plante moran

audit • tax • consulting

Complying with the Military Lending Act's expanded protections

BACKGROUND

Congress passed the Military Lending Act (MLA)[1] in 2006 to provide specific protections for active duty service members and their dependents in consumer credit transactions.

In July 2015, the Department of Defense (DoD) issued a final rule amending the implementing regulations of the Military Lending Act (MLA).[2] The DoD received multiple questions regarding compliance with their July 2015 Final Rule, which forced the DoD to publish an interpretive rule on Aug. 26, 2016.[3]

The DoD's July 2015 final rule and its interpretive rule amend the MLA regulation to expand specific protections provided to service members and their families and to address a wider range of credit products that fall outside the scope of the DoD's existing regulation.

The DoD's July 2015 final rule and its July 2016 interpretive rule amend the MLA regulation to expand specific protections

1. *Authority: 10 U.S.C §987; Implementing Regulation: 12 C.F.R §232.*
2. *Document Citation: 81 F.R. 43559 (https://www.federalregister.gov/articles/2015/07/22/2015-17480/limitations-on-terms-of-consumer-credit-extended-to-service-members-and-dependents).*
3. *Document Citation: 81 F.R. 58840 (https://www.federalregister.gov/articles/2016/08/26/2016-20486/military-lending-act-limitations-on-terms-of-consumer-credit-extended-to-service-members-and).*

The MLA now caps the military annual percentage rate (MAPR) on covered transactions at 36 percent, requires disclosures to alert service members and their dependents of their rights, and prohibits creditors from requiring arbitration in the event of a dispute, among many other protections.

Compliance is required by Oct. 3, 2016, except for credit cards, whose compliance date is Oct. 3, 2017. The Secretary of Defense has the discretion to extend the mandatory compliance date for credit cards an additional year to October 2018.

What credit is covered?

The final regulation defines consumer credit to mean "credit offered or extended primarily for personal, family, or household purpose and that is subject to a finance charge or is payable by written agreement in more than four installments."

Covered loans include:

- Personal installment loans
- Personal lines of credit
- Overdraft lines of credit
  (Overdraft protection services are not covered.[4])
- Credit cards
- Car and boat refinances
- "Lot" loans, that is, loans secured by real property with no dwelling
- Hybrid purchase money and cash advance loans

The MLA definition excludes:

- Purchase money loans such as car purchase loans
- "Residential mortgages," that is, loans secured by an interest in a dwelling, including home equity loans. Dwelling is defined as a residential structure that contains one to four units, whether or not the structure is attached to real property, and includes condominium units, mobile homes, and boathouses.

4. *32 C.F.R. §232.3(f).*

- Loans above the Regulation Z threshold (currently $54,600)
- Business loans

Who is a covered borrower?

Under 12 C.F.R. §232.3(g), a covered borrower is a consumer who "at the time the consumer becomes obligated on a consumer credit transaction or establishes an account for consumer credit, is a covered member…or dependent." A covered member is a member of the armed forces serving on active duty or active guard and reserve duty or a "dependent," which includes spouses of a member of the armed services. A borrower is not covered for accounts established prior to a customer serving on active duty.[5]

The definition excludes a customer who was a covered borrower at the time the account was established but is no longer a covered borrower. This means that the protections (except arguably the prohibition against mandatory arbitration) only apply if the customer was a covered borrower both at the time the loan was made and at the time the provision is being enforced. For example, a cardholder covered at the time the account was opened, would be subject to the 36 percent MAPR cap. However, if the cardholder subsequently leaves service or gets divorced the 36 percent MAPR cap would not continue to apply.

Creditors may use single contracts for all customers that limit application of the MLA provisions to covered borrowers. This means that the creditor can have one contract that provides, for example, that the mandatory arbitration clause only applies to non-covered borrowers.

A covered member is a member of the armed forces serving on active duty or active guard and reserve duty or a "dependent"

The regulation prohibits providing a consumer loan with an MAPR that exceeds 36 percent. How is the MAPR different from the APR under Regulation Z?

The MAPR is different from the Truth in Leading Act (TILA) and Regulation Z APR definition because the calculation includes fees

5. *Id. at §232.2(a).*

that are not considered "finance charges" under Regulation Z, such as application fees, and "participation" fees, such as annual fees. This means that if a borrower pays a processing fee in cash, the lender's system has to capture that cash advance fee in calculating the MAPR.

