

## EXPERT ANALYSIS

### Students, Loan Servicers and the Servicemembers Civil Relief Act

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Over the past two years, mortgage loan servicers have faced an onslaught of regulatory scrutiny, enforcement actions and targeted litigation. The Department of Justice, state attorneys general and the federal banking regulators have extracted tens of billions of dollars in settlements, borrower compensation and independent consultant fees from the mortgage servicing industry. With consent orders signed and settlements drawing to a close, regulators are sharpening their focus on other areas, and it appears student loan servicers are high on their current priority list.

Certainly there are parallels between the two industries. Student loans make up an increasingly large portion of a typical family's outstanding debt. Between 2004 and 2012, the average student loan balance per borrower nearly tripled — in fact, student loan debt is the only type of debt that actually increased during the recession.<sup>1</sup> Nationwide, student loan debt is \$1.2 trillion<sup>2</sup> and is second only to mortgage debt on consumers' balance sheets.<sup>3</sup> The sharp increase in home mortgage default rates has drawn federal scrutiny and spurred several recent mortgage actions. Also, as the default rate on student loans ticks up, a similar wave of enforcement actions is likely for student loan servicers. And a core area of focus — as was true with the mortgage servicing settlements — is sure to be the Servicemembers Civil Relief Act.<sup>4</sup>

The SCRA provides significant protections to active-duty service members regarding debts incurred prior to military service. These protections let them concentrate on their military responsibilities without worrying about financial matters at home. The SCRA applies to all debts, including student loans, and can modify the interest rate, restrict certain collection activities, and limit credit bureau reporting on an eligible service member's account.

Because of the recession and education-related veterans benefits, SCRA compliance has become even more important for student loan servicers. During the recession, many individuals found shelter from a weak job market in higher education. The National Center for Education Statistics shows the number of individuals enrolled in degree-granting institutions increased from 18.2 million in 2007 to 21.5 million in 2011.<sup>5</sup> Simultaneously, the number of college graduates joining the military also grew rapidly, with the U.S. Navy alone seeing a 60 percent increase in the number of college graduates entering its ranks since 2007.<sup>6</sup> Both trends are likely related to slow economic growth, and increases in higher education enrollment and the military may feed off one another. Many service members leaving active duty use government programs such as the GI Bill to fund their education. In many instances, they may be eligible for SCRA benefits for their student loans.

In this environment, student lenders may face SCRA actions from any one of several different sources. The SCRA explicitly allows the Department of Justice to bring an enforcement action under the statute if the department finds either that a creditor engaged in a pattern or practice of violating the act or that a violation raises "an issue of significant public importance."<sup>7</sup> Because servicers typically use uniform servicing practices, and because courts are likely to find that matters affecting military preparation inherently raise issues of significant public importance,<sup>8</sup> the statute

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sets a low bar for Justice Department action. Federal banking regulators also already have used their supervisory powers to ensure SCRA compliance by mortgage and credit card servicers, so student loan servicers are a natural next step.<sup>9</sup> After the 2010 SCRA amendments, individual borrowers have a private right of action against creditors for statutory violations.<sup>10</sup>

This is not a hypothetical concern. The Justice Department recently stated in congressional testimony that it is actively scrutinizing student loan servicers for SCRA violations.<sup>11</sup> Similarly, the Consumer Financial Protection Bureau recently issued its “mid-year snapshot” of student loan complaints, indicating that borrowers with private student loans continue to complain of difficulties in obtaining interest rate relief under the SCRA.<sup>12</sup> The CFPB does not have direct enforcement authority over the SCRA, but has pledged to work with the Justice Department in exploring service member issues.

The failure to provide eligible service members with SCRA benefits can be costly. Under Section 597 of the SCRA, if the Justice Department brings a civil action, the court may assess a statutory civil penalty up to \$55,000 for a first violation and \$110,000 for any subsequent violation.<sup>13</sup> New legislative proposals seek to double these penalties.<sup>14</sup> Recent settlements have required mortgage servicers to pay service members the greater of \$500 or treble damages in addition to making a refund of any excess interest charged. And fees for violating other provisions of the SCRA have been as high as \$125,000 per incident under some settlements.<sup>15</sup> But far more important than the financial penalties are the reputational risks to the servicers involved, not only with individual borrowers, but with investors, banking regulators and the Department of Education.

