When you need funding for your business, obtaining the most favorable financing terms is priority number one. If you’re applying for a small business loan, you’ll need to decide whether a fixed or variable interest rate is best.

These are two very different options and it’s important to understand how your choice impacts the cost of borrowing. This brief guide details the ins and outs of fixed interest rates for small business loans.

**Fixed Interest Rate Explained**

To put it simply, a fixed interest rate doesn’t fluctuate over time. Unlike a variable interest rate, it’s not sensitive to changes in an underlying index rate. Fixed interest rates are determined by several factors, including your personal and business credit profile as well as your annual business revenue. [Click here](#) to see your estimated fixed rate for a term loan from Bond Street.

**Advantages of a Fixed Interest Rate**

The primary benefit of choosing a fixed interest rate versus a variable rate is predictability. Because the interest rate is unchanging, your payments remain the same from start to finish. That takes the guesswork out of estimating your business’s monthly expenditures as the loan is being repaid.

For example, let’s say you want to borrow $50,000 to renovate and expand your business premises. The lender is offering a three-year repayment term with a fixed rate of 8%, which would put your monthly payments at around $1,566. Knowing that beforehand can help you gauge whether your business has sufficient income to maintain the payments.

You also have the advantage of knowing how much the interest adds up to. Using the previous example, the total amount of interest paid would come to approximately $6,400 over the life of the loan. Being aware of the total interest cost is beneficial in two ways.

First, it allows you to determine whether the long-term expense of the loan is worth it to your business. If you’re borrowing money to grow the business and the interest exceeds any additional revenue you anticipate bringing in as a result, that’s a sign that the loan may be too costly.

Second, it allows you to estimate how much of a tax benefit you’ll get by deducting the loan interest each year. With a variable rate, it’s much harder to pin down the amount of interest
you’ll pay from one year to the next. Understanding how the interest adds up and what you can deduct is helpful if you’re on the fence about committing to a particular lender’s terms.

**Drawbacks of a Fixed Rate**

While a fixed interest rate offers a greater degree of transparency, there are certain disadvantages small business owners should be mindful of. A loan with a fixed interest rate has the potential be more expensive over time compared to a loan with a variable rate, with regard to both the interest and the monthly payments.

Consider the following example:

**Loan A**

- Loan amount: $100,000
- Loan term: 10 years
- Interest rate: 10% fixed rate
- Monthly payment: $1,321.51
- Total interest paid: $58,580.88

**Loan B**

- Loan amount: $100,000
- Loan term: 10 years
- Interest rate: 7.5% variable rate
- Monthly payment: $1,187.02
- Total interest paid: $42,442.12

In the second scenario, the assumption is that the underlying index the variable rate is tied to doesn’t increase, meaning the rate remains low. As you can see, a variable rate translates to lower monthly payments, as well as less interest paid over time. When considering a fixed interest rate, it’s important to factor in the potential savings your business may miss out on with a variable rate.

**When Is a Fixed Interest Rate Most Appropriate?**

A fixed interest rate makes the most sense for business owners who want to avoid any surprises in the loan process. For instance, you may prefer this option when borrowing larger amounts that require a longer repayment term, since there’s no risk of the rate
increasing.

A fixed rate is also better suited to established businesses with a stable cash flow that can accommodate a larger payment. If you desire more flexibility where the payments are concerned, be sure to read our primer on variable interest rates.

More from the Resource Center: Variable Interest Rate Explained