



APR Can Cost You

By Barry Habib

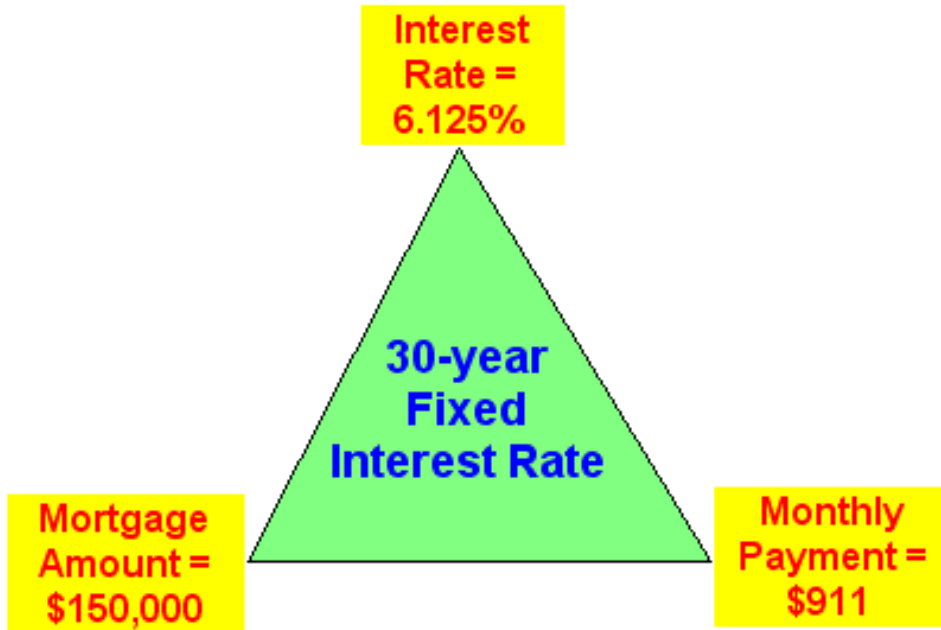
Contributing Editor to CNBC.com

A borrower who is shopping for the best mortgage rate can easily be seduced by low rate offers that are accompanied by low Annual Percentage Rates (APR). Federal Law requires that APR be disclosed along side the actual interest rate...this is in order to help borrowers make a more informed decision on their mortgage. The truth is that APR is a very poor way to comparison shop for a mortgage and can cause borrowers to make costly wrong decisions.

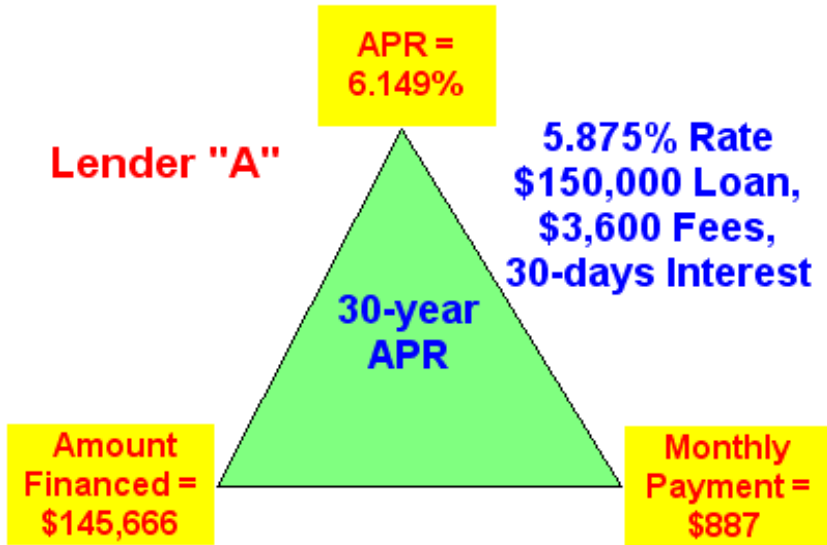
APR was created in order to provide a way for borrowers to account for costs associated with the mortgage. This sounds good because it may not be very easy to choose between a loan with a lower rate and higher fees or a loan at a higher rate and low fees. The problem is that the APR calculation makes some very bad assumptions. First, APR assumes zero inflation and that the value or buying power of a Dollar today will be exactly equal to the value of a Dollar 10, 20 even 30 years from now. Next, the APR calculation assumes that the mortgage will never be prepaid or paid off. That means no refinancing or selling the home...highly unlikely since the average life of a home mortgage loan is less than four years. Just think, about your own clients. Is it not rare to see the same loan in place for even 5-years...forget 30-years. The APR calculation does not consider the value of the money used for fees. So if you spent thousands of dollars in points or fees to get a lower rate, the APR calculation does not give any value to the money if it were not spent on closing costs. Finally, APR does not take tax consequences into consideration. This can be significant since higher fees on the mortgage may not be deductible while the higher interest rate typically is deductible. Moreover, APR can be manipulated, making it totally worthless.