### **COMPLIANCE, CHALLENGES AND LITIGATION RISKS**

While mortgage lenders were criticized for not complying with the SCRA's foreclosure and default judgment provisions, student loan servicers face exposure primarily under Section 527 of the statute. Section 527 provides service members with interest rate protections. If a service member enters into a financial obligation, such as a student loan, and later enters active military service, he or she may be entitled to a reduced interest rate of 6 percent. However, this protection only applies if the service member incurs the debt prior to entering military service and provides the creditor with “written notice and a copy of the military orders calling the servicemember to military service.”<sup>16</sup>

If the service member is on active duty for a longer period than is indicated in these orders, he or she must also provide “any orders further extending military service.”<sup>17</sup>

SCRA protection is retroactive; once a service member provides a creditor with active-duty orders, the creditor must reduce the interest rate as of the date the orders call the borrower to military service.<sup>18</sup>

Although the SCRA may appear straightforward, the devil is in the details. Implementation involves complicated issues for student loan servicers.

#### ***Definition of ‘interest’***

Under Section 527 of the SCRA, interest is defined broadly to include “service charges, renewal charges, fees, or any other charges (except bona fide insurance) with respect to an obligation or liability.”<sup>19</sup> With this language, Congress aimed to protect service members against unscrupulous lenders who would reduce a loan's interest rate but shift the uncharged interest to miscellaneous loan “fees” or “charges.” While well-intentioned, the Justice Department and federal banking agencies have interpreted the definition of interest under the SCRA more broadly than the definition of interest under other statutes. The SCRA definition requires creditors to implement controls to ensure student loan servicers capture, in the calculation of the interest rate, all “interest” under the SCRA.

### **Charging fees**

Because the SCRA defines interest so broadly, many servicers turn off all charges and fees related to a borrower's account, but this is not always necessary. If a borrower's loan interest rate is below 6 percent, a student loan servicer may charge fees, so long as the fees and interest combined do not exceed 6 percent. Also, Section 527 only applies to charges and fees "with respect to" the original student loan. Determining whether a specific charge or fee is "with respect to" a loan is a fact-intensive endeavor. But there are some charges — such as those for copies of documents, pay-by-phone charges or other collateral costs — that federal regulators have determined are not "with respect to" the loan and are not considered as interest under the SCRA. Yet other charges that have not traditionally been viewed as part of "interest" in any context have been included in the definition of interest.

### **Written notice and active-duty orders**

To receive the SCRA's interest rate protection, a service member must provide the creditor with "written notice and a copy of the military orders calling the service member to military service and any orders further extending military service."<sup>20</sup> Both the written notice and the military orders must be provided to the creditor within 180 days after the end of active-duty service.<sup>21</sup>

While the service member's obligation to provide "orders calling the service member to military service" is clear, service members may receive several different documents pertaining to active duty, including enlistment contracts, enlistment orders, travel orders, temporary/permanent change-of-station orders, training orders, military pay documents, and dismissal orders, any of which the service member might provide to creditors. Therefore, creditors must determine whether specific papers call a borrower to military service. Even if a creditor makes the appropriate distinction, federal regulators have taken varying positions on whether a specific type of document qualifies as a "military order" under Section 527. With an assortment of potential orders and often ambiguous regulatory guidance, complying with the SCRA's interest rate protection can be tricky.

### **Eligible borrowers**

Although the SCRA applies to individuals on "military service," this term has a specific statutory meaning that may not match its conventional understanding. "Military service" under the SCRA includes members of the regular military (Army, Navy, Air Force, Marine Corps and Coast Guard), the reserves or the National Guard who are called to active-duty service under Title 10 of the U.S. Code.<sup>22</sup> The SCRA also applies to National Guard members who are called to active duty under 32 U.S.C. § 502(f), when that call to duty is authorized by the president or secretary of defense for more than 30 consecutive days, paid for by federal funds and in response to a presidentially declared national emergency.<sup>23</sup> The SCRA also protects commissioned officers of the Public Health Service and National Oceanic and Atmospheric Administration who are called to active duty.<sup>24</sup>

There are several groups of people who perform activities similar to federal SCRA service but are not covered by the act. Members of the National Guard serving pursuant to state or federal orders that do not meet the requirements above are not entitled to SCRA protection. Military contractors, even if serving side by side with regular service members, are not entitled to SCRA protection. And members of the federal government who are overseas but not part of the military are not entitled to SCRA protection.

