

**Report of the Military Financial Protection Task Force
Required By Executive Order S-16-06**

EXECUTIVE SUMMARY:

On August 23, 2006, the Governor issued Executive Order S-16-06 to establish the position of the Governor's Advisor for Military Affairs, and to create a State Military Financial Protection Task Force. The Director of the Governor's Office of Planning and Research and the Commissioner of the Department of Corporations act as co-chairs of the Task Force. By February 1, 2007, the Governor directed the Task Force to review existing law to determine whether additional legislation is needed to protect military families in the short term from unlawful financial investment schemes and practices. In addition, by that same date the Governor directed the Task Force to report its findings and recommendations publicly. On September 14, 2006, the Task Force met in a plenary session to discuss the scope of the problems. Subsequently, the co-chairs met with various members of the military, industry groups, and other Task Force members, or their designees, to address potential solutions and recommendations. This report represents the recommendation of the Task Force. In short, the Task Force recommends support of Assembly Bill 7, a bill pending in the California Legislature, which is designed to allow the State to enforce provisions of a federal military financial protection law.

IDENTIFICATION OF PROBLEM:

The Department of Corporations licenses and regulates deferred deposit originators making deferred deposit transactions, or "payday loans," under the California Deferred Deposit Transaction Law. The Department of Corporations also licenses and regulates consumer finance lenders under the California Finance Lenders Law. Both laws are designed to protect borrowers of small consumer loans. These loans, however, carry relatively high interest rates.

In a typical payday loan transaction, a borrower writes a check for \$300 dollars made payable to a payday lender. In return, the payday lender agrees to postpone the deposit of the check for up to 31 days and provides \$255 in cash to the borrower. Thus, the payday lender charges a fee of \$45 to defer the deposit of a \$300 check – 15% of the face amount of the check. In 2005, the average number of days for these transactions in California was 17 rather than the maximum 31, which has the effect of increasing the amount of an annualized percentage rate. Frequently, these products have an annual percentage rate exceeding 400%.

In an August 9, 2006 report to Congress entitled *Report on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents*, the Department of Defense indicates that military members can become trapped in wage-stripping debt through multiple payday loans and loan terms that require them to either pay off the entire amount on payday, or to continue paying fees to roll over the loan amount from month to month. This cycle of continuous debt is common among borrowers. The Navy-Marine Corps Relief Society states that 91% of payday loans are made to people who take out five or more loans per year.

The Department of Defense report also identified other predatory financial schemes aimed at the military. For example, the report described the Department of Corporations's action in May 2006 to prevent one unlicensed finance lender, Pioneer Military Lending, from charging nonresident military members more charges in California than the amounts allowed for resident military members.

Incurring high amounts of debt affects military personnel even more than civilians. The military considers debt ratios of its service members as one factor in assessing troop readiness for deployment. Excessive debt prevents deployment of service personnel, which increase the frequency or length of deployment for those service members who are able to deploy. Service members with excessive debt may also have their security clearances revoked. According to the Navy, the number of security clearances that have been revoked due to debts has increased dramatically, from 124 in 2000 to 1,999 in 2005.

Since the military demands responsible and accountable use of credit products, lenders are able to out-market the military by offering fast, "no questions asked" high-cost credit. They take advantage of known financial vulnerabilities of military personnel, which include:

- Personal financial wealth – or the cosmetic of wealth – is very important to young men and women today.
- Service members avoid counseling or talking about financial problems or mistakes they make.
- The demands of military life – especially in time of war – can cloud sound financial judgment by service members.
- They are reliably paid by the government, twice a month.
- They are legally accountable under the Uniform Code of Military Justice to meet their debt requirements.
- Their unique security clearance requirements subject them to financial background checks, making preservation of their credit history critical.
- They are concentrated in particular geographic areas. In its testimony before the Assembly Banking and Finance Committee in 2005, the Department of Corporations indicated that the zip code for Oceanside, home to Camp Pendleton, has more payday lenders than any other zip code in California. Moreover, the number of payday lenders in close proximity to military bases is increasing.
- They are receptive to affinity marketing.

