



# **Report on Implementation of Limitations on Terms of Consumer Credit Extended to Service Members and Dependents**

**July 22, 2008**



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## 1. Introduction

Over the past five years, the Department of Defense (the Department) became increasingly aware of the impact high-cost, short-term lending was having on Service members and their families. State governments were also looking at these products, in some circumstances, to permit them to regulate their use, and in other circumstances to consider additional restrictions and prohibitions. By 2005, the use of high-cost credit and high-pressure collection activities was being discussed in the U.S. Congress. No legislation was passed during that session; however, the Congress requested the Department report on predatory lending practices that may impact Service members and their families.

The 2006 Report to Congress on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents looked at: the prevalence and nature of certain practices, the efforts of the Department to educate Service members and their families on credit, low-cost alternatives to high-cost credit, the overall impact of these credit practices, and recommendations for limitations. Following the receipt of the report, the Senate Banking Committee held a hearing to further review this issue.

Subsequent to the report and the hearing, the Armed Services Committees of the House and Senate included the Talent-Nelson Amendment (§ 670) as part of the John Warner National Defense Authorization Act for Fiscal Year 2007,<sup>1</sup> which provides the Department authority to develop a regulation in consultation with the Federal regulatory agencies. With the assistance of the Military Services, U.S. Treasury, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Reserve Board, Federal Deposit Insurance Corporation, Federal Trade Commission and the National Credit Union Administration, the Department released a draft regulation for comment on April 11, 2007.

Some regulators and the financial industry commented that the draft regulation prudently applied the restrictions of the statute in order to afford Service members and their families protection without hindering their access to beneficial credit. Several consumer advocates saw the draft as too narrow in its coverage and expressed concern that the industries covered by the regulation would modify their products to avoid being subject to its restrictions when offering credit to Service members and their families. Consumer advocates also expressed their criticism that the regulation did not cover products previously cited as being potentially harmful, particularly "military installment loans."

The Department addressed these concerns in the preamble to 32 CFR Part 232 (the regulation), officially published on August 31, 2007:

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<sup>1</sup> Statute: 10 USC § 987

"The Department continues to believe that the scope of the proposed rule and the definition of consumer credit are appropriate. The Department maintains the ability to issue additional rules in the future and the Department plans to continue surveying Service members and their families to collect data on their use of credit products. The Department will also monitor market developments that affect Service members and will obtain a variety of inputs from regulatory agencies, consumer protection groups and the credit industry to assess the level of protection provided by the final rule. The Department will review this data to determine if further revisions are needed."

Some respondents thought that the Department could not adequately enforce the regulation and that there was no specific mechanism requiring State regulators to enforce the regulation. The preamble addressed these concerns as follows:

"The Department does not view the regulation as having substantial direct effects on States, or distribution of power and authority. States determine whether they will enforce the regulation or not for creditors under their jurisdiction. Associations of state supervisors recommended the Department seek written agreements between the Department and state regulatory agencies about enforcement, supervision, and information sharing to help state authorities enforce those areas that will normally fall under their jurisdiction. The Department intends to rely on federal and state regulators to oversee or enforce compliance with the final rule, to the extent possible under their statutory authority, for their respective creditors."

This report has been developed to address coverage and state enforcement and to provide overall feedback on the implementation of the regulation. The request for this report is described in the Special Interest Item found on pages 355 and 356 of Senate Report 110-77 accompanying the Fiscal Year 2008 National Defense Authorization Act. The text of this Special Interest Item is as follows:

***"Implementation of limitations on terms of consumer credit extended to service members and dependents***

The committee notes the progress of the Department of Defense in drafting rules to implement section 670 of the John Warner National Defense Authorization Act for Fiscal Year 2007 (Public Law 109-364), which provided protections for service members and their dependents against predatory lending. The rules were published on April 11, 2007, in the Federal Register (72 Fed. Reg. 18,157). Eliminating predatory lending is a complex problem, and the committee recognizes the need for sound discretion in ensuring service members have access to credit while also ensuring that barriers to predatory lending practices are implemented as Congress intended.

The rules proposed by the Department excluded military installment loans, a form of predatory lending singled out in the Department's 'Report on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents' of August

9, 2006. The committee expects the Department to carefully consider the risks involved in its approach as it finalizes its rules, to make regulatory changes when appropriate, and to recommend statutory changes when needed to eliminate predatory lending.

The committee is also concerned about the Department's heavy reliance on the States for enforcement in its proposed rules. The committee will look to the Department to monitor enforcement nationally to ensure consistent treatment of service members regardless of where they are stationed. The Department should continue to work with State legislatures to achieve fair and uniform enforcement for the benefit of military personnel and their dependents.

The committee directs the Secretary of Defense to report to the congressional defense committees by April 1, 2008 on the Department's implementation of section 670 of the John Warner National Defense Authorization Act for Fiscal Year 2007 (Public Law 109-364), including any recommendations for regulatory or statutory change."

## 2. Executive Summary

Although the regulation has been in effect for less than six months as of this writing, feedback from various sources indicates the implementation of and compliance with the regulation has been effective in curbing payday and vehicle title loans, and has restricted refund anticipation loans obtained by Service member and their families.

- Installation-level financial counselors and legal assistance officers reported limited use of payday and vehicle title loans in describing circumstances where Service members need financial counseling and assistance.
- Banks and credit unions associated with the military and Military Aid Societies have increased their availability of affordable small-dollar loans to meet immediate cash needs.
- Advocacy groups have identified an internet-based payday lender that changed its product to avoid the restrictions in the regulation.
  - They also identified three states where the regulation did not adequately preclude the lenders from continuing to offer high cost loans that should have been controlled by the regulation.
  - These examples point towards there being only a very limited desire for lenders providing covered loans to modify their products to avoid the regulation.
- The Department has an opportunity to work with states and through avenues such as the AFDCB to preclude Service members and their families from accessing these few occurrences.
- Likewise, the Department views oversight of installment loans as providing an opportunity to work with Federal and states regulators, and internal systems, to protect Service members and their families.
  - Increasing the regulation's coverage to include these loans would potentially decrease availability of beneficial credit for Service members and their families.
  - This may also occur if the Department attempts to place limits on overdraft protection programs and high fee/low available balance credit cards. We note that the Office of Thrift Supervision (OTS) is seeking information on these products in advance of rulemaking and the Federal Deposit Insurance Corporation (FDIC) is in the process of reviewing a survey of overdraft protection programs offered by member banks.
  - In committing to this framework, the Department is concerned that all lenders have sufficient oversight by external regulatory agencies.

- While the Department does not see a need at this time for significant change in current statutes and regulations to provide effective credit protection for Service members and their families, there is one issue that may require Congressional attention:
  - Modification of the definition of covered borrower in 10 USC § 987(i)(2)(C) to coincide with the description used in DEERS. As described on pages 16 and 17, this approach relieves the borrower of the burden of proving (or disproving) he or she is covered by the regulation.
- The Department has established a balanced approach in using the regulation to curb products with demonstrated high costs and balloon payments, while working with Federal and state governments to protect Service members and their families in other credit circumstances.
  - The Department will continue to work closely with Federal agencies and is in the process of establishing MOUs with states to solidify these relationships.
- As a foundation to all of its protection efforts, the Department is continuing the Financial Readiness Campaign to help Service members and families discern financial products that will enhance their abilities in the marketplace, rather than provide them "easy credit."

### 3. Gathering Feedback

In developing the materials to prepare the report, the Department sought input from consumer advocacy groups, Federal and State financial regulators, trade associations representing financial institutions, the Military Aid Societies and the Military Services. The consumer advocacy groups had expressed their concerns about the exclusion of installment loans as part of their June 11, 2007, input to the request for comment of the proposed rule. Additionally, these groups expressed concern about courtesy overdraft products and credit cards that have low available credit and high fees. On November 2, 2007, the Department requested feedback from the consumer groups if they had found evidence that there were practices and products that may be harmful to Service members and their families. These groups provided a consolidated response on November 30, 2007, saying their June 11, 2007, response was still effective.

Subsequently, the Department sent requests to trade associations representing banks, credit unions, and other financial services companies to obtain their feedback on the concerns posed in the Senate Special Interest Item, plus the items addressed by the consumer advocates, and other areas of interest to the Department. In order to provide an opportunity for all interested parties to give input, the Department posted a Federal Register Notice.<sup>2</sup> To focus feedback on the Special Interest Item and the items that had been brought to the attention of the Department by the consumer advocacy groups, the Department included the following requests for comments along with the Special Interest Item:

"To help develop this report, the Department of Defense is seeking comments from the public about the potential negative impact of certain consumer loan products on Service members. Please indicate whether the following products, which are not currently regulated by 32 CFR 232.3, negatively impact Service members to the degree that the Department of Defense should regulate them. If regulation is needed, please provide proposed solutions. These products are:

- Installment loans, not covered in the definitions of credit in 32 CFR 232.3. These installment loans may include excessive fees and interest rates, loan flipping, and regular inclusion of high cost ancillary credit insurance products.
- Credit cards that are characterized by minimal available credit coupled with high fees.
- Fee-based, high-cost, courtesy overdraft products.

Additionally, the Department of Defense is seeking comments from the public on the implementation of 32 CFR Part 232, specifically issues concerning:

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<sup>2</sup> Federal Register, Vol. 72, No. 247, December 27, 2007, pages 73336 – 73337

- Disclosure requirements and identification of the covered borrower as required by 32 CFR 232.5 and 232.6.
- Implementation of alternative small-dollar credit products and recommended changes that can facilitate producing and delivering these products to Service members and their families.
- Oversight and enforcement of the regulation with respect to Internet-based lenders offering credit covered by the definitions in 32 CFR 232.3.
- Methods for the Department of Defense to use in monitoring enforcement of the rule."

