

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

Remember the 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

- ⇒ Explain why people borrow money.
- ⇒ Identify the rights and responsibilities of borrowing money.
- ⇒ Demonstrate appropriate situations to borrow money.
- ⇒ Evaluate the impact of borrowing money.

“Mom, it is not fair. If Bill can have a new truck, why will you not let me have one too? His parents love him more than the both of you love me. Otherwise, you would buy me a new car. I hate driving Dad’s old car. It IS 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. It was only \$28,800 suggested price, with a \$2,000 rebate.

In 72 months, he figured he could pay it off at \$375 a month ($\$26,800 / 72 = \375). If you add a little for interest, it would be about \$375.

Is Rik right?

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.

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



People borrow money for many reasons: to buy a car or a house; to remodel their home; to pay for college expenses; to open a business; and, in some cases, to pay their bills. Borrowing money allows us to get what we want today or to pay for things when we do not have enough cash. While that sounds great, we must remember that borrowed money must be paid back. Making poor decisions about loans can affect our finances for a long time.

Borrowing money does not mean that we have more money. In fact, it is the opposite. Borrowing money means we are using tomorrow's income to buy things today. If we are not careful, we will borrow too much – leaving us with a big stack of bills and no money to pay them!

Lesson

All choices have costs, and that is certainly true when borrowing money. In most cases, borrowing money involves getting a loan; in return, you promise to repay that loan. The amount you repay, however, is not just the amount you borrowed. It also includes interest. Depending upon the rate of interest and the amount of the monthly payment, it could increase the price of your purchase by double, triple, or even more.

U.S. Debt

Consumers in the United States have \$950 billion in credit card debt as of March 2008, and \$1.6 trillion in auto loans and other nonrevolving debt.

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.

Interest is payment for using someone else's money and is stated as a percentage. The percentage charged is the **interest rate**. Interest and other fees increase your cost of borrowing, but they also make it possible for lenders to stay in business.

People who lend money expect more in return. For them, lending money needs an incentive, and that incentive is getting back more than they lent to you. The additional amount is generally called interest.

Why People Borrow Money

People borrow money for many reasons; some reasons 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 need more information.

Today, people make hundreds of loans every day from a variety of lenders, including banks, credit unions, insurance companies, mortgage companies, and other financial service providers. People also borrow thousands of dollars daily using their credit cards. Every time you use a credit card, it is a short-term loan from the company providing the card. Like other loans, it must be repaid with interest.

If you have to pay interest and fees that increase your costs, why do you borrow? The answer is relatively simple: You borrow because you want or need a way to make purchases. For many people, borrowing is the only way they are able to purchase items such as cars and houses.

Following are a few examples:

- 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.

● ● ●
**Borrowing
Rule No. 1:**

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

● ● ●

In the box below, rank the above reasons that people borrow money – starting with the best reason and ending with the worst reason.

1.
2.
3.
4.
5.
6.

Does your ranking look something like this?

- **Home loan:** A house tends to increase in value and will be worth more when we want to sell it.
- **Student loan:** Investing in ourselves or our children with a college education increases potential earnings.
- **Refinance loan:** Refinancing our mortgage reduces our payments and saves money in the long-run.
- **Auto loan:** Even though most of us get a loan to pay for a car, we would be much better off to save up the money and pay cash – avoiding the extra interest paid on something that declines in value. 
- **Home equity loan:** Borrowing against your home is high risk, unless you are remodeling or making major repairs. What if you borrow money on your home to pay for a wedding, take a big vacation, buy new furniture or spend it on other purposes – then cannot make the payments? You may actually lose your home and have no place to live. 
- **Personal loan:** Saving money for emergencies, vacations, and other purchases is a much better option. Personal loans tend to have high interest rates, which greatly increases the cost of your purchase.

As a general rule, you should borrow money when you are investing in the future – not just to buy something you want now. Borrowing to make minor purchases is a sure way to overspend or generate 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, an auto 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.

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.

Depending upon the type of loan, it will include other “terms” or “conditions.”

Different kinds of credit

While there are many different types of credit accounts, there are only four types of credit: secured credit, unsecured credit, installment credit, and noninstallment credit. **Secured credit** is backed by **collateral**. In other words, you pledge something of value to the lender who can seize and sell 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 credit to obtain. A home mortgage and a car loan are common examples of secured credit.

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 do fail to repay it. The lender must have more confidence in you as a person and your credit history before lending you money. Unsecured loans are based primarily on how you have managed money in the past and in your current financial situation. If you fail to repay the loan, the lender can sue and take you to court. You would be required to pay the money if the court finds you guilty and orders you to either pay or requires you to turn over some asset to offset any money the lender does not receive.

Installment credit can be either **secured** (requiring collateral) or **unsecured** (no collateral). Installment 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, where each payment reduces the amount owed and allows you to borrow more. Common examples include auto, personal, and education loans.

Noninstallment credit can also be secured or unsecured. This type of credit requires you to pay back the entire amount by a specific date. For example, your cell phone bill says “payable in full upon receipt.” That means, you owe the entire amount at one time. Bills from the cable company or your doctor are types of noninstallment credit accounts that require “lump sum” payments.

Financial Impact

Making one or two payments monthly will probably 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 on top of other monthly payments may be more than you can handle.

If you have too much debt, then it becomes very difficult to make your monthly payments. Missing payments or making late payments has a negative effect on your ability to get additional credit when you really need it. Also, you will probably end up paying even higher interest rates and more late fees than people with good credit.



COMPLETE: Borrow, Do Not Borrow – Activity 7.1.1
Review student answers before continuing with this lesson.

List three things you learned from this activity:

- 1.
- 2.
- 3.

Conclusion

Learning when to borrow and when NOT to borrow will improve your financial future. If you buy everything on credit, you are reducing the amount of money you will have available for future purchases. Before borrowing, stop and think about how many hours you will need to work and how many years it will take to pay off the loan.

Borrowing money is based on a contractual agreement. Failing to make payments or defaulting on a loan will have a long-term negative impact on your ability to get credit for many years. Even buying things on sale is more expensive when you borrow to buy them. Depending upon the terms of the loan agreement, you may end up paying more for the sale item than when making the purchase for cash at the full price.

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.

How can that be right? $\$475 \times 72$ is over \$34,000.

Even though the truck price was \$26,800, Rik had to include interest on his loan payment.

If he lowered his payments to \$375 a month, he would need to make payments for 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 awhile.

Name: _____ Class Period: _____

Borrow, Do Not Borrow – Activity 7.1.1

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. Your friend Harold just bought a new skateboard, so you want a new one too.

Borrow

Do Not Borrow

Why? _____

5. 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.

Borrow

Do Not Borrow

Why? _____

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

Borrow

Do Not Borrow

Why? _____

7. 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? _____

8. 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? _____