### **Protections for reservists**

Under the SCRA, members of the regular military are entitled to the statute's benefits beginning on the day they receive orders calling them to military service. However, members of the reserves — and under the SCRA this includes members of the National Guard and the regular reserve components of the military — are entitled to statutory benefits beginning on the day that they receive orders calling them to military service, rather than the day their military service actually begins.

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This extended protection is an important benefit for service members. But determining whether an individual is a reservist is not always easy. Military orders come in dozens of different forms depending on the service member's military branch, duty assignment, and reservist or active-duty status. Identifying whether a particular service member is a reservist or regular military member requires a keen understanding of these different types of orders.

Reservists are entitled to SCRA protection beginning on the day they receive their active-duty orders. For creditors, determining the date the service member received orders can be difficult. Military orders themselves do not indicate when the borrower received them. Reservists called to active duty likely are focused on important military, family and personal matters, not on cataloguing the date they received their orders. To account for this uncertainty, federal regulators have used the date the military issued active duty orders as a proxy for the date the borrower received the orders.

#### **End of SCRA protection**

In most instances, SCRA interest rate protection ends when a service member leaves active duty. However, for "an obligation or liability consisting of a mortgage, trust deed, or other security in the nature of a mortgage," SCRA interest rate protection ends one year after the end of active-duty service.<sup>25</sup> While student loan borrowers generally only receive SCRA interest rate protection during active duty, borrowers who use real estate collateral to secure student loans may enjoy SCRA benefits for an additional year.

#### **Servicing federal and private loans**

Some participants in the student loan industry service both loans owned by the Department of Education and those owned by private investors. And many borrowers have multiple loans, some of which are federal, while others are private. The different rules governing these loans can be confusing for both servicers and borrowers, and they become more confusing when the SCRA is involved. In some instances, the owners of certain student loans require servicers to provide benefits that are more generous than those required under the SCRA, while others require strict adherence to the statutory text. When one company services multiple loans for a single borrower under different standards, there is a significant increase in compliance challenges and the likelihood of borrower confusion.

#### **Credit bureau reporting**

Many creditors operate under the false belief that the SCRA prohibits negative reports to credit bureaus. In fact, the SCRA only states that creditors may not report negative credit information solely because a service member seeks benefits under the SCRA.<sup>26</sup> In essence, this is an anti-retaliation provision; negative credit bureau reporting still is permitted if the service member fails to make timely student loan payments.

#### **Collection activities: Section 521**

Although student loan servicers face the greatest SCRA exposure under the interest rate provision, the statute also provides default judgment protection. For student loan servicers initiating their own collection proceedings or subcontracting with others for collection activities, Section 521 provides additional procedures servicers must follow when seeking a default judgment. Student loan servicers should be aware of these procedures. They should closely monitor their subservicers and debt collection counsel to ensure their compliance with Section 521.

#### **Secured student lending: Section 533**

While secured student lending makes up a small portion of total student loan debt in the United States, it poses risks for loan servicers. As mentioned above, secured student loans are entitled to SCRA protection not only during the period of the service member's active duty but for an additional year.<sup>27</sup> Collection procedures for secured student loans become even more difficult. If a student loan is secured by a service member's real property and the servicer seeks to foreclose, the servicer must comply with Section 533 of the SCRA (for non-judicial foreclosures) or Section

521 (for judicial foreclosures). Regulators have sought penalties as high as \$125,000 for SCRA-related foreclosure errors, making foreclosure of an active-duty service member's real property a risky proposition.