The MAPR calculation also includes fees and premiums for:

- credit insurance
- debt cancellation
- debt suspension
- fees for a credit-related ancillary product sold in connection with the credit transaction

The final rule includes any ancillary fee sold with an extension of credit to a covered borrower so long as that ancillary product is associated with an extension of credit – which could arise at any time in an ongoing open account for consumer credit. Certain "bona fide" fees may be excluded in the case of credit cards, as are certain application fees for "small amount loans" as defined in the regulation.[6]

For open-end credit, the DoD has re-introduced the "effective" or "historic" APR concept. In effect, this requires a retroactive calculation of the APR, based on the customer's actual balance and actual fees (including application, processing, and participation fees) imposed during the billing period.

For open-end credit, the DoD has re-introduced the "effective" or "historic" APR concept

The DoD notes that in the event that a creditor cannot make the calculation at the outset of the billing cycle, the creditor could calculate the "total charges that [are] included in the MAPR and waive an amount necessary to comply with the 36 percent limit…"[7] If an MAPR cannot be calculated because of a zero balance, no fee may be charged during that billing cycle except for a "participation" fee not exceeding $100 per year. (A bona fide fee over this amount may be charged for credit cards.)

Fees the law requires creditors to pay may be passed through to a borrower without being included in the MAPR calculation.

6. *Id. at §232.3(p) and 4(c).*

7. *Id.*

Does the exclusion of bona fide fees from the MAPR calculation apply to overdraft lines of credit and other open-end credit products?

No. The exclusion is only available to credit card products.

How does a lender calculate the MAPR of an open-end account if a fee is imposed during a billing cycle, but there is no balance for that billing cycle?

If an MAPR cannot be calculated because there is no balance, the creditor may not impose any fee or charge during that billing period except for a participation fee or annual fee that is $100 or less.[8] This means that the fee may be charged in months when the customer is not using the fee, but not in months when the customer is using the account. The $100 limit does not apply if the participation fee is a bona fide credit card fee as provided in 12 C.F.R §232(d).[9] In other words, if it is a bona fide annual fee, it may be excluded from the MAPR calculation.

Also, fees that are not included in the MAPR calculation may be charged even if the balance is zero. Thus, a late fee, which is not included in the MAPR, may be charged in these circumstances.

The Rule provides that the MAPR for open-end credit should be calculated based on the "effective" APR contained in Regulation Z. That provision of Regulation Z provides that in months where there is no balance and a minimum or fixed charge, or other charge unrelated to the periodic rate (except a transaction charge), is charged, no APR can be calculated. The DoD's interpretive rule confirmed that this "no MAPR calculable" rule applies under the rule. Thus, for example, where the customer has a zero balance because there was an advance payment or other credit (e.g. from a returned purchase) and the account has incurred transactions as described above, the MAPR cannot be calculated and the fees are permitted.

The Rule provides that the MAPR for open-end credit should be calculated based on the "effective" APR contained in Regulation Z

8. *80 F.R. 43583 (July 22, 2015).*
9. *32 C.F.R. §232.4(d)(3)(ii).*

What are the bona fide fees excluded from the MAPR calculation for credit cards?

The final regulation allows certain fees imposed on credit card accounts to be excluded from the calculation if they are bona fide as well as "reasonable for that type of fee."[10] The regulation offers a "safe harbor" for purposes of determining whether a fee is reasonable (but not necessarily bona fide).

Bona fide is not defined, though the regulation provides "standards" to assess whether a bona fide fee is "reasonable." The standard includes comparing fees "typically imposed by other creditors for the same or a substantially similar product or service," i.e., "like-kind fees."

Under the "safe harbor," a bona fide fee is "reasonable" if the fee is less than or equal to an average amount of a fee for the same or a "substantially similar" product or service charged by five (5) or more creditors with at least $3 billion in outstanding U.S. credit card balances during the last three years.[11] A fee that is higher than an average amount calculated under this section may still be reasonable, "depending on other factors related to the credit card account." In addition, the fact that no other creditors charge a fee for the same or substantially similar product does not per se mean it is not reasonable.[12]

Minimum interest charges are excludable if they are bona fide

Minimum interest charges are excludable if they are bona fide.

Creditors may rely on commercially compiled sources for information when determining whether their fees are reasonable and excludable from the MAPR based on a comparison of fees of "substantially similar products" of certain other creditors. The interpretive rule states, "The Final Rule intends to provide a firm, yet flexible, adaptable standard allowing credit card issuers to exclude bona fide and reasonable credit cards from the calculation of the MAPR." In addition, card issuers may rely on commercially available databases or other industry sources, so long as they meet the conditions of the regulation, e.g., a comparison of fees charged by five or more creditors with $3 billion in outstanding loans any time during the three-year period preceding the time the average is computed.

