Military Lending Act Compliance Continues to Plague Auto Finance Industry

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Military Lending Act Coverage

Since the Department of Defense released its amended interpretive rule in December 2017, the Military Lending Act ("MLA") has been a source of much confusion and consternation for the auto finance industry. Before that time, most of the industry operated under the understanding that the MLA's exclusion from coverage for consumer credit transactions "expressly intended to finance the purchase of a motor vehicle when the credit is secured by the vehicle being purchased" extended to all auto financing transactions.

The DOD dramatically changed that interpretation when it published its interpretive rule with the "clarifying" FAQ #2, stating that financing "credit-related costs" disqualifies the transaction from the exclusion. Though the DOD failed to define the term "credit-related costs," it did provide several examples of what types of products or services, if financed, would disqualify a transaction from the MLA's purchase-money exclusion-namely, GAP and credit insurance. In other words, if a purchase-money transaction also finances "credit-related costs," then the transaction is covered under the MLA. The MLA requires creditors to identify covered borrowers, provide required verbal and written disclosures, calculate the Military Annual Percentage Rate of the transaction, and comply with other MLA consumer protections, one of which is discussed in more detail below.

Conversely, FAQ #2 stated that if the transaction finances "costs related to the object securing the credit," then it still qualifies for the MLA's exclusion. Again, the FAQ didn't define the term, but provided examples-leather seats, extended warranties, and negative equity.

Vehicle Title Prohibition

One of the "other" protections the MLA provides covered borrowers is prohibiting the credit transaction from being secured by a motor vehicle title. This destroys the practicality and economics of financing the purchase of a vehicle with a credit-related product. No finance source in its right mind will make an unsecured loan, or purchase a retail installment sale contract, without obtaining a security interest in the vehicle as collateral. This effectively takes away from covered borrowers the opportunity to purchase GAP.

Could the covered borrower purchase the GAP for cash? Well, for most GAP products, no, because GAP waiver products are agreements creditors enter into waiving their right to collect deficiencies in the event the vehicle is a total loss. In other words, the legal structure of this product is that it's a part of the

financing document. There are third-party GAP insurance products, but they are not as prevalent, and covered borrowers usually don't have the spare cash to buy these products after making their down payments.

Note that there is a carve-out to the vehicle title prohibition, but it only applies to banks, savings associations, and credit unions. And, that carve out isn't broad enough to help most auto finance deals, even if a bank, savings association, or credit union ultimately takes assignment of the retail installment sale contract.

Best Practice Approaches to Compliance

Dealers are thrust into a Catch-22 situation. Most sell GAP waiver and historically have offered it to all customers. However, they are now effectively prohibited from offering it to covered borrowers because the GAP waiver cannot be financed *(since no finance source will make a loan or buy a retail installment sale contract that is not secured by the vehicle being purchased)*. What's a dealer to do? The choices are limited, and unpalatable. The outcome is even worse for a covered borrower-he or she cannot purchase a legitimate product that would protect him or her from liability in the event the vehicle is subject to a total loss.

So, what are the options for dealers and finance sources? The most conservative approach, which many have chosen, is to completely stop selling and financing GAP and other types of credit insurance products. That means no consumer is given an option to purchase a GAP waiver. Why a complete stop to the sale of GAP waiver? Because many states have laws prohibiting creditors from discriminating against servicemembers. In these states, dealers may be challenged as discriminating if they do not offer servicemembers the same products they offer non-servicemembers. Why take such a conservative approach? Easy answer-the penalties under the MLA for not complying. They are draconian. Nonconforming transactions are *void from inception*, and the MLA provides both criminal and civil penalties, along with a private right of action. Moreover, offering products and services only to certain consumers, but not to covered borrowers could result in allegations of a UDAAP violation.

The other option is to offer and sell GAP waiver and credit products only to non-covered borrowers. Some creditors have chosen this path. This requires the creditor to check the covered borrower status of every applicant. If a covered borrower is involved, GAP and other credit-related products are not offered or financed. This approach may work for creditors in a state with no servicemember anti-discrimination laws and/or where creditors have undergone a careful analysis and concluded that no programs are available to covered borrowers. If creditors take this approach, they should document their analysis and have a formal policy in place consistent with such analysis. Note that this path is not without risk! It does not mitigate all state discrimination or UDAAP claims that may arise from offering certain products only to non-covered borrowers.

Creditors who take the second approach should take advantage of the MLA's safe harbor for determining covered borrower status. To obtain the safe harbor, creditors must verify the consumer's covered borrower status, either through the MLA database or by using a consumer report obtained from a nationwide consumer reporting agency; and they must keep a record of their findings.

What Happens Next?

After significant efforts of industry trade groups to educate the DOD regarding the negative ramifications of FAQ #2, many anticipated that the DOD would withdraw this portion of its interpretive

rule. While the DOD seemed poised to do so, the political winds shifted, and efforts stalled. Trade groups continue to press on, explaining to the DOD and Congress the benefits of GAP waiver and citing the frequency with which covered borrowers purchase it. Meanwhile, the Bureau of Consumer Financial Protection's director, Mick Mulvaney, announced in August that the Bureau will no longer conduct routine supervisory examinations of creditors for violations of the MLA, indicating that the Bureau lacks authority to do so. Democratic senators promptly responded to the announcement, urging the Bureau to continue its oversight. The DOD, military groups, and consumer advocates also opposed this supervisory rollback. Though further developments are likely forthcoming, it remains unclear what the final outcome will be, or when it will arrive. Accordingly, those in the auto finance industry are left with the challenge of deciding how to comply with the MLA.

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