How to Calculate the Interest Rate on Payday Loans

Payday lenders, their trade association, and even some regulators and news reporters seem to believe that quoting an Annual Percentage Rate (APR) on payday loans is somehow unfair or deceitful to consumers. They say that the loan is only taken out for 14-days so an annual interest disclosure is somehow misleading to consumers. We believe that the payday lending industry (encouraged by their trade association) predominantly discloses the percentage or dollar amount per $100 loaned because that is the method that is most advantageous to the lender and hides the true cost of credit to their borrowers.

In 1968, Congress passed the Federal Truth-in-Lending Act, 15 U.S.C. § 1601 (TILA). One of the key credit concepts created by Congress was the concept of the "Annual Percentage Rate." Congress discussed certain credit practices at the time that triggered special concerns. The credit industry used various methodologies for calculating interest, some of which resulted in an understatement of the simple interest rate. These types of calculations generated "add-on" interest or "discount" interest. Other parts of the credit industry employed monthly interest rates. Some creditors disclosed no rate. Finally, Congress recognized the fact that some creditors added a number of additional fees or charges to the transactions. "This permits a creditor to quote a low rate while actually earning a higher yield through the additional fees and charges…The end result of these inconsistent and non-comparable practices is confusion in the public mind about the true costs of credit."[1] The mandated use of the APR (and the accompanying concept of "finance charge") was central to the standardization of disclosures that permits consumers to comparison shop.

30-year mortgage loans do not quote the interest over 30-years, neither do 5-year auto loans quote 5 years of interest, it is always an annual rate. Additionally, you never hear credit card issuer say that quoting an Annual Percentage Rate is somehow unfair to their borrowers because each month when the consumer receives their statement they have the option to pay the balance in full. They also don't try to deceive consumers by saying in oral discussions or advertising that they charge only 1.5% per month on their balances, not 18% Annual Percentage Rate.

Additionally, credit card issuers also don't complain that nearly half of their accounts pay their balance off each month so they should be able to say to those card holders that their loans are "free" or at "no cost." Credit card issuers, mortgage and auto lenders clearly disclose one rate – the Annual Percentage Rate to describe the cost of credit for their product, in full compliance with the Act. So should Payday Lenders!

[1] H.R. Rep. No. 1040 (1967), 1967 WL 4174, *reprinted in* 1968 U.S.C.C.A.N. 1962, 1970.
Congress cited a study of 800 families who were asked to estimate the rate of finance charge they were paying. The study showed that they dramatically underestimated what they actually paid.

So, How do you Calculate the True Annual Percentage Rate on a Payday Loan?

You will need to know three things before you start, as follows:

First, what is the amount of credit the borrower will receive (Amount Financed) = i.e., $350.00.

Second, what is the dollar amount the credit will cost (Finance Charge) = i.e., $50.00.

Third, what is the term of the loan = i.e., 14-days.

Step 1 – Divide the total Finance Charge ($50.00) by the Amount Financed - the amount the borrower will receive ($350.00) = 0.142857.

Step 2 – Multiply the answer (0.142857) by the number of days in the year (365) = 52.142857.

Step 3 – Divide the answer (52.142857) by term of the loan (14-days) = 3.724489.

Step 4 – Move the decimal point to the right two places and add a percent sign = 3.724489 becomes 372.45% Annual Percentage Rate *(see note below)*.

What if you Know the Cost per $100.00 and Want to Convert That to a True Annual Percentage Rate?

You will need to know three things before you start, as follows:

First, what is the amount of credit the borrower will receive (amount Financed) = i.e., $500.00.

Second, what is the cost for the loan per hundred = i.e., $20.00 or 20%.

Third, what is the term of the loan = i.e., 14-days.

Step 1 – Divide the Amount Financed - amount the borrower will receive ($500.00) by 100 = 5.

Step 2 – Multiply the answer (5) by the amount per hundred ($20.00 or 20%) to find the total Finance Charge = $100.00.

Step 3 – Divide the total Finance Charge ($100.00) by the amount the borrower will receive ($500.00) = 0.2.

Step 4 – Multiply the answer (0.2) by the number of days in the year (365) = 73.

Step 5 – Divide the answer (73) by term of the loan (14-days) = 5.214285.

Step 6 – Move the decimal point to the right two places and add a percent sign = 5.214285 becomes 521.43% Annual Percentage Rate *(see note below)*.

Note: Annual Percentage Rate always has no more than two places to the right of the decimal point. (i.e., 372.4489% rounded, becomes 372.45%) (5.214285% rounded, becomes 521.43%).