FinStart

Everything you need to know about 'interest'

'Interest' is the cost of debt.

How is it calculated?

Interest on loans is expressed as 'prime rate plus a certain percentage', like 'prime plus 2.5%'.

- Prime rate is a lending rate that banks use for their customers with good credit standing.
- Major Canadian banks tend to keep their prime rates at the same level and change them at the same time, depending on the level of interest rates.
- The 'plus' percentage reflects your creditworthiness and the type of loan you're taking.

The rate of interest can be 'fixed' or 'floating'. It's often your choice.

Floating rate interest will change over time.

- The prime component of 'prime plus 2.5%' will change each time the banks change the prime rate.
- The percentage that is added to prime is set when you get the loan and will stay the same until you pay down the loan.

Fixed rate interest is set when you take out the loan and stays the same until you pay it down.

- For example, if the loan is described as 'prime plus 5%' and prime rate is 3.95% when you take out the loan, your interest rate will be fixed at 8.95% for the life of the loan (3.95+5).

At the time you take out a loan, floating rate will be cheaper than a fixed rate loan.

- The risk you take with floating rate loans is that if interest rates rise, your floating rate will rise too. It may even get bigger than the fixed rate you were offered at the beginning.
- If interest rates fall, your floating rate loan will become even cheaper while the fixed rate will stay the same.