ABA Staff Analysis: Military Lending Act Final Regulation
Updated August 5, 2015

The Department of Defense (DOD) on July 22, 2015 published final amendments to the Military Lending Act (MLA) regulation, which restricts the terms on certain consumer loans made to military personnel and their spouses and dependents. The final regulation significantly expands its application to include all consumer credit except for residential mortgages and purchase money loans. All banks, at a minimum, will have to determine the military status of applicants for covered loans and provide certain disclosures.

Specifically, the final rule:

- Covers consumer loans as defined in Regulation Z except for residential mortgages and purchase money loans such as car purchase loans.

- Limits what banks may charge in fees and interest on certain consumer loans by imposing a 36% "military" APR cap. The 36% cap is ***not*** a 36% interest rate cap nor a 36% APR cap, but an MAPR cap that is an "all-in" APR that includes other fees such as application fees and annual fees that are not finance charges under Regulation Z.

- Imposes disclosures which must be provided to military personnel and their spouses and their dependents when they obtain a loan.

- Prohibits enforcement of arbitration agreements.

- Prohibits certain terms, provisions, including:

    - Waivers of the right to legal recourse under any state or federal law;
    - Imposition of "onerous legal notice provisions";
    - Demands of "unreasonable notice from the covered borrower as a condition for legal action"; and
    - Use of a check or other method of access to a bank account which may prohibit "liquid" secured credit.

Banks are responsible for determining an applicant's military status. As a practical matter, this means banks must inquire "directly or indirectly" with the DOD's database or to a nationwide consumer reporting agency that provides such information, if such agency exists.

While issues and risks remain, the final rule addressed many of the issues ABA raised. For example, the proposal would have required banks to access the unreliable DOD database to determine military status, potentially multiple times for a single application. The final rule allows nationwide consumer reporting agencies as an alternative source, to the degree the information is available through credit reports. In addition, it allows more flexibility so that in many cases a single inquiry about military status

will be sufficient in order to take advantage of the safe harbor. The provision making the safe harbor unavailable if the bank had "actual knowledge" of the applicant's status has been removed. The final rule also shortened the oral disclosures and allows them to be provided through a toll-free number, rather than only in person.

Mandatory Compliance date

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

1. 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." Though the DOD stresses that the definition is "consistent" with the Truth in Lending Act (TILA) definition, the MLA definition includes important exclusions. Specifically, the MLA definition excludes "residential mortgages" and purchase money loans such as car purchase loans. Overdraft lines of credit, and "most if not all" deposit advance products are covered. Overdrafts (e.g. overdraft protection services) are not covered.[1]

2. Who is a covered borrower?

Under §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. It does not include accounts that were established prior to a customer serving on active duty.[2] It also does not include a customer who was a covered borrower at the time the account was established but is no longer a covered borrower.

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

The MAPR is different from the TILA (Regulation Z) APR definition because the calculation includes fees that are not considered "finance charges" under Regulation Z, such as application and "participation" fees, such as annual fees. The MAPR calculation also includes fees and premiums for credit insurance, debt cancellation, and debt suspension, fees for a credit-related ancillary product sold in connection with the credit transaction for closed-end and credit or an account for open-end credit. The proposal had only included such ancillary fees sold only "in connection with and either at or before consummation" of the credit transaction. The final rule includes in the MAPR calculation the fee for any ancillary product 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

[1] 32 CFR 232.3(f).
[2] *Id.* at 232.2(a).

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.[3]

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 imposed during the billing period. For the reasons the Federal Reserve Board's abandoned this calculation, the "effective APR" aspect of the MAPR calculation could cause even small, modest fees to exceed the 36% MAPR significantly. To illustrate, a $20 annual fee or a $5 cash advance fee on a credit card with a 12% interest rate could easily exceed the 36% MAPR depending on the customer's balance and the date of transaction and payment. The DOD states that "a creditor reasonably could be expected to estimate at the outset of a billing cycle whether charges to a covered borrower can produce an APR in excess of the limit…particularly because the creditor already would know the periodic rate and whether the non-periodic fees are covered by the exclusion for a bona fide fee…" [4] This statement seems to overlook the fact that key factors in the calculation, including the balance and payments and the timing of new transactions and payment cannot be known at the outset of a billing cycle. The DOD then also notes that in the event a creditor cannot make the calculation at the outset of the billing cycle, it could calculate the "total charges that [are] included in the MAPR and waive an amount necessary to comply with the 36 percent limit…"[5]

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

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

5. How does a bank calculate the MAPR of an open-end account if an annual or participation 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. The $100 limit does not apply if the participation fee is "bona fide" as provided in §232(d).[6] In other words, if it is a "bona fide" annual fee, it may be excluded from the MAPR calculation.

