Capital One Home Loans, January 13, 2017

What Is the Difference Between Interest Rates and APR?

You're ready to find the best home loan. All you need to do is compare interest rates, right? Well, not really. There's another number to look at: the annual percentage rate, or APR.

But what exactly is the APR? It's related to the interest rate, which is the percentage of interest on your loan amount. If your interest rate is 5%, you'll pay back the amount of the loan plus 5% of that loan. But lenders rarely lend you money with only interest tacked on. They also add fees, points, mortgage insurance and other charges. These other costs, along with the interest rate, are what make up the APR. While the interest rate is the cost of borrowing money, the APR is the cost of processing the loan.

Why does it matter?

You need to look at both the interest rate and the APR to see if a loan is a good value. Say you have a choice between two loans. One has a low interest rate and a high APR, and the other has a low interest rate and a low APR. In most cases, the second loan is a better bet. You'll pay less over the life of the loan with a lower APR.

Nobody likes math, but a little arithmetic helps explain this better. Let's say you borrow $200,000 with an interest rate of 6%, giving you a monthly payment of $1,200. The fees and closing costs come to $5,000, and rather than have you pay that upfront, the lender adds that to the original loan amount. Now you're borrowing $205,000 at a 6% interest rate, giving you a monthly payment of $1,230. To reflect the extra they've added to the loan, lenders use the APR. Your interest rate is still 6%, but the APR is 6.15% because of the additional $5,000 on your loan.

Comparing loans using APR

Be careful when comparing loans: you have to compare the interest rate on loan A to the interest rate on loan B, and same with the APR. And when evaluating, keep in mind that APR refers to the entire life of the loan. That’s 30 years for most conventional loans. Most homebuyers sell or refinance long before that, usually around 7 years. If you don’t keep the loan for 30 years, the actual amount you’ll pay will be higher than the APR advertised.

To understand why, you need a handle on compounding interest, which is a lot of – you guessed it – math. Don’t slog through the numbers yourself. “The best tip we can provide is to work with a lender you trust to build a spreadsheet and compare exact parts of each loan,” says Sacha Ferrandi, Founder of Source Capital Funding, Inc., a real estate finance firm in California, Arizona and Minnesota. “Another great idea is to bring other quotes to a lender and ask them, ‘How is your loan better?’ and let them explain the advantages.”

Ferrandi also warns against using APRs when evaluating adjustable rate mortgages (ARMs). The interest rates on ARMs go up and down, so looking at APR, which includes the interest rate, on an ARM isn’t very helpful. Again, if you’re thinking about an ARM, ask your lender to show you how each part of the loan compares to other products.

It might be easier to only focus on interest rates when shopping for home loans, but doing so can cost you thousands of dollars. So take a deep breath and ask your lender to explain the APRs on your various loan options. A little investment in time and effort can make a real difference in how much you pay for your home.

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Meta Description

This article explains the difference between interest rates and APR, why it matters, and how to use each when finding the best mortgage loan.

Headline

What Is the Difference Between Interest Rates and APR?

Subheadline

Understanding the basics of APR helps you spend less on your mortgage loan.

Summary

When shopping for mortgage loans, many borrowers only look at interest rates. But the APR is just as important, and consumers need to know the difference between the two if they want to get the right mortgage loan for them.