February 25, 2008

The Honorable Leslye A. Arsht
Deputy Undersecretary of Defense
Military Community and Family Policy
4000 Defense Pentagon
Washington, DC 20301-4000

Dear Secretary Arsht:

The American Financial Services Association ("AFSA") is grateful for the opportunity to contribute to the development of the report that the Department of Defense will submit to the Armed Services committees of the House and the Senate concerning the National Defense Authorization Act for Fiscal Year 2006 ("Warner Act"). As you will be aware, AFSA’s significant interest in the application of the Act is ensuring that access to beneficial forms of credit is preserved for members of the military and their families while, at the same time, ensuring that sensible consumer protections are maintained. In this letter we focus on what we understand are the Department’s principal concerns. We recognize that the Department may, after receiving input from other sources, have concerns that are not addressed here and we invite the Department to bring those concerns to us for further comment.

In its final rule on the Warner Act, the Department of Defense notes “the potential for unintended consequences that could adversely affect credit availability if it were to adopt a broadly applicable regulation.” The Department looked to identify the key problems and to use the authority given to it by the Warner Act to define “consumer credit” in a way that accomplishes the intent of the Act while preserving the availability of beneficial forms of credit to its members and their dependents.

The Department understands the importance of maintaining access to beneficial credit as a compelling need for its personnel. This recognition of the beneficial aspects of credit, especially for the less well-off, is articulated and emphasized by Nobel Prize winning economist Muhammad Yunus: “If economists would only recognize the powerful socio-economic implications of credit, they might recognize the need to promote credit as a human right.”

THE PROBLEM

This is by no means to say that there are no potentially dangerous products and that all credit is good. The Department rightly identified payday loans, title loans and RALs as especially problematic. The key here is to understand what it is about these products that makes them problematic. The way for the RAL problem to be resolved is a combination of better education and, especially, more efficient processing by the IRS. The shorter the time between filing and refund, the less people will want to use RALs.
The crux of the problem with payday loans and title loans is the combination of two factors: first, that such lenders do not typically test the ability to repay, relying instead on the leverage value of the post-dated check or car title to compel repayment; and second, that the loan is typically payable in full before the borrower’s circumstances have had much chance to change appreciably and without the opportunity for the debt to amortize in manageable amounts. All too often, therefore, the borrower, having no alternative but to renew the loan, becomes mired in a cycle of debt. It is this cycle of debt which the Department rightly recognized as the chief problem. “Cycle of debt represents a more significant concern to the Department than the high cost of credit.”

**INSTALLMENT LOANS**

We have been asked to revisit the issue of where installment loans fit into this discussion. Are they part of the problem? We believe that without question they are not.

Do traditional, legitimate installment loan companies test the ability to repay? Yes, they work out a budget with the borrower, assessing the borrower’s income and expenses and calculate the borrower’s monthly remaining disposable income. Installment lenders then make sure that the borrower can afford the loan by ensuring that the monthly installments to repay the loan are less than the borrower’s calculated remaining disposable income. Not all loans end up being paid on time, but this is despite the best efforts of the lender and usually results from either faulty information from or about the borrower, a borrower subsequently taking out other loans, or the borrower’s circumstances changing in some other way that are not foreseen by the lender or the borrower at the time of origination.

Is the loan payable in one sum after a short time? No, true installment loans (as opposed to some of those devised by payday lenders to get around the letter of certain statutes) are payable in equal monthly installments of principal and interest. The borrower’s principal amortizes, that is it reduces each month. Thus, the borrower has a simple “road-map out of debt” if he or she remains disciplined. In fact, then, far from being part of the problem, installment loans can be an excellent and valuable solution to military families and others for many valid reasons.

These beneficial features of installment loans were correctly recognized by the Department’s conclusion: “Isolating detrimental credit products without impeding the availability of favorable installment loans was of central concern in developing regulation. Consequently, installment loans that do not fit the definition of ‘consumer credit’ in Section 232.3(b)...are not covered by the regulation.”

