Understanding interest rates can save you money

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Unless you pay cash for everything, you're impacted by interest. Understanding the different types of interest can give you a clearer picture of how your money accumulates and what things really cost when financing is factored in.

Interest rates for lenders. Most people don't think of themselves as lenders, but if you have a savings account or own government or corporate bonds, you are, in effect, lending money to those institutions and earning interest on the “loan” you are giving your bank. This interest income is often taxable, so shop around for the highest rates to maximize your earnings and help offset taxation.

Savings and interest-bearing checking accounts typically offer low rates – often 1 per cent or less. Some even charge fees for not maintaining a minimum account balance. Be informed on what interest you're receiving from your financial institution and don't be afraid to compare rates across banks to ensure you get the most bang for your buck.

Interest rates for borrowers. Interest has even more impact on you as a borrower, particularly for large credit purchases. Think about it: You could be paying off your home for 25 years or more, so reducing the interest rate by a few points could save tens of thousands of dollars over the life of the loan.

Banks charge several different interest rates, depending on the type of loan. Secured loans (those "secured" by property such as a house or car) often have lower monthly payment rates than other loan types. With lower payments, you can ideally retain some of your money and allocate those funds to other uses, such as building up your emergency fund.

Interest rates for home equity loans and lines of credit are often tied (or indexed) to the bank's prime rate. Prime rates are interest rates set by financial institutions that fluctuate according to the…economic outlook and market conditions.

Interest rates for credit cards are set by financial institutions and are based on several factors, including the bank's cost of funds and administrative expenses, [market]…rates[, and your credit rating]. Be advised: Banks that offer low or special interest rates will usually increase those rates if a payment is missed or late. Be sure to review your credit card policy with your financial institution in order to avoid any late fees and/or rate increases.

Payday loans typically range from approximately $100 to $1000, depending upon your state’s legal minimum. The average loan time is two weeks, after which time you would have to repay the loan along with the fees and interest you accrued over that period. These loans usually cost 400% annual interest (APR), if not more. And the finance charge to borrow $100 ranges from $15 to $30 for two week loans. These finance charges are sometimes accompanied by interest rates ranging from 300% to 750% APR. For loans shorter than two weeks, the APR can be even higher. Often times with payday loans, the rates are so much higher than other types of loans they can end up putting you more in debt than you were to start with.

Fixed vs. Variable. Home mortgages offer interest rates that are either fixed for the life of the loan or fluctuate over time. Variable rates are usually adjusted annually to reflect changes in the bank's prime rate. (Variable rate loans start with a very low interest rate. However, you can plan on the interest rate increasing each year based upon the maximum allowable annual increase – usually 1% to 2% depending on the loan. Many in the housing bubble got into trouble by getting into a variable rate loan and then could not refinance the loan because their house dropped in value. Each year, their payments jumped considerably. They were trapped and soon could no longer afford their house payments. It makes sense to use a variable rate loan only if you plan on owning your house for a short time. However, if you plan on owning your home for a long time, consider the fixed rate loan. Once your payment is fixed, it will stay that way for the life of the loan. If rates go down, you can usually refinance to a lower rate. But, your payment will never go up.)

Remember, it pays to think of yourself as both a lender and a borrower. If you're considering taking out a loan, whether it be for your car, home, school or an emergency, be sure to use Visa Canada's How Much Will Your Loan Cost You? calculator to find out the true cost of your loan.

More information about how interest rates work and other credit issues can also be found at Practical Money Skills Canada (www.practicalmoneyskills.ca) a free personal finance management site sponsored by Visa Canada.
