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APR VS. INTEREST RATE: WHAT'S THE DIFFERENCE?

Knowing how the interest rate and the APR are different can help you comparison shop for a mortgage.

By: Coryanne Hicks - July 16, 2021

Homebuyers often seek the lowest mortgage interest rate, but another number – the annual percentage rate, or APR – is just as important when deciding how much house you can afford. The interest rate and the APR are not the same thing, although both relate to the cost of borrowing money.

The interest rate is the annual cost of borrowing the principal loan amount, expressed as a percentage, and does not include all fees you'll pay for the loan. On the other hand, the APR is the annual cost of the loan, including fees, and reflects the true cost of borrowing. This is why the APR is often higher than the interest rate.

What Is an Interest Rate?

An interest rate is the percentage of principal paid to a lender to borrow money. The interest rate can be fixed for the entirety of the loan or variable and change as prevailing rates change.

"An interest rate is regularly determined by factors such as market and economic trends, as well as the federal lending rate," says Ryan Cicchelli, founder of Generations Insurance & Financial Services in Cadillac, Michigan.

Your credit score and overall financial health influence how much interest you pay but so does timing. You'll want to get a loan when interest rates are low, but borrowers who can't wait for favorable conditions may have to pay higher rates, Cicchelli says.

Compound interest also factors into how much you end up paying overall, says Brian Martucci, personal finance expert for the Money Crashers website.

Compounding happens when interest is added to the principal amount, and then a new interest rate applies to a larger principal. "The more frequent the compounding, the greater the total interest charge," he says.

Your loan payments will go partially toward principal and partially toward interest.

"As borrowers pay down their loan's principal, the portion of their payments going toward interest will gradually decrease as the portion paying the principal gradually increases," Cicchelli says. "It takes a lot of time in most cases, but this is how people can earn home equity and turn their homesteads into true assets."

What Is an APR?

An APR is the total yearly cost of borrowing and includes not only the interest rate but also other charges. This means the APR is almost always higher than the interest rate.

"APR tries to take into account the fact that there are usually certain costs associated with getting a loan," says Andrew Weinberg, principal of Silver Fin Capital Group. "The types of costs that do go into the APR calculation are the costs that you would not have incurred if you bought a property for cash."

You could pay for:

- Discount points.
- Origination fees.
- Broker fees.
- Mortgage insurance premiums.
- Closing costs.
- Underwriting fees.

APR can get complicated because the costs included in it vary by lender, Weinberg says. Closing costs are one example.

Adds Cicchelli: "Lenders essentially decide how much they want to charge beyond the interest rate of loans, and that information gives borrowers a clearer picture of the true cost of their loans."

A lender could offer a low interest rate, for instance, but offset that with fees, resulting in a high overall cost for borrowers, says Jeffrey C. Taylor, co-founder and managing director of Mphasis Digital Risk, a technology and risk firm that consults with mortgage lenders. Make sure you look at the interest rate and the APR to make an informed decision.

"The closer the APR is to the advertised interest rate, the lower the lender's fees," he says.

Can You Use the APR to Compare Mortgage Offers?

The interest rate and the APR can be helpful when shopping for a loan, but the APR is a broader and more useful measure of costs.

"If two lenders offer the same interest rates but wildly different APRs, borrowers can use this information to help them shop around," Cicchelli says. "It is very possible the lender with the higher interest rate still has a lower total cost over time."

Let's assume Lender A charges 4% interest with no points and Lender B charges 3.875% interest with one discount point, which typically costs 1% of the loan amount. In this case, Lender A could be a better deal, even though the interest rate is higher.

One caveat: If you aren't planning to stay in your home for more than seven years, then the interest rate could be a better comparison tool than the APR, Taylor says. The APR calculation assumes you keep the loan for the entire term, and the break-even point for paying back points and other fees is usually five to seven years, he says.

You can find the interest rate and the APR in the loan estimate, a government document that's standardized across lenders. The interest rate should be on the first page and the APR on the third page.

Is It Better to Have a Lower Interest Rate or Lower APR?

The answer to this question depends on what is more important to you: the lowest possible monthly mortgage payment or the lowest possible total loan cost.

Focus on the interest rate if the monthly payment is your priority and the APR if the overall loan cost is your concern.

"Lower interest rates mean lower monthly payments," Cicchelli says. "But that could easily translate to a higher overall loan cost."

If you plan to live in your home for 30 years, a low interest rate might be the most important factor. You might be willing to pay points that will lower your interest rate but increase your APR.

Conversely, if you intend to flip your home in a few years, then going with the lower APR could make the purchase more profitable for you, Cicchelli says.