COMMENTS

Of

CENTER FOR RESPONSIBLE LENDING
CONSUMER FEDERATION OF AMERICA
CONSUMERS UNION
NATIONAL ASSOCIATION OF CONSUMER ADVOCATES
NATIONAL CONSUMER LAW CENTER

On

Proposed Rulemaking

Limitations on Terms of Consumer Credit Extended to Service Members and Dependents

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INTRODUCTION

The consumer groups identified above submit comments in response to the proposed rules implementing the John Warner National Defense Authorization Act for Fiscal Year 2007, § 670, codified at 10 U.S.C. § 987. (These comments refer to the law as the "Military Lending Act," or "MLA.) Our organizations have worked extensively with military groups and others who represent service personnel whose lives have been affected by the high-cost lending, which the MLA was intended to stop. We also have direct experience with the successes—and failures—of laws aimed at curbing these practices, and our comments on the proposed rules are informed by the lessons of the past.

We understand that the Department of Defense seeks to protect its military personnel from predatory lending and intends to carry out the Congressional direction embodied in the Military Lending Act (MLA). But we are greatly concerned that the rules as proposed, written narrowly—too narrowly— in an attempt to avoid unintended consequences, will actually allow the very practices the Department is committed to eliminating. We fear that the real unintended consequences of the rules, as proposed, will be that the law itself will have little impact on the damaging products aimed at our military personnel.

As the Department of Defense recognizes in the supplement to the proposed rules, two problems characterize predatory payday loans and other similarly structured abusive small loans. First, their annual interest rates are absurdly high, ranging from a typical 400 percent to 900 percent and even higher. Second, predatory lenders induce borrowers to pay those rates over the long term not by offering a product that is competitive with other fund sources, but by trapping them in one small loan that they cannot afford to pay off. The lenders then renew the loan multiple times and collect fees for each renewal without lowering the principal.

The solution to the first problem, an inclusive 36 percent cap on annual interest rates for consumer loans, is an essential feature of the Military Lending Act. Propitiously, this feature also solves the problem of loan flipping. While payday and other predatory lenders who offer a single high-cost product do not find it worth their while to target military families at a 36 percent rate, legitimate and responsible lenders do find it possible to work under that limit.

Unfortunately, predatory lenders need only tweak their products very slightly so that they do not fall under the definitions in the rules, and will thus be free to charge interest rates greatly in excess of the 36 percent cap, and to flip loans repeatedly to military personnel who are trapped in loans they cannot afford to pay off. Indeed, there are several products already on the market that would escape coverage under the act. We know from past experience that evasion products spread rapidly and widely.

There are also many abusive and high-cost products, including those that are specifically targeted by the Military Lending Act, which would be exempted from the proposed rules.

As we know from our collective, extensive research on predatory lending and our experience with the industry, those products will serve as models on which the industry will base future abusive products as they continue to target the vulnerable population of military families. Being subject to the borrower protections for military families offered within the Military Lending Act will be the exception rather than the rule for predatory lenders.

These comments first urge the department to take advantage of the extension provided for in the MLA and ensure that final rules are adequate to fully implement the Act, by promulgating any narrowly-crafted rules as interim rules. *(Section I.)*

Next, we discuss the serious loopholes in coverage created by the definitions, providing examples of the payday loans, title loans, and RALs existing in the market today which would not be eliminated by the proposed definitions, and would become models for widespread evasion of the law. We also discuss a segment of the predatory lending market targeted by the DoD report which is untouched by the proposed rules—military installment lending. *(Section II.)*

The third section discusses the definition of the "military annual percentage rate" (MAPR) and issues relating to the fees and charges that should be included in the rules. *(Section III.)*

Fourth, we recommend revisions to the proposed anti-discrimination provisions concerning state laws that are necessary to ensure that state laws which protect their own residents equally protect service members stationed in those states, as the MLA intended. *(Section IV.)*

Fifth, flaws in the proposed safe harbor relating to identification of covered borrowers and possible solutions are identified. *(Section V.)*

Finally, we recommend that the Department set up a system for monitoring and reviewing the effectiveness of the final rules, to ensure that the rules keep pace with market developments, and to ensure that they are adequate to implement the goals of Congress and the Department, so that our service members do not have to fight financial abuse on the home front. *(Section VII.)*

Select questions posed by the Department in the supplementary information will be discussed as they relate to the above points, with a concentration on what we see as the major challenges to full and effective implementation of the Act presented by the proposed rules.

I. TO ENSURE THAT FINAL RULES DO NOT CONTAIN SIGNIFICANT LOOPHOLES, NARROWLY TAILORED RULES SIMILAR TO THOSE PROPOSED, IF PROMULGATED, SHOULD BE INTERIM RULES ONLY.

We urge the Department to accept the suggested framework we offer in these comments to close the loopholes in the proposed rules. However, we understand the time constraints created by the statutory effective date of October 1, 2007.

To the extent that the Department chooses not to broaden the scope of the rules significantly beyond the three products that have been targeted, or to close all of the significant loopholes in the definitions of those products, we strongly urge that the first set of rules be adopted only as interim rules, under MLA § 670(d).

The Act specifically allows the Department to adopt interim rules, and provides a 270-day period following the implementation of interim rules to develop final rules. This extension permits the Department time to devise calibrated rules that reach the full range of destructive, high cost lending.

We believe that the loopholes in the proposed rules are so wide that service members would feel very little impact from the implementation of the law. We fear that adopting narrowly targeted rules would mean, as a practical matter, that the benefits of the law would be postponed indefinitely. By adopting such rules as interim rules under the Act, the Department can ensure that there is a specific date by which the Act will apply to the full realm of predatory lending at which it is directed.

II. THE PROPOSED DEFINITIONS OF CONSUMER CREDIT WILL EXCLUDE FROM THE ACT MANY PRODUCTS IDENTIFIED BY THE DoD REPORT AND TARGETED BY CONGRESS.[1]

A. The Proposed Rules Omit Many Types of Destructive High Cost Credit Products.

> ***Question 1: (In Summary) Should certain depository institutions be excluded from the Act?***

As we discussed in our initial comments, there are many types of destructive, predatory credit products.[2] Such products are offered by all types of institutions. Among such destructive, high-cost credit products omitted by the rules are:

- Military, internet and other installment loans over 90 days;
- Credit cards, including high-fee subprime cards;

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[1] In Section II-F, below, we suggest general principles for changes to the definitions of "consumer credit" and common to all the types of products we discuss here – payday, title loans, RALs, and military installment loans. Where changes are needed relating just to one type of product, corrective suggestions are offered within the discussion of that segment of the market.

[2] For a list of many of these products, s*ee Comments of the National Consumer Law Center, Consumer Federation of America, Center for Responsible Lending, Consumers Union, National Association of Consumer Advocates regarding Limitations on Terms of Consumer Credit Extended to Service Members and Dependents,* F.R. Doc. 06-9518, DOD-2006-02-0216 (February 5, 2007), *hereafter* February Comments.

- Deceptive, triple-digit bank overdraft loans;
- Payday-like products offered by banks;

Congress drafted the MLA broadly, with only two specific exemptions in the statute. Congress intended the 36 percent cap to cover all other products, and excluding them is inconsistent with the Act and outside DoD's regulatory authority.

