How Credit Works

Summary
Students learn credit terminology and analyze an actual loan application from a family member.

Main Core Tie
General Financial Literacy
Strand 4 Standard 2

Time Frame
2 class periods of 45 minutes each

Materials
See student worksheets in the Instructional Procedures section.

Background for Teachers

Credit and Debt
The sword cuts both ways, as the saying goes. The same applies to credit: it can be a tool or a trap, depending on how it’s handled. Used well, credit can be an asset to help build wealth as part of a financial plan; used poorly, credit can lead to excessive debt, which can quickly consume an individual's financial resources. As with any tool, credit must be used carefully and with caution. Today more than ever, students need to be keenly aware of credit and the lure of "easy money." Credit card companies routinely offer cards to college students, with an average credit limit of $3,683 in 1999. One fifth of undergrads carry at least four cards, and the average revolving balance for all college students is $1,843. These are students who passed through the halls of your high school within the last year or so.

And those are just the credit card statistics. Other sources of credit include traditional financial institutions like banks and credit unions, finance companies, auto dealers, pawn shops, rent-to-own businesses, "pay day" cash-advance lenders, and friends and family. In short, there is no lack of credit available to high school students. The more students know about using credit wisely, the better the odds of it becoming a tool instead of a trap.

What are some of the basics of credit? One simple strategy is to avoid interest by paying off the full balance on a credit card every month. Another is to always pay bills on time, which builds a strong credit reputation. Yet another is to avoid bouncing checks.
In addition to the "Top Ten Questions to Ask Before Signing On the Dotted Line," other questions to consider are: What is the total amount of credit needed? How is the interest calculated? Is there a penalty for early payoff of the balance? What collateral is needed to secure the credit? What will be the value of the item being financed upon final payment? What is the reputation of the credit institution? What other financial obligations already exist?

When credit is abused, it can lead to excessive debt and potential bankruptcy. It's easier to get into debt than to get out of it, but teaching students the basics of credit greatly increases their chances of avoiding debt as a trap in the future.

Credit History and the Five C's of Credit
Credit history is very important to an individual's ability to obtain credit. A person's credit history is the equivalent of his or her credit reputation. A damaged credit reputation can follow the individual for up to 10 years before being cleared.

Many people think access to credit is a right. It actually is a privilege and convenience available to those who are considered creditworthy. The determination of who qualifies for credit will vary by
institution. constant in the qualifying process. To be approved, an individual must have the ability and willingness to repay the loan or credit amount, document the ownership of assets to be used as collateral, have an established credit history, and, less critical but still important, have good character, appearance, and behavior. These characteristics are sometimes referred to as "The Five Cs of Credit": Capacity, Collateral, Capital, Conditions, and Character. We discuss three of the "Cs of Credit" in the High School Program: Capacity, Character, and Capital.

Credit Report
A credit report provides a very complete and detailed record of an individual's payment history. It includes all monies that have been borrowed from a lender and use of all credit cards. If payment is not received within 30 days after the due date, the account is flagged as delinquent with a code of "2." This alerts creditors that either a payment has not been made on time or it has been missed completely. An example of "Timeliness of Payments: codes could range from "0" (approved not used) to "9" (seriously delinquent/bad debt). Creditors use these ratings to determine if they will extend credit. The three major credit reporting agencies are Equifax, Experian (formerly TRW), and Trans Union.

Source: NEFE.org

Instructional Procedures
How Credit Works
Objective: Discover what students already know about credit and what they would like to learn about it.

Student perceptions about credit will vary widely. Most of them may be somewhat familiar with credit cards, and many will at least have heard of a mortgage (through their parents). One of the more common misconceptions about credit is that it is free and relatively unlimited. Students often draw these conclusions from watching their parents use credit cards at department stores, grocery stores, gas stations, etc. What students often miss is the size of the check that goes in the mail to pay the credit card companies.

Create a K-W-L Chart on an overhead, flip chart or the chalkboard. Lead a class discussion about credit by asking the following two questions, and recording student answers:

- What do you know about credit (any type)?
- What do you want to know about credit?

