Standard 7: **The student will identify the procedures and analyze the responsibilities of borrowing money.**

It Is In Your Interest

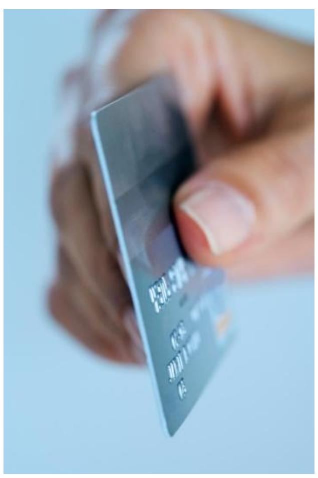
Priority Academic Student Skills
Personal Financial Literacy

Objective 7.1: Identify and analyze sources of credit (e.g., financial institutions, private lenders, and retail businesses) and credit products (e.g., student loans, credit cards, and car loans).

Objective 7.2: Identify standard loan practices, predatory lending practices (e.g., rapid tax return, rapid access loans, and payday loans), and legal debt collection practices.

Objective 7.3: Explain the importance of establishing a positive credit history (e.g., maintaining a reasonable debt to income ratio), describe information contained in a credit report, and explain the factors that affect a credit score (e.g., the relationship between interest rates and credit scores).

Objective 7.4: Explain how the terms of a loan (e.g., interest rates, fees, and repayment schedules) affect the cost of credit.



Lesson Objectives

- ⇒ Identify potential sources of credit.
- ⇒ Compare credit sources.
- ⇒ Evaluate credit practices.
- ⇒ Calculate credit costs.
- ⇒ Demonstrate the ability to make good credit choices.

Jason did not understand how it happened. He had received a credit card application in high school, and at first, it was easy to pay the balance each month.

Then, one month, his car needed TWO tires after hitting a nail-ridden board; and then, his battery failed. He could not quite pay the entire bill, but he was sure he would the next month.

Then, he asked Susan to the prom; she accepted, and he had more bills than expected.

Now, in the middle of the summer, he was almost maxed on his credit card limit, and it would take several months to pay off the card, if he could even do it then! The interest rates were killing him, and he did not want to tell his parents because they had warned him against using credit cards.

What should Jason do?

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 (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 (for example, a house or a car) for the lender.

Noninstallment 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

If you can think of something to buy, you can find a lender to provide the money! But, not all lenders are the same. With so many different types of lenders, borrowers have a lot of options. Finding the best lender can be challenging, and it can make a big difference in the total amount you pay for your purchase. Poor credit choices are very costly and can continue causing problems for many years.

Lesson

Borrowing money is serious business. When shopping for a loan, it is important to compare lenders. The type of lender you choose determines many of the terms of your loan agreement. Building a good relationship with your "banker" can be helpful in getting your loan. Traditional financial institutions such as banks and credit unions tend to have lower interest rates than other lenders. But that is not always the case.

The qualifications for borrowing money vary from lender to lender. Knowing the characteristics and requirements of different credit sources will help you make better choices when looking for a loan.

PRESENTATION

The multimedia slide presentation for this lesson outlines the content in this section. You may want to use it with your students, or print off the slides to use as lecture notes.

COMPLETE: Types of Lenders – Activity 7.2.1

Review student answers before continuing with this lesson.

In the box below, explain what you learned from this activity.

Answer:

Calculating Interest Rates

In its simplest form, the interest rate on a loan is calculated as the dollar amount of interest charged divided by the amount of money borrowed. For example, if you borrow $1,000 that must be repaid at the end of one year at 6 percent interest, you would pay the $1,000 plus $60 in interest. (6% of $1,000 is $60)

Calculating interest on most loans, however, is more complex because few loans are repaid in just one year with just one payment. Most loans require you to make a series of payments for a specific amount of time. (Note: Interest rates on credit cards are more complex and discussed later in this lesson.)

Interest rates are always stated as APR, or the **annual percentage rate (**the percentage cost of credit on an annual basis, which must be disclosed by law). Suppose you decide to borrow that same $1,000 at 6 percent and repay it in three months instead of one year. You would still pay back $1,060 to the lender, but your APR would be different because interest rates are calculated for the entire year.

To find your APR, follow these steps:

1. Divide the number of months in the year (12) by the number of months you are borrowing the money (3 in this example).

   12/3 = 4

2. Multiply the rate of interest paid (6 percent in this example) by 4 (the answer in step 1).

   6 x 4 = 24

   Your annual rate of interest for this loan is a whopping 24 percent!

Now, suppose you borrow $1,000 for two years at 6 percent.

1. Divide the number of months in the year (12) by the numbers of months you are borrowing the money (now, it is 24).

   12/24 = .5

2. Multiply the rate of interest paid (again, it is 6 percent) by .5.

   6 x .5 = 3

   Your annual rate of interest for this loan is only 3 percent.

The APR does not reflect the total amount of interest paid in one year. Instead, it simply standardizes rates so you can compare them from one year to the next.

