



Notice on Defense Department's New Rules for Consumer Loans to Service Members

The Department of Defense has finalized a regulation for consumer payday loans, vehicle title loans, and tax refund anticipation loans made to service members and their dependents. The regulation will affect all creditors (as defined in the regulation) who make these types of loans, including insured depository institutions like banks, savings and loan associations and credit unions.

While the scope of the regulation is narrow, and will likely affect traditional lenders from time to time, FIPCO is providing the following article to help users understand the new regulation. In addition, FIPCO has created two model forms to help creditors comply with certain aspects of the regulation. The forms are posted on FIPCO's website at www.fipco.com. The regulation is effective **October 1, 2007**.

Introduction

On October 17, 2006, President Bush signed the 2007 Defense Authorization Act which contained a payday lending provision, known as the "Talent Amendment" (Amendment). The Amendment was designed to restrict the ability of payday lenders to extend credit to members of the military and their dependents by establishing interest rate ceilings and restrictions on such extensions of credit.

The Department of Defense (DoD) was charged with writing regulations to implement the Amendment. In its proposed regulations, DoD asked whether insured depository institutions should be excluded from coverage. While WBA and many others strongly supported this exclusion, the DoD ultimately did not adopt it. Therefore, traditional financial institutions such as banks, savings and loan associations, and credit unions are covered by the final regulation. The final regulation is effective **October 1, 2007**. There is no delayed compliance date.

The final regulation imposes new disclosure requirements, limitations, and restrictions on payday loans, vehicle title loans, and tax refund anticipation loans, as defined in the regulation, that are made to service members or their dependents. This means if an institution makes a payday loan, vehicle title loan, or tax refund anticipation loan, the institution must know whether or not the applicant is a service member or a service member's dependent. If so, then the lender must provide the new disclosures (along with the other disclosures that are normally given in these types of loans), and must abide by the limitations and restrictions set forth in the regulation.

This article highlights certain provisions of the final regulation including: definitions; identification of borrowers covered by the regulation; content and delivery of mandatory disclosures; and limitations and restrictions on covered transactions.

Definitions

1. "Closed-end credit" means consumer credit other than "open-end credit" as that

term is defined in Regulation Z (Truth in Lending) 12 CFR part 226.

2. "Consumer credit" means closed-end credit offered or extended to a covered borrower primarily for personal, family or household purposes, for payday, vehicle title, or tax refund anticipation loans defined in (i), (ii) and (iii) below.

(i) Payday loans. Closed-end credit with a term of 91 days or fewer in which the amount financed does not exceed \$2,000 and the covered borrower:

(a) Receives funds from and incurs interest and/or is charged a fee by a creditor, and contemporaneously with the receipt of funds, provides a check or other payment instrument to the creditor who agrees with the covered borrower not to deposit or present the check or payment instrument for more than one day; or

(b) Receives funds from and incurs interest and/or is charged a fee by a creditor, and contemporaneously with the receipt of funds, authorizes the creditor to initiate a debit or debits to the covered borrower's deposit account (by electronic fund transfer or remotely created check) after one or more days. This provision does not apply to any right of a depository institution under statute or common law to offset indebtedness against funds on deposit in the event of the covered borrower's delinquency or default.

(ii) Vehicle title loans. Closed-end credit with a term of 181 days or fewer that is secured by the title to a motor vehicle, that has been registered for use on public roads and owned by a covered borrower, other than a purchase money transaction described in 3. (ii) below.

(iii) Tax refund anticipation loans. Closed-end credit in which the covered borrower expressly grants the creditor the right to receive all or part of the borrower's income tax refund or agrees to repay the loan with the proceeds of the borrower's refund.

3. "Consumer credit" does *not* mean:

(i) Residential mortgages, which are any credit transactions secured by an interest in the covered borrower's dwelling, including transactions to finance the purchase or initial construction of a dwelling, refinance transactions, home equity loans or lines of credit, and reverse mortgages;

(ii) Any credit transaction to finance the purchase or lease of a motor vehicle when the credit is secured by the vehicle being purchased or leased;

(iii) Any credit transaction to finance the purchase of personal property when the credit is secured by the property being purchased;

(iv) Credit secured by a qualified retirement account as defined in the Internal Revenue Code; and

(v) Any other credit transaction that is not consumer credit extended by a creditor, is an exempt transaction, or is not otherwise subject to disclosure requirements for purposes of Regulation Z.

