



PERSONAL
LOANS 101:
**UNDERSTANDING
APR**



Everyone needs access to affordable credit, whether it is to make a small purchase, pay for an unexpected emergency, repair their car or obtain a mortgage on their first home.

How do you choose the best loan to fit your individual circumstances? Like most of us, you probably want a loan that is easy to obtain and understand. You do not want to read pages filled with small print and legal jargon or go through a confusing process to determine what loan best meets your needs. You want a simple way to compare different types of loans.

Many people look for the **Annual Percentage Rate**, or **APR**, to be that simple way without understanding how it works or what it means. To make a smart decision about what loan is best for you, look at a number of factors. APR is one factor that can be helpful, but only if you are comparing loans of similar size and duration. APR is not helpful when comparing different types of loans.

WHAT IS APR AND HOW SHOULD IT BE USED?

APR DEFINITION

In the Truth in Lending Act (TILA), the federal government defines Annual Percentage Rate as the cost of credit expressed as a yearly interest rate. Most people assume that the APR is equal to the yearly interest rate, but APR includes the interest rate plus some of the costs involved in getting the loan and any yearly fees, such as loan origination fees and processing fees. APR was developed to assist consumers when comparing similar loan products.

The Truth in Lending Act requires lenders to tell, in writing, the loan's:

- APR – the *annual* cost of credit expressed as a *percentage*;
- Amount financed – the dollar amount of credit provided to a borrower;
- Finance charge – the total dollar cost of credit; and
- Total payments – the total amount of money that will be paid over the loan term.

These factors can change with different credit products, and are important parts of a loan. The amount borrowed and term (amount of time to pay it back) impact all four of these factors.

WHEN APR IS THE BEST MEASUREMENT OF LOAN COST - AND WHEN IT IS NOT

APR is a very useful tool when comparing similar kinds of loans with similar terms. For example, the APR on a 30-year fixed rate mortgage allows you to evaluate and compare loans from different mortgage lenders, where one offer has higher fees with a lower interest rate and another has lower fees with a higher interest rate. In this situation, APR is a valuable tool because all of the relevant fees and interest have been calculated. Similarly, when shopping for a new car, APR can be very helpful in determining the best loan for your needs. In these apples-to-apples comparisons, APR can be an excellent measurement device.

APR tells you the rate, but not the cost in actual dollars and cents you will pay over the length of your loan. If you pay the same rate for a longer period of time, the cost goes up. Different loan products will have different amounts financed and different terms, which means the APRs likely will be different. While APR is helpful when comparing similar loans – such as vehicle loans – it becomes confusing when comparing different types of loans – such as mortgages to vehicle loans.

APR AND THE COST OF LENDING

Every loan, regardless of type or size, has certain expenses built into the APR. These costs are directly related to the work the lender puts into making each loan, such as underwriting, rent, salaries, licensing and regulatory compliance. These fixed costs and overhead expenses are the same for each loan, whether the loan is for \$2,000 or \$20,000. So in general, bigger loans will tend to have higher costs but lower APRs, while smaller loans will have lower costs and higher APRs. In many cases, APR will have an inverse relationship with a borrower's out-of-pocket costs.

Do not assume that a larger loan is your best choice just because it has a lower APR. This common misperception can lead you to get a bigger loan than you actually need, resulting in increased indebtedness and overall costs over a longer time period. Your total out-of-pocket expense for a loan is often more important than a lower APR.

APR AND SMALL-DOLLAR LOANS (LOANS UNDER \$3,000)

Be very cautious when using APR to compare different types of loans with different terms and fees – especially when trying to compare small-dollar loans. Even the consumer watchdog agency, the Consumer Financial Protection Bureau (CFPB), recognizes the difficulty in using APR to compare small-dollar loans. In its March 2013 Semi-Annual Report, the CFPB stated:

“One standard approach to comparing loan costs is the APR; however, APRs may not be provided in every case, or include all fees. For example, APRs are not disclosed when a consumer incurs an overdraft fee, and other products might have application or other fees that are not included in this calculation.”

Examples


Let's compare several loans with varying length, amount borrowed and fees.

| Example | 1 | 2 | 3 | 4 | 5 | 6 |
|-------------------------|----------|----------|------------|------------|------------|------------|
| Length of Loan (Months) | 1 | 6 | 6 | 12 | 24 | 24 |
| Amount Financed | \$500.00 | \$500.00 | \$1,000.00 | \$1,000.00 | \$1,000.00 | \$2,000.00 |
| Monthly Payment | \$546.00 | \$102.45 | \$193.58 | \$106.05 | \$63.07 | \$121.05 |
| APR | 110% | 74.88% | 53.43% | 47.02% | 43.46% | 38.77% |
| Total Payments (Cost) | \$546.00 | \$614.70 | \$1,161.48 | \$1,272.60 | \$1,513.68 | \$2,905.20 |
| Finance Charge | \$46.00 | \$114.70 | \$161.48 | \$272.60 | \$513.68 | \$905.20 |

Notice that the APR starts high and gets smaller as the loans get larger and/or longer. The APR for the first loan (\$500 borrowed for one month) is 110% while the APR for the last loan (\$2,000 borrowed for 24 months) is almost 39%.

