New Regulations Impose 36 Percent APR Limit on Loans to US Service Members

By October 3, 2016, US financial institutions must comply with the final rule[1] issued by the US Department of Defense ("Department") in July 2015, which amended its regulations under the Military Lending Act ("MLA").[2] The rule expands the MLA's 36 percent cost limit to additional types of consumer credit transactions (beyond just payday, vehicle title and tax refund anticipation loans) involving active duty members of the armed forces and their dependents.[3] The new rule also changes how a lender may determine whether an applicant is a covered borrower and modifies the disclosures required for those borrowers. The October 3 compliance date is particularly important, as the MLA's enforcement provisions include criminal and civil liability for noncompliance and provide for a private right of action. This Legal Update summarizes the Department's new MLA's regulations, discusses provisions specific to credit card providers and credit unions, and highlights the penalties and liabilities for noncompliance.

Background

Congress passed the MLA in 2007 in light of the Department's recognition that "financial readiness [is equated] with mission readiness," [4] and its concerns regarding "the debt trap some forms of credit can present for Service members and their families."[5] The MLA prohibits a creditor that extends consumer credit to a covered member from charging an annual percentage rate of interest greater than 36 percent, which Department regulations calculate as a "military annual percentage rate" ("MAPR"). The MLA expressly excludes home mortgages and auto-secured purchase loans from the definition of "consumer credit," but otherwise delegates authority to the Department to define the meaning of the term "consumer credit" (and thus the scope of the prohibitions).

Recently, the Department determined that expanding the definition of "consumer credit" to include a broader range of open- and closed-end consumer credit products was necessary to close loopholes that permit lenders to evade the MLA's requirements. The Consumer Financial Protection Bureau ("CFPB") also highlighted the MLA's shortcomings in 2014.[6] The CFPB worked with the Department to expand the scope of the MLA regulations and has committed to enforcing MLA requirements and restrictions for lenders within its purview.[7]

Military APR Limit

The MLA regulations previously capped the MAPR at 36 percent for certain payday loans, title loans and refund anticipation loans to "covered borrowers."[8] Specifically, under the previous MLA regulations, the 36 percent MAPR limit applied only to (1) closed-end payday loans of up to $2,000 with terms of up to 91 days; (2) closed-end auto title loans with terms up to 181 days; and (3) closed-end refund anticipation loans. However, effective October 3, 2016, the new

regulations will apply the 36 percent MAPR limit to additional types of consumer credit extended to a covered borrower and payable by a written agreement in more than four installments.[9]

Residential mortgage transactions (i.e., dwelling-secured credit transactions) will continue to be excluded from the MLA's restrictions.[10] The regulations do not expressly exempt loans to purchase, and loans that are secured by, real property that does *not* include a dwelling. A creditor making a loan to a Service member to purchase a lot of land on which the Service member intends to build a dwelling may have a colorable argument that the loan is exempt. However, it is not clear how the regulations will be interpreted in such a case.

Likewise, credit transactions that are expressly intended to finance the purchase of a motor vehicle or personal property, and are secured by the vehicle or property, are still excluded from the MLA's restrictions. In its Interpretative Rule for the new regulations, the Department explains that hybrid purchase money and cash advance loans, in which the creditor simultaneously extends purchase money and credit exceeding the purchase price as a cash advance, remain subject to the MAPR limit.[11] Thus, car loan providers that extend financing beyond the purchase price of the vehicle will not be exempt from the MLA.

The new regulations also broaden the definition of MAPR. Effective on October 3, the definition of MAPR will include any application fee (except those charged by federal credit unions or insured depository institutions when making short-term, small amount loans). It also will include fees imposed for participation in any plan or arrangement for consumer credit (excluding bona fide fees charged for credit card accounts, discussed in further detail below), in addition to any fee otherwise falling under the definition of a "finance charge" (such as a credit insurance fee or any fee for a credit-related ancillary product sold in connection with the credit transaction), according to the MLA's Regulation Z.[12] To clarify the scope of MAPR, the Department provides that any charge identified in the MLA regulations must be included in the MAPR "even if that charge would be excluded from the finance charge under Regulation Z."[13] As many lending institutions publicly commented, the 36 percent cap on MAPR is not simply a 36 percent usury cap, but includes a broad array of charges and fees within its scope.

