

## Lesson 12

# Take Control of Debt: Not All Loans Are the Same

### Lesson Description

This lesson examines the features of a loan with a fixed period of repayment (term loan). After distinguishing these loans from revolving credit, students compare the benefits and costs of term loans with different interest rates and term lengths. Outside of class, students research the terms of an auto loan and compute financing costs and payment amounts using online resources.

### National Standards in K-12 Personal Finance Education ([www.jumpstart.org](http://www.jumpstart.org))

#### *Credit and Debt*

Standard 1: Identify the costs and benefits of various types of credit.

### Instructional Objectives

Students will:

- Compare term loans and revolving credit.
- Distinguish between APR and finance charges.
- Analyze the effect of differing APR and loan length on monthly payment and total finance charges.
- Identify ways to reduce overall finance charges on a term loan.

### Time Required

One 50-minute class period

### Materials Required

- Copies of classroom visuals
  - *Visual 1: Types of Consumer Credit*
  - *Visual 2: Comparing Credit Offers for Term Loans*
  - *Visual 3: Term Loans: Making Important Decisions*
- Copies of the following handouts for each student
  - *Handout 1: The Cost of Credit*
  - *Handout 2: Loan Research*

### Procedure

*Building Wealth*, pages 19–24, and the **Take Control of Debt** section of the CD-ROM contain information and visuals related to this lesson.

1. Ask students to name some common types of credit. Record responses on the board.  
*Answers will vary but might include credit cards, car loans, mortgages and student loans*
2. Display *Visual 1: Types of Consumer Credit*. Discuss the differences between revolving credit and term loans using the information from the visual and the following questions. Classify student responses in #1 as term (closed-end) loans or revolving (open-end) credit.
  - What are the features of revolving credit?

*Open-end credit is a line of available credit that is usually designed to be used over and over. It might be a credit card or a line of credit at a bank.*

- What are the features of term loans?

*With a term loan, the loan amount, the number and dollar value of payments and the total finance charges are agreed upon at the start of the loan.*

3. Display *Visual 2: Comparing Credit Offers for Term Loans*. Review the information on the visual by emphasizing that the APR is stated as a percentage, while the finance charges are always stated in dollar amounts. Since the formula to compute these numbers is standardized, borrowers are able to compare offers from different creditors.
4. Tell students that this lesson will focus on the features of term loans. Display *Visual 3: Term Loans: Making Important Decisions*. Ask students to read the text and answer the questions in their notes. Use the following questions to facilitate discussion:
  - What are the important features to consider when comparing term loans?  
*APR and total finance charges*
  - Why would some borrowers finance a car at a lender other than Pixley?  
*Pixley might not offer the same low APR to every borrower. The interest rate offered to a particular borrower is based on a variety of factors, including a borrower's credit score.*
  - Why would some people choose to pay more than \$1,000 extra by selecting a 60-month loan instead of a 36-month loan?  
*The borrower's budget might not allow the higher monthly payment.*

5. Play CD-ROM to illustrate how the length of a loan can significantly impact the total cost of credit (CD-ROM section **Take Control of Debt**: “Choosing the Right Loan” and “Paying Loans off Early”).

Note: The calculator on the CD-ROM rounds payment to the next lower dollar amount, so slight differences will occur between the CD-ROM calculations and those of Visual 3.

6. Distribute *Handout 1: The Cost of Credit*. Have students work in pairs to answer the questions. After students are finished, review the correct answers using the key provided.

## Closure

7. Review the major concepts of the lesson, using the following questions:
  - What are the two types of credit?  
*Term loans and revolving credit*
  - How are the two types of credit different?  
*Answers may vary but should emphasize that a term loan typically has a fixed number of payments of a predetermined amount, while revolving credit has flexible payments with a minimum payment required.*
  - How can a borrower reduce the total finance charges for a term loan?  
*By shopping for a lower APR and limiting the term of the loan*
  - What factors affect the total finance charges on credit?  
*The total amount of the loan, the interest rate and the length of the loan determine the total cost of credit.*

## Assessment

8. Distribute *Handout 2: Loan Research*. Have students independently complete the assignment by conducting online research.

