Remember the Interest

Standard 7

The student will identify the procedures and analyze the responsibilities of borrowing money.

Lesson Objectives

- Explain why people borrow money.
- Identify the rights and responsibilities of borrowing money.
- Demonstrate when it is appropriate to borrow money.
- Evaluate the impact of borrowing money.

Personal Financial Literacy Vocabulary

Credit: An agreement to provide goods, services, or money in exchange for future payments with interest by a specific date or according to a specific schedule; the use of someone else's money for a fee.

Collateral: Something of value (often a house or a car) pledged by a borrower as security for a loan. If the borrower fails to make payments on the loan, the collateral may be sold; proceeds from the sale may then be used to pay down the unpaid debt.

Comparison shopping: The process of seeking information about products and services to find the best quality or utility at the best price.

Interest: Payment for the use of someone else's money; usually expressed as an annual rate in terms of a percent of the principal (i.e., the amount owed).

Installment credit: A loan repaid with a fixed number of equal payments.

Interest rate: The percentage rate of interest charged to the borrower or paid to a lender, saver, or investor.

Loan agreement: A type of contract between the borrower and the lender explaining the requirements of fulfilling the loan.

Mortgage: A long-term loan to buy real estate including land and the structures on it.

Secured credit: Credit with collateral (i.e., a house or a car) for the lender.

Non-installment credit: Single-payment loans and loans that permit the borrower to make irregular payments and to borrow additional funds without submitting a new credit application; also known as *revolving* or *open-end credit*.

Unsecured credit: Credit without collateral, such as credit cards.

Introduction

"Mom, it is not fair. If Bill can have a new truck, why can't I have one too? His parents love him more than you love me. Otherwise, you would buy me a new car. I hate driving Dad's old car. It's NOT fair. I want a truck. All my friends have new trucks, and I want one too."

"Alright, Rik. If you want a new truck, go pick out one, and we will see how much it really costs to buy that new truck."
Rik went online to customize the one he wanted. The total cost was $28,800, with a $2,000 rebate. He figured he could pay it off in 72 months with payments of $347. ($26,800/72 = $347).

Is Rik right?

Lesson

Borrowing money allows you to make a purchase when you do not have enough money to pay for it. But, borrowing does not mean you have more money. In fact, it is the opposite. Borrowing money means you are using future income to pay for today's expenses. If you are not careful, you can borrow so much that you have more bills than you can pay, both now and for years to come. On top of that, you end up paying more than you borrowed because lenders charge you interest on the money you borrowed. Depending upon the interest rate and the time you take to repay the loan, the price of your purchase could double, triple or increase by even more.

Interest is payment for using someone else's money, and it is stated as a percentage of the loan. This percentage is called the interest rate. While interest rates and other potential fees increase your cost of borrowing money, they are the reason that lenders can stay in business. No one should be expected to "give" you money; they should have something in return because you are using their money and they are taking a risk that you may not make your payments.

Using Credit

People borrow money for many different reasons, and some are better than others. How do you decide what is a good reason and what is not so good? The answer is this: It depends. To make a good decision about when to borrow, you generally need more information than just knowing the monthly payment.

Borrowing Rule # 1:

Do not sign any loan agreement unless you read it carefully and *understand everything in the agreement*.

There are hundreds of different options available to people who want to borrow money. Potential lenders include banks, credit unions, insurance companies, mortgage companies, and numerous other financial service providers. One of the most common ways to borrow is by using a credit card, even though people may not think of it like that. Our society borrows millions of dollars a day using credit cards because they are so convenient to use. However, every time you swipe that card, you are getting a short-term loan from the credit card company. And like all other loans, it must be repaid with interest.

Now you may be asking this: Why do people borrow money if it costs more than paying cash, if they have to pay interest, or if they have to pay other fees that increase the total cost of their purchase? The answer is relatively simple. People borrow money because they want or need to make a purchase. In some cases, it may be the only way they are able to buy things they need or it may be more convenient than using cash.

