

the Mortgage Bulletin

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The APR can be unreliable

Some well-intentioned consumers use a quoted or advertised APR figure in order to make an accurate comparison of rates. Most loan agents would say that relying on an APR is not the best way to make this comparison.

This is because virtually every loan agent and direct lender uses slightly different figures to compute the APR. And the formula for ARM loans simply does not reflect reality. Ask twenty loan agents to compute the APR the same loan and you'll not likely get two matching figures.

And this is not necessarily because any of those surveyed is trying to mislead.

Here's the APR formula. Take a 30 year fixed \$650,000 loan at 6%, with \$2,500 in NON-RECURRING closing costs. The monthly payment is \$3,897.08. Next, deduct \$2,500 giving a net loan of \$647,500. Next, use the same monthly payment and solve for the interest rate. The APR is thus 6.036%.

That's simple. But some lenders include portions of NON-RECURRING closing costs for such things as prepaid interest from close for the balance of the month, or one year's insurance premium.

If the insurance costs \$1,000 and 15 days prepaid interest is \$1602.74, the total costs are \$5,102.74, the net loan is \$644,987.26 and the APR becomes 6.072%.

Or a closing date might result in 25 days (\$2,672.23) prepaid interest, a net loan of \$643,827.77 and an APR of. Use the same formula and the APR becomes 6.089%.

Or maybe the insurance premium is \$1,500 instead of \$1,000. You get still another APR figure. Or maybe advance interest is used, but not the cost of the insurance premium.

The rules are not clear on exactly which of these costs are to be used. Further, many lenders use broad averages for estimated costs.

Rather than rely on the APR for a fixed rate loan, you need to know only two things:

what is the rate, and what are the NON-RECURRING costs? Which brings up another question: "Are the NON-RECURRING costs guaranteed?"

If you carefully read the preceding discussion and study the figures, you will readily understand that the APR figure for a fixed rate loan can differ significantly. So why rely on it?

As for adjustable rate loans, the situation is even more complex and the APR figure becomes meaningless. Here's why.

Without going into the minute details of the formula, suffice it to say that the same basic process, with all the variables mentioned is employed. Except –

Except that the initial monthly payment is used for the time it will be fixed – three, five, seven, or ten years. Then the remaining monthly payments, for twenty-seven, twenty-five, twenty-three, or twenty years fixed AT THE FULLY INDEXED RATE.

All the payments are added together and the total divided by 360 (a thirty year loan) and that is the payment used to calculate the APR in the same fashion as described for a fixed rate loan.

This CANNOT BE ACCURATE because the note calls for the rate to change after the initial fixed period and then at the end of each subsequent year by adding the margin to the index, limited by the lifetime and annual caps.

What would be the odds of the underlying index being exactly the same at the end of each year for all those years?

Knowing all of this, how wise is it to use an APR to decide on who has the best priced loan? Not very.

Next time somebody tells you they are going to make a decision based on the quoted APR, tell them to contact us. We'll do our best to dissuade them because it can be unreliable



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