APR vs. interest rate for mortgages: Which matters more?

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APR and interest rate are both important numbers when choosing a mortgage loan. But which matters more?

Some experts say APR is most important because it includes your interest rate *and* your loan fees. It's the 'real' cost of a mortgage.

But APR is often too broad to be a good comparison tool.

Today's mortgage shoppers have a lot of flexibility to choose their interest rates and upfront fees. So you should choose the combination of short- and long-term costs that makes sense for you — rather than looking for the lowest APR or interest rate alone.

What is APR?

A loan's annual percentage rate (APR) measures the total cost of borrowing money. APR is designed to represent the long-term cost of a loan, from closing day to the date it's paid off.

Rather than looking at interest rate alone, the APR on a mortgage includes lender charges and fees like:

- Mortgage insurance
- Discount points
- Mortgage origination fees
- Other closing costs

Mortgage lenders are mandated by the **Truth-in-Lending Act (TILA)** to disclose a home loan's APR as well as the interest rate each time they provide a loan offer.

APR can be found on the **Loan Estimate** you'll get from any lender after being pre-approved. It is provided to enable borrowers to make a more informed decision when it comes to loan choices.

How is APR calculated?

APR is calculated by finding the total cost of a mortgage loan's upfront fees, then spreading them over the life of the loan to estimate the yearly cost. This is added to the interest rate to find the 'real' annual cost of financing.

This indicates the true amount you will pay on top of the balance of the mortgage. However, not all lending institutions include the same fees in their APR calculation.

By law, the APR must include interest, points, loan origination fee, broker fee, and mortgage insurance. There are also third-party fees that legally cannot be included, such as notary, home appraisal, and attorney costs. And there are other fees that some lenders include while others don't.

This means APR is not a perfect way to compare mortgage loans apples-to-apples. You must look at the interest rate and total upfront fees, too.

What's the difference between APR and interest rate?

A mortgage interest rate represents only the amount you'll pay your lender each year in interest. APR includes interest *as well as* loan fees; it measures the total amount you're paying above and beyond the loan's principal. That means APR will normally be higher than your interest rate.

The interest rate will indicate what you would expect to pay monthly for your mortgage. The APR, on the other hand, should give you a bigger picture of what the total mortgage loan cost is over the life of your loan.

When you ask for a rate quote from a lender, the most prominent number advertised is normally the interest rate. But APR must be included, too.

APR vs. interest rate for mortgage shopping

You might think APR is a better way to compare mortgage offers than interest rates alone. After all, wouldn't you want to know which loan has a lower cost *overall* — not just a lower mortgage rate?

Well, not necessarily. There are pros and cons to using either APR or interest rate to shop for a mortgage loan.

Benefits of comparing APR

Interest rate is typically the first number most home buyers look at. But it can be deceiving.

For example, the interest rate quoted for an **FHA mortgage** could appear enticingly low. Advertised rates for FHA loans are typically below rates for a comparable conventional loan.

But because an FHA loan requires annual mortgage insurance — which costs 0.85% of the loan amount each year — its APR will often be higher than a conventional loan.

APR is often a better tool for comparing multiple loan products: For instance, an FHA loan vs. a conventional loan.

Factors like your credit score and down payment also make a difference when it comes to loan fees and APR.

APR is often a better tool for comparing multiple loan products.

If you have a low interest rate loan but tons of fees, calculating APR costs can help you better understand how much you'll really be saving or spending.

APR is a more complete metric for comparing mortgages with different interest rates and total fees. It levels out the playing field, allowing you to see things from an apples-to-apples perspective.

Drawbacks of using APR to compare loans

For many borrowers, though, APR is not a realistic way to compare costs.

That's because the APR calculation makes a few big assumptions:

- APR assumes you'll keep your loan for its full term
- APR assumes you won't sell the home or refinance
- APR assumes you won't pay off the loan early

Most borrowers do not pay off their mortgage in full. It's typical to sell or refinance after only a few years. So, comparing loans based on their long-term cost might not make sense.

And APR doesn't account for different financial priorities.

For example, some borrowers choose to pay **discount points**. Points can add thousands to your upfront fees but significantly reduce your interest rate.

In this case, having lower mortgage payments or building equity is a priority. Hence, it might be wiser to put more stock in the interest rate number than the APR number.

On the flip side, some borrowers want or need to save money at closing.

They might accept a lender with a higher interest rate and APR if it's willing to cover part of their upfront costs.

In this scenario, having a higher interest rate loan with fewer upfront fees can be more affordable month-two-month.

Borrowers should consider how much liquid assets they have and what they are comfortable with paying at the get-go rather than simply pursuing a loan with the lowest APR.

When to use APR vs. interest rate

Be cautious not to overvalue the APR number. APR is most useful if you plan to keep the loan for its entire term.

If you are purchasing a home with plans to move or refinance within 5 to 10 years, it makes more sense to pay attention to interest rates so that you can keep your monthly payments lower.

Remember, too, that lenders don't include the same costs in their APR calculations.

That's why you should ask specifically what is included in your APR so that you can make an accurate assessment when comparing offers.

If you only plan to stay in the home for a few years, comparing the 5-year cost of each loan might be more helpful than APR.

The 5-year cost projection can be found on **page 3 of your Loan Estimate**, directly above the APR. It shows the real cost of your loan after 5 years, including loan principal, interest, and upfront costs.

This number will be more realistic for a short-term borrower than APR, which spreads loan costs over the full loan term — often 30 years.

Fixed- vs. adjustable-rate mortgage APRs

On a fixed-rate mortgage, the APR will almost always be higher than the interest rate. That's because your rate stays the same over the life of the loan — so adding fees on top of the fixed rate will naturally increase the APR.

But what about an adjustable-rate mortgage?

If you're comparing **ARM interest rates**, you may notice something odd: the APR can be *lower* than the interest rate.

This isn't because ARMs have low or no loan fees. Rather, it's because of the way lenders calculate APR on an adjustable-rate loan.

The annual percentage rate on an ARM is based on the index rate your loan is tied to. An index is simply a measurement of the economic conditions at the time, expressed in an interest rate.

But ARM APRs assume the index rate will stay the same over the life of the loan. Not likely.

For instance, say you take out a 5/1 ARM. Your initial interest rate is 3.5%, and your 'margin' is 2.25%. On the day your loan closes, the index rate that your loan's tied to is at 0.5%.

- Initial interest rate: 3.5%
- Index rate at closing: 0.5%
- Your loan's margin: 2.25%
- APR: 2.75%

This calculation can make ARMs look incredibly attractive during a low-rate period like the one we're currently in — especially if you're shopping based on APR.

But this calculation makes the assumption your interest rate will fall when the loan finally adjusts. If you take the ARM out when rates are at rock bottom, this is unlikely to happen. It's more likely your interest rate and monthly mortgage payment will increase.

So, don't be fooled by the ultra-low APR on an adjustable-rate mortgage. It's an estimate based on some big assumptions

And many borrowers sell or refinance before their ARM's fixed-rate period is up, in any case.

How to find the best mortgage deal

When thinking about APR vs. interest rate, remember it's not one or the other. You can (and should) look at both numbers.

When deciding which mortgage to opt for, consider both the interest rate and the APR. You can first use the interest rate as a tool to filter down your options. Then, once you shortlist the preferred interest rate offers, you can compare the APRs on those offers carefully to get the best possible deal.

Also, if you have a high credit score, use it to your advantage.

If you have great credit but are undecided between two lenders who have similar repayment terms — with one boasting a lower interest rate but higher APR and the other offering a lower APR but higher interest rate — try to negotiate terms with both.

Aim to get either the fees or interest rate reduced to match or beat the other offer.

When in doubt, and for best results, consult KeyFactor_MLO, a mortgage professional who can help you determine the best loan deals based on APR vs. interest rate.