MODULE 2 — FIRST STEPS TO FINANCIAL INDEPENDENCE

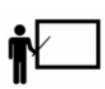
LESSON 2.4 Debt & Easy Access Credit

This lesson teaches students about good and bad debt, how to reduce debt, and easy access credit. The FIT Work has students reflecting about easy access credit and making wise financial decisions.

MATERIALS & PREPARATION

- ☐ Good Debt vs. Bad Debt sheet (page 2.36) one for each student
- ☐ Easy Access Credit Resource sheets (page 2.38-2.40) one for each student
- ☐ FIT Work 2.4 sheet (page 2.41) one for each student


FIT Tool: Debt Reducer Calculator


Slide Presentation 2.4

LEARNING GOALS

- Students are introduced to the financial concepts (vocabulary) through a game.
- Students understand the importance of setting goals.

JUMP$TART PERSONAL FINANCIAL EDUCATION NATIONAL STANDARDS ALIGNMENT

- Financial Responsibility and Decision-Making
- Planning and Money Management
- Saving and Investing

DO THIS

1. Group students in teams of 2-3. Ask students if they know what debt is. Define debt as an obligation to pay someone else. Ask students to name examples of debt. Examples: home mortgage, home equity loan, car loan, credit card debt, student loans.

2. Ask students if there is such a thing as “good debt.” Discuss.

3. Define good debt as borrowing or financing to purchase something that can appreciate/gain in value. Define bad debt as borrowing or financing to purchase something that in the long run costs you more than its initial value.

4. Hand out the Good Debt vs. Bad Debt sheet (page 2.36). Explain to students they are to answer each of the questions and then create a skit that illustrates and answers the question. Give them an appropriate amount of time.

NOTES:

5. Have student teams complete the Good Debt vs. Bad Debt sheet. When teams have completed the sheet, have them present their skits for the class. Have students put the sheet in their PF Portfolio.

6. Ask students what happens when people "live beyond their means" or borrow to maintain their lifestyle. Discuss with students that more and more adults and young people are getting into serious debt, especially credit card debt.

7. Discuss with students what happens when debt such as credit card bills, home equity loans, home mortgages, car payments, and student loans are not paid on time or not paid at all. Some examples are late fees, foreclosure on your house, repossessed cars, and increased debt from interest charges. Discuss how compound interest charges can quickly cause debt to get out of control.

8. Use the FIT Tool: Debt Reducer Calculator to show how expensive debt can be. Since 2005-06, the minimum payment on a credit card must be 4% of the balance. Make sure students understand that the FIT Tool scenarios only reflect situations when there are <u>no</u> <u>additional</u> <u>charges</u> made to the card.

9. Provide the following scenario.
   Anne has a credit card with a balance of $1,200. The interest rate is 9.89%. Her fixed monthly payment is $48. When will she be debt free? How much will she pay in interest?

   Amount of debt: $1,200
   Interest rate: 9.89%
   Fixed monthly payment: $48
   Total interest paid: $149.28
   Debt free: 2 years and 5 months

10. After each example, discuss the length of time and the amount of interest paid.

11. Present the follow scenario:
   Arman has a credit card with a balance of $15,750. The interest rate is 19.89%. His fixed monthly payment is $630. When will he be debt free? How much will he pay in interest?

   Amount of debt: $15,750
   Interest rate: 19.89%
   Fixed monthly payment: $630
   Total interest paid: $4,757
   Debt free: 2 years and 9 months

NOTES:

12. Ask students how Arman could pay his debt off sooner. Guide students to increasing his monthly payment. Use the Accelerated Debt Reduction portion of the FIT Tool: Debt Reducer Calculator to add extra payments and discuss how increasing payment amounts saves you money.

13. Discuss other ways to reduce debt. For example:
- Reduce spending and use the difference to pay down debt.
- Cut up credit card.
- Spend only cash.
- Adjust spending plan.
- Pay more than just the minimum payment.
- Transfer to a credit card with a lower interest rate.
- Negotiate a lower interest rate.
- Prioritize payment options.

14. Explain to students that sometimes people get into situations where they need cash immediately and do not have an emergency fund to rely on. Pawnshops, payday loans, rent-to-own, and title loans are all examples of easy access credit and how people can get fast cash. Using these services can make a bad financial situation worse, and habitually using them can create a cycle of bad debt that can be difficult to escape.