An important aspect of determining the effectiveness of the implementation of the regulation is understanding its impact on Service members and their families. The Department has asked about the use of payday, vehicle title, and refund anticipation loans in the past and has baseline information through 2007. Additionally, the Department asked about the use of overdraft protection and installment loans in 2007.

There was not sufficient time to conduct surveys of Service members and their families to gather information following the implementation of the regulation October 1, 2007, so the Department requested installation-level 'personal financial management' counselors, legal assistance officers and Military Aid Society counselors to provide feedback about their clients (without providing any information that would violate privacy or attorney-client restrictions) when their clients:

- Obtained a payday loan, vehicle title loan, or tax refund anticipation loan,
- Obtained another type of loan with an annual percentage rate (APR) in excess of 36% (when all fees, charges, and insurances are included in the calculation of the APR), or
- Were in any situation where they felt there were no alternatives or assistance available.

Counselors and legal assistance officers were to gather the following information and ask the following question in these circumstances:

- Describe the borrower: grade, married/single, single/multiple family paychecks, etc.
- What circumstances required the borrower to obtain high cost loans?
- What was the borrower's level of debt, and how much cash was needed to satisfy immediate needs?
- What types of credit were outstanding (to include credit cards, installment loans, overdraft protection, lines of credit, etc.)?

- Were there low-cost alternatives (to include banks, credit unions, and military aid societies) where the borrower obtained a loan or where the individual was turned-down from receiving support?

Through these various sources, the Department sought as much information as possible to provide constructive feedback concerning the implementation of the regulation and potentially harmful forms of credit (or harmful credit products). This information is intended to provide an informed assessment, but is not being provided as a comprehensive evaluation of the topics covered. A list of the contributing organizations is included at Appendix 1.

#### 4. Implementation

The regulation was published on August 31, 2007 and went into effect on October 1, 2007. Media coverage of the release of the regulation was light. The date of implementation, October 1, 2007, also passed without significant comment. The Department prepared several messages for internal media in order to inform Service members and their families of the protections afforded them by the regulation as well as their responsibility to correctly identify themselves as being covered by the regulation when asked by lenders impacted by the regulation.

##### Impact on the Military Consumer:

Over 80 installation-level personal financial management counselors from the Military Services provided informal feedback at the military pre-conference of the Association for Financial Counseling and Planning Education (AFCPE) in mid-November 2007. They had seen clients with payday lending concerns as the law was going into effect, but they mentioned they had seen a drop in cases associated with payday loans after the initial transition. They also were not seeing any increase in the use of other sources of high-cost lending as a result of prohibitions on payday loans.

The Military Services requested installation-level financial counselors and legal assistance officers provide non-attributable feedback on counseling sessions that featured one of the credit products covered by the regulation (payday, vehicle title, or refund anticipation loan), other credit products with an annual percentage rate above 36 percent, or in circumstances where the client felt he or she had no viable solution to resolve the credit problem. It should be noted that the period for this data call was after enactment of the federal regulation, so loans covered by the regulation were obtained contrary to the federal law. Variance in numbers between services reflected not only regional differences in how the federal protections were implemented, but also the effectiveness of campaigns in each service to educate service members and provide alternative sources of relief.

- *Describe the borrower – grade, married/single, single/multiple family paychecks, etc.*

The Military Services provided 391 case studies (Army reported 233, Navy 35, Marine Corps 11 and Air Force 113). The following table provides the demographic make-up of the clients reported by financial counselors and legal assistance attorneys:

Marital Status:		#	%	Income:			#	%
Single or divorced		117	30	Single			312	80
Married or separated		274	70	Two			79	20
Grade:	E1	E2	E3	E4	E5	E6	E7	O1+
#	13	25	70	114	100	50	16	3
%	3	6	18	29	26	13	4	1

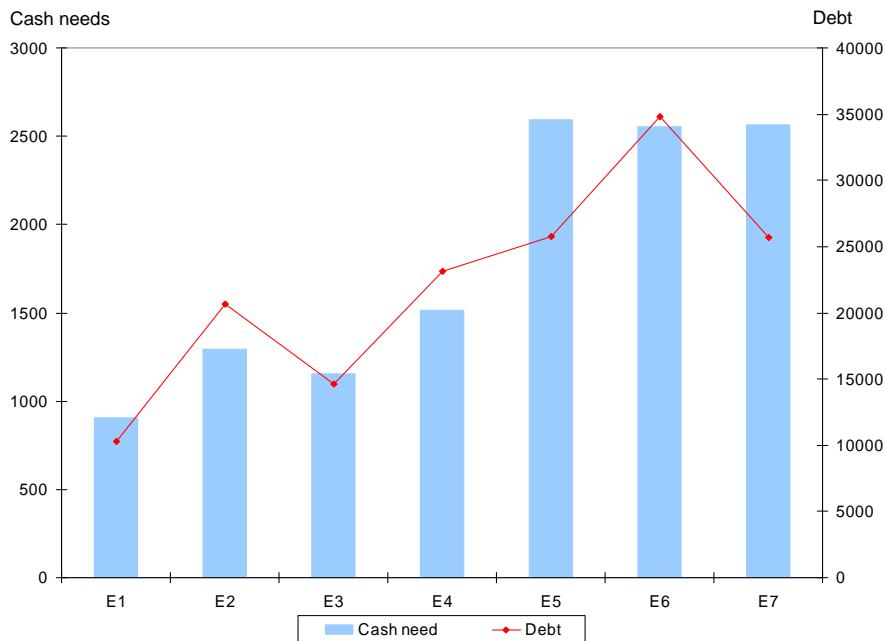
- *What circumstances required the borrower to obtain high cost loans?*

Specific circumstances varied – the following represents the 391 cases in terms of broad categories:

Category	Number	Percent
Overspending (Living outside their means)	195	52
Sudden Decrease in Income (unexpected)	13	3
Decrease in Income (expected - PCS)	11	3
Unforeseen Expense (Emergency)	57	15
Other – To include divorces and marital separations, insufficient funds to purchase needed household products, such as furniture and basic appliances	101	26
Insufficient detail to determine circumstances	14	3

- *What was the borrower's level of debt, and how much cash was needed to satisfy immediate needs?*

The average level of debt for enlisted clients was \$28,888 (excluding cases that referenced mortgages as being part of the outstanding debt). They needed an average of \$2,351 to satisfy their immediate cash needs. The following chart shows the debt load and cash needs by enlisted grade. The average debt of \$32,279 and average cash need of \$7,217 for the three officers counseled was driven by the unforeseen emergency needs of one officer, and was not included on the chart.



- *What types of credit were outstanding (to include credit cards, installment loans, overdraft protection, lines of credit, etc.)?*

As would be expected, unmanageable debt requiring counseling and legal assistance is the result of overextending all credit products available. The following represents the percentage of clients that had outstanding debt using the following products:

Product	%*	Product	%*
Credit cards, in-store credit and lines of credit	66	Installment loans, personal loans and signature loans	63
Auto loans	30	Payday loans	22
Use of overdrafts and overdraft protection	19	Student Loans	6
Advances from military pay	5	Mortgages	4
Rent-to-own debt	2	Vehicle title loans	1

\* Percentages exceed 100 since some Service members used multiple loan products.

Credit cards and installment loans were the most common contributor to the clients' debt load. Individuals with large levels of outstanding debt normally had one or more auto loans and a small number had mortgages and outstanding student loans. Counselors forwarded 92 case studies (22 percent) in which the client admitted to either having had payday loans or carrying payday loan debt. Although 22 percent may appear to be a significant percentage of clients, counselors were instructed to document *all* cases in which clients had obtained payday loans, as well as others that featured loans with APRs over 36 percent. Feedback from Air Force financial counselors included sources of payday loans. Of the 40 Air Force clients who admitted to having payday loans, 4 (10 percent) obtained them from storefronts, 18 (45 percent) borrowed over the internet and 18 obtained loans from kiosks.<sup>3</sup> The small number of loans obtained through storefront operations may be an indication that the regulation had a direct impact on these operations.

- *Were there low cost alternatives (to include banks, credit unions, and military aid societies) where the borrower obtained a loan or where the individual was turned-down from receiving support?*

Input from counselors to this question showed that alternative low cost sources of cash to resolve immediate needs were available and more often considered by the client. Seventy two percent of the case studies provided feedback on whether alternatives were considered by the client. Information on these cases showed that 25 percent of clients considered banks and credit unions , 46 percent considered military aid societies, 17 percent used other sources, and 7 percent chose debt management programs. Five percent did not consider using an alternative low cost loan. Not all counselors

<sup>3</sup> Kiosk lending outlets are fully automated terminals that function similarly to Automatic Teller Machines.

documented whether clients were successful obtaining funds from these alternatives. Feedback from the Air Force included approval information – 53 percent of requests were approved (9 percent of requests to banks and credit unions, 92 percent to Air Force Aid Society and 23 percent to other sources).

The general profile of these clients could be summarized from this data to be junior non-commissioned officers, married with a single income, with over \$28,000 in debt and an immediate cash need of approximately \$2,300. They have multiple debts that can no longer be managed without some intervention. High interest rate sources of easily available cash are often times the solution because of poor credit history and score, or insufficient capacity to take on additional debt. Service members find sources for "easy credit" with which they believe they can get by, but often these loans exacerbate their situation. Over half of the Service members in the report have credit problems because of chronic overspending. Most of the remaining Service members had some unforeseen event or circumstance (emergency, loss of income, divorce, etc.) that overwhelmed their already over-burdened finances.

