COMPUTING REGULATION Z ANNUAL PERCENTAGE RATES AND "ANNUAL EFFECTIVE RATES" FOR FIXED RATE MORTGAGES: A SIMPLIFIED GUIDE

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ABSTRACT

For fixed rate mortgages, this pedagogical paper examines the differences between the standard annual percentage rate (APR) computation and the annual effective rate (AER) suggested in [1]. Shortcomings of the APR have been noted [1] [2], especially because APR is computed over the entire term of the mortgage while the average mortgage life is less than ten years. The paper shows elementary students a step-by-step process for computing AERs, and provides several sensitivity analyses to illustrate how the difference between AER and APR depends upon several variables, including expected loan life, stated annual contract interest rate, and number of discount points.

REFERENCES

[1] Buch, J., Rhoda, K.L., and Talaga, J. The usefulness of the APR for mortgage marketing in the USA and the UK. *The International Journal of Bank Marketing*, 2002, *20* (2), 76-85.
[2] Longhofer, S.D. APR flawed for fair-lending analysis. Regulation, 2000, 23 (1), 12-13.