Following are a few examples of the common uses of credit:

- A mortgage to buy a home.
- A refinance loan that replaces the original mortgage with a loan at a lower interest rate.
- A personal loan to get cash for an emergency, to make special purchases, to fund a vacation, to make home repairs and other purposes.
- A student loan to pay for a college education.
- A home equity loan borrowed against the equity you own in your home; these can be used for a variety of purposes.
- An auto loan to buy a car.

A basic rule of thumb says you should borrow money when investing in the future — not just to buy something you want now. Borrowing to make minor purchases, buying what you "want" or buying what you think you "deserve" almost always lead to over spending and generating more debt than you can manage.

Rights and Responsibilities of Borrowing Money

Each loan has some kind of loan agreement, a special type of contract requiring both the borrower and the lender to do exactly what is stated in the document. Whether it is a credit card, a mortgage, a car loan, or any other kind of loan, the loan agreement specifies the rights and responsibilities of both parties. Before deciding to borrow money, the wise borrower will comparison shop to evaluate the different terms of the loan as specified in the loan agreement.

While loans may vary with their terms and conditions, some of the basic components of a loan agreement include:

- Amount - the exact amount you are borrowing;
- Interest rate - the rate of interest you will be charged;
- Payment - the exact amount you are required to pay back to the lender and how frequently that payment should be made (weekly, monthly, annually, etc.);
- Prepayment - a special clause that allows you to make additional payments and pay off the loan faster;
- Late fees - the additional amount owed if you are late with a payment; and,
- Default - what happens if you fail to make the payments as agreed.

Different Kinds of Credit

Even though there are a large number of potential lenders or types of loans, there are only four different types of credit: secured credit, unsecured credit, installment credit, and non-installment credit.

Secured credit is backed by collateral. In this case, you pledge something of value to the lender who can seize it if you fail to repay the loan. Some items that might be used as collateral include cars, real estate, jewelry, investments, and other assets that are acceptable to the lender. Because you have pledged something as collateral, the lender has less risk in getting something in return for the loan. As a result, secured credit is often the easiest to obtain. Examples of secured credit include home mortgages and car loans.

Unsecured credit means the lender loans you money based on your willingness and your ability to repay the money. Because you pledge no collateral, the creditor is taking a greater risk of losing the money if you fail to make the payments. In this case, the lender needs more confidence in you and your credit history before making the loan. Unsecured loans are based primarily on how you have managed money in the past as well as your current financial situation. If you fail to repay the loan, the lender can sue and take you to court, which can get expensive because you may be required to repay the loan plus pay all court costs if found guilty. It also creates a problem for you to get additional credit in the future.

Installment credit is either secured (requiring collateral) or unsecured (no collateral). This type of credit requires you to make periodic, regular payments for a certain period of time to repay the full amount of your loan plus interest. Sometimes installment credit is called "open ended" or "revolving" credit. With installment credit, each payment you make reduces the balance you owe and allows you to borrow more. Examples of installment credit include credit cards, car loans, mortgages, and personal loans.

Non-installment credit can also be secured or unsecured; it requires you to pay the entire amount due by a specific date. For example, when you get you cell phone bill each month, it says "payable in full upon receipt". That means you owe the entire amount at one time. Bills from the cable company, your doctor and other service providers are often non-installment credit requiring a "lump sum" payment.

Financial Impact

Making one or two payments monthly may not cause too many problems for your budget. However, when you continue borrowing from many different sources, the amount of debt can rise very quickly. It sounds good when the local Buy Me Now store advertises a new DVD player for only $10 a month, but that $10 a month on top of other monthly payments starts to consume your paycheck and can quickly become more than you can handle.

Having too much debt makes it very difficult to pay your bills and can lead to many other problems. Missing payments or making late payments lowers your credit score and can quickly get you into financial trouble. Low credit scores increase your interest rates when you borrow money, and they may also prevent you from getting car insurance, a job, or a place to live. On top of that, paying late fees adds to your monthly payments, making it even harder to pay your bills.

REMINDER

Secured credit is backed by collateral. Unsecured credit means the lender loans you money based on your willingness and your ability to repay the money.

