What is an APR?

We probably field more questions about the Annual Percentage Rate (APR) than any other single mortgage concept. Calculation of the APR is governed by the Truth In Lending Act (TILA), which is enforced by the Consumer Financial Protection Bureau (CFPB). Here's what the CFPB has to say about the APR in their June 2013 Laws and Regulations circular (just plow through it...we'll be back):

"Credit costs may vary depending on the interest rate, the amount of the loan and other charges, the timing and amounts of advances, and the repayment schedule. The APR [...] is designed to take into account all relevant factors and to provide a uniform measure for comparing the cost of various credit transactions.

The APR is a measure of the cost of credit, expressed as a nominal yearly rate. It relates the amount and timing of value received by the consumer to the amount and timing of payments made. The disclosure of the APR is central to the uniform credit cost disclosure envisioned by the TILA.

Since an APR measures the total cost of credit, including costs such as transaction charges or premiums for credit guarantee insurance, it is not an "interest" rate, as that term is generally used."

Not an Interest Rate

What does it mean that the APR is not an "interest" rate in the general sense? Mainly, it means that the APR is not used to calculate your monthly payment or your periodic interest costs. In fact , what you traditionally think of as your "interest rate" is used in calculating your APR.

The APR is a Comparative Tool

The basic logic behind the APR is that some of the closing costs you pay when you set up a mortgage are loan-related. When assessing the total cost of a loan you should consider these costs, closing costs and any "credit guarantee insurance" (mortgage insurance), in addition to the interest that you pay.

The purpose of the APR is to aggregate all of these costs into one number, expressed as a yearly interest rate. With this one number, you can then compare various loan options.

The CFPB is definitely onto something here. As an example, when the time comes to lock in your interest rate, you are going to select a combination of interest rate and discount points for your loan. The more you pay in discount points, the lower your note rate will be. Further, if your loan requires mortgage insurance, you may have to choose a method of payment for this cost.

How do you compare loans with different interest rates and closing costs and mortgage insurance costs? The APR is the means by which the CFPB makes sure the credit cost for every set of loan terms you may consider is disclosed to you in a uniform way, allowing you to compare one loan option to another.

So, APR is a comparative tool…check. How well does it work as a decision-making tool? That depends.

Julee Felsman • VP of Mortgage Lending
juleef@rate.com • (503) 799-3711
NMLS#120831
CA - CA-DBO120831 • OR - Licensed • WA - MLO-120831

What Does the APR Assume?

Before deciding what do with an APR, we should dig a little deeper. There are some key assumptions built into the math behind the APR:

- You will never pay more than minimum monthly payments.
- If your loan has an adjustable rate, the index will always remain the same as it is today.
- If your loan has mortgage insurance, you will pay it for the maximum time required by the loan and/or allowed by the law (the Homeowners Protection Act).
- You will keep your loan for the full term.

How exclusively you should rely on the APR as a decision-making tool depends very much on how closely these assumptions fit your plans (and, if your loan is an ARM, how comfortable you are assuming that present interest rates may be representative for the full loan term).

Possible Scenarios

Let's say you are refinancing to a 15-year loan and plan to make minimum payments until your home is paid off. The APR is a perfect fit. When assessing loan options, you can trust that the lowest-cost loan option is the one with the lowest APR.

What if you are buying your first home and expect to live there 4-6 years before moving on? What if you plan to prepay your loan aggressively and pay it off early? In these cases, the loan with the lowest APR may actually cost you more (in dollars and cents) than a loan with a higher APR. How can this be?

Because the APR assumes minimum payments over the full term of your loan, a loan with higher up-front costs and a lower interest rate tends to have a lower APR. This makes sense: If you pay a chunk of money today to buy a lower rate, but then save on the interest costs for 15 or 20 or 30 years, you can reasonably expect to get back that up-front investment (and then some) over the years.

If, on the other hand, you are only going to keep a loan for a few years, odds are good that you will not have the loan long enough to recoup a significant up-front investment in points. A loan with a higher interest rate and APR, but lower closing costs, may well cost you less overall in dollars and cents.

If your head hasn't exploded yet and you want to nerd out a bit more with the numbers, check out our DIY APR information (a separate pdf).

The APR Disclosures

As you go through the loan process, you'll see numerous APRs. We'll calculate the APR for every loan scenario we discuss. You'll acknowledge receipt of an APR when you sign your Truth-in-Lending (TIL) disclosure form. We'll recalculate the APR and send a new TIL form if any aspect of your loan changes in a way that changes the APR. And you'll receive a final TIL with your final APR when you sign your closing papers. By law, this final APR must be no more than .125% higher than the last APR we sent to you.

Julee Felsman • VP of Mortgage Lending
juleef@rate.com • (503) 799-3711
NMLS#120831
CA - CA-DBO120831 • OR - Licensed • WA - MLO-120831