The annual percentage rate (APR) is the effective rate of interest that is charged on an **installment loan**, a loan that is repaid with a fixed number of periodic equal-sized payments. Most loans from banks, retail stores, and other lenders are installment loans.

Thanks to the *Truth in Lending Act* in 1969, lenders are required to report the APR in boldface type on the front page of all loan contracts. This law also requires lenders to disclose the terms and conditions of the loan when you borrow the money.

Even with the legislation, APR can be calculated in different ways and can sometimes cause confusion. That is the reason borrowers should read <u>all</u> of the fine print before signing any loan agreements and ask questions until they are comfortable with the terms. It is too late for questions after signing the papers.

Calculating Interest Rates on Credit Cards

Credit card interest rates are generally computed on the **average daily balance**. The lender multiplies this amount by the **periodic interest rate** to calculate how much interest you owe for the month. For example, if your total of daily balances equals $3,000 for a 30-day period, your average daily balance is $100. If the periodic interest rate is 12% (1% monthly), your interest expense for the month is $1.

Most credit card companies give you a grace period before adding interest to new charges. A grace period is usually about 20 days and may apply only if you pay your balance in full.

Interest rates on credit cards range from very low (even as low as zero percent on special offers) to very high (over 25 percent). Because credit cards are open-ended, card companies can increase your interest rate at any time and for almost any reason. Most card companies will notify you about 30 days in advance if they are changing the terms, so it is important to read any information sent by your lender. If you choose not to pay the higher interest rate, then you are expected to pay the credit card in full within those 30 days.

CALCULATING INTEREST

To determine your **average daily balance,** add your daily balances for each day in a billing period, which is usually 30 days. Divide by the number of days in the billing period.

The **periodic interest rate** is the fractional amount of an annual interest rate. It is used to calculate interest for a period shorter than a year.

Making Minimum Payments

The minimum payment on credit card debt is a percentage of your current balance. The good news is that the minimum payment drops as your balance is paid; the bad news is that making only minimum payments means you will be paying a lot of interest for a long time—greatly increasing the cost of the goods and services you purchased.

Minimum payments on credit cards are determined by the credit card company and vary from card to card. Suppose you have a balance of $2,400 on your credit card; you pay 15 percent interest on the balance, and your credit card company requires a 2 percent minimum payment. To calculate your minimum payment, multiply the balance by the minimum payment percent: $2,400 x .02 = $48. $48 is your minimum payment.

When making credit card payments, pay more than the minimum balance! When possible, pay off your credit card bill each month to eliminate interest charges.

However, part of that payment goes to pay the interest and part of it goes to pay down the total amount of the purchases. If you divide your interest rate (15) by the number of months in a year (12) and multiply that by your balance ($2,400), you can determine how much of the payment is interest. (.15/12) x $2,400 = $30)

Your minimum payment is $48, and your interest payment is $30, which means you are only paying $18 a month for the charges on your credit card. Next month, your balance will be $2,400 - $18, or $2,384.

At this rate, it will take you 288 months to pay off your credit card, and you will have paid $3,456.59 in interest. 288 months is only 24 years!!! And, you can do it ONLY if you do not charge anything else on your credit card.

Remember, other fees and charges may be added to your bill if you are late with a payment, exceed the maximum credit limit, purchase credit insurance, or other circumstances.

Here is a good rule to follow: If you cannot afford to pay off your credit card bill each month, then rethink your decision to charge your purchase. Only you can weigh the cost of buying on credit against the benefit of having it today.

In the box below, describe the most important things you have learned from this lesson.

1.

2.

3.

4.

Has the lesson changed the way you think about credit? Why or why not?

The first thing Jason should do is quit spending! The only way to get out of debt is to stop accumulating more of it.

The second thing Jason should do is talk to his parents. He should explain what happened and what he plans to do to pay off the credit card.

He may need to get an extra job or find a way to cut his expenses so he can pay his credit card bill. Either way, he will be glad he did—and so will his parents.

Jason is not the only person to have this problem, and he will not be the last. That is why it is important to take control of your spending, instead of having it control you.

Conclusion

While borrowing money is convenient, it is also expensive. Making good choices about borrowing includes borrowing only what you need, understanding the terms of the loan, and choosing the best lender. Knowing what is expected of you and the lending company will help prevent future problems.

Name: ____________________________ Class Period: ___________________________

It Is In Your Interest
Review Lesson 7.2

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

1. Which of the following types of lenders offers loans to high risk customers for very high fees?

    a. Payday Loan Companies
    b. Credit Card Cash Advance
    c. Home Equity Bank Loans
    d. Credit Unions

2. What is the definition of a periodic interest rate?

    a. Annual interest rate
    b. Fractional amount of the daily interest rate
    c. Fractional amount of an annual interest rate
    d. Annual interest rate divided by the daily interest rate

3. What is the definition of a minimum payment?

    a. One twelfth of your total balance
    b. A percentage of your current balance
    c. The dollar amount required to avoid foreclosure
    d. The dollar amount specified in the *Truth in Lending Act*

4. Interest rates on credit cards

    a. are the same for everyone.
    b. vary depending upon several factors.
    c. vary based on a person's age and income.
    d. are the same, regardless of which company issues them.