## Lesson 12 – Take Control of Debt: Not All Loans Are the Same

### Visual 1: Types of Consumer Credit

**Revolving credit**—a line of credit that may be used repeatedly, with a prearranged borrowing limit; periodic finance charges are computed on the unpaid balance; minimum payment is usually a percentage of the balance due



Common types of revolving (open-end) credit include:

- Credit cards (bank or department store)
- Home equity lines of credit
- Check-overdraft accounts that allow a borrower to write checks over the actual balance in the bank

**Term credit**—a loan for a predetermined amount that requires specified payments at regular intervals over the life of the loan; finance charges are agreed upon at the start of the loan

Common types of term (closed-end) credit include:

- Mortgage loans
- Student loans
- Vehicle loans
- Loans for other major purchases



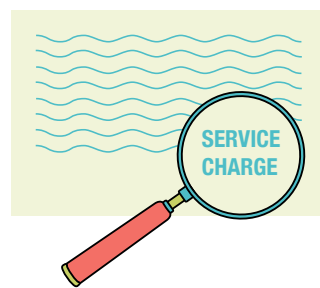
## Lesson 12 – Take Control of Debt: Not All Loans Are the Same

### Visual 2: Comparing Credit Offers for Term Loans

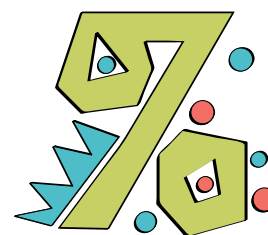
Truth in Lending laws and regulations require all creditors to state, in writing and before the borrower signs any agreement, the cost of credit in terms of the finance charge and the annual percentage rate (APR).

To compare credit offers, consider these two items:

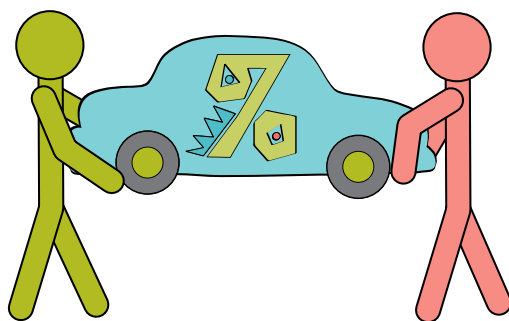
- **Finance charge**—the total dollar amount you pay to use credit. It includes interest costs and other costs, such as service charges and some credit-related insurance premiums.



- **Annual percentage rate (APR)**—the percentage cost of credit on a yearly basis. The APR is the key to comparing costs, regardless of the amount of credit or how long you have to repay it.



Federal law does not set interest rates or other credit charges, but it does require their disclosure so that you can compare credit costs.



## Lesson 12 – Take Control of Debt: Not All Loans Are the Same

### Visual 3: Term Loans: Making Important Decisions

Betty wants to buy a new car. After her down payment, she wants to finance \$15,000. What should she consider as she starts to shop for a loan?

She starts by looking at a 5-year loan from three lenders.

Lender	APR	Finance charges
Pixley Bank and Trust	6.5%	\$2,609.53
XYZ Savings and Loan	7.5%	\$3,034.15
Joe's Auto Sales	15.0%	\$6,410.94

*What is the relationship between the interest rate and the total interest paid?*

Since Pixley Bank and Trust offered the lowest interest rate, she decides to finance the car with that bank. As she completes the paperwork for the loan, the loan officer asks her to choose the length of the loan term.

Loan term	# of payments	Monthly payment	Finance charges
3 years	36	\$459.74	\$1,550.46
4 years	48	\$355.72	\$2,074.77
5 years	60	\$293.49	\$2,609.53

*What is the relationship between the loan term and the total interest paid?*

Name: \_\_\_\_\_ Date: \_\_\_\_\_

## Lesson 12 – Take Control of Debt: Not All Loans Are the Same

### Handout 1: The Cost of Credit

Suppose you wanted to buy a new car. You have saved some money for a down payment, but you would like to finance \$15,000. Consider the three loan offers below. To find the monthly payment, add the stated finance charges to the loan amount (\$15,000) and divide by the number of payments.

#### Pixley Bank and Trust

5.9% APR for 36 months

Total finance charges are \$1,403.39.

What is the total cost of the car loan (principal + finance charges)? \_\_\_\_\_

What is the monthly payment (total cost/number of payments)? \_\_\_\_\_

#### XYZ Savings and Loan

7.5% APR for 48 months

Total finance charges are \$2,408.81.

What is the total cost of the car loan (principal + finance charges)? \_\_\_\_\_

What is the monthly payment (total cost/number of payments)? \_\_\_\_\_

#### Joe's Auto Sales

7.5% APR for 72 months

Total finance charges are \$3,673.32

What is the total cost of the car loan (principal + finance charges)? \_\_\_\_\_

What is the monthly payment (total cost/number of payments)? \_\_\_\_\_

Now think about buying a house. After the down payment, you would like to finance \$125,000. Compare the two offers below.

#### Mary's Mortgage Company

15-year loan with 6% APR (180 monthly payments)

Total finance charges are \$64,867.79.

