What is APR and What Does It MEAN TO ME?

By

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What is APR and what does it mean to me?

This is a question that borrowers ask me all the time. It's a point of confusion for many home buyers / borrowers. More often than not, APR is confused with **note rate** *(the actual interest rate a borrower pays for a mortgage)*, and often borrowers think that interest rate or note rate is the same as annual percentage rate.

APR stands for Annual Percentage Rate*, and is a numeric representation of the costs associated with transacting your loan. It can be used to compare two or more loan* ***"offers,"*** *to see if one loan offer has more costs, or, is, in effect, more expensive than another. It does not represent an actual note rate, and your monthly payment is not based on APR; it's based on the interest rate or note rate.*

Generally, the higher the one-time costs, as a percentage of the loan amount, the higher your APR will be. Your **APR** will be higher than your note rate in most cases. The rule of thumb is that the higher the APR is, the higher the closing costs. ***All things being equal, a loan with a note rate of 6.0% and an APR of 6.094% has fewer closing costs than a loan with a note rate of 6.0% and an APR of 6.235%, for example.***

In the **United States**, the disclosure and calculation of APR has been governed by the federal government since the Truth in Lending Act became effective date on May 29, 1968. APR has done nothing but create confusion ever since, especially as there are differing APRs for different loan products, and differing opinions on how to calculate the different APRs, and what fees or costs should be included in those calculations.

I will, to the best of my ability, explain how to calculate APR as it relates to mortgages. Please keep in mind the calculation below is a "rough-and-dirty" method, and is only related to mortgage products. It is not the correct way to calculate APR for other financial products.

The APR format

Like note rates, APR is expressed as a percentage. Note rates are generally expressed in one-eighth percentage increments, i.e., 3.5%, 3.625%, 3.75% and so on. Since APR is an expression of the fees or costs associated with obtaining the loan, it does not follow the one-eighth percentage increment format.

For example, a borrower may obtain a mortgage with a note rate of 3.75%, but have an APR of 4.871%. As you can see the format is different, and in most cases, the APR is higher than the note rate.

What APR includes

Since APR is an expression of the costliness of a loan, we have to figure out what costs are taken into consideration when calculating APR. In general, all of the one-time charges associated with obtaining or processing the loan will go into calculating the APR. These are all true costs or closing costs, rather than items you pay in advance on your own behalf *(like prepaid items)*. These items include, but may not be limited to the following:

- **Discount or Buy-down Points**
- **Loan Origination Fee - If Applicable**
- **Lender Underwriting Fees**
- **Credit Report Fees**
- **Appraisal Fee** *(If paid at closing, as opposed to paid before closing)*
- **Property Re-inspect Fee - If Applicable**
- **Attorney's Fees - If Applicable**
- **Mobile Notary Fee - If Applicable**
- **Flood Determination Fee - If Applicable**
- **Tax Service Fees - If Applicable**
- **Escrow Fees**
- **County Recording Fees**
- **Up-Front Mortgage Insurance Premium - If Applicable**
- **VA Funding Fee - If Applicable**
- **Transfer or Excise Tax - If Applicable**
- **Pre-paid Interest or Daily Interest Charges**

Note: Depending on your particular loan situation, some of the above-mentioned fees may not apply.

The items that are not included in APR calculations are the following:

- **Pre-paid Property Taxes**
- **Pre-paid Hazard Insurance**
- **Pre-paid HOA Dues**
- **Title insurance** *(While title insurance is an actual or true cost associated with doing a loan, insurance is not considered an APR item and is therefore not included.)*

How is APR calculated?

First you need to know the total loan amount, the note rate, the term of the loan, the total fees for the loan, and the monthly payment.

Let's assume you're borrowing $200,000, have been quoted an interest rate of 6.0% for a 30-year fixed loan, the fees are an even $2,000.00, and the monthly payment on the loan is $1,199.10. *(These figures have been simplified and may not represent reality.)*

The easiest way to calculate APR is to use an APR calculator, or a spreadsheet program with a built-in **RATE** function. If you are a super geek, you may want to learn how to calculate APR by hand, but that is beyond the scope of this article.

Using the following figures from above, plug these numbers into the **RATE** function of your spreadsheet.

A	**360**	**Number of months for the term of the loan**
B	**1,199.10**	**Monthly payment**
Please note: This figure must be a negative number for the calculations to work correctly		
C	**198,000**	**Loan amount less all the applicable APR fees**

The **RATE** function should wind up looking like the following:

= **RATE** *(360, -1,199.10, 198,000)*

In every case, the **RATE** function format will be as follows:

= **RATE** *(total number of months you pay on the loan, your monthly payment expressed as a negative, the current loan amount minus the closing costs)*

In the case of our example above, it should render 0.0507831756. Multiply that number by 12 to get the annual rate of 0.609398, then take that figure and multiply it by 100 to get the APR, or 6.094%.

So a 30-year fixed loan of $200,000 with a note rate of 6.0% and closing costs of $2,000 will have an APR of 6.094%.

If the fees were to double from $2,000 to $4,000, the APR would rise to 6.189%. Notice that this is double of 0.094%. ***That means the APR will rise and fall proportionally with the fees associated with processing your loan.***

Where in my loan application will I find my APR?

You will find the estimated APR on the **third page** of a document called **"the Loan Estimate,"** under a section named **"comparisons,"** along with other key figures *(like how much of your payment is going towards interest vs principle, and a figure called TIP, or Total Interest Percentage).*

Are there certain types of loans that have higher APRs than other types of loans?

Yes, generally FHA loans have higher APRs than conventional loans because FHA loans have a portion of the mortgage insurance included in the loan amount. Since this upfront mortgage insurance is financed, this is a cost and it will skew the APR higher than a comparable conventional loan.

So, what does all of this mean to me?

There has always been confusion about how to compare two loan offers based on APR. The assumption is that one can simply compare two APR rates and quickly figure out which offer is the best, or the least expensive. This can be the case when the loan is a refinance, but this type of comparison is almost impossible to do on a purchase transaction before a home is identified, as the fees for the transaction cannot be fully known before a home is found.

Often lenders will leave out fees that are unknown at the time of the rate quote, rendering an incomplete and incorrect APR.

**I always recommend that borrowers obtain something called an "itemized fee sheet," which lists each potential fee that would go into the transaction, and compares offers based upon the actual estimated fees, rather than just comparing APR rates. This way, each fee can be compared side by side on each offer.
It is easier to compare fees line by line than when they are expressed as a rate.**

About **Mike** the Money Man

Here's all what you need to know about the mortgage industry today: One large lender is promoting a tool that doesn't require you to interact with a human to make one of the biggest financial decisions of your life.

I believe you deserve better. And I've spent nearly 20 years providing my clients with the guidance they need so they don't just get a loan - they get the right loan.

You see, the mortgage process isn't quite as simple as the ads make it seem. It takes knowledge and experience to navigate, particularly in a competitive real-estate market, where the right combination of speed and expertise can make the difference between a successful offer and losing out on your dream home.

My clients, many of whom are first-time homebuyers or have run into resistance from other lenders, always know where they stand in that complex process. That's because I take the time to explain their options, so they can make an informed, confident decision. And most of them, like the clients below, would even say that I'm an advisor and advocate first, and a mortgage professional second.

I 'm still in contact continue to be a resource with a number for many of those my past clients, often years after they purchased or refinanced their homes. They come to me because they know I provide a level of personal service uncommon in this industry. They come to me because they know I care. And they come to me because they know I have the willingness, and the knowledge, to help.

I'd love to help you - whether you're buying, refinancing or just weighing your options. Email me or give me a call today.

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