4. "Covered borrower" means a person with the following status at the time he or she becomes obligated on a consumer credit transaction covered by the regulation:

(i) A regular or reserve member of the Army, Navy, Marine Corps, Air Force, or Coast Guard, serving on active duty under a call or order that does not specify a period of 30 days or fewer, or such a member serving on Active Guard and Reserve duty as that term is defined in 10 U.S.C. 101(d)(6); or

(ii) The member's spouse, the member's child defined in 38 U.S.C. 101(4), or 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 the regulation.

5. "Credit" means the right granted by a creditor to defer payment of debt or to incur debt and defer payment.

6. "Creditor" means a person who is engaged in the business of extending consumer credit with respect to a consumer credit transaction covered by the regulation. It includes a natural person, organization, corporation, partnership, proprietorship, association, cooperation, estate, trust, and any other business entity and who meets the definition of "creditor" for purposes of Regulation Z.

7. "Dwelling" means a residential structure that contains one to four units, whether or not the structure is attached to real property. The term includes an individual condominium unit, cooperative unit, mobile home, and manufactured home.

8. "Electronic fund transfer" has the same meaning for purposes of this regulation as in Regulation E (Electronic Fund Transfers) issued by the Board of Governors of the Federal Reserve System (FRB), 12 CFR part 205.

9. "Military annual percentage rate" (MAPR). The MAPR is the cost of the consumer credit transaction expressed as an annual rate. The MAPR shall be calculated based on the costs in this definition but in all other respects it shall be calculated and disclosed following the rules used for calculating the Annual Percentage Rate (APR) for closed-end credit transactions under Regulation Z.

The MAPR includes the following cost elements associated with the extension of consumer credit to a covered borrower if they are financed, deducted from the proceeds of the consumer credit, or otherwise are required to be paid as a condition of the credit:

(i) Interest, fees, credit service charges, credit renewal charges;

(ii) Credit insurance premiums including charges for single premium credit insurance, fees for debt cancellation or debt suspension agreements; and

(iii) Fees for credit-related ancillary products sold in connection with and either at or before consummation of the credit transaction.

10. The "MAPR" does *not* include:

(i) Fees or charges imposed for actual unanticipated late payments, default, delinquency, or similar occurrence;

(ii) Taxes or fees prescribed by law that actually are or will be paid to public officials for determining the existence of, or for perfecting, releasing, or satisfying a security interest;

(iii) Any tax levied on security instruments or documents evidencing indebtedness if the payment of such taxes is a requirement for recording the instrument securing the evidence of indebtedness; and

(iv) Tax return preparation fees associated with a tax refund anticipation loan, whether or not the fees are deducted from the loan proceeds.

11. "Regulation Z" means any of the rules, regulations, or interpretations thereof, issued by the FRB to implement the Truth in Lending Act, including any interpretation or approval issued by the FRB. Words that are not defined in this regulation have the meanings given them in Regulation Z, including any interpretation or approval issued by the FRB. Words that are not defined in this regulation or Regulation Z, or any interpretation thereof, have the meanings given them by State or Federal law, or contract.

Terms of Consumer Credit to a Covered Borrower

1. Neither a creditor who extends consumer credit to a covered borrower nor an assignee of the creditor shall require the member or dependent to pay a military annual percentage rate (MAPR) with respect to such extension of credit, except as:

- (i) Agreed to under the terms of the credit agreement or promissory note;
- (ii) Authorized by applicable State or Federal law; and
- (iii) Not specifically prohibited by the regulation.

2. A creditor as defined in the regulation or an assignee may not impose an MAPR greater than 36 percent in connection with an extension of consumer credit to a covered borrower.

Identification of Covered Borrower

The creditor must know whether or not the applicant for the types of credit described earlier is a "covered borrower". The regulations provide a "covered borrower identification statement" for this purpose (see regulation for model text). If the applicant signs this statement denying that he or she is a covered borrower, the creditor is provided a general safe harbor, subject to a caveat noted later in this section.

