

Understanding the Cost of Borrowing Reference Sheet

Quick reference for APR, interest rates, fees, and loan comparisons

KEY TERMS

- **Principal:** The original amount of money borrowed
- **Interest Rate:** Percentage charged for borrowing money
- **APR:** Annual Percentage Rate - total yearly cost including fees
- **Collateral:** Asset pledged to secure a loan
- **Default:** Failure to repay according to terms
- **Debt-to-Income Ratio:** Monthly debt / Monthly gross income

TYPES OF CREDIT

- **Secured:** Backed by collateral (auto loans, mortgages) - Lower rates
- **Unsecured:** No collateral (credit cards, personal loans) - Higher rates
- **Installment:** Fixed payments over set period (auto, mortgage)
- **Revolving:** Flexible payments, reusable credit (credit cards)

Essential Formulas for Calculating Loan Costs

Total Interest Paid

$$\text{Total Interest} = \text{Total Payments} - \text{Principal}$$

Example: \$12,437 - \$10,000 = \$2,437 interest

Total Cost of Loan

$$\text{Total Cost} = \text{Principal} + \text{Interest} + \text{Fees}$$

Always compare total cost, not just monthly payment

Debt-to-Income Ratio

$$\text{DTI} = (\text{Monthly Debt} / \text{Gross Income}) \times 100$$

Aim for under 36%; max usually 43% for mortgages

Simple Interest

$$\text{Interest} = \text{Principal} \times \text{Rate} \times \text{Time}$$

Example: \$10,000 x 0.05 x 3 years = \$1,500

Loan Type	Typical APR	Term Length	Best For
Federal Student Loan	4.5% - 7%	10-25 years	Education expenses; flexible repayment options
Auto Loan (New)	5% - 8%	3-6 years	Purchasing vehicles; secured by car

Loan Type	Typical APR	Term Length	Best For
Auto Loan (Used)	6% - 10%	3-5 years	Used vehicles; higher rates than new
Mortgage (30-year)	6% - 8%	15-30 years	Home purchase; lowest rates, longest terms
Personal Loan	8% - 15%	2-7 years	Debt consolidation; large purchases
Credit Card	16% - 29%	Revolving	Short-term purchases; pay off monthly
Payday Loan	300% - 500%+	2-4 weeks	AVOID - predatory lending

Real Cost Comparisons: Same \$10,000 Borrowed

Student Loan (4.5%, 10 years)

Monthly Payment: \$103.64

Total Interest: \$2,437

Total Cost: \$12,437

Credit Card (18%, min payments)

Monthly Payment: ~\$200 (decreasing)

Time to Pay Off: 28 years

Total Interest: \$15,432

Total Cost: \$25,432

Personal Loan (12%, 5 years)

Monthly Payment: \$222.44

Total Interest: \$3,347

Total Cost: \$13,347

Auto Loan (6%, 5 years)

Monthly Payment: \$193.33

Total Interest: \$1,600

Total Cost: \$11,600

Hidden Costs and Fees to Watch For

Common Fees

- Origination fees (1-8% of loan)
- Application fees
- Prepayment penalties
- Late payment fees
- Annual fees (credit cards)

Red Flags

- APR significantly higher than interest rate
- Balloon payments at end of term
- Variable rates that can increase
- Mandatory add-ons (insurance, warranties)
- No clear disclosure of total cost

Smart Borrowing Strategies

Before You Borrow

- Compare at least 3 lenders
- Check your credit score first
- Calculate total cost, not just monthly payment
- Read all terms and conditions
- Ask about all fees upfront

To Reduce Costs

- Improve credit score before applying
- Make larger down payment
- Choose shorter loan term
- Set up autopay for rate discount
- Make extra payments toward principal

Loan Comparison Checklist

- APR (not just interest rate)
- Total cost over life of loan
- Monthly payment amount
- All fees included
- Prepayment penalties

Managing Existing Debt

- Pay more than minimum
- Pay highest interest first (avalanche)
- Consider refinancing at lower rate
- Avoid new debt while paying off
- Contact lender if struggling

When Should You Borrow?

Good Reasons to Borrow

- Education that increases earning potential
- Home purchase (builds equity)
- Reliable transportation for work
- Emergency (after emergency fund depleted)
- Business investment with solid plan
- Consolidating high-interest debt at lower rate

Poor Reasons to Borrow

- Vacations or entertainment
- Everyday expenses (food, utilities)
- Impulse purchases
- Items that lose value quickly
- Paying off debt with more debt (without rate reduction)
- Living beyond your means

Key Takeaway: Always Calculate Total Cost

The true cost of borrowing extends far beyond the monthly payment. A loan with a lower monthly payment but longer term can cost thousands more in interest. Always compare: (1) the APR (includes all fees), (2) the total cost over the life of the loan, and (3) whether the purchase justifies the total cost. For example, the same \$10,000 costs \$12,437 as a student loan but \$25,432 on a credit card with minimum payments. That's a difference of nearly \$13,000 - more than the original loan!