The case studies collected for this report cannot be used to make general comments about the financial condition of Service members or the impact of the regulation on Service members and their families. These case studies perhaps provide a view of where Service members have used lending products covered by the regulation, in the context of their overall debt, to include other high cost loans.

The case studies from the Military Services were not conclusive about the effectiveness of the regulation: less than 24 percent of case studies featured these loans. Feedback from the Navy Marine Corps Relief Society (NMCRS) provided a clearer indicator of the impact of the regulation on Service members:

"Over the past four months since the implementation of the Military Lending Act on Oct 1, 2007, the Society has monitored both the effectiveness of the legislation and the impact of lending practices not covered by the regulation. On the positive side, we have experienced a decrease in the assistance provided to active duty personnel entrapped by the predatory loan industry. In the first nine months of 2007, the Society assisted victims of payday loan industry with loans and grants averaging 100K/month. In the four months since Oct 1, the average has been \$40K/month."

The NMCRS input goes on to say that most of the payday loan contracts encountered by their offices since the implementation of the regulation involve retirees and their families instead of their active duty counterparts and that payday loans are still available for active members and their families through internet sources.

## Impact on Creditors Providing Payday, Vehicle Title, and Refund Anticipation Loans:

The consumer advocacy groups that provided input for this report<sup>4</sup> sought out available information to determine the impact of the regulation on creditors offering payday loans, particularly from storefront locations. Their review of state sources showed that evidence of closures is not readily available this soon. Many states will only note closures when lenders fail to renew their license, which may not be annually. Colorado requires annual licensing but has not started their process for 2008. Anecdotal information from state regulators shows that there has been a net decrease in the number of storefront operations around military installations. In an effort to quantify the impact, the consumer groups asked Dr. Steven M. Graves, who produced maps showing storefronts around military installations in 2005 and 2006, to calculate the impact in California ZIP codes: "Statewide there has been a slight *increase* in the number of payday lenders since 2004, reaching a peak perhaps in 2006. Between January 2007 and January 2008, about 126 shops have closed (about 5%). A significant number (27) of those closures have been near military bases."<sup>5</sup>

Compliance with the regulation generally appears to be effective, particularly concerning storefront operations. Discussions with state regulators who are members of the National Association of Consumer Credit Administrators (NACCA) only revealed a few incidents where lenders had inadvertently provided loans to covered borrowers. The Consumer Federation of America (CFA) searched the internet to determine the level of compliance at sites found through "Google.com" using the terms "payday loans," and "payday loans military apply." They reviewed the first four pages of military oriented sites and the first page of payday loan sites.

In their military payday loan search they visited 30 sites that offered loans (not articles or general information). These sites fell into three categories: sites providing lists of web addresses to payday lenders, sites that accepted applications from borrowers and then forwarded the application to a payday lender, and actual payday lenders. Several of the military oriented sites linked to installment loan companies.<sup>6</sup>

Thirteen of the sites asked applicants to identify whether they are active duty military or a dependent of an active duty member. These sites stated that loans could no longer be made to members of the military or their families. For example, one site posted the message: "Due to restrictive federal legislation, we are no longer able to offer military personnel (or their immediate family) our short-term loans. As a result, we were not able to approve your loan request. We appreciate all you do for our country, and we regret not being able to assist you."

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<sup>4</sup> Center for Responsible Lending; Consumer Federation of America; Consumers Union of U.S., Inc; National Association of Consumer Advocates; and the National Consumer Law Center.

<sup>5</sup> Consolidated response from consumer advocacy groups submitted February 25, 2008 to 72 Federal Register 73336-7 (December 27, 2007), Docket Number DoD-2006-OS-0216, page 5.

<sup>6</sup> Ibid, page 6.

Eleven sites were reviewed as a result of searching "payday loans" on Google.com. Only three of these sites requested identification of the applicant as an active duty member of the military or a dependent of an active duty member. CFA could not determine if the remaining sites might make an assessment of military affiliation after the application is submitted.

The Department asked for comments on appropriate ways to ensure internet-based lenders comply with the requirements of the regulation. Only the NACCA submitted comments concerning this difficult issue. They made the following statement: "As to the applicability of the Act to Internet-based lenders offering credit covered by the definitions in 32 CFR 232.3, some states have consumer credit laws whose applicability extends to Internet lenders or others who offer consumer credit to residents of their state, regardless of the physical location of the lender." The application of this concept will be discussed further as part of the Department's cooperation with state regulators.

#### "Morphed" Credit Products:

NMCRS expressed concern that lenders may be restructuring their products to evade the restrictions required by the regulation. NMCRS used Military Financial, Inc. as an example of a lender who revised its product from a closed-end loan to an open-end line of credit. The Department was also aware of the Military Financial Inc. example<sup>7</sup>; however, the Department has not received other examples of lenders "morphing" their product as a result of the regulation.

The consumer groups also made comment about the impact of state-wide changes that have recently occurred and the reaction of the impacted lenders. In Illinois, payday lenders lengthened the terms of their products to avoid the Illinois Payday Reform Act, which defines covered loans as being at or less than 120 days. The Military Financial, Inc and the Illinois payday lending examples may provide insight into how the Department may address "morphed" payday, vehicle and refund anticipation products.

Some in the payday lending industry reported in the past that the military community was only a small part of their market.<sup>8</sup> Additionally, modifying a payday product to avoid the definition of the regulation may require the lender to file for additional state licenses. These measures may prove to be less profitable for the lender than limiting payday loans to borrowers not covered by the regulation. Conversely, the change to Illinois statute limited the terms of payday loans for all borrowers within the state. The lenders were required to offer loans within the limits of the new law or to modify their products. Most payday lenders in Illinois elected to offer "installment" payday loans for over 121 days with annual percentage rates of over 500 percent.<sup>9</sup>

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<sup>7</sup> *Army Times, Air Force Times, and Navy Times*, December 31, 2007.

<sup>8</sup> "Payday Lenders Target the Military," <http://www.responsiblelending.org/pdfs/ip011-PaydayMilitary-0905.pdf>

<sup>9</sup> Consumer advocates report page 4.

Similarly, the regulation limited the ability of Military Financial, Inc. to reach its exclusive market with their payday loan product, and since a Delaware statute (where the company is licensed) allows them to offer an open-end credit product, modifying their product to this format permitted them to continue to offer high-fee short term products to Service members and their families. Military Financial, Inc. was one of the few companies that offered payday loans exclusively to the military prior to the implementation of the regulation. Their dependency on the military market appears to have prompted Military Financial, Inc. to modify their product. (Storefront and other internet lenders may be less likely to modify their products to avoid the regulation, when the military represents only a small percentage of their market, and the various state statutes may be as restrictive for other potential products).

The consumer groups addressed similar concerns over vehicle title loans offered in Virginia and Kansas, which allow title loan companies to market a line of credit product instead of a closed-end loan. The consumer groups recommend that the regulation be modified to cover open-end variations of payday and vehicle title loans. However, during the comment period on the draft regulation, financial institutions and trade associations cautioned that there would be potential for unintended limitations on the availability of credit if the definitions were extended to include open-ended variations for the covered credit products.

In circumstances where there are only a few companies who "morphed" their products, particularly around military installations, the Department may have the opportunity to use the Armed Forces Disciplinary Control Board (AFDCB) as a method of determining whether to preclude Service members and their families from obtaining these products. This observation was made both in the consolidated input from the bank associations<sup>10</sup> and by the Navy Federal Credit Union. Furthermore, broadcasting information to the military community that these products may be a costly and potentially harmful alternative may have the desired deterrent effect.

#### Comments Concerning the Statute and Regulation:

The Department requested respondents to the Federal Register notice provide feedback concerning the identification and disclosure requirements specified in §232.5 and §232.6 of the regulation. HSBC and the National Association of State Credit Union Administrators (NASCUS) were the only respondents to comment on these two sections of the regulation. HSBC was the only financial institution to comment, presumably since they provide RALs and other financial institutions responding do not offer credit covered by the regulation. HSBC had concerns with both identification and disclosure requirements. NASCUS commented on both from a regulatory perspective.

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<sup>10</sup> American Banker Association, Financial Services Roundtable, Association of Military Banks of America, Consumer Bankers Association, and the Independent Community Bankers Association.

As the originator of RALs, HSBC had concern with comments made in the preamble that the tax preparer should complete an optional verification procedure if the tax client produces information that would lead the tax preparer to believe the client is in the military (such as documents showing military income). As the originator of the loan, HSBC stated it does not have access to this information and is concerned about the criminal liability involved in providing a loan to a covered borrower. Further HSBC does not believe this information is "dispositive of the question whether a person is a covered borrower." They recommended adding a sentence to the end of §232.5(a)(2) that states: "Information known to a tax preparer is not imputed to a creditor of a tax refund anticipation loan for these purposes, unless such information is specifically provided to the RAL lender in a manner other than transmission of tax forms." The Department believes tax preparers and lenders making the RALs should develop their own processes as part of their business agreements to ensure covered borrowers are appropriately identified. NASCUS reiterated this position in their comments concerning identification of covered borrowers by credit unions: "NASCUS believes that the procedures implemented by a credit union to identify a covered borrower are best addressed by the industry."

HSBC offered an alternative solution to identifying the covered borrower. They believe making a query to the Defense Manpower Data Center database should function as the verification required to establish a "safe harbor" from criminal liability. The regulation currently includes access to the database through a website (<https://www.dmdc.osd.mil/mla/owa/home>). This alternative could be considered except that the DMDC database does not entirely cover all borrowers defined in 10 USC §987(i):

“(1) COVERED MEMBER.—The term ‘covered member’ means a member of the armed forces who is—

“(A) on active duty under a call or order that does not specify a period of 30 days or less; or

“(B) on active Guard and Reserve Duty.

