

What are interest rates?

So much talk about interest rates but so little about what they actually are. That's a scenario often attributed to news stories – so if you find yourself nodding along nonplussed at the detail, then nod no further. Or be ready to nod with authority.

First things first. The Bank of England set something called a Bank Rate. This influences other interest rates, like high street bank rates, rates of borrowing and more. It means that, when you're looking for a loan, savings account or credit card, it's a competitive market.

Interest rates are attached to things like savings accounts, loans (like mortgages) or credit cards. A percentage value that can change over time and can be used as an indicator of how worthwhile that product could be. And they're variable. Banks or building societies will change the interest rate they offer you depending on the risk of lending you the money – which is why a credit score is important. But that's a topic for another time.

So what is a “good” interest rate?

Well, bigger isn't always better.

If you're borrowing, for instance, the higher the interest rate the more wary you should be. Interest rates on loans tell you how much you're charged for borrowing – and the percentage itself is a percentage of the total amount of the loan. A 10% interest rate on a loan would mean that you're obliged to pay back an extra 10% of the total amount.

But, if you're saving up, bigger is better. The percentage indicates how much money will be paid into your account as a percentage of your savings. Or, in more quantifiable terms: A 5% rate on a savings account means that for every £100 you add, £5 of interest will be added to your account - we cover this in more detail in a bit.

If your savings account is a stocks and shares ISA, it won't have an interest rate. Instead, your money will grow depending on the success of buying and selling stocks and shares.

APR

You're going to see these three letters a fair amount. If you're shopping for a new credit card, or taking out a loan, you'll need to know the **Annual Percentage Rate, (APR)**. It includes the amount of interest you'll be charged, plus any fees you need to be aware of, like annual fees.

The APR can be used as a barometer – a guideline — for comparing one debt with another. After all, not all debts are equal, and it's all about finding what works for you.

If you see the term “Representative APR”, you'll need to stay alert.

Representative APR means that you could be charged a higher rate than is advertised, because only 51% of applicants to that credit card or loan will be charged the exact Representative APR. This is due to all applications being assessed on an individual basis, so the APR you get is determined by your own circumstances and credit history

Compound interest also works against you in loans – meaning you could end up paying interest on your interest. And then again. And then you've got a problem. But more on compound interest later.

AER

AER is shorthand for Annual Equivalent Rate. It's used for savings accounts, and it can be seen as an APR copycat for savings. AER gives you a clue as to what you'd accrue in interest over one year of saving.

Sometimes a savings account will display a gross rate – which is the actual amount of interest it offers, and doesn't take compounding into account.

Some accounts pay interest annually. If that's the case, both the gross rate and the AER will stay the same. That's because you won't benefit from compound interest as readily on that account (if the interest is paid annually, you'll only see the fruits of your labour 12 months from the account's opening, so whilst compounding will occur, it'll be only yearly rather than monthly).

If it's paid monthly, however, things get a little more involved. The gross rate will be different from the AER rate, because you'll earn interest on the interest every month – as long as it remains in the account – and the AER represents this.

Compound Confusion?

We've mentioned compound interest. A lot. And by now you're probably wondering what on earth we're blabbering about.

Well, it's like the magic bean of the financial world. It won't spontaneously grow into a gigantic beanstalk overnight, but it'll grow your money exponentially over the years. Same thing, really.

As a simple example, let's say you stick £100 into a savings account which, after tax, gives you 6% interest a year. You'd get £6 in interest after one year, giving you a grand total of £106. That's assuming you don't withdraw any money, or stick in any more after your initial deposit.

Now, in the second year, the value of the money in the account will increase by 6% again.

That keeps happening, year in, year out. You earn interest on all the interest. From year 1, year 2, year 3, and so on. The numbers really add up quickly, so the longer you save for, the more you benefit from compound interest.

So, are you nodding with authority? Is your brain teeming with interest intelligence? Now you've caught up on our guide to interest rates, there's plenty more to discover to boost your savings journey.

If you're looking for a loan, you can find out more about [borrowing here](#)