The amortizing structure of installment loans would tend logically to make them less likely to envelop borrowers in a cycle of debt. AFSA would like to point out a rare but thorough academic study which demonstrates that this is what actually happens in real life. Such studies are very expensive to conduct in the United States but a group, Innovations for Poverty Action, led by Professors Dean Karlan of Yale and Jonathan
Zinman of Dartmouth did conduct such a study\(^1\) in South Africa with what critics would call a high cost, for-profit installment lender. Their conclusions were clear. It was determined that borrowers who were given access to installment credit were “six to twelve months later less likely to go hungry, and their chances of being in poverty fell by 19%. Not coincidentally they were more likely to have kept their jobs. People reported more control over their lives and a more positive outlook. The readier access to credit did not tempt the new customers into a debt trap. Far from tempting the poor into unpayable debt, they helped them keep their jobs, put food on the table and build up a credit history.”

**AFFORDABILITY, HIGH COST LOANS AND APRs**

The most effective and meaningful way to measure a loan’s affordability is through a budget and through the manageability of the loan’s repayment schedule. We recognize that some have argued that one should be able to identify and perhaps outlaw products if they are found to be “high interest.” The fallacy of the argument here is that people tend to use one confusing and inappropriate measure of cost to the exclusion of others. We refer, of course, to Annual Percentage Rate, whether Military or the Annual Percentage Rate as calculated according to the Federal Reserve Board’s APR. APRs were devised and remain useful for the purpose of comparing loans of like maturity and amount, where perhaps one loan has higher fees and the other higher interest. APRs are quite misleading however, when comparing loans of different amounts and maturities.

The larger and longer the loan, the less the impact of the lender’s fixed costs on the APR as there are more and higher payments over which the fixed costs are spread. In other words APRs are chiefly a function of term and loan size and an inherently poor indicator of underlying cost or of the lender’s profit on a relatively short-term, small dollar loan.

As the World Bank’s Consultative Group to Assist the Poorest pointed out in its first Donor Brief on Microfinance, “it costs much more to make a thousand $200 loans than to make one $200,000 loan. To be sustainable, Microfinance Institutions must charge high interest rates. Clients willingly pay these rates because they value the service so highly. When governments enforce interest rate caps, MFIs can’t charge enough to be sustainable.” Thus they recommend only investing in MFIs where “the government’s interest rate policy is conducive to sustainable microfinance.”\(^2\)

Imposing an arbitrary limit for all credit products on APRs means that people who need small loans would have to borrow more money for longer terms than they actually need, and as a result, pay higher charges in real terms, or be denied credit altogether.

What other means are there for assessing whether a loan may be truly “high cost?” The obvious one, and that used by small loan borrowers in practice, is the actual dollar cost

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2 Microfinance Donor Projects: 12 Questions about Sound Practice, Consultative Group to Assist the Poor, April 2002.
(or Finance Charge, which is also required by Regulation Z to be disclosed alongside the APR). It does not benefit a borrower to pay more dollars just to get a lower APR. A second measure which can be valuable is the total charges as a percentage of principal. Both these figures, the charges and the amount financed, are also on the installment loan contract. Again, the longer a loan, the lower its APR but the higher the charges as a percent of principal. In fact we have prepared and attached a chart demonstrating that APRs are often a contra-indicator of the true cost of a loan by either of these measures. A 30 year $500,000 mortgage with a low APR is considerably more “high cost” by either of these more meaningful measures than a $500 installment loan with a high APR. Consequently, the exclusive use of APRs to indicate the cost of a credit product must arise either from a lack of understanding by some consumer advocates of the actual costs of making and servicing loans or from a genuine ideological conviction that only large, long loans are in the public interest and that the less wealthy should be denied access to credit altogether.

There has been much talk recently from politicians and even regulators about the need to CREATE a kind of low dollar, low APR loan product and to compel banks to provide these, but this talk merely demonstrates that such loans do not exist in any meaningful amount today and that banks could only be forced to make them at a loss, or perhaps with some as yet unavailable government subsidy. As such we suggest that they should not form part of the Department’s calculations at this time.

**LOOPHOLES AND EVASION**

We are pleased to hear that the approach taken by the Department seems to be working, and that the Department is not concerned about the limited instances of “morphing” by payday and title loan companies that have occurred so far. We also understand that this situation could change, especially if more states pass restrictive legislation which would force such companies to morph in order to do any business in those states. AFSA would like to make it clear that, if such morphing begins to take place on a wider scale, we would welcome the chance to discuss other ways in which such subterfuges could be distinguished from legitimate installment products and we cautiously welcome the idea of an anti-evasion provision for this purpose.

