

What Is Annual Percentage Rate (APR)?

The annual percentage rate (APR) refers to the yearly interest generated by a sum charged to borrowers or paid to investors. APR is expressed as a percentage representing the actual yearly cost of funds over the term of a loan or income earned on an investment. This includes any fees or additional costs associated with the transaction but does not take compounding into account. The APR provides consumers with a bottom-line number they can compare among lenders, credit cards, or investment products.

How the Annual Percentage Rate (APR) Works

- An annual percentage rate is expressed as an interest rate. It calculates what percentage of the principal you'll pay each year by taking things such as monthly payments and fees into account. APR is also the annual rate of interest paid on investments without accounting for the compounding of interest within that year.
- The Truth in Lending Act (TILA) of 1968 mandates that lenders disclose the APR they charge to borrowers. Credit card companies are allowed to advertise interest rates monthly, but they must report the APR to customers before they sign an agreement.
- Credit card companies can increase your interest rate for new purchases but not existing balances if they provide you with 45 days' notice first.

How Is APR Calculated?

APR is calculated by multiplying the periodic interest rate by the number of periods in a year in which it was applied. It does not indicate how many times the rate is applied to the balance.

$$APR = \left(\left(\frac{\text{Fees} + \text{Interest}}{\text{Principal}} \right) \times 365 \right) \times 100$$

where:

Interest = Total interest paid over life of the loan

Principal = Loan amount

n = Number of days in loan term

Key Takeaways

- An annual percentage rate (APR) is the yearly rate charged for a loan or earned by an investment and includes interest and fees.
- Financial institutions must disclose a financial instrument's APR before an agreement is signed.
- The APR provides a consistent basis for presenting annual interest rate information to protect consumers from misleading advertising.
- An APR may not reflect the actual cost of borrowing because lenders have a fair amount of leeway in calculating it, excluding certain fees.
- APR shouldn't be confused with APY (annual percentage yield), a calculation that takes the compounding of interest into account.