

What Is the Difference between Fixed and Variable Interest Rates on Loans?

Charging customers interest is how a financial institution bank makes money and returns profit to its owners and shareholders. If you borrow money to buy a car or a pickup truck, your lender will charge you an interest rate on the loan amount.

There are two types of interest rates: fixed and variable (also known as "adjustable rate mortgages").

A fixed interest rate is one that will remain stable over the entire term of the loan. If you get a loan to purchase a car, and the interest rate is fixed, you will pay the same amount each month until the loan is paid off.

If your loan carries a variable interest rate, that rate will likely fluctuate over time. Normally, a variable interest rate is tied to a financial index, such as the Prime rate (the interest rate banks charge their best customers) or the rate on U.S. Treasury Bills. If that index changes, the interest rate on your loan will change as well.

For example, if your credit card agreement or loan document says your interest rate is tied to the Prime rate plus 5.99 percent, that means any time the Prime rate changes, the interest rate you pay will be 5.99 percent higher than that number.

Some borrowers get confused between fixed and variable interest rate loans because variable rate loans are sometimes fixed for a certain number of months or years before converting into a variable rate loan. There may also be limits to how fast a variable rate loan can rise in a specific period of time.

The important thing to understand is if you get a loan with a variable interest rate, you can count on that rate changing at least once during the loan term.

Before you sign any loan documents, be sure to read the fine print so you know whether your loan carries a fixed interest rate or a variable interest rate.