Prepared Statement

of

The Honorable David S. C. Chu

Under Secretary of Defense (Personnel and Readiness)

Before the

Senate Committee on Banking, Housing, and Urban Affairs

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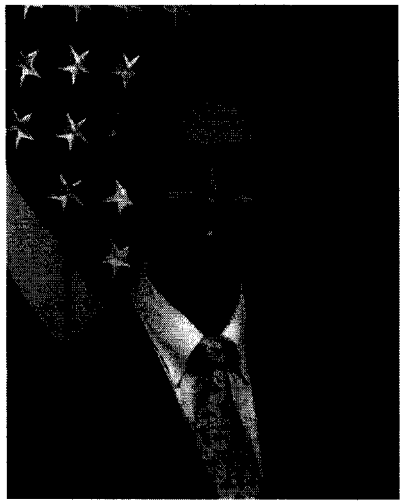


David S. C. Chu was sworn in as the Under Secretary of Defense for Personnel and Readiness on June 1, 2001. A Presidential appointee confirmed by the Senate, he is the Secretary's senior policy advisor on recruitment, career development, pay and benefits for 1.4 million active duty military personnel, 1.2 million Guard and Reserve personnel and 680,000 DoD civilians and is responsible for overseeing the state of military readiness.

The Under Secretary of Defense for Personnel and Readiness also oversees the $15 billion Defense Health Program, Defense Commissaries and Exchanges with $16 billion in annual sales, the Defense Education Activity which supports over 100,000 students, and the Defense Equal Opportunity Management Institute, the nation's largest equal opportunity training program.

Dr. Chu began his service to the nation in 1968 when he was commissioned in the Army and became an instructor at the U.S. Army Logistics Management Center, Fort Lee VA. He later served a tour of duty in the Republic of Vietnam, working in the Office of the Comptroller, Headquarters, 1st Logistical Command. He obtained the rank of captain and completed his service with the Army in 1970.

Dr. Chu earlier served in government as the Director and then Assistant Secretary of Defense (Program Analysis and Evaluation) from May 1981 to January 1993. In that capacity, he advised the Secretary of Defense on the future size and structure of the armed forces, their equipment, and their preparation for crisis or conflict.

From 1978 to 1981, Dr. Chu served as the Assistant Director for National Security and International Affairs, Congressional Budget Office, providing advice to the Congress on the full range of national security and international economic issues.

Prior to rejoining the Department of Defense, Dr. Chu served in several senior executive positions with RAND, including Director of the Arroyo Center, the Army's federally funded research and development center for studies and analysis and Director of RAND's Washington Office.

Dr. Chu received a Bachelor of Arts Degree, magna cum laude, in Economics and Mathematics from Yale University in 1964 and a Doctorate in Economics, also from Yale, in 1972. He is a fellow of the National Academy of Public Administration and a recipient of its National Public Service Award. He holds the Department of Defense Medal for Distinguished Public service with silver palm.

Mr. Chairman and members of the committee, it is a privilege to testify on the predatory lending DoD report. This report, required by Section 579 of the Fiscal Year 2006 National Defense Authorization Act, reviews the impact of lending practices that prey on Service members and their families, the efforts of the Department to ameliorate those impacts, and recommendations for legislative remedies to assist our military families.

This Administration recognizes personal finance as a primary aspect of "quality of life" for Service members and their families. It has included payday lending as one of ten key issues requiring the assistance of state governments to protect their well-being. Permit me to summarize how we reached this conclusion as context for the report.

Social Compact

In 2001, the President directed the Secretary of Defense to "undertake a review of measures for improving the quality of life for our military personnel." We collaborated with the Military Services to develop a "Social Compact" that describes the reciprocal nature of the commitments among Service members (to the defense of the nation), their families (to being part of that commitment) and the Department of Defense (to caring for their well-being). This bottom-up review articulated the linkage between quality of life programs as a human capital management tool and the strategic goal of the Department – military readiness.

The Social Compact lays out long term strategic-level plans for key aspects of quality of life, of which financial readiness is one. The long-term vision for financial readiness is to develop *a military culture that values financial competency and responsible financial behavior.* Financial readiness is equally important as other military skills and attributes.