## CONCLUSION

The SCRA creates compliance challenges for student loan servicers, but difficulty does not excuse compliance. Student loan servicers who underestimate the SCRA do so at their own peril. The Justice Department and the federal banking agencies are watching creditors closely for compliance with the act, and prior settlements show that SCRA mistakes can prove costly. By focusing on the SCRA now, student loan servicers can sleep easy — because they are reducing the likelihood of expensive enforcement actions and protecting service members. **WJ**

## NOTES

<sup>1</sup> Donghoon Lee, Senior Economist, Fed. Reserve Bank of N.Y., Household Debt and Credit: Student Debt, Presentation at the Fed. Reserve Bank of N.Y. (Feb. 28, 2013), at 5, available at <http://www.newyorkfed.org/newsevents/mediaadvisory/2013/Lee022813.pdf>.

<sup>2</sup> Chris Denhart, *How the \$1.2 Trillion College Debt Crisis is Crippling Students, Parents, and the Economy*, FORBES, Aug. 7, 2013.

<sup>3</sup> See Lee, *supra* note 1, at 5.

<sup>4</sup> 50 U.S.C. app. §§ 501-597b (2012).

<sup>5</sup> NAT'L CTR. FOR EDUC. STATISTICS, TOTAL FALL ENROLLMENT IN DEGREE-GRANTING INSTITUTIONS, BY ATTENDANCE STATUS, SEX, AND AGE: SELECTED YEARS, 1970 THROUGH 2020 (September 2011), available at [http://nces.ed.gov/programs/digest/d11/tables/dt11\\_200.asp](http://nces.ed.gov/programs/digest/d11/tables/dt11_200.asp).

<sup>6</sup> Michael Tomsic, *In Weak Economy, College Grads 'Surge' Into Military*, NPR, Aug. 18, 2012, available at <http://www.npr.org/2012/08/18/158505630/in-weak-economy-college-grads-surge-into-military>.

<sup>7</sup> 50 U.S.C. app. § 597(a).

<sup>8</sup> See *United States v. Williams*, No. 1:12-cv-551, 2013 WL 596473, at \*3 (E.D. Va. Feb. 14, 2013) (entertaining an action by the government under Section 597 when a borrower alleged a single violation of Section 535 of the SCRA).

<sup>9</sup> See 12 U.S.C. § 1818(b).

<sup>10</sup> Veterans' Benefits Act of 2010, Pub. L. No. 111-275, 124 Stat. 2864 (2010) (relevant provision codified at 50 U.S.C. app. § 597a).

<sup>11</sup> *Preserving the Rights of Servicemembers, Veterans, and their Families in the Financial Marketplace: Hearing Before the S. Comm. on Veterans' Affairs*, 113th Cong. (2013) (statement of Eric Halperin, Special Counsel for Fair Lending, Dep't of Justice), available at <http://www.senate.gov/isvp/?type=live&comm=vetaff&filename=vetaff073113&stt=38:20>.

<sup>12</sup> CONSUMER FIN. PROT. BUREAU, MID-YEAR SNAPSHOT OF PRIVATE STUDENT LOAN COMPLAINTS (2013).

<sup>13</sup> 50 U.S.C. app. § 597(b)(3).

<sup>14</sup> See H.R. 5747, 112th Cong. (2012); S. 3323, 112th Cong. (2012).

<sup>15</sup> Office of the Comptroller of the Currency, Independent Foreclosure Review Payment Agreement Details, available at <http://www.occ.gov/news-issuances/news-releases/2013/nr-ia-2013-60a.pdf>.

<sup>16</sup> 50 U.S.C. app. § 527(b)(1).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* § 527(a) (stating that loans covered by Section 527 receive the interest rate protection "during the period of military service").

<sup>19</sup> *Id.* § 527(d)(1).

<sup>20</sup> *Id.* § 527(b)(1).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* § 511(2)(A)(i).

<sup>23</sup> *Id.* § 511(2)(A)(ii).

<sup>24</sup> *Id.* § 511(2)(B).

<sup>25</sup> *Id.* § 527(a)(1)(A).

<sup>26</sup> *Id.* § 518(3).

<sup>27</sup> *Id.* § 527(a)(1)(A).



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