What is the total cost of the mortgage (principal + finance charges)? \_\_\_\_\_

What is the monthly payment (total cost/number of payments)? \_\_\_\_\_

#### Fred's Finance Company

30-year loan with 6.5% APR (360 monthly payments)

Total finance charges are \$159,430.61.

What is the total cost of the mortgage (principal + finance charges)? \_\_\_\_\_

What is the monthly payment (total cost/number of payments)? \_\_\_\_\_

## Lesson 12 – Take Control of Debt: Not All Loans Are the Same

# Handout 1: The Cost of Credit

## Answers

### Pixley Bank and Trust

5.9% APR for 36 months

Total finance charges are \$1,403.39.

What is the total cost of the car loan (principal + finance charges)? \$16,403.39

What is the monthly payment (total cost/number of payments)? \$455.65

### XYZ Savings and Loan

7.5% APR for 48 months

Total finance charges are \$2,408.81.

What is the total cost of the car loan (principal + finance charges)? \$17,408.81

What is the monthly payment (total cost/number of payments)? \$362.68

### Joe's Auto Sales

7.5% APR for 72 months

Total finance charges are \$3,673.32

What is the total cost of the car loan (principal + finance charges)? \$18,673.32

What is the monthly payment (total cost/number of payments)? \$259.35

Now think about buying a house. After the down payment, you would like to finance \$125,000.

Compare the two offers below.

### Mary's Mortgage Company

15-year loan with 6% APR (180 monthly payments)

Total finance charges are \$64,867.79.

What is the total cost of the mortgage (principal + finance charges)? \$189,867.79

What is the monthly payment (total cost/number of payments)? \$1,054.82

### Fred's Finance Company

30-year loan with 6.5% APR (360 monthly payments)

Total finance charges are \$159,430.61.

What is the total cost of the mortgage (principal + finance charges)? \$284,430.61

What is the monthly payment (total cost/number of payments)? \$790.09

Name: \_\_\_\_\_ Date: \_\_\_\_\_

## Lesson 12 – Take Control of Debt: Not All Loans Are the Same

# Handout 2: Loan Research

Complete the following table using information from a commercial bank’s website. Search for rates for a new car. Assume that you would like to finance \$20,000. Find information for loans with terms of 36, 48, 60 and 72 months. Print and attach the online rate quote. Use the loan calculator at [www.dallasfed.org/educate/calculators/closed-calc.cfm](http://www.dallasfed.org/educate/calculators/closed-calc.cfm) to compute the finance charges.

Name of bank or credit union: \_\_\_\_\_

Website: \_\_\_\_\_

	36 months	48 months	60 months	72 months
<b>Amount financed</b>	\$20,000	\$20,000	\$20,000	\$20,000
<b>Annual percentage rate (APR)</b>				
<b>Monthly payment</b>				
<b>Total finance charges</b>				
<b>Total cost of the car (finance charges + \$20,000)</b>				

1. What is the difference between an APR and finance charges?

\_\_\_\_\_

2. What happens to the total finance charges as a loan term lengthens?

\_\_\_\_\_

3. What happens to the monthly payment as a loan term lengthens?

\_\_\_\_\_

4. What is the effect of a higher APR on total finance charges?

\_\_\_\_\_

5. What is the effect of a higher APR on monthly payment?

\_\_\_\_\_

6. What two factors can a borrower consider in order to minimize the cost of credit?

\_\_\_\_\_



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# Handout 2: Loan Research

### Suggested Answers

Student research on car loans should be assessed by considering the following items:

- Did the student collect lending rates for all four loan terms from a financial institution and attach the rate quote?
- Did the student accurately compute the monthly payment, the total finance charges and the total cost of purchasing the car?

1. What is the difference between an APR and the finance charge?

*The APR is the percentage cost of credit on a yearly basis. Finance charge is the dollar amount the borrower pays to the lender. APR is always stated as a percentage, whereas the finance charge is always stated as a dollar amount.*

2. What happens to the total finance charges as a loan term lengthens?

*If everything else remains the same, finance charges increase as the loan term increases.*

3. What happens to the monthly payment as a loan term lengthens?

*If everything else remains the same, a longer loan term reduces the monthly payment.*

4. What is the effect of a higher APR on total finance charges?

*If everything else remains the same, finance charges increase as the APR increases.*

5. What is the effect of a higher APR on monthly payment?

*If everything else remains the same, a higher APR increases the monthly payment.*

6. What two factors can a borrower consider in order to minimize the cost of credit?

*The borrower could consider the length of the loan term and the APR offered by the lender.*