10. *80 F.R. 43583 (July 22, 2015).*
11. *32 C.F.R. §232.4(d)(3)(ii).*
12. *Id.*

The supplementary information suggests that such information can be obtained from the "complete contract terms" on issuers' websites or from the Bureau's website. (Although a review of card issuers' and the Bureau's website shows that only ranges of interest rates and fees may be provided.[13])

Due to the variance of participation fees, the regulation provides that a participation fee may be reasonable if the amount "reasonably corresponds to the credit limit in effect or credit made available when the fee is imposed, to the services offered under the credit card account or to other factors relating to the credit card account."[14] In regard to the services offered under a credit card account or to other factors, such as benefits, relating to the credit card account, the interpretive rule further states, "Under the Department's flexibly applied conditional exclusion, creditors may use any reasonable approach in identifying whether a fee is substantially similar for purposes of comparison and reasonable overall. Thus, the Department's policy, in this regard, permits a creditor to consider the benefits provided by a rewards program in determining whether a fee is reasonable overall." Therefore, card issuers may consider benefits of credit card rewards programs in determining whether the amount of a fee is (a) less than or equal to the average fee of other similar products and (b) reasonable overall.

For open-end credit, creditors have the option to waive fees or periodic charges that exceed the 36 percent MAPR at the end of a billing cycle or earlier. There may be instances when, for open-end credit, the MAPR may exceed 36 percent in a given month, depending on the balance and the fees and interest imposed in a given month. Creditors may waive amounts exceeding 36 percent MAPR for covered borrowers, but impose them on those who are not covered.

For open-end credit, creditors have the option to waive fees or periodic charges that exceed the 36 percent MAPR at the end of a billing cycle or earlier

If some charges are bona fide but others are not, may the credit card issuer still exclude the bona fide fee from the MAPR calculation?

No. If any fee is not a bona fide fee, all fees (including bona fide fees) must be included in the MAPR calculation.[15]

13. *The Bureau is currently "upgrading" its system for collecting information from credit card issuers, which may add greater detail and account specificity.*

14. *Id. at §232.4(d)(3)(iv).*

15. *Id. at §232.4(d)(4)(ii).*

Are there any special considerations for calculating the MAPR for small dollar loans?

Yes, but they are very limited. Some application fees may be excluded from the MAPR calculation for "short-term small amount loans" provided that the application fee is not charged more than once in a rolling 12-month period.[16]

How are "short-term small amount loans" defined?

The exception for excluding the application fee from the MAPR calculation only applies to closed-end loans that are:

- Subject to a federal law that "expressly limits" the rate of interest that an insured depository institution or federal credit union may charge and which limitation is "comparable" to a limitation of an APR of 36 percent;
- Made in accordance with the requirements of the federal regulatory agency that implements the federal law so long as that law:
    - Contains a fixed numerical limit on the maximum maturity term which cannot exceed nine months; and
    - Limits the amount of any application fee[17]

Included in this exclusion are certain "payday alternative loans" offered by credit unions pursuant to the National Credit Union Administration rules that limit the APR and application fee that may be charged. There is no bank product subject to similar federal law at this time.

Beyond the MAPR 36 percent cap, what are the other restrictions on the terms of covered loans and what do they mean?

There are a number of additional restrictions on covered loans made to service members and their spouses and dependents. Prohibitions applicable to financial institutions include:

- Requirements to submit to arbitration or "other onerous legal notice provisions in the case of a dispute"[18] or demands of

16. *Id. at §232.4(c)(2).*
17. *Id. at §232.3(t).*
18. *Id. at §232.8(c)*

"unreasonable notice from the covered borrower as a condition for legal action."[19]

- While "arbitration" may be well-understood, the meaning of the other terms are not. These provisions are undefined and the regulation offers no examples. The DoD, when it adopted the regulation in 2007, indicated that their meanings would be "determined on a case-by-case basis."[20]

- Waivers of the right to legal recourse under any state or f ederal law including any provision of the Service Members Civil Relief Act.[21]
  - The final regulation does not define the "right to legal recourse" nor does it provide examples. It is not clear whether and how this provision might impact standard provisions in consumer credit forms under which the consumer explicitly or implicitly waives rights to legal recourse.
  - Creditors, though, may exercise a "statutory right" to take a security interest in funds deposited into a covered borrower's account, which means the creditor may apply a statutory right of set-off. The security interest under a statutory right may be taken at any time.
  - The MLA preempts any inconsistent state laws except if greater protection is provided by such state laws.
- Use of a check or other method of access to a financial institution account.[22]
  - Read literally, this section of the rule makes it unlawful for a creditor to use a check or other method of access to a covered borrower's checking or savings account with respect to credit extended to covered borrowers. The interpretive rule, though, makes it clear that this section "does not in any way imply that a creditor cannot be paid." However, creditors may not use remotely created checks or post-dated checks provided at the time credit is extended (as is common in payday loans) in order to collect payments. Additional guidance from the DoD

19. *Id. at §232.8(d).*
20. *72 F.R. 50589 (August 31, 2007).*
21. *32 C.F.R. §232.8(b).*
22. *Id. at §232.8(e).*

states that this prohibition of the use of remotely created checks or post-dated checks is the limit of this section's prohibitions on the use of a check or other method of access to a cash account.