Name: ____________________________ Class Period: ___________________________

Types of Lenders – Activity 7.2.1

When borrowing money, you have many choices. Following are some of the different kinds of lenders available. You can borrow from them as long as you meet their requirements. However, not all lenders are the same. Interest rates, terms of the loan, and other factors will vary from lender to lender. Before borrowing, be sure you comparison shop to find the best deal.

Commercial Banks

Commercial banks generally offer a greater variety of credit than other lenders, including credit cards, lines of credit, term loans, and installment loans—both on a secured or an unsecured basis. Most banks make loans for several purposes: buying cars, boats, real estate, and homes; taking vacations; paying off other loans; investing in a business; paying taxes; or many other reasons. As a general rule, banks tend to be rather selective, choosing to make loans to individuals and businesses with established credit histories. While most banks prefer that you have an account with them before seeking a loan, it is not required.

Credit Unions

Credit unions are cooperative associations that hold deposits and make loans to their members. To borrow money from a credit union, you must meet their membership requirements and purchase a credit union share to activate your membership and use their services. Credit unions are similar to commercial banks, offering most types of consumer credit. Their rates are often lower than banks, primarily due to differences in structure and federal requirements. Also, they tend to specialize in individual loans rather than commercial or business loans, and they tend to make smaller loans than most banks.

Consumer Finance Companies

Consumer finance companies primarily make installment loans and second mortgages. They also make a large number of debt consolidation loans, especially to high-risk customers. Financial companies are generally more willing to make relatively small loans that most banks avoid because of the risk and expense. They are also more willing to approve loans for applicants with poor or no credit histories than banks or credit unions; however, the interest rates they charge are also much higher. In addition, they tend to charge higher fees and require collateral for many of their loans.

Sales Finance Companies
Sales finance companies were formed to lend money to customers of an associated company. For example, Ford Motor Credit Company provides loans if you want to buy a vehicle at a Ford dealership. Oftentimes, sales finance companies offer borrowers special interest rates or financing offers to stimulate business at the associated company. In those cases, their loans tend to have lower interest rates than similar loans from banks or credit unions. Loans from sales finance companies are generally convenient and relatively easy to get, and unless they are offering special incentives, you may pay higher rates than borrowing from other sources.

Life Insurance Companies
While you may not think about borrowing from a life insurance company, it can be a good source of funds if you own a policy with cash value. Life insurance loans have relatively low interest rates compared to rates at other types of lenders. If you decide to borrow against your insurance policy, however, any unpaid loan amount will be deducted from the face value when disbursed to the beneficiaries.

Brokerage Firms
Brokerage firms are a source of credit for investors who have securities on deposit in a margin account. A margin account allows you to borrow money to buy stocks, but the funds may also be used for other purposes. The maximum you can borrow depends upon the market value of your investments and the amount the brokerage firm is willing to lend. You may also have to use your securities as collateral for the loan.

Pawnbrokers
Pawnbrokers offer short-term, single-payment loans secured by the personal property you leave with the lender. If you do not repay your loan and the interest by the due date, pawnbrokers can sell your property to get their money. While they provide quick access to cash for people with bad credit or with no other source of funds, borrowing from a pawnbroker tends to be extremely expensive because of the high interest rates they charge.

Payday Lenders
Payday lenders provide short-terms loans that will be repaid when you get your next paycheck. Generally, they are small loans for amounts between $100 and $500. However, the annual percentage rates are extraordinary — sometimes as high as 400%! Payday lenders are often used by individuals who have no other options because previous credit problems and low credit scores. In addition, people without bank accounts or those using check cashing services may use payday lenders because they have no relationship with any other lender. Some people view payday loans as a predatory lending practice because of unfair or abusive credit practices; however, others say they serve a purpose for those without any other options.

Name: ____________________________ Class Period: ___________________________

Types of Lenders – Activity 7.2.1

1. Commercial banks	_____ A.	More willing to make loans that commercial banks and credit unions frequently avoid.
2. Credit Unions	_____ B.	Source of credit for investors who have securities on deposit in a margin account.
3. Consumer Finance Companies	_____ C.	Generally offer a greater variety of credit than do other lenders.
4. Sales Finance Companies	_____ D.	Offer short-term, single-payment loans secured by personal property left in the possession of the lender.
5. Life Insurance Companies	_____ E.	A source of credit for certain policyholders who own policies that include a savings component, or cash value.
6. Brokerage Firms	_____ F.	Formed to lend money to customers of an affiliated company.
7. Pawnbrokers	_____ G.	Loans often for amounts between \$100 and \$500, and interest rates can be extraordinary.
8. Payday Lenders	_____ H.	Cooperative associations that accept savings from and make loans to member individuals.