February 5, 2007

The Honorable Dr. David S. C. Chu  
Under Secretary of Defense for Personnel and Readiness  
2000 Defense Pentagon  
Washington, DC  20301-4000

SUBJECT:  Department of Defense (DOD) Notice and Request for Comments (DOD-2006-OS-0216) – Limitations on Terms of Consumer Credit Extended to Servicemembers and Dependents (Public Law 109-364 Section 670):  
Comments of American Financial Services Association

Dear Dr. Chu:

The American Financial Services Association (“AFSA”) hereby submits this comment letter in response to the request by the Department of Defense for our observations, comments and recommendations on the Department’s forthcoming regulations, implementing the requirements of the recently-enacted Section 670 of the John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. 109-364, Section 670, “Limitations on Terms of Consumer Credit Extended to Servicemembers and Dependents,” herein after referred to as the “Payday Lending Law.”

The Association, founded in 1916, is the trade association for a wide variety of consumer finance companies. AFSA's mission is to protect and improve the consumer credit business, maintain a positive public image, and create a legislative climate in which reasonable credit regulation can and will be enacted. AFSA operates in the public interest, encourages and maintains ethical business practices, and supports financial education for consumers of all ages.

I. Executive Summary

AFSA believes that broad application of the Payday Lending Law provisions would have the unintended consequence of severely restricting access to fair and affordable credit for countless servicemembers and their families. Unless the enabling regulations clearly and narrowly target only payday lending, the severe penalties for violations, including the potential for imprisonment and the complete nullification of a borrower’s contractual obligations, together with the vague and internally inconsistent provisions of the legislation, will result in many, if not all, consumer credit grantors of choice ceasing to offer credit of any form to deserving servicemembers or their dependents. Therefore, AFSA respectfully recommends that the Department of Defense exercise its regulatory
authority under this statute to define “Creditor” and “Consumer Credit,” under the newly enacted Payday Lending Law narrowly as follows:

“Consumer Credit” means a cash advance, having a term of less than 120 days, made to a covered member or a dependent of a covered member in exchange for—

1. the personal check or share draft of the covered member or a dependent of the covered member, in the amount of the advance plus a fee, where presentment or negotiation of such check or share draft, held by a third party institution, is deferred by agreement of the parties until a designated future date; or
2. the authorization by the covered member or a dependent of the covered member to debit the transaction account or share draft account, held by a third party institution, of the covered member or a dependent of the covered member, in the amount of the advance plus a fee, where such account will be debited on or after a designated future date; or
3. the surrender of possession of a title to a vehicle by the covered member or dependent of the covered member as security for the advance without the perfection of a security interest in the vehicle.

“Creditor” means a person or entity who offers Consumer Credit, as defined above, to a covered member or a dependent of the covered member.

Furthermore, AFSA respectfully requests that the Department of Defense include in the regulations that it issues under the Payday Lending Law an express statement that the Payday Lending Law’s provisions do not apply to motor vehicle installment sale and lease contracts entered into between covered members of the military or their dependents and other motor vehicle dealers.

II. Introduction

AFSA appreciates the opportunity to work with the Department of Defense as a partner to responsibly and effectively implement the protections of the Payday Lending Law in a manner that protects servicemembers and their dependents against the abusive practices of payday lenders. At the same time, it is imperative that the implementing regulations do not result in the unintended consequences of restricting the availability of legitimate and appropriate credit products to deserving servicemembers and their dependents [e.g., those with an ability to repay, and particularly those who otherwise are not and will not be served by lenders such as conventional commercial banks, credit unions, or by the Armed Services’ (“Services”) emergency relief organizations].

In this letter we hope to accomplish the following:

A. Explain that the crucial need for credit by America’s servicemembers is not being met by conventional commercial banks, credit unions, or military relief societies;
B. Distinguish the legitimate products and services offered by our members from the products offered by payday and title lenders;
C. Outline a solution for addressing the problems posed by payday lending, which will not jeopardize servicemembers access to traditional credit products. These traditional credit products include installment loans, as well as motor vehicle installment sale and lease contracts.

III. Conventional Commercial Banks, Credit Unions, and Military Relief Societies Do Not Provide Adequate Credit to Servicemembers and Their Families

It is an axiom in any free market, including the consumer credit market, that competitors will step in and attempt to serve any part of a market which is not adequately served. This is the case in providing credit services to military personnel. Conventional commercial banks and credit unions simply do not serve all of the credit needs of members of the military.