“(2) DEPENDENT.—The term ‘dependent’, with respect to a covered member, means—

“(A) the member’s spouse;

“(B) the member’s child (as defined in section 101(4) of title 38); or

“(C) an individual for whom the member provided more than one-half of the individual’s support for 180 days immediately preceding an extension of consumer credit covered by this section.

Some of the individuals defined in (C) above are not included in the database, which is based on definitions used for the Defense Eligibility Enrollment Reporting System (DEERS) as described in DoD Instruction 1000.13. The Instruction defines this category of dependent (in accordance with 10 USC §1072(2)(E)) as being a "Father, Mother, Father-in-Law, Mother-in-Law, Stepparent, or Parent-by-Adoption, if a member of a

household maintained by or for an authorized sponsor and dependent on that sponsor for over 50 percent of his or her support."<sup>11</sup>

This category of individuals in the DEERS database is more limited in scope than the group defined in (C) above. Conceivably, (C) above could include other relatives or friends who receive the stated level of funding from the sponsor but do not live in a household maintained by the sponsor. Also, the requirement that the individual have received this support for 180 days immediately preceding an extension of a covered loan is not compatible with maintaining a database to define this group. The alternative of using a database could only be considered if (C) above was modified in the statute to match the definition included in the DoD Instruction 1000.13 and 10 USC §1072(2)(E).

Applying a definition of the covered borrower that is consistent with the database could provide a more consistent approach to identification. This approach could allow creditors a more efficient method of assuring they are complying with the law and regulators a consistent approach they can apply during their compliance evaluation. Most importantly, this approach would relieve the borrower of the burden of proving (or disproving) he or she is covered by the regulation.

HSBC also commented that the disclosure of the Military APR (MAPR) included in §232.6 of the regulation is confusing when presented with disclosures required by Regulation Z (Truth In Lending Act). Navy Federal Credit Union and others made the same point in their response to our Federal Register notice. HSBC contends that the MAPR should only be used to determine whether the credit should be extended to the covered borrower. Navy Federal Credit Union contends the statute does not require the MAPR be made part of the mandatory disclosures. The statute has thus far been interpreted to require the disclosure of the MAPR and, were the statute interpreted not to require disclosure of the MAPR, the Department would require disclosure because the Department believes the MAPR is applicable as a disclosure for the three credit products defined in the regulation. In addition, the Department notes that there are generally no fees or other charges included that would make the MAPR different from the TILA APR. In the event there are additional fees, the covered borrower should understand how these fees impact the cost of the covered credit as expressed as an annual percentage rate.

#### Alternative Low-cost Small Dollar Credit Products:

As described in the preamble to the regulation, identifying alternatives for Service members and their families is important for assisting them in reestablishing their financial well being. As stated in the preamble: "The Department prefers that Service members and their families who experience financial duress seek help through Military Aid Societies, military banks and defense credit unions rather than [through] credit products that would more likely mire them in a cycle of debt. These institutions have established

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<sup>11</sup> DoD Instruction 1000.13, Enclosure 4, paragraph E4.A1.1.1.

programs and products designed to help Service members and their families resolve their financial crises, rebuild their credit rating and establish savings."

The Military Aid Societies have developed loan programs that are easily accessible by Service members and their families for small dollar loans. Army Emergency Relief has seen their Command Referral Program increase in popularity. This no-interest loan allows Soldiers to borrow up to \$1,000. In 2005, the Command Referral Program constituted seven percent of the dollar volume of assistance. In 2006, this program increased to 19 percent of the dollar volume, and as of September 2007, the Command Referral Program constituted 24 percent of assistance.<sup>12</sup> Likewise, the NMCRS has seen an increase in the usage of their Quick Assist Loan, particularly since the implementation of the regulation. The no-interest Quick Assist Loan allows Sailors and Marines to borrow up to \$300 without a referral with up to 10 months to repay. The loan was instituted in 2007 and as of January 2008, NMCRS has provided over 3,830 loans.<sup>13</sup> The Air Force Aid Society started its Falcon Loan program on March 3, 2008. The Falcon Loan program provides no-interest loans to Airmen of up to \$500 with 10 months to repay.<sup>14</sup>

The Defense Credit Union Council (DCUC) reported on the alternative products provided by their members. DCUC reported there are 47 credit unions offering low cost installment loans, two-week loans, and lines of credit at approximately 135 installations worldwide. Average maximum amount on these loans is \$577. Interest rates on these loans vary from approximately 7 to 24 percent APR, with the average interest rate of approximately 17 percent APR with no additional fees. Some of the line of credit products feature nominal annual fees along with an APR of approximately 18 percent. Three of the loan programs feature savings components and at least seven of the programs require financial counseling.

The National Association of Federal Credit Unions (NAFCU) reported that 92 percent of the 156 credit union members surveyed offer small affordable loans of \$500 or less. All of the survey respondents offer loans without origination fees, provide approvals within 24 hours and offer loans with APRs well below 36 percent. Seventy five percent of respondents said their small loans are offered with payment periods beyond one pay period.

The bank trade associations reported their member banks have responded to the needs of Service members and their families with loans featuring streamlined application processes for amounts ranging from \$100 - \$2,000 with interest payments between 12% and 18% with minimal fees. The bank trade associations focused their comments on the

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<sup>12</sup> Army Emergency Relief website, Section Notes webpage for October 2007; [http://www.aerhq.org/News\\_SectionNotes.asp](http://www.aerhq.org/News_SectionNotes.asp).

<sup>13</sup> Navy Marine-Corps Relief Society letter, February 14, 2008.

<sup>14</sup> Michael Hoffman, "\$500 Loans Soon Available from Aid Society," *Air Force Times*, February 20, 2008, [http://www.airforcetimes.com/news/2008/02/airforce\\_falcon\\_loan\\_08220w/](http://www.airforcetimes.com/news/2008/02/airforce_falcon_loan_08220w/).

experience of one bank member of the Association of Military Banks of America. This member bank has branches on 37 military installations and provided over 7,700 loans in 2007 (total of \$8.2 million) to Service members and families experiencing financial difficulty. This represented an increase of 80 percent in the number of loans and 60 percent in the amount loaned over their 2006 activity for this product. Comparing October – December 2007 to the same period in 2006, loan volume increased from 1,200 loans for \$1.5 million to 1,900 loans for \$1.8 million. The bank believes this increase is attributable to the implementation of the regulation.

As mentioned in the preamble to the regulation, the FDIC has established a pilot program with 30 banks offering affordable alternative loans. The pilot begins in May 2008 and will be studied for two years. The participating banks are headquartered in 17 states, with 550 branches located in 27 states. A member of AMBA (Armed Forces Bank) is included on this list of participating banks. Key features of small-dollar lending programs featured in the FDIC pilot include:

- Loan amounts of up to \$1,000;
- Amortization periods longer than a single pay cycle and up to 36 months for closed-end credit, or minimum payments that reduce principal (i.e., do not result in negative amortization) for open-end credit;
- Annual percentage rates (APR) below 36 percent;
- No prepayment penalties;
- Origination and/or maintenance fees limited to the amount necessary to cover actual costs; and
- An automatic savings component.<sup>15</sup>

In addition to the on-going efforts of the Military Aid Societies, banks and credit unions, three companies have approached the Department with similar concepts that would allow Service members to borrow against their future pay. The Department is considering the applicability of these proposals which look to eliminate much of the cost of producing small affordable loans by streamlining the application process and using a connection to the borrower's pay to repay the loan. Two of the options are offering a line of credit approach and one features a closed-end loan. All have proposed offering small loans and reasonable payback schedules. These proposals require additional review prior to determining their viability.

#### Education Program Update:

As stated in the preamble of the regulation, financial protection for Service members and their families is based on providing relevant limits in statute and policy, affordable alternatives, and financial education. Several of the respondents included comments about the importance of education. Both the bank and credit union trade associations

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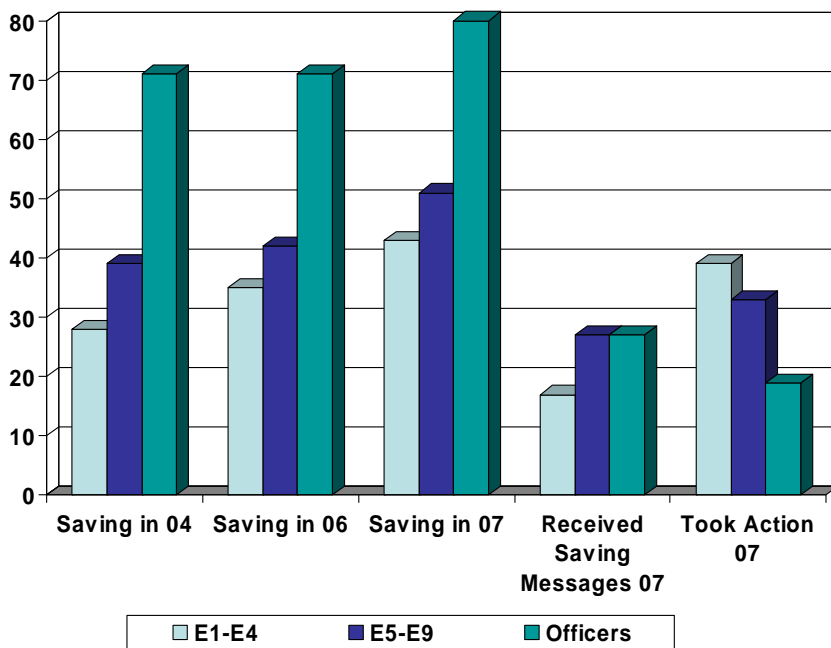
<sup>15</sup> FDIC website, Small-Dollar Loan Pilot Program, <http://www.fdic.gov/small-dollarloans>.

referenced their on-going efforts to support the Department's financial readiness campaign. Notable collaborations have included the 2007 and 2008 Military Saves Campaigns during the last week in February of each year. Military Saves is a social marketing campaign to highlight the need for members of the military and their families to establish savings – both for short term emergencies and for long term goals. Further information is available at [www.militarysaves.org](http://www.militarysaves.org).

