

A good tool to compare loans across different lenders is the Annual Percentage Rate (APR). The Federal Truth in Lending law requires mortgage companies to disclose the APR when they advertise a rate. It is designed to represent the true cost of the loan to the borrower, expressed in the form of a yearly rate. The purpose is to prevent lenders from hiding fees and upfront costs behind low advertised interest rates.

However the APR is in fact a very confusing number. Even lenders admit it is confusing since it includes some, but not all, of the various fees and insurance premiums that accompany a mortgage. The rules for calculation of this number have not been clearly defined, so APRs vary from lender to lender and from loan to loan, depending on which types of fees and charges are included.

We do not recommend relying upon the APR as an indicator of a loan product's value. The APR calculation is based upon the assumption that you keep your loan for the entire period of the loan, say 30 years, which in reality may not be the true hold period for a borrower.

In addition, the APR model is flawed in that when a product is variable and tied to an index, the index is assumed to never change. This obviously is an invalid assumption that can lead again to a number, which in fact can not be compared, from one quoting source to another.

Finally, the APR won't tell you anything about balloon payments and prepayment penalties and how long your rate is locked for. So a loan with a lower APR is not necessarily a better loan. You can use APRs as a guideline to shop for loans but you should not depend solely on the APR in choosing which loan is best for your needs, it is important to look at other factors.