- Thus, lenders may also:
  - Require an electronic fund transfer to repay the consumer credit transaction if permitted by law;
  - Require direct deposit of the consumer's salary as a condition of eligibility for covered credit or to debit automatically the checking account; or
  - Take a "security interest in funds deposited after the extension of credit in an account established in connection with the consumer credit transaction."
- Creditors may also make loans secured by a financial institution account to covered borrowers. The security interest may be taken at any time, not just after the loan is made.

Creditors may also make loans secured by a bank account to covered borrowers

- Requirement as a condition of consumer credit that the borrower establish an allotment to repay the loan[23]
- Prepayment penalties[24]

What are the other restrictions on covered loans made to service members and their spouses and dependents that do not apply to financial institutions?

- A prohibition against refinancing or renewing covered credit by the same creditor with the proceeds of other consumer credit extended by that creditor to the same covered borrower[25]
- A prohibition against using the title of a vehicle as security for a covered loan[26]

What disclosures must covered borrowers receive?

- "Statement" of the MAPR.[27]
  - Creditors may comply with this provision by "describing the charges the creditor may impose related to the con-

23. *Id. at §232.8(g).*
24. *Id. at §232.8(h).*
25. *Id. at §232.8(a).*
26. *Id. at §232.8(f).*
27. *Id. at §232.6(a)(1).*
28. *Id.*

sumer credit to calculate the MAPR."[28] Section 232.6(c)(2) provides a model statement. Lenders are not required to disclose the numerical MAPR.[29]

- Any disclosures required by Regulation Z
- A clear description of the payment obligation of the covered borrower.[30]
    - For closed-end credit, a payment schedule suffices. For open-end credit, "any disclosure required by Regulation Z" suffices.

The statement of the MAPR and the payment obligation description must be provided in writing and orally

How must the disclosures be provided?

The disclosures must be provided in writing.[31] The statement of the MAPR and the payment obligation description must also be provided orally.[32] Oral disclosures may be made through a toll-free number.[33] The toll-free number must be provided on (1) the application form or (2) with the written disclosures described above.

What must be included in the oral disclosures?

To satisfy the oral disclosure requirement, financial institutions may provide orally:

1. The general MAPR statement provided in the regulation (See question 12 above for a description of the general MAPR statement.);
2. A "general description of how the payment obligation is calculated or a description of what the borrower's payment obligation would be based on an estimate of the amount the borrower may borrow"

   For open-end, this might be something like the minimum payment description currently required for credit cards. For closed-end, it might be a general description that payments are due monthly (or weekly etc., as appropriate).
3. These would be followed by a reference to the written materials the borrower receives.

29. *Id.*
30. *Id. at §232.6(a)(3).*
31. *Id. at §232.6(d)(1).*
32. *Id. at §232.6(d)(2).*
33. *Id. at §232.6(d)(2(ii)(B) (July 22, 2015).*

Below is the general reference that the American Bankers Association (ABA) submitted to the DoD:

"Federal law requires that you receive a clear description of your required payments. Please review the disclosures and your credit agreement carefully to understand your payment obligations."

When must the financial institution provide the disclosures?

Disclosures must be provided "before or at the time the borrower becomes obligated on the transaction or establishes an account for the consumer credit."[34] Oral disclosures provided through a toll-free number must be available from the time the creditor provides the toll-free telephone number, which may be at application or with the MLA disclosures. Because the oral disclosures may be generic and general, creditors need not ensure that specific payment information is available through the 800 number before the consumer becomes obligated on the loan. The oral disclosures also need only be available for a period "reasonably necessary to allow a covered borrower to contact the creditor for the purpose of listening to the disclosure."

Creditors may provide MLA disclosures, including Regulation Z disclosures, after a borrower has become obligated on a transaction under certain circumstances, (e.g. purchase orders or requests made by mail, telephone, or fax) consistent with Regulation Z. This is an exception to the general rule that the MLA disclosures must be provided before or at the time the borrower becomes obligated on the transaction or establishes an account for the consumer credit. The discussion in the interpretive rule focuses on the Regulation Z disclosures that must be provided under the Rule, but concludes with the statement, "Thus, the disclosures required in Section 232.6(a) [which includes all the MLA disclosures, including those unrelated to Regulation Z] may be provided at the time prescribed in Regulation Z."

