Please note: This is a transcription so there may be slight grammatical errors.

Jennifer Doss:

We hear about interest rates all the time in the news, but what are they and how are they calculated?

An interest rate is either the reward for saving money or the cost of borrowing it. Interest is calculated as a percentage of the total money that you saved or borrowed. You'll see this term pop up in several different areas of your finances. One example can be in a savings account at a bank. Usually, if you keep your savings in a bank, that money will accrue a small amount of interest to reward you for saving. The higher the interest rate on your savings account, the more money you'll earn.

You'll also hear about interest rates when it comes to the cost of borrowing money, for instance, on your credit cards, home mortgage or car loan. For the lender, typically a bank, the risk associated with every loan is whether the borrower will repay it. Interest encourages the lender to accept that risk. If you are a borrower who is considered low risk, that means you have a good reputation as a reliable borrower. Since the lending institution knows you are likely to repay the loan, you will likely receive a lower interest rate. On the other hand, if you are a borrower who is considered high risk, you will almost certainly have a higher interest rate.

Your risk level is typically assessed by looking at your credit score. A high credit score indicates you are lower risk and usually means you'll have more choices between different lenders, interest rates, terms, and options. Credit scores range from 300 to 850. Generally, a score over 670 is considered good. Your credit score is determined by your payment history, total amount owed, types of credit, and length of credit history.

Here's an example of how interest rates work. If you took out a one-year home improvement loan of $10,000 at 6% interest, that interest rate would cost you an extra $600 over the course of the next year. The higher the interest rate and the higher the original amount of money you borrowed, the more money you will pay as interest. This is how banks make their money. The same holds true for other kinds of loans.

It's important to understand that interest rates have an impact on how you spend money. When you hear headlines on the news about interest rates being high, that means a loan from the bank will cost you more, which typically encourages people to borrow less and save more. So we see a drop in the number of people who are applying for loans.

The opposite occurs when interest rates are low. In those times, you might borrow more and save less. A low interest rate on borrowed money is usually a good thing, but it shouldn't be the only factor when deciding whether to take out a loan. If interest rates are high or you have a low credit score, it might be a good idea to save more money before you borrow for a major purchase.

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