Debt

Lesson 5: Student Activities | Hall of Fame: Ages 18+

FINANCIAL FOOTBALL

Avoiding Fumbles with Debt Management

Understanding the costs and benefits of debt is essential to managing it effectively throughout life. This 45-minute module will prepare you to think critically about types of debt, debt loads, and strategies for managing debt.

Getting Game-Ready: Each football game won is the result of careful planning, strategic plays, and judgment calls. There is a risk, with each pass and rush, that yards might be lost instead of gained on the path to the goal line.

In life, managing debt demands similar planning, careful decision-making, and a solid understanding of the risks, costs, and benefits. With a solid management plan, taking out loans can provide funds that allow you to reach goals such as going to college or buying a house. However, debt can also spiral out of control, negatively impacting your financial opportunities now and in the future. While the topic of debt may seem overwhelming, it's important to keep your head in the game and take informed action to reach your goals.

Module Level: Hall of Fame, Ages 18+

Subjects: Economics, Math, Finance, Consumer Sciences, Life Skills

Materials: Facilitators may print and photocopy handouts and quiz.

- **Pre- and Post-Test questions:** Answer these questions before completing the Debt activities to see how much you already know about the topic. After you've finished all the activities with your teacher and classmates, try taking the quiz again to see how your understanding has grown.
- **Practical Money Skills Debt resources:** practicalmoneyskills.com/ff40
- **Index cards**
- **Glossary of Terms:** Learn basic financial concepts with this list of terms.

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Learning Objectives

– Explore types of debt and their costs and benefits
– Calculate debt-to-income ratio
– Discover strategies to manage and alleviate debt
– Discuss the dangers of debt and how to prevent lasting negative impacts
– Identify tools for debt management planning

Key Terms and Concepts

Before you start the lesson, review the key terms and concepts below. The answers to each debt question will get you prepped and game-ready.

What types of loans are sometimes considered good debt? Bad debt?

Borrowing money (taking on debt) can help you reach goals but it can also become a burden. To decide whether a debt is good or bad for your personal situation you will need to consider its benefits and costs. In general, debt that helps you earn more in the long term with proper planning, such as school loans, business loans, or real estate mortgages are sometimes considered good debt. Meanwhile, debt that has no potential of making you money is considered bad debt. In other words, good debt helps your future self and bad debt hurts your future self.

What is debt load and how is it calculated?

The sum total of all the money you owe is called your debt load. To determine whether your load is more than you can afford, you'll want to calculate your debt-to-income ratio by comparing the amount you owe to the amount you earn.

How much debt is too much debt?

Excessive debt is a problem that only gets worse the longer it continues. Warning signs that debt is getting out of hand include not being able to pay bills and owing late fees. Lenders typically like to see a debt-to-income ratio (DTI) of 35% or less.

When does it make sense to take out a loan?

There are many different types of loans.

- Student loans
- Mortgage loans
- Auto loans
- Personal loans
- Peer-to-peer loans

Learning Objectives, cont.

Taking out a loan is a big responsibility and commitment. When you're choosing a loan, it's important to consider the interest rate, length of the loan, and overall cost of borrowing the money. Loans can allow you to leverage time — giving you access to opportunities such as education, real estate, and transportation. However, debt can also quickly grow and get out of hand, so it's critical to consider how much debt you can afford to repay.

Did You Know?

If you can't afford your monthly payments, your creditors may be willing to put you on a new payment plan.

How can I prevent debt problems?

- Keep track of what you owe and monitor your credit report for accuracy
- Avoid borrowing more money than you can afford to repay
- Not everyone receives a steady paycheck. If your income varies, it is of particular importance to minimize your debt burden
- Create a plan for repayment when considering loan options
- Pay bills on time; if you can't make a payment, call to notify and negotiate with your creditor
- Know your consumer rights. Find out more at the Consumer Financial Protection Bureau's website

How can I rebuild my finances after debt?

You can't rewrite your credit history, but you can rebuild it. Whether you've undergone a major life event or filed for bankruptcy, reestablishing your credit rating takes time and discipline so it's helpful to create a plan you can stick to. You'll need to demonstrate that you're able to pay your bills on time every month and make regular repayments to a credit line.

Five ways to rebuild financial credibility:

- Consider a credit builder loan
- Using a secured credit card account and avoiding balances greater than 9% of the credit limit
- Becoming an authorized user who has a good credit score
- Making payments on time
- Reducing total debt balances

Student Activities

> Debt Pre- and Post-Test

> Strategies for Managing Debt handout

> Examining Debt Load handout

Debt Pre- and Post-Test

Student Name: ______________________________

Directions: Answer the questions with the most appropriate answer, noting a, b, c, d or filling in the blank.

1. Your personal debt is:

a. The PIN code for your debit card

b. What is in your savings account

c. What you owe in money, goods, or services

d. The same as your credit score

2. Which of the following is a warning sign that you could have a problem with debt?

a. You aren't sure how much you owe

b. This month's bills arrive before last month's have been paid

c. You often owe late fees

d. All of the above

3. Decisions you can make that will help pay down your debt include:

a. Canceling your credit cards

b. Opening a new, low-interest credit card account

c. Increasing your income and reducing your expenses

d. All of the above

4. How could you determine whether your debt load is more than you can afford?

5. So-called "good debt" is debt that helps to improve your_______________.

Strategies for Managing Debt

Directions: You'll be divided into small teams to complete this activity.

