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Loan Interest Rates: Flat Rates vs Fixed Rates vs Variable Rates

by Hann Liew

Don't know if you are getting a good deal on your home loan, auto financing or personal loan? Its all in the interest rate!

What is an Interest Rate?

Put it simply, the interest rate is the reward for the bank for lending you money to buy things (home, car, etc.). The higher the interest rate, the higher the 'reward' you are giving to the bank for lending you money. Conversely, if you lend the bank money (via a deposit in a current/savings account or fixed deposit), you should expect to earn a 'reward' in the form of interest. In this case, the higher the interest rate, the higher the reward the bank is giving you to lend your money to it.

For example: You borrow RM10,000 from the bank at a 10% p.a. interest rate, promising to pay it all back in one lump sum in 1 years time. In this instance, the total amount you have to pay back is RM10,000 + (RM10,000 x 10% = RM1,000) = RM11,000. The RM10,000 here is called the principal, and the RM1,000 here is called the interest cost.

So in theory, when you are borrowing money from the bank, you want the lowest rate possible! Sounds easy enough, but the comparison is complicated with the various types of interest rates in the Malaysian loan market.

How many types of interest rates are there?

In truth, many! But for simplicity, most loan products in Malaysia are sold with 3 types of interest rates:

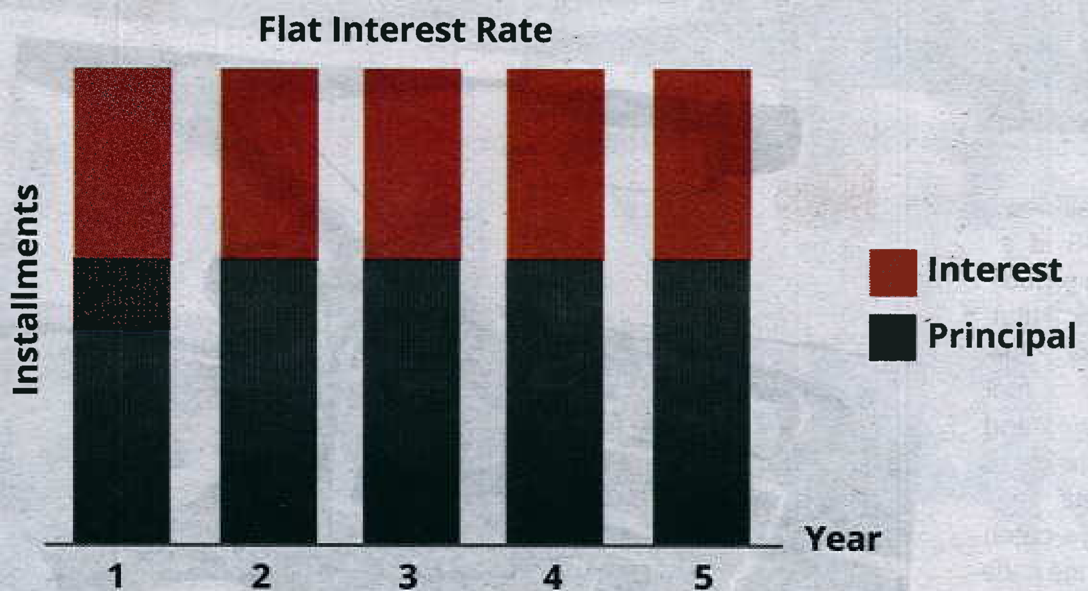
1. **Flat Rate (on full principal)**
   typically for Personal Loan and Hire Purchase Financing (Car / Motorcycle Loans)

2. **Fixed Rate (on reducing balance)**
   typically for Credit Cards and some Home Loan (Mortgage) products

3. **Variable Rate (on reducing balance)**
   typically for Home Loan (Mortgage) products