The regulation states that an applicant will not be considered a covered borrower and the regulation will not apply if:

- 1. Prior to becoming obligated on the transaction, each applicant is provided with a clear and conspicuous "covered borrower identification statement" substantially similar to that which is prescribed in the regulation and each applicant signs the statement indicating he or she is not a covered borrower; and
- 2. The creditor has not determined through optional verification procedures described below, that any applicant is a covered borrower.

The creditor may, but is not required to, verify the status of an applicant as a covered borrower by requesting the applicant to provide a current (previous month) military leave and earning statement, or a military identification card (DD Form 2 for members, DD Form 1173 for dependents). Upon such a request, activated members of the National Guard or Reserves shall also provide a copy of the military orders calling the covered member to military service and any orders further extending military service.

In addition, the creditor may, but is not required to, verify the status of an applicant as a covered borrower by accessing the information available at <http://www.dmdc.osd.mil/mla/owa/home>.

As noted earlier, a general safe harbor is provided to a creditor when an applicant signs a statement indicating that he or she is *not* a covered borrower. However, creditors should be cautious about this because such a signed statement does not create a safe harbor if the creditor obtains documentation as part of the credit transaction reflecting that the applicant *is* a covered borrower. In such cases, creditors should seek to resolve the inconsistency. If they are unable to do so, they may avoid any risk of noncompliance by treating the applicant as a covered borrower or by declining to extend the credit due to the inability to verify information provided in the applicant's signed statement.

Finally, the regulation shall not apply to a consumer credit transaction in which the creditor rolls over, renews, repays, refinances, or consolidates consumer credit in accordance with the limitations described later in this article if, in the previous transaction, the conditions in 1 and 2 above had been met, subject to the caution noted in the previous paragraph.

Mandatory Disclosures

1. With respect to any extension of consumer credit (including any consumer credit originated or extended through the Internet) to a covered borrower, a creditor shall provide to the member or dependent the following information clearly and conspicuously before consummation of the consumer credit transaction:

(i) The MAPR applicable to the extension of consumer credit, and the total dollar amount of all charges included in the MAPR.

(ii) Any disclosures required by Regulation Z.

(iii) A clear description of the payment obligation of the covered borrower, as applicable. A payment schedule provided pursuant to Regulation Z satisfies the requirement.

(iv) A statement that "Federal law provides important protections to regular or reserve members of the Army, Navy, Marine Corps, Air Force, or Coast Guard, serving on active duty under a call or order that does not specify a period of 30 days or fewer, and their dependents. Members of the Armed Forces and their dependents may be able to obtain financial assistance from Army Emergency Relief, Navy and Marine Corps Relief Society, the Air Force Aid Society, or Coast Guard Mutual Aid. Members of the Armed Forces and their dependents may request free legal advice regarding an application for credit from a service legal assistance office or financial counseling from a consumer credit counselor."

2. The creditor shall provide all of the disclosures above in writing and in a form the covered borrower can keep.

3. The creditor also shall orally provide the disclosures required by (i), (iii), and (iv) above before consummation. In mail and internet transactions, the creditor satisfies this requirement if it provides a toll-free telephone number on or with the written disclosures that consumers may use to obtain oral disclosures and the creditor provides oral disclosures when the covered borrower contacts the creditor for this purpose.

4. The refinancing or renewal of a covered loan requires new disclosures described in 1, 2, and 3 above only when the transaction would be considered a new transaction that requires disclosures under Regulation Z.

Preemption

Any State or Federal law, rule or regulation including any State usury law is preempted by the regulation to the extent that such law, rule or regulation is inconsistent with the regulation except those which provide protection to a covered borrower greater than those protections provided by the regulation.

In addition, different treatment under State law of covered borrowers is prohibited. States may not:

1. Authorize creditors to charge covered borrowers rates of interest that are higher than the legal limit for residents of the State, or
2. Permit the violation or waiver of any State consumer lending protection that is for the benefit of residents of the State on the basis of the covered borrower's nonresident or military status, regardless of the covered borrower's domicile or permanent home of record, provided that the protection would otherwise apply to the covered borrower.

