A Simple Way to Compare Loans

In this Chapter you will learn:

- A more effective way to compare loan rates and fees than the lender's published APR.

Holly's Definition of "APR" (Annual Percentage Rate):

The rate you are paying for the money you borrow, taking into consideration all costs of borrowing (i.e. Note Rate, Fees, Adjustment periods and Adjustment Caps for Adjustable Rate Mortgages). APR was designed by regulators to help borrowers compare apples to apples when examining loan options by giving borrowers a rate that takes into account all important aspects of a loan, and the true cost of borrowing.

The Problem:

In the real world, when you compare APR quotes, you may be **comparing apples to oranges**. There are differing opinions on how APR is calculated. Two lenders who are really offering the exact same loan can have different APR's. This is especially true with adjustable rate mortgages. In addition, banks and brokers have slightly different rules for calculating APR, so you cannot effectively compare the two offers without breaking them down into their component parts.

The Normal People's Guide Solution:

This chapter will simply and briefly show you how to compare loans. If you are comparing fixed rate mortgages, the lender's published APR can be helpful. For example, if the note rate is 6.5% and the APR is 6.7%, you are paying approximately 2 points overall in points and applicable fees. This is simplified, but a good rule of thumb.

However, with adjustable loans, the published APR is notoriously unreliable. There are several problems with the way APR is calculated for adjustable loans:

- ✓ Adjustable Rate Mortgages take into account the Adjustment Caps and many other pieces of information that are often entered incorrectly.
- ✓ The APR calculation assumes that when the rate adjusts (i.e. in 5 years when the fixed portion of a 5-year ARM is complete) it will adjust to the rate it would be if it adjusted today. Of course the index changes often, so the odds that it will be the same several years from now are slim.
- ✓ APR calculations also assume that when the rate adjusts, it will stay the same for the rest of the term of the loan, which is also not true.
- ✓ Two lenders offering the same rate, but with loans tied to different Indexes, may get different APR calculations.

These are some of the reasons ARMs are nearly impossible to compare fairly by simply comparing the lender published APRs. Even comparing fixed rate loans among lenders can be tricky. Lenders are supposed to follow specific rules when calculating APR, but many don't know the rules, or—if they do—they don't follow them. Following is a table that includes the pieces of information you will want to use to compare for any loan.

Your own personal APR

There are three steps to calculating your personal APR:

1. Add all the points and fees and describe the loan rate and term
2. Calculate the fees as a percent of the loan amount
3. Add the **interest rate** and **the fees as a percent of loan amount** to calculate your APR.

Why would you want to go to all this trouble? You may not want to. Some people are more analytical than others. The analytical personalities may want to do the math. The rest of us just want to know the important facts and can make a holistic decision from those. This chapter will help both personality types fairly compare loan options.

To use this method of comparison, include the lender fees **that matter to you**. This is your own personal comparison. So you don't have to follow anyone else's rules. If all fees are important to you, use all fees, even though they may not be included in a lender's APR calculation. It's best to be consistent, adding the same fee categories for all loans you are offered.

Appraisal and credit report fees are not normally included in the APR, but I've put a line in there for you, in case they are important for you to include. The fees in bold type are the ones normally included in the APR calculation for both banks and brokers.

APR Calculation for Analytical People

Step One - Add all the points and fees and describe the loan rate and term

Step 1 - Calculate Points and Fees	
Description of Fees	Value
Origination fee (a.k.a. "Points")	$
Discount fee (buying the rate down below par pricing)	$
Mortgage Broker fee	$
Total Points	$
Processing fee	$
Junk fees (i.e. "Admin fee" or any others identified in Chapter 3)	$
Underwriting (identified as an "Admin fee" at some banks)	$
Other lender fees	$
Total fees (not including points)	$
Total of all points and fees	$

Description of Loan	
Initial interest rate	%
Number of years rate is fixed	

Step Two - Calculate the fees expressed as a percent

Step 2 - Calculate Fees as a Percent		
Symbol	Description	Value
L	Loan Amount	
Q	Qualifying Fees	
Calculation	(Q ÷ L) X 10 = F	
F	Fees Expressed as a Percent	

Step Three - Add the interest rate and the fees expressed as a percent to calculate your APR

Step 3 - Calculate APR		
Symbol	Description	Value
R	Interest Rate	
F	Fees Expressed as a Percent	
Calculation	R + F = APR	

Armed with this much simpler APR calculation for each loan you are considering, you can more easily compare apples to apples.

Let's do an example:

You are getting a loan for $400,000 and you have 2 offers for a 30-year fixed loan. Choice A is 6.0%, one point cost and $1,200 in junk fees. Choice B is 6.125%, a half point cost, and no junk fees. All other fees are the same between the two of them.