15. Group students in teams of 3-4. Tell students that they will be teaching the other students about different types of easy access credit. Provide each student with a copy of the Easy Access Credit Resource sheets (pages 2.38-2.40). They can use this to learn about pawnshops, payday loans, rent-to-own, and title loans. Teams can also use textbooks, books, and/or the Internet to find additional information.

Have the students answer the following questions/prompts for each type of easy access credit:
- Describe it.
- Why do people use it?
- Why can it be a bad financial move?
- What other interesting information can you share about it?

16. Have each team teach the class about easy access credit. Have students take notes for their PF Portfolio. Check for understanding.

17. Discuss how debt impacts credit history and credit score. Explain that once a person has established credit that they are given a score. The score is listed on credit reports. Credit reports

NOTES:

are meaningful to borrowers and lenders. A person may not get a loan based on a lower credit score.

18. Optional: Have a representative from a banking institution come in and present information on debt, credit cards, and easy access credit.

FIT WORK

Optional: FIT Work 2.4 sheet (page 2.41). Students reflect on easy access credit and making wise financial decisions. The answer key is on page 2.42. Remind students they are responsible for keeping all FIT Work sheets in the PF Portfolio.

ASSESSMENT

- Observe how teams work together – look for collaboration, leadership, communication, and teamwork qualities and skills.
- Observe and listen to team presentations/lessons – look for mastery of content.
- Review Easy Access Credit notes for accuracy.
- Review FIT Work 2.4 sheet for mastery of content and completion.

PFP

- Good Debt vs. Bad Debt sheet (page 2.36)
- Easy Access Credit notes
- FIT Work 2.4 sheet (page 2.41)

GOOD DEBT VS. BAD DEBT

Name ______________________________

Date ______________________________

Read the following scenarios and determine if the person has acquired "good debt" or "bad debt." Include consequences for your decision and your rationale. Pick one of the scenarios and create a short skit to share with the class.

Rosie just bought a new house. Her 30-year home mortgage is $150,000. In addition, she is considering taking out a home equity loan of $20,000 to remodel her kitchen. She is discussing this option with her best friend over a cup of coffee. Why could this be considered good debt?

Norman is at the auto shop with his brother. He wants to purchase four chrome wheels at $1,500, two car seat covers at $250, and a stereo system at $500. Norman has $2,000 in savings and is considering charging the total bill to his credit card. His brother is discussing the purchases with him. Why could this be considered bad debt?

Pauline needs to pay $7,000 for one semester of college tuition and books. She does not have any savings to pay for it. She is considering charging it to her credit card. She will pay it back over a period of time. She is discussing the matter with her mother. Do you consider this to be good debt or bad debt? Why?

Jeffrey wants to start a business. He is at the bank applying for a $30,000 loan. He is there with his wife. Is this considered good debt or bad debt? Why?

Hilary has a once-in-a-lifetime trip to the Galapagos Islands. The entire trip is going to cost her $3,000. She only has $1,500 in savings. Hilary is considering charging the trip on her credit card. Her friend is trying to talk her into going on the trip. Why is this bad debt?

GOOD DEBT VS. BAD DEBT

Name ____

Date ____

Read the following scenarios and determine if the person has acquired "good debt" or "bad debt." Include consequences for your decision and your rationale. Pick one of the scenarios and create a short skit to share with the class.

Rosie just bought a new house. Her 30-year home mortgage is $150,000. In addition, she is considering taking out a home equity loan of $20,000 to remodel her kitchen. She is discussing this option with her best friend over a cup of coffee. Why could this be considered good debt?

> This is good debt because the loan is being used for something that will increase the value of her home.

Norman is at the auto shop with his brother. He wants to purchase four chrome wheels at $1,500, two car seat covers at $250, and a stereo system at $500. Norman has $2,000 in savings and is considering charging the total bill to his credit card. His brother is discussing the purchases with him. Why could this be considered bad debt?

> The money he would use to add those extras to his car does not increase the value of the car. He is also depleting his savings for an unnecessary purchase and going into more debt because of the interest he has to pay on the credit card.

Pauline needs to pay $7,000 for one semester of college tuition and books. She does not have any savings to pay for it. She is considering charging it to her credit card. She will pay it back over a period of time. She is discussing the matter with her mother. Do you consider this to be good debt or bad debt? Why?

> This is bad debt because interest on credit cards is usually high and since she plans to pay it back over time, she will have to pay substantial interest to the credit card company. Since a college education can significantly impact Pauline's ability to get a job with a decent salary once she graduates, she may want to get a student loan at a lower interest rate.

