Interest Rate on Loans to Soldiers Capped

BY VANESSA SUMO

The Tidewater region of Virginia is home not only to various Navy facilities but also to many payday lenders. The Department of Defense thinks that this is not a coincidence. When Congress asked the Pentagon to report on abusive lending practices aimed at military servicemen, it concluded that "predatory" lenders target soldiers and their families through their "ubiquitous presence around military installations."

Payday lenders typically make small loans of a few hundred dollars due on the borrower's next payday. In exchange for immediate cash, borrowers write post-dated checks for the amount of the loan plus a fee. In a typical transaction, a borrower pays a $15 finance charge on a loan of $100, to be repaid in two weeks. That works out to an annual interest rate of 390 percent. The cost of a payday loan can quickly balloon if this credit is routinely rolled over. For instance, a borrower would eventually pay back $490 for a mere $100 loan that is renewed or "flipped" every two weeks for an entire year (assuming that a $15 fee is charged each time). But apart from the financial well-being of its troops, the Department of Defense is also worried about debt troubles that cause soldiers to lose their security clearances, which would prevent highly trained troops from being assigned to posts where they are needed the most.

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In response to these concerns, Congress recently passed a 36 percent annual interest rate cap on consumer credit extended to military servicemen and their dependents. The rate cap includes all fees and charges associated with the loan. The Department of Defense must draft implementing rules by October 2007. But a version of the proposed rules released in April has narrowed the definition of consumer credit to include only payday, vehicle title, and tax refund anticipation loans, products which were the focus of the Pentagon report. (Payday lending already has been effectively outlawed in a number of states, including North Carolina.)

The Community Financial Services Association, the national trade group for payday lenders, says that its members will stop offering loans to military personnel under this new law. The maximum fee that payday outfits will be allowed to charge will not be sufficient to cover the costs of extending short-term credit. "Payday lenders can't offer a loan at 36 percent," says the association's spokeswoman.

Some analysts worry that the rate cap will actually end up hurting soldiers and their families. If the rate cap drives lenders out of the market, then this group will lose a sometimes important source of credit. "The likely impact of such a rule would be to make military personnel with short-term credit needs significantly worse off," said William Brown, an accounting and finance professor at the University of North Carolina at Greensboro, who testified before a Senate Committee last year.

Certain characteristics of the military and its lifestyle may limit a soldier's ability to handle short-term credit crunches. Many enlisted personnel are young, usually in their early 20s, and thus tend to have little precautionary savings. Soldiers may be deployed abroad for a long period, which would make it difficult to deal with pressing financial demands at home. A report by the RAND Corporation, a nonprofit think tank, finds that a majority of military spouses believe that their frequent and disruptive moves have adversely affected their employment prospects.

In these instances, soldiers or their dependents may prefer a payday loan to bouncing a check, paying late fees on a utility bill or credit card, or going to a pawnshop, options which could turn out to be more costly. Moreover, a survey conducted by Brown with Charles Cushman, a political management professor at George Washington University, finds that military servicemen choose payday loans because of the simplicity and speed of the application process.

Banks don't compete in this market because they perceive such products as "too high risk to offer profitably except at extremely high interest rates, thus inviting criticism from media, public policy officials, and consumer advocates," wrote Sheila Bair, at the time a finance professor at the University of Massachusetts and now chairwoman of the Federal Deposit Insurance Corp. (FDIC), in a June 2005 report. Moreover, banks and credit unions may be wary of creating a similar line for fear of cannibalizing their profits from overdraft protection fees, according to Bair's study.

Despite the hesitation by some banks and credit unions, Bair thinks that they have the tools and infrastructure required to offer relatively low-cost alternatives to payday loans. A conference hosted by the FDIC late last year to discuss "affordable, responsible loans for the military" demonstrated some of the efforts in the industry to develop such products. Additionally, the FDIC plans to give banks Community Reinvestment Act credit for making small-dollar, short-term loans to military members as an alternative to payday loans. **RF**