**EDUCATION**

We do not believe that the APR of a credit product is by itself indicative of whether a loan is “legitimate” or not. They are not a valid indicator of cost or profit. This is because, as we have already shown, APRs in small loans are chiefly a function of loan size and maturity. Some loans may still be marketed which carry problematic features and military families, like all other consumers, should know how to recognize and avoid these. It is a very sad and unnecessary fact that there are a number of consumers who leave high school with very poor financial literacy skills. The AFSA Education Foundation (AFSAEF) has developed and made available free of charge MoneySKILL®-- an online personal finance course aimed at the thousands of young adults who graduate each year without a basic understanding of money management fundamentals. Teacher
training workshops, which are offered nationwide, have proven to be the most effective way to familiarize teachers with MoneySKILL. AFSAEF has also offered the materials to the Department and suggested they be used to educate Service members and their families. At the very least all adults should know how to prepare a budget and should understand the importance of savings.

**ANCILLARY PRODUCTS**

Credit insurance and other debt cancellation products are readily available to Service Members as well as the general public. These products are a frequent target of consumer advocates -- we believe unfairly so. They are convenient, inexpensive, provide value to consumers and are extensively regulated by the states. Additionally, the Federal government has built additional consumer protections through the Truth in Lending statutes and Regulation Z of the Federal Reserve Board. As a result of the regulatory requirements, creditors must provide written disclosures to consumers of the cost and ensure that the purchase of the product is voluntary.

Research shows that borrowers, especially those likely to be entering into traditional, true installment loans, who purchase credit insurance, are motivated to do so because of the sense of security provided by credit insurance. Credit life insurance, is a low cost form of term life insurance that pays the borrowers remaining loan balance if the borrower dies. Unlike other forms of life insurance, credit life insurance is not individually underwritten. Therefore, credit life insurance is available to all borrowers regardless of how dangerous their occupations and without regard for their health. Moreover, the death benefits paid under a credit insurance policy are paid in addition to the Service Member’s primary SGLI proceeds that pass to the service member’s surviving spouse, parents or estate. This product insures that a surviving spouse will not loose the collateral pledged in the loan, which in many situations may be the family automobile. For families with limited disposable income, and facing the costs and disruptions that attend an untimely death, the margin of security provided by credit life insurance can be substantial.

In addition to credit life insurance, a service personnel non-military spouse may also choose to purchase credit disability or credit involuntary unemployment insurance coverage. These products pay the monthly loan payments during the period of disability or involuntary unemployment. As with credit life insurance, these voluntary products offer individuals and their families facing financial uncertainty and distress, much needed relief in the event of a personal disaster. Again, for families without appreciable “emergency” funds, the benefits afforded by such coverages can be substantial.

As studies have indicated, consumers who have purchased the products overwhelmingly viewed the insurance as a value added to their loan transaction. For example, in 2001, over 90% of consumers that had purchased credit insurance on installment credit held a

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favorable opinion of the insurance. Furthermore, 94.2% of borrowers that purchased such credit insurance indicated that they would purchase it again.

The Department’s request for comments uses the following phrase in reference to credit insurance, “...regular inclusion of high cost ancillary credit insurance products.” We take the phrase “regular inclusion” to be a reference to a common, although proven false, allegation that credit insurance is “packed” into the installment loan without the borrower’s knowledge. We also take the phrase “high cost” to refer to another consumer group allegation regarding credit insurance; that it is overpriced. We would like to address each of these two misconceptions.

Packing

“Coercive pressure to purchase credit insurance has generally been defined as the explicit or implicit suggestion to the borrower that loan approval was conditional on the purchase of insurance when, in fact, it was not.” Certain groups have falsely accused the credit insurance industry of engaging in deceptive sales practices to increase their sales figures. This allegation has been consistently and repeatedly disproved by numerous studies performed over the last 25 years by independent academic and governmental institutions.

A. Federal Reserve Board Studies

The Board of Governors of the Federal Reserve (the Fed) has sponsored three credit insurance studies. The Fed concluded after its first study that “the relatively low proportion of loan customers, especially those of retailers or commercial banks, who perceive pressures, either explicitly or implicitly, to make the joint purchase (of the loan and the credit insurance) is not consistent with the hypothesis that involuntary tying is widespread. This conclusion is given further support by the very high rate of approval of the service and by the high proportion of customers who do not regard the service as expensive. Rather, the high frequency of purchase of credit insurance together with consumer attitudes are more consistent with the hypothesis that the joint purchases are voluntary.”

