Blood pressure by itself is not a sufficient measurement to describe your health; similarly, the Annual Percentage Rate (APR) as a sole measurement does not accurately describe the quality of a loan. Oportun, a community development financial institution (CDFI) whose mission is to provide affordable credit-building loans to Latinos, knows that. In partnership with the Center for Financial Services Innovation (CFSI), they have set about to understand and demystify the cost of credit that consumers face.

It’s easy to rely on the commonly-used measurement, but APR is an imprecise tool to understand short-term credit (or microcredit) quality for two reasons: first, it is calculated over the course of a year, making short-term loans sound particularly expensive; second, it does not take into account a person’s “ability to repay.”

Oportun wanted to go further, seeking to understand just how expensive its loans are compared to other forms of credit that its customers might use. That’s why Oportun turned to CFSI, which created the “true cost of a loan” model to compare different small-dollar credit options based on how much each loan costs consumers in full. Oportun’s vision is that one day consumers will have an apples-to-apples comparison of the credit options available to them in order to make the best decisions for their financial lives.

Oportun analyzed dozens of different loan and credit products to account for all charges, fees, and penalties. Then, it applied data around how people are actually likely to use the products, rather than assuming “best case” scenarios. By including consumer cash-flow analysis and assessing people’s ability to repay, Oportun possesses a richer set of measurements around how its products affect its customers’ day-to-day financial health.

“The devil is in the details here,” says Sarah Livnat, senior director at Oportun. “The financial services industry has not been looking at small-dollar lending from the position of an actual consumer and the options they’re faced with.”

Comparing the True Cost of Loans

The model CFSI created did just that. “CFSI helped us do the math to understand how we’ve helped each and every customer save money on their loans versus alternative products,” said Livnat. “In our first nine years of lending, we saved customers over $345 million in interest and fees.”
This is groundbreaking research for two reasons. First, measuring what matters to consumers – for instance, the “all in” cost of a loan based on actual behavioral patterns and credit options available – has simply never been done before. Second, providers like Oportun are now able to accurately understand the credit options their community has and to clearly show how much money their customers are saving. This model can be expanded to other states and used by other providers as well.

Implications for Policymakers and Providers Alike

Measuring the “true cost of a loan” is especially influential in a policy environment where the quality of small-dollar loans often gets assessed by a single number. Says Livnat: “It’s a useful framework to be able to talk to policymakers, legislators, or consumer advocates to help them understand that there’s more to a loan than whether it’s above 36 percent APR. When you compare [an Oportun loan] to a payday loan, there’s an immense amount of savings provided to the consumer – and that’s valuable.”

Why is this so important? Because for the tens of millions of Americans that truly need short-term, small-dollar credit, access to that credit is paramount. This tool provides an intuitive way to incorporate access, APR, and repayment behaviors – and thus a way of assessing more than just “What APR is ‘too high’?”

As an advocate for cost-effective financial products that help – rather than prey – on low-income consumers, CFSI was able to frame the conversation about effective borrowing options by breaking down each loan into its cost on a monthly basis and in total. “We knew we needed a trusted partner who had experience in this area and already had a channel to communicate in this space,” says Livnat of the partnership with CFSI.

CFSI can apply the tool to different loan portfolios, states, and incorporate different repayment scenarios, thus helping policymakers and financial providers understand how decisions they make can help or hurt consumers. CFSI’s study allows the conversation around predatory lending to incorporate consumer access and behavior – previously unmeasurable components. “This research was meant to ground policymakers in the mental framework of consumers,” says Livnat. By moving beyond APR, the “true cost of a loan” model does just that.