These messages are directed at the most prominent core problems associated with the use of credit found in the case studies collected for this report: overspending – living beyond one's means, and being prepared for unforeseen emergencies. Once motivated to make a change, Service members and their families can take advantage of the counseling and educational resources available through Military OneSource, installation family readiness centers and from partner organizations, such as banks, credit unions, the Financial Institutions Regulatory Authority, CFA and the InCharge Institute.

Concurrent with financial education campaigns focused on the individual service members, military leadership in the Services are driving greater command awareness on the importance of financial health and its link to both quality of life and military readiness. Changing the cultural attitude towards financial health will encourage Service members to seek help from DoD sponsored relief rather than high cost commercial lenders.

Tabulated responses to three of the survey questions included in the DMDC Status of the Force Active Duty Survey, April 2007, shown below, provides positive indications that awareness and education efforts are making a difference.



The chart shows a steady increase in the percentage of Service members who reported that they are regularly setting aside income for savings on a monthly basis. In 2007, the Department asked if they had received messages in the past 12 months about reducing debt and increasing savings, and whether they had taken any action upon hearing those messages. Although only 17 percent of junior enlisted Service members said they remembered hearing a message, 39 percent of those who had heard, took some action to reduce debt, establish savings, or increase savings.

Messages about the implementation of the new regulation were sent through all media channels to ensure Service members were aware of the limitations associated with the regulation and their responsibilities associated with identifying themselves as covered borrowers. Press releases for external media, interviews with leadership, and internal public affairs guidance were released prior to the implementation of the regulation. To a large degree impacted lenders were aware of the implementation of the regulation and provided their own point of sale media that warned Service members and their families that they could no longer expect to obtain payday, vehicle title, or refund anticipation loans.

The Community Financial Services Association, a payday lending trade organization, partnered with the military in California to provide information pamphlets, jointly developed between CFSA and the Navy, to their 1500 member stores in California. These pamphlets provided advice and contact numbers to Service members and their families turned away from their stores on where to seek emergency financial assistance.

Since the implementation of the regulation, the Department has been focusing on the involvement of state regulators in the oversight of payday and vehicle title lenders to ensure they comply with the regulation (federal depositories make refund anticipation loans). The Federal Financial Institutions Examinations Counsel (FFIEC), which includes the FDIC, the Board of Governors of the Federal Reserve System, the National Credit Union Administration, the Office of the Comptroller of the Currency (OCC), the OTS and additionally, the Conference of State Bank Supervisors (CSBS), have developed examination procedures to evaluate compliance with the rule. The next section provides information on the direction the Department has taken to gain state support.

## 5. State Support

The national associations representing state regulators<sup>16</sup> followed the development of the regulation and made comment through the Federal Register notice on the draft document. As part of the request for comments, the Department asked a question concerning the Department's regulatory relationship with states. The comments of NASCUS, NACCA, and CSBS were considered in developing both the regulation and its preamble:

- Question 17 from the draft regulation: Department is concerned that reliance solely on private litigation or criminal prosecution with respect to these other creditors [non-Federal depositories] may be insufficient to ensure uniform compliance with these rules with respect to all creditors. Comment is requested on all aspects of these issues, and on how to ensure uniform implementation of, and compliance with, the statute by creditors not subject to oversight by the federal bank, thrift, and credit union regulatory agencies.
- NASCUS response: NASCUS believes that it is crucial that written agreements about enforcement, supervision and areas of information sharing should be stipulated in the regulation. State regulatory authorities will likely be responsible for enforcement in many areas, so clear guidelines will alleviate confusion at the state level. Similar agreements have been formed in the past between Financial Crimes Enforcement Network (FinCEN) and the Office of Foreign Asset Control (OFAC) and the states.
- NACCA response: The proposed rule provides that any credit agreement which fails to comply with the regulation is void from inception. It further provides that a creditor or assignee that knowingly violates the regulation shall be subject to certain criminal penalties. These penalties should be helpful in encouraging compliance. Federal depository regulatory agencies have authority to enforce these rules. However, state regulatory agencies would not have specific authority unless applicable state law expressly provides for the state to enforce these regulations. State regulatory agencies could assist DOD in determining the most effective way to ensure uniform implementation and enforcement. State attorneys general would also not have specific authority to enforce the regulations as proposed. We do note that states may be able to take action under existing consumer credit protection laws including deceptive practices, unconscionability, or related statutes.
- CSBS response: CSBS would like to emphasize the important role these [state] regulators play in the supervision and enforcement of single-pay, short-term loans and title loans in those states which authorize these transactions. We believe this

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<sup>16</sup> NACCA, NASCUS and CSBS

existing regulatory structure provides an important resource for the Department of Defense (DoD). With bank supervision, we have a long history of coordinated supervision and enforcement between state authorities and the federal banking agencies.

From the inception of the regulation, state governments were seen as important partners in overseeing that lenders subject to state regulatory supervision complied with the regulation. The commentary to §232.7 on Preemption stated the following:

232.7 Preemption: The final rule implements the statute. Although, revisions have been made, this section has been drafted to clarify the statutory language, no substantive change is intended. Some respondents expressed concern about the adequacy of enforcement for lenders that are not subject to enforcement by the federal depository institution supervisory agencies. The Department does not view the regulation as having substantial direct effects on States, or distribution of power and authority. States determine whether they will enforce the regulation or not for creditors under their jurisdiction. Associations of state supervisors recommended the Department seek written agreements between the Department and state regulatory agencies about enforcement, supervision, and information sharing to help state authorities enforce those areas that will normally fall under their jurisdiction. The Department intends to rely on federal and state regulators to oversee or enforce compliance with the final rule, to the extent possible under their statutory authority, for their respective creditors.

The Department conducted an initial assessment of the number of states able to participate with the Department in the oversight and enforcement of the regulation. NASCUS assisted the Department in surveying state governments to gain the initial assessment of their ability to participate. The initial review showed that 10 states acknowledged they could not supervise and enforce the regulation, 22 states said they were capable of enforcing the regulation, and 18 states were still considering whether they had sufficient authority. Of the 18 pending, 6 were seen as having the equivalent of enforcement capability since payday and vehicle title loans are not authorized within these states.

Following the release of the regulation, representatives from the Department met with the leadership of NACCA and NASCUS to discuss next steps. NACCA established a committee of state regulators to funnel questions to the Department from state regulators and to provide feedback on questions posed by the Department concerning state enforcement procedures, policies and precedents. NASCUS developed a working group of state regulator members to discuss the development of a model agreement to be used to define relationships with each state regulator. NASCUS broadened this group to include the leadership of NACCA and CSBS to provide feedback.

The Under Secretary of Defense for Personnel and Readiness (USD(P&R)) sent letters to the Governors of the 50 states, requesting that their regulatory agencies work with the Department to oversee and enforce the regulation. These letters, reflecting the initially assessed capability of the states, requested the Governors to work with the Department in whatever capacity they may have. USD(P&R) recognized California and Nevada for having enacted legislation that specifically authorized enforcement of the federal law and DoD regulation by the same state organization tasked with regulating these products. Subsequent to the release of the letter, the Department learned that Rhode Island had also enacted legislation to allow for enforcement.

A draft model memorandum of understanding (MOU) was developed in November and provided to the national associations for their review and comment. Department representatives have subsequently met with representative of the national associations on February 4, 2008, to revise the draft MOU(included in Appendix 2).

NASCUS and NACCA also submitted comments to the Federal Register notice posted for this report:

- NASCUS comments: We propose that establishing a hot line through DoD, coupled with a Web site, to report predatory lending will provide proper communications methods for military personnel and their families to report abuses with the DoD. The DoD may then inform a regulator of an abusive act and he or she can take appropriate action; abusive lenders can be controlled if their acts are addressed.
- NACCA comments: There are no specific statutory authorizations in the Act [10 USC § 987] as to the ability of states to enforce these provisions and/or to otherwise refer information to the DoD. Such authorizing language would be helpful to states who want to cooperate with the DoD. States may also be able to use a Memorandum of Understanding (MOU) or changes to their specific statutory authority to enforce violations of the DoD statutes and/or refer information to DoD. This area seems to call for on-going cooperation among the states and DoD as to implementation and to ensure compliance.

Additionally, the banking trade associations included a comment that the use of a MOU is appropriate for defining the relationship between the Department and state regulators in the same manner that the OCC has used this format to define roles and relationships with state regulators. The bank trade associations believe this type of arrangement defined by MOU should also apply to the relationship DoD has with the Federal Regulatory Agencies.

Similarly, the consumer advocacy groups recommended in their public comments for this report that "The Department of Defense should enlist the formal assistance of state credit regulators to enforce regulations implementing the Military Lending Act as they regulate covered lenders under their jurisdiction." These comments were made in

reference to oversight and enforcement of the regulation with respect to internet-based covered lenders. NACCA makes a further recommendation concerning the oversight of internet-based lenders by state regulators: "The current Act does not make specific reference to Internet lenders who are offering covered transactions. The DoD regulation could be more specific on the applicability of the Act to these transactions."

