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An interest rate is the amount that is paid on money borrowed for the use of money from a lender. Interest rate is usually calculated on yearly basis. Interest rates can be of two types. They can be either variable or fixed.

Variable interest rate, also known as floating interest rate, varies according to the changes in the market. It is the adjustable rate which applies to loan, mortgage or credit. Variable interest rates typically cost less than fixed rate loans, but there is always a risk that interest rates may be hiked in future. Fixed interest rate is a pre-determined amount which remains the same throughout the period of the loan. As it does not fluctuate, borrowers can make accurate calculations of their future payments. Over the entire period, interest is paid in equal monthly installments and is not affected by any changes in the market.

Interest rates are of three forms which include prime interest rate, nominal interest rate and discount rate. Prime interest rate or prime lending rate is the lowest rate that is offered by the bank only to specific customers. Interest rates charged by the banks are largely dependent on the default risk of the customers. The customers with high credibility are most favored by the banks. The possibility of default for such customers is very low and so, the bank prefers to offer best interest rates to these customers. Usually, the banks best customers are large business enterprises and corporations.

Prime interest rate is mostly determined by the federal funds rate, a rate at which a bank lends to another bank overnight. Unlike other interest rates, prime interest rate does not change regularly. It is changed only when banks decide on it all together. Prime rate is considered as a measure of nation's economic growth. Prime interest rate is also considered important for retailers as it affects the interest rates of small businesses and personal loans.

Nominal interest rate is a pre-determined interest rate which does not take inflation into account. It is mostly less than the effective interest rate and is considered unreliable. Real interest rate is calculated by subtracting inflation from nominal interest rate. Effective interest, also known as yield, is the interest which adds annual compound interest to nominal interest rate. The main use of effective interest rate is that it makes comparison of loans easy. As each loan has its own compounding term, comparison becomes easy when it is converted to its equivalent annual interest rate. Effective interest rate differs from annual percentages. Effective interest rate can be different depending on different situations.

Discount rate is the rate which the Federal Reserve charges to the banks that borrow loans from it and also computes the present value for future cash flows. This form of borrowing is usually restricted and is pursued in case when the other means did not work out. The discount rate set by the Federal Reserve is presented to the board for its approval. Hence discount rates will differ for different banks.

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