Lesson Description

Students will learn what a payday loan is and the high cost involved in using such a loan. Working in groups, students will calculate an annual percentage rate (APR) on a loan.

Concepts

Annual percentage rate
Interest
Interest rate
Loan
Payday loan

Objectives

Students will:

- Define loan, payday loan, interest rate and annual percentage rate.
- Calculate an annual percentage rate.
- Explain key facts regarding payday loans.

Content Standards

National Standards in K-12 Personal Finance

Financial Responsibility and Decision Making: Apply reliable information and systematic decision making to personal financial decisions.

- **Standard 1:** Take responsibility for personal financial decisions.
  - Eighth-grade expectation 1: Identify ways to be a financially responsible young adult.
- **Standard 2:** Find and evaluate financial information from a variety of sources.
  - Eighth-grade expectation 1: Analyze and evaluate advertising claims.
  - High school expectation 1: Determine whether financial information is objective, accurate and current.

Credit and Debt: Maintain creditworthiness, borrow at favorable terms and manage debt.

- **Standard 1:** Identify the costs and benefits of various types of credit.
  - Eighth-grade expectation 2: Explain how interest rate and loan length affect the cost of credit.
  - Eighth-grade expectation 5: Given an "easy access" loan amount and a two-week borrowing fee, calculate the interest rate for the loan period and its annual equivalent.

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Time Required

60 minutes

Materials

- Copies of Handouts 8.1, 8.2 and 8.3 for each student
- A visual of Handout 8.3
- A calculator for each student

Procedures

1. Introduce the topic by asking the following questions.
   - Have you ever borrowed money from someone? *(Answers will vary.)*
   - Give some examples of things for which you have borrowed money? *(Answers will vary, but might include lunch, gas, etc.)*
   - Have you ever loaned money to someone? *(Answers will vary.)*
   - For what did you lend? *(Answers will vary but may include lunch money, advance on a weekly allowance, etc.)*

2. Define a **loan** as a sum of money provided temporarily on the condition that the amount borrowed be repaid, usually with interest.

3. Explain that when people borrow money, they are using money that belongs to someone else. The price or fee for using someone else's money is **interest**. Explain that the amount of interest on a loan is often expressed as an **interest rate**, such as 5 percent, which is the percentage of the principal that must be repaid (in addition to the principal) over a specified time period.

4. Define **annual percentage rate** (APR) as the percentage cost of credit on an annual basis. Explain that lenders are required by law to disclose the APR to borrowers. Discuss the following:
   - The annual percentage rate (APR) may be different from the stated interest rate.
   - APR is the total cost of credit to the consumer. APR combines the interest paid over the life of the loan and all fees that are paid up front. APR is commonly used to compare loan programs from different lenders in order to help consumers make a better-informed choice. (Note: Rules regarding fees that must be included in APR are different for mortgage loans than for auto loans and short-term loans.)
   - APR does not affect the monthly payment on a loan. The monthly payments are a function of the interest rate and length of the loan.

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5. Explain that computing APR for loans of longer than a year requires some complicated mathematics. In these cases, it is easier to use an APR calculator like the one found at: http://www.efunda.com/formulae/finance/apr_calculator.cfm. Tell the students that there are key pieces of information that consumers must have in order to compute the APR, whether using a calculator or not. Discuss the following:
   - Consumers must know the amount of credit to be received—that is, the amount of the loan. For example, if a person wants to borrow $3,000 to buy a used car, the amount financed is $3,000.
   - Consumers must know the dollar amount the credit will cost—that is, the fees and interest charges associated with a loan. Examples of fees included when computing APR are loan-processing fees and underwriting fees. The loan-processing fee for the used car loan above is $50, and the interest rate is 7 percent. (Note: When using an APR calculator, it is not necessary to know the dollar amount in interest; knowing the interest rate is enough.)
   - Consumers must know the length of the loan, often referred to as the "term" of the loan. In the case of the car loan, the term is 24 months.
   - Entering this information into the APR calculator tells us that this loan, with a stated interest rate of 7 percent, has an APR of 8.63791 percent.
   - If another dealer offered a stated interest rate of 6 percent for a two-year loan but charged a $100 fee, the APR would be 9.24659 percent.
   - Obviously, APR is as important a factor as the stated interest rate when loans are being compared. Even though the interest rate on the second loan is lower, the APR is higher because the fee is higher.