Financially ready Service members seek out information to be proficient, and seek assistance when they encounter difficulty. Financially ready Service members would not seek to hide their financial problems by continuing to build debt to the point of destroying their finances, adversely impacting their family life and jeopardizing their military careers.

The goals associated with this strategic plan focus on the benefits of financial readiness to the individual and to the Department. We seek to:

- Reduce the stresses related to financial problems – the stress of out-of-control debt that can impact the performance of Service members and their family's quality of life.
- Increase savings – a personal and family goal of motivated Service members to control their finances and plan and prepare for their futures.
- Decrease dependence on high interest rate or unsecured debt – the vulnerability associated with living from paycheck to paycheck.
- Decrease the prevalence of predatory practices – protection from financial practices that seek to deceive Service members or that take advantage of them at a moment of vulnerability.

These goals establish an environment and culture in which Service members can feel secure about their finances and are ready to engage in the military mission. To accomplish these goals, Service members need to be competent in dealing with finances, protected from financial predators and motivated to achieve financial readiness. The Department uses awareness media, education programs and assistance through counseling to help Service members conform their behavior to the goals. But these tools do not protect them from predators as they develop their financial competency.

Financial Education Policy and Metrics

The Military Services are expected to provide instruction and information to meet the needs of Service members and their families. To this end, the Department published in November 2004: DoD Instruction 1342.27, *Personal Financial Management Programs for Service Member.*

As outlined in the Government Accountability Office Report 05-348, each Military Service tailors its programs for training first-term Service members on the basics of personal finance. These programs vary in terms of venue and duration, but all Military Service programs must cover the same core topics to the level of competency necessary for first-term Service members to achieve financial readiness. The Department monitors the ability of Service members to pay their bills on time, as a reflection of their financial competency and ability to apply basic financial principles. The Department has tracked the performance of the first four enlisted ranks as a leading indicator for the rest of the force. Since 2002, these Service members' self-reported assessments indicate they are paying better attention to keeping up with their monthly payments (graph at Table 1).

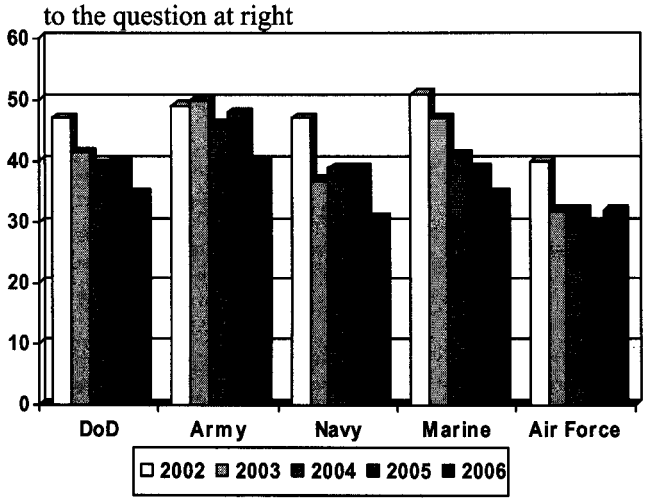
The Department is adding another indicator this year to the performance measure for personal finance: enrollment in the Thrift Savings Plan.

I review these metrics quarterly along with metrics that measure other important aspects of Service member and family quality of life.

The Department is developing an evaluation tool that measures first-term Service members' ability to apply basic principles to scenarios they may encounter. This tool will standardize the evaluation process throughout the Military Services and will help ensure that Service members can apply the instruction they receive.

Table 1: Trend Analysis: E1 – E4 Ability to Pay Bills on Time

Percentage answering yes to one or more of the answers to the question at right



	2002	2003	2004	2005	2006
DoD	47	41.5	39.5	40	35
Army	49	50	46	48	40
Navy	47	37	39	39	31
Marine	51	47	41	39	35
Air Force	40	32	32	30	32

Question: "In the past 12 months, did any of the following happen to you (and your spouse)? Mark yes or no for each item."

