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APR v. Interest Rate – The Difference Explained

When you think about getting the best mortgage home loan, you probably think about getting a nice, low interest rate. While a low interest rate is important for a good deal, you should also realize that there are other fees that going into a mortgage loan which may make it more expensive than the interest rate would imply. In order to help consumers figure out the actual cost of the home loan, lenders can calculate the APR or annual percentage rate of the mortgage. In fact, they are required by law to post this helpful number next to the base interest rate of the loan.

As mentioned the interest rate on your home loan is the fee the lender charges you for being able to borrow money for a certain period of time. For example, if you have good credit, on a 30-year fixed rate mortgage loan for $200,000, you might get an interest rate of 6.5 percent. That means that over the course of the thirty years, you will repay the bank the principal $200,000 as well as $ 255,090.40 in interest charges. As much as that amount is there are still other mortgage charges and fees that make the loan even more costly.

That is where the APR comes in. The annual percentage rate is designed to take into account the total cost of the loan by figuring in not only the base interest rate, but also the closing costs, points, and other fees.

For example, you might have to pay a certain number of points in order to obtain your mortgage loan. One point is equal to one percent of the loan value. Generally you pay points to the lender in order to lower the interest rate on your mortgage. A lower interest rate means the lender will make money in the long run on the loan, so he will charge you the point fee upfront to help make up for the profit loss. If you had to pay one point on a $200,000 loan, you would be paying $2,000. With the APR, that amount would be added into the base interest rate to have the rate more accurately reflect the cost of the loan.

The other main fees added into the APR are the loan closing costs. These include things like the application fee and private mortgage insurance. Any service the lender provides during the processing of the loan is included in the APR. Closing costs can total anywhere from a few hundred to a few thousand dollars depending on the location and price of your home.

So consider the previous example in terms of the APR. The interest rate you received on a $200,000 is 6.5 percent. Yet, let’s say you are also required to pay $4,000 in points and closing costs. That increases the total cost of the loan, making the APR or real interest rate higher at around 6.7 percent.

Understanding the difference between the interest rate and the APR will help you be a more effective mortgage shopper. Using the APR to compare loans will ensure that you are comparing apples to apples, making it possible to see which loan is actually the cheapest.