Covered Borrowers

The MAPR limits and MLA disclosure obligations apply only to covered borrowers. A "covered borrower" is a member of the armed forces serving on active duty or active guard and reserve duty, or a dependent of such a member.[14] In response to comments by some credit card issuers and others that the definition of "covered borrower" did not address whether MLA protections would continue to apply to a Service member who is longer on active duty or leaves the military, the new MLA regulations clarify that "covered borrower" means a consumer who holds that status at the inception of the transaction and continues to hold the status of a covered borrower throughout the credit transaction.[15] For instance, for open-end credit, the MLA would not continue to apply to a consumer who loses his or her status as a covered borrower.[16]

The new MLA regulations effectively shift the burden to creditors to identify whether a consumer is a covered member. Previously, a creditor could rely on an applicant's self-certification regarding whether the applicant was an active duty Service member or a dependent of an active duty Service member—with Department regulations providing that such a self-certification would be legally conclusive as to his or her coverage under the MLA. In the final rule, the Department eliminated that aspect of the "safe harbor," out of a concern that Service members or their spouses/dependents might make false statements as to their status and get extensions of credit without the MLA's protections.

Under the new regulations, to obtain a legally conclusive determination as to a consumer's status, a creditor must obtain information about the consumer either from the Department's online MLA database (directly or indirectly) or from a nationwide consumer reporting agency.[17] In addition, the creditor must maintain a record of the information it obtains from such sources.[18] In response to comments that the new "safe harbor" effectively requires lenders that offer consumer credit to check the status of every single customer in order to identify a relatively small number of customers, the Department clarified that "nothing in the . . . final rule requires a creditor to conduct a covered-borrower check," [19] and revised the regulation such that a "creditor is permitted to apply its own method to assess whether a consumer is a covered borrower."

However, the Department also acknowledged "that a creditor should be afforded a degree of certainty regarding whether an extension of consumer credit is being made to a covered borrower." For that reason, it is likely that some financial institutions will opt to use the Department's "safe harbor."

The Department further notes that a creditor that plans to take advantage of the "safe harbor" is only required to make the status check once, at the time (i) the consumer initiates the transaction, (ii) the consumer applies to establish the account, or (iii) the creditor develops or processes a firm offer of credit.[20] However, the new MLA regulations place a 60-day limit on scenario (iii), above, related to prescreened firm offers of credit, such that a creditor may rely on its initial covered borrower determination only if the consumer responds to the creditor's offer within 60 days of the creditor making the offer.[21] After that time, the creditor may not rely on its initial determination and instead may (but is not required to) act on the consumer's response as if the consumer is initiating the transaction or applying to establish the account.

Disclosure Requirements

The Department has also amended the provisions governing the disclosures that a creditor must provide to a covered borrower, partly in recognition of the disclosures the consumer also will receive under Regulation Z. The new rule (i) eliminates the requirement that disclosures be provided "clearly and conspicuously"; (ii) requires a creditor to provide a statement of the MAPR that describes charges the creditor may impose; and (iii) provides a creditor with more flexibility in delivering the required disclosures to covered borrowers.

Despite the Federal Trade Commission's concerns that eliminating the "clear and conspicuous" disclosure requirement might result in creditors hiding information in fine print, the Department predicts that such risk is minimal.[22] The Department reasoned that a creditor that makes the disclosures pursuant to Regulation Z would provide a clear description of a borrower's payment obligations under that regulation, and the covered borrower will still receive the MLA's substantive protections.[23]

Under the new rule, a creditor must provide a "statement" of the MAPR instead of "the MAPR applicable to the extension of consumer credit, and the total dollar amount of all charges included in the MAPR," as required previously.[24] A creditor may satisfy the MAPR statement requirement by providing a description of the charges the creditor may impose relating to the consumer credit and that are used to calculate the MAPR. While the new rule does not require a creditor to provide a numerical rate or dollar amount of all charges included in the MAPR, the creditor must disclose items relating to the costs of consumer credit to comply with Regulation Z.

A creditor is required to disclose the statement of the MAPR and a description of the covered borrower's payment obligation both in writing and orally.[25] The Department's new rule permits a creditor to satisfy the oral disclosure mandate

by providing the information directly "in person," or by including a toll-free telephone number that a covered borrower can use to obtain the oral disclosures.[26]

Credit Card Providers

Recognizing the substantial time creditors would need to bring their operations into compliance with the final rule, the Department has temporarily exempted credit cards from the new definition of "consumer credit" until October 3, 2017, with the possibility of an additional one-year exemption until 2018. Of course, the fee restrictions of the CARD Act (implemented by the CFPB's Regulation Z) still apply to credit card products.

The Department has also determined that imposing the same MAPR limit on credit card products "likely would result in dramatic changes to the terms, conditions, and availability of those products to Service members and their families,"[27] and decided to treat credit card products differently going forward. When the amended MLA regulations become effective for credit card products in 2017, a credit card application fee, participation fee, transaction-based fee or other similar fee will be excluded from the MAPR limit calculation, to the extent that the fee is bona fide and reasonable.[28] To determine reasonableness, a credit card provider must compare the bona fide fee to the fees "typically imposed by other creditors for the same or a substantially similar product or service."[29] A bona fide fee is presumed to be reasonable if it is less than or equal to the average amount of the fee for the same or substantially similar product charged by at least 5 other creditors that have extended at least $3 billion in credit card loans in the past 3 years.[30] Although a fee may be reasonable even if it exceeds that average amount, the Department has refrained from providing objective criteria of a "reasonable" fee in that circumstance, indicating that this condition is intended to promote flexibility so that creditors may continue to offer various credit card products.

In effect, the new MLA regulations require a credit card provider to break down the different types of charges and services it offers, determine which fees may be categorized as a bona fide application, participation or transaction fee, and compare such fees with those charged by its competitors—all before October 2017 (or 2018, if extended). A provider contemplating new credit card features must determine how the additional costs would align with the new requirements. The Department's "reasonable" standard presents regulatory uncertainty for credit card providers planning to offer innovative products that cannot be compared against existing products. Credit card providers should also continue to monitor the Department's rulemaking activity for potential updates to its MLA interpretation.

Credit Unions

The updated MLA regulations include an exception for federal credit unions and insured depository institutions, allowing them to exclude application fees charged in connection with short-term, small amount loans in the MAPR calculation.[31] A "short-term, small amount loan" is defined as a closed-end loan subject to a federal law, other than the MLA, that explicitly limits the interest rate that may be charged, the maximum loan maturity term (which must not exceed 9 months) and the application fee.[32] The National Credit Union Administration commented during the rulemaking that the Federal Credit Union Act already imposes an interest rate limit on what a credit union may charge for a loan, and that limit does not include the actual costs associated with processing the loan application.[33] Credit unions and insured depository institutions should note that this exception only applies with respect to application fees. Those institutions still must include other charges in the MAPR

calculation, and they remain subject to the MLA's other provisions.

Penalties and Liabilities for MLA Violations

The MLA imposes significant penalties and liabilities for violations.[34] A creditor that knowingly violates the MLA faces criminal fines and up to one year in prison. Further, any contract in violation of the MLA is void from the inception of the contract. The MLA also provides for a private right of action (which Congress added to the MLA in 2013). Creditors that violate the MLA are civilly liable for actual damages, statutory damages of $500 per violation, punitive damages and attorney's fees. Although the statute also provides a defense to civil liability, it applies only where a defendant shows by a preponderance of the evidence that the violation was not intentional and resulted from a bona fide error, notwithstanding the maintenance of procedures reasonably adapted to avoid any such error. The bona fide error provisions are similar to those found in the Truth In Lending Act ("TILA") and do not include errors of legal judgment with respect to a person's obligations under the MLA.