Most of these consumer credit products are not appropriate for active duty military. Military personnel deploy for extended periods, or may leave on training missions for several weeks. Short-term credit products are difficult to manage in such conditions, often being left for dependents or family to manage.

Also, the military offers protections to any service member or dependent that is in financial trouble. Payday loans or other "emergency" credit products are not needed by military personnel, as The Department of Defense makes counseling available for active duty service members and their dependents, and also assistance through military-specific financial relief organizations when in financial extremis.

Currently, California state law does *not* provide consumer loan protections that are tailored specifically to members of the military. Recent federal law (as described below) provides various consumer protections for military members and will likely have a preemptive effect over state consumer laws. The federal law, however, does not direct any particular federal or state agency to enforce its provisions.

PROPOSED SOLUTION:

Recommend supporting Assembly Bill 7, by Assemblyman Ted Lieu, a bill that would:

- Amend lending laws administered by The Department of Corporations to require consumer finance lenders and payday lenders to comply with new federal consumer protections added by HR 5122 (National Defense Authorization Act). Effective October 1, 2007, this new federal law places a 36% interest rate cap on consumer credit made to military members and their dependents, prohibits the taking of checks for security on a loan (thereby banning payday loans to military members and their dependents), and adds other limitations and restrictions. This amendment to state law would enable The Department of Corporations to enforce the federal protections to better protect military members and their families.
- Amend existing lending laws to confirm that a lender's failure to make a payday loan or other consumer loan to a military member does not violate specified anti-discrimination laws that are designed to protect military members from discrimination in the marketing and selling of financial products. This amendment to state law would enable licensed lenders to comply with the federal law (which prohibits or restricts certain loans to military members) without inadvertently violating the anti-discrimination provisions of the Military and Veterans Code. This provision is identical to one that was agreed upon by interested parties in last year's AB 1965 (Lieu, 2006) and has been specifically requested by representatives of the payday industry.

PROGRAM BACKGROUND/LEGISLATIVE HISTORY:

Examples of legislative and program proposals to help members of the military understand and avoid financial problems associated with fraudulent practices and unsuitable loan products:

Department of Defense

The military is proactively seeking ways to improve the financial health of active duty personnel outside of legislation. In July 2005, The Department of Defense implemented the Troops Against Predatory Scams program (TAP\$). TAP\$ is designed to educate troops on abusive financial practices, and to address problems generated by the use of unsuitable investment and loan products. TAP\$ hosts educational events and publishes and distributes educational materials to members of the military. The TAP\$ program is discussed in the Governor's publication, "Restoring The Golden State."

The military is also:

- Developing a “Culture of Financial Health” in all ranks of service to differentiate between personnel in financial difficulty (a common quality of life issue) and those who are financially irresponsible (a disciplinary issue and rare).
- Developing a better relationship with banks and credit unions, especially those already positioned on military installations, to provide competitive products that compete with higher cost, unsuitable, options.
- Reviewing internal procedures on pay, benefits and taxes to reduce unnecessary financial stress on military personnel.
- Establishing a network of Command Financial Specialists that can provide confidential counsel, advice and referral to personnel in financial difficulty.
- Addressing issues that establish unnecessary fear in service members from seeking help from their command resources.
- Making available financial relief to service members and their families, through various military support organizations.

California Legislature

This past year, the Legislature considered AB 1965 (Lieu). This bill would have added consumer protections for military personnel who are called to active duty. For instance, the bill would have allowed military members to defer payments on loans, and to execute repayment plans. In addition, the bill would have prohibited payday lenders from all of the following: garnishing wages, making payday loans after receiving notice from a borrower’s superior officer, marketing loans in a manner that suggests military affiliation, and requiring waivers of rights and mandatory arbitration. At one point, the bill contained a 36% interest rate limitation. AB 1965 did not pass the Senate floor. New federal legislation described below has superseded the provisions in AB 1965 and has made its consumer protections unnecessary.