As already stated, the Department is pursuing MOUs to formalize relationships with state regulatory agencies. The Department will also accomplish a similar effort with the Federal Regulatory Agencies as deemed necessary by both parties. The Department believes it would be premature to request a modification to 10 USC § 987 that would require states to enforce the regulation. As with other aspects of Service member quality of life that are overseen by state governments, the Department has sought to work with states through state-level agreements or state-generated legislation.

The Department will be developing a more formal internal approach to relaying information concerning allegations to the appropriate regulator so it may take the appropriate enforcement action, and to the appropriate agencies within the Department to investigate and potentially take formal action through the AFDCB.

NASCUS recommends the Department use a hotline for individuals who have concerns about a credit product; however, the Department believes this recommendation requires more evaluation. Hotlines provide easy access to individuals who need assistance; however, the debut of a new hotline would require considerable marketing to make it effective since there is a proliferation of existing help-lines and hotlines at the Department, Military Service and military installation level. Existing channels of communication, such as unit leadership, the installation legal assistance officers and financial counselors, the Military OneSource help-line, the Federal Trade Commission's Military Sentinel hotline, and the Better Business Bureau's Military BBB Online, are all designed to assist Service members and their families with consumer issues. The important next step is to include these conduits of information in the communication process to funnel information to the appropriate actors.

## 6. Installment Loans

Installment loans were initially identified as part of the overall review of problematic loan products in the 2006 Report to Congress on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents. The primary issues identified in the report were lack of state licensing and "loan packing" of commercial life insurance policies into "military installment loans." When defining the covered loans included in the regulation, "military installment loans" could not be adequately defined to differentiate them from the countless other types of installment products offered by depository institutions and finance companies. The preamble of the regulation made the following statement about installment loans:

"[T]here are installment loans with favorable terms and some with terms that can increase the interest rate well beyond the limits prescribed by 10 U.S.C. § 987. Isolating detrimental credit products without impeding the availability of favorable installment loans was of central concern in developing the regulation. Consequently, installment loans that do not fit the definition of 'consumer credit' in Section 232.3(b), including the definition of 'payday loans,' 'vehicle loans,' or 'tax refund anticipation loans' are not covered by the regulation. The Department's intent is to balance protections with access to credit. The protections posed in the statute assist Service members, when applied with precision to preclude unintended barriers."

The Department holds to this perspective, which was reaffirmed in the correspondence received from trade associations and regulators in preparation for this report. Trade associations defend the methods used by most banks, credit unions, savings associations and finance companies in making installment loans available to the general public. They contend that the vast majority of lenders require that the borrower show that he or she has the ability to repay the loan as part of the application process. The bank trade associations listed the 27 consumer laws and Federal regulations stipulating the protections required of them to provide credit to consumers.

The trade associations contend that increasing the coverage in the regulation to include installment loans to address the few institutions that create problems for Service members and their families could create "probable unintended adverse consequences." Financial institutions and their trade associations made reference during the comment period for the regulation that they might preclude offering certain products to Service members and their families as a result of expanded coverage in the regulation, rather than risk any liability for not complying with the regulation. Feedback from insured depository institutions during the initial implementation of the regulation was that they would stop offering any products that resembled the regulation's definition of payday or vehicle title loans, rather than establish provisions to offer such products, even to the general public. The Department sees the loss of beneficial credit as a very real potential consequence of expanding the coverage of the regulation.

NASCUS reiterated this position, stating, "NASCUS believes regulation of additional products is premature considering the regulation has only been effective five months. Additionally, an expanded regulation may impact the availability of credit to military members and their families." NASCUS also points out that covering additional products may dilute their ability to oversee the credit products currently covered by the regulation. "State regulators have increasing responsibilities in the area of non-depository financial service providers and continue to address credit challenges impacting depository financial institutions. Many states may not have the proper resources at this time for expanded enforcement. The ability to effectively enforce expanded provisions regarding installment loans, credit card products and courtesy overdraft programs could make it difficult to effectively enforce the credit provisions in the DoD's regulation."

With this said, consumer advocates and the NMCRS still have concerns about installment lending that warrant consideration. They expanded their review of installment lending to more than just companies that offer "military installment loans." They included examples of finance companies that have installment products with high fees and interest rates. Their examples included storefront companies that are situated near military installations or advertise in installation newspapers, and internet-based companies.

The consumer advocate examples of "installment loan stores" include lenders licensed under the Consumer Installment Loan Act (CILA) in Illinois, which provide high cost installment loans instead of complying with the Illinois Payday Reform Act. NMCRS included two examples of high cost loans taken by sailors from CILA lenders, both contracts having 600 percent APRs. Other examples from the consumer advocates included lenders in Nevada, Texas and Virginia. These lenders charge rates ranging from 40 percent to 521 percent interest for installment products. One lender provides short term loans, which are not secured contemporaneously by a check or access to a bank account. These loans have APRs that range from 220.16 percent for a 31 day loan and to 886.43 percent for a seven day loan.

The consumer advocates presented examples of internet-based installment lenders that focus their marketing on the military. Using a search engine to find "military loan," they obtained 1,080,000 hits. They focused on the sponsored websites and the top ten obtained through the search engine. They found:

- Some of the sites do not disclose the rates of their loans until the borrower applies for the loan.
- Some of the sites make loans based on proof of income, and do not ask for other data reflecting debt.
- Some sites advertise easy qualification, saying "yes when others say no," and advertise speedy approval processes.

NMCRS provided two examples of internet-based sites which have exceptionally high rate structures. One lender provides loans that range from 59 percent APR and \$75 fee for a \$10,000 loan for 120 months to a 141 percent APR loan and \$500 fee for a \$1,000 loan for 12 months. This lender makes loans in California, New Mexico, Idaho and Utah, with a FDIC member bank originating their loans in other states. The other lender provides small loans for 365 percent APR and large loans for 87 percent APR. This lender does not actually make the loans, which are made through a FDIC member bank. Again, these sites focus on rapid approval with verification of income and no apparent concern for credit rating or current debt load.

The review of installment lenders by the consumer advocates and the NMCRS shows some have high rates and terms, some do not list their terms and conditions, and some do not determine a borrower's ability to repay the loan. These lenders operate under the same rules as other lenders that provide loans with far lower APRs and that do determine the borrower's overall financial status prior to making a loan. Any rules that would restrain the high cost lenders would also subject the other lenders to additional identification and disclosure requirements, and perceived additional liability.

As part of awareness and education programs, the Department can inform Service members and their families of what to look for in choosing a lender and what to determine as potentially harmful. In some instances media attention, as with the Military Times article on Military Financial, Inc. may provide visibility to products and services.

In addition, since there are far fewer installment lenders in the vicinity of military installations, they can also be subject to the oversight of the AFDCB process. The bank trade associations recommend that the precedent set in the statute and the regulation be used by AFDCBs to "address lending practices that may not be 'illegal' by law or regulation, but which are clearly abusive and 'unfair.' A commander, through the board, could use 32 CFR Part 232 as a benchmark for determining whether a lender is predatory, e.g. offering a product deliberately designed to circumvent the prohibitions of 32 CFR Part 232."

Although the effectiveness has yet to be understood, California recently passed a law, AB1528, which made it illegal for any company to market state regulated financial products suggesting a military affiliation unless there is an actual military relationship established. States, partnering with DoD, can take action to restrict the effectiveness of this marketing, or at least provide better authority for AFDCB to place the sites (real property or internet) off limits.

These lenders are licensed in the United States and storefront non-depository finance companies fall under the jurisdiction of the states in which the Service member is assigned. Some states have used their jurisdiction to regulate internet lending. Consequently, the Department sees working with state regulators as essential, both in

terms of implementation of the regulation and also in terms of assisting Service members and their families with other credit products under their jurisdiction.

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## 7. Other Credit Products

The consumer advocates identified courtesy overdraft protection and high fee, low available balance credit cards in their June 11, 2007, correspondence as being potentially problematic for Service members and their families. They reiterated their concerns in their November 31, 2007, letter to the Deputy Under Secretary of Defense (Military Community and Family Policy) and also in their response provided to the Department on February 25, 2008. The Department included these two credit products in its correspondence to trade associations and in its Federal Register notice requesting comment. As with installment loans, input from consumer groups, financial institutions and trade associations, and regulators was important to hear on these two topics.

### Courtesy Overdraft Protection:

Overdraft programs are designed to protect consumers from the embarrassment, expense and negative impact on credit rating. Insured depository institutions generally offer protection through line of credit programs, through funds transfer from other accounts held by the checking account holder, and through fee-based programs commonly called courtesy overdraft programs. Consumers sign up for line of credit and funds transfer programs; however, courtesy overdraft programs are generally packaged with checking accounts, not requiring a separate agreement with the checking account holder. Line of credit programs are provided with an APR and require TILA disclosures. Funds transfer programs are generally offered with a nominal fee for the transfer.