Part 1: Work with your team to fill out seven index cards, one for each of the following debts or loans. On each index card, write down an interest rate and loan amount based on the ranges provided below for each item.

- Auto loan index card: 0% - 20%, $1,000 - $10,000
- Credit card debt #1 index card: 12% - 34%, $250 - $15,000
- Credit card debt #2 index card: 12% - 34%, $250 - $15,000
- Credit card debt #3 index card: 12% - 34%, $250 - $15,000
- Mortgage index card: 4% - 5%, $100,000 - $300,000
- Payday loan index card: 300% - 450%, $350 - $500
- Auto title loan index card: 750%, $2,500 - $10,000

Part 2: On a blank piece of paper, write down an answer key that identifies the order in which you'll repay your seven debts, using one of the following two repayment strategies.

> **Debt Snowball Method:** This method of paying off loans works by prioritizing debts based on their size. By paying off smaller loans first, you'll be able to pay off several loans earlier on, and your payments "snowball" as you're psychologically rewarded. Many people feel more motivated to pay off loans if they can see visible progress.
>
> **Debt Avalanche Method:** Paying off debt through the debt avalanche method first means, making the minimum payment on each debt, then using any remaining money to start paying off the debt that has the highest interest rate. Once you've paid off your highest interest rate debt, tackle the debt with the next highest interest rate. Using this method can result in paying off debt more quickly while reducing overall interest rates.

Part 3: Swap cards with another team and compete. The team that can first correctly order its seven index cards for each strategy wins. The teacher holds each team's answer key and acts as the referee.

Examining Debt Load

Directions: This activity can be done in small teams or individually.

The sum total of all the money you owe is called debt load. To determine whether your debt load is more than you can afford, you would calculate your debt/income ratio by comparing the amount you owe to the amount you earn.

Part 1: Review John and Susan's personal finances:

- John has an average monthly income of $4,200 after taxes; a monthly mortgage of $1,100; and a debt of $700.
- Susan has an average monthly income of $5,400 after taxes; a monthly mortgage of $1,700; and a debt of $200.

Part 2: Read Understanding Debt Load on the Practical Money Skills website: practicalmoneyskills.com/ff41.

Part 3: Based on what you've read, calculate who has a better debt to income ratio: John or Susan.

Glossary of Terms

Study this list of personal finance terms to warm up before playing Financial Football. By mastering these terms, you will have a better opportunity to answer questions in the game correctly and score.

Bad debt: Debt taken on for items that a consumer cannot afford and that does not generate opportunities for future income. (See good debt)

Bankruptcy: A condition of insolvency where an individual or business is unable to repay debts. Bankruptcy is a way to eliminate debts or repay them under court protection and supervision, although child support payments, alimony, fines, taxes, and some student loan obligations are typically not eliminated. Bankruptcy will stay on your credit report 7 or 10 years depending on the type of bankruptcy filing, possibly affecting your ability to buy or rent a home; it will also likely result in higher interest rates on future loans.

Collateral: This is an asset, like a property, that you may need to provide to a lender to get a loan. In many cases, collateral is required for certain types of loans, like mortgages and auto loans.

Cost-benefit analysis: Analyzing whether the cost of an item is more than, equal to, or less than the benefit that comes from its purchase.

Creditor: A person or business to whom money is owed.

Debt: The state of owing money to another individual or business, or the amount of money borrowed.

Debt avalanche method: Paying off debt through the debt avalanche method means first making the minimum payment on each debt, then using any remaining money to start paying off the debt that has the highest interest rate. Once you've paid off your highest interest rate debt, tackle the debt with the next highest interest. Using this method can result in paying off debt more quickly while reducing overall interest rates.

Debt counseling: This means debt management advice and services available through either of the following national organizations: American Consumer Credit Counseling, National Foundation for Credit Counseling.

Debt load: The sum total of all the money you owe.

Debt snowball method: This method of paying off loans works by prioritizing debts based on their size. By paying off smaller loans first, you'll be able to pay off several loans earlier on, and your payments "snowball" as you're psychologically rewarded. Many people feel more motivated to pay off loans if they can see visible progress.

Debt-to-income ratio: A calculation comparing the amount you owe to the amount you earn. Debt-to-income ratio may be used to see how much debt you can afford to take on.

Equity: In business, equity is a business's value and someone who has equity in the company owns part of the company. Two business partners who own equal parts of a business both have an equal amount of equity in the company. If the business is a corporation, the owner's equity is called shareholders' equity and shareholders receive shares or stock. Someone who owns half of the corporation's stocks owns half the company.

Finance: To borrow funds for the purpose of a purchase.

Glossary of Terms, cont.

Foreclosure: A legal process in which a mortgaged property is confiscated because the borrower has failed to keep up payments.

Good debt: The concept that sometimes it is worth taking on certain types of debt in order to generate opportunities for income in the long run. Some common examples of good debt include college education loans and real estate.

Liabilities: Everything that you owe, which may include your mortgage, credit card balance, interest, student loans, and loans from family and friends. The sum total of all the money you owe is what's commonly known as your debt load.

Loan: Money or assets borrowed and paid back with interest over time.

Loan principal: An amount borrowed that remains unpaid, excluding interest.

Loan term: The period of time during which a loan is active.

Mortgage: A mortgage is a loan needed to purchase a property; it includes three parts: a down payment, monthly payments, