



Theme 4: Borrow

Topic Connections: Connects with *Money Smart* curriculum in the classroom: Lesson 7 (Credit), Lesson 8 (Credit Cards), Lesson 9 (Understanding Financial Ratios), Lesson 12 (College and Student Loans), and Lesson 13 (Understanding the Economy).

Topic Overview:

Life is full of big purchases, from college costs to buying a home to covering unexpected car repairs and medical bills. Borrowing money for major expenses is not uncommon, but there are some things to consider before you take out a loan. Knowing your debt-to-income ratio is one helpful tool to monitor your level of debt.

From the classroom:

What is credit? How do you become creditworthy? Credit is the use of someone else's money for a fee. People borrow money for many different reasons, such as getting a student loan to pay for college or a mortgage to purchase a home. Being creditworthy means you can show lenders you are able to repay borrowed money when you promised. Creditworthiness is usually assessed by four items: capacity, which means you are able to meet your payments; capital, which determines the value of things you own; character, or how you have paid bills in the past; and collateral, or things of value you can use to secure the loan.

How do you manage your credit? What is bad credit? Managing credit effectively means repaying borrowed money based on the agreed-upon terms. For credit cards, paying off a balance in full by the statement due date and not using up all of the credit available to you is another good strategy. Bad credit happens from missing or making late payments, letting a credit card balance run higher and higher, and using credit to pay off existing credit (for example: using a credit card to make a loan payment). Also be aware that your credit score will likely lower if you owe a significant amount on your credit card compared to the card's credit limit.

What is the difference between credit and debit cards? Even though debit and credit cards look very similar, they use money in very different ways. If you use a credit card, you are borrowing money that you must pay back, in addition to interest if you do not pay the balance in full by the due date. But, if you use a debit card, which is issued by your bank and linked to your checking or savings account, the money taken from the account is yours and you will never incur interest charges. A debit card requires you to have enough money at the time you pay for something because it takes the money directly out of your checking account.

How do you pay for college? Aside from using savings and searching for scholarships to help pay for college, you can also apply for federal financial aid. The process begins by completing the Free Application for Federal Student Aid, also known as FAFSA. Student aid options include: grants and scholarships, which you do not have to repay; student loans, which have to be repaid with interest; and work-study programs, which allow a student to work and earn money while attending college.

How do financial ratios affect me? Financial ratios offer a snapshot of a person's financial behaviors, and lenders often consider ratios in determining whether you are creditworthy. A common ratio called "debt-to-income" is used to compare the amount of debt you have to the amount of income you earn. A high debt-to-income ratio signals to lenders that a borrower may struggle to meet monthly repayments. Your debt-to-income ratio excluding your rent/mortgage payment should be significantly lower than your net monthly income. Some lenders also compute your debt-to-income ratio at the exclusion of your rent/mortgage.

Words To Know:

Credit: The ability to borrow money and pay it back later.

Credit Card: A plastic card that can be used to obtain credit (such as to purchase goods and services).

Credit Card Accountability Responsibility and Disclosure Act: A law that prohibits certain practices that are unfair or abusive. The law also makes the rates and fees on credit cards more transparent so consumers can understand how much they are paying for their credit card and can compare different cards.

Credit Report: A record of your credit - and some bill repayment history - and the status of your credit accounts. This information includes how often you make your payments on time, how much credit you have, how much credit you have available, how much credit you are using, and whether a debt or bill collector is collecting money you owe.

Credit Score: A number, roughly between 300 and 800, that measures an individual's credit worthiness. The most well known type of credit score is the FICO® score. This score represents the answer from a mathematical formula that assigns numerical values to various pieces of information in your credit report.

Creditworthiness: A creditor's measure of a consumer's past and future ability and willingness to repay debts.

Debit Card: A plastic card that can be used to deposit or withdraw cash from a checking or other bank deposit account, such as at automated teller machines or at retail locations that accept cards.

Debt-to-Income Ratio: A ratio that measures your monthly debt payments against your monthly gross income. To calculate, you divide your monthly debt by your monthly gross income. For example: if you pay \$200 each month for a car loan and \$1,000 each month for a home loan, your total debt payment each month is \$1,200 ($\$200 + \$1,000$). If your monthly gross income is \$4,000, then your debt-to-income ratio is 30% ($\$1,200 \div \$4,000$).

Financial Ratios: Useful indicators of financial performance.

Free Application for Federal Student Aid (FAFSA): The free application used to apply for federal student aid, such as federal grants, loans, and work-study.

Student Loans: A sum of money borrowed by an individual to help pay for college with the intent that it will be repaid at a future date, along with any agreed-upon interest.

Conversation Starters ... Ask Your Child:

- When you want to borrow something from someone, how do you show people that you are trustworthy?
- Where do you think money comes from? What is the difference between cash, credit, and debit?
- What do you think it would be like to live in a cashless society?
- How do you know which credit offers are legitimate? How could you tell whether an offer was deceptive?
- How much will it cost to go to the college of your choice?

What if My Teen Wants To...:

What if my teen wants to get a credit card or debit card? The first thought that may cross your mind about letting your teen use a card is the potential dangers of overspending, especially with the popularity of online shopping. The Credit CARD Act of 2009 includes a requirement that anyone under 21 who wants to obtain a credit card must have a qualified co-signer on the account or must prove he or she alone can repay any debt. This is intended to protect young people from getting overwhelmed by credit card debt. But it also offers an opportunity to teach your teen about responsible use of credit cards. If you decide to co-sign for a credit card with a young adult, it is best to establish clear expectations with a written agreement about paying the credit card on time. As a co-signer, you are obligated to pay the debt to the lender if your teen can't or won't make the payments. Failing to pay the debt can damage your own credit report.