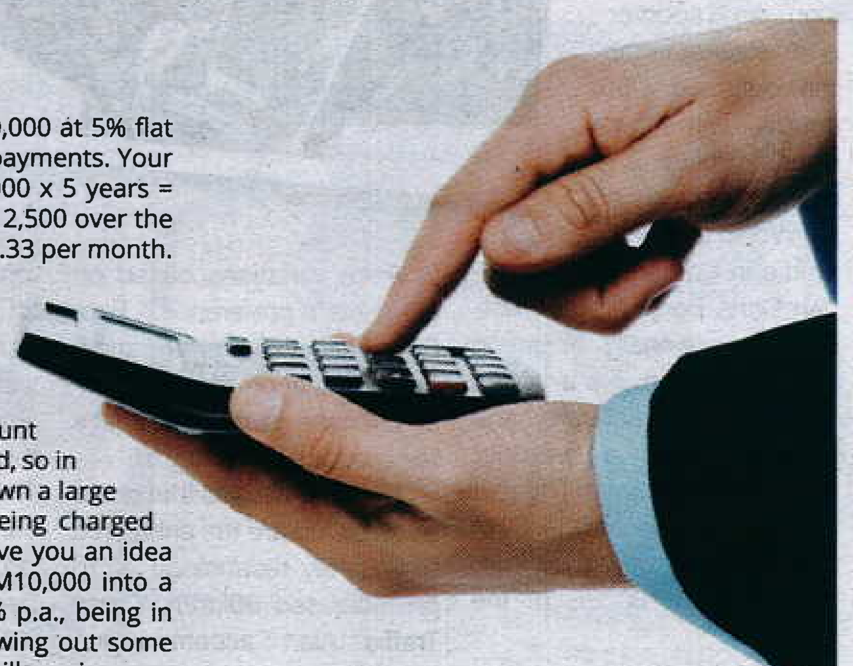
Flat Rate (on full principal)

In Malaysia, personal loans and hire purchase financing (auto loans and equipment) are quoted on a flat rate basis. This means that interest is charged on your full principal over the tenure. The interest cost for a flat interest rate loan product is easy to calculate, you just multiply the rate with the number of years and the initial amount borrowed (principal).



For example:

You apply for a personal loan of RM10,000 at 5% flat p.a. for 5 years, so with 60 monthly repayments. Your total interest cost will be 5% x RM10,000 x 5 years = RM2,500. So you have to pay back RM12,500 over the course of 5 years, amounting to RM208.33 per month.



Sounds easy enough, although the effective interest rate on your borrowing is much higher than 5% p.a., where the flat interest rate of 5% is always charged on the original amount borrowed, no matter what's been repaid, so in the last year even when you've paid down a large part of your loan, you still end up being charged interest on the whole RM10,000. To give you an idea of how this works, imagine putting RM10,000 into a savings account to earn interest of 5% p.a., being in a flat rate product is like you withdrawing out some money each month but the bank still paying you RM500 interest every year, even if you have almost no money left in the account towards the end! No bank in the world will do that, so why should you! (in many developed countries, quoting flat rates on loans is illegal!)

