African Bank Limited press release

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Interest? What's that?

So, you've heard people talking about this thing called interest but you're not exactly sure what it means. Well, it's important that you do understand what it is because all credit is affected by interest, explains Mellony Ramalho, African Bank's Group Executive: Sales, Branch Network.

So, what exactly is interest? "Interest is simply the cost of borrowing money. There will always be a cost if you want to borrow money. What you need to understand is that banks borrow money from various institutions and individuals so they can lend money to you. The borrowing of this money is called taking deposits and is a core function of any bank," explains Ramalho.

The interest rate and fees for your loan are based on the all-inclusive cost of borrowing. The interest rate on your loan can vary and will depend on your credit score. "If you have a poor credit record, the bank will charge a higher interest rate when they lend you money, because you are more likely not to repay a part or all of your loan. If you have a good credit record, you may be offered a lower rate as your risk to the bank is lower. This is why it is so important to have a good credit record. Your credit record is based on your history of making agreed loan repayments. You can therefore ensure you have a good credit rating by keeping your finances in order, not missing payments and paying off your debts as fast as possible."

Once the interest rate is worked out as a percentage then you can find out what the interest would be on your loan. "There are two types of interest: simple and compound interest. Simple interest means that for each period (say a month or year, for example), interest is calculated on the original loan amount. The interest will therefore be exactly the same in each period. This is, as it sounds, simple to work out, but it is also, unfortunately, not the type of interest most commonly used."

"With compound interest, interest is calculated on the amount still owing at the beginning of each period. That will include the interest from the previous period, which is added on to the original amount, if you have not paid your full instalment in the previous period. This is the system used by banks and lenders to calculate interest on loans."

Ramalho says that working out compound interest can seem complicated but banks have special calculators that can work it out for you. "The key is understanding that with compound interest, you need to try and reduce your total amount outstanding by making your full repayment each month so that the amount outstanding at the beginning of each period reduces. Each month you are therefore paying less interest and more of the original amount you borrowed, paying off the loan over the original anticipated term. The best way to do this is to pay more than just minimum repayments each month so those payments go toward the actual loan and not just the interest every month."

She says it's also important to shop around and compare the interest rates and fees that different banks charge before making a decision. "See if they'll fix the interest rate you're charged. This means your repayments will stay the same and won't increase if the interest rate increases. Remember to calculate the total cost of credit charged before making your decision. Some banks will charge for credit insurance, which is added to your monthly instalment and makes it more expensive but gives you protection in certain instances where you cannot pay the instalments on your loan. These situations typically cover death, disability or retrenchment."

"Don't be afraid to ask questions and make sure you understand exactly what you are going to be repaying before signing any agreements. Remember that the more you repay each month the faster you will reduce your interest and a greater amount of your instalment is used to repay your actual loan amount. The longer you take, the bigger the interest grows and you can end up paying a lot more than you originally anticipated to pay," concludes Ramalho.

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