and in writing to covered persons.

The DOD has the sole authority to promulgate regulations under the MLA, although the statute provides that the department must consult with certain sister federal agencies, including federal banking agencies and the Consumer Financial Protection Bureau, not less than every two years following issuance of the implementing regulations. The DOD issued a final rule in 2007, following extensive outreach and study. The DOD's 2007 final rule covered three types of loans: payday loans, vehicle title loans and refund anticipation loans, based on findings by the department that these loans shared several predatory characteristics, including: (1) lending without regard to the borrower's ability to repay the loan; (2) excessive fees and excessive interest rates; (3) balloon payments with unrealistic payment terms; (4) wealth stripping related to repeated rollovers; and (5) fraudulent or deceptive practices.

Proposed Rule



Leonard N. Chanin

The proposed rule would dramatically expand the scope of the credit products covered by the DOD rule and would cover far more closed-end loans as well as open-end accounts. (Under the statute, mortgage loans and home equity lines of credit, as well as transactions to purchase motor vehicles or personal property, secured by such vehicles or property, are exempt from coverage.) For example, the proposal would cover installment loans and other closed-end loans, and open-end plans, such as overdraft lines of credit and credit cards. Special rules would apply to the calculation of a military annual percentage rate ("MAPR") for covered transactions. However, the proposed definition of the MAPR would require the inclusion of fees that are not required for the APR calculation under Regulation Z.

The proposed rule would impose significant limitations on the terms of credit extended to active duty service members and their spouses and dependents. Specifically, the proposed rules would, among other things: (1) prohibit borrowers from submitting disputes to arbitration or to be subject to other "onerous legal notice provisions" in the case of a dispute; (2) prohibit lenders from limiting the ability of borrowers to prepay an obligation or imposing a fee for prepaying credit, in part or in full; (3) provide that if a credit contract contains provisions prohibited under the law, the contract is void at inception; (4) prohibit the imposition of a MAPR in excess of 36 percent; and (5) require the provision of new disclosures in writing and orally before/at the time an account is opened/loan is consummated. Creditors would have to determine whether a borrower is an active duty service member or a spouse or dependent by accessing information via a DOD database, or using another method to make such a determination.

The MAPR has been the subject of much discussion, and some confusion. Most importantly, the MAPR is not simply the interest rate on the loan. That is, the MAPR includes a number of fees, both finance charges and nonfinance charges. Thus, even if a lender's interest rate is 36 percent or less, that does not mean the loan would be permissible under the proposed rule. Lenders would be required to perform a separate calculation of the MAPR to determine if the loan exceeds the 36 percent MAPR. The calculation could prove to be particularly challenging for open-end credit transactions, because the MAPR is calculated for each billing cycle. For example, if certain fees are imposed in a specific cycle, and the consumer has a "low" balance, the MAPR may be exceeded; this could require the creation and use of a new calculation system along with controls and a crediting/rebate process. Furthermore, by resurrecting the historical APR that Regulation Z once required, the anomalies associated with that calculation will also arise under the DOD's proposed rule.

For all covered credit transactions, the assessment of the following fees or charges would have to be included in the MAPR calculation: (1) fees for credit insurance premiums, debt cancellation or debt suspension agreements; (2) fees for "credit-related ancillary products" sold in connection with the credit transaction at consummation or upon account opening; (3) finance charges that are "associated with" the consumer credit, even if the charge would not be considered a finance charge under Regulation Z; (4) application fees; and (5) "participation" fees, including annual fees. For credit card accounts, certain fees would be excludable from the MAPR calculation under the proposed rule, but only if the credit card issuer establishes that the fee is "bona fide." To qualify as a bona fide fee, the fee would have to meet an elaborate "reasonable and customary" test that would require credit card issuers to also determine whether their fees are "like-kind" fees by comparing their fees to fees typically imposed by other issuers for the same or a substantially similar product or service. Several industry commenters told the DOD in comment letters that this approach is unworkable in practice.

