Understanding Compound Interest

Interest is the cost of borrowing money. Interest can increase the amount you earn on an investment or the amount you owe on a loan. There are different types of interest and it's important to understand how interest can work to help or hurt your finances.

Interest Key terms

Simple Interest: The interest that accumulates only on the principal balance of your loan.

Principal Balance: The total amount you currently owe, minus any interest that's yet to accrue. Every time you make a payment, a portion of that money goes toward the interest that is accruing on your loan and any fees you may have been charged, and the rest is used to pay down your principal balance.

Compound Interest: Compound interest is interest calculated on the initial principal and also on the accumulated interest of previous periods of a deposit or loan.

Compound interest can be thought of as making interest on your interest and can grow your money faster than simple interest which is calculated only on the principal amount. On the other side, if your loan payments have compound interest your interest will continue growing at a faster rate than simple interest because you are being charged interest on the interest that has already accrued on the loan.

Compound Interest Formula

Compound interest is calculated by multiplying the principal amount by one plus the annual interest rate raised to the number of compound periods minus one. The total initial amount of the loan is then subtracted from the resulting value.