We addressed the problems with these products at length in our initial comments, and will incorporate those concerns herein without repeating them. We wish only to point out that these products—while less visible than the storefront payday lenders outside military bases—likely contribute as much or more to the financial problems of service members as the products covered by these rules. Almost all service members have bank accounts, and are vulnerable to the problems in high-cost overdraft systems. After we submitted our last comments, we received this email:

> My son recently joined the ARMY and opened an account with WAMU..., he continues to use his debit card at a negative balance and WAMU keeps on letting him do it...He recently made a charge for $2.87 and was charged $35.00 for overdraft fee...2X....now I know it is his responsibility, but what is going on here? Over the last 2 months, the account has been hit for over $600.00 in fees

This story is consistent with the experience of one credit union that found that its "courtesy" overdraft programs can drive young service members into the same cycle of high fees and negative balances as payday loans.[3]

Another report we received after submitting our initial comments came from the Navy Marine Corps Relief Society. A sailor seeking to rebuild her credit after a divorce was ensnared by a deceptive subprime credit card with a nominal interest rate of 9.9 percent that cost $294.60 in fees and interest for $84.85 in purchases in the first two months – an annual rate of over 2,000 percent.

We have no problem with an exemption for lower-cost lenders, though we continue to oppose a blanket exemption for any group of creditors. Rather than expose service members to a wide array of high-cost products by adopting sweeping lender exclusions, narrowly-tailored price-triggered exclusions would meet the goals of the MLA, and balance the needs of service members with the concerns of providers of legitimate products.

B. The Proposed Definition of "Payday Loans" Would Not Capture Many Existing Payday Loan Products, and These Would Provide a Model For Further Widespread Evasion of the Act.

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[3] Mary Cunningham, "Why Our Credit Union Has Wrestled With Realities of 'Courtesy Pay,'" *Credit Union Journal*, January 17, 2005 (copy attached to February Comments, *supra* note 2, as Appendix D.)

Question 2: The Department seeks comments concerning whether the duration limit and monetary limit on the amount of the loan included in the definition of payday lending creates any unintended consequences for other credit products.

1. Loopholes in the Proposed Definition of Payday Loan, §232.3(b)(1)(i)

The proposed definition of payday lending includes four elements, *each* of which creates broad loopholes. The result is that the real "unintended consequences" which are of concern is that the proposal would allow existing models of high-cost, abusive practices to continue unabated. In fact, it virtually assures that those models become more widespread and continue targeting the earnings of military families.

To be a covered payday loan under the proposed rules, a transaction must meet all four elements of the definition:

* Must have an amount financed of $2000 or less,
* Must be "closed-end,"
* Must have a term of 91 days or less, *and*
* Must take a contemporaneous check or debit authorization for payment no earlier than one day from the time the credit is extended; debit authorizations secured through bank offset rights are exempt.

If any *one* of these elements is missing, then the transaction is entirely exempt from the Act's protections, giving predatory lenders a roadmap for how to structure their products. A $500, closed-end loan, secured by contemporaneously given post-dated check, could legally charge a 360 percent rate by the simple expedient of being repayable in 92 days. Or a $2000 loan, secured by one or more post-dated checks, repayable in 90 days, could legally charge 360 percent by the simple expedient of structuring the credit as open-end. Or a $150 closed-end loan, repayable in 14- days, could charge 360 percent by simply taking a promissory note instead of a check or debit authorization.

Furthermore, since these transactions would not be subject to the law at all under the proposed rules, the statutory prohibition against roll-overs would not apply, and the very same debt treadmill that was the subject of concern in the DOD report will continue unaffected by the law, and hence unabated.

To expand on the pitfalls presented by each of the required elements of the definition:

Amount limit: We understand that DoD has chosen to focus initially on small loans. But a 50 percent interest rate is no more justifiable—and in fact, is more problematic—if the loan is $2,500, or $5,000.

Further, as the rules are drafted, the dollar figure can be readily manipulated. The supplementary information indicates that the "amount financed" for a $2000 loan will be determined by the current Truth in Lending Act definition. *72 Fed. Reg. at 18163*. This

definition, in effect, would allow creditors to pad the loan with the kind of charges it was aimed at curbing, and help take the loan above the maximum loan limit by doing so. For example, under TIL rules, a $2500 loan that includes $500 credit insurance premiums would be a $2500 loan, and therefore over the proposed $2000 limit.

Therefore, if the rules include a dollar cap on the coverage of the Act, the loan amount should be calculated according to MLA rules, not the TILA rules explicitly rejected by Congress for this purpose. That $2500 loan with $500 credit insurance would be – and should be - a $2000 loan under MLA rules.

The closed-end requirement / Open-end exclusion: [4] As we described in our initial comments, payday lenders are already structuring their products as "open-end" loans in order to avoid state restrictions on closed-end loans. We elaborate on some of those models below, *§ II-B-2*.

Duration limit: Illinois recently passed a law to limit the rate on payday loans, which it defines in part as loans of 120 days or less. The payday lenders immediately restructured their products, which are now known as "121 loans." The 350 percent internet payday loan available through Purposeloans.com is example of a loan with 6 installments, presumably semi-monthly. Adding only a couple of days would exempt this loan from the MLA. Moreover, even with traditional payday loans, rollovers typically extend the term beyond 90 days. Therefore, with only modest changes in terminology, a loan with the same terms and same costs could be characterized as a 91-day loan exempt from the Act.

Contemporaneous check or debit authorization: The final definitional requirement for a payday loan—that it be secured by a contemporaneous check or debit authorization—is particularly problematic for several reasons. First, taking a check or debit authorization as security is a prohibited act under the MLA, §987(e). It is self-contradictory to make prohibited conduct essential to being covered by the Act in the first place.

Apart from the logical conundrum presented by making this an element of the definition, the requirement that the security be "contemporaneous" also invites evasion. Can the borrower come in one day to sign the security instrument, and then return the next day, or a week later, for the loan? Can a repeat borrower have an initial security agreement, and then invoke it weeks or months later for new installments?

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[4] The proposed rules define "closed-end credit" as "consumer credit other than 'open-end credit' as that term is defined in Regulation Z (Truth in Lending), 12 CRF part 226." Regulation Z defines "open-end credit" as consumer credit offered under a plan in which:

(i) The creditor reasonably contemplates repeated transactions;

(ii) The creditor may impose a finance charge from time to time on an outstanding unpaid balance; and

(iii) The amount of credit that may be extended to the consumer during the term of the plan (up to any limit set by the creditor) is generally made available to the extent that any outstanding balance is repaid. 12 C.F.R. § 226.2(a)(20).

One can also imagine other types of security that do not meet the regulation's definition. A $150 closed-end loan, repayable in 14 days, could charge 360 percent by simply taking a promissory note instead of a check or debit authorization.

The bank set-off exclusion: The regulations also appear to have the unintended consequences of sanctioning bank payday loans, no matter how egregious the terms, by exempting any loan that is secured by "any right of a depository institution under statute or common law to offset indebtedness against funds on deposit in the event of the covered borrower's delinquency or default."[5] That is, a 500 percent payday loan might be exempt if it is made by an institution that holds a preexisting account with the borrower. However, the fact that an institution has access to a borrower's account does not justify extortionate terms on a new loan.

2. Examples of Existing Payday Loan Products and Payday-like Products that Would Not be Covered Under the Proposed Definition.

We discuss below several products offered by both bank and non-bank lenders that have the same predatory characteristics as payday loans, in fact *are* payday loans. Yet they would not be covered under the proposed definition. The chart first summarizes which of the four required elements of the proposed definition would not be met, meaning that their lenders could safely ignore MLA in its entirety. Each product is then described in more detail.