- Bounced 2 or more checks
- Failed to make a monthly/minimum payment on credit card, AAFES, NEXCOM account, or Military Star card
- Fell behind in rent or mortgage
- Was pressured to pay bills by stores, creditors, or bill collectors
- Had telephone, cable or internet shut off
- Had water, heat or electricity shut off
- Had a car, household appliance or furniture repossessed
- Failed to make car payment
- Obtained payday loan

Source: Defense Manpower and Data Center surveys

Financial Readiness Campaign

To assist the Military Services in delivering financial messages, the Department established the Financial Readiness Campaign in May 2003. It is now supported by 26 nonprofit organizations and federal agencies. In the past three years, Service members have benefited from the materials and assistance from:

- Air Force Aid Society (AFAS) – provides financial counseling and emergency monetary support for airmen in need.
- American Savings Education Council (ASEC) – provides over 60 award winning public service announcements that have been shown on American Forces Radio and Television Service (AFRTS).

- Army Emergency Relief (AER) – provides counseling, education programs and emergency financial relief to soldiers.
- Consumer Federation of America (CFA) – established the "Military Saves Campaign" as part of the CFA "America Saves" initiative, to encourage Service members to establish emergency savings and invest in the Thrift Savings Program.
- Association of Military Banks of America (AMBA) –AMBA members provide educational programs to supplement programs offered by the Military Services, as part of the responsibility for residing on military installations. Additionally, AMBA assists the CFA in deploying the Military Saves Campaign.
- Council of Better Business Bureaus – works with the Military Services to assist Service members and their families with a variety of consumer-related issues, along with providing education programs upon request.
- Defense Credit Union Council (DCUC) – members of DCUC provide education programs to supplement programs offered by the Military Services, and assist in the deployment of Military Saves.
- Federal Deposit Insurance Corporation (FDIC) – made available their "Money Smart" curriculum and train-the-trainer program to the Military Services, as well as AMBA and DCUC members.
- Federal Reserve Board – studies the impact of the AER sponsored education course conducted at Fort Bliss, TX, to determine the effect of training on financial behavior.
- Federal Trade Commission (FTC) – provides most widely disseminated materials available outside of DoD, on various topics concerning consumer protection.

- Financial Literacy and Education Commission (FLEC) – consolidates the materials available through the federal agencies via the "www.mymoney.gov" website, and accompanying toll-free number. It is widely advertised and linked to DoD and Military Service websites concerning personal finance.
- InCharge Institute – provides access to credit counseling/debt management, and publishes a quarterly magazine "Military Money" in partnership with the National Military Family Association (NMFA). The magazine is designed primarily to reach out to military spouses on a variety of financial, spouse and family life topics. To accompany the magazine, InCharge also provides public service announcements called the "Military Money Minute," on AFRTS, covering helpful financial tips on military pay, deployment preparation, etc.
- Institute for Consumer Financial Education – helps individuals and counselors with credit questions and understanding credit reports.
- Moneywise with Kelvin Boston – provides access to his syndicated television program for broadcast on AFRTS.
- National Association for Credit Counseling – partners with military installations to provide educational classes and credit counseling services.
- National Association of Securities Dealers (NASD) Foundation – funds a multi-year awareness and education program to supplement the programs provided by the Military Services. Included in the program are multimedia public service announcements (through sources such as AFRTS, Military Times magazines and local radio); an interactive website; sponsorship of a scholarship program for military spouses (through partnership with NMFA) to accredit them as Financial Counselors in return for volunteer

hours in military communities; and education for Military Service Financial Counselors and Educators.

- National Endowment for Financial Education (NEFE) – provides access to its "Project for Financial Independence," to severely injured Service members, members of the Guard and Reserve, and their families. The Project for Financial Independence connects Certified Financial Planners with Service members (geographically separated from an active duty military installation where they can obtain financial counseling) to accomplish pro bono financial planning.
- National Military Family Association (NMFA) – partners with several other organizations to facilitate reaching military spouses, a primary target of the Financial Readiness Campaign.
- Navy-Marine Corps Relief Society – provides education, counseling and emergency financial support for sailors and Marines in need.
- Securities and Exchange Commission – provides seminars at military installations, along with investor education materials in libraries on military installations.