6. Distribute a copy of *Handout 8.1: Calculating the Annual Percentage Rate for Short-Term Loans* and a calculator to each student. Tell the students that the handout includes the steps for calculating an APR for a short-term (less than a year) loan. Review the steps with the students. Use the following example to calculate an APR on the board: A consumer borrows $500 for car repairs. The sum of the fees and interest charges is $50. The term of the loan is 21 days.
   - Step 1 – Divide the sum of the fees and finance charges ($50) by the amount financed. $50 ÷ $500.00 = .1
   - Step 2 – Multiply the answer by the number of days in a year. 1 x 365 = 36.5
   - Step 3 – Divide the answer by the term of the loan in days. 36.5 ÷ 21 = 1.7381
   - Step 4 – Move the decimal point two places to the right and add a percent sign. 1.7381 becomes 173.8% (rounded) to state the annual percentage rate.

   SOURCE: http://stoppaydaypredators.org/

7. Remind students that APR expresses the cost of the loan by incorporating not only the interest payment based on the stated interest rate but also incorporating all upfront fees paid by the borrower. This becomes very important when comparing loans and when analyzing the cost of short-term loans. Distribute a copy of *Handout 8.2: APR Problems* to each student. Tell the students to calculate the APR

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for each example. Allow time for the students to complete their work. Review the answers as follows:

A. Interest Charge - $5 Amount of Loan - $500 Term - 14-days APR – 26%
[($5/$500) X 365]/14 = 26%

B. Interest Charge - $12 Amount of Loan - $200 Term - 21-days APR – 104%
[($12/$200) X 365]/21 = 104%

C. Interest Charge - $5 Amount of Loan - $750 Term - 14-days APR – 17%
[($5/$750) X 365]/14 = 17%

8. Review the definition of Annual Percentage Rate as the percentage cost of credit on an annual basis. Remind the students that the APR is the total cost of credit to the consumer and is intended to make it easier to compare loan options in order to help the consumer make better-informed choices. Point out that the APRs for the short-term loans from Handout 8.2 were much higher than the APR from the car loan—a longer-term loan.

9. Ask the students whether they or others they know have used short-term loans to obtain things that they want. *(Answers will vary.)* Point out that when fees and interest are combined for short-term loans, the APRs become very high, as illustrated by the problems listed on Handout 8.2.

10. Ask the students if they have heard advertisements for payday loans. *(Answers will vary.)* Explain that these are short-term loans that typically have very high APRs. Explain the following:

- A **payday loan** is a small, short-term loan that is intended to cover a borrower's expenses until his or her next payday.
- A payday loan may also be called a "paycheck advance" or "payday advance."
- Usually the initial term for the loan is two weeks.
- The loans are also sometimes called "cash advances," although that term can also refer to cash provided against a prearranged line of credit, such as a credit card.

11. Display a visual of *Handout 8.3: Payday Loan Fact Sheet* and distribute a copy of the handout to each student. Ask the students the following questions.

- What is the amount of a typical payday loan? ($300)
- What fees does a payday loan have? *(loan fees and, if extended past the initial term, rollover fees)*
- When rollover fees are included, what is the range for the annual percentage rate of payday loans? *(about 390 percent to 780 percent depending on the amount and length {term} of the loan)*
- What percentage of borrowers are unable to repay their payday loans? *(about 91 percent)*
- What percentage of payday loans go to repeat borrowers? *(99 percent)*

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- Do any states prohibit such loans? *(Yes—as of 2009, there are 11 states, the District of Columbia and two territories that prohibit these loans. The states and territories are: Connecticut, Georgia, Maine, Maryland, Massachusetts, New Jersey, New York, North Carolina, Pennsylvania, Vermont, West Virginia, Puerto Rico and the Virgin Islands. Three other states—Arkansas, Ohio and New Hampshire—allow payday loans, only if the loans are low-cost for consumers. These states severely restrict the interest rate and fees the payday loan companies can charge. Many other states in which payday loans are legal restrict some of the companies' business practices by not allowing rollover loans or loan refinancing.)*

SOURCES: National Conference of State Legislatures. www.ncsl.org/default.aspx?tabid=12473; Consumer Federation of America Payday Loan Consumer Information. www.paydayloaninfo.org/stateinfo.asp