Jeffrey wants to start a business. He is at the bank applying for a $30,000 loan. He is there with his wife. Is this considered good debt or bad debt? Why?

> This is good debt because he is using the loan to start a business which could increase his income and assets.

Hilary has a once-in-a-lifetime trip to the Galapagos Islands. The entire trip is going to cost her $3,000. She only has $1,500 in savings. Hilary is considering charging the trip on her credit card. Her friend is trying to talk her into going on the trip. Why is this bad debt?

> This bad debt because it is for an unnecessary expense, which also depletes her savings.

Easy Access Credit

Payday Loan

Payday loans are short-term cash loans based on the borrower's personal check held for future deposit or on electronic access to the borrower's bank account. Borrowers write a personal check for the amount borrowed plus the finance charge and receive cash. Lenders hold the checks until the next payday when the loans and the finance charge must be paid in one lump sum.

To pay a loan, borrowers can redeem the check by paying the loan with cash, allow the check to be deposited at the bank, or just pay the finance charge to roll the loan over for another pay period. In some cases, borrowers sign over electronic access to their bank accounts to receive and repay payday loans.

Payday loans can be made by payday loan stores, check cashers, and pawn shops. Some rent-to-own companies also make payday loans. Loans are also marketed via toll-free telephone numbers and over the Internet. To get a payday loan, a person needs an open bank account in relatively good standing, a steady source of income, and identification. Lenders do not conduct a full credit check or ask questions to determine if a borrower can afford to repay the loan.

Payday loans can trap consumers in repeat borrowing cycles due to the extreme high cost to borrow, the very short repayment term, and the consequences of failing to make good on the check used to secure the loan.

<u>Is payday lending legal</u>?
Payday lending is authorized by state laws or regulations in 37 states. Some states allow licensed lenders to make payday loans. Twelve states and two territories have not enacted payday loan authorizing legislation.

<u>What are the terms of payday loans</u>?
Payday loans range in size from $100 to $1,000, depending on state legal maximums. The average loan term is about two weeks. The finance charge ranges from $15 to $30 to borrow $100. For two-week loans, these finance charges result in interest rates from 390% to 780% APR. Shorter term loans have even higher APRs.

Payday loans are extremely expensive compared to other cash loans. A $300 cash advance on the average credit card, repaid in one month, would cost $13.99 finance charge and an annual interest rate of almost 57%. By comparison, the same amount for a payday loan costing $17.50 per $100 for two weeks would cost $105 if renewed one time or 426% annual interest.

Car Title Loan

A car title loan refers to a loan in which someone's car title and a copy of their car keys are held by the lender until the person repays in full. They are also called a "title loan" or "car pawn" or "title pledge loans" or "motor vehicle lines of credit."

Pawnbrokers, used car lots, and stand-alone storefronts provide title loans and are found mostly in strip malls, near convenience or liquor stores, and in neighborhoods where there are few bank branches.

A rent-to-own arrangement starts off as a traditional rental agreement, but the two parties agree to transfer ownership at the end of a specified period of time. The seller benefits from the high monthly interest rates, and the buyer benefits from the less restrictive credit qualifications (only a few references and proof of steady employment is needed).

A $600 television set, for example, might end up costing the buyer nearly $1,500 in total payments. Since these monthly rent-to-own payments are usually smaller than equivalent bank loans, the buyer doesn't always feel the pinch. The seller can afford to take an occasional loss as long as those who remain in the rent-to-own program continue until the end. Repossessed items are sometimes sold again under new rent-to-own arrangements.

Despite the high interest rates and risk, these customers will eventually assume ownership rights to their purchases. The alternative might be to buy inferior used goods with available cash, or enter into other high interest loans with lending institutions.

Rent to own arrangements are legal, but consumers should be aware of all the hidden costs and conditions prior to entering into the agreement.

Pawn Shops

A pawn shop is a lot like a dozen garage sales and a flea market all rolled into one. Pawn shops provide people with a fast, easy way to borrow small amounts of money. There are three transactions that happen in any pawn shop:

- People borrow money by putting up something they own as collateral.
- People sell used merchandise.
- People buy new and used merchandise.

The basic idea behind a pawn shop is to loan people money. This is how it works:

- Bring in something of value and give it to the pawnbroker as collateral for a loan (this act is called pawning).
- The pawnbroker loans money against that collateral.
- When the loan plus the interest is repaid, the collateral is given back.
- If the loan is not repaid, the pawnbroker keeps the collateral.

