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# PREDATORY INSTALLMENT LENDING IN 2017

## STATES BATTLE TO RESTRAIN HIGH-COST LOANS

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## APPENDIX D

## METHODOLOGY

A key component of this report is a comparison of the maximum APR permitted for installment loans under different state laws. The purpose of an APR is to express the full cost of a loan on an annual basis, so that the costs of loans of different amounts, different lengths, and different mixtures of interest and fees can be compared to each other.[2] The APR is especially important for revealing the full cost of a loan that charges fees in addition to a periodic interest rate. For example, Arizona allows 36% interest on a $500 six-month loan, but also allows an origination fee of 5% of the principal. Taking both the interest and this origination fee into account, the APR is 54%. If only the interest were allowed, the APR would be 36%.

Throughout this report, we discuss the "full APR." The federal Truth in Lending Act (TILA),[3] as implemented by Regulation Z, sets forth rules for calculating and disclosing an APR in consumer credit transactions. However, because of loopholes in Regulation Z, an APR calculated by its rules does not include all the charges that creditors impose as a condition of the extension of credit. These loopholes are especially significant for open-end loans but can also plague closed-end loans. As a result, the APR calculated under TILA rules often understates the real cost of a loan.

Instead of using the TILA APR calculation rules for this and our 2015 report, we have calculated "full APRs." Our full APRs include not only the interest that the state law allows the lender to charge, but also all fees specified in the statute that are a condition of the extension of credit. We include these fees whether or not they are included in the

[1] *See* 15 U.S.C. § 1601(a) ("It is the purpose of [the Truth in Lending Act, which requires disclosure of the APR] to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him"); National Consumer Law Center, Truth in Lending § 1.1.1 (9th ed. 2015), *updated at* www.nclc.org/library (purpose of TILA to provide uniformity and enable comparison of disclosures of cost of credit).

[3] The Truth in Lending Act, 15 U.S.C. §§ 1601–1666j, enacted in 1968, requires disclosure of the APR and other key credit terms, and standardizes the language and calculations for these disclosures.

APR as defined by TILA and whether they are charged at the outset of the loan or built into the loan to be charged later.[4]

Thus, in calculating the "full APR," we include all fees that the borrower is bound to pay in order to obtain and use the extension of credit. These fees include, for example, application fees, investigation fees, document preparation fees, transaction fees, "points," annual fees, and monthly fees. We do not, however, include charges such as late charges or dishonored check charges that are imposed only if some future, avoidable event occurs.[5] Nor do we include any fees that can be charged only for mortgage loans, since the report focuses solely on non-real estate lending. We also do not include credit insurance premiums in the "full APR" calculations. As discussed in our 2015 report, however, charges for credit insurance premiums and other ancillary products often drive up the cost of credit significantly.

For this and our 2015 report, we have calculated the maximum "full APRs" allowed under each state's installment loan laws for two hypothetical loans: a $500, six-month loan and a $2000 two-year loan. If a state has several statutes, or its statute allows several different rates, we have used the highest rate allowed. For open-end credit, we have calculated the "full APR" for:

(1) a $500 cash advance, taken at the time of account opening, with payments sufficient to repay the advance in six months, with no additional cash advances, and

(2) a $2000 cash advance, taken at account opening and repaid over a two-year period with no additional advances.

For open-end credit statutes that allow an annual fee, we charged the first annual fee at account opening, and the second one (for the two-year loan) on the anniversary date, at which point we adjusted the payment amount to take the additional charge into account.

In many states, the allowed rates produce a higher "full APR" for the $500 loan than for the $2000 loan. This occurs for two reasons. First, some states impose lower rate caps on larger loans. Second, in states where lenders are permitted to charge a fixed fee on top of the interest rate, that fee will have a greater impact on a smaller loan than a larger one. For example, an additional $50 charged on a $500 loan will have more of an impact on the APR than the same $50 fee will have on a $2000 loan.

Many state lending laws have ambiguities that affect the calculation of the full APR. For example, a lending law may allow a lender to charge an origination fee without specifying whether it can also charge interest on that fee. In the absence of clear statutory language or regulatory guidance, in our calculations we treated origination fees as amounts that can be added to the principal and on which interest can be charged. For other ambiguities, we have used our best judgment to find an interpretation that seems consistent with the statutory language and the intent of the statute. Policymakers should consider

[4] The Department of Defense has adopted a similar fee-inclusive approach in implementing the Military Lending Act's 36% cap on certain extensions of credit to servicemembers. *See* 32 C.F.R. § 232.3(h).

[5] We also do not include fees imposed by state offices for recording security interests, since the report focuses on unsecured loans.

  

issuing regulations or other guidance to close loopholes created by these ambiguities that high-cost lenders could exploit.

A thorough discussion of credit math calculations under state lending laws may be found in National Consumer Law Center, *Consumer Credit Regulation* Ch. 5 (2d ed. 2015), updated at http://library.nclc.org/CCR.