Military Lending Act Poses Challenges and Risks for Lenders

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New regulations issued by the Department of Defense (DOD) under the Military Lending Act (MLA) will have a major impact on financial institutions. Although the MLA has been on the books since 2006, its focus on closed-end payday loans, vehicle title loans, and tax-refund anticipation loans meant that the law historically had limited relevance to most financial institutions. The new DOD regulations, however, extend the MLA to cover credit products issued and serviced by many banks and credit unions, most notably credit cards and student loans.

The revised MLA regulations will increase compliance costs for issuers and servicers of covered products. These costs will be magnified because the regulations apply to a high-risk area in which attentive regulators will have little tolerance for error. Under the new rules, creditors should review accounts at the time of issuance to determine whether the MLA applies. If it does, they will need to adjust both the contract terms and servicing procedures to account for the MLA's new scope and requirements. But the amended regulations and commentary leave many important questions unanswered, such as how to determine whether a fee is "bona fide" and "reasonable," how to apply the Military Annual Percentage Rate (MAPR) cap to open-end credit products, and how the MLA database will hold up under the crush of increased searches. Even though the amendments build in time for implementation, financial institutions would be well served by making plans now given the lack of clarity surrounding many of these important questions. This article discusses the major provisions of the MLA and analyzes these more difficult interpretative questions.

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Overview of New Requirements

The new regulations significantly expand the scope of the MLA. The regulations expand the MLA's coverage by defining "consumer credit" to cover the same forms of credit covered by the Truth in Lending Act (TILA) (*i.e.*, credit offered or extended primarily for personal, family, or household purposes, and that is subject to a finance charge or is payable by written agreement in more than four installments). Importantly, as a result, the MLA now covers credit cards and student loans. It does not cover residential mortgages or most auto loans, however, nor does it generally cover overdraft protection on deposit products. Due to the magnitude of these changes and the complexity of compliance, the DOD has delayed the effective dates. Compliance is not required until October 3, 2016, and a two-year exemption was granted for credit cards until October 3, 2017.

In terms of substance, the MLA imposes requirements in three primary areas of concern to lenders. First, the MLA requires that certain loan disclosures be made prior to extending credit. These disclosures include a statement of the applicable MAPR and a clear description of the payment obligation. The disclosures must be made both orally and in writing, although the oral disclosure can be made through a toll-free number provided to the borrower. Second, the MLA prohibits extensions of credit under which a borrower is required, among other things, to submit to arbitration, or for which the borrower is either prohibited from or penalized for prepaying the loan. Third, and

most importantly, the MLA bars creditors from imposing an MAPR greater than 36 percent. The MAPR is calculated using the same basic formula prescribed in Regulation Z, but it also includes credit insurance fees, ancillary fees, and "finance charges" as defined under Regulation Z. The assessment of late fees, delinquency fees, or fees for exceeding the credit limit are excluded from the term "finance charge" in Regulation Z and they are likewise excluded from the MAPR.

The MLA applies to servicemembers on active duty who open an account while on qualifying military service or their dependents. The amendments define "covered member" as a member of the armed forces who is serving on active duty under Titles 10, 14, or 32 of the US Code, for a period of at least 31 days, or active guard and reserve duty as defined in Title 10. The protections terminate when the servicemember leaves covered military service.

Areas of Potential Risk or Uncertainty

Although the final rule amending the MLA's implementing regulation includes commentary and explanation, the amendments leave several important areas of uncertainty that will likely prove to be a source of challenges and regulatory risk for lenders.

Bona Fide and Reasonable Fees

The cap on MAPR notwithstanding, the MLA regulations contain a provision that allows the assessment of certain fees on credit cards, so long as the fees are "bona fide" and are "reasonable." This exclusion is designed to allow creditors to continue assessing fees specifically "tied to bona fide, specific products or services" that a servicemember may use based on his or her account choices, such as cash advance, participation, or foreign transaction fees. For each of these bona fide fees, the regulations provide a safe harbor if the fee is "reasonable," meaning it is equal to or less than the average of the amount charged by five other credit card issuers of sufficient size (more than $3 billion outstanding in credit card loans) for a like-kind fee. Although well-intentioned, this exception will be difficult to implement because of several ambiguities in the regulations and commentary.

First, the term "bona fide" is never fully defined. Instead, only vague standards are offered, such as the fee being related to the "[s]ervice member's own choices regarding use of the card." The assessment of whether a fee is "bona fide" appears to be left to the discretion of lenders, which presents risk of regulators later disagreeing with a lender's good-faith determination. In the future, regulators should either provide more robust guidance on the types of fees that are "bona fide," or provide a definition that can be used by lenders when making that assessment, as there is currently the potential for variance across the industry.