Furthermore, the Services’ military aid societies have neither broad lending policies nor the financial capacity to meet the need. According to the Department of Defense’s report to Congress, the Military Aid Societies total lending to Servicemembers in 2005 amounted to $87,332,758, in 100,808 transactions each averaging only $866. This represents the total capacity of the Military Aid Societies in that year, under the existing financial (capital) restrictions and regulatory requirements that limit Military Aid Society lending to very narrow and limited purposes (e.g., emergency loans for urgent required travel, rent, food, utilities and essential automobile repairs). That total is just a small fraction of 1% of the total lending to servicemembers by AFSA member companies. Moreover, our member companies report that many of their clients have come to them specifically because they were denied funding from a Military Aid Society.

IV. Payday Loans v. Installment Loans

In order to implement reasonable and functional rules, it is necessary to understand the distinction between payday and installment loans.

AFSA agrees most strongly with the Department of Defense that payday and title lending practices (as detailed in the Department’s August 9, 2006 report to the Congress) can be very harmful to servicemembers, and should be prohibited by the Payday Lending Law. The very nature of the “payday loan” transaction and its widespread use by servicemembers are serious distractions to the mission readiness of the armed forces. Thus, it is correct and proper that the payday lending industry’s focus on the military be severely curtailed. Payday loans are a relatively new type of consumer financing, having originated and evolved primarily within the last eight years; whereas, the consumer finance industry has been providing military servicemembers fair and affordable access to credit for over half a century.
The consumer finance industry, in providing installment loans, has operated within a longstanding legal framework, licensed and thoroughly regulated by state banking agencies and/or other state agencies that supervise licensed lenders. In fact, the consumer finance industry came into being precisely to serve low and moderate income working families that did not have access to credit from conventional commercial banks and credit unions. Moreover, AFSA believes that a broad interpretation of the Payday Lending Law would foreclose on the opportunity for servicemembers to obtain traditional credit products, forcing them into the hands of underground lenders, which would, in fact, further exacerbate the military readiness problem.

The crucial factors distinguishing payday lenders from AFSA lenders are:

A. payday lenders typically do not test the consumer’s ability to repay the credit extended (relying on the threat value of the post-dated check); and

B. the payday loan must be repaid in one single payment, typically due less than one month from the date of the loan.

These two aspects of payday loans combine to result, all too often, in the borrower being unable to pay the payday loan off on maturity. Therefore, the borrower is forced to renew the loan at either the same or a greater principal amount, thereby paying additional fees on what amounts to the same borrowing. As the payday loan is renewed each month without the principal having been reduced or any extra cash being received by the borrower, the prospect of the loan ever being paid off becomes increasingly remote. It may not be that the rate on the loan is abusive, but that the loan is made without regard to the customer’s ability to repay. In fact, all that payday lenders require is that the borrower has held a job and has had, at one point, a checking account!

An installment loan, such as might be provided by one of our members, is a completely different case. Not only do our members examine the borrower's ability repay, but the typical product, payable in equal monthly installments of principal and interest, provides a manageable installment schedule that serves as a predictable and clear roadmap for the borrower to repay the loan.

That is not to say that an installment loan will not be renewed. Sometimes, they are. However, an installment loan renewal is not comparable to the insidious “snowballing” effect of recurring and cumulative fees associated with payday loan rollovers. Renewing an installment loan is not a sign that the loan was not affordable in the first place, rather it is an indication that the installment plan has progressed successfully. It usually means that the principal has been substantially paid down and that the borrower now has newly earned credit and additional availability of cash. When an installment loan is renewed, the customer typically receives extra cash. There is no post-dated check hanging over the borrower’s head, as is the case with a payday loan. Thus, there is no pressure on the borrower to renew a properly underwritten installment loan unless the borrower wishes to access newly earned credit.
Furthermore, AFSA and many of its individual member companies, have made a huge investment in financial literacy programs, including: MoneySKILL, an interactive curriculum offered free of charge to schools and other interested organizations; the Jump$tart Coalition, the nation’s leading initiative promoting increased personal financial literacy for youth; and AWARE (Americans Well-informed on Automobile Retailing Economics), whose research conducted last year found that those in the military are more knowledgeable about the vehicle financing process than civilians.