However, the actual cost, or total finance charge, is smallest for the first loan and gets larger as the loan amount gets larger and/or longer (\$46 for the first loan and \$905.25 for the last loan).

Look at examples 3, 4, and 5, which are for the same amount. Of these, example 3 has the highest APR and the highest monthly payment, but the lowest total cost. Example 5 has the lowest APR and lowest monthly payment, but the highest total cost.



The best loan is one you can afford and that allows you to get out of debt quickly. The monthly payment should fit comfortably within your budget without any big, one-time payments. Look carefully at all of the details when evaluating loans. For most consumers, APR is important, but not as important as the total cost of the loan.

CREDIT SCORES AND APR

You should know your credit score because it can directly impact the APR you are charged for a loan. Handling your finances responsibly provides you with many more options, and, in many cases a lower APR. For many types of loans, borrowers with high credit scores get lower APRs and are approved for credit more often than consumers with lower credit scores or poor credit histories.

Your risk of non-payment also impacts the interest rate you will be quoted for a mortgage or credit card. The lesson here is: know your credit score – it can impact your APR, and, in many cases, it is the deciding factor for whether you are approved or rejected for a loan.

MAKING SMART CREDIT CHOICES

Everyone's financial situation is different, and you must consider your needs and responsibilities when choosing a loan and deciding if you even should take out a loan. Look at your current bills and income, and your current and future needs. Prepare a budget before taking out any loan to determine if you will have enough money available to repay it. Choosing the credit product that fits into your budget minimizes the total dollar cost of the loan and allows you the ability to responsibly pay back the debt.

MONTHLY SPENDING WORKSHEET

Use the “Monthly Spending Plan” shown below to determine if you have enough income to cover your living expenses. The only time to take on a new monthly credit payment is when you are spending less each month than you take home. The additional debt load should not cut into the amount you have committed to saving.

| | |
|--|-------------------|
| Monthly Take Home | \$ _____ |
| Saving | - \$ _____ |
| TOTAL INCOME | = \$ _____ |
| Monthly Expenses: | |
| Mortgage Payment/Rent | - \$ _____ |
| Utilities | - \$ _____ |
| Groceries/Lunches/Dinners Out | - \$ _____ |
| Transportation | - \$ _____ |
| Insurance (Home, Vehicle, Life) | - \$ _____ |
| Taxes | - \$ _____ |
| Clothing | - \$ _____ |
| Personal | - \$ _____ |
| Entertainment | - \$ _____ |
| Gifts & Contributions | - \$ _____ |
| Family | - \$ _____ |
| Education | - \$ _____ |
| Credit Card Payments | - \$ _____ |
| Vehicle Payments | - \$ _____ |
| Other Creditor Payments | - \$ _____ |
| TOTAL EXPENSES: | = \$ _____ |
| Total Income Minus Total Expenses = | \$ _____ |

COMPARISON SHOPPING WORKSHEET

Shop around for the best loan, and make sure you compare the monthly payment and total cost, in addition to the interest rate and APR.

Do not let anyone pressure you into making a decision, make sure you understand the terms of the loan, and read all documents before signing them – and make sure that no lines are left blank.

| | Loan A | Loan B | Loan C |
|-------------------------|--------|--------|--------|
| Length of Loan (Months) | | | |
| Amount Financed | | | |
| Monthly Payment | | | |
| APR | | | |
| Total Payments (Cost) | | | |
| Finance Charge | | | |

THINGS TO REMEMBER

- Consider a loan's interest rate, associated costs, fees, and term.
- Prepare a budget before obtaining a loan to determine your ability to repay the total payments due.
- Compare similar loan amounts with similar terms.
- Always calculate your total costs and don't rely on just the APR. It is only one factor you should consider.
- Be careful not to take a larger loan just because the APR is lower.
- Don't borrow more money than you need just because you have been approved for a higher amount.
- Never sign documents for a loan until all your questions have been answered and you are confident that you are making a wise decision.

GOVERNMENT RESOURCES

Federal Trade Commission

www.ftc.gov

877-FTC-HELP (382-4357)

Consumer Financial Protection Bureau

www.consumerfinance.gov

855-411-2372



AFSA Education Foundation

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