FACTFILE:
GCSE ECONOMICS
UNIT 3.3
FINANCIAL CAPABILITY – MONEY AND FINANCIAL PRODUCTS

Rewarding Learning

Interest Rate

Learning Outcomes

Students should be able to:

- explain the role of interest rates and the reasons for interest rate differences and change;
- interpret different interest rates and evaluate how they affect saving, borrowing and investment.

Interest Rate:

Definition:

An interest rate is a yearly charge levied by a financial institution or bank as follows:

- Savings – a bank will pay interest to savers who deposit money with it, over a long period of time;
- Credit – a bank will charge customers interest in return for lending money to them – e.g. for a loan, overdraft or credit card.

Interpretation of an Interest Rate:

- Annual Percentage Rate (APR %) – this applies to borrowings and is rate of interest applied by the financial institution on the funds advanced. The purpose of an APR is to allow individuals to compare the cost of credit across different types of borrowings (e.g. overdraft, loan, store card) and inform decision making. The higher the APR, the more expensive the interest payments. Generally speaking, the more riskier a borrower is deemed to be (e.g. due to poor credit scores/ratings) the higher the APR levied by the provider of funds.
- Annual Equivalent Rate (AER %) – this applies to savings and is the rate of interest applied by the financial institution on the money deposited by individuals. The purpose of an AER is to allow individuals to compare the expected rates of return on different investment products (e.g. savings/deposit accounts and ISA's) and inform decision making.

Note: with the exception of an ISA, income tax is paid by savers on the interest income earned from savings. Therefore the AER may be quoted either before (gross) or after (net) the payment of tax.

Role of an Interest Rate:

- To encourage saving – an interest rate might encourage individuals to save money – the higher the interest rate, the more attractive saving becomes.
- To encourage borrowing – an interest rate might encourage individuals to borrow money – the lower the interest rate, the cheaper and thus more attractive it is to borrow money.
- Income – the interest rate is the main way in which a financial institution makes money. The general concept is that:
  - (i) Savers will be given a low rate of interest on their savings, e.g. 3% p.a.
  - (ii) Borrowers will be charged a higher rate of interest on their outstanding borrowings, e.g. 10% p.a.

The difference between the two rates – 7% in this case allows the bank to pay its costs and make a profit.

- Government – the government might use the interest rate to control consumer spending in the economy – therefore, if interest rates are low, consumers might spend more since credit is obtained more cheaply and interest rates on savings are negligible. This acts as an incentive to increase consumer spending. However, when interest rates rise, it is expected that consumer spending will decrease since credit is more expensive and individuals will tend to save more, thus reduce demand in the economy.

Interest Rate Changes/Differences:
Interest rates change for various reasons including:

Savings:

- Base Rate Changes – the Base Rate of interest in the economy is determined by the Bank of England. Interest rates given by financial providers based on savings are linked to the base rate (usually a few percentage points lower than the base rate). Therefore, interest rates can change in line with national economic decisions.
- Amount Deposited – financial institutions/ banks often set an interest rate linked to the actual amount saved by an individual, e.g. savings totalling £1 – £100,000 might attract an AER of 0.5% p.a., whereas amounts deposited over £100,000 might attract an AER of 0.75% p.a. – this has the effect of making saving more attractive.
- Length of Term – the length of time for which sums of money are deposited with financial institutions also influences the interest rate received. The general concept is that, the longer the monies are deposited, the higher the interest rate will be, e.g. a saver deposits £1,000,000 for 1 year and might receive 1% AER (gross) p.a., whereas if the same investor deposits £1,000,000 for a period of 2 years, then an AER of 1.3% (gross) might be received.
- Competition – financial institutions very often compete for investors funds in order to attract customers and make a profit. One way of doing this is to offer investors a higher rate of interest (AER %) than their nearest competitor, which also has an influence on the different interest rates available.

Borrowings:

- Base Rate Changes – the Base Rate of interest in the economy is determined by the Bank of England. Interest rates levied by financial providers based on borrowings are linked to the base rate (usually 10–15 percentage points higher than the base rate). Therefore, interest rates can change in line with national economic decisions.
- Purpose of Borrowings – a lender will often set an interest rate in relation to the funds advanced based on the purpose of the borrowings. Funds advanced on the basis of security and over a longer time period are usually subject to a lower rate of interest (e.g. 3% p.a.), compared to interest rates charged on unsecured lending (e.g. 11% p.a.) which in turn tends to be of a short term nature.
- Amount Borrowed – financial institutions/ banks often set an interest rate linked to the actual amount borrowed by an individual, e.g. borrowings totalling £1 – £7,500 might attract an APR of 12% p.a., whereas amounts borrowed over £7,500 might attract an APR of 10% p.a. – this has the effect of making borrowing larger amounts of money more attractive.
- Length of Term – the length of time for which sums of money are borrowed from financial institutions also influences the interest rate charged, e.g. an individual borrows £1,000 using an approved overdraft facility for 1 year and might pay 5% interest p.a., whereas if the same individual borrows £1,000 for a period of 2 years, then an APR of 10% might be charged.
- Credit Score – the interest rate levied by a financial institution will in part be dependent on the credit status of an individual, i.e. a credit score/rating. Generally speaking, the lower an individual's credit score, the greater the risk of default and therefore the lender is likely to charge a higher rate of interest (APR) than an individual with a high credit score (by definition a lower risk defaulter).
- Competition – financial institutions very often compete with each other in order to attract customers, provide borrowing facilities, charge interest and make a profit. One way of doing this is to offer investors a lower rate of interest (APR %) than their nearest competitor, which also has an influence on the different interest rates available.

Summary:

An interest rate is a yearly charge levied by a financial institution or bank as follows:

- Savings – a bank will pay interest to savers who deposit money with it, over a long period of time;
- Credit – a bank will charge customers interest in return for lending money to them – e.g. for a loan, overdraft or credit card.

There are various types of interest rates, including an AER (Annual Equivalent Rate) and an APR (Annual Percentage Rate).

There are a range of factors which appear to influence the rates of interest.

The impact of a change in interest rates can be two-fold:

- Savings – it can either encourage savers to save or spend;
- Borrowings – it can either encourage borrowers to borrow more or reduce borrowings.

Review Questions:

1. Define the term 'interest rate'.
2. Define the term 'AER'.
3. Define the term 'APR'.
4. Your best friend, Harry (who has just turned 16 years of age), has just won £10,000 on a lottery scratchcard and has asked you for advice on a savings product. What advice would you give to your friend if the objective is to earn as much interest as possible?
5. Pamela, another friend of yours is thinking about buying a new mobile phone costing £400. She is unsure whether to borrow the money using a bank overdraft or use her savings. What advice would you give to your friend if the objective is to keep the cost as low as possible?