Building Wealth

In the Classroom

Lesson 9

Take Control of Debt—The Cost of Credit

Federal Reserve
Bank of Dallas

Instructional objectives

You will:

- Identify the types of credit available to a consumer.
- Compare and contrast the different sources of credit.
- Examine the cost of borrowing.
- Analyze the impact of purchases financed with credit.

Credit and Debt

What's the connection?

Credit and debt

Credit represents the granting of money or something else of value in exchange for a promise of future repayment.

Having credit enables consumers to buy goods or assets without having to pay for them in cash at the time of purchase.

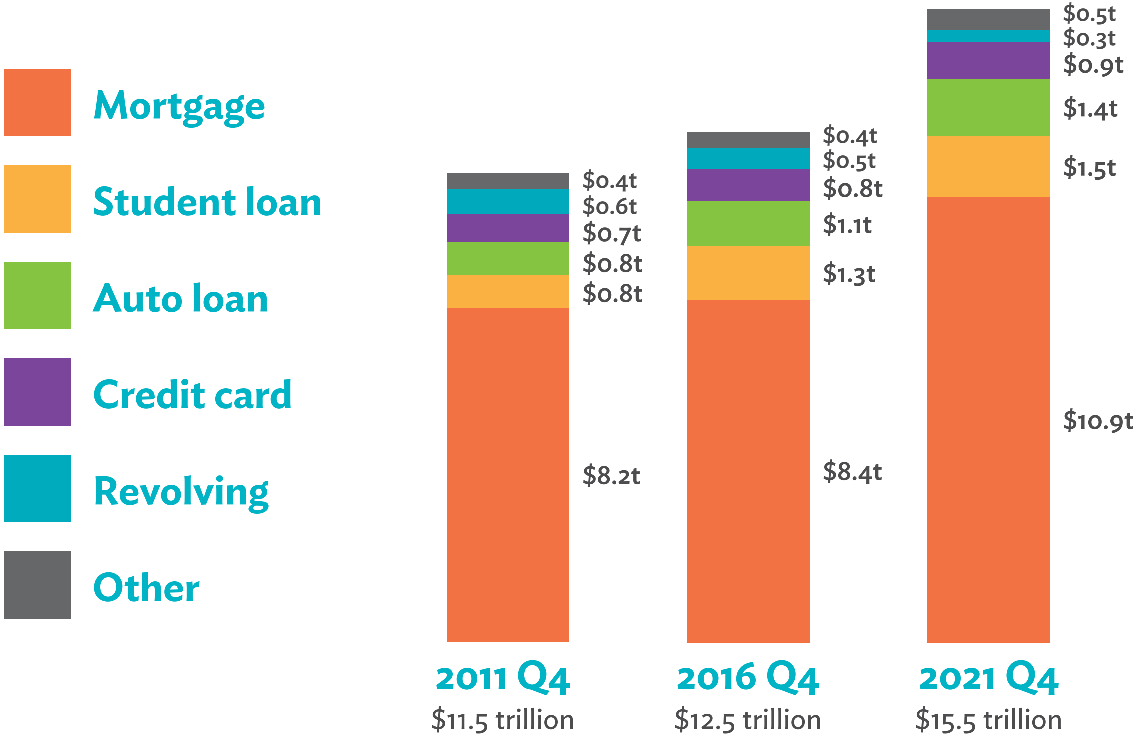
Credit and debt

Debt represents money owed, also known as a liability.

Debt is accumulated when households use credit.

Taking on debt decreases your net worth.

U.S. household debt and its composition



Use the graph to answer the following questions:

What is the first thing that stands out to you?

What else did you observe?

What new questions do you have?

Types of Credit

Revolving, installment and service

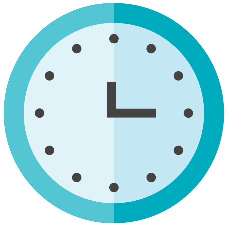
Types of credit

Revolving credit

When people can access a capped limit of funds that may be used repeatedly after partial or total repayments have been made.

- Home equity line of credit.
- Credit card.

Types of credit



Installment credit

When people borrow funds with a fixed payment and schedule for a specified time.

- Car loan.
- Student loan.
- Home loan.

Types of credit

Service credit

Includes types of credit with service providers and requires full payment for each period.

- Cellphone service bill.
- Gym membership bill.
- TV subscription bill.

Characteristics of revolving and installment credit

Loans

- Fixed term and payment.
- Lower interest rate.
- Based on the borrower's need such as paying for college or buying a car.

Credit cards

- Set credit limit.
- Minimum payment.
- Higher interest rate.
- Potential rewards: airline miles, hotel points and cash back.