To date, the MLA has not been extensively litigated—there is one unpublished federal appellate decision.[35] As financial institutions work to develop compliance strategies to navigate the Department's new rules, they will have to be mindful of litigation risk as well.

Conclusion

With the October compliance deadline just days away, lenders that offer credit to Service members or their families will need to ensure that their credit terms conform with the MLA's new requirements. Given the Department's attention to TILA and Regulation Z in amending the MLA regulations and the CFPB's robust regulatory activity under TILA, creditors should generally expect increased CFPB scrutiny of credit made to military personnel. Finally, Holly Petraeus, the CFPB's Assistant Director of the Office of Servicemember Affairs, recently announced her upcoming retirement from the CFPB. The appointment of a new Assistant Director[36] may prompt further CFPB activity in the area of military lending.

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Endnotes

1 Limitations on Terms of Consumer Credit Extended to Service Members and Dependents, Final Rule, 80 Fed. Reg. 43,560 (July 22, 2015). The Department of Defense separately issued an Interpretive Rule clarifying its MLA regulations on August 26, 2016 (81 Fed. Reg. 58,840).

2 10 U.S.C. § 987; 32 C.F.R. Part 232.

3 *Id.*

4 Limitations on Terms of Consumer Credit Extended to Service Members and Dependents, Final Rule, 72 Fed. Reg. 50,580 (Aug. 31, 2007).

5 *Id.* 72 Fed. Reg. at 50,582.

6 *See* the December 2014 CFPB Report available at http://files.consumerfinance.gov/f/201412_cfpb_the-extension-of-high-cost-credit-to-servicemembers-and-their-families.pdf.

7 The Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, National Credit Union Administration, and Federal Trade Commission also have authority to enforce the MLA.

[8] 72 Fed. Reg. 50,580 (Aug. 31, 2007).
[9] 32 C.F.R. § 232.3(f).
[10] *Id.* § 232.3(f)(2).
[11] 81 Fed. Reg. 58,840 (Aug. 26, 2016).
[12] *Id.* § 232.4(c).
[13] 12 C.F.R. § 232.4(c)(1)(iv).
[14] *Id.* § 232.3(g).
[15] *Id.* § 232.2(a)(1).
[16] *See id.* § 232.3(g)(4) (A "covered borrower does not mean a consumer who (though a covered borrower at the time he or she became obligated on a consumer credit transaction or established an account for consumer credit) no longer is a covered member …or a dependent … of a covered member").
[17] *Id.* § 232.5(b)(2). The Department's MLA database is available online on the Defense Manpower Data Center Status Finder.
[18] *Id.* § 232.5(b)(3).
[19] 80 Fed. Reg. 43,576.
[20] 32 C.F.R. § 232.5(3).
[21] *Id.* § 232.5(3)(iii).
[22] 80 Fed. Reg. 43,586.
[23] 80 Fed. Reg. 43,586-87.
[24] 32 C.F.R. § 232.6(a)(1).
[25] *Id.* § 232.6(a)(1), (3).
[26] *Id.* § 232.6(d)(2)(ii).
[27] 80 Fed. Reg. 43,572.
[28] 32 C.F.R. § 232.4(d)(3).
[29] *Id.* § 232.4(d)(3)(i).
[30] *Id.* § 232.4(d)(3)(ii).
[31] *Id.* § 232.4(c)(1).
[32] *Id.*, § 232.3(t).
[33] 80 Fed. Reg. 43,570.
[34] 10 U.S.C. § 987(f).
[35] *Cox v. Cmty. Loans of Am. Inc.*, 625 F. App'x 453 (11th Cir. 2015).
[36] The CFPB reported it was accepting job applications for the Assistant Director position until September 9, 2016.