

The APR : Why it is important

If you are purchasing or refinancing your home, then there is a good chance that your mortgage transaction will be subject to the federal Truth in Lending Act. The Truth in Lending Act requires that the consumer be given adequate disclosures so that they can compare options and make an informed credit decision. To a great extent, this is correct and can be expressed in three simple letters: APR.

The APR is the Annual Percentage Rate and its disclosure is absolutely required - and for good reason. The APR as presented at the loan closing, is a snapshot of the cost of the loan as it looks right now, on an annual basis, after taking into account any finance charges (including points, some application fees and other origination costs) incurred over the full contractual term of the loan. The APR shown in advertisements generally is good indication of the cost of the loan, but **only** if it includes anticipated finance charges, and not just the "points" and prepaid interest. If your broker or lender gives you the rate but cannot or will not give you the APR – Beware!

Here's an example of how it works: Let's say that you saw an advertisement for a mortgage loan from two different sources

Loan #1 in the amount of \$250,000 has a **fixed interest rate of 5.25% for 30 years** with **one and one-half "points."** The loan has an advertised **APR of 5.44%**. Its monthly payments for the next 360 months are \$1,380.51.

Loan #2 in the amount of \$250,000 has a **fixed interest rate of 5.25% for 30 years** and has an advertised **APR of 5.47%**. Its monthly payments for the next 360 months are also \$1,380.51. This lender charges **three quarters of a "point"** to originate this loan.

The initial reaction from a consumer may be something like this:

"Sign me up for loan #2 – it has the same rate and this lender is only charging me three quarters of a point! I am paying much less for this origination, and I am one smart shopper!"

Maybe not. The APR is a reflection of the contractual payment stream (in this case, they are both the same – 360 payments at \$1,380.51 per month) compared to the amount of the loan (both \$250,000) LESS any prepaid finance charges you pay to the lender or broker to originate the loan.

Prepaid finance charges include but may not be limited to:

- Interest from disbursement to the end of the month.
- Origination points
- Origination service charges.
- Rate lock fees (common if the loan is sold on the secondary market).
- Mortgage insurance if required for a loan with a minimal down-payment.
- Any other charge passed on to the consumer which is over and above the cost of the services to the lender. For example, if closing costs are disclosed as \$900, but the lender is only charged \$500 by a title company for these services, then the extra \$400 charged the consumer is a finance charge and must be reflected in the APR. The same logic applies to appraisal fees, credit fees or other items which are passed on to the consumer.

Prepaid finance charges are separate from other closing costs which the borrower may be charged such as county or state recording fees, property taxes, hazard or insurance premiums, or other required underwriting or origination charges which are passed on to the borrower on a direct cost basis.

Let's look again at the two loans and see what prepaid charges may have been assessed in the examples:

	Loan #1	Loan #2
Amount of Loan	\$250,000	\$250,000
Less prepaid finance charges of:		
Service charge, or "points"	(3,750.00)	(1,875.00)
Interest from disbursement to end of month	(1,093.75)	(1,093.75)
Loan processing charges	(1,000.00)	(1,500.00)
Rate lock fee	(500.00)	(500.00)
Document preparation fee	0	(150.00)
Closing and title cost charged consumer in excess of lender's or broker's cost	0	(950.00)
Application and other fees charged consumer in excess of cost of the services to lender or broker	0	(1,025.00)
Total prepaid finance charges	\$6,343.75	\$7,093.75
Balance after subtracting finance charges	\$243,656.25	\$242,906.25
When the balance is discounted against the full 360 payments of \$1,380.51 each, the corresponding APRs are:	5.44%	5.47%

Based on the information available, in this instance loan #1 is the better deal. Paying "points" may also have more favorable tax implications than paying fees and charges – check with your tax advisor for more information.

The APR is only one measure of comparing loans between competing lenders and generally is best used when comparing two loans with equal repayment periods and terms (fixed rate vs. variable rate). Your final interest rate and corresponding APR is also dependent on qualifying for the loan for which you have applied and generally can only be guaranteed after all of the underwriting has been completed.

A mortgage loan can be a long term commitment – up to 30 years! Make sure that you have all of the facts about your loan BEFORE you sign the application or pay any fees.

Call us at 773-561-7051 for our current rates or if you have questions about the financing process. We pride ourselves on the relationships that we have built with our customers for the past 75 years.

The information used here is for example purposes only and does not constitute an offer or commitment for financing.

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