Lines of credit

- Set credit limit.
- Continuous and repeated access.
- Variable monthly payments.
- Can be used for any purpose.
- Interest rates can vary and change over time.

Additional Sources of Credit

Peer-to-peer lending and high-cost credit

Peer-to-peer lending

Peer-to-peer lending involves lending money through online services by matching borrowers with investors. The borrower never deals directly with the investor; rather a peer-to-peer provider handles all the transactions.

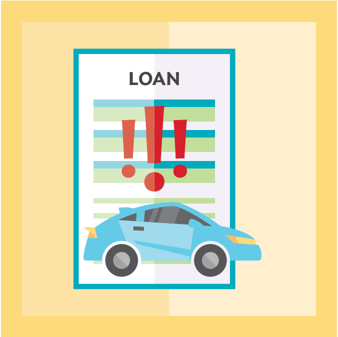
- Online platform.
- Fast application process.
- Alternative source of credit.

High-cost credit

Payday loan is a type of short-term loan taken out against the borrower's paycheck. In exchange for money, the borrower writes a post-dated check.

- Small-dollar loan.
- Typically, due by the next payday.
- High interest rate and fee(s).

High-cost credit

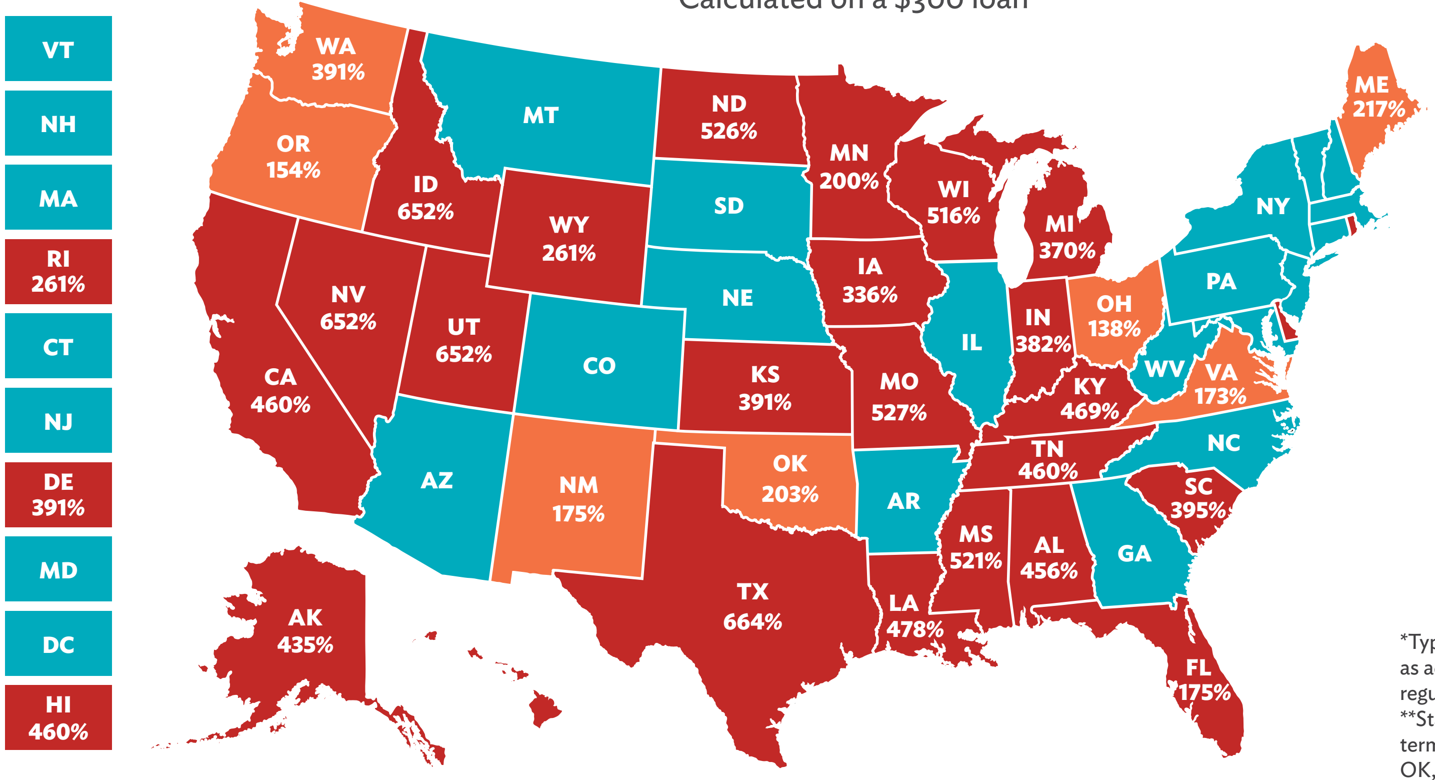


Auto title loan is a type of short-term loan that requires your car as collateral to borrow money. If you don't pay the loan back, the lender can repossess (take) your car.

