What is APR and How Does it Work?

Description

APR, or annual percentage rate, is a little word that packs a big punch. Many Canadians think APR is the same as an "interest rate," which isn't exactly right.

So then, what exactly is APR, how does it affect your credit card, and how is it different than an interest rate? Let's take a closer look and see.

What is APR?

APR is simply what you pay annually to borrow money. APR takes into account *all* borrowing costs — interest rates and lending fees — and boils them down into an annual percentage. Think of it as the unofficial price tag on a credit card: the higher the APR, the more costly an outstanding balance on your credit card will be.

How is APR different from an interest rate?

An interest rate is just that — a rate charged by a lender. APR, on the other hand, includes not just your interest rate but any lending fees you have to pay. In this way, it gives you a more accurate picture of what it costs to borrow money.

Think of a mortgage. Mortgages have a slew of scattered costs: application fees, CMHS insurance, closing costs. For that reason your lender could give you a 4% interest rate, but when you factor in all the fees, your APR jumps to 4.4%.

But now let's return to a credit card's APR. Unlike mortgages and most personal loans, credit cards don't have fees built into their rates. For this reason, your credit card's interest rate will almost always be the same as its APR. You may pay annual fees to own a credit card, sure, but those fees are charged separately: they're not incurred to borrow money.

Even though the terms might seem interchangeable (and though most Canadians will say "interest rate" when they mean APR), APR is still more accurate, as interest rate could be any length of time—daily, monthly, annually — whereas APR is exactly what credit card companies are giving you: an annual percentage rate.

When do you pay APR?

If you don't pay your card's full balance by the due date, you'll pay APR on your purchases. So, if your card has a $500 balance, you have to pay the full $500 to avoid getting charged APR — yes, even if your minimum is far less than your balance.

Do credit cards have a grace period?

Yes! Credit card companies often offer an interest-free period, the "grace period," which extends from the time you make a purchase to the end of your billing cycle. During this time, you won't pay interest on your purchases, and so long as you pay off the entire balance by the end of your billing cycle, you'll never incur interest.

But what happens if you don't pay off your entire balance? In that case, you'll pay the APR charge. Your credit card company will go back to your purchase date, then charge interest for every day you didn't pay your balance. You'll continue to pay interest, until you finally repay the charge.

How does APR work?

APR is an annual rate, but in practice an annual rate isn't helpful. Most Canadians will use their credit cards weekly, if not daily, and depending on how much you pay off, your balance will fluctuate constantly throughout each billing cycle. Because of this, credit card companies will usually use one of two methods to calculate how much interest you owe.

1. The daily balance method

For the daily balance method, your credit card company will first divide your APR by 365 to get your daily percentage rate. Your credit card company will then multiply your balance by this rate at the end of each day. Finally, at the end of your billing cycle, they'll add all the daily charges up to calculate the total interest you owe for that month.

2. The average daily balance method

The average daily balance method is somewhat similar to the preceding method: your credit card company will divide your APR by 365 to get a daily rate.

But instead of multiplying this rate by your daily balances, they'll multiply it by the number of days in your billing cycle to get a monthly rate. Then, your credit card company will multiply this monthly rate by your average credit card balance for each day to calculate the total interest you owe.

How is a credit card's APR determined?

Credit card companies are pretty methodical about calculating your credit card's APR. Though every company might use slightly different methods, here are some of the main factors that determine your APR.

1. Creditworthiness

Lenders want to know the likelihood that you'll pay them back. So, the first thing they'll look at is your credit score. An excellent credit score usually means you'll get a lower APR, whereas a poor credit score translates to a higher one.

2. Type of credit card

Your APR will also depend on the type of credit card you're taking out. Rewards cards, for instance, will likely have higher APRs than standard cards without rewards. Meanwhile, cards that are specifically low rate credit cards not surprisingly have lower rates than most other cards.

3. The unique benefits of a credit card itself

Finally, certain benefits are built into your credit card's APR, such as the card's grace period, fraud prevention, and the processing fees a credit card company pays when you make a transaction. Also, unlike mortgages, which are secured to your home, credit cards aren't protected by collateral: this presents risks to the credit card company, risks that are balanced by a higher APR.

What are the different types of credit card APR?

Credit cards often have more than one APR, and you'll pay these APRs depending on your crediting activities. In sum, credit cards can have any—or all—of these five APRs:

1. Purchase APR

The purchase APR is your convention interest rate: it's the charge that's applied to the balances you don't pay off by the end of your billing cycle. Unless you get a low-interest credit card or a card with a promotional APR, you can expect most Canadian credit cards to have a purchase APR of around 20%.

2. Cash advance APR

If you're using your credit card to withdraw cash or get a cash advance, you'll pay a cash advance APR, which is usually higher than the purchase APR.

Keep in mind: your credit card company may consider some “cash-like” transactions to be cash advances, such as buying lottery tickets, casino chips, traveler cheques, and wire transfers, and you’ll be charged cash advance APR for each of these purchases.

3. Balance transfer APR

The balance transfer APR is the rate you owe for transferring a balance from one credit card to another, typically to benefit from the lower APR on a new card. The balance transfer APR is usually the same as the the purchase APR, though unlike the latter, balance transfer APRs don’t have a grace period: you’ll start paying interest immediately after you make the transfer.

4. Promotional APR

Some credit card companies will offer new cardholders an introductory promotional APR, which can be unbelievably low. Promotional APRs are temporary, lasting around 12 to 18 months, and when coupled with a balance transfer they can help you pay down a significant amount of debt. Keep in mind: once the promotional APR ends, a new APR will snap into place.

5. Penalty APR

If you violate your cardholder agreement—like being 60 days late on a payment—you’ll pay a penalty APR on the amount you still owe. These penalties can be steep—often as high as 30%—and if you miss enough payments, they can really start to eat into your wealth.

How can you avoid paying APR?

Simple: don’t hold a balance on your credit card. Considering that credit cards often have high APRs—some above 20%—your best strategy is to pay your balance in full every month.

But, hey, sometimes life happens, and you have to make an unexpected high purchase (or a bunch of little purchases). If your balance starts to get out of control, consider doing a balance transfer to a card with a promotional APR. Pay down the debt as quickly as you can—ideally before the promotion ends—then make a practice of paying your balance every month to avoid paying APR.

Some offers on The Motley Fool are from our partners — it’s part of how we make money and keep this site going. But does that impact our reviews? Nope. Our commitment is to you. If a product isn’t any good, our review will reflect that, or we won’t list it at all. Also, while we aim to feature the best products available, we do not review every product on the market.

PP NOTIFY USER

1. tmfkopp

Date
2025/08/04
Date Created

2021/04/07

Author

sporrello