

What is an Annual Percentage Rate (APR)?

The annual percentage rate (APR) is an interest rate that is different from the note rate. It is commonly used to compare loan programs from different lenders. The Federal Truth in Lending law requires mortgage companies to disclose the APR when they advertise a rate. Typically the APR is found next to the rate.

Example:

30-year fixed	8%	1 point	8.107% APR
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The APR does **NOT** affect your monthly payments. Your monthly payments are a function of the interest rate and the length of the loan.

The APR is a very confusing number! Even mortgage bankers and brokers admit it is confusing. The APR is designed to measure the "true cost of a loan." It creates a level playing field for lenders. It prevents lenders from advertising a low rate and hiding fees.

If life were easy, all you would have to do is compare APRs from the lenders/brokers you are working with, then pick the easiest one and you would have the right loan. Right? Wrong!

Unfortunately, different lenders calculate APRs differently! So a loan with a lower APR is not necessarily a better rate. The best way to compare loans in the author's opinion is to ask lenders to provide you with a good-faith estimate of their costs on the same type of program (e.g. 30-year fixed) at the same interest rate. Then delete all fees that are independent of the loan such as homeowners insurance, title fees, escrow fees, attorney fees, etc. Now add up all the loan fees. The lender that has lower loan fees has a cheaper loan than the lender with higher loan fees.

The reason why APRs are confusing is because the rules to compute APR are not clearly defined.

What fees are included in the APR?

The following fees ARE generally included in the APR:

- Points - both discount points and origination points
- Pre-paid interest. The interest paid from the date the loan closes to the end of the month. Most mortgage companies assume 15 days of interest in their calculations. However, companies may use any number between 1 and 30!
- Loan-processing fee
- Underwriting fee
- Document-preparation fee
- Private mortgage-insurance

The following fees are SOMETIMES included in the APR:

- Loan-application fee
- Credit life insurance (insurance that pays off the mortgage in the event of a borrowers death)

The following fees are normally NOT included in the APR:

- Title or abstract fee
- Escrow fee
- Attorney fee
- Notary fee
- Document preparation (charged by the closing agent)
- Home-inspection fees
- Recording fee
- Transfer taxes
- Credit report
- Appraisal fee

An APR does not tell you how long your rate is locked for. A lender who offers you a 10-day rate lock may have a lower APR than a lender who offers you a 60-day rate lock!

Calculating APRs on adjustable and balloon loans is even more complex because future rates are unknown. The result is even more confusion about how lenders calculate APRs.

Do not attempt to compare a 30-year loan with a 15-year loan using their respective APRs. A 15-year loan may have a lower interest rate, but could have a higher APR, since the loan fees are amortized over a shorter period of time.

Finally, many lenders do not even know what they include in their APR because they use software programs to compute their APRs. It is quite possible that the same lender with the same fees using two different software programs may arrive at two different APRs!

Conclusion :

Use the APR as a starting point to compare loans. The APR is a result of a complex calculation and not clearly defined. There is no substitute to getting a good-faith estimate from each lender to compare costs. Remember to exclude those costs that are independent of the loan.