These partnerships allow the Military Services to choose the programs that can best supplement the education, awareness and counseling services they provide.

Education and Predatory Lending

Predatory lending practices are covered as topics in initial financial education training and in refresher courses offered at the military installations. As described in the report, the Military Services have provided over 11,800 classes and trained over 324,000 Service members (approximately 24 percent of the force), as well as 19,400 family members.

In addition to these classes, Financial Readiness Campaign partner organizations conducted 1,300 classes for a total of 60,600 Service members and family members. These classes were primarily provided by the staff of banks and credit unions located on military installations. These institutions provide these classes as part of their responsibilities outlined in the DoD Financial Management Regulation. Other organizations involved include local Credit Counseling Agencies, state financial regulatory agencies, the InCharge Institute and the NASD Foundation.

The Military Service financial educators, along with partner organizations, have also distributed over 223,000 brochures and pamphlets, with the Military Services and Federal Trade Commission the primary provider of these products. In addition, *Military Money Magazine* has run several articles, including two cover article editions, on predatory lending. The free distribution of the magazine is through military commissaries, family support centers, other service agencies on the installation. The magazine is sent to residents on the military installations and home addresses off the installation upon request. Approximately 250,000 copies are distributed per quarter.

Predatory Lending Practices Considered

The lending practices covered in education programs parallel those covered in the report: payday loans, Internet loans, military installment loans, tax refund anticipation loans and rent-to-own programs. Education programs also cover budgeting, the appropriate use of credit, credit cards, and other financial services.

The loans covered in the report include those with high interest rates, little or no responsible underwriting, loan flipping or repeat renewals that ensure profit without significant

payment of principal, loan packing with high cost ancillary products whose cost is not included in computing interest rates, a non-mortgage loan structure or terms that transform these loans into the equivalent of highly secured transactions; and loans that involve fraud or deception, waiver of meaningful legal redress, or operation outside of state usury or small loan protection law or regulation. These characteristics strip earnings or savings from the borrower, place the borrower's key assets at undue risk, potentially deepen the borrower's financial shortfall and trap the borrower in a cycle of debt. These loans take advantage of the borrower's lack of understanding, vulnerability or both.

The types of loans included in the report were chosen as a result of feedback from military financial counselors and legal assistance attorneys who have provided counsel to Service members with financial problems. The Military Services and Military Aid Societies provided 3,393 case studies providing information about incidents where Service members have requested assistance with their lending problems. These case studies showed that the typical scenario involved indebtedness resulting from a lack of financial control, a financial emergency, or both. Many of these cases involved military borrowers who owed money to installment lenders and payday lenders that created a cycle of debt.

Efforts to Curb the Prevalence and Impact of Predatory Loans

The Department has attempted to use the processes and resources available within the Department to curb the prevalence of payday lenders. But the Armed Forces Disciplinary Control Board (AFDCB) and command policy are not adequate to address the issue. The AFDCB is designed to address commercial entities providing services that are a detriment to good order and discipline, and in violation of federal or state statute. Without appropriate

statute, commanders and AFDCBs have difficulty citing payday lenders as the focus of remedial action. Moreover, in states that authorize payday lending, AFDCBs must establish their own local guidelines in addition to the provisions of state law, ensure all affected businesses are aware of these new rules, and then require these businesses to comply. The Department has considered establishing guidelines that would ameliorate the concerns posed by lenders characterized above, but establishing these policies within DoD poses legal problems and raises the potential for troublesome litigation against the Department. There is no established authority for DoD to make rules governing off-base private business dealings.

Military installment companies have also attempted to evade state usury limits and oversight. In 2005, the California Department of Corporations considered a complaint filed against one such company, alleging it operates without a license, charges usurious interest, collects prepaid finance charges which are not permitted in California, contracts for excessive dishonored check fees, and automatically adds various forms of credit insurance to loan agreements (98 percent of contracts include "voluntary" insurance purchases).