6. 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."[7] The regulation offers a "safe harbor" for purposes of determining whether a fee is reasonable (but not necessarily bona fide). While the final rule is an improvement over the proposed exclusion for bona fide fees that were "reasonable" *and* "customary," determining whether a fee is "bona fide" and reasonable, even with the "safe harbor" is subjective, susceptible to challenge, and risky.

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[3] *Id.* at 232.3(p) and 4(c).
[4] 80 FR 43583 (July 22, 2015).
[5] *Id.*
[6] 32 CFR 232(d).
[7] *Id.* at 232.4(d).

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" – "like-kind fees" – and offers the example of a cash advance fee. "Substantially similar product" is not defined. The Supplementary Information attempts to explain how to compare more complicated but common credit card programs, such as rewards cards, given that for such programs, higher annual fees may be imposed in exchange for additional services and waivers of other fees. A somewhat simplistic explanation offers little practical direction other than the creditor is permitted "to assess the reasonableness of a participation fee by taking into account the potential value of any 'rewards points' that may be awarded to a covered borrow."[8]

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 5 or more creditors with at least $3 billion in an outstanding U.S. credit card balances during the last 3 years.[9] 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.[10]

Potential issues with using the safe harbor include determining what a "substantially similar product or service" is, given the variations in the credit card market, and where card issuers might obtain all the fees of competitors. The Supplementary Information suggests that the information can be obtained from the "complete contract terms" on issuers' websites or from the Bureau's website, though a recent review of card issuers' and Bureau's website shows that only ranges of interest rates and fees may be provided.[11]

The regulation recognizes that participation fees might vary depending on whether other fees are charged. Accordingly, it 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."[12]

7. 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.[13]

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[8] 80 FR 43574 (July 22, 2015).
[9] 32 CFR 232.4(d)(3)(ii).
[10] *Id.*
[11] The Bureau is currently "upgrading" its system for collecting information from credit card issuers, which may add greater detail and account specificity.
[12] 32 CFR 232.4(d)(3)(iv).
[13] 32 CFR 232.4(d)(4)(ii).

8. 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.[14]

9. 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 9 months; and

    - Limits the amount of any application fee.[15]

Included in this exclusion are certain "Payday Alternative Loans" offered by credit unions pursuant to the National Credit Union Administration rules that limits the APR and application fee that may be charged. There is no bank product subject to similar federal law (which includes a regulation) at this time.

10. Beyond the MAPR 36% 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 though banks are excluded from two of them. Many of the terms are undefined, vague, confusing, and subjective. Prohibitions applicable to banks include:

- ***Requirements to submit to arbitration or "other onerous legal notice provisions in the case of a dispute"[16] or demands of "unreasonable notice from the covered borrower as a condition for legal action."[17]*** While "arbitration" may be well-understood, the meaning of the other terms are not. These provisions are undefined and the regulation offers no examples. Nor is it clear the difference between an "onerous legal" notice and an "unreasonable" notice. The DOD, when it

[14] *Id.* at 232.4(c)(2).
[15] *Id.* at 232.3(t).
[16] *Id.* at 232.8(c).
[17] *Id.* at 232.8(d).

adopted the regulation in 2007, indicated that their meaning would be "determined on a case-by-case basis."[18]

- ***Waivers of the right to legal recourse under any state or federal law including any provision of the Servicemembers Civil Relief Act.***[19] The final regulation does not define the "right to legal recourse" nor does it provide examples, although footnote 183 in the Supplementary Information explains that nothing in the regulation affects the federal law governing the interest rate a financial institution may charge.[20] 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. These include, for example, conflict of law waivers.

- ***Use of a check or other method of access to a bank account.***[21] This prohibition appears to target payday-like practices of ensuring payment by obtaining an advance check from the consumer at the time of the loan, to be processed when the loan becomes due. Exceptions to this restriction allow lenders:

    - To require an electronic fund transfer to repay the consumer credit transaction if permitted by law;

    - To require direct deposit of the consumer's salary as a condition of eligibility for covered credit or to debit automatically the checking account; or

    - To take a "security interest in funds deposited after the extension of credit in an account established in connection with the consumer credit transaction."

The last provision raises concerns that the regulation prohibits lenders from offering service members and their spouses and dependents access to "liquid" secured credit, that is, credit (such as credit card credit) that is secured by a financial account such as a savings account. Such accounts are often used as a way to build or rebuild credit. However, the security interest in these products is taken *at the time the account is established*, not *after* the account is established as the exception provides.