Limitations

1. It is unlawful for any creditor to extend consumer credit to a covered borrower with respect to which:

(i) The creditor rolls over, renews, repays, refinances, or consolidates any consumer credit extended to the covered borrower by the same creditor with the proceeds of other consumer credit extended by that creditor to the same covered borrower, unless the new transaction results in more favorable terms to the covered borrower, such as a lower MAPR. However, the regulation shall not apply to a transaction permitted by this paragraph when the same creditor extends consumer credit to a covered borrower to refinance or renew an extension of credit that was not covered by the regulation because the consumer was not a covered borrower at the time of the original transaction.

(ii) The covered borrower is required to waive his or her right to legal recourse under any otherwise applicable provision of State or Federal law, including any provision of the Servicemembers Civil Relief Act.

(iii) The creditor requires the covered borrower to submit to arbitration or imposes other onerous legal notice provisions in the case of a dispute.

(iv) The creditor demands unreasonable notice from the covered borrower as a condition for legal action.

(v) The creditor uses a check or other method of access to a deposit, savings, or other financial account maintained by the covered borrower, or uses the title of a vehicle as security for the obligation, except that, in connection with a consumer credit transaction with an MAPR that does not exceed 36%:

(a) The creditor may require an electronic fund transfer to repay a consumer credit transaction, unless otherwise prohibited by Regulation E;

(b) The creditor may require direct deposit of the consumer's salary as a condition of eligibility for consumer credit, unless otherwise prohibited by law; or

(c) The creditor may, if not otherwise prohibited by applicable law, take a security interest in funds deposited after the extension of credit in an account established in connection with the consumer credit transaction.

(vi) The creditor requires as a condition for the extension of consumer credit that the covered borrower establish an allotment to repay the obligation.

(vii) The covered borrower is prohibited from prepaying the consumer credit or is charged a penalty fee for prepaying all or part of the consumer credit.

2. For the purposes of this limitations section, an assignee may not engage in any transaction or take any action that would be prohibited for the creditor.

Penalties and Remedies

1. A creditor or assignee who knowingly violates the law as implemented by the regulation will have committed a misdemeanor and shall be fined as provided in title 18, United States Code, or imprisoned for not more than one year, or both.

2. The remedies and rights provided in the regulation are in addition to and do not preclude any remedy otherwise available under State or Federal law or regulation to the person claiming relief under the statute, including any award for consequential damages and punitive damages.

3. Any credit agreement, promissory note, or other contract with a covered borrower that fails to comply with the regulation or which contains one or more provisions prohibited by the regulation is void from the inception of the contract.

4. Notwithstanding any Federal or State law, rule or regulation, no agreement to arbitrate any dispute involving the extension of consumer credit to a covered borrower pursuant to the regulations shall be enforceable against any covered borrower, or any person who was a covered borrower when the agreement was made.

Enforcement

The federal banking, thrift and credit union regulatory agencies have authority to enforce the regulations with respect to the institutions that they supervise. However, for other creditors enforcement will likely be left to each State's regulatory agencies.

Servicemembers Civil Relief Act

The regulation may not be construed to limit or otherwise affect the applicability of the Servicemembers Civil Relief Act.

Effective Date and Transition

The regulation shall apply only to consumer credit that is extended to a covered borrower and consummated on or after October 1, 2007.

Conclusion

While the regulation is narrow in scope and may not apply to the types of transactions traditional financial institutions typically enter into, it is nonetheless important for institutions to understand the rules.

A financial institution will need to determine if it makes any of the three types of loans covered by the regulation, whether or not on a routine basis. If so, the institution will need to determine whether it will continue to make such loans. If it will, then the institution must determine if the applicant for such a loan is a covered

borrower and provide to each covered borrower the mandatory disclosures described earlier, while also following the limitations and restrictions imposed by the regulation. Failure to do so could result in stiff monetary penalties, imprisonment or both.

Copies of the full text of the final regulation, including its preamble and the specific text for the covered borrower identification statement, may be obtained from WBA or viewed at: www.gpoaccess.gov/fr/index.html. *Federal Register*, Vol. 72, No. 169, 08/31/2007, 50579-50592.

This article does not cover every aspect of the new regulation. It is for informational purposes only and is not intended as, nor does it constitute, legal advice. If legal or other expert assistance is required, the services of a competent and professional person should be sought.

Any questions regarding this notice may be directed to WBA's Legal Department 608/441-1200 or wbalegal@wisbank.com. Please include your name, financial institution name and a phone number in all e-mail correspondence.