In addition, the proposed rule would create a safe harbor under which lenders could use a DOD database to determine whether a consumer is a covered person. Under the proposed rule, if a lender has "actual knowledge" that the consumer is a covered person, for example, based on internal records,

the lender must treat that consumer as a covered person even if the DOD database does not indicate that the consumer is on active duty or is the spouse or dependent of an active duty service member.

Implications of the Proposed Rule

There are major operational problems with the proposed rule that will pose significant legal risks to lenders, due primarily to lack of clarity in the proposal, such as the requirement for credit card issuers to compare “similar” credit products. For example, credit card issuers, including retailers that issue private-label cards, would have to determine whether a fee is “bona fide” in order to exclude the fee from the MAPR. Credit card issuers price their products according to different factors and card features, such as the existence or absence of “rewards” features, which may be tied to an annual fee, or other fees that may apply to anticipated consumer use of the card. Differential pricing is based on the need for card issuers to compete in the marketplace and meet the needs of consumers who demand different card features.

Given the variety of features offered on different cards, it is far from clear which cards should be compared under the proposed rule. If a lender gets the comparison wrong and the fee is not “bona fide,” then both that fee and any other fees excluded from the MAPR must be included in the MAPR calculation, even if those other fees are bona fide. And, if those fees would result in a MAPR greater than 36 percent for any billing cycle, the lender will have violated the MLA and becomes subject to both private litigation and agency action. Violating the MLA also can result in voiding the underlying credit agreement. These harsh results are likely to give lenders pause in providing credit to covered persons and could result in a negative impact on lending to service members and their families.

In addition, there are a number of anomalies that would result if the rule is adopted as proposed, especially for open-end credit and the calculation of the MAPR on periodic statements. Under the proposed rule, depending on when in a billing cycle a service member engages in a transaction, such as a cash advance transaction, a lender may or may not be able to assess a fee for that transaction because the MAPR may be exceeded. For example, assume a covered person engages in a cash advance transaction (an example used by the DOD) during the first day of a billing cycle and incurs a percentage-based cash advance fee. Assume on the last day of a different billing cycle, the same individual engages in the same transaction.

The MAPRs for these two cycles could be vastly different because, while the amount of the fee would be the same, the average daily balance will be significantly higher for the first cycle than for the second cycle. The result is that a card issuer may not be able to assess the fee in the second billing cycle, a result that simply does not make sense in practice and would be confusing to consumers. Similarly, two different card issuers with the same account pricing would have to treat a covered account differently under the proposed rule depending on when during the billing cycle each issuer’s respective customer engaged in a transaction that resulted in imposition of certain types of fees. These types of outcomes raise compliance issues and likely would lead to consumer confusion.

What’s Ahead

In light of concerns raised in comment letters, many in the industry remain hopeful that the DOD will take a step back and reconsider fundamental aspects of the proposed rule, including the DOD’s abandonment of a product-based approach to regulating lending to covered borrowers that is based on predatory characteristics or practices. It seems that the DOD rushed headlong into proposing sweeping coverage for all credit products, including, for example, credit cards and other credit, without

determining that such products are predatory or pose significant risks to service members or other covered persons.

Also, it is troubling that the CFPB, in its comment letter on the DOD proposal, embraced all of the approaches set forth in the proposed rule — with apparently little concern about access to credit for service members. While the CFPB's support for the proposed rule is hardly a surprise, it remains unclear what effect the CFPB's letter and public statements of support will have as the DOD seeks to address the many problems that the proposal presents, especially for credit cards. However, the specific issues, both legal and operational, raised by the comment letters submitted by representatives of the industry about the challenges associated with the DOD proposal stand in stark contrast to the comment letter submitted by the CFPB. Lenders, consumer groups and federal financial regulatory agencies, as well as active duty service members and their spouses and dependents, must now wait to see how the DOD will resolve the many competing views provided on its proposed rule.

—By Leonard N. Chanin and Ryan H. Rogers, Morrison & Foerster LLP

Leonard Chanin is counsel and Ryan Rogers is an associate in Morrison & Foerster's Washington, D.C., office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2015, Portfolio Media, Inc.