The Administration

Governor Arnold Schwarzenegger established the State Military Protection Task Force on August 23, 2006 by issuing Executive Order S-16-06. This Task Force is directed to develop proposals for legislation that address the unique issues facing the men and women in the military based in California including, but not limited to, programs for the education and protection of military personnel from unlawful financial and investment schemes and practices. The Task Force is assigned to report to the Governor and the Legislature on such proposals from time to time as it deems necessary. In addition, the Task Force must review existing law to determine whether additional legislation is needed to protect military families in the short term as it continues its work; it is assigned to publicly report its findings and recommendations in this regard no later than February 1, 2007.

Congress

Effective on or before October 1, 2007, Section 670 of the John Warner National Defense Authorization Act of 2007 (Public Law 109-364), as added by H.R. 5122, would limit the interest rate in consumer loans made to members of the military to 36%. This federal law would

likely prevent lenders (including Pioneer Military Lending) doing business in this state from making loans to military members stationed in California on any terms inconsistent with protections provided to California residents. The federal law also provides various consumer protections for members of the military. AB 7 would conform California law to the federal law, thereby avoiding any potential conflict or preemption.

The Industry

One large payday lender, Advance America, has elected not to offer payday loans to service members anymore. However, Advance America must currently continue to do so in California so as not to violate anti-discrimination laws protecting service members.

IMPACT OF FEDERAL LAW:

Under long-standing legal principles that reflect the relationship between the state and federal governments, the federal law will have preemptive effect over any contrary state law. So, even if California were to adopt no financial legislation to protect the military, the federal law would prohibit various transactions with military personnel stationed in California anyway. But without action by California, the State will have no authority to enforce the provisions of the federal law, effectively diluting the protective features of the federal law. For this reason, among others, the Task Force recommends action.

By passing AB 7, the State would help incorporate consumer protections of federal law. These protections are *not* currently afforded to members of the military and their dependents under the California Finance Lenders Law or the California Deferred Deposit Transaction Law. Effective October 1, 2007 or sooner upon designation by the Secretary of Defense, these federal loan protections apply primarily to unsecured consumer loans and would generally make it unlawful to:

- Roll over (renew, repay or refinance) current loans of military members with proceeds of other loans made to those same borrowers.
- Require military members to waive federal or state legal rights afforded to them including any provision of the Service Members Civil Relief Act.
- Require military members to submit to arbitration or to comply with onerous legal notice provisions.
- Demand that military members provide unreasonable notice to maintain a legal action.
- Use a check or other deposit method or access to a financial account (doing away with payday loan transactions), or a title of a vehicle, as security for a loan made to military members.
- Require military members to establish repayment allotments as a condition to obtaining loans.

- Prohibit military members from prepaying a loan and prohibit prepayment penalties.

In addition, the federal law limits the interest rate on loans to military members to a 36% annual percentage rate, and requires specified disclosures including payment obligations and rate of interest.

Based on these federal provisions, payday lenders operating under the California Deferred Deposit Transaction Law will be prohibited from making payday loans to members of the military because a payday loan transaction typically requires the taking of a check as security for the loan. In addition, any other financial product directed to the military must carry an interest rate limited to no more than 36%.

Consumer finance lenders operating under the California Finance Lenders Law will be able to make loans under the federal law, although it is unclear whether they will be willing to do so. Under current state law, the rate of charge on smaller consumer loans is already capped at no more than 30%.

JUSTIFICATION:

Support for legislation such as AB 7 is needed for the following reasons:

- Military readiness and troop morale are significantly impaired because military personnel have continued to incur excessive financial obligations through payday lending. A recent Department of Defense report and other sources of information, including military advocates, indicate that state laws should be amended to safeguard military members and their families.
- Impairment of military readiness requires immediate, uniform action throughout California by the State government.
- The military remains one of the largest economic sectors in California with the Department of Defense spending more than \$43 billion annually on approximately 160,000 active-duty military personnel affiliated with more than 60 military installations.
- Payday lenders and other finance lenders are licensed and regulated under California law. These state laws do not set forth consumer protections that are designed specifically for military members who are vulnerable to unsuitable financial products.
- Education programs such as the TAP\$ program cannot alone prevent predatory practices described in the cited Department of Defense report.