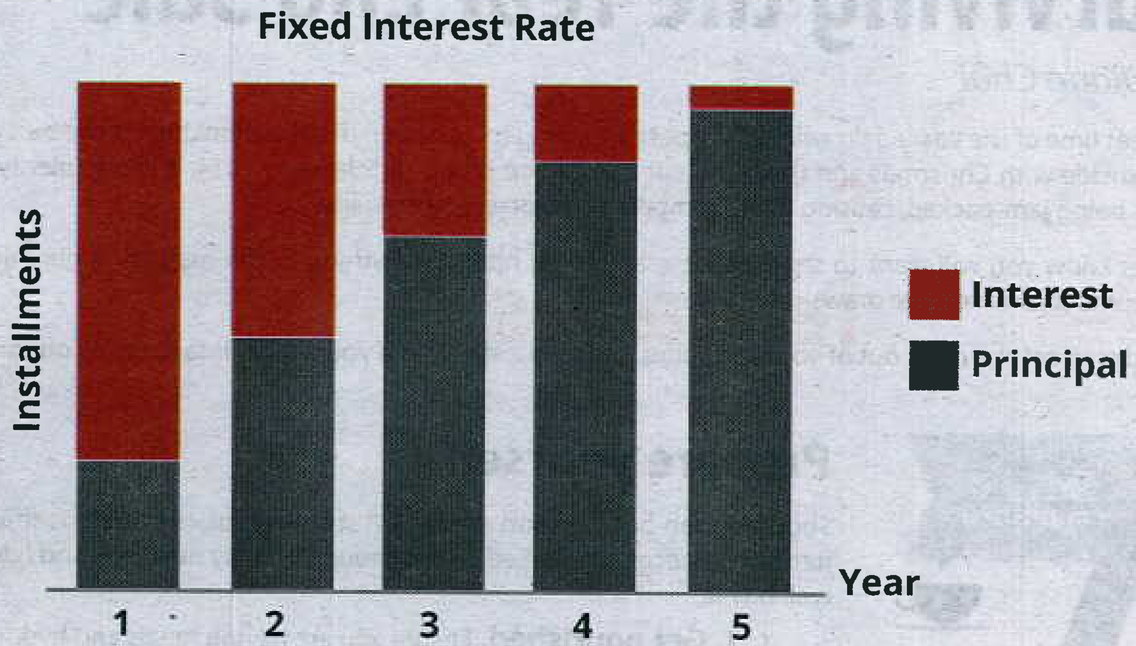
As a rule of thumb, to compare a flat rate to fixed or variable rate, you have to multiply it by 1.8-1.9x. Hence, a 5% p.a. flat interest rate sounds cheap but in reality if you wish to compare this rate to say a fixed interest rate on a credit card, you will probably be looking at comparing that 5% p.a. flat rate with a fixed rate of 9.0-9.5% p.a.

Fixed Rate (on reducing balance)

In Malaysia, credit cards products and some mortgages are quoted on a fixed rate basis. Fixed rates on borrowings are slightly harder to understand and calculate than a flat rate of interest, but they do make more economic sense. Here, you get charged interest on your reducing loan balance, so you only pay x% on whatever you currently owe. For mortgages, the repayment amounts are fixed though, to make things easier for the consumer.

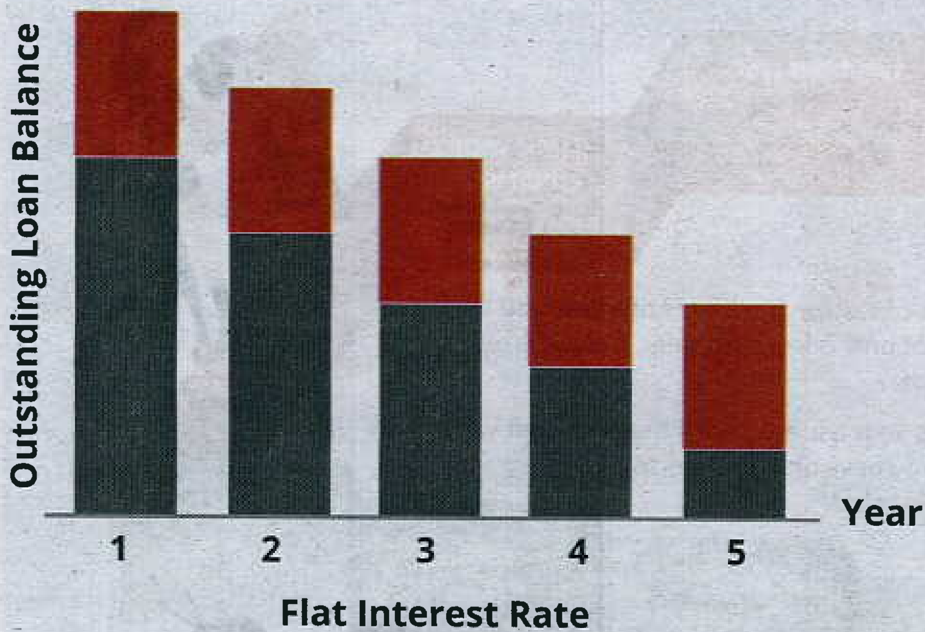
For example:

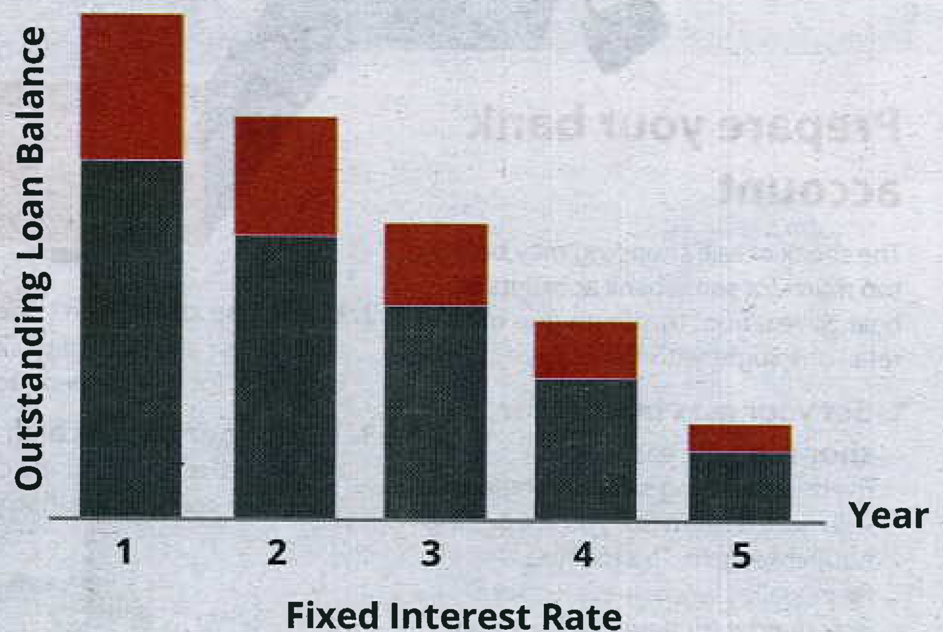
You apply for a 25-year mortgage of RM500,000 at 5% fixed p.a, with monthly repayments. Your total interest cost is not 5% x RM500,000 x 25 years = RM625,000 as per the flat rate example, your total interest cost is actually closer to RM375,000 over the 25 years as the interest amount reduces as you pay your loan balance off. The calculation to get RM375,000 is slightly more complicated, but its certainly lower than the flat rate of 5% p.a. While the interest cost reduces over the tenure of the loan, your repayments are fixed. A larger portion of your first few fixed repayments go towards interest costs, with the final repayments focused on reducing principal owed.



Flat Rate vs Fixed Rate

Flat Interest Rate vs. Fixed Interest Rate





Principal Interest

Variable Rate (on reducing balance)

A variable rate is frequently used for some home loan (mortgage) products in Malaysia. As with the fixed rate product, you get charged interest on your reducing loan balance, the main difference here is that you typically get charged a variable rate which can change. This variable rate is normally benchmarked to the Base Lending Rate (BLR) in Malaysia. Rates are quoted as BLR +- x% where the reference rate is normally the Base Lending Rate (BLR), a rate set internally by the bank, but should track the rate set by the Central Bank. So if you are quoted a rate of BLR - 2.20% on your variable rate loan, your current interest rate is 4.40% p.a. (BLR = 6.60% p.a. at time of writing in November 2013). If the BLR changes, your interest rate will change too.

For example:

You apply for a 25-year mortgage of RM500,000 at a variable rate of BLR - 2.00%. The current BLR (at time of writing) is 6.60% p.a. so your interest charge will be 4.60% p.a. on your current balance. If the BLR doesn't change for 25 years then you have effectively gotten a 4.60% p.a. fixed rate mortgage. This is unlikely to happen, so you can expect to pay less / more than the initial repayment depending on changes in BLR.

While variable rates and fixed rates are both applied on the reducing balance of the loan amount, they are hard to compare directly as one is fixed and the other is likely to change over time!

Hann Liew is the Founder and Editor-in-Chief of SaveMoney.my, an online consumer advice portal which aims to help Malaysians save money through smart (and most of the time painless) savings in their daily banking, technology, and lifestyle spending habits.