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[5] 32 C.F.R. § 232.3(B)(1)(i)(b) (proposed).

	Open-end Credit	Term Longer than 91 Days	Amount Financed Exceeds $2,000	Lacks Contemp. Check/Debit Authorization
a. Wells Fargo Bank/US Bank Direct Deposit Advances (Nationwide)	X			X
b. Adv. America "Choice" loan (PA.)	X			
c. Adv. America Installment Loan (IL.)		X (5 months)		
d. The Cash Store (IL.)		X (121 days)		
e. QC Holdings Installment Loan (IL.)		X (5-6 months)		
f. Handy Cash Loan Center installment loan (NV.)		X (one-year)		X
g. Lucky Credit 4 U Installment Loan (NV.)		X (one year)		
h. Koster Finance LLC Installment Loans (NV.)		X (one-year)		
i Rent-a-Center Signature Loans (Nationwide)		X (?)		X
j. Sale/Leaseback Loan (GA.)	X	X		X

a. Wells Fargo and U.S. Bank direct deposit advance loans

Wells Fargo and U.S. Bank, both federally-chartered banks, offer a payday advance product to customers nationwide with direct deposit accounts. Customers pay $2 per $20 borrowed, repayable upon the next direct deposit.[6] The advertised APR, based on a 30-day loan, is 120 percent. Loans may, however, be much shorter than 30 days. The APR for a one-week advance with this fee schedule would be 521.4 percent. These products are not covered by the proposed regulations because they are revolving "open-end credit" as defined by Regulation Z.

b. Advance America "Choice" line-of-credit

Advance America offers its "Choice" product in Pennsylvania, a state with a 24 percent APR small loan rate cap but no cap on open-end credit. The product is a $500 revolving line of credit with an annual rate of 5.98 percent plus a monthly participation fee of

[6] *See* US Bank Checking Account Advance, http://www.usbank.com/cgi_w/cfm/personal/products_and_services/checking/caa.cfm.; Wells Fargo Direct Deposit Advance Service Agreement and Product Guide, https://www.wellsfargo.com/downloads/pdf/checking/dda/termsandconditions_english.pdf. The finance charge for the U.S. Bank product is $1 per $10 borrowed.

$149.95 that falls outside the Regulation Z definition of a finance charge.[7] While the definition of the "military annual percentage rate" (MAPR) in the proposed regulations would cover such charges, with the MAPR reaching 370 percent on a $500 "Choice" loan, the product is open-end credit and thus outside the scope of the proposed regulations.

c – e. Advance America, QC Holding, and Cash Store installment loans

Illinois provides a prime example of how payday lenders would evade the narrow definitions in the proposed regulations. In 2005, Illinois enacted restrictions on payday loans, defined in part as loans for 120 days or less. There is no rate cap for lenders licensed under the Consumer Installment Loan Act, leading the majority of payday lenders in the state to offer installment loans for more than 120 days. For example, Advance America now offers a five-month installment loan in the state with a fee of $34 per $100 borrowed *each month*.[8] QC Holdings has introduced a similar product, with loan terms of five to six months and fees of $30 per $100 borrowed *each month*.[9] The Cash Store offers a 140-day loan with nine biweekly interest payments and a final balloon payment of the entire principal. Consumers are told that they can pay off the installment loan on their next payday. None of these loans would be covered under the proposed regulations because the repayment period is longer than 91 days.

f – h. Handy Cash Loan Center, Lucky Cash 4 U, and Koster Finance LLC installment loans

Nevada payday lenders and high-cost installment lenders have similarly adjusted their business practices to get around new consumer protections enacted in 2005. Handy Cash Loan Centers, for example, offers small, unsecured installment loans with 25 equal payments every two weeks. The APR on a $200 Handy Cash loan is 803 percent, with the borrower paying finance charges of $1,602.60 plus principal over the life of the loan. The lender Lucky Credit 4 U offers similar terms for unsecured, one-year installment loans. In another example, Koster Finance LLC offers one-year installment loans with triple-digit interest rates. One contract shows that the terms of an installment loan for $989.01 include an APR of 492.75 percent. Over the course of the loan, the borrower paid a finance charge of $5,064.36 with the final amount paid being $6,054.17 over the course of the loan. The loan was secured by checks given to the lender at the beginning of the loan. Prior to July 2005, each of these lenders offered loans with repayment

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[7] Advance America, Cash Advance Centers, Inc, Annual Report (Form 10-K), at 44 (Mar. 1, 2007); contract on file with the Center for Responsible Lending.

[8] *Id* at 8; Advance America Cash Advance, Illinois Fees, available Advance America Cash Advance, Illinois Fees, available at http://www.advanceamerica.net/files/fees/il_fees.pdf , (accessed June 8, 2007) (printout on file with the Center for Responsible Lending).

[9] QC Holdings, Inc., Annual Report (Form 10-K), at 5 (Mar. 14, 2007)

periods of 2 weeks to 16 weeks. The Handy Cash and Koster Finance installment loans are not covered by the proposed regulations because the terms are longer than 91 days. The Handy Cash and Lucky Credit installment loans are further exempted because the contracts do not appear to require contemporaneous checks and/or debit authorizations.[10]

i. Rent-A-Center installment loans

Rent-A-Center started offering financial services, including payday loans, in 2005. By the end of 2006, at least some financial services were offered at 150 locations in 14 states. During 2007, the company aims to add these services to an additional 350 to 400 stores. Marketed collectively as "The Cash AdvantEdge," both signature loans and payday loans will be offered. While the signature loan appears to function exactly the same as a payday loan—fees of $17.64 per $100 borrowed—these loans are not covered by the proposed regulations because the terms could be longer than 91 days and contemporaneous checks and/or debit authorizations are not required.

j. Sale/leaseback or sale/repurchase transactions

"Sale/leaseback" transactions, a method of subterfuge whereby borrowers purportedly sell personal property items to lenders then immediately "lease" or "buy" the items back, would similarly fall outside the scope of the proposed regulations. A recent decision by Court of Appeals of Georgia found:

> Consistent with the practice of payday lending, the [sale/leaseback] customers were required to apply for an advancement of funds by providing the name of their employers and length of employment, their salary and pay dates, checking account information, a recent pay stub, and bank statements. The customers also provided a check or electronic debit authorization in the amount of the principal amount advanced to them plus interest.
>
> Following the advancement of funds, the customers' first payment was due within two weeks. The customers could be released from the agreement by paying the principal amount advanced to them plus a 25 percent to 27 percent fee, amounting to an APR of 650 percent to 702 percent. If the customers were unable to do so, then he or she was required to renew the transaction term for another two-week period by paying another 25 percent to 27 percent fee. None of these payments were applied to the principal amount owed. If the customers failed to make a required payment, their checks were cashed or an electronic debit from their bank account was made immediately thereafter.[11]

Despite the consistency with the practice of payday lending, recognized by the courts, these subterfuge scams would not be covered by the proposed regulations because they (i) are not closed-end credit, and (ii) do not require contemporaneous check or debit

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[10] Contracts on file with the Center for Responsible Lending.

[11] Clay v. Oxendine, --- S.E.2d ----, 2007 WL 901199, 2007.

authorization. These lenders may also argue that they fall outside the Act because the repayment term, with extensions, exceeds 90 days.

