

## The Fallacy of APR (Annual Percentage Rate)

The term “annual percentage rate” as it is used in the United States is a term defined in the federal Truth in Lending Act (TILA), as clarified in Regulation Z. The term was created to be used in disclosures by lenders to consumers for transactions that are regulated by the TILA. The term, also known by the moniker “APR” is the effective interest rate on a loan after taking into account the “finance charges” (upfront costs) associated with the extension of credit.

### Here's what's good about APR

Consider the following example.

Lender A lends you \$10,000 at a face rate of 10% for 60 months (5 years paid monthly) and doesn't charge you anything up front for that loan. Lender B lends you \$10,000 for 60 months at a face rate of 9% but requires you pay an origination fee of \$500 upfront to obtain that rate. So which is the better deal? Unless you're a mathematician the answer is not so obvious.

And, that's why APR was created. In our example the APR is for the loan at 10% with no upfront fees is 10% (since there are no finance charges to increase the effective interest rate). The APR on the 9% loan is actually 11.17%.

The manner in which APR is computed is actually makes a great deal of since. Here's how it works. On the 9% loan with the \$10,000 loan amount the actual amount funded was only \$9,500 (the \$10,000 face amount of the loan less the \$500 we deducted as an upfront fee.). This net amount funded is referred to in the TILA as the “amount financed”. APR is then computed by determining what interest rate would create the identical payment if the loan amount were \$9,500 instead of \$10,000. If you have a financial calculator handy you will discover that the answer is 11.17%.

Thus, the concept of requiring lenders to disclose the APR would not be bad were it not for a few other fatal defects built into the system.

### Here's what's bad about APR

The defects are especially evident when utilized in the context of mortgage loans. For some unknown reason Congress saw fit to exclude certain fees paid in connection with a mortgage loan from the definition of annual percentage rate. Most notably these are appraisal fees, credit report fees, and application fees charged to all applicants.

The following example illustrates the problem.

Lender A is willing to lend you \$50,000 at 6% on a 30 year mortgage. Lender A is willing to forego the cost of an appraisal and credit report and does not charge an application fee. The only fee charged by Lender A is a \$50 processing fee that is only charged in the event your loan application is approved.

Lender B, on the other hand, is willing to make the same loan at the same interest rate but charges an application fee of \$200, requires an appraisal for \$300, and a credit report fee of \$50. Thus, the total upfront cost of financing with Lender B is \$550.

But because each of the fees charged by Lender B is excluded from the definition of finance charges they are not considered when computing APR. It doesn't take a Rhodes Scholar to see that Lender A has the better deal. But utilizing the government disclosure plan the APR on would be higher on Lender A's loan than on Lender's B's loan, even though Lender B is charging \$500 more in upfront costs.

Of even more concern is that the definition of finance charge in the TILA and Regulation Z has a variety of gray areas. Thus, one lender may include a certain charge in computing APR while another lender does not.

And to make matters even worse, unscrupulous lenders will purposely omit items from their computation of APR because they are perfectly aware that the federal agency charged with enforcing violations rarely does so and when they do it is only against huge national banks or lenders.

Annual percentage rate, when used in advertising, can be manipulated by lenders in other ways. Its computation is dependent on loan amount where fixed fees (those not determined as a percentage of the loan amount) are included in the finance charges used to compute APR. Thus, if one lender is basing its computation of APR on a hypothetical loan amount of \$100,000 and another is basing the computation on a hypothetical loan amount of \$500,000 the APR will be less on the larger loan amount even though both lenders charge exactly \$1,000 in prepaid costs.

The bottom line is that APR is at best a poor method of comparing competing loan quotes. There are far superior ways of comparing competing quotes from mortgage lenders. For more on how to successfully compare mortgage loans and lenders take a few minutes to read [How to Shop for a Mortgage Loan and Lender](#).