- High interest rate and fee(s).
- Small-dollar loan.
- Requires using auto title as collateral for the loan.
- Must be 18 years old to take out the loan.
- States determine interest rate and fee rules and whether payday and auto title lenders can operate within each state.

U.S. Payday Interest Rates

Calculated on a $300 loan*



Strong rate caps stop the payday loan debt trap

Some protections against the payday loan debt trap**

No protections against the payday loan debt trap

*Typical APR based on rate for a 14-day loan as advertised by largest payday chains or state regulator, except where otherwise noted.
**States with some protections include term limits longer than 14 days (NM, OH, OK, OR, VA), limits on fees (OR, ME), and/or number of loans per borrower (WA).

Try it on your own

Use handout 2 to record which option you would choose and why and list the advantages and disadvantages of each choice.

Name________________________________ Date______________

Lesson 9—Handout 2

Cost of Credit

Shiloh, 19, High School Senior

Shiloh just graduated high school and has been accepted to a state university 300 miles from home. The cost of tuition, room and board are covered by grants and scholarships, but the meal plan, which is $3,000 per year, books and additional living expenses are not covered.

The financial aid offer Shiloh received gives the option of taking a federal student loan up to $9,500 per year to help cover the additional costs.

$3,000 per year

$5,000 per year

$9,500 per year

Which would you choose? List the advantages and disadvantages of your choice.

Student loan

Shiloh 19, High School Senior

Shiloh just graduated high school and has been accepted to a state university 300 miles from home. The cost of tuition, room and board are covered by grants and scholarships, but the meal plan, which is $3,000 per year, books and additional living expenses are not covered.

The financial aid offer Shiloh received gives the option of taking a federal student loan up to $9,500 per year to help cover the additional costs.

Which would you choose and why?

$3,000 per year

$5,000 per year

$9,500 per year

Shiloh is adding it all up.

The cost of taking out the same loan every year over the course of four years in college.

$3,000 per year =	$12,000
$5,000 per year =	$20,000
$9,500 per year =	$38,000

Shiloh is adding it all up.

What does the monthly payment look like?

$12,000	$20,000	$38,000
Payment: $119.96	***Payment: $199.93***	***Payment: $379.87***
Total interest paid: **$2,395.23**	Total interest paid: **$3,992.06**	Total interest paid: **$7,584.91**
Total payments: **$14,395.23**	Total payments: **$23,992.06**	Total payments: **$45,584.91**

Assumes 3.73% interest, which is the 2022 undergraduate fixed interest rate for federal student loans and a 20-year loan term.

Shiloh is adding it all up.

Monthly payment for college loans

$12,000

Payment: $71.02

Total interest paid: **$5,045.22**

Total payments: **$17,045.02**

$20,000

Payment: $118.37

Total interest paid: **$8,408.70**

Total payments: **$28,408.70**

$38,000

Payment: $224.90

Total interest paid: **$15,976.54**

Total payments: **$53,976.54**

Assumes 3.73% interest which is the 2022 undergraduate fixed interest rate for federal student loans and a 20-year loan term.

Medical bill

Reece 19, Guest Services Clerk

Reece is currently working part time as a guest services clerk at a local hotel. As a part-time employee, Reece doesn't qualify for health insurance. After an accident in the kitchen at home, Reece received stitches at a local urgent care facility. The final bill was $800, and Reece couldn't afford to pay the bill with cash nor has any family or friends to borrow money from.

The three options Reece is considering are to the right.

Which would you choose and why?

Pay the bill on a credit card and make fixed monthly payments for a year.

Pay the bill on a credit card and make minimum monthly payments until the debt is paid off.

Apply for a payment plan (loan) with the urgent care and make fixed monthly payments for 2 years.

Medical bill—adding it all up

Credit card with fixed monthly payments

$75.65 per month is needed to pay off the balance in 1 year.

The total interest is **$107.77**.
(assumes 24% interest)

Credit card with minimum monthly payments

$24 per month is the required minimum payment. It would take 4 years and 8 months to pay off the balance.

The total interest is **$531.47**.
(assumes 24% interest)

Payment plan with urgent care

$33 per month is needed to pay off the balance in 2 years.

The total interest is **$0**.
(assumes 0% interest to set up payment plan)

Auto loan

Avery 22, Social Media Strategist

Avery recently moved to Houston, Texas, for a new job and is currently using a ride-sharing app to commute to work. The cost of using the ride-sharing app is about $600 per month. Avery is considering purchasing a car and has budgeted $500 per month for the payment and insurance. Below are the estimated costs of each choice.