Moreover, we noted in our February comments that the sale/lease-back evasion would assuredly be used to try to circumvent the statute's exemption for purchase money loans. *MLA §987(i)(6)(B), proposed DoD §232.3(b)(2)(ii), (iii).* The draft regulations do not incorporate the suggestions we previously made for defining purchase-money loans in a way that avoids this sale/leaseback evasion. We suggested the following:

> "Purchase-money security interest" means a security interest in personal property taken in conjunction with a consumer credit transaction that finances the initial acquisition of a specific item of property named in the credit agreement. It does not include transactions in which the servicemember or dependent had previously acquired some interest to the property, even if full legal title had not been acquired. Nor does it include a security interest purportedly taken in any item purchased through a credit arrangement provided for general purposes and not for a specific item of property.

We urge the Department to amend the proposed regulations to incorporate this definition.

C. The Proposed Definition of "Vehicle Title Loans" Would Not Capture Some Existing Car Title Loan Models

> ***Question 3: The Department seeks comments as to whether the limits established for vehicle title loans for duration of the loan included as part of the definition cause any unintended consequences for other credit products.***

1. Loopholes in the proposed definition of "Vehicle Title Loans", §232.3(b)(1)(ii).

The requirements for meeting the definition of vehicle title loans will cause similar "unintended consequences" to that of payday loans. To be subject to the Act at all under these rules, an auto title lender must meet all elements of a three-pronged definition. The loan must:

* Have a term of 181 days or less,
* Be a closed-end transaction, and
* Be secured by a non-purchase money security interest in the title to a motor vehicle.

Here, too, the absence of any *one* element means the entire transaction is wholly exempt from the law's protections. A $1000, closed-end loan, with a term of 30 days, can charge 360 percent interest by virtue of taking a security interest in a computer that the Service member owns, instead of a vehicle. A $600 loan, repayable in minimum monthly payments of $200, secured by a non-purchase money security interest in the service member's vehicle can charge 50 percent interest by virtue of structuring the loan as open-end credit.

Duration: As with payday loans, a duration requirement simply assures that high-cost auto loans will become "182" loans, the same unintended consequence that Illinois' 120 payday loan duration requirement had.[12]

Closed-end requirement / Open-end exclusion: The title lender who purports to be the largest in the country already has a product that is cast as open-end. Allowable under the proposed rules, that product stands as a model for that company—and all other title lenders who crowd the perimeters of military bases—to adopt and continue to make loans without any regard for the MLA.

Title as security: As with the definition of "payday loans," there is a self-contradictory requirement that one of the necessary elements for coverage under the Act is to have a feature prohibited by the Act. The Act prohibits taking title to a car as security, except in connection with purchase money credit. *MLA §987(e)(5); proposed §232.8(a)(5)*. And yet the definition of "consumer credit" says auto title lenders must take title of the vehicle to be covered. Only lenders who violate the Act (by taking title of the vehicle as security in this case) are subject to the consumer protections of the Act, such as the 36 percent MAPR or the ban on rollovers. This is inconsistent and sends the message to lenders that one or another violation of the Act will be tolerated.

The proposed regulations also fail to define "security" interest. In our February comments, we noted that such a definition is necessary to ensure that lenders do not use creative forms of using the car as security. A $300, 14-day loan, at 360 percent might attempt to escape coverage by simply taking a set of keys to the car, instead of taking the title as security. We previously proposed this language to prevent this evasion:

> For purposes of this section, "security interest" includes taking keys or title to a vehicle as security for the obligation, including but not limited to the actual or constructive possession of the title to the vehicle.

Finally, by defining coverage only for loans secured by a non-purchase money security interest in vehicles, it is likely that some high-cost lenders targeting the military will simply start taking non-purchase money security interests in other expensive personal property, such as computers.

[12] CFA's most recent State Car Title Loan Law review notes that two states permit durations of as much as a year, when permitted renewals are factored in. (New Hampshire – 30 days, 11 renewals; Oregon—60 days, 6 renewals.)

2. Examples of existing car title loans that would not be covered under the proposed definition

a. Open-End Title Loans

By excluding vehicle title loans using open-end credit, the proposed regulations effectively exclude all vehicle title loans made in the states of Kansas and Virginia, at least those made by the largest title lender. With this successful model in place, it is an easy matter for title lenders around the country to switch to that product when they wish to loan to military borrowers without complying with the MLA's 36 percent cap or anti-renewal provisions.[13]

Car title lenders in Virginia, a major military market, already characterize title loans as open-end credit to take advantage of exceptions in Virginia usury law. For instance, title lender Fast Auto Loans, Inc. offers a "Motor Vehicle Equity Line of Credit" in Virginia with an APR of 300 percent.[14] According to the Virginia Bureau of Financial Institutions:

> [The Bureau] has received a number of calls about a fairly new product being offered in Virginia called a "motor vehicle equity line of credit". These are generally small loans secured by your motor vehicle (a lien is recorded on your automobile title). Borrowers are required to provide the lender with a duplicate set of keys for the motor vehicle. According to the motor vehicle equity lines of credit we have seen, borrowers who fail to make required payments within ten days after the payment due date (or are otherwise in default of their agreement with the lender) could lose their car. The amount you can borrow is typically based on the value of your car (which you must own outright). Interest is calculated on the balance of the loan at a very high annual rate, often **300% to 360%**! Because of the high interest rate on these loans and the risk of losing your car, consider a loan from a bank, a credit union, or a family member before obtaining a motor vehicle equity line of credit.[15]

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[13] One state in which the lender used that model recently enacted legislation to close the "open-end" loophole under which this lender drove his 244% title loans through. However, there are no military bases in Iowa, so that state reform will not be much comfort to service members deprived of MLA's protections by the DoD's proposed open-end loophole.

[14] *Fast Auto Loans, Inc.* Motor Vehicle Equity Line of Credit Agreement – Version VA1003 (received Feb.8, 2005, on file with the Center for Responsible Lending and Consumer Federation of America).

[15] Virginia State Corporation Commission Bureau of Financial Institutions, Consumer Affairs and Information: Know the Facts About Motor Vehicle Equity Lines of Credit, available at http://www.scc.virginia.gov/division/banking/cons.htm (accessed May 27, 2007) (printout on file with the Center for Responsible Lending) (emphasis in original).

Title lenders in Kansas similarly characterize their loans as open-end credit to avoid state usury limits.[16]

b. Sale / Repurchase Evasion

In addition to allowing the open-end business model described above, the proposed regulations also fail to prevent vehicle title lenders from engaging in sale/lease-back or sale/repurchase subterfuge to skirt state small loan laws. For example, Quick Kar Sales in Arkansas used a "sale/sale back scheme [in] a transparent sham to disguise loans with unconscionably high interest rates."[17] The loan required two transactions –the borrower sells the vehicle to the lender, then the lender immediately sells the car back to the borrower "with a sale price substantially exceeding the amount of the cash loan." Loan amounts were between $200 and $500 with the effective APRs exceeding 300 percent.[18]

As with typical vehicle title loans, the borrower in this transaction kept possession of the car but delivered the title to the lender. According to the Complaint filed in court, "[T]he defendants attempt to disguise what is, in reality, a high interest loan, as a sale of the car in question to Quick Kar Sales coupled with the simultaneous sale of the same car back to the customer." Because this transaction is characterized by the lender as a purchase-money transaction, the lender would argue that the loan is not covered by the proposed regulations.

In Section II-B-2-j, above, we suggested a definition of "purchase money security interest" to prevent this common dodge.

