CONCEPTS AND KEY DEFINITIONS

ADAPTED FROM CGAP course on setting interest rates, Microfinance TRAPS, ADA Transparency Training, MicroFinanceTransparency

Nominal Interest Rate	The interest rate quoted to the borrower that is to be paid on a loan contract. Usually stated as a monthly or annual percentage. Does not reflect inflation, loan fees, commissions and other expenses.
Effective Interest Rate	Interest rate that converts all financial costs such as interest, fees, commissions May other loan requirements (forced savings) that impact the total cost of the loan to the client.
Annual Percentage Rate (APR)	Method of communicating an **annualized effective interest rate**, that takes into account all additional charges and fees, loan term and other loan requirements. The APR method converts this weekly or monthly interest rate into what would be called an annual rate that doesn't take into account the effect of compounding. Most commonly used in microfinance.
Effective Interest Rate (EIR)	Method of communicating an **annualized effective interest rate,** that takes into account all additional charges and fees, loan term and other loan requirements. The EIR method converts this weekly or monthly interest rate into what would be called an annual rate but differs from APR because the formula takes into consideration the effects of compounding, i.e. the fact that for each period, interest is not calculated on the principal, but on the amount of the previous period, including capital and interest. It could be called Continuous Compounding Interest. Method typically used in Europe and West Africa *"The compounded interest rate reflects the opportunity cost for the borrower not to be able to invest the interest he pays to the lender into an asset generating the same percentage of return. As such, investment opportunities are rarely available to individual borrowers, as opposed to institutional investors; the EIR might be more precise in financial terms but not necessarily the most accurate reflection of the true cost paid by a microfinance borrower… The difference between interest rates quoted using the APR and EIR formula diverge more as the number of compounding periods in the year increase and as the period interest rate increases, i.e., loans with interest calculated quarterly will have APRs that are close in both formulas, but when interest is calculated weekly, or even daily, the two APRs can give quite different figures." (source: Microfinance TRAPS, June 2013)*
Flat balance calculation method	"Interest" is calculated on the **initial loan amount**. It doesn't correspond to the definition of « interest », it is rather a fee with payment spread across the loan term.
Declining balance calculation method	**Interest is calculated on the** outstanding balance of the loan**, i.e.,** the balance of money that remains in the borrower's hands as the loan is repaid during the loan term.