Establishing Credit

LESSON DESCRIPTION AND BACKGROUND

Lenders are in business to grant loans to individuals and businesses. However, the applicant's ability to repay a loan can mean the difference between profit and loss for the lender. To reduce risk, the lender assesses the applicant's creditworthiness by reviewing his or her character, capacity for repayment and collateral. They also pay particular interest to the applicant's credit score. In this lesson, the students work through exercises to assess the three "Cs" of several loan applications. They discover how they can establish a credit record, and they learn about the rights and responsibilities they have as borrowers.

Lesson 16 is correlated with national standards for mathematics and economics, and with personal finance guidelines, as shown in Tables 1-3 in the introductory section of this publication.

ECONOMICS AND PERSONAL FINANCE CONCEPTS

- Credit history
- Credit score
- The three "Cs" of credit: character, capacity, collateral
- The rights and responsibilities of borrowers

OBJECTIVES

At the end of this lesson, the student will be able to:

- Identify and define the **three "Cs" of credit**.
- Explain how **credit history** is used to determine creditworthiness.
- Explain borrowers' rights when obtaining credit.
- Explain borrowers' responsibilities for managing credit.
- Describe ways in which a young person may establish credit.

TIME REQUIRED

Two 45-minute class periods

MATERIALS

- A copy for each student of **Introduction** and **Vocabulary** sections of **Lesson 16** from the *Student Workbook*
- A copy for each student of **Reading 16.1** from the *Student Workbook*
- Copies of **Exercise 16.1A**, **16.1B**, and **16.1C**, from the *Student Workbook* as specified in Procedure 3
- A copy for each student of **Exercise 16.1D** and **16.1E** from the *Student Workbook*
- A copy for each student of **Lesson 16 Assessment** from the *Student Workbook*

ADDITIONAL RESOURCES

To download visuals, find related lessons, correlations to state standards, interactives, and more, visit http://fffl.councilforeconed.org/6-8/lesson16.

PROCEDURE

1. Distribute a copy of **Introduction** and **Vocabulary** sections of **Lesson 16** in the *Student Workbook* to each student and use it to introduce the lesson's focus on credit. Sellers and credit-granting organizations, such as banks, provide consumers with credit. Credit is a loan extended to consumers or businesses.

2. Explain that those who provide credit are called "lenders." Lenders must use caution when granting credit, for an obvious reason; they do not want to lose money by making a bad loan. To guard against that risk, they look for certain characteristics among loan applicants. The characteristics are "character,"

"capacity," and "collateral." They are referred to in this lesson as "the three "Cs" of credit." Distribute copies of **Reading 16.1** from the *Student Workbook*; assign the students to do the reading. When they have finished the reading, review it with them to make sure they know what a lender looks for in evaluating the character, capacity, and collateral of a loan applicant.

3. Introduce the following activity as one in which the students will make use of the three "Cs" of credit as they examine loan applications.

a. Divide the class into six groups of students. Distribute copies of **Exercise 16.1A** to two groups, copies of **Exercise 16.1B** to two groups, and copies of **Exercise 16.1C** to two groups. Also give each student a copy of **Exercise 16.1E**.

b. Explain the task. In each group, the students should examine the loan application carefully, including the credit report. Then, based on information provided in the application, they should evaluate the applicant's creditworthiness by reference to the three "Cs" and recommend that the loan be granted or denied. They should use the Applicant Summary Sheet (**Exercise 16.1E**) to record their evaluations and recommendations.

c. Point out that the applications and credit reports shown in these exercises are not as lengthy as actual loan applications and credit reports. Still, the somewhat simplified exercise sheets will give the students enough information to make a decision. Help the students get started as necessary.

d. When each group has completed the task, a spokesperson from each group will present the group's assessment of the three Cs and the group's recommendation about the loan. Main points that should be addressed are noted below.

Answers to Exercise 16.1

Application 1: The Andersons

Character: ***They pay their rent and make other payments on time.***

Capacity and Debt Ratios: ***Required payments for credit before new loan are $332 ($180 + 90 + 62 = $332), which is 11.6 percent of their net monthly income, which is $2,863. With the new loan payment, required payments for credit would be $572 (19.98 percent of net income). This would put the Andersons just below the maximum amount they should be spending on consumer credit. The couple should be able to afford the new total of payments if there are no emergencies.***

Collateral: Acceptable. ***They have $5,000 in cash (checking and savings).***

Recommendation: ***Approve loan.***

Application 2: Joey Deligh

Character: ***Has problems making required payments.***

Capacity and Debt Ratios: ***Required payments for current debts are $1,338 (24 percent of his net monthly income). He should not take on any more debt. Even after paying off his old car, he will have 19 percent of his net income committed to debt ($500 + 348 + 125 + 75 = $1,048 ÷ 5,527 = 19 percent). If he drives his car for a while, he can save for a large down payment on another car sometime in the future. Assuming he doesn't sell his old car, if he were to buy a new car by borrowing $38,000, he would have 32.9 percent of his net income committed to debt ($500 + 348 + 125 + 75 + 773 = $1,821 ÷ 5,527 = 32.9 percent).***

Collateral: ***Cash plus investments and equity in home is less than outstanding debt.***

Recommendation: ***Would not approve loan.***

Application 3: The Ransdias

Character: ***Good record of paying debts.***

Capacity: ***Required payments for outstanding credit are $1,272 per month. Net monthly income is $10,028. Have sufficient earnings to pay bills. Even with the new***

loan, only 16.1 percent of income would be committed to consumer debt ($340 + 145 + 247 + 293 + 587 = $1,612 ÷ $10,028 = 16.1 percent).