[Note: Students might find it of interest that payday lenders were labeled "loan sharks" during the Great Depression. *(This is the origin of the term.)*]

Closure

12. Review the key points of the lesson by discussing the following:
    - What is a loan? *(a sum of money provided temporarily on the condition that the amount borrowed be returned, usually with interest)*
    - What is interest on a loan? *(the price of using someone else's money)*
    - What is an annual percentage rate? *[APR is the total cost of credit to a consumer because it combines all fees as well as the interest paid (finance charges) on the loan.]*
    - Why it is important for consumers to know what the APR is and be able to calculate the rate? *(The APR is the total cost of credit to the consumer and allows the consumer to compare loan options and to make better-informed decisions.)*
    - How can consumers determine APR for long-term loans such as car loans or mortgages? *(by using an online APR calculator)*
    - What information must consumers know to use an APR calculator? *(length of the loan, fees and interest rate)*
    - What are the steps to calculate an annual percentage rate for a short-term loan?
        - Divide the sum of any fees and interest charges by the amount financed, i.e., the amount borrowed.
        - Multiply the answer by the number of days in the year if the loan is for one year or less.
        - Divide the answer by the term of the loan expressed in number of days.
        - Move the decimal point to the right two places and add the percent sign.

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- What is a payday loan? *(a small, short-term loan intended to cover a borrower's expenses until his or her next payday)*
- What are the disadvantages of a payday loan? *(high interest rates, additional fees, increased debt)*
- Why do people use payday loans? *(to pay for goods or services before they receive their paycheck)*

Assessment

13. Divide the class into groups. Using the information provided on *Handout 8.3: Payday Loan Fact Sheet*, have each group develop a short public service announcement (commercial) aimed at high school students outlining the drawbacks of using a payday loan. Have the groups deliver the announcement in class and then discuss with the class which group was most effective in delivering the message and illustrating the facts contained in Handout 8.3.

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Handout 8.1: Calculating the Annual Percentage Rate for Short-Term Loans

Directions: Use the following steps to compute the annual percentage rate (APR) for a loan of less than one year.

Step 1 – Divide the sum of the fees and interest charges by the amount financed.

Step 2 – Multiply the answer by the number of days in a year.

Step 3 – Divide the answer by the term of the loan in days.

Step 4 – Move the decimal point two places to the right and add a percent sign.

SOURCE: http://stoppaydaypredators.org/

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Handout 8.2: APR Problems

Directions: For each problem below, calculate the APR. Use the steps for computing APR found on Handout 8.1. Show your work. Round answers to the nearest whole number.

A. Andrew borrowed $500 to repair his car. The finance charge on the loan was $5, and the term on the loan was 14 days. What was the APR for Andrew's loan?

B. Shondra borrowed $200 for the books she needed for her second semester of college. The finance charge for her loan was $12, and the term was 21 days. What was the APR for Shondra's loan?

C. Mario borrowed $750 to pay a doctor bill. The finance charge was $5, and the term was 14 days. What was the APR for Mario's loan?

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Handout 8.3: Payday Loan Fact Sheet

- The term of a payday loan is usually two weeks—until the next paycheck—and annual percentage rates are often 390 percent to 780 percent when loan fees and rollover fees are included.
- A typical payday loan is about $300.
- The borrower can give a post-dated check to a lender to be held until the next paycheck.
- Approximately 91 percent of borrowers are unable to repay their payday loans.
- Lenders charge fees, called "rollover fees," when borrowers want to extend the loan beyond the original term.
- Approximately 99 percent of payday loans go to repeat borrowers, and government reports conclude that the industry relies on repeat (rollover) borrowers.
- Fees paid on loans that go past 90 days total approximately $4.2 billion annually.
- Currently 14 states, the District of Columbia and two territories prohibit or greatly restrict payday loans, whereas 36 states allow them.
- Payday lenders have partnered with national banks in some states to avoid state prohibitions and restrictions.

SOURCES:
Consumer Federation of America web site, www.paydayloaninfo.org/
Credit Abuse Resistance Education Program (C.A.R.E.), www.careprogram.us
Center for Policy Alternatives, www.cfpa.org
"'Fringe' Lenders: Traditional Institutions Search for Alternatives," *Bridges*, Winter 2007-2008,
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Statistics provided by the Center for Responsible Lending

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