Internet lenders claim jurisdiction in states with lax protections and unlimited rates and often attempt to bypass the state credit, usury or payday loan laws of the state where the borrower receives the loan. All military installment lenders cited in the report listed Nevada as their home state. State regulators have successfully enforced home-state law against Internet payday lenders making loans to consumers in their states in Colorado, New York, Massachusetts, Kansas, Pennsylvania and the District of Columbia.

The scope and methods of payday, military installment and Internet lenders are outside the capability of the Department to place "off limits" as a way of dealing with good order and discipline concerns associated with these lenders' practices. It is also unrealistic to believe that

the Department can adequately control these concerns through education alone. The recent survey accomplished by the Consumer Credit Research Foundation stated that the primary reason Service members choose payday loans is because they are convenient. Certainly, obtaining "fast cash" from a payday lender is far more convenient than debt counseling or addressing inherent overspending that creates situations where sub-prime loans are needed. The Department seeks your assistance in helping Service members find convenient, less costly options that build their financial future.

Alternatives

The Department would prefer Service members and their families seek out the alternatives available through Military Aid Societies, military banks and defense credit unions. These institutions have established programs and products designed to help Service members and their families resolve their financial crises, rebuild their credit and establish savings.

The Military Aid Societies are strong advocates for limiting the cost associated with credit and for developing alternative products by financial institutions for Service members who cannot otherwise qualify for loans. Within their own resources they provided $87.3 million in no-cost loans and grants to Service members and their families in 2005.

As described in the report, many military banks and defense credit unions have developed products and services to assist Service members recover from their financial problems. These alternative programs require Service members to commit to changing their financial behavior. The Department is seeking this outcome in its awareness campaigns, education programs, and the counseling services it offers, and supports reasonable alternative programs that help Service members recover their financial well-being.

Legislative Recommendations

For the reasons outlined above, the Department is requesting the Congress' assistance in establishing limits that will help Service members seek out alternatives capable of motivating them to change their financial behavior. The report outlines several recommendations that are designed to curb the corrosive nature of predatory loans. Each recommendation seeks to limit the abuses articulated in the report:

- **Require that unambiguous and uniform price disclosures be given to all Service members and family members with regard to any extension of credit (excluding mortgage lending).** All fees, charges, insurance premiums and ancillary products sold with any extension of credit should be included within the definition of finance charge for the computation and disclosure of the annual percentage rate (APR) for all loans made to military borrowers. As stated in the report, some loan companies pack loans with additional fees not included in the APR calculation. Additionally, many Internet lenders do not disclose their interest rates and fees on their websites, and are only disclosed after the borrower has committed to taking the loan.
- **Require a federal ceiling on the cost of credit to military borrowers, capping the APR to prevent any lenders from imposing usurious rates.** Lenders should be prohibited from directly or indirectly imposing, charging, or collecting rates in excess of 36 percent APR with regard to extensions of credit made to Service members. This APR is expected to cover all cost elements associated with the extension of credit. This limitation is expected to affect all lenders referenced in the report (payday, installment, Internet, tax refund anticipation, and rent-to-own). This limit may affect payday lenders, but by their own statistics, the military represent only one to four percent of their market.

True, a 36 percent APR may preclude some Service members from obtaining credit. The Department believes Service members who require loans with interest rates above 36 percent APR should seek assistance and not consider further increasing their debt load. The 36 percent APR limit creates a barrier for installment lenders to refrain from packing fees and premiums onto the base interest rate they charge for a loan. The limit of 36 percent APR is considered appropriate, since it mirrors the limitations found in several states for their small loan products. For those states where the cap is lower than 36 percent, the state limit and consumer protections would apply.

