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A Comparative Study of the Truth in Lending Act

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A COMPARATIVE STUDY OF
THE TRUTH IN LENDING ACT

BY

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Submitted in fulfilment
of the Honors Program
Special Studies re-
quirement for the
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A COMPARATIVE STUDY OF
THE TRUTH IN LENDING ACT

Less than two generations ago America discovered mass production. Scarcely one generation ago America discovered mass distribution. In the present generation America is discovering mass finance.¹

But since this adage was written, some forty years ago, America has rapidly progressed out of the discovery stage — it is now well into the application stage.

While many people may regard consumer credit as a relatively new concept, such is not the case. It probably began in the United States early in the nineteenth century (a few years after it was initiated in England), but it has only in recent years acquired such a position of social and economic imminence. Today, credit is an integral part of our life style and the volume of consumer credit sales reaches monumental proportions.

At the beginning of 1970 over half of all U. S. families were making instalment payments of some kind other than mortgages. Consumer credit outstanding (excluding mortgage debt) totaled the phenomenal sum of 122.5 billion dollars.² Consider also that consumers pay anywhere from 6% to 40% for the use of that money.

¹Evans Clark. Financing the Consumer (New York: Harper & Brothers, 1930), p. 1.

²Changing Times, XXII, no. 11 (November, 1970), p. 27.

Yet, while the consumer indebtedness is substantial enough to warrant concern, credit is not entirely unfavorable. It allows people to enjoy a higher standard of living than would otherwise be possible. There is also the element of convenience — it allows people to buy things before they can pay for them. There's also the added period of enjoyment people get from using products and services while they are paying for them.

On the other hand, the unwise use of credit has serious ramifications. Each year thousands of people have declared personal bankruptcy. Perhaps the primary reason being that they buy things they don't need or can't pay for. Many over-extend their financial capacity due to their lack of sound financial skills and the comparative ease with which credit is granted. They then become credit risks after skipping payments and getting into trouble with creditors.

Unfortunately, little can be done to protect the consumer from himself. Therefore, attention must focus on protecting the consumer-borrower from the lender.

Governmental Regulatory Measures

Historically, the type of statute that has dominated the growth of consumer credit has been the antiquated usury laws. These laws, as originated, set flat 6% and 8% per annum ceilings on the rate of interest that could be charged for loans of money. But in the twentieth century, these

ceiling rates have been increased by most states and some states have increased rates more than others. In fact, two states have no ceiling whatsoever.³ As a result, exceptions and exemptions have come from both the courts and the legislatures. In most states general usury statutes now cover only a small portion of consumer credit transactions and this coverage is highly erratic.

Most state legislatures recognized the distinction between credit sales and direct loans, and many laws have been enacted to permit loans to be made at rates in excess of usury statutes. Most common are the Small Loan Laws, which require the lender to be licensed and limit both the amount and length of the loan. While each state has a statute which puts a ceiling on the maximum finance charge which finance companies can legally levy on their customers, the variance in rate from state to state has been the common objection to these state laws. And due to the amount of risk, one may assume that finance companies, for the most part, charge the legal maximum.

There seems, however, to be greater flexibility in the area of sales financing. This is probably due to court interpretations of the "time-price differential", i. e., the difference between the "cost" price and the "time" price of a commodity. Some states hold the time-price differential

³A Summary of the Uniform Consumer Credit Code, prep. by Nathaniel E. Butler. (Chicago: National Conference of Commissioners on Uniform State Laws, 1969), p. 1.

is not interest, since a credit sale does not constitute a loan of money. Other states contend that a credit sale should be treated as a loan of money and therefore subject to small loan or usury laws. The remainder of states have no instalment sales legislation and seem content, for the most part, to rely on free-bargaining between the buyer and the seller.

It is into this complicated situation that the Federal Truth in Lending Act has come.

The Truth in Lending Act

In 1963, legislative session of the Congress had before it legislation requiring that every consumer-borrower be informed of the total dollar finance charge and of the true simple interest rate actually involved in the loan.

There was little dissent from the general view that consumer should have accurate and full information about the "true" cost of their credit transactions.

However, there were some reservations centering around the complexity involved. Instalment sales typically include finance charges and provisions for insurance and other services. There was skepticism as to whether it was feasible to reduce these complex transactions to an interest equivalent.

It is perhaps interesting to note that while the Federal Reserve System approved of its social and economic value

it shunned the responsibility for its administration. In May of 1968, this act was passed into law by the 90th Congress in order to:

. . . safeguard the consumer in connection with the utilization of credit by requiring full-disclosure of the terms and conditions of financial charges in credit transactions or in offers to extend credit; by restricting the garnishment of wages; and by creating the National Commission on Consumer Finance to study and make recommendations on the need for further regulation of the consumer finance industry, and for other purposes.⁴

In its entirety, this act is the Federal Consumer Credit Protection Act, but Title I, requiring disclosures of the terms of a credit transaction and regulating credit advertising, of the Act is officially named the "Truth in Lending Act".

While Truth in Lending covers the bulk of credit transactions, there are some exemptions. These are as follows:

(1) Credit transactions involving extensions of credit for business or commercial purposes, or to government or governmental agencies or instrumentalities, or to organizations.