D. The Proposed Definition of "Tax Refund Anticipation Loans" Invites Evasion

1. Loopholes in the proposed definition of "tax refund anticipation loans," § 232.3(b)(1)(iii)

The only "tax refund anticipation loans" which would be subject to the Act under the proposed regulations are those that meet these two elements:

* closed-end, and
* the borrower *expressly* grants the creditor the right to receive all or part of the borrower's income tax refund or agrees to repay the loan with the proceeds of the borrower's refund.

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[16] Jean Ann Fox and Elizabeth Guy, Driven into Debt: CFA Car Title Loan Store and Online Survey, Consumer Federation of America, Nov. 2005.

[17] Arkansas v. Quick Kar Sales LLC, Case No. CV2006-8364, Cir. Ct. of Pulanski Co., Ark., Complaint filed Aug. 3, 2006.

[18] Id. at para. 13.

Closed-end requirement / open-end exclusion: Open-end RALs exist today, though they are not common. Although the particular product on the market now is not a high-cost product, it, too provides a model for predatory lenders to follow.

Requirement of express tie to repayment with refund or proceeds of the refund: This would exempt tax refund-related products if they do not include a specific reference to the tax refund in the contract. Tax refund-related loan products have been marketed which do not include that provision in the contract. Instead, the borrowers are induced to come back to the provider for tax preparation and to use the refund to repay the loan.

2. Examples of non-qualifying RALs

Pay-Stub Loans

The definition of a RAL requires that the borrower either grant the lender an interest in the tax refund or agree to repay the loan from the proceeds of the tax refund. However, some of the more egregious forms of RALs—"paystub" or "holiday" loans that are not even based on a completed, accurate tax return—do not fit this definition. The loan may be based on an estimate of the tax refund, and the timing of the repayment requirement encourages the borrower to return for the tax filing, but this may not be a formal requirement of the loan.

While some providers have stopped the pay-stub loan,[19] the unfortunate fact in the high-cost loan industry is that once the example is on the market, it will be seized on by others.

Should the definition of consumer credit—whether interim or final—specifically describe a "refund anticipation loan," we recommend the following definition:

> The term 'refund anticipation loan' means any loan of money or any other thing of value to a taxpayer in connection with the taxpayer's anticipated receipt of a Federal tax refund. Such term includes a loan secured by the tax refund or an arrangement to repay a loan directly or indirectly from the proceeds of a tax refund, whether the loan is made prior to, concurrently with, or after the preparation of the taxpayer''s return or receipt of the taxpayer's form W-2.

E. Military Installment Loans, One of the Specified Targets of the DoD Report and the MLA Itself, Would Not Be Covered Under the Proposed Definitions.

Military installment lending is one of the high-cost, debt-trap loan products targeted by the MLA and the DoD report.

[19] HSBC announced in March, 2007 that it would discontinue its pay stub loan product. *HSBC Finance Corporation Sets New Course in Taxpayer Financial Services Business: Discontinues Certain Tax Refund Loan Products*, HSBC Press Release, March 15, 2007.

Military installment loans would be completely exempt from the law, including the 36 percent MAPR and ban on roll-overs in the Military Lending Act. Yet they were among the specific types of high-cost loans identified in the DoD report as problem loans specifically targeted to the military. While nominally these installment loans were at 36 percent, they were flipped frequently, and they were virtually always packed with "off-the-rate," high-cost ancillary credit insurance products that raised the real cost considerably above the 36 percent price tag – but provide very little or no value at all to service members.

In the supplementary information to the proposed rules, the Department cites these products as having "excessive fees and interest," though it does not cite them for the debt trap of "repeated rollover / refinancing." (*72 Fed. Reg. at 18159*). That is inconsistent with the findings of the Department's own report.

> Repeat lending or loan flipping are characteristic of installment lenders as well as payday lenders. For example, Pioneer reports that it typically makes a number of loans to the same customer over the course of several years, "many of which were refinanced with a new loan after approximately one third of the scheduled payments were made. *We market the opportunity to refinance existing loans prior to maturity, thereby increasing the amount borrowed and increasing the fees and other income we realize.* In fiscal 2005, approximately 45.8% of the number and 30.2% of the amount of our loan originations were refinancings of outstanding loans."[20] (Emphasis added.)

The Department's own findings thus place military lending in the same category of payday loans in their excessive costs, and the debt trap cycle of debt that makes regaining control of finances much harder. There is no justification for omitting these products.

Indeed, it is not simply the traditional military installment lenders that would benefit from the installment loan loophole. Certainly the service member with a **450 percent** online loan from Check-N-Go and the First Bank of Delaware, secured by access to his bank account, is in precisely the situation that Congress had in mind when it enacted the 36 percent cap, and prohibited access to bank accounts as security for loans. *MLA § 987(e)(5).* Yet, because this loan was cast as an installment loan exceeding the proposed time limit, it would not be covered under these proposed rules, either.[21]

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[20] Department of Defense, *Report on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents,* p. 18 (August 9, 2006), *citing* Pioneer Financial Services, Inc., Form 10-K Fiscal Year Ended September 30, 2005, SEC, pp. 3, 40.

[21] Loan documents on file with Consumer Federation of America. The City Attorney of San Francisco has challenged payday lenders and the partnering bank for this effort to circumvent California's payday loan law. *See* People v. Check 'Go of California, *et al* , Civ. No. ____, (Super Ct. of Cal., Cty of San Francisco, *filed* April 26, 2007).

These loans require electronic repayment, and the lender uses a fine print provision in the contract to access the accounts even if the service member tries to exercise his right to cancel automatic electronic repayment authorization. In our February comments, we made recommendations necessary to assure that the prohibition on access to accounts as security was not subject to such manipulation. We again urge the

The omission is glaring, too, in light of the provisions in the MLA itself directed squarely at insurance packing by military installment lending providers found in the DoD report.[22] Congress specifically defined the "interest" charges to be counted toward the 36 percent cap more broadly than the TIL definition of "finance charge" in order to capture "credit insurance premiums [and] any ancillary product sold with any extension of credit." *MLA §987(i)(3), (4).*

For example, a Marine lance corporal stationed at Camp Lejeune in North Carolina provided CFA an affidavit describing a series of three installment loans with Patriot Loan Company. Patriot is owned by Security Finance and operates loan outlets near military installations in several states. Patriot is not licensed in North Carolina[23] and claims that Georgia law applies to loans made near Camp Lejeune. He paid 64.7 percent annual interest for a small loan that came laden with credit insurance premiums and fees, including a four percent loan fee, another eight percent loan fee, accident and health insurance, a maintenance charge and single life insurance. This Marine paid back $900 for a $698.58 loan split between $358 in cash and a $266 renewal of a prior loan. In other words, he paid nearly 65% interest on a loan consisting primarily of fees and roll-over debt – yet that loan would not be covered by the proposed rules.[24]

Another provision of the MLA, § 987(d)(2), relating to the application of state law to service members based within that state, is also targeted at military installment lenders.[25] The DoD report stated that a "particular concern with the lack of universal state licensing is that these companies do not have to comply with state laws covering disclosure, rate caps, fee limits, loan size and collateral requirements" and asked Congress to close the non-resident borrower loophole.[26] This practice was not documented for payday lenders, title lenders, and does not involve refund anticipation loans. The Department was targeting military installment lenders when it asked Congress to close this consumer protection loophole.

Department to include those protections in the rules, whether interim or final. *See* February comments, at pp. 47 – 51.

[22] The "insurance packing" problem endemic to the military installment lending industry had been cited in DoD's Report to Congress, *Id* at 19. (citing Omni's 98% penetration rate of so-called "voluntary" insurance.)

