



Annual Percentage Rates, Annual Percentage Yields, and Finance Charges

Whether you are borrowing money to make a large purchase or depositing your money in a financial institution so you can make money (e.g., savings account, certificate of deposit), you will need a basic understanding of some key financial terms: annual percentage rate, annual percentage yield, and finance charges.

Annual Percentage Rate (APR)

APR is the cost of credit on a yearly basis expressed as a percentage rate (e.g., 18 percent or 8.5 percent). The APR is usually slightly higher than the stated or advertised interest rate on closed-end loans (e.g., mortgages and car loans) because the following additional fees that may be required by the lender must be included in the APR calculation:

- credit life insurance
- discount points
- document preparation fee
- loan application fee
- loan processing fee
- origination points
- prepaid interest
- private mortgage insurance
- underwriting fee

Example

15-year mortgage
Advertised fixed interest rate = 8%
APR = 8.20%

However, for credit cards, which are open-ended loans (i.e., the amount borrowed each month varies), the APR and yearly interest rate are the same.

The Federal Truth in Lending Act requires lenders to provide APRs so borrowers have a tool to quickly compare the cost of loans. However, as with any tools, users must know how to use them for their project or situation to get the best end product. When comparing APRs on closed-end loans,

- compare loans with the same loan conditions (i.e., loan amount, repayment period, and interest rate);
- ask the lender for a list of the fees to be included in the APR calculation;
- ask for a good-faith estimate when looking for a home mortgage. Keep in mind that this is an estimate and the final numbers may change.

Annual Percentage Yield (APY)

This is the annual rate of interest plus the effect of compounding on the interest earned. This is the number quoted when banks and other financial institutions try to get you to deposit money in savings accounts or buy certificates of deposit. In these cases, you are the lender, so the higher the APY, the more money you will make from amounts on deposit.

Example

8-month CD
Interest rate = 4.65%
APY = 4.75%

Finance Charge

This is the total amount of interest and other fees you paid to borrow money. On closed-end loans, the amount of finance charge is stated on the contract. On open-ended loans, such as a credit card, the finance charge is listed on each monthly statement. See the example below to see how finance charges affect credit card accounts with varying rates.

Credit card balance: \$1,000

Assumptions: No additional charges will be made until the current balance is paid in full. Monthly payments will be paid by the due date.

APR: 14%

Monthly payment amount	\$30.00	\$100.00
Number of months to repay	43	11
Total finance charge	\$273.74	\$69.50

APR: 18%

Monthly payment amount	\$30.00	\$100.00
Number of months to repay	47	11
Total finance charge	\$396.67	\$91.57

General Rules for Borrowing/ Lending Money

1. The higher the APR, the more the credit will cost.
2. The longer the loan repayment period, the more interest you will pay.
3. Compare at least three lenders for the loan you need before making a decision.
4. When you are the borrower, look for the lowest APR.
5. When you leave money in a savings account or certificate of deposit, you are making a loan to the financial institution. The interest you earn is your loan fee.
6. The more frequent the compounding period (semiannual, quarterly, monthly), the more interest you will earn on a savings deposit.
7. When you are the lender, look for the highest APY.

Annual Percentage Rate (APR)

The cost of borrowing money expressed as a percentage rate per year.

Used when you borrow money.

The lower the APR, the lower your credit costs.

Annual Percentage Yield (APY)

The annual rate of interest plus compounding paid to you on deposits that you have in financial institutions.

Used when you have deposit money in savings accounts or buy certificates of deposit

The higher the APY, the more money you make.

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