

Houston, We Have a Problem

November 1, 2016 | [Michael A. Benoit](#)

Remember Apollo 13? During the ship's confusing orbital crisis, its control center in Houston scrambled for solutions. It appears the vehicle finance industry may have its own crisis looming. In a [previous article](#), I wrote about the confusion the Consumer Financial Protection Bureau's proposed rule to regulate small dollar loans, if finalized, might create for the vehicle finance industry. Not to be outdone, it seems the Department of Defense has - probably unintentionally - decided to join the orbit of confusion with new guidance interpreting its recent revisions to the rule implementing the Military Lending Act.

At its core, the MLA requires creditors to determine whether borrowers are "covered borrowers" (generally a servicemember and his/her spouse and dependents) and calculate and disclose a "Military Annual Percentage Rate" that cannot exceed 36 percent. The main difference between a garden-variety APR and an MAPR is that the latter includes charges for items such as credit insurance, debt cancellation, and other "credit-related ancillary products." So, the MAPR calculation would include the cost of a GAP product, credit insurance, etc. MLA violations carry both civil and criminal penalties that apply to dealers and assignees alike.

Using the latitude and discretion Congress provided it, the DoD chose to exclude from the rule's coverage purchase-money vehicle finance transactions and purchase-money personal property finance transactions, to the extent they were secured by the vehicle or personal property being purchased. This exclusion was important because dealers have no way to calculate an MAPR accurately, and, to my knowledge, none of the DMS providers has undertaken to create a means to do so.

While the revised rule continues the exclusion for these kinds of credit, the DoD made some seemingly subtle changes to the rule's language that were, presumably, intended to clarify the extent of the exclusion. The new language provides that "consumer credit" does not include "[a]ny credit transaction that is expressly intended to finance the purchase of [a motor vehicle] [personal property] when the credit is secured by the [vehicle] [property] being purchased." [emphasis added]

The phrase "expressly intended" is a new addition to the rule. It caused a fair amount of chatter when the revisions were finalized, as it was not entirely clear what the phrase was intended to accomplish. However, the industry generally concluded that this new language was more about style than substance. After all, the vast majority of purchase-money vehicle finance transactions are originated by dealers, and they rarely, if ever, engage in financing transactions that are *not* secured by a vehicle being purchased - certainly not if they want banks and finance companies to buy the financing contracts - so virtually every vehicle finance transaction is by nature "expressly intended" to finance the purchase of a motor vehicle.

Any comfort industry had with its interpretation was called into question when the DoD published its guidance on August 26, 2016, that included the question:

Does credit that a creditor extends for the purpose of purchasing personal property, which secures the credit, fall within the exception to "consumer credit" ... where the creditor simultaneously extends credit in an amount greater than the purchase price?

The DoD responded:

No. ["Consumer credit" is defined] as credit extended to a covered borrower primarily for personal, family, or household purposes that is subject to a finance charge or payable by written agreement in more than four installments. [The rule] provides a list of exceptions ... including an exception for any credit transaction that is expressly intended to finance the purchase of personal property when the credit is secured by the property being purchased. A hybrid purchase money and cash advance loan is not expressly intended to finance the purchase of personal property, because the loan provides additional financing that is unrelated to the purchase. To qualify for the purchase money exception from the definition of consumer credit, a loan must finance only the acquisition of personal property. Any credit transaction that provides purchase money secured financing of personal property along with additional "cash-out" financing is not eligible for the exception ... and must comply with the provisions set forth in the MLA regulation.

While the guidance is directed at the exclusion for purchase-money personal property transactions (as opposed to purchase-money vehicle transactions), one need only substitute "vehicle" for "personal property," and you have the rule's verbatim exclusion for purchase-money vehicle finance transactions. Logic requires that we assume this personal property guidance would apply to vehicle finance as well.

Most troubling is the statement that "to qualify for the purchase money exception from the definition of consumer credit, a loan must finance only the acquisition of personal property." Virtually no vehicle finance transaction is limited to financing the vehicle. It also finances taxes, title and registration fees, other government-mandated fees (e.g., the smog fee in California), dealer-generated administrative fees, etc. Does this mean dealers have to determine whether every customer is a "covered borrower" subject to MLA protection? I certainly hope not because I'm not confident that any dealer is equipped to make that determination or to calculate and disclose an MAPR.

Assuming we can get comfortable that government fees, taxes, and the like won't effectively blow up the exclusion, would the fact that a dealer financed a service contract in a given transaction do just that? Vehicle finance has evolved to a point where very little down payment is required to get someone in a car, and finance sources routinely offer advances to dealers in excess of 100 percent LTV to give dealers the flexibility to sell valuable ancillary products like service contracts and credit insurance. Is the rule intended to constrict a dealer's ability to sell these products? Or would they be eligible for treatment as "personal property" subject to their own exclusion?

And let's not forget negative equity, a fairly common component of vehicle finance today. Would that be the "hybrid" transaction to which the guidance refers? Will dealers find themselves denying credit to servicemembers and their families because they don't have the lump sum of cash necessary to pay off their existing auto credit? I doubt that's what anyone intended.

I'm not sure of the answers to these questions, but I can't resist the opportunity to parse the government's language to my ends. I periodically rant about the difference between a credit sale (i.e.,

the way most vehicle finance occurs) and a loan (i.e., cold hard cash). "Loan" is not a defined term in either the MLA or the rule and carries no contextual meaning. Both define "consumer credit," and the rule does so in a manner broad enough to include both credit sales and loans. Yet, "loan" is the word the DoD chooses to use in its guidance instead of the defined term "consumer credit."

Could it be that the guidance does not apply to ordinary vehicle finance but only to "loans" in the true sense of the word? I can make that argument with a perfectly straight face, but I am not confident the DoD and the other agencies with enforcement authority (e.g., the banking agencies, FTC, CFPB, etc.) would agree. Sadly, the choosing and using of words with true and established definitions continues to deteriorate in the governmental arena. This undermines me and my peers when we try to support our positions. As a result, prudence requires us lawyer-types to refrain from offering much comfort to our clients.

Treating credit sales that finance taxes, fees, ancillary products, and/or negative equity as outside the purchase-money exclusion essentially eviscerates that exclusion, and I certainly hope that is not what the DoD intends. If it is, it shouldn't be.

The vehicle finance industry needs a quick fix from Congress or the DoD. Unfortunately, relief is unlikely to be forthcoming. Congress is mired in budget bills as well as all the nonsense that goes on in an election year. And the leanly staffed office at the DoD tasked with managing the rule is concurrently responsible for a myriad of other unrelated areas of military administration.

"Houston, we have a problem!"

When Apollo 13 made that call, Houston worked around the clock to find a solution to a dangerously time-sensitive problem and avoid a national tragedy. As we all know, the effort was a success and an example of government working the way it should.

Is industry's "Houston" listening? I guess we'll see, as we continue our perilous orbit.

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