

INTEREST RATES - KEY CONCEPTS AND DEFINITIONS
CGAP

Nominal interest rate	A nominal rate is the stated rate to be paid on a loan contract, usually stated as a monthly or annual percentage. It does not take into account related loan fees, commissions and other expenses.
Effective interest rate	An effective rate converts all financial costs such as interest, fees and commissions into a declining balance interest calculation for the repayment period. The effective rate represents the financial cost to the borrower if there are no forced savings. It includes all financial charges as a percent of the loan amount used during each payment period. The best way to calculate this rate is to use the internal rate of return function on a financial calculator.
Annual Percentage Rate (APR)	The APR is the effective interest rate per period multiplied by the number of periods in a year.
Real interest rate	A real interest rate adjusts the interest rate to remove the effect of inflation. A negative real rate implies that the rate of interest charged is inadequate to cover inflation. People frequently speak of positive rates of interest to mean that the rate is set to cover inflation.
Interest Spread	The spread is the amount between the nominal lending rate and the nominal rate of interest paid on savings or other sources of funds stated as a percentage.
Flat rate method	Interest is calculated by multiplying the term of the loan by the monthly interest rate by the principal amount, irrespective of the payment schedule (which may be a lump sum or in instalments).
Declining Balance method	Interest is calculated on the principal amount of the loan that is actually in the hands of the borrower during each period of the loan term.
Fees and commission	Fees and commissions are charges that can be fixed amounts or a percentage of the loan amount. They are often one-time charges collected upon disbursement of the loan or deducted from the initial loan amount.
Penalty	Penalty interest is charged on a loan when payments are missed or delayed. Normally a penalty interest is stipulated in the loan contract as a certain percent increase over the interest rate applied to the loan. In some cases it is a fixed and predetermined rate.
Compound	Compound interest is the concept of earning interest on top of interest in a savings account. This occurs when the interest is left in the account from period to period and the bank 'capitalizes' the interest (adds the interest to the savings account balance) for purposes of paying interest in later periods.
Adjustable	Adjustable rates are rates that change over the term of the loan to reflect changes in general market rates. The manner in which this adjustment occurs is clearly stated in the loan contract.
Indexed	An indexed rate is a rate tied to something other than local currency; for example an inflation index or a foreign currency.