The Fed further concluded that “creditors in general do not subject borrowers to undue pressure to purchase a product (credit insurance) that they do not want.” The Fed also concluded that “consumers who purchase credit insurance believe it is a valuable product and would be inclined to purchase insurance in the future.”

4 Durkin, supra note 1, at 211.
5 Id.
6 John M. Barron, Ph.D. & Michael E. Staten, Ph.D., Credit Insurance: Rhetoric and Reality, Monograph No. 30, p. 2-5, Purdue University Credit Research Center, 1994.
7 Robert A. Eisenbeis and Paul R. Schweitzer, Tie-Ins Between the Granting of Credit and Sales of Insurance by Bank Holding Companies and Other Lenders, Staff Study 101, p. 49, Board of Governors of the Federal Reserve System, February 1979.
9 Id. at 7.
The most recent Fed credit insurance study (performed in 2001) concluded that “insurance packing, that is, including insurance in the loan without notifying the consumer, . . seems unlikely in most cases.”\textsuperscript{10} Supporting the position that credit insurance packing is a myth, are the credit insurance penetration rates on installment credit. The penetration rate of credit insurance sales in connection with installment credit in 2001 was only 22.7\%.\textsuperscript{11} Such figures do not support the allegation that installment loans contain the “regular inclusion” of credit insurance.

B. The Purdue Study

Another independent study was performed in 1993, by Purdue University’s Credit Research Center.\textsuperscript{12} Included among the issues the study sought to probe were whether consumers are aware of their credit insurance purchase; and, the prevalence of coercive sales tactics in the marketing of credit insurance.

In 1994, Purdue University issued a report (Purdue report) stating that “purchase patterns for credit insurance are readily explainable without reliance on seller coercion as a factor.”\textsuperscript{13} The study found that “the majority of credit insurance consumers have not felt pressured to purchase the insurance and were generally satisfied with their credit insurance.”\textsuperscript{14}

The Purdue report expanded upon four previous national studies of credit insurance, conducted between 1970 and 1985. Prior results have consistently contradicted consumer activist criticisms - “all of the [four earlier] studies reached the same general conclusion that consumers viewed the benefits of credit insurance favorably, relative to its cost. Furthermore, none of the studies detected convincing evidence that creditors coerced borrowers into purchasing credit insurance on a widespread basis.”\textsuperscript{15}

\begin{itemize}
  \item \textsuperscript{10} Durkin, \textit{supra}, at 211.
  \item \textsuperscript{11} Durkin, \textit{supra}, at 210.
  \item \textsuperscript{12} The Credit Research Center, established in 1974, is a publicly supported, nonpartisan research and educational organization. The Center operates as a nonprofit unit of the Krannert Graduate School of Management at Purdue University.
  \item \textsuperscript{13} John M. Barron, Ph.D. & Michael E. Staten, Ph.D., Credit Insurance: Rhetoric and Reality, Monograph No. 30, p. 1-2, Purdue University Credit Research Center, 1994.
  \item \textsuperscript{14} Id. At 1-1.
  \item \textsuperscript{15} Charles L. Hubbard, Consumer Credit Life and Disability Insurance, Ohio University, 1973; Robert A. Eisenbeis and Paul R. Schweitzer, Tie-Ins Between the Granting of Credit and Sales of Insurance by Bank Holding Companies and Other Lenders, Staff Study 101, Board of Governors of the Federal Reserve System, February 1979; Anthony W. Cymnak and Glenn B. Canner, Consumer Experiences with Credit Insurance: Some New Evidence, Economic Review, Federal Reserve Bank of San Francisco, Summer 1986; and Joel Huber, Consumer Perception of Credit Insurance on Retail Purchases, Monograph No. 13, Purdue University Credit Research Center, 1978. \textit{Reprinted in} John M. Barron, Ph.D. & Michael E. Staten, Ph.D., Credit Insurance: Rhetoric and Reality, Monograph No. 30, p. 2-1, Purdue University Credit Research Center, 1994.
\end{itemize}
The Purdue University study concluded that “the evidence regarding consumer awareness of both levels of coverage (life and life plus) is quite inconsistent with an assertion that consumers are largely unaware of their credit insurance purchases.”