- **Prohibit lenders from extending credit to Service members and family members without due regard for the Service member's ability to repay.** Perhaps the most important limit that can be applied is assuring Service members are not provided loans they cannot repay in a timely manner. If they are in situations that require them to take loans to meet short-term obligations without considering their short- and long-term ability to repay, then they should be obtaining counseling and assistance to restructure their debt and develop long-term budgets that can help them recover from their financial concerns. Such a prohibition would also limit the use of high interest credit to make impulse and unnecessary purchases, since these outlays push Service members and their families deeper into debt. Lenders that require checks, access to bank accounts or car titles to secure obligations consider these essential assets to mitigate their risk and do not consider the ability of the borrower to repay the loan. Lenders that require allotments to repay loans deliver their products under the same expectations. Access to essential assets places the borrower in a position of undue duress, with no options but to pay according to the schedule, even if the borrower has no capability of doing so. Again, this is not of

concern to the lender holding these assets. If this restriction precludes some Service members from obtaining credit, then they may consider the alternatives – counseling, assistance and a change in financial behavior.

- **Prohibit provisions in loan contracts that require Service members and family members to waive their rights to take legal action.** Service members should maintain full legal recourse against unscrupulous lenders. Loan contracts to Service members should not include mandatory arbitration clauses or onerous notice provisions, and should not require the Service member to waive his or her right of recourse, such as the right to participate in a plaintiff class. Waiver is not a matter of "choice" in take-it-or-leave-it contracts of adhesion. To the contrary, Service members should be given the opportunity to hold lenders accountable for situations where they have violated their rights.
- **Prohibit contract clauses that require Service members to waive any special legal protections afforded to them.** These proposed protections, and those provided to Service members through the Servicemembers Civil Relief Act, were intended to strengthen our national defense by enabling Service members to devote their entire energy to the defense needs of the Nation. In the interest of our national defense, such protections should not be subjected to waiver (other than in circumstances stated in the Servicemembers Civil Relief Act), in writing or otherwise.
- **Prohibit states from discriminating against Service members and family members stationed within their borders, and prohibit lenders from making loans to Service members that violate consumer protections of the state in which their base is located.** States should be prohibited from discriminating against Service members stationed within their borders and should be required to assure that such Service members

are entitled to and receive the benefit of all protections offered to citizens of the state, including regulation of lenders located in the state or that provide loans via the Internet to Service members stationed there. States have a vested interest in assuring the financial safety and stability of Service members stationed within their borders. States should be prohibited from authorizing predatory lenders to treat "non-resident" Service members stationed within the state's borders differently than the state would permit that lender to treat in-state residents. Lenders should be prohibited from charging Service members stationed within a state an APR higher than the legal limit for residents of the state, and should also be prohibited from violating any other consumer lending protections for residents of the state in which the base is located.

Conclusion

The Department appreciates the opportunity to report to the Congress on the issue of predatory lending. The report outlines the prevalence around military installations of payday lenders and the overt marketing of some installment and Internet lenders. The report and this testimony provide an overview of the efforts within the Department to educate, inform and influence Service members and their families to take control of their finances, build wealth and escape the cycle of debt – for their own well-being and to enhance their military readiness. The Department's strategic plan seeks to increase savings and decrease dependence on debt. The strategic plan also focuses on improving the protection afforded Service members and their families in the market place – again to help assure their military readiness.

The vision for personal finance in the Department is to develop *a military culture that values financial competency and responsible financial behavior*, in other words, a system that values Service members addressing their financial problems, rather than perpetuating them through high interest loans. Service members inherently understand that limits on interest rates are appropriate, even if these limits would decrease the availability of credit. When asked in a recent survey conducted by the Consumer Credit Research Foundation if Service members strongly/somewhat agree or disagree with the statement: "The government should limit the interest rates that lenders can charge even if it means fewer people will be able to get credit," over 74 percent of the Service members surveyed agreed with the statement (with over 40 percent strongly agreeing). Similarly when asked their position on the statement "There is too much credit available today," 75 percent of Service members not using payday loans and 63 percent of Service members using payday loans agreed (with 51 percent of non-users strongly agreeing).

Service members agree that there should be limits. Commanders have made their positions known that limits should be established. This issue is an important part of the Department's social compact with commanders, Service members and their families, for their well-being and in support of military readiness. The Department asks for your assistance enacting the statutory language necessary to establish more effective limits.

I thank you for this opportunity to share these concerns with you and the committee. The Department stands ready to assist the committee in developing effective limits on predatory lending.