

## FinancialQuotient

# What is a flat-rate loan?

---

Zhang Weiqi

---

### WHAT DOES IT MEAN?

A flat-rate loan is a type of fixed interest rate loan which computes interest on the original loan amount for the full duration of the loan. A flat-rate loan can be repaid monthly, quarterly, annually or at any pre-specified frequency.

For example, if you borrow \$50,000 for five years with monthly instalments, and if the applied rate

is 3 per cent a year on a flat-rate basis, you will need to pay total interest of  $3 \text{ per cent} \times 5 \times \$50,000 = \$7,500$  over the five-year period.

The primary advantage of a flat-rate loan is the simplicity of its calculation. However, do note that the flat rate is different from the effective interest rate. The effective interest rate of a flat-rate loan is usually much higher than the quoted interest rate.

For example, a five-year 3 per cent a year flat-rate loan with

monthly repayment, carries an effective interest rate of 5.79 per cent, ignoring any administration and processing charges.

### WHY IS IT IMPORTANT?

Many applied interest rates quoted for car loans and personal loans in Singapore are flat-rate based. As a result, the effective interest rate borne by the borrowers is usually higher than the quoted flat rate.

Currently, all financial institutions are required to publish the ef-

fective interest rate (EIR) of their loans. If there is an administration or processing fee, it will also be included in the published effective interest rate.

That is why you often see two published rates for car loans or personal loans: One lower applied rate, which is often quoted on a flat-rate basis, and another EIR, which incorporates the conversion from flat rate and any administration or processing fees.

The EIR of any loan serves as a ba-

sis to compare across different types of loans, and it is the effective rate borne by the borrowers.

### IF YOU WANT TO USE THE TERM, JUST SAY:

The effective interest rate of my car loan is much higher than the advertised 2.3 per cent because it is a flat-rate loan.

- 
- The writer is senior lecturer in the Department of Finance at NUS Business School.