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Why loan rates may be so high

Your credit score may not be the only thing driving your rate

By Gail Liberman and Alan Lavine
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PALM BEACH GARDENS, Fla. (MarketWatch) -- Too many borrowers may be unfairly blaming credit scores for their higher-than-expected loan rates or extra credit-card fees, according to a recent working paper.

The real culprit may be your own misunderstanding of how the lending process works, coupled with a failure to conduct adequate research before you apply, suggests the MIT Department of Economics working paper.

The paper, written by a team of Federal Reserve and university researchers led by Sumit Agarwal of the Federal Reserve Bank of Chicago, admits a FICO credit score may determine if you're offered a loan. But other factors may contribute more heavily to your rate and fees.

Take a home-equity loan or home-equity credit line: The greatest impact on your annual percentage rate is based on the "loan-to-value ratio," the report said. That's the percentage of the home's appraised value that you're actually borrowing.

Lenders often issue tiered annual percentage rates, based on loan-to-value ratios of 80% or less, 80% to 90% and 90% or more. So if you're shopping lenders, expect any rate you're quoted to be based on your home's loan-to-value ratio.

Too often, the paper indicates, potential borrowers misestimate their home value and find themselves asking lenders the rates for the wrong loan-to-value category. Meanwhile, once you apply for a loan at the higher rate you're quoted, loan officers often have discretion to give it to you -- despite the fact that they typically have access to appraisal information that could place you in the correct loan-to-value ratio category at a lower rate.

Such a "rate changing mistake" can increase your APR by an average of 1.25 percentage points for home-equity loans and 1.50 percentage points for home-equity credit lines, the report says.

Avoid this scenario by asking in advance upon what variables the lender bases its rates. Assuming they are based on loan-to-value ratios, be sure to accurately estimate your home value before you shop for a loan. Lenders often have access to this information if you ask for it in advance. Web sites that also can provide estimates of this information include www.zillow.com and www.realestateabc.com.

Besides the loan-to-value ratios, factors that could influence your home-equity rates are whether you have a first mortgage, or, if your loan is for a condominium, which is considered a riskier property. Income and years on the job also may weigh in.

More variables

The paper also analyzed how 14,798 persons used lender teaser-rate credit-card offers for balance transfers. These offers have a very low teaser rate for six to nine months. Catch: Any purchases charged on that new card get a higher interest rate, and any monthly payments made to pay down the balance on that new card pay down the highest-rate debt last.

If you get such an offer, the best strategy is to transfer your balances to the new card and pay them down at the low rate during the teaser period, but make no new purchases on it. However, the researchers found that only about one-third of customers follow that strategy.

Instead, slightly more than one-third continued to make new purchases on the card every month, running up balances at the higher interest rate. The remaining one-third experienced a "eureka" moment between the first and sixth month, after experiencing surprisingly high interest charges. Only then, did they evidently stop the costly practice of making new purchases on the card.

The paper, "The Age of Reason: Financial Decisions Over the Lifecycle," published by the Social Science Research Network, found credit scores have little impact on credit-card annual percentage rates or on auto-loan terms. It also noted that sophistication in making financial choices peaks at around age 53.

Among the other important variables that can affect how much you pay for a loan:

1. **Term.** The longer the term, the higher the interest rates and/or fees and the more you typically pay. Shoot for

the lowest term you can afford.

2. **Home occupancy.** For mortgages and home equity loans, you're apt to qualify for better rates if you live in your home rather than rent a property or use it as a vacation home.

3. **Amount you borrow.** Home loans for amounts to $417,000, which may be sold to Fannie Mae and Freddie Mac, generally have lower rates than those with higher amounts.

4. **Whether the rate is fixed or variable.** Variable or adjustable-rate loans start out with lower rates, but have the potential to increase as much as interest rate caps, if any, permit.

5. **Fees.** If your rate is unusually low, look carefully for other fees. You may have upfront costs, points, annual fees or termination fees.

Spouses Gail Liberman and Alan Lavine are syndicated columnists. Their latest book is "Quick Steps to Financial Stability" (Que/Penguin). You can contact them at www.moneycouple.com.