Consumer advocates have expressed concerns about courtesy overdraft programs, which they see “are triggered by small dollar debit card transactions; on average, the typical debit card transaction that spurs a \$34 overdraft fee is for a \$20 purchase. Essentially, when a consumer is overdrawn, their debit card functions as an extremely high-cost credit card. Overall, consumers pay \$17.5 billion in overdraft fees every year for \$15.8 billion in credit extended to them for only a few days.” The Center for Responsible Lending contracted with Lightspeed Research Inc to track the transactions of 5,681 households over 18 months. As part of this group, they obtained 228 transactions involving overdraft protection from Defense Finance and Accounting Service payees (members of the military, retirees and their families, and civil servants). Their results are as follows:

- Less than one percent (0.4%) were caused by an ATM withdrawal
- 3% were caused by bank fees
- 15% were caused by ACH transactions, which are usually online bill payments
- 41% were caused by a debit card point of sale (POS) transaction, typically when a debit card is used at a checkout counter

- 42% were caused by checks.

Consumer advocates find particular concern over the ATM and POS transactions, since these could be declined by the bank at no cost to the consumer. The bank trade associations made comment in their response concerning courtesy overdrafts that consumers may appreciate being able to use their debit card when no funds are available. However, in these circumstances consumers could have chosen an alternative payment, such as a credit card had they been aware they would go over their balance.

Consumer advocates go on to say: “While the overdrafts of younger, enlisted military members could not be specifically identified, this group likely bears the highest cost for overdrafts, because consumers age 18-24 tend to use their debit cards more frequently and for smaller purchases. Thus if funds in their account are low, they are at greater risk of overdrawing through a small transaction paid for with a debit card.”

Perhaps in some circumstances these overdraft charges may provide enough incentive for young consumers to learn how to keep track of their debit card expenditures. However, some consumers intentionally use courtesy overdrafts as a high-cost form of credit. These individuals need other solutions, as do other consumers who continue to use high-cost credit to sustain their finances. Input from the bank trade associations provided the best practices released by the Federal Regulatory Agencies in 2005, which were partially based on best practices developed by the banking industry:

- Avoid promoting overdrafts;
- Fairly represent overdraft protection programs and alternatives;
- Train staff to explain program features and choices;
- Clearly explain the discretionary nature of programs;
- Clearly disclose program fees;
- Demonstrate when multiple fees will be charged;
- Explain the impact of transaction clearing policies
- Illustrate the types of transactions covered including card transactions, preauthorized automatic debits, telephone-initiated transfers, and other electronic transfers
- Provide election or opt-out [provisions] for the service;
- Alert consumers, where feasible (e.g., at a teller window) before a transaction triggers any fees;
- Prominently distinguish balances from overdraft protection funds availability;

- Promptly notify consumers of overdraft protection program usage each time used;
- Consider daily limits on consumers' costs;
- Monitor overdraft protection program usages; and
- Fairly report program usage.

Some of these best practices lead to assistance that can help chronic users of overdraft programs. There are examples of military banks using automated systems to oversee the use of overdraft programs. When members are spotted overusing courtesy overdraft protection, the automated system sends emails and text messages to these members recommending they obtain a "work-out" loan. Similarly, some military banks send text messages alerting members that they have low balances in their checking accounts. NAFCU acknowledged in their response that "most credit unions typically monitor usage of their overdraft products for potential abuse."

In 2006, the FDIC initiated a study of overdraft protection services offered by the institutions it regulates. The study's stated purpose is to identify the types of overdraft protection products offered by FDIC-supervised banks, the characteristics of those products (e.g., terms, conditions and prices), and how often customers use the products. In the first phase of the FDIC's study, the agency's examiners interviewed staff at about 500 institutions to gather information about services offered, fees, and related policies and practices. In the second phase, transaction-level data was requested from about 100 institutions regarding NSF and overdraft activity. FDIC staff is in the process of reviewing survey results and data collected thus far, and plan to publish a report summarizing their findings.

The consumer advocates recommend banks and credit unions offer line of credit, and that the Department use its relationship with banks and credit unions on military installations to make offering this product a mandatory requirement; however, consumers must qualify for line of credit products. NAFCU reports that only three percent of credit unions responding to their September 2005 survey offered only courtesy fee-based overdraft products. Consumer advocates also recommend banks and credit unions be encouraged to offer affordable line of credit programs by having these low cost products qualify as small dollar loan programs and receive Community Reinvestment Act credit.

#### Credit Cards with High-fees and Low Available Balances:

Credit cards with high-fee and low available credit balances have created situations where cardholders are using the card to do not much more than pay the mandatory fees. These cards have been referred to by the consumer advocates as "fee-harvester" cards, which front-load the mandatory fees of \$178 for a card with an available balance of \$250.

Hence, the cardholder may not realize the starting balance on the card may be only \$72 and quickly trigger over-limit charges on top of the extensive fees.<sup>17</sup>

The consumer advocates recommend the Department cover fee-harvester cards in the regulation; however, this could lead to additional barriers to beneficial credit. NAFCU writes in their response: "Applying the military interest cap and loan restrictions to conventional mainstream financial products like credit cards, coupled with the potential imposition of strict monetary and criminal penalties for knowing violations, could cause many credit unions to significantly reduce or eliminate the credit options available to our nation's military families."

Additionally, "the Federal Reserve Board has proposed that certain information for such cards be included in a highlighted table of important terms that are provided to consumers. Specifically, if the total fees for the card equal or exceed 25 percent [of the minimum credit limit], the card issuers must disclose in the table the remaining credit available. The table must be highlighted and be included in the credit card applications and account opening disclosures."<sup>18</sup>

Disclosures are effective only if read and understood by the consumer. As with other changes in the marketplace, education programs will need to keep pace with these modifications to ensure military consumers are aware of these disclosures and fully understand their ramifications.

In addition to the FDIC review of overdraft protection programs, we note that the OTS has published an advance notice of proposed rulemaking that seeks information on overdraft and credit card products in an effort to determine whether they are being offered in an unfair or deceptive manner.

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<sup>17</sup> Consumer advocates report, page 12.

<sup>18</sup> ABA, AMBA, CBA, FSR and ICBA (Bank Trade Associations) Consolidated Letter, February 25, 2008, page 10.

## 8. Conclusions

Although the regulation has been in effect for less than six months as of this writing, feedback from various sources indicates the implementation of and compliance with the regulation has been effective in curbing payday and vehicle title loans, and has restricted refund anticipation loans obtained by Service members and their families. Installation-level financial counselors and legal assistance officers reported limited use of payday and vehicle title loans in describing circumstances where Service members needed financial counseling and assistance. Banks and credit unions associated with the military and Military Aid Societies have increased their availability of affordable small-dollar loans to meet the immediate cash needs of Service members and their families.

Advocacy groups identified an internet-based payday lender that appeared to have changed its product to avoid the restrictions in the regulation. They also identified three states where the regulation did not adequately preclude the lenders from continuing to offer high cost loans that should have been controlled by the regulation. These limited examples suggest that few lenders have actually modified their products to avoid the application of the regulation. The Department has an opportunity to work with states and through avenues such as the AFDCB to preclude Service members and their families from accessing credit through these few occurrences.

Likewise, the Department views oversight of installment loans as providing an opportunity to work with Federal and states regulators, and internal systems, to protect Service members and their families. Increasing the coverage in the regulation to include these loans would potentially decrease availability of beneficial credit for Service members and their families. This may also occur if the Department attempts to place limits on overdraft protection programs and high fee/low available balance credit cards.

The Department has established a balanced approach in using the regulation to curb products with demonstrated high costs and balloon payments, while working with Federal and state governments to protect Service members and their families from the risks associated with other products. In committing to this framework, the Department will work to ensure that external regulatory agencies are aware of and can provide appropriate oversight of these products. The Department will continue to work closely with Federal agencies and is in the process of establishing MOUs with states to solidify these relationships.

As a foundation to all of its protection efforts, the Department is continuing the Financial Readiness Campaign to make Service members and their families aware that they need to be in charge of their finances. To aid them in their development, Department continues to provide educational programs to help them discern financial product that will enhance their marketplace opportunities and credit worthiness, rather than provide them "easy credit." Recent national events have shown that the availability

of credit is a delicate balance that requires sound regulations, adept lenders, and educated consumers.

## 9. Recommendation

The Department does not see a need at this time for significant change in current statutes and regulations to provide effective credit protection for Service members and their families. There is one issue that requires Congressional attention:

- Modification of the definition of covered borrower in 10 USC § 987(i)(2)(C) to coincide with the description used in DEERS (definition included in DoD Instruction 1000.13 and 10 USC §1072(2)(E)). As described on pages 16 and 17, this approach could allow creditors a more efficient method of assuring they are complying with the law, regulators a consistent approach they can apply during their compliance evaluation. Most importantly this approach relieves the borrower of the burden of proving (or disproving) he or she is covered by the regulation.