Conclusion

Learning when to borrow and when not to borrow is an important part of building a good financial future. Buying everything on credit reduces the amount of money you will have to make future purchases, and it can also lead to negative consequences for others important factors such as credit scores. Before using that credit card or borrowing for that new car, be sure you stop to think about the possible outcome. You might even want to calculate how many hours you have to work to make those payments and how many years it will take to pay off that loan.

Borrowing money is a legal, contractual agreement between you and the lender. Failing to make payments or defaulting on a loan has a negative impact on your ability to get credit for many years. It also increases the cost you pay for future goods and services and may even reduce your potential to find a job. Just because something is on sale does not mean it is a good buy, especially if you need to use credit to pay for it. Depending upon the terms of the loan agreement, you may end up paying more for that "sale" item than paying cash at the full price.

Savvy consumers understand the value of borrowing money and will make that choice only when they are aware of the potential costs and benefits. They also understand their rights and responsibilities as a borrower to protect themselves from getting into financial trouble.

FINAL NOTE: If you disagreed with Rik's computations, you are right! When Rik talked to the new truck manager, he could not believe the payments would be $100 more than he calculated. He had failed to account for the interest on the loan (and of course, he did not include any monthly allowance for other costs such as insurance, gasoline, maintenance, etc.)

Based on the loan offered to Rik, his payments would be $475 a month for 72 months (6 years). If he lowered his payments to $375 a month, he would need to make payments for 96 months (8 years) and the total cost of the truck would be more than $37,000. Rik decided that driving Dad's old car was not so bad after all. At least for a little longer.

Name:__________________________________Class Period: _________________________________

Remember the Interest Review 7.1

Answer the following questions and give the completed lesson to your teacher to review.

1. List two differences between secured credit and unsecured credit.

2. Explain the difference between installment credit and non-installment credit.

3. Determine which of the following are examples of installment or non-installment credit:

Credit Card	Installment	Non-installment
Making One Lump Sum Payment	Installment	Non-installment
Cable Bill	Installment	Non-installment
Mortgage	Installment	Non-installment

4. Discuss one reason that people borrow money. Explain why they borrow money for that specific purpose and if it is a good reason to take out a loan.

5. Define a loan agreement, and explain why it is important.

Name:________________________________ Class Period: ______________________________

Remember the Interest Activity 7.1A

Answer the following questions and give the completed lesson to your teacher to review.

Following are a few examples of the reasons people borrow money, as discussed in the lesson. In the box below, rank these reasons – starting with the best reason and ending with the least

- A mortgage allows you to buy a home.
- A refinance loan lets you replace the original mortgage with a loan at a lower interest rate.
- A personal loan gives you cash for an emergency, to make special purchases, to fund a vacation, to make home repairs and for other purposes.
- A student loan provides money to pay for a college education.
- A home equity loan is money borrowed against the equity you own in your home and can be used for anything.
- An auto loan can help you buy a car.

1.

2.

3.

4.

5.

6.

Explain your reason for the rankings:

Name:______________________________Class Period: ______________________________

Borrow, Do Not Borrow Activity 7.1B

Read the following statements and decide whether you should borrow or not borrow to complete the transaction.

1. With the move to high-definition television, you decide to buy a new flat screen HDTV for your room.

Borrow Do Not Borrow

Why? ____

2. You have taken a summer job and need reliable transportation, so you decide to buy a used car.

Borrow Do Not Borrow

Why? ____

3. You are at the mall with friends and see a new pair of boots, but you do not have enough cash to buy them.

Borrow Do Not Borrow

Why? ____

4. You friend Harold just bought a new skateboard, so you want a new one too. Borrow Do Not Borrow

Why? ____

5. You have maxed out your credit card, so you are considering getting a loan to make your payments.

Borrow Do Not Borrow

Why? ____

6. Your friends are going on a special trip to celebrate graduation, but you do not have the money to go.

Borrow Do Not Borrow

Why? ____

7. You receive a scholarship to go to your favorite college, but it is not enough money to pay all of your expenses.

Borrow Do Not Borrow

Why? ____

8. You have just graduated from college and have a new job. You have enough money for a down payment on a house, but need a loan to buy a house because you plan to stay in the area for a long period of time. You have an emergency savings account and feel confident that your job is secure.

Borrow Do Not Borrow

Why? ____