CBS

Interest

Interest is the charge for the privilege of borrowing money, typically expressed as annual percentage rate.

Paying interest

When we take out a loan from a financial institution, we don't just pay back the money we borrow, but also a sum of interest on top.

There are two main types of interest that can be applied to loans: simple and compound.

Simple interest is a set rate on the amount originally lent to the borrower that the borrower has to pay for the ability to use the money.

Compound interest is interest on both the principle and the compounding interest paid on that loan. This is the most common type of interest that financial institutions use.

There are many considerations that go into calculating the type of interest and the amount a lender will charge a borrower.

- Opportunity cost - the cost of the inability of the lender to use the money they're lending out
- The amount of expected inflation
- The risk that the lender will be unable to pay the loan back
- The length of time that the money is being lent out for
- The possibility that interest rates may be affected by government intervention
- The liquidity of the loan being made

Earning interest

When you put your money into a savings account with a commercial bank, it earns interest. Interest is money the bank pays you so that they can use your money to fund loans for other people.

That doesn't mean you can't have your money whenever you want it, though. That's just how banks make money – by selling money.

Interest on savings accounts is usually compounded daily and paid monthly. The cool thing about compounded interest is that the bank is paying you interest on the money they've paid you in interest!