Debit cards can also be great tools to teach budgeting and making choices between needs and wants. If you feel your teen is ready to take on the responsibility of making purchasing decisions with his or her own money, you may consider setting up a joint checking account so that you can help your teen monitor cash flow. This creates an excellent opportunity to talk with your teen about the types of purchases he or she makes, the struggles and triumphs of managing money, how to use online banking, and how to read account statements. Be aware that young adults are likely to misjudge how far money will go, especially in the beginning. The learning curves, no matter how steep, are lessons that stick, and it helps to guide your teen through these bumps now under the shelter of your home rather than out in the real world, where financial consequences can be huge.

What if my teen wants to take out a student loan? Fill out the FAFSA with your teen if you haven't done so already. This will help a school determine how much federal and state student aid your teen is eligible for. Next, research with your teen different types of aid such as work-study programs, grants, scholarships, and loan options. There are several types of federal student loans, and that information can be found at <https://studentaid.ed.gov/sa/types/loans>. Consider the minimum payments that will be necessary to pay off the loans, and how it compares to projected earnings.

What if my teen wants to borrow money? If your teen wants to borrow money to buy a "want" item like a brand new car or the latest cell phone, offer suggestions for how the purchase could be made by creating a budget, saving, and working toward the goal. Help reinforce the idea that, while people often borrow money to make investments in themselves, such as through a college education, borrowing money for items that we want isn't always the smartest financial choice. If your teen is planning for college and considering borrowing money to pay for tuition, there are ways to reduce loan amounts by investigating scholarships, grants, and work-study programs by investigating scholarships, grants, and work-study programs at <https://studentaid.ed.gov/>.

Family Activities:

Compare Colleges: If your teen is interested in going to college, help him or her research and compare the top three college choices. Use a resource such as College Scorecard at <https://collegescorecard.ed.gov/> to compare the cost of each, and discuss how much money would need to be saved or borrowed to cover expenses.

Compare Credit Cards: Save several credit card offers you may receive in the mail and show them to your teen. Talk about the different annual percentage rates, fees, penalties, and terms and conditions offered by each credit card issuer.

Resources:

Articles:

- *Providing Financial Aid: Saving for a Child's Future* by the Federal Deposit Insurance Corporation: Read tips for how to save and invest for future expenses such as a college education. www.fdic.gov/consumers/consumer/news/cnfall12/parentsfinancing.html
- *The Financial Aid Process* by Federal Student Aid, U.S. Department of Education: Review the steps it takes to apply for and receive financial aid in this easy-to-read infographic. www.studentaid.ed.gov/sites/default/files/financial-aid-process.png
- *How Much Will College Cost in 25 Years?* by Kelli B. Grant, CNBC, Detroit Free Press: Read about how the cost of college will change over the next quarter century. <http://archive.freep.com/article/20140913/FEATURES01/309130060/college-cost-in-25-years>
- *Know Before You Owe: Credit Cards* by the Consumer Financial Protection Bureau: Read a sample credit card agreement and learn about how interest is calculated and what happens if late payments occur. www.consumerfinance.gov/credit-cards/knowbeforeyouowe/

Online Tools:

- *FAFSA* by Federal Student Aid, the U.S. Department of Education: Get help paying for college by completing the Free Application for Federal Student Aid (FAFSA). <https://fafsa.ed.gov/>
- *Federal Student Aid* by Federal Student Aid, the U.S. Department of Education: Get help preparing for, applying to, and paying for college. <https://studentaid.ed.gov/>
- *Compare and Pay for College* by NerdWallet.com: Compare colleges and explore financial aid. www.nerdwallet.com/nerdscholar/compare-colleges-and-pay
- *College Board* by The College Board: Use this comprehensive website to research and plan for college. www.collegeboard.org
- *Stories* by I'mFirst.org, Center for Student Opportunity: Watch inspiring videos of first-generation college students and graduates. www.imfirst.org/stories/#.VCoF5mRdVNs
- *Credit, Loans, and Debt* by Consumer.gov: Read about using credit, credit history, and how to manage debt. www.consumer.gov/section/credit-loans-and-debt
- *Credit Reports* by AnnualCreditReport.com: Get access to your annual free credit report. www.annualcreditreport.com/index.action

- Debt-to-Income Ratio Calculator by Bankrate: Compare the ratio of your debt to your income. www.bankrate.com/calculators/mortgages/ratio-debt-calculator.aspx
- When Will I Be Debt-Free? Calculator by CNN Money: Determine how long it will take to pay off debt, using this calculator. <http://money.cnn.com/calculator/pf/debt-free/>

Games/Apps:

- Farmblitz by Financial Entertainment: You inherit a farm in this game where both money and crops must be managed and debt and savings balanced. <http://financialentertainment.org/play/farmblitz.html>
- Celebrity Calamity by Financial Entertainment: You are in charge of managing celebrity credit cards and spending in this game. <http://financialentertainment.org/play/celebritycalamity.html>
- Getting into College: The Best Apps to Use by NerdWallet.com: Learn about new college-focused apps. www.nerdwallet.com/blog/nerdscholar/2013/getting-into-college-best-apps/