[23] N.C. Commissioner of Banks, Consumer Finance Licensees, *available at* https://www.nccob.org/online/CFS/CFSCompanyListing.aspx (accessed June 1, 2007) (printout on file with the Center for Responsible Lending).

[24] Affidavit and loan contracts on file with CFA.

[25] We discuss the anti-discrimination provisions in Section IV, below.

[26] DOD Report, *supra* note 20 at 18, 51-52.

Omitting such lenders from the definition, in fact, is likely to *reverse* progress made in making state law protections available to service members stationed within the borders of states with good consumer protections. Some installment lenders, such as Pioneer, are changing business practices and obtaining state licenses in response to pressure to reform lending practices to service members.[27] Excluding military installment lenders from the proposed regulations would provide an incentive for lenders such as Pioneer to return to the business practice of claiming exemption from state protections, leaving soldiers and their families with less protection than all other residents of the state where they are stationed.

The definition of "consumer credit" was intended by Congress to cover military installment loans, and it is incumbent upon the Department to ensure that they are.

F. Principles For the Definition of "Consumer Credit"

> ***Question 4: [Related question] [T]he Department solicits comments on regulatory approaches that would encourage creditors to offer affordable, small-dollar, short-term loans to Service members and their dependents. For example, should transactions that would otherwise be covered as payday loans be exempt from coverage under these rules if the MAPR is less than 24% MAPR or some other rate specified in the rules? Would a similar rule be appropriate for vehicle-title loans or tax refund anticipation loans? Are there other approaches that DoD should consider?***

The best way to encourage creditors to offer affordable, small-dollar, short-term loans to Service members is to prohibit the high-cost products. For example, if banks were prohibited from trapping service members with abusive triple-digit ATM and debit card overdraft loans, the banks would have an incentive to develop a reasonably priced line of credit that credit impaired members could use for overdraft protection.[28] Despite urging by the FDIC, banks have been slow to develop reasonable alternatives for service members,[29] and these regulations could be the impetus they need.

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[27] "In September 2006, prior to the enactment of the New Lending Act for Service Members, we made the decision to change our business model to require that our internet lender and lenders located outside a state be licensed in each state where such lender is making loans to persons who are located in the state when the loan is made." Pioneer Financial Services, Inc., Annual Report (Form 10-K), at 5 (Dec. 19, 2006).

[28] Banks claim that credit-impaired customers do not qualify for their lines of credit, but they can give no explanation for why a customer can be allowed to overdraw the account by $1,000 but cannot have a line of credit in the same amount. At a recent conference of military credit unions, an executive with one credit union described how he was finally able to bring his small loan product into the black by turning it into a line of credit – thus avoiding the transaction costs of renewals; when asked why customers could not use that line of credit for overdraft protection instead of incurring bounce loans, he said "well, I never thought of that."

[29] *See* Alan Kline, "Troop Support ," American Banker (May 1, 2007) ("The Federal Deposit Insurance Corp. is encouraging community banks to make more small-dollar loans to cash-strapped soldiers - dangling Community Reinvestment Act credit as an incentive - but most banks are not rushing to make the loans.").

With respect to DoD's question about exemptions, as our previous comments indicate, we believe that the definitions proposed are so limited that *further* exemptions would be superfluous. We do, however, think that a price-triggered exemption or safe harbor is a better *alternative* to the excessively narrow definitions.

We urge the Department to adopt a broad definition of consumer credit, eliminating the definitional elements that create loopholes, and instead to create price-triggered exemptions such as those DoD proposes in its Question 4, above.

The only safe loophole is a low-cost loophole:

The proposed rules seek to "avoid unintended consequences" by defining the scope of the product to which the Act applies so narrowly that even its most directly targeted products will, in large part, escape, giving rise to a very different set of "unintended consequences" – that of undermining the statute itself.

Instead, a definition of "consumer credit" which encompasses these characteristics can honor the Act's goals, and implement the Department's clear desire to reduce financial stress on its service members.

Definition of "Consumer Credit": To take the loopholes out of the definition of consumer credit , it is necessary to

* *remove any duration limit;*
* *apply to both open- and closed-end credit; and*
* *avoid defining coverage by reference to practices prohibited by the Act.*

Amount cap: The dollar cap should be removed. If the DoD proceeds with a cap, at a minimum, it should be defined as the real proceeds to the borrower, excluding all charges and fees. (See II-B-1, above.)

Targeted exemptions or safe harbor: After assuring that the targeted practices will be covered by a definition without broad loopholes, narrow exemptions can be drawn for legitimate, lower-cost products. This would give more freedom to lower cost products without undermining the protection by creating loopholes as in the proposed scheme. For example, closed-end credit with a MAPR of *x*% or less,[30] or open-end credit with a TIL APR below *x*% and fees less than 5% of the credit line could be exempt.

Even if the Department feels committed to enacting interim rules that do not reach all products, it would be preferable to start with a broad definition of consumer credit and to exempt specific products. For example, if the Department is not yet ready to include

[30] For closed-end credit, the MAPR and the TILA APR are virtually identical, though credit insurance premiums might be included in the MAPR and not in the TILA APR. Thus, it would be a simple matter for a creditor to determine whether a product fit the exemption.

credit cards, it is better to have a broad definition of consumer credit and to specifically exempt credit cards than to create loopholes aimed at credit cards but big enough to swallow other products as well.

We would be happy to work with the Department, the federal financial regulators, and industry in crafting specific language for final rules. If these early rules, which we fervently hope any weak rules such as those proposed will be, are interim rules, there is ample time to craft a fairer balance before June, 2008. We believe that getting that balance right is the most important challenge facing the Department – and the proposed rules do not meet that challenge.

G. The Rules – Whether Interim or Final – Must Include an Anti-Evasion Provision.

As we discussed in our initial comments, predatory lenders will always develop creative ways to exploit loopholes in the law. Even if the rules had followed our recommendations to avoid *foreseeable* loopholes, a general anti-evasion rule would be necessary to address imaginative subterfuges or ruses not on our radar screen.

A general anti-evasion provision is all the more essential in light of the approach that DoD has taken, defining the covered products in specific ways that provide a roadmap to evasion. While we strongly urge DoD to close the loopholes as we have discussed in these comments, the final regulations must also have a general rule against tactics designed to evade the law.

We recommend the following provision, to be added to the "Limitations" in section 232.8:

> (c) No person may use any device, subterfuge, or pretense designed to evade the provisions of this Part.[31]

III. THE PROPOSED RULES REGARDING THE MAPR AND THE CALCULATION OF "INTEREST"

> ***Question 5: [Related question] The Department solicits comment on whether there are fees [other than late fees] that should be expressly excluded ...***

We believe the reverse question should be posed: are there too many fees excluded—or arguably excluded—by the proposed regulations.

<u>1. The proposal regarding the computation of the MAPR is ambiguous as it relates to credit insurance and ancillary products, and should be clarified: § 232.3(g)</u>

[31] *Cf.* Virginia Small Loan Act, Va. Code § 6.1-251

Credit insurance packing was one of the abusive practices targeted in the DoD report,[32] and addressed by Congress. It chose not to adopt the TILA definition of "finance charge" for the precise reason that TILA has the loopholes that led to the credit insurance packing epidemic in the first place.[33] Consequently, rather than using a TILA-measured APR, the MLA mandates a more-inclusive definition of interest. "Interest" includes, without limitation, "credit insurance premiums" and "any ancillary products sold with any extension of credit." *§987(i)(3)*. The MLA "annual percentage rate" includes single premium credit insurance and other ancillary products sold in connection with the credit transaction." *§ 987(i)(4).*

The proposed rule, however, is ambiguous as to whether only "required" credit insurance or ancillary products will be excluded. It provides that the MAPR includes "cost elements…if they are financed, deducted from the proceeds, or otherwise required to be paid as a condition of the credit: …" *§ 232.3(h)*. If this is interpreted to mean that only charges which are required as a condition of the credit – even if financed or deducted – - can be excluded from the MAPR calculation, then the rule is contrary to the statute.

