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# What Does It Cost You to Borrow Money?

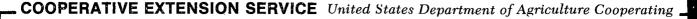
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**Economics Department** 

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#### WHAT DOES IT COST YOU TO BORROW MONEY?

Along with everything else, the cost of borrowing money-or buying on creditkeeps rising. Just at the time you need the money, the more it seems to cost. Most of us try to avoid paying more for the things we buy than they are worth. A housewife may visit several grocery stores to get the best foods at the lowest prices; but she may borrow money without giving much thought to the price she pays for that privilege.

Interest is the price we pay for the use of someone else's money. The person in the market for funds to borrow should exercise the same care he or she would in purchasing anything else.

Despite the truth-in-lending law, which requires lenders to state the "annual percentage rate" being charged, there are still many traps remaining for the uninformed borrower.Many comparisons are not easily made. For example, commercial lenders, while stating on the contract the annual percentage rate of interest as required, sometimes require that some of the money be left on deposit (which cannot then be used), thus increasing the effective rate of interest. The interest rate may also be stated in monthly terms.

Some lenders "discount" the loan; that is, they take the interest off the loan principle and give the borrower the rest of the money. For example, on a \$100 loan at 8% interest for one year, the lender may deduct the \$8 and give the borrower only \$92. The borrower is still obligated to pay back the \$100. The interest is already paid but since he has only \$92 to actually use, the effective rate is nearly 8.7% rather than the stated 8%.

If, as with most consumer loans, the repayments are made monthly or weekly

instead of at the end of the year, the effective interest rate is nearly double the stated amount. Sometimes, as with small loan companies, the interest rate varies on different parts of the loan. For example; "3% per month on the first \$300 of the loan, 1% per month on the next \$300 and 3/4% per month on the remainder."

Throw in loans made for odd numbers of months and statements such as "the average monthly interest cost is only 41¢" and it becomes apparent that there are many different ways of figuring interest and comparisons seem impossible. For the harassed consumer, fortunately, there is an easily calculated formula that can be used to make comparisons of various sources and methods of borrowing or buying on charge accounts.

The first step is to find out what the total dollar costs are for each plan offered. The dollar costs may be the same, but may cover different time periods or amounts actually received, however. The total dollar cost can be substituted into the following formula to find the effective rate of interest for each plan:

#### CONSTANT RATIO METHOD OF CALCULATING EFFECTIVE INTEREST RATES

(2)x(Number of Payment Periods in a Year)	)
(Original Unpaid Balance)	
Effec.	
<u>x (Total Finance Charges)</u> = Rate of	
x (Total Payments Required + 1) Int.	

As an example of the use of the formula, assume that you borrow \$1,000 to be repaid at \$90 per month for one year. The interest might be at 8%, or \$80. Twelve payments will be a total of \$1080 repaid. Substituting into the formula we get:  $\frac{2 \times 12 \times \$80*}{\$1000 \times (12 + 1)} = \frac{1920}{13000} = .1477 \text{ or } 14.8$ 

percent a year.

\*If there are charges in addition to the \$80 interest, they are really a part of the cost and must be added to the total finance charges to arrive at the effective rate of interest.

In fairness to various types of lenders, there are good reasons why some must charge more than others for different types of loans. It should be noted that the basic rate of interest is calculated by stating a given amount of money (say \$1000) borrowed at a given rate of interest (say 8%) for one full year with one payment (of \$1080) to be made at the end of the year. This is the "loan for productive purposes" made to businesses and persons for producing goods or services that will in turn supply the funds necessary to repay the loan. These are usually made at the lender's lowest rates.

The typical consumer's loan is a fairly new development and is usually made to pay a doctor bill, purchase a car or take a vacation. These are repaid from the debtor's future salary or other income, and usually on the installment basis. For a number of reasons, they are usually at a higher rate of interest.

Before lenders make loans they want some assurance they will get their money back, with interest. In addition, it costs money to make a loan. In a commercial setting, there are costs of help, rents, and so on as with any normal business. There are expenses for making credit investigations, possible collection costs, bookkeeping records and many others. Many of these costs are as great for a \$50 loan as they are for a \$10,000 loan. These and other factors. plus laws that limit interest rates that can be charged by traditional lenders. combine to make the lender who has limited funds select the borrowers from among those with the best credit ratings and where the granting of the credit will entail the least cost to him. These are mainly the people applying for "production" loans.

Because many consumers cannot get loans under the above circumstances, most states have special provisions for them. In most instances, however, small loan companies (and others making such loans) can make only the maximum charge specified and cannot make additional charges for the various expenses. Since these expenses must be paid in some way by the borrower, the stated interest rate may seem quite high. Working through alternatives, using the formula above will show you the real cost of using different sources of credit.

#### Robert J. Antonides, Extension Economist and Associate Professor 2500 printed for educational purposes at an estimated cost of 2c each

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