Step 1 for Loan Choice A	
Description of Fees	Value
Origination fee (a.k.a. "Points")	$4,000
Discount fee (buying the rate down below par pricing)	$0
Mortgage Broker fee	$0
Total Points	$4,000
Processing fee	$500
Junk fees (i.e. "Admin fee" or any others identified in Chapter 3)	$1,200
Underwriting (identified as an "Admin fee" at some banks)	$500
Other lender fees	$250
Total fees (not including points)	$2,450
Total of all points and fees	$6,450

Description of Loan	
Initial interest rate	6.00%
Number of years rate is fixed	30

Step 1 for Loan Choice B	
Description of Fees	Value

Origination fee (a.k.a. "Points")	$2,000
Discount fee (buying the rate down below par pricing)	$0
Mortgage Broker fee	$0
Total Points	$2,000
Processing fee	$500
Junk fees (i.e. "Admin fee" or any others identified in Chapter 3)	$0
Underwriting (identified as an "Admin fee" at some banks)	$500
Other lender fees	$250
Total fees (not including points)	$1,250
Total of all points and fees	$3,250

Description of Loan	
Initial interest rate	6.125%
Number of years rate is fixed	30

Step 2 for Choice A - Calculate Fees as a Percent		
Symbol	Description	Value
L	Loan Amount	$400,000
Q	Qualifying Fees	$6,450
Calculation	($6,450 ÷ $400,000) X 10 = F	0.161
F	Fees Expressed as a Percent	0.161

Step 2 for Choice B - Calculate Fees as a Percent		
Symbol	Description	Value
L	Loan Amount	$400,000
Q	Qualifying Fees	$3,250
Calculation	($3,250 ÷ $400,000) X 10 = F	0.0813
F	Fees Expressed as a Percent	0.0813

Step 3 for Choice A - Calculate APR		
Symbol	Description	Value

R	Interest Rate	6.00%
F	Fees Expressed as a Percent	0.161
Calculation	R + F = APR	**6.161%**

Step 3 for Choice B - Calculate APR		
Symbol	Description	Value
R	Interest Rate	6.125%
F	Fees Expressed as a Percent	0.0813
Calculation	R + F = APR	**6.206%**

You'll notice that Choice A is charging junk fees and a higher origination fee. Choice B charges half the origination of A, and no junk fees; but the interest rate is 0.125% higher.

Even though the lender offering Choice A isn't very straightforward because they charge junk fees (and that may be a red flag that you probably shouldn't work with them), Choice A is better than Choice B **if you keep the loan 30 years**. The reason for this is that the interest rate is lower, and therefore your payment is lower. **So you will save more money over time taking the lower rate, and paying more up front.** You may also choose to negotiate with the more straightforward lender to see if he can match the other quote.

To make the wisest decision, it is important to determine if you are likely to keep the loan long enough for the up-front fees you pay for the lower rate to make sense. For that calculation, please see Chapter 4 on Points.

Analysis for Holistic People

Holistic people usually just want to get a "feel" for the best choice among all the options. The information you gather will be the same. I recommend that you include all fees and points. Leave none out. If lenders quote different rates, one way to even the playing field would be to choose a specific rate, and ask them all to give you the total cost for that rate. This works best with fixed rate loans. When comparing adjustable rate mortgages, you would do well to compare other important factors.

Comparing Adjustable Rate Mortgages

The different aspects of Hybrid Adjustable Rate Mortgages are described in depth in the "Hybrid ARM" chapter. Please review that chapter if you are skipping around and haven't read it yet. It defines the terms I will use next.

If the rate and fees offered by different lenders are similar, then the following characteristics should carry some weight.

Index

The most commonly used index for Hybrid ARMs is the 1-year LIBOR. The next most common is the Treasury. I prefer the Treasury, of the two. However, if the indexes are different for the loans offered to you, you may want to go online and look at the history of the indexes. Some are more volatile and have reached higher rates in the past. So choose the one that makes you feel the most comfortable.

Margin

Most Hybrid ARM margins are 2.25% to 2.75%. This is only a heavily-weighted factor if the more important ones are similar. If you keep the loan when the rate adjusts, a half point difference in rate makes a difference. So choose the lower margin.

First Adjustment Cap and Life Cap

The First Adjustment Cap limits how high or low your rate can go upon first adjustment. The Life Cap determines the highest and lowest your rate can go at any time in your loan term. For loans whose initial rate is 5 years or more, the first adjustment cap and life cap are often the same. You will most likely find that these caps are similar among all of your loan choices. The First Adjustment Caps range from 2% to 5%. Life Caps typically are 5% or 6%.

The cap limits how high the rate can go, but it also limits how low it can go. So it can be a double-edged sword. However, often the rate cannot go down as much as it can go up, because it starts out fairly low, so lower Adjustment Caps may be a better choice. They limit your risk of a higher rate, and the chances that your rate will go down the full 5% are slim. That likelihood depends upon your start rate. If you start at 5%, there is no chance it will go down to zero. When your rate adjusts, the lender adds the Index and the Margin. So even if the Index value is zero (not likely), your Margin will determine the rate, and be at least 2.25%.

Chapter Summary:

You no longer need to wade through APR quotes that are manipulated to obscure the truth. You now have the tools necessary to do a fair comparison of loan offers for yourself.