Collateral: ***Have more in collateral than loans.***

Recommendation: ***Approve loan.***

4. Look back on **Exercise 16.1**, focusing on the fact that one of the applicants probably would not be approved for the loan he requested. From this observation, move on to introduce the concept of borrowers' rights and responsibilities.

a. Ask the students what they would do if they were denied a loan***. (The students may say that they would just do without the item they wished to purchase with the loan, that they would seek another source for a loan, or that they would seek information as to why they were denied the loan and take action to repair their credit reports. All of these answers are acceptable.)***

b. Explain that borrowers have "rights" and "responsibilities" associated with the credit they obtain. Each person has a right to view his or her credit report, for no charge, once a year. When an application for credit is denied, the applicant also has a right to view his or her credit report, for no charge, within 30 days of the denial. If any important information on the report is in error, the credit-reporting agency must change the information and notify lenders about the correction. If the applicant disagrees with the credit-reporting agency about information on the report, the applicant has a right to attach his or her explanation of the problem to the credit report. This explanation must also be sent to lenders. These rights for credit consumers are guaranteed by a law called the Fair Credit Reporting Act. It should also be noted that the Credit Card Accountability Responsibility and Disclosure Act of 2009 (or Credit CARD Act of 2009) contains provisions that, among other things, includes a Credit Cardholders' Bill of Rights.

c. Explain that borrowers also have other rights, including the following:

- The right to information about the Annual Percentage Rate (APR) and the total finance charges for a loan in question.
- Eligibility for credit without discrimination based on gender, religion, race, nationality, or marital status.
- The right to contest charges on your credit card statement if you think they are wrong.
- Protection from abuse by credit collection agencies if you are late making payments.

5. Explain that along with these rights come responsibilities. Ask the students what some responsibilities may be. ***(Borrowers are responsible for repayment of the loan plus interest, making payments on time, providing accurate information on credit applications.)***

6. Shift the emphasis to a consideration of the students' own creditworthiness.

a. Ask: Would it be easy or difficult for you to get approved for a loan today? ***(Difficult, because students [as a rule] have no income, collateral, or credit history.)***

b. With the students, turn back to the first page of **Reading 16.1**. Use the section on young people seeking to borrow money as the basis for a discussion of how the students might begin soon to establish and develop a good credit history. ***(Possibilities include open a checking or savings account [and don't bounce a check], obtain a department store credit card by getting an adult to be a co-signer on the credit application [and make your payments in full and on time], etc.)***

CLOSURE

Use the following questions to review the lesson.

- When a lender is considering your "character", what does he or she examine? ***(Your record of paying your debts on***

time; your history of managing finances, such as a checking account; your employment stability; and your residential stability.)

- When a lender is considering your "capacity," what characteristics does he or she examine? ***(Your income from all sources; your assets; your current debts; and your net worth [the difference between everything you own and everything you owe to others].)***
- Lenders want to be sure you won't just walk away from a loan without paying. They want to be sure you have "collateral." What types of things might serve as collateral for a loan? ***(A car, a house, etc.)***
- If you have no credit history, what might you do to establish credit? ***(Open a checking or savings account, establish a department store account or a layaway plan, obtain a small starter loan or credit card, get a cosigner for a loan.)***
- What rights do you have as a borrower? ***(You are eligible to be considered for a loan without discrimination based on gender, race, religion, nationality, or marital status; you must be provided with information about interest rates and fees; you cannot be subject to abusive credit collection practices; you can obtain a free copy of your credit report once a year from each of the credit reporting agencies.)***
- What are your responsibilities as a borrower? ***(You must make at least the minimum payment when payment is due; you must pay any applicable finance charge; you must pay late fees for late payments.)***

ASSESSMENT

Distribute a copy of **Exercise 16.1D** and **Lesson 16 Assessment** from the *Student Workbook* to each student. Assign the students to complete the assessment, working independently. The task is to evaluate the loan application for Rhett Willis, shown on **Exercise 16.1D**.

Answers to Lesson 16 Assessment

Character: Sometimes has difficulty making payments on time, especially in the last six months. Always makes payments, though. Capacity: Savings and checking account balances are more than credit card debt. Required payments for outstanding debts are $305, 9.6 percent of his net monthly income of $3,174. After the new loan, his payments will be $544 (17.1 percent of his net monthly income—more than is recommended, but less than the maximum of 20 percent of net monthly income that should be committed to debt.) Collateral: Motor home counts as collateral. Would recommend that the loan be granted.)

EXTENSION

Instruct students to create a "Note to Self." Explain that in just a few years, they will be interested in using credit, in the form of credit cards, a car loan, or student loans. Their character, capacity, and collateral will determine whether they are extended credit, how much credit they are offered, and the interest rate they will be obligated to pay.

Remind students of their examination of credit applications. Which would they have denied and which would they have accepted? What details in the applicant's credit histories reflected poorly on the applicant?

In their note, students should instruct themselves on how they will prove themselves to be creditworthy by addressing character, capacity and collateral. For example, a student could show good character by managing his or her checking account responsibly or by paying a cell phone bill on time. He or she could show capacity by getting a part-time job. Collateral could include money saved in a saving account.