At the end of this lesson, come back to this chart and ask the following question:
- What have you learned about credit?

Ask the following questions.
- What did you learn that surprised you about how credit works?
- How do you feel about using credit?
- What advice would you give to someone who is about to use credit for the first time?

Credit Masquerade
Objective: Students define basic terms and concepts related to credit.

Hearing credit terminology is one thing; being able to talk about intelligently with others is another. This activity essentially forces students to think of specific, pointed questions related to credit. When students actually apply for credit at some point in their lives, the experience in this activity will help them communicate clearly their questions and concerns about their credit needs.

- How Credit Works (pdf)
Using the list of words and phrases students generated in the "Give Me Credit" activity, write down one term or concept related to credit on 3 by 5 cards. Randomly place one card on each student's back, so that the student does not know what is written on the card. Instruct students to meander around asking only "yes/no" questions, with no hints allowed. All students must answer any question asked truthfully, until everyone figures out the word or phrase on their back.

Students turn in their cards to the instructor when they figure them out; if there are additional cards, the instructor will place another one on a student's back until all the cards are distributed. Potential words and phrases could include: "buy now, pay later;" credit; interest; APR; term; prepayment penalty; loan; debt; finance charge; grace period; annual fee; origination fee; mortgage; home equity loan; credit card; debit card; compound interest; credit limit; balance; principal; interest rate; minimum payment; student loan; credit report; credit score; bankruptcy; credit reporting agency; and others.

Ask the following questions.

- How does it feel to be "in the dark" when you're trying to get a particular piece of information?
- What strategies did you learn about asking questions?
- How can an activity like this help you learn about investigating credit offers you'll receive after you graduate?

- **Credit Masquerade**
  (pdf)

**Let's Break Down a Deal**

**Objective:** Students learn to analyze real-life credit offers.

The credit industry often focuses consumer attention on the size of the monthly payment, but students will learn through this activity to dissect credit advertisements and look for the key variables in any loan situation (size of the loan, interest rate, fees, monthly payment, length of loan, etc.).

Divide students into groups of four or five.

Distribute a scenario card to each group. (Scenario cards are available in the pdf below.) Each group must make a decision on which financing offer to accept.

Once all groups have finished, each group makes a short presentation explaining the offers and their final answer.

Rationales should include at least the following comparisons:

- total finance charges
- monthly payments
- loan lengths

Pending instructor approval, students can bring in actual credit offers from local media (TV, radio, newspaper, direct mail) to analyze instead of using a scenario card.

Ask the following questions.

- Which variable carried the most weight in your group’s decision-making process? Why?
- How can you use a credit analysis process like this in your own life?
- How would you feel about committing yourself to two, three or four years of monthly payments?
- Which is more important to you: a smaller payment or paying less interest?

- **Let's Break Down a Deal - Scenario Cards**
  (pdf)

**Loan Ranger**

**Objective:** Students analyze an actual loan application from a family member.

Up to this point, the activities students have completed have been mostly theoretical. In this activity, students analyze the real thing--an actual loan document borrowed from a family
member. Students may be surprised at the amount of "legalese" in a loan document. Seeing the Federal Truth-in-Lending Disclosure Statement (which should be included in all loan documents now) will reinforce the calculation of key variables in a loan situation.

Ask students to analyze a loan application from a family member. The loan can be current or one that has been paid off. Types of loans could include car loans, student loans, home improvement loans, mortgages, etc.

Students gather the following data:
- APR
- Loan term
- Monthly payment
- Loan amount
- Finance charge over the life of the loan
- Total payment amount

Students next create a bar chart in a spreadsheet program showing the amount of interest and principal paid for the life of the loan.

Students then investigate current interest rates for a comparable loan (principal amount, loan term, etc.).

- Loan Ranger (pdf)

Assessment Plan
Students will be able to evaluate a loan application.

Bibliography
These mini lessons are provided by NEFE (www.nefe.org).

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