Second, assessing whether a fee is "reasonable" requires a lender to make comparisons to fees charged by other institutions for "substantially similar product[s] or service[s]." Beyond the difficulty of determining the fees charged by competitors (the commentary optimistically states that schedules of fees are available on lender Web sites), the regulations are unclear as to when this assessment is to be made. For example, is it sufficient to measure fees for reasonableness on a periodic basis, or must they be reviewed whenever they are charged to customers? If periodic, how frequently? Prior to the required date of compliance for credit card products, further guidance from the regulators on the required periodicity of the reasonableness assessments would help to ensure a consistent approach by lenders.

Open-End Credit

Applying the MAPR cap to open-end credit accounts, such as credit cards, will likely present additional challenges for lenders, as even a small fee could cause the MAPR to exceed 36 percent if the balance on the account is low. The DOD's commentary on the challenges presented by this rule, which states that lenders could be expected to estimate at the outset of a billing cycle whether charges could cause the MAPR to exceed 36 percent, seems disconnected from the realities of card servicing because it is impossible to predict the end-of-cycle balance and actual customer transactions. In cases in which the account has a zero balance, the only permissible fee is a participation fee not to exceed $100 per year (excluding bona fide fees).

Ancillary Products

The inclusion of fees for ancillary or "add-on" products in the MAPR calculation moves close to an outright ban on the sale of such products to military borrowers. These fees have attracted the attention of regulators, particularly the Consumer Financial Protection Bureau (CFPB), who have expressed disapproval of them. In

its commentary, the DOD likewise states that most of these products are not suitable for military borrowers due to benefits already provided by the military.

MLA Database

The amended regulation permits a creditor to obtain a safe harbor from liability by verifying the status of a consumer on the Defense Manpower Data Center (DMDC) online database (MLA Database), either directly or indirectly, or by using a consumer credit report that contains military status. The regulations provide that in order to receive the safe harbor, the search must occur at the time the consumer seeks to obtain credit (at the time the applicant initiates a transaction or 30 days prior, at the time the applicant applies for credit or 30 days prior, or when the creditor develops or processes a firm offer of credit). The commentary largely ignores the serious concerns by lenders about the potential credit bottlenecks that could be caused by this requirement. The DOD seems to take the view that because lenders are not *required* to search the MLA Database when extending credit it need not address concerns about the ability of the MLA Database to handle these searches. For example, the DMDC was offline for several days in October 2014 and similar unavailability in the future could result in serious disruptions for lenders.

Legal Notice Provisions

The amended regulation bans lenders from requiring that eligible borrowers submit to "onerous legal notice provisions in the case of a dispute" or demanding "unreasonable notice from the covered borrower as a condition for legal action." The DOD stated previously that the meaning of these provisions would be determined on a case-by-case basis, and it has not offered any additional definition or commentary in the Final Rule.

Importance of Compliance

The amendments to the MLA's implementing regulation create a new set of legal requirements in a high-risk area. Financial regulators, including the CFPB, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Department of Justice, among others, have focused attention on military customers in recent years, often taking a nearly zero-tolerance approach to oversight. The Servicemembers Civil Relief Act (SCRA), in particular, has been an area of regulator attention. Lenders should fully expect the same level of scrutiny under the MLA and they should design MLA compliance programs, policies, and procedures with this expectation in mind. Administrative enforcement of the MLA will be handled by the CFPB and the Federal Trade Commission, as well as by the prudential regulators.

Beyond the enforcement mechanisms available to regulators, such as civil money penalties and restitution, the MLA itself contains serious consequences for noncompliance. The regulations provide that agreements that violate the MLA are void. Additionally, the MLA authorizes criminal sanctions for knowing violations of its provisions, and allows private plaintiffs to recover actual damages of at least $500 per violation, plus punitive damages, attorneys' fees, and other remedies.

Conclusion

The revised MLA regulations will present challenges and regulatory risks for lenders—in particular, for credit card and student loan issuers. Beyond the heightened attention placed on military borrowers by the CFPB and other regulators, the number of interpretive questions that are left unresolved by the regulations increases the risk created by the change. Most importantly, first, the regulations leave many issues unresolved surrounding the determination of whether a fee is "bona fide" and "reasonable." For example, the regulations leave the term "bona fide" undefined and are not clear on how often the reasonableness of fees must be assessed. Second, there are still serious concerns about the ability of the MLA database to handle the increased volume of searches, and it is not clear how lenders should handle instances when the database is offline while still receiving the benefit of the safe harbor. Finally, the new regulations include restrictions related to arbitration and legal notice provisions, which are undefined and vague. In all likelihood, additional guidance will be required in these areas to help lenders implement the new MLA requirements. In the meantime, lenders should begin to proactively assess the application of the MLA to their business and begin planning for compliance.