### Appendix 1: List of Contributing Organizations

Name of Organization(s)	Type of correspondence/ length	Date delivered/ posted	In response to
Departments of the Army, Navy and Air Force	Transmittal letters with 391 case studies	02/25/2008	DUSD(MC&FP) October 29, 2007 Letter
Navy-Marine Corps Relief Society	3 page letter w/16 atch	02/14/2008	DUSD(MC&FP) October 29, 2007 Letter
Coast Guard Mutual Assistance	1 page letter w/1 atch	02/14/2008	DUSD(MC&FP) October 29, 2007 Letter
The Military Coalition	2 page letter	2/22/2008	Federal Register Notice Docket Number (Doc) DoD-2006-OS-216
National Association of Consumer Credit Administrators	3 page letter	03/04/2008	Federal Register Notice Docket Number (Doc) DoD-2006-OS-216
National Association of State Credit Union Administrators	3 page letter	03/04/2008	Federal Register Notice Doc DoD-2006-OS-216
Center for Responsible Lending, Consumer Federation of America, National Consumer Law Center	1 page letter	11/28/2007	DUSD(MC&FP) November 2, 2007 Letter
Center for Responsible Lending, Consumer Federation of America, Consumers Union of U.S., Inc., National Association of Consumer Advocates, and National Consumer Law Center	20 page report	02/25/2008	DUSD(MC&FP) November 2, 2007 Letter and Federal Register Notice Doc DoD-2006-OS-216
American Bankers Association, Association of Military Banks of America, Consumer Bankers Association, Financial Services Roundtable, and Independent Community Bankers of America	21 page report w/3 atch	02/25/2008	DUSD(MC&FP) January 7, 2008 Letter and Federal Register Notice Doc DoD-2006-OS-216

Bank of America	4 page letter	03/04/ 2008	Federal Register Notice Doc DoD-2006-OS-216
HSBC	6 page letter	03/04/ 2008	Federal Register Notice Doc DoD-2006-OS-216
Credit Union National Association and the Defense Credit Union Council	3 page letter	02/25/ 2008	DUSD(MC&FP) January 7, 2008 Letter
Defense Credit Union Council	3 page letter w/ 2 atch	02/15/ 2008	DUSD(MC&FP) January 7, 2008 Letter
National Association of Federal Credit Unions	9 page letter	02/15/ 2008	DUSD (MC&FP) January 7, 2008 Letter and Federal Register Notice Doc DoD-2006- OS-216
Navy Federal Credit Union	5 page letter	03/04/ 2008	Federal Register Notice Doc DoD-2006-OS-216
American Financial Services Association	9 page letter w/1 atch	03/04/ 2008	DUSD(MC&FP) January 7, 2008 Letter
Omni Financial Services	11 page letter	03/04/ 2008	Federal Register Notice Doc DoD-2006-OS-216
Consumer Credit Industry Association	6 page letter w/1 atch	02/21/ 2008	Federal Register Notice Doc DoD-2006-OS-216
Online Lenders Alliance	3 page letter	02/25/ 2008	Federal Register Notice Doc DoD-2006-OS-216
Capital One Financial Corporation	5 page letter	03/04/ 2008	Federal Register Notice Doc DoD-2006-OS-216
Central States Health and Life Co. of Omaha	1 page letter	03/04/ 2008	Federal Register Notice Doc DoD-2006-OS-216
The Plateau Group, Inc.	3 page letter	02/11/ 2008	Federal Register Notice Doc DoD-2006-OS-216
DMF Group	2 page Federal Register response	03/04/ 2008	Federal Register Notice Doc DoD-2006-OS-216

**Appendix 2: Model Memorandum of Understanding**

**MEMORANDUM OF UNDERSTANDING**

**BETWEEN**

**THE STATE REGULATORY AGENCY**

**AND**

**THE DEPARTMENT OF DEFENSE**

The State Regulatory Agency and the Department of Defense (DoD) (each, the “Requesting Agency” and the “Responding Agency” with respect to the sharing of information; collectively the “Agencies”) are entering into this Memorandum of Understanding (“MOU”) to enhance their communication and exchanges of information to achieve prompt and effective resolution and redress of consumer complaints and alleged violations of 32 CFR Part 232 relating to the financial institutions and their financial affiliates that the State Regulatory Agency supervises, examines or regulates (“Regulated Institutions”).

Pursuant to the foregoing, this MOU is made and entered into as of (effective date, between the DoD and the State Regulatory Agency.

1. Complaint Referrals and Information Sharing

(a) To the extent permitted by applicable law, including but not limited to the Right to Financial Privacy Act the Privacy Act, and the Freedom of Information Act, the DoD agrees to refer to the State Regulatory Agency consumer complaints and allegations of violations of consumer protection laws (which includes 32 CFR Part 232) concerning Regulated Institutions subject to the jurisdiction of the State Regulatory Agency, and the State Regulatory Agency agrees to inform DoD of consumer complaints and allegations of violations of consumer protection laws concerning Regulated Institutions.

(b) The State Regulatory Agency agrees to use its examination authority to oversee the compliance of 32 CFR Part 232 within the Regulated Institutions and agrees to use its enforcement authority to take appropriate action concerning violations to the extent permitted under applicable law.

(c) The Agencies agree to explore means to enhance processes and procedures for such sharing and to facilitate the sharing of information concerning the status and resolution of complaints and actions taken based on complaints or evidence of alleged violations of consumer protection laws referred by DoD to the State Regulatory Agency.

## 2. Confidentiality

(a) For purposes of this MOU, any of the following information obtained by a Requesting Agency shall be treated as Controlled Unclassified Information (CUI):

(i) the name, address, or other personally identifiable information relating to any consumer;

(ii) any determinations by the Responding Agency, including the findings, resolution, and compensation amount relating to any complaint; and

(iii) any information deemed by statute as requiring control due to confidentiality.

(b) The Requesting Agency agrees to use any Information it receives pursuant to this Memorandum only for purposes directly related to the exercise of its authority. The Requesting Agency may not make any additional use, or disclosure, of CUI without the prior approval of the Responding Agency which shall not be unreasonably denied.

(c) All CUI provided pursuant to this Memorandum belongs to, and shall remain the property of, the Responding Agency. The Requesting Agency shall also take all actions reasonably necessary to preserve and protect any privilege or claim of confidentiality relating to CUI, including:

(i) restricting access to -CUI obtained pursuant to this Memorandum to only those of its officers, employees, or agents (including outside counsel, accountants, and consultants) who have a *need-to-know* such information in carrying out the responsibilities of the Requesting Agency;

(ii) informing those of its officers, employees, or agents who are provided access to such CUI of the Requesting Agency's responsibilities under this Memorandum; and

(iii) establishing appropriate physical safeguards for maintaining such CUI.

(d) If the Requesting Agency receives a request from a third party for Responding Agency CUI, or is served with a subpoena, order, or other process requiring production of such information, the Requesting Agency shall:

(i) immediately notify the Responding Agency and provide to it copies of such request, subpoena, order, or other process as well as attachments thereto;

(ii) provide the Responding Agency the opportunity to take whatever action it deems appropriate to preserve, protect, and maintain the confidentiality of such information or any related privileges;

(iii) cooperate fully with the Responding Agency to preserve, protect, and maintain the confidentiality of such information or any related privileges;

(iv) notify the party seeking the information that it was obtained from and is considered the property of the Responding Agency and that requests for such information must be made directly to the Responding Agency in accordance with applicable Federal or State law;

(v) resist, to the extent practicable, production of such information, pending receipt of written consent from the Responding Agency to the production of that information; and

(vi) consent to any application by the Responding Agency to intervene in any action to preserve, protect, and maintain the confidentiality of such information or any related privileges.

(e) Nothing in this Memorandum shall prevent the Requesting Agency from complying with a legally valid and enforceable order by a court, adjudicatory body, or legislative body of competent jurisdiction compelling production of CUI, providing that the Requesting Agency:

(i) reasonably determines that efforts to quash, appeal, or resist compliance with the order would be unsuccessful;

(ii) attempts, to the extent practicable, to secure a protective order to preserve, protect, and maintain the confidentiality of such information or any related privileges; and

(iii) immediately notifies the Responding Agency of its intent to comply with the order and of any actions taken in compliance with the order.

### 3. Definitions

(a) **Controlled Unclassified Information (CUI):** Unclassified information that does not meet the standard for national security classification under Executive Order 12958, as amended, but is pertinent to the national interest of the United States or to the important interests of entities outside the U.S. Federal government, and under law or policy requires protection from disclosure, special handling safeguards, and prescribed limits on exchange or dissemination.

(b) Need-to-know: A determination made by an authorized holder of the CUI that a prospective recipient requires access to specific CUI in order to perform or assist in a lawful and authorized governmental function.

(c) Physical safeguards: During working hours, reasonable steps should be taken to minimize risk of access by unauthorized personnel. After working hours, CUI shall be stored in unlocked containers, desks or cabinets if Agency or Agency-contract building security is provided, or in locked desks, file cabinets, bookcases, locked rooms, or similar items. CUI and material may be transmitted via first-class mail, parcel post or – for bulk shipments – fourth-class mail. Electronic transmission of CUI (voice, data or facsimile) should be by approved secure communications systems whenever practical. CUI should be destroyed by means or methods that would make it difficult to recognize or reconstruct the information (e.g., shredding).

(c) Requesting Agency: Either the DoD or the State Regulatory Agency; whichever is provided information in order to investigate an alleged violation of the regulation, to take appropriate enforcement action, or to be informed on the results of investigative or enforcement actions taken by the Responding Agency.

(d) Responding Agency: Either the DoD or the State Regulatory Agency; whichever has provided information to the Requesting Agency.

#### 4. Miscellaneous

(a) Authority. Each party to this MOU has requisite legal authority to enter into this MOU. In the event of any material change to its authority, a party will provide written notification to the other party within ten (10) calendar days of any such change.

(b) Termination. Either party may terminate this MOU with respect to prospective sharing of information by providing thirty (30) calendar days advance written notice to the other party. In the event of termination, information obtained by a Requesting Agency under this MOU, if not returned, will remain the property of the Responding Agency and the Requesting Agency will continue to observe all terms and conditions of this MOU that relate to such information.

(c) Agency Contacts. As soon as practicable after execution of this MOU, each Agency will advise the other of the name, title, and contact information, including addresses and telephone and fax numbers, for the appropriate official(s) to contact for purposes of notices and exchanges of information hereunder. This contact information will be updated as appropriate.

DEPARTMENT OF DEFENSE

By:

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Leslye A. Arsht  
Deputy Under Secretary of Defense  
(Military Community and Family Policy)

THE STATE REGULATORY AGENCY

By:

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Agency Commissioner/Superintendent