So how does APR work anyway? I like to explain it to my clients by using triangles. I often draw two sets of triangle for my clients to

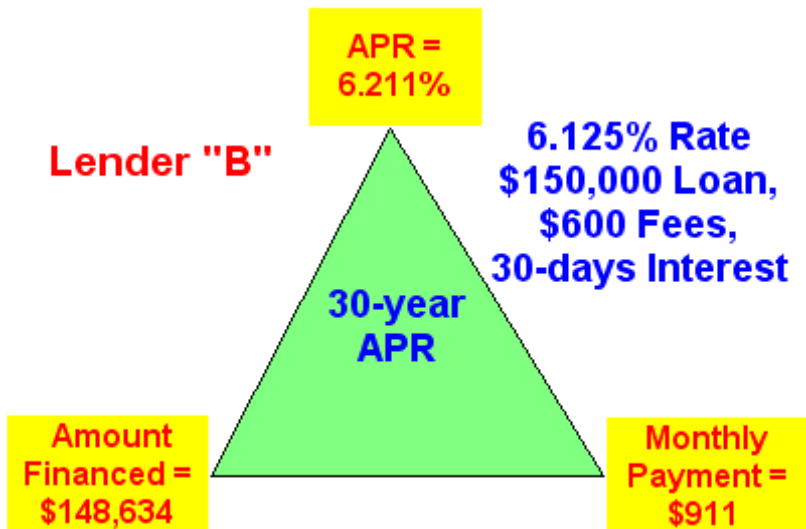
illustrate the difference between Interest Rate and APR. The reason for the triangle is because there are 3 sources of input...“Interest Rate”, “Mortgage Amount” and “Monthly Payment”. If you know any two of the three, you can calculate the third. See the triangle below.



Since any two of the three variables allows you to calculate the third, a \$616 monthly payment for a \$150,000 mortgage calculates to an interest rate of 6.125%. But the APR calculation uses different information. The APR calculation only keeps the “Monthly Payment” information the same. Instead of the “Mortgage Amount”, APR uses “Amount Financed”. This is the “Amount Financed” information on the Truth in Lending statement. Amount Financed takes into consideration the fees that are lender imposed. This includes application fees, points, commitment fees...*and interim or per diem interest*. So, Amount Financed is the mortgage amount less any lender fees, points and interim interest. The more fees, the lower the Amount Financed. The monthly payment is then calculated as a product of the Amount Financed to give you the “Annual Percentage Rate” or “APR”. So the lower the “Amount Financed”, the higher the “APR” is. Amount Financed can be manipulated by assuming a closing on the last day instead of the first day of the month. That would increase the Amount Financed and decrease the APR.



Here is a real example on a \$150,000 fixed rate 30-year mortgage with zero points: Lender "A" (triangle above) is offering a great low rate of 5.875% and lender "B" (triangle below) is offering a higher rate of 6.125%.



A closer look shows that Lender "A" is charging \$3,000 more in fees than Lender "B". How do you compare? If you look at APR, Lender "A" (5.875% with \$3,000 higher fees) has an APR of 6.149%. Lender "B" (6.125% but a \$3,000 savings in fees) has an APR of 6.211%. So according to the APR, Lender A is a better deal even though the fees

are \$3,000 higher...this is exactly what these high fee lenders are hoping you look at.

Let's look at the real story. The payment difference between the two is \$24 per month. So is it worth paying \$3,000 in fees to Lender A in order to save \$24 per month? Hardly. It will take 10.5 years for a borrower to just to get back their investment! A bad choice when you consider that mortgage loans typically are retired within four years. To make the decision to go with Lender "A" even worse, if that's possible, borrowers rarely take the value of today's dollars into account. Rather than giving Lender "A" the windfall of your hard earned \$3,000, you should give it to yourself. Reduce the loan balance on your mortgage by the fees you are saving. In the example above that would reduce the loan from \$150,000 to \$147,000. This makes the payment difference just \$6 per month instead of \$24 per month! The true time to break even is really 500 months (more than 40-years!). So it is impossible to benefit from the higher fee program from Lender "A" because the maximum period on the loan is 30 years or 360 months. One more thing...when you calculate your tax deduction on the payment difference, it makes even more sense to avoid paying higher non deductible fees. The obvious correct choice is to go with Lender "B" even though the APR is lower with Lender "A".

Bottom line...your clients should forget APR and think twice about those advertised low rates when they are accompanied by higher fees. Use the above illustrations to drive your point home.