The installment credit products offered by the member companies of AFSA are not the problem – they are the solution to an otherwise ill-served segment of military families who cannot otherwise obtain legitimate and affordable credit. As Consumers Union stated in July 2003, in its report entitled, *Payday lenders burden working families and the U.S. Armed Forces*: “Unlike many other states, Texas’ thriving signature loan industry provides [in the form of regulated installment loans] a clearly safer and more affordable alternative to high-risk, high-cost payday loans.”

V. **Solution to the Problems Posed by Payday Lending is for the Regulations to Address the Specific Product**

A. **Broad Application of the Payday Lending Law Would Unnecessarily Eliminate Access to Responsible Sources of Consumer Credit Needed by Servicemembers and their Dependents.**

AFSA believes that broad application of the Payday Lending Law provisions would have the unintended consequence of severely restricting access to fair and affordable credit for countless servicemembers and their families. Unless the enabling regulations clearly and narrowly target only payday lending, the severe penalties for violations, including the potential for imprisonment and the complete nullification of a borrower’s contractual obligations, together with the vague and internally inconsistent provisions of the legislation, will result in many, if not all, consumer credit grantors of choice ceasing to offer credit of any form to deserving servicemembers or their dependents. Therefore, AFSA respectfully recommends that the Department of Defense exercise its regulatory authority under this statute to define “Creditor” and “Consumer Credit,” under the newly enacted Payday Lending Law narrowly as follows:

“Consumer Credit” means a cash advance, having a term of less than 120 days, made to a covered member or a dependent of a covered member in exchange for—

1. the personal check or share draft of the covered member or a dependent of the covered member, in the amount of the advance plus a fee, where presentment or negotiation of such check or share draft, held by a third party institution, is deferred by agreement of the parties until a designated future date; or
2. the authorization by the covered member or a dependent of the covered member to debit the transaction account or share draft account, held by a third party institution, of the covered member or a dependent of the covered member, in the amount of the advance plus a fee, where such account will be debited on or after a designated future date; or
3. the surrender of possession of a title to a vehicle by the covered member or dependent of the covered member as security for the advance without the perfection of a security interest in the vehicle.

“Creditor” means a person or entity who offers Consumer Credit, as defined above, to a covered member or a dependent of the covered member.

B. Individual Issues

In addition to the foregoing, AFSA has the following particular additional concerns with potential Payday Lending Law rulemaking by the Department of Defense:

1. Section 987(i)(e): Rollovers, Renewals, Repayments, Refinances, Consolidations Extended to Same Borrower by Same Creditor with Proceeds of Other Credit Extended to Servicemembers or their Dependents

Assuming that the Department of Defense determines that the Payday Lending Law definition of “creditor” and “consumer credit” should be extended to non-payday lenders, including conventional commercial banks, credit unions and consumer finance organizations (as noted above, AFSA believes that no such application is merited), then a broad (rather than narrow) application of the “rollover” provision of Section 987(e) nevertheless will have the unintended negative effect of constraining the extension of responsible and legitimate credit to servicemembers and their dependents.

There are good and reasonable reasons for servicemembers and their dependents to rollover or extend loans, or seek additional credit from the same lender several times a year. Examples of good and reasonable reasons include: to take advantage of lower interest rates, to extend payment terms to allow for additional credit (such as in cases of: an additional child arriving, unanticipated financial expense or difficulties not covered by the Military Aid Societies), or to consolidate higher interest rate bills into a lower rate loan.

Additionally, the extension of the prohibition on “rollovers” to responsible consumer finance organizations serving the military community will not curtail servicemembers or their dependents from seeking credit, but merely drive those valued and respected customers away from their established relationships with responsible consumer finance organizations to less responsible (and perhaps abusive) lenders. AFSA believes this is just one of the unintended and adverse consequences that the Department of Defense wishes to avoid through the rulemaking process.
As a practical measure, AFSA suggests that the interests of servicemembers and their dependents could be protected, and the legitimate interests of consumer finance organizations accommodated, if the Department of Defense rulemaking allowed a consumer finance organization and servicemembers or their dependents to enter into a total of four rollovers, renewals, repayments, refinances and/or consolidations in each twelve month period.