It seems logical that both packing and coercive pressure applied to a reluctant borrower would, on average, be reflected by customer dissatisfaction with the credit insurance purchase. In recent studies that asked people who actually purchased or said they purchased credit insurance, the resounding majority of respondents said they would purchase credit insurance again. If people had unknowingly purchased credit insurance or had been coerced into purchasing it, then it does not make sense that they would overwhelmingly state that they would buy it again. Exhibit 1 shows the results of the studies.

**EXHIBIT 1**

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<td>(Percent of Respondents who Actually Purchased or Said They Purchased)</td>
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**CREDIT CARD ISSUES**

In addition to our concerns about installment loans, we would also like to take this opportunity to briefly address issues relating to credit cards. The question posed is whether credit cards with “high fees” and “minimal available credit” negatively affect Service members to the degree that the Department should regulate them. We here emphasize existing protections related to misleading advertising and state simply that we do not believe the Department should attempt to regulate credit card products. It is logical that consumers on the lowest end of the creditworthiness spectrum will pay more for credit, or have less credit made available to them, as they pose significantly greater risk to a creditor. We do not believe that products with higher fees than others, or lower credit lines, are necessarily bad for Service members, particularly if the alternative is the loss of credit access. Furthermore, if the Service member believes his or her card is “overpriced” compared to others for which he or she may qualify, the highly competitive nature of the credit card industry, and the sheer number of available credit cards provides plenty of opportunity for the Service member to obtain a more desirable card.

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16 John M. Barron, Ph.D. & Michael E. Staten, Ph.D., Credit Insurance: Rhetoric and Reality, Monograph No. 30, p. 5-4, Purdue University Credit Research Center, 1994.
17 Id., at p. 2-6 and 6-7 and Durkin, *supra*, at 212.
This is not to say that credit cards—including those with low credit lines or comparatively higher fees—should not have consumer protections. Critical to this is promoting greater consumer understanding of the costs associated with credit card products and we welcome the fact that the Federal Reserve Board is in the process of substantially improving the federally required credit card disclosures explaining these costs to consumers.

Furthermore, the federal banking agencies have the authority to take enforcement against credit card issuers that market their cards in an unfair or deceptive manner. The Office of the Comptroller of the Currency (“OCC”), for example, has recently taken action against a national bank in connection with a credit card product that had little usable credit line at the time the card was issued. The bank allegedly advertised the card in a manner that suggested consumers would be able to use it in a manner incompatible with the initial credit line. The OCC has also issued generally applicable guidance to national banks regarding advertisements of credit cards where the initial available credit line is likely to be so limited that the advertised possible uses are substantially illusory. These protections are important ones, and effectively remove the need for the Department to consider additional regulation of its own.

CONCLUSIONS

AFSA appreciates the opportunity to restate its case for the exclusion of legitimate installment loans from the definition of consumer credit used by the Department in its regulations and to, again, outline its position for Service personnel. Traditional installment lending provides access to affordable credit by working with borrowers to determine that they have the ability to repay the loan. Additionally, installment loans utilize amortization as a means of protecting borrowers from an endless cycle of debt.

We understand that the Department has identified isolated instances where payday and title lenders are attempting to evade coverage under the regulations. Should the Department feel the need to address these instances through a formal regulatory process, AFSA stands ready to assist in that effort, to ensure appropriate protections and access to legitimate beneficial installment loans for Service members’ and their dependents. Please address any questions or requests for additional information to the undersigned at (202) 296-5544.

Sincerely,

[Signature]

Chris Stinebert
President & CEO
American Financial Services Association
APR as ‘contra-indicator’ of cost

Certain indicators of affordability or the ability to repay are much more important than APRs when it comes to small loans. They include:

- Total Dollar Cost
- Total charges as a percentage of principal
- Manageability of repayment schedule, for example, equal monthly installments of principal and interest with no balloon payment
- A budget showing that such monthly payments are less than the borrower’s monthly free income

Thus, imposing an arbitrary limit on APRs will mean that people who need small loans will be forced to borrow more money for longer terms than they need, and to pay higher real charges or be denied access to credit altogether. Borrowers are forced to look elsewhere for credit – to loan sharks and other illegal options. This must be guarded against very carefully here in the USA.