34. *Id. at §232.6(a).*

If the financial institution uses a general customer service 800 number to provide the oral disclosures, is the bank required to provide the required oral disclosures automatically or is it able to provide them only if requested?

The bank need only provide them if the caller makes the request.

How does a financial institution determine an applicant's military status?

To enjoy the safe harbor that it has properly identified the military status of applicants, a lender must (1) access the DoD's MLA database or (2) use information about military status contained in a consumer report from one of the "nationwide" consumer reporting agencies. Lenders may not rely on the applicant's declaration.

Creditors may use any Internet address the DoD provides to access the MLA database to ascertain military status and enjoy the safe harbor. Creditors are not bound to use the Internet address provided in the Final Rule as it may change. In addition, some creditors may arrange with DoD for "direct access" to the MLA database.

Banks may not rely on the applicant's declaration

Assignees are permitted to rely on a covered borrower identification safe harbor if the assignee maintains the original creditor's record of a covered borrower's military status obtained from the DoD's MLA database or from a credit bureau.

When must the financial institution determine an applicant's military status in order to enjoy the safe harbor?

In order to enjoy the protections of the safe harbor, the lender must determine military status at the time:

- An applicant applies to establish the account or 30 days prior to that time;
- An account is established or 30 days prior to that time;
- An applicant initiates a transaction or 30 days prior to that time; or

- The creditor develops or processes a "firm offer of credit" that includes the status of the consumer so long as the consumer responds to the offer no later than 60 days after the creditor provided the offer.[35]

§232.5(b)(2)(B) prohibits lenders, including an assignee, from directly or indirectly obtaining information from any DoD database to ascertain whether a consumer "had been a covered borrower as of the date of that transaction or as of the date that account was established." This means that financial institutions may only obtain current information from the database. They will not be able to find out past history of military status. It does not mean that the lender may not inquire with the database after the account is opened, for example, to determine whether the borrower is still entitled to the protections.

Creditors are not prohibited from periodically screening credit portfolios to detect changes to a covered borrower's status

Creditors are not prohibited from periodically screening credit portfolios to detect changes to a covered borrower's status. Thus, a lender may periodically check a customer's status to determine whether the customer is entitled to the Final Rule's protections and discontinue them if they are no longer a covered borrower. The interpretive rule also notes that if other federal laws provide "greater protections" to covered borrowers, creditors should comply with such laws.

What records must the lender retain to make use of the safe harbor?

Lenders are only entitled to the safe harbor if they timely create and thereafter maintain a record of the information obtained.[36] A record could include, for example, a screen shot from the DoD database or a copy of the credit report.

How long should the lender retain records?

The statute of limitations can extend to five years, so records should be retained for five years.

35. *Id. at §232.5(b)(3).*

36. *Id.*

What are the penalties for violations?

The penalties for violations are unusually harsh and include criminal penalties.[37]

Criminal penalties
Creditors knowingly violating the regulation are subject to fines and imprisonment for up to one year.

Voidance of the contract
Any agreement is void from inception of the contract if any provision is violated.

Private right of action and civil liability
A person who violates the regulation is liable to any actual damage, but not less than $500 for each violation, punitive damages, appropriate equitable or declaratory relief, and any other relief provided by law.[38]

Arbitration
No agreement to arbitrate any dispute involving the extension of covered consumer credit to a covered borrower is enforceable against any covered borrower or any person who was a covered borrower when the agreement was made.

Costs of the action
Those found to violate the regulation are liable for the costs of the action and reasonable attorney fees.

Regulation Z violation
A violation of Regulation Z involving any product covered by the regulation is also a violation of the MLA.

37. *32 C.F.R. §232.9.*

38. *The MLA was amended in January 2013 to add a private right of action in federal court.*

What are lenders' compliance options?

- Deny the loan. Financial institutions are not permitted to make loans to covered borrowers that do not comply.
- Conform all loans. Given some of the vague provisions and prohibitions, this may be difficult to achieve with certainty.
- Offer separate loans for covered borrowers
- Eliminate or not develop certain products due to compliance burdens

FOR MORE INFORMATION

ELIZABETH SNYDER

elizabeth.snyder@plantemoran
312.980.3369

BILL DELIGIANNIS

Bill.Deligiannis@plantemoran.com
312.928.5341

plante moran

audit • tax • consulting