- ***Requirement as a condition of consumer credit that the borrower establish an allotment to repay the loan.***[22]

- ***Prepayment penalties.***[23]

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[18] 72 FR 50589 (August 31, 2007).
[19] 32 CFR 232.8(b).
[20] 80 FR 43581 (July 22, 2015).
[21] 32 CFR 232.8(e).
[22] *Id.* at 232.8(g).
[23] *Id.* at 232.8(h).

11. What are the other restrictions on covered loans made to service members and their spouses and dependents that do NOT apply to banks?

- 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.[24]

- A prohibition against using the title of a vehicle as security for a covered loan.[25]

12. What disclosures must covered borrowers receive?

- ***"Statement" of the MAPR.***[26] Banks may comply with this provision by "describing the charges the creditor may impose related to the consumer credit to calculate the MAPR."[27] Section 232.6(c)(2) provides a model statement. Lenders are not required to disclose the numerical MAPR.[28]

- ***Any disclosures required by Regulation Z.***

- ***Clear description of the payment obligation of the covered borrower.***[29] For closed-end credit, a payment schedule suffices. For open-end credit, the account opening disclosures required under Regulation Z suffice.

The proposal had required disclosure of additional information describing protections and financial resources available to service members and their spouses and dependents. That disclosure was eliminated.

13. How must the disclosures be provided?

The disclosures must be provided in writing.[30] The statement of the MAPR and the payment obligation description must also be provided orally.[31] Oral disclosures may be made through a toll-free number.[32]

The proposal required oral disclosures to be provided in person, with limited exceptions. However, the final rule permits the information that must be provided orally to be made in person or through a toll-

[24] *Id.* at 232.8(a).
[25] *Id.* at 232.8(f).
[26] *Id.* at 232.6(a)(1).
[27] *Id*.
[28] *Id*.
[29] *Id*. at 232.6(a)(3).
[30] *Id.* at 232.6(d)(1).
[31] *Id.* at 232.6(d)(2).
[32] *Id*. at 232.6(d)(2(ii)(B) (July 22, 2015).

free number.[33] The toll-free number must be provided on (1) the application form or (2) with the written disclosures described above.

The proposal required that the disclosures be "clearly and conspicuous." However the final regulation omits this requirement.

14. When must the bank 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]

15. How does a bank determine an applicant's military status?

To ensure compliance, banks must determine military status of applicants by (1) assessing the DOD's database or (2) using a statement, code or other indicator describing military status contained in a consumer report from one of the "nationwide" consumer reporting agencies. They may not rely on the applicant's declaration.

Currently, lenders may rely on the statements of applicants to determine applicants' military status. However, the DOD was concerned about "service members or their dependents who make false statements."[35] Accordingly, it proposed that lenders could no longer rely on the applicants' declaration of their military status. Rather, to ensure compliance, lenders would be required to rely on the regulation's "safe harbor," which entailed assessing the DOD's database. However, there were significant concerns that the safe harbor was unworkable given the lack of reliability of the DOD database with regard to availability and accuracy when used for Servicemember Civil Relief Act purposes. In addition, there were concerns about the ability of the DOD's database to handle the expected significant increase in the volume of inquiries that would result due to the expanded application of the MLA regulation.

The final regulation offers some potential relief because obtaining military status information from credit reports is potentially convenient and efficient. However, there remain concerns about the reliability of the DOD database and, at this time, it does not appear that any of the nationwide consumer reporting agencies provide such information. They may do so by the mandatory compliance date of October 3, 2016.

The proposal would not have allowed lenders to rely on the safe harbor if they had "actual knowledge" of an applicant's active military status. This would have entailed lenders reviewing all documents throughout the organization manually or creating a centralized database. Accordingly, the provision was eliminated.

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[33] *Id*. at 232.6(d)(2).
[34] *Id*. at 232.6(a).
[35] 80 FR 43576 (July 22, 2015).

16. When must the bank determine an applicant's military status?

The lender must determine military status at the time:

- An applicant initiates a transaction or 30 days prior to that time;
- An applicant applies to establish the account 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.[36]

ABA had raised concerns that multiple inquiries to determine military status would be required, e.g., at a minimum at the time of application and again when the loan was consummated. The 30-day period streamlines compliance and will reduce the volume of potential inquiries into the DOD database by reducing the potential for multiple inquiries.

Curiously, §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."

17. 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.[37] A record could include, for example, a screen shot from the DOD database or a copy of the credit report.

18. What are the penalties for violations?

The penalties for violations are unusually harsh and include criminal penalties.

- ***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.

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[36] 32 CFR 232.5(b)(3).
[37] *Id.*
[38] The MLA was amended in January 2013 to add a private right of action in federal court.

- ***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.

Questions? Contact ABA's Nessa Feddis and Rob Rowe for more information.