Indeed, the DoD report cites the practices of a military installment lender that automatically added a variety of premiums, with the result that 98% of its loans included so-called "voluntary" insurance premiums, not counted in the APR.[34] The MLA's definition was intended to explicitly close that TIL loophole on loans made to service personnel, but the proposed rule may re-open it.

Even apart from credit insurance, the "otherwise required" language could also affect other fees and lead to a rule that is in fact narrower than the TIL definition of finance charge, not broader, as mandated by the statute. The TIL definition of finance charge is a charge imposed as a condition of *or incident to* the extension of credit; thus, as a general rule, fees are included in the TIL APR even if not "required." Therefore, including the "otherwise required" language could open the door for a host of other side charges which are, in theory, not "required."

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[32] *See* DoD Report, *supra* note 20, at p. 19. "Insurance packing" refers to increasing the cost of a loan by padding the loan amount with high-cost, low-value credit insurance premiums which theoretically will pay some or all of the loan in the case of death, disability, or unemployment. However, there generally is less than meets the eye to these products, and they are particularly unsuitable for military personnel. They provide very high profits for the lenders, though, which, apart from the MLA, do not generally have to be reflected in the APR-price tag.

[33] *See generally*, National Consumer Law Center, Truth in Lending, § 3.9.4.5.2 (5th Ed. 2003), National Consumer law Center, The Cost of Credit, § 8.5.4 (3rd Ed. 2005). Under TIL, the cost of premiums for credit insurance that is voluntarily purchased may be excluded from the finance charge. 15 U.S.C. § 1605(b); Reg. Z, § 226.4(d). However, the FTC and some courts view the presence of credit insurance in a very high portion of a lenders' loans as evidence that the sales are coerced. NCLC, Truth in Lending, § 3.9.4.5.2.3.

[34] *See* DoD Report, *supra* note 20, at p. 19

To implement the Act's clear definitions, the provision should, at a minimum, simply incorporate the statutory language, without superimposing limitations.

> The MAPR includes all cost elements associated with the extension of credit, including fees, service charges, renewal charges, credit insurance premiums, any ancillary product sold with any extension of credit to a servicemember or the servicemember's dependent, as applicable, and any other charge or premium.[35]

As drafted, the Department's proposed rule may have the unintended consequences of facilitating evasion of the 36 percent cap through continued fee-packing.

<u>2. The late fees can be a loophole that the Department can and should close under its MLA Authority to regulate fees.</u>

The definition of MAPR "does not include a fee imposed for actual unanticipated late payments, default, delinquency, or similar occurrence." As we discussed in our initial comments, there are several serious problems with this omission.

First, as the banking industry acknowledges, default fees and interest rates "are interdependent as a matter of both law and economics" and both are a form of "loan compensation."[36] More and more, creditors use and in fact *encourage* penalty fees as a means of generating profits, not as a way of deterring behavior or compensating for risk. Hair trigger penalty fees and default rates have become widespread with credit cards, and provide a model for other lenders to follow.[37]

Second, the very borrowers who are the target of the MLA's protections are those who are likely to trigger late fees, and excluding those fees means that their interest rates will be far in excess of 36%. Moreover, although the regulation excludes a default "fee," a lender might argue that default interest rates are also excluded from the cap.

Finally, excluding default fees gives predatory lenders a road map for how to structure their loans to have nominal interest rates under 36% but with terms that encourage defaults and default fees. Instead of rolling over a payday loan, the loan could be due in full in 15 or 30 days, but the borrower would call the rollover fee a late fee. Or, a loan could carry a 36 percent interest rate, but paying any installment even one day late—

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[35] In our February comments, we proposed a definition which was more explicit, combing the MLA language with other federal definitions. *See February Comments*, at p. 40 – 43.

[36] *See* Amici Curiae Brief Of American Bankers Association *et al.*, *Smiley v. Citibank*, No. 95-860, 1996 WL 144104 at *6 (Mar. 29, 1996).

[37] Credit card issuers have reported that 35 percent of their active U.S. accounts were assessed late fees in 2005, and 13 percent were assessed over limit fees. Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, GAO-06-929, at 33. September 2006, *available at* www.gao.gov/new.items/d06929.pdf. One major issuer has a practice of offering multiple low-limit credit cards to overextended borrowers in order to maximize over-limit fees. Robert Berner, *Cap One's Credit Trap*, Business Week, November 6, 2006

which distressed borrowers are likely to do at some point—would trigger a supplemental 50% default rate.

The 36 percent cap is already high enough to take into account the risks posed by a borrower with an inconsistent payment history, and there is no justification for permitting additional penalty fees on top of that amount. Therefore, we believe that the regulations should be amended to omit this exclusion.

Another alternative would be to use the Department's authority under §670(h)(C) to set a maximum amount to assure that any excluded fees do not become exceptions that swallow the 36 percent rule. The regulations must also include a general anti-evasion provision, as discussed in Section III-G, above, to prevent unscrupulous lenders from manipulating the structure of their loans to take advantage of the exclusion of default fees.

IV. ENSURING STATE LAW PROTECTIONS FOR NON-RESIDENT MILITARY FAMILIES

The MLA includes a provision which prohibits states from sanctioning lending to service members based within their borders at rates higher than those permitted for their residents, or permitting violation of the states' consumer protection laws on the basis of the borrower's military status. *MLA § 987(d)(2).*

This provision was enacted pursuant to recommendations in DoD's Report to Congress, which included the following:

> f. Prohibit states from discriminating against Service members and family members stationed within their borders, and prohibit lenders from making loans to Service members that violate consumer protections of the state in which their base is located.

DoD went on to list three rationales for this recommendation: (1) Service members should benefit from all protections offered to citizens of the state in which the Service member is stationed, including regulation of lenders located in the state or that provide loans via the Internet to service members stationed there. (2) States should be prohibited from authorizing predatory lenders to treat "non-resident" service members differently from in-state residents. (3) Lenders should be prohibited from charging service members stationed within a state an APR higher than the legal limit for residents of the state.[38]

The provision in the statute closed the judicially-created loophole by which military installment lenders ignore the consumer protection and credit regulatory laws of the state in which their military customers are based.[39] Unfortunately, even though the DoD

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[38] DoD Report, *supra* note 20, at 51-52.

[39] *See* Manning v. Pioneer Military Lending, Inc. 2 F.3d. 280 (8th Cir. 1993). *See generally* February Comments, *supra* note 2, at 58.

requested and Congress delivered that protection, the DoD's proposed regulations are so narrow that the protection is illusory.

The way in which the proposed rules essentially strip that provision of its fundamental purpose relates back to the definition of "credit" and, in turn, the extraordinarily narrow definition of "consumer credit." Proposed rule §232.7(b) provides that states may not:

> (1) authorize *creditors* to charge *covered borrowers* MAPRs for *consumer credit* higher than the legal limit for residents of the state, or
> (2) Permit the violation or waiver of any State consumer lending protection that is for the benefit of residents of the State on the basis of the *covered borrower's* nonresident or military status, regardless of the *covered borrower's* domicile or permanent home of record, provided that the protection would otherwise apply to the *covered borrower*.