(2) Transactions in securities or commodities accounts by a broker-dealer registered with the Securities and Exchange Commission.

(3) Credit transactions, other than real property transactions, in which the total amount to be financed exceeds \$25,000.

(4) Transactions under public utility tariffs, if the Board (the Board of Governors of the Federal Reserve System) determines that a State regulatory body regulates the charges for the public utility services involved, the charges for delayed payment, and any discount allowed for early payment.⁵

⁴U. S. Congress. Consumer Credit Protection Act, 90th Congress, 5th sess., (Washington, 1968).

⁵Ibid., Sec. 104.

Despite its initial reluctance, the Board of Governors of the Federal Reserve System has been the regulatory agency designated to prescribe the regulations to carry out the purposes of the Act.

What Truth in Lending Does

For consumers. The full-disclosure facet of the Act assures consumer-borrowers that they will be informed as to the real cost of their credit. The consumer must be told, first, the amount of the total finance charge and, second, the annual amount; it is expressed either as the finance charge per \$100 of unpaid balance or the "annual percentage rate". Lenders have until January 1, 1971, to begin using the percentage rate, however, even though either method reflects the same amount.

Department store and credit card accounts previously reflected only the service charge per month on the balance due, which was typically $1\frac{1}{2}\%$. Now, under the Truth in Lending Act, the annual rates (which would typically be 18% or 18 dollars per 100 dollars of unpaid balance) must be disclosed.

Also important is the fact that all lenders are now required to employ the same basis formula for computing finance charges and annual percentage rates.

Equally as important as the use of annual rates is the inclusion of other fees and service charges with the interest. Formally separated, a consumer might negotiate a sales con-

tract at a fair rate of interest and find himself loaded up with fees and service charges. These costs are now among those that must be included with the interest charge. They are as follows:

(1) Extra interest charge expressed as a discount and any time-price differential.

(2) Service, transaction, activity, and other carrying charges.

(3) Finder's fees.

(4) "Points" — extra sums figured as a percentage of the loan amount and charged in a lump sum.

(5) Appraisal and credit report fees (except in real estate transactions).

(6) The cost of credit life, accident, health, or loss of income insurance that the lender requires to be bought (such insurance is designed to pay off the loan if the borrower dies or becomes ill or disabled).

(7) Premiums for other types of insurance that protect the lender against a borrower's default or other credit losses.

(8) Any charge that the borrower is required to pay because the institution making the loan is going to sell the obligation to another lender.⁶

As one would expect, credit costs will appear to rise,

⁶Changing Times, XXIII, no. 6 (June, 1969), p. 9.

but the consumer can be assured that the finance charges are all-inclusive. Previous to Truth in Lending, consumers who had been aware that their cost of credit was higher than the rate shown often did not understand these extra charges or, if they did, lacked the mathematical skill to compute them.

The consumer is also benefitted in a more indirect way. Under the pre-existing situation, the buyer who shopped for lower interest rates may or may not have been getting the best buy for his money. The current situation is somewhat more simplified — he need only compare finance charges.

For lenders. Lenders are finding themselves not only compelled to fully disclose the terms of a credit transaction, but also, credit advertising must be of a full-disclosure nature. For example, if in the advertising of credit, other than open end plans, the amount of the downpayment, the amount of the instalment, or the dollar amount of the finance charge is stated, then the advertisement must state all of the following items:

- (1) The cash price or the amount of the loan as applicable.
- (2) The downpayment, if any.
- (3) The number, amount, and due dates or period of payments scheduled to repay the indebtedness if the credit is extended.
- (4) The rate of the finance charge expressed as an annual percentage rate.⁷

Op cit., U. S. Congress, p. 13, 14.

Lenders are criminally liable for willful and knowing violations of the Truth in Lending Act. Section 112 of the Act provides for a fine of not more than \$5,000 or imprisonment of not more than one year or both. The Act also provides, under Section 130, that failure to disclose information as required makes the creditor liable in an amount equal to the sum of (1) twice the amount of the finance charge in connection with the transaction (but, the amount will not be less than \$100 or exceed \$1000), and (2) the costs of the action together with a reasonable attorney's fee.

Many lenders, regardless of the requirements placed upon them by the Truth in Lending Act, are encouraged by the fact that consumers seem to be more confident about negotiating credit transactions.

Summary

While the Truth in Lending Act is Federal, states can obtain exemptions by passing its own "truth in lending" laws. One new reform law is called the Uniform Consumer Credit Code (UCCC).

While there are both pros and cons regarding the value of UCCC, most of the adversity to it stems from the fact that it favors the credit industry. Critics contend that it will open the door to anyone who wants to go into the money-lending business. This contention is supported by the fact

that no license is required unless interest rates charged exceed 18%, and no limit is placed on the number of above-18% lenders. More directly, they charge that retailers could sell on credit, as they do now, at high rates of interest without need of a license and without fear of losing it for misbehavior.

It is also expected to appeal to lenders on the basis of its maximum interest rates (36% per annum on the first \$300, 21% on the portion from \$300 to \$1000, and 15% on any excess).

But regardless of the fact that Truth in Lending may be circumvented, it is the first substantial consumer credit protection legislation. Its appearance alone seems to serve as notification that emphasis is being shifted from "Let the buyer beware" and turned toward "Let the seller beware".

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