DREHER TOMKIES LLP

ALERT

FOR CLIENTS AND FRIENDS OF DREHER TOMKIES LLP

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THE TRUTH IN LENDING LIE

Occasionally, good intentions do not produce good results.

The Truth in Lending Act was enacted by Congress in 1968 with the intention of providing consumers with a better way of comparing the cost of credit. 15 U.S.C. § 1601(a). However, it is now being used by certain advocacy groups to misrepresent the cost of credit and to mislead legislators and regulators. The goal of these advocacy groups appears to be to put certain financial services businesses out of business under the theory that "the end justifies the means."

When Congress enacted the Truth in Lending Act, it was trying to provide a means to compare various credit programs by "annualizing" the cost of credit. By "annualizing" various fees on long term mortgage loans, consumers could see the comparative costs of competing credit programs being offered to them. A 25 year mortgage loan with origination fees and points could be compared to a 30 year mortgage loan with different origination fees and points. By dividing the various fees and points by the term of the loan and then adding them to the yearly interest rate, an "annual percentage rate" could be arrived at that provided the consumer with valuable information on which to base a credit decision. Comparing a 25 year loan and a 30 year loan works well. Even comparing a 5 year automobile loan to a 3 year automobile loan produces comparable results and "annual percentage rates" that are understandable to consumers.

In each of the above examples, the fees are treated, for Truth in Lending purposes, as if they are interest, even though they are not. However, the "annual percentage rate" is misleading because the consumer has to pay the fees up front and does not get to pay them over the multiple year term of the loan. The clearest and fairest way of explaining the cost of credit to consumers is to clearly disclose (1) the interest rate that is paid throughout the loan term and (2) the fees that are paid up front. That is the way the cost of credit was contracted for and disclosed prior to 1968. With the enactment of Truth in Lending, we got confusion. Now the federally mandated disclosure is always expressed as an "annual percentage rate," notwithstanding its misleading results. The best that can be said for this mandated disclosure is that when comparing loans of comparable length, it does provide additional information to the consumer before the credit contract is signed.

However, when comparing loan products of substantially different lengths, the "annual percentage rate" comparison loses its validity. A fee divided by a 30 year term and the same fee divided by a 3 year term produces widely different results in the "annual percentage rate" notwithstanding that the consumer may be paying exactly the same yearly interest rate and exactly the same upfront fee.

Clearly, the use of an annualized rate can be more misleading than helpful to the consumer. Clearly, "annual percentage rate" is not an interest rate. It is a manufactured number that does not reflect the real world of paying upfront fees and a yearly interest rate.

People understand upfront fees and a yearly interest rate, but they almost never understand the misleading nature of an "annual percentage rate" disclosure. And consumer advocacy groups trade on this lack of understanding.

Now comes very short duration lending programs. Some credit programs are offered over a period of less than one year. Truth in Lending requires that all fees be annualized in calculating the "annual percentage rate." This means that a fee charged on a one month loan must be multiplied by 12 in order to calculate the "annual percentage rate." As anyone can see, this artificially inflates the "annual percentage rate" dramatically. The consumer, of course, never pays the fee 12 times, but the required "annual percentage rate" disclosure treats the fee as if it were paid 12 times. The "annual percentage rate" becomes a meaningless number because it is based on an incorrect assumption. Thus, comparing the "annual percentage rate" on a one month loan to the "annual percentage rate" on a 30 year loan or even a 3 year loan is not only not meaningful, it is deceptive. Consumers do not understand this, but consumer advocacy groups should. Congress did not intend this result.

Consumer advocacy groups not only fail to explain the deceptive use of "annual percentage rate" disclosures, they trade on this lack of understanding in presenting their positions. Legislators and regulators can be misled as well. These advocacy groups not only fail to disclose the deceptive nature of an "annual percentage rate" disclosure, but they actively and probably intentionally quote an "annual percentage rate" calculation but call it interest. This is patently false. Hence, the Truth-in-Lending Lie. ❑

✧ *Darrell Dreher and Susan Ostrander*

Darrell L. Dreher
ddreher@dltlaw.com

Elizabeth L. Anstaett
eanstaett@dltlaw.com

Margaret M. Stolar
mstolar@dltlaw.com

Robin R. De Leo
robin@dreher-la.com

Susan M. Manship
smanship@dltlaw.com

2750 HUNTINGTON CENTER
41 S. HIGH STREET
COLUMBUS, OHIO 43215
TELEPHONE: (614) 628-8000 FACSIMILE: (614) 628-1600
WWW.DLTLAW.COM

To see all previously sent ALERTS, visit our website at www.dltlaw.com

Michael C. Tomkies
mtomkies@dltlaw.com

Charles V. Gall
cgall@dltlaw.com

Judith M. Scheiderer
jscheiderer@dltlaw.com

Susan L. Ostrander
sostrander@dltlaw.com

Emily C. Barlage
ebarlage@dltlaw.com