

MORTGAGE LENDING UPDATE

By David Griffin

Past President of Mortgage Bankers Association of Middle Georgia

The Mysterious APR

Why is it that when a mortgage lender quotes a particular interest rate, say 4.25%, they also give you (within 3 days of a formal application) a form entitled "Truth In Lending" that shows the Annual Percentage Rate (APR) at a higher percentage amount, say 4.569%? What is that? A bait and switch?

The answer is no. Congress (Flip Wilson would say the devil.) made them do it. Congress, in its admitted, infinite wisdom, decided that consumers needed to be provided a single number they, the consumer, could use to differentiate between competing offers of credit from alternate lenders. That variable is the APR and the lower the APR, the better the deal.

Said in another way, the APR is a totally artificial number. It is not the note rate on the loan and does not determine your monthly payment. It is calculated according to a formula determined by Congress and is supposed to provide a method for comparing one mortgage offer against another, even when the rates, points, and costs differ. The APR is supposed to help a consumer determine the "true cost" of borrowing.

But, why is the amount of the APR provided to consumers on the Truth In Lending form always higher than the promised or quoted note rate? The reason is that there are usually fees (defined as prepaid finance charges) required by the lender to close the loan. The APR takes these lender fees into consideration as a part of the overall cost of the loan. Some lenders charge more than others. Their APR's will be higher for the same quoted interest rate. If a particular lender doesn't charge any fees at all for their loans, then their APR's would exactly match their quoted interest rates.

But, how is the APR calculated? Is it just some standard amount above the stated rate of interest? No, sir, the APR will be nearer the stated interest rate on a loan with fewer fees and farther above the stated interest rate on a loan with higher fees. The difference will depend upon the differing amounts of required charges.

Right, but how is the APR calculated? I'm glad you asked this geek that question. There is an orderly relationship between the four variables contained in any loan. The four variables are: a.) number of payments, b.) amount of periodic repayment, c.) interest rate charged and d.) original loan amount. If you know any three of these variables, you can find the missing fourth variable using a financial calculator.

(Note: You will not be able to work this out on a standard 4 function –add-subtract-multiply-divide– calculator. You will need to have a "financial" calculator programmed for time value of money functions. Wal-Mart sells entry level financial calculators beginning around \$30. I'm partial to the Texas Instruments brand, but Hewlett Packard is the dominant name in financial circles and is similarly priced. Most lenders' websites also have financial calculators built into them that you can use for free.)

Let's consider a loan amount of \$100, at an interest rate of 0% for a term of ten months. You guessed it. The monthly payment is \$10 because there is no interest charged. Now let's say the interest rate is 10% on this ten month, \$100 loan. The monthly payment turns out to be \$10.46 per month. The 46 cents is the interest you pay each month over the 10 month loan term, which works out to be \$4.60 total in interest.

Now here's the part concerning APR. Let's say that on the above example, the person making the above \$100 loan charges the recipient of the loan a 1.0% "loan fee". That's one dollar. If I make you a loan for \$100, but charge you a \$1 fee for my efforts, you don't get the use of the entire \$100 loan amount. You only receive a net loan amount of \$99, but you're still required to make the \$10.46 monthly payment.

Now, let's calculate the APR (or your "true cost of credit") on the above example, taking into consideration the 1% loan fee and your net loan proceeds of \$99. (We know three variables and we're searching for the fourth.) We plug into our financial calculator a term of 10 months, a required monthly payment of \$10.46 and the net loan amount of \$99. (Not \$100 because I skimmed a \$1.00 fee off the top, right?) We now ask the financial calculator to solve for interest rate, or in this case, the annualized percentage rate or APR. The APR in this example turns out to be 12.158%, not 10%, all because of that one dollar fee.

David Griffin has been financing homes in Macon, Warner Robins and all of Middle Georgia since 1983 and is a member of the Mortgage Bankers Association of Georgia, mbag.org. For an archive of past articles visit mbag.org/ML_Update.htm.(10/5/10)