However, the rule, as drafted, would not apply to the very practice at which it was aimed. The first subsection would apply only to "creditors," who, in turn, are defined as persons who extend "consumer credit," and only to the "consumer credit" extended by those creditors. Unfortunately, as we discuss above, under the proposed rules, the military installment lenders who generated and utilized the *Manning* loophole are not "creditors" and the high-cost, debt-trap products they target at the military are not "consumer credit."

Both subsections (1) and (2) also refer to *covered borrowers*. As the definition of *covered borrower* is drafted, there appears to be a necessary tie to a *consumer credit transaction* covered by the rules. *Proposed §232.3(c).* That is, a borrower of a military installment loan is not a "covered borrower," so subsection (2) may not apply to those loans either. It is not only unnecessary to tie the anti-discrimination provisions only to loans covered by the Act, it would defeat the purpose of that provision of the MLA to do so.

Modest changes to the proposed rule would give service members stationed away from home the full legal protections states give to their own residents. Assuring that military installment lending is covered by the rules is one such change, as we suggest in Section II. This rule should also apply to all lenders, which will at least ensure that whatever state regulation and protections a state may have in place, will apply to service members on an equal basis to the state's residents. We suggest the following language:

> (b) States shall not:
>
> (1) Permit a higher rate of interest to be charged to a regular or reserve member of the armed forces as described in §232.3(c)(1) or a dependent as described in §232.3(c)(2) than is permitted for residents of that state for similar transactions, irrespective of whether the transaction is subject to this Part, or

> (2) Permit any violation or waiver of any State consumer lending protection on the basis of the borrower's military status, regardless of the borrower's domicile or permanent home of record, irrespective of whether the transaction is subject to this Part.

This would not have negative "unintended consequences" for banks or credit unions. Banks and credit unions are already either subject to or exempt from state laws, based on laws unrelated to the *Manning* decision reversed by the MLA. The determination for application of state law to banks and credit unions does not turn on whether the borrower is a resident or non-resident: if a bank is exempt from state law, it is exempt for everyone, not just nonresident military.

V. THE "SAFE HARBOR" FOR SELF-IDENTIFICATION OF COVERED BORROWERS IS TOO EXPANSIVE AND SUBJECT TO ABUSE.

> ***Question 7: Since this issue is critical to the success of the regulation, and also protecting the reputation of the creditor, the Department solicits further comment on the proposed "safe harbor" concept and the methodology proposed to implement the intended balance in approach to identification.***

Under the proposed rule, coverage of the MLA is narrowly applied to just three fringe lending products (payday, car title, and tax refund loans). These are the only creditors who will need to identify a covered service member under the proposed rules. None of these lenders need a "safe harbor" to avoid being at "reputational" risk for failing to identify protected military borrowers, because they do not have the same dependence on reputation that the banks have. The safe harbor encourages these lenders to ignore clues of protected status, and to require only documentation that will maintain ignorance of military status.

The DoD discussion of the safe harbor provision states there is one "caveat":

> [If] the creditor obtains documentation as part of the credit transaction reflecting that the applicant is a covered borrower (such as, a current military leave and earning statement as proof of employment, or a tax filing that takes advantage of a specific tax provision designed to benefit the military), the applicant's declaration would not create a safe harbor for the creditor.

There are two problems. First, this description refers only to "documentation," and appears to allow the lender to ignore other evidence that the borrower is a Service member. For example, the lender apparently could ignore a direct oral statement that "I'm a soldier, can I take out this loan?" Or the lender could even ignore that the soldier is wearing a military uniform while applying.

Second, the description from the commentary above does not match the actual language of the regulation, which is much narrower than the commentary. The regulation states

that the creditor loses the safe harbor if the creditor has "determined, pursuant to the optional verification procedures in paragraph (b) of this section, that any such applicant is a covered borrower." The optional verification procedure in paragraph (b) allows the creditor to verify the applicant's status by requesting a military leave and earning statement, a military identification card, or a copy of the orders calling the member to military service. Thus, a lender could argue that unless it requests one of those three documents to verify military status – which it would have no reason to do if the applicant checks the "no" box claiming not to be a covered member – then it is protected by the safe harbor. (And military borrowers desperate for cash will likely go along with a lender's instructions to check such a box.) In other words, even if the lender has other documentation of military status —such as evidence of military direct deposit, or even the tax return referenced in the commentary—the lender might argue that it is entitled to the safe harbor.

We agree that a lender should not be held liable for deception, but the burden of compliance should be on lenders to factor all indicators of covered status into a decision to make loans that, after all, could violate federal law.

The proposed section 232.5 "Identification of covered borrower" should be amended to prohibit lenders from ignoring any indicators of covered status. Accordingly, we recommend that section 232.5(a)(2) be revised to state that the creditor is protected if the borrower denies military status and:

> (2) The creditor does not have reason to believe that the borrower is a Covered Borrower.

VI. THE RULES SHOULD INCLUDE A PROVISION FOR MONITORING AND PERIODIC ASSESSMENT TO ENSURE THAT THEY ARE ACHIEVING THEIR INTENDED GOALS

We understand that some of the provisions of MLA involve the Department in issues which, though extraordinarily important to the effectiveness and morale of our service personnel, are new to it. Indeed, because substantive consumer protection has historically been the purview of the states, not the federal government, in many respects, substantive protections are also comparatively new to the federal financial regulators.

Therefore, it would be unrealistic to assume that the first round of rules would "get it right 100%." Particularly when the primary targets are industries that have traditionally exploited all loopholes they can find, it is foreseeable that they will continue to do so. Consequently, we strongly recommend (1) that any narrowly drawn rules be interim rules only, (2) that broader rules be enacted within 270 days, and (3) that the rules provide for monitoring and periodic evaluation.

We suggest that the monitoring process include:

- Annual examination for the first two years, periodic examination after that to evaluate the regulations' effectiveness at protecting military families from predatory lending
- Require additional rulemaking to address ongoing predatory lending practices

To insure that the DoD has accurate information when evaluating the effectiveness of the first round of MLA regulations, the regulations should specify collection of data regarding the financial products used by service members and their families and any resulting problems. At a minimum, this data should include:

(i) Demographic information for military installations
(ii) The prevalence of lenders offering high-interest loans located near military installations or using marketing targeted to service members. High-interest loans are loans with an MAPR over 36 percent.
(iii) Actions taken to limit the prevalence of high-interest lenders
(iv) The number of lenders offering high interest loans that advertise in publications marketed to service members or their families
(v) The number of service members who lose their security clearance because of debt problems and the types of products that led to those problems.
(vi) Survey information from base debt counselors and relief societies, including the composition of the debt of service members who run into financial problems
(vii) Any Armed Forces Disciplinary Control Board actions regarding high cost lenders, any off-limit orders to financial service companies, the number of collection contacts with commanders regarding loans to Service members.

CONCLUSION

These comments do not address a number of the questions posed in the supplementary information, some of which our February comments anticipated.[40] The unasked question, we feel, is the more important one: does the proposal implement the law as Congress intended? Because much improvement is needed before we can answer yes, we urge the Department to adopt the rules as interim rules and to take advantage of the extension that Congress provided for, work with all stake-holders, and develop permanent rules to achieve its goals.

[40] For example, we propose a simple disclosure for the MLA APR, *February Comments,* p. 44. *Question* 9.