If an item is pawned for a loan, within a certain period of time, the pawner of an item may purchase it back for the amount of the loan plus some agreed upon amount for interest. The amount of time, and rate of interest, is governed by state law and the pawnbroker's policies. If the loan is not paid (or extended) within the time period, the customer forfeits title of the item to the pawnbroker. The pawnbroker does not report the defaulted loan on the customer's credit report, since the pawnbroker has title to and physical possession of the item. The pawnbroker may recoup the loan value through outright sale of the item at his pawn shop.

The pawnbroker should only accept items that are not stolen property. Laws to protect both the pawnbroker and the community-at-large exist in some areas. These laws often require the pawnbroker to establish positive identification of the seller through photo ID (i.e., drivers license or government-issued ID), as well as a holding period placed on an item purchased by a pawnbroker to allow for local law enforcement authorities to track down stolen items.

Easy Access Credit

Like payday loans, car title loans are marketed as small emergency loans, but these loans put, at high risk, an asset essential to the well-being of working families – their car.

Typical car title loans have annual interest rates of 300% and the loan amount is no higher than 30 to 50 percent of what the lender says is the value of the car. Like payday loans, car title loans are usually made without regard to a person's ability to repay.

Car title loans are set up to be repaid as a single large payment after a very short term, usually a month. The person taking the loan has to give the lender the title to his/her car or a set of keys. If the loan is not repaid in one month or another round of fees paid to extend the loan, the lender will take the car, sell it, and possibly keep the full sale price.

<u>What is abusive about car title loans</u>?

Rollovers: Often, people cannot pay the full amount owed on the due date, so they must extend or "roll over" the loan repeatedly. This creates a situation where many consumers pay fees higher than the amount originally borrowed.

Losing the car and "equity": If a person cannot afford to pay fees every month to rollover the loan, the lender may take the car without advance notice. This can lead to further financial problems, if the person is dependent on the car to get to work. It can also lead to health and other problems as well, if there is no car to get to the doctor's office or to get children to school. When the lender takes the car, he/she will sell the car and may keep the full value, not just the amount owed.

Extremely high interest rates: The interest rates charged are often very high, sometimes 300% or more.

Disguised loans: In states where car title loans are illegal, title lenders hide the true nature of their products to exploit loopholes in existing laws—for example, pretending that their abusive loans are "sales and leasebacks" or "pawns" when that is not the case.

Internet loans: Using the Internet to borrow money leads to increased risk. It's possible that car title lenders will not keep private information confidential. Also, they might not be physically located in the same state and often aren't even present in the United States. They may lend over the Internet in order to avoid the protections of state laws and to make it virtually impossible for anyone or any government agency to find them.

<u>Are car title loans legal</u>?

High-priced title loans are illegal in about half of the states. However, the car title lending industry has grown tremendously in states that have failed to take adequate steps to protect consumers or have passed industry-friendly laws.

Rent-to-Own

For many consumers with poor or non-existent credit histories, owning big ticket items such as furniture, electronics, or cars can seem unattainable. Qualified buyers can often get low-interest loans from banks to finance these purchases, but some can only qualify to pay high-interest rental prices every month. Under traditional rental agreements, there is no sense of ownership. If the renter cannot make the rental payment, the item is repossessed by the owner.

FIT Work 2.4

Name ___________________________

Date ___________________________

Desmond is anxious to purchase some sneakers that are on sale this week. Unfortunately, he does not have the money to pay for them. Rather than wait until he saves enough, he decides to take out a title loan using his car as collateral. Was this a good decision? Why or why not?

What happens if he is unable to pay back the loan?

What advice would you give Desmond?

FIT Work 2.4

Name ___________________________

Date ___________________________

Desmond is anxious to purchase some sneakers that are on sale this week. Unfortunately, he does not have the money to pay for them. Rather than wait until he saves enough, he decides to take out a title loan using his car as collateral. Was this a good decision? Why or why not?

No. Car title loans have extremely high interest rates (often over 300%). Desmond will be further in debt than before because he will have to pay back the loan plus the amount of interest. This means that his sneakers actually cost a lot more than the sale price because of the interest he had to pay for the loan.

What happens if he is unable to pay back the loan?

Two things could happen. Desmond can extend the loan at an even higher interest rate or the title loan company will take away his car.

What advice would you give Desmond?

If he really wants that certain pair of sneakers, he can wait until he has enough money saved to pay for them. They may not be on sale by then but at least he will not get himself further into debt with the car title loan. He can also buy another pair now that he can afford.