ARGUMENTS PRO AND CON:

PRO:

- AB 7 would benefit military members and their families by allowing the Department of Corporations to enforce federal consumer protections that are designed to help them avoid loan products with exorbitant fees that impact their morale in a time of deployment. This legislation would also benefit payday lenders and finance lenders by avoiding conflicts of laws that may expose them to liability. This bill would benefit the Department of Corporations because it allows enforcement of federal law without any further administrative action such as rulemaking.

CON:

- It may be argued that it is premature to incorporate and enforce the federal law as proposed by AB 7. However, this argument is not persuasive given the problems encountered by military members and their families, as discussed above.

PROBABLE SUPPORT AND OPPOSITION:

The organizations that will likely support AB 7 will be affiliated with branches of the Armed Forces, and consumer groups such as the California Reinvestment Coalition.

Organizations representing financial service providers, such as the California Financial Service Providers, are not expected to oppose this legislation since it conforms state law to federal law to help facilitate their compliance efforts. Some banks and credit card providers are pressing for changes to the federal law, but we are unaware of any substantial amendments being considered.

FISCAL IMPACT:

None. This measure is not expected to have any fiscal impact on state programs.

ECONOMIC IMPACT:

AB 7 would help conform state law to existing federal law, so there will be no adverse economic impact on consumer finance lenders. Moreover, at least one payday lender (Advance America) has recently imposed a moratorium on making payday loans to members of the military as a proactive step to comply with the federal law.

LEGAL IMPACT:

AB 7 conforms state law to federal law. By recommending support of this bill, the Task Force will help prevent licensed lenders from violating current licensing laws and the antidiscrimination provisions set forth in the Military and Veterans Code. In addition, this legislation protects the military from potential threats to troop readiness by limiting debt ratios for service members.

The federal law preempts state laws that do not provide at least equivalent protection to military members. By conforming the state law to federal law, AB 7 also helps address any federal preemption concerns.

Currently, the Department of Corporations is involved in a lawsuit with Pioneer Military Lending. The Department of Corporations is seeking to require that company to comply with the California Finance Lenders law when making loans to all military borrowers located in this state regardless of their residency. The federal law now prohibits the Pioneer business model of making loans to nonresident military members on terms different from those offered to resident military members. Therefore, by incorporating the federal law, AB 7 would not impact that ongoing case.

The federal law prohibits arbitration. Thus, it should be noted that the federal law could have a chilling impact on the desire of some lenders to make unsecured consumer loans to military members.

COMPARISON WITH OTHER STATES:

Some states have enacted laws to help protect the military from unfair or fraudulent payday lending practices. However, no state has yet incorporated by reference the federal law, as proposed by AB 7.

PERFORMANCE INDICATORS:

Any outcomes of AB 7 can be measured on a case-by-case analysis regarding efforts by the Department of Corporations to enforce the laws under its jurisdiction.

AFFECTED AGENCIES AND THEIR ROLES/VIEWS:

The following agencies would have an interest in AB 7:

Governors' Advisor of Military Affairs (Office of Planning and Research) – coordinates the development of state policies that are crucial to the military.

Department of Corporations – licenses and regulates consumer lenders including payday lenders as California's investment and financing authority.

California Military Department – serves as the state's military force, the California National Guard, and administers state military programs.

Department of Finance – reviews legislative proposals for fiscal impact on state agency programs.

Department of Financial Institutions – licenses and regulates state-chartered banks and credit unions.

POST SCRIPT:

On a personal note, the co-chairs of the Task Force would like to express their appreciation to the Governor for this assignment. It has been a pleasure to work with members of the military as well as the other members of this Task Force.