Which would you choose and why?

	4-year loan	6-year loan
Auto price:	$14,000	$20,000
Loan term:	48 months	72 months
Interest rate:	5.3%	6.7%
Down payment:	$2,000	$2,000
Monthly payment:	$312.50	$338.11

Auto loan—adding it all up

4-year loan

Monthly payment: $312.50

Price	$14,000
Sales tax 8.5% (price x 0.085)	
Fees	$300
Down payment	($2,000)
Total financed	$13,490
Interest 5.3%	$1,510.08

Use the formula to calculate the total cost of purchasing a car including the sales tax.

Price + Sales tax + Interest + Fees = Total cost

Auto loan—adding it all up

4-year loan

Total cost: $17,000.08

Price	$14,000
Sales tax 8.5% (price x 0.085)	**$1,190**
Fees	$300
Down payment	($2,000)
Total financed	$13,490
Interest 5.3%	$1,510.08

Price + Sales tax + Interest + Fees = Total cost

Price: $14,000

Sales tax: $1,190

Interest: $1,520.08

Fees: $300

= **$17,000.08**

Auto loan—adding it all up

6-year loan **Monthly payment: $338.11**

Price	$20,000
Sales tax 8.5% (price x 0.085)	
Fees	$300
Down payment	($2,000)
Total financed	$20,000
Interest 6.7%	$4,343.66

Use the formula to calculate the total cost of purchasing a car including the sales tax.

Total cost formula

Price + Sales tax + Interest + Fees = Total cost

Auto loan—answers adding it all up

6-year loan **Total cost: $26,343.66**

Price	$20,000
Sales tax 8.5% (price x 0.085)	**$1,700**
Fees	$300
Down payment	($2,000)
Total financed	$20,000
Interest 6.7%	$4,343.66

Price + Sales tax + Interest + Fees = Total cost

Price: $20,000

Sales tax: $1,700

Interest: $4,343.66

Fees: $300

= **$26,343.66**

What additional costs should you consider before purchasing a car?

Before You Sign

Understanding the lingo

Understanding the lingo

Loan

A sum of money lent with interest. It is a liability or debt and decreases your wealth.

It is important to choose loans carefully, which includes understanding the following terms:

- **Principal** is the unpaid balance on a loan.
- **Interest** is a fee for the use of money over time.
- **Interest rate** is the percentage charged for a loan.
- **Annual percentage rate (APR)** is the annual rate that is charged for borrowing. The APR includes any fees or additional costs associated with the loan.

Understanding the lingo

Finance charge

A fee charged for the use of credit. It may be a flat fee or a percentage of borrowings. It can include: transaction fees, account maintenance fees or late fees.

Prepayment penalty

A fee charged for paying back the loan before the end of its term.

Lenders are not allowed to charge you a prepayment penalty if you pay your student loans off early.

Save Money by Choosing the Right Loan

It's very important to have a good foundation, including emergency savings, a budget or spending plan before taking on debt.

Taking on debt tips

When you are ready to take on a credit obligation:

Shop and negotiate for the lowest interest rate.

Obtain your credit score well before you plan to apply for credit.

Use an online loan calculator to compare rates.

Taking on debt tips

Save interest expense by increasing your monthly payments or choosing a shorter payment term on your loans.

Always read the fine print on any credit application.

Seek assistance from family members, local nonprofit credit counseling services or others to make sure a loan is right for you.

Summarize learning objectives

Credit is the granting of money or something else of value in exchange for a promise of future repayment.

Debt represents money owed.

Revolving credit is when people can access a capped limit of funds that may be used repeatedly after partial or total repayments have been made.

Installment credit is when people borrow funds with a fixed payment and schedule for a specified time.

Summarize learning objectives

Service credit includes types of credit with service providers and requires full payment for each period.

Peer-to-peer lending involves lending money through online services by matching borrowers with investors.

Payday loan is a type of short-term loan taken out against the borrower's paycheck. In exchange for money, the borrower writes a post-dated check.

Summarize learning objectives

Auto title loan is a type of short-term loan that requires your car as collateral to borrow money. If you don't pay the loan back, the lender can repossess (take) your car.

A ***loan*** is a sum of money lent with interest.

Principal is the unpaid balance on a loan.

Summarize learning objectives

Interest is a fee for the use of money over time.

Interest rate is the percentage charged for a loan.

Annual percentage rate (APR) is the annual rate that is charged for borrowing. The APR includes any fees or additional costs associated with the loan.

Summarize learning objectives

Finance charge is a fee charged for the use of credit. It may be a flat fee or a percentage of borrowings. It can include: transaction fees, account maintenance fees or late fees.

Prepayment penalty is a fee charged for paying back the loan before the end of its term.

Sources

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