2. Clarification of Retail Finance Provisions

The Payday Lending Law contains a limitation on terms of certain types of consumer credit extended to servicemembers and their dependents. The section places limits on the rates that can be charged to the defined group and provides limitations on several other terms and conditions of consumer credit extended to servicemembers.

a. Retail Financing Not Covered by the Payday Lending Law

We respectfully request that the Department of Defense include in the regulations it issues under the Payday Lending Law an express statement that the Payday Lending Law’s provisions do not apply to retail installment sale and lease contracts and retail charge agreements entered into between covered members of the military and their dependents and retail merchants. Many consumers finance or lease motor vehicles and other personal property through automobile dealerships and other retail merchants. In fact, retail financing is one of the most common forms of financing the purchase of automobiles and other goods and services. With dealership financing, the customer and the dealership enter into a retail installment sale contract (or lease or retail charge agreement), where the customer agrees to pay the amount financed plus an agreed-upon finance charge (or lease payments) over a period of time. The dealership may retain the contract, but usually sells it to an assignee (such as a conventional commercial bank, finance company or credit union), which services the account and collects the payments.

It seems clear the Congress did not intend the Payday Lending Law to apply to these forms of retail financing. The protections of the Payday Lending Law apply only to "consumer credit" as defined in the Payday Lending Law. In creating that definition, Congress made a conscious decision not to interfere with residential mortgages and the extension of credit for the purchase of automobiles and other personal property. The Payday Lending Law’s definition of "consumer credit" specifically excludes residential mortgages and "a loan procured in the course of purchasing a car or other personal property, when that loan is offered for the express purpose of financing the purchase and is secured by the car or personal property procured." Retail financing through a retail installment sale contract or retail charge agreement is offered for the express purpose of financing the purchase of the goods and is secured by the goods purchased. Thus, it seems clear that Congress did not intend the Payday Lending Law to apply to this form of purchase money financing. It also seems clear that Congress did not intend the Payday
Lending Law to apply to motor vehicle leases for motor vehicle or other personal property given that concepts such as an “annual percentage rate” and “interest rate” are widely understood as having no application to a vehicle lease.

However, we are concerned that some might mistakenly conclude that the Payday Lending Law applies to retail installment sale contracts and leases and retail charge agreements. Some might misinterpret the exclusion of “a loan procured in the course of purchasing a car or other personal property,” from the scope of the Payday Lending Law as not applying to retail financing because the retail installment sale contracts and retail charge agreements that underlie retail financing are not considered “loans” under many state statutes. Further, some might misinterpret the term “consumer credit” as applying to a lease of a motor vehicle or other personal property because many state statutes use the same term with a different definition that includes leases of motor vehicles or other personal property.

If a court or regulator were to actually misinterpret the Payday Lending Law as described above, it would seriously affect the ability of automotive dealers and other retailers to offer retail financing to covered servicemembers and their families. Fear of such misinterpretations by itself may lead to limitations on servicemembers and their families obtaining the favorable credit products typically used to finance automobiles. Clearly, the Department of Defense wants to avoid such unintended results.

An effective way to avoid these misinterpretations that is consistent with both the text and intent of the Payday Lending Law would be for the regulations to state expressly that the Payday Lending Law does not apply to a retail sale or lease through a retail merchant.

b. Security Interests in Vehicles Not Prohibited

We also respectfully request that the Department of Defense include in the regulations an express statement that the Payday Lending Law’s provisions do not prohibit a creditor from taking and perfecting a security interest in a vehicle in a manner permitted under state law.

The Payday Lending Law prohibits a creditor extending consumer credit to a covered servicemember or family member from using “the title of a vehicle as security for the obligation.” It seems clear that this provision was intended to stop title lenders from taking physical possession of the borrower’s vehicle title to use as leverage for repayment of the loan. Taking possession of the title does not give the title lender an enforceable interest in the borrower’s vehicle. It merely blocks the borrower from transferring ownership and in some cases registering or reregistering the vehicle. Thus, the title lender does not really intend the vehicle to serve as collateral. It is intended as leverage to prompt repayment.
However, we are concerned that some might misinterpret this provision as prohibiting a creditor from taking a security interest in the vehicle itself. This is because the process of taking and perfecting a security interest in a motor vehicle requires that the creditor apply to the state to have a lien noted on the vehicle’s title. In most states, this application results in the state sending the vehicle title with the creditor’s lien noted on it to the creditor and the creditor has the right to retain possession of the vehicle title until the lien is satisfied. Some might mistakenly conclude that these activities would qualify as using the title of a vehicle as security for the obligation.

If a court or regulator were to make this mistake, in combination with the mistaken application of the Payday Lending Law to dealership financing as discussed above, it would dramatically reduce the availability of vehicle financing to covered servicemembers and their families. It would also dramatically increase the cost to those who still qualified because few dealers, manufacturers, or finance companies would be willing to offer low rate financing of the sort frequently available now if the obligation could not be secured by the vehicle. Again, fear of such misinterpretations by itself may lead to this consequence.

3. **Conflicting Definition of Annual Percentage Rate**

The Truth in Lending Act, 15 USC 1601, et seq. and its implementing regulation, Regulation Z (“TILA”), have governed disclosures of consumer credit in the United States since 1968. The intent of TILA was to “... assure a meaningful disclosure of credit terms so that the consumer will be able to compare the various credit terms available to him...” (15 USC Section 1601). If the implementing regulations of the Payday Lending Law allow the definition of Annual Percentage Rate to include, “all fees and charges,” it will conflict with “Annual Percentage Rate” as it is calculated in Regulation Z, because Regulation Z excludes a number of charges from the finance charge. If creditors are required by regulation to include “all fees and charges” in the Annual Percentage Rate, and are required to disclose this new Annual Percentage Rate, the result will be conflicting disclosures of Annual Percentage Rate. This will be confusing to customers, and will require systems revisions for creditors to be able to provide two different Annual Percentage Rate disclosures, which will for most creditors not be able to be accomplished by October 1, 2007. AFSA respectfully submits that any regulation promulgated under the Payday Lending Law clarify that the Annual Percentage Rate under the law is calculated in an identical manner as the Annual Percentage Rate required by TILA and Regulation Z.

4. **Issues Affecting Credit Cards**

The Payday Lending Law includes several provisions which could have the significant unintended consequence of making credit cards unavailable to servicemembers and their dependents. AFSA echoes the many comments that have been submitted with respect to the impact of the Payday Lending Law on credit card programs. We take the opportunity
to highlight only a few of the key issues. While many of the issues we describe here raise problems in the context of other types of loans, they are particularly pronounced in connection with credit cards.

a. Oral Disclosures

The Payday Lending Law contains a requirement that all disclosures in connection with “consumer credit,” including those required under the TILA, be provided in writing and orally. Given the voluminous disclosures required under at account opening and on a periodic or other basis (e.g., the periodic statement), it is not clear how lenders could offer credit cards to servicemembers and their dependents if such disclosures must be provided orally. This raises obvious practical difficulties if “consumer credit” is defined beyond the definition provided above. (We believe this also illustrates the clear congressional intent to apply the Payday Lending Law only to payday lenders. Congress certainly could not have intended for monthly phone calls or personal visits to be made to each servicemember to make the required TILA disclosures for credit cards!)

b. Calculation and Disclosure of APR

As explained in section 3 above, the Payday Lending Law provides a definition of “Annual Percentage Rate” (“APR”) that is different from that provided in TILA. Creditors must disclose this new APR, and can not exceed a certain APR cap. If applicable to credit cards, the Payday Lending Law would have the effect of creditors disclosing two different APRs for the same account, creating confusion for servicemembers and their families. Additionally, because the definition is so broad in the Payday Lending Law, it would be difficult for credit card issuers to comply with the APR limit in some circumstances, even if the true periodic rate on the account is much lower. For example, by including a variety of fees, the Payday Lending Law’s definition of APR would artificially inflate the APR, potentially causing a lender to violate the cap in a given month even if the effective interest rate on the credit card balance was very low or even 0%. Mathematically, this is particularly likely if the card balance is low. These fees (e.g., late fees, a fee to expedite card replacement) cannot be known in advance by the lender, making it difficult for the lender to disclose the APR and to guard against inadvertent violation of the Payday Lending Law.

VI. Conclusion

AFSA and its members thank the Department of Defense for giving due consideration and weight to our thoughts and suggestions. Rulemaking that fairly and fully implements the intent of the Payday Lending Law would avoid unintended negative consequences to servicemembers and their dependents and ensure continued availability to them of the benefits of the legitimate and responsible credit products offered by consumer finance organizations – including AFSA members.
We look forward to cooperating and working with the Department in this endeavor.

And, we believe that the suggested narrow implementation of the Payday Lending Law will well serve the interests of all concerned.

Respectfully submitted,

Bill Himpler
Executive Vice President, Federal Affairs
American Financial Services Association