What is the Difference Between APR and Interest Rate?

When comparing long-term loans, the interest rate and the annual percentage rate (APR) are often confused. While the interest rate refers to the annual interest expense of the loan, the APR reflects the annual cost of borrowing money from the lender.

Clear as mud? Don’t worry; we can help. Let’s take a closer look at the difference between these two terms and how each one impacts your loan.

Interest rate defined

The interest rate, or the nominal rate, is the rate of interest the lender charges the borrower for the loan. For example, a $300,000 mortgage with a 4% interest rate would have an annual interest expense of $12,000, or $1,000 a month.

Interest rates are influenced by the federal funds rate, which is set by the Federal Reserve, otherwise known as “the Fed.” The federal funds rate is the interest rate at which banks lend each other money overnight.

During an economic recession, the Fed will lower the federal funds rate to encourage consumers to borrow and spend more money. During the coronavirus recession, for example, the Fed slashed the federal funds rate to just .25%.

In contrast, during times of economic growth, the Fed will raise the federal funds rate to encourage personal savings for balancing out the cash flow and stabilizing inflation.

APR defined

The APR on a loan is the approximate annual cost of borrowing money from a financial institution.

The APR includes the interest expense, along with all other fees and costs involved in taking out the loan. This can reflect closing costs, loan origination fees, mortgage insurance, broker fees and rebates. The APR is expressed as a percentage of the entire loan amount and will nearly always be greater than the interest rate.

On a $300,000 mortgage with closing costs, loan origination fees and mortgage insurance totaling $5,000, the loan amount would be adjusted to $305,000. The 4% interest rate will then be used to calculate a new annual interest expense of $12,200. To determine the APR on the loan, divide the annual payment of $12,200 by the original loan amount to get 4.06%. The borrower will now pay this percentage of their loan each month.

Which number is more important to consider when taking out a loan?

Here’s where the two terms can get confusing.

When comparing rates on two different loans, the loan with the lower nominal interest rate will generally offer the better value since the bulk of the loan amount is being financed at a lower rate. Usually, the loan with a lower nominal rate will also feature a lower APR.

While a loan with a lower APR is generally the better choice, it’s important for borrowers to consider the length of time they plan to stay in their home. Most home buyers will need to purchase discount points, also known as mortgage points, to qualify for loans with lower APRs. Each point costs 1% of the mortgage (or $1,000 for every $100,000) and will lower the interest rate by .25%. Discount points need to be purchased upfront. This means the borrower will need to pay thousands of dollars at closing to qualify for a lower-APR loan.

It can take more than five years for the borrower to break even on the extra costs they paid for the loan through their lower monthly payments. Consequently, for home buyers who plan to move within the next decade or sooner, it may make more sense to choose a loan with a higher APR and fewer upfront costs.

Taking out a home loan involves multiple decisions, which will affect your finances for years to come. It’s important to learn the difference between interest rates and APRs and to run the numbers to determine which loan offers you the better value before choosing a loan.

If you’re planning to take out a home loan in the near future, stop by Island Federal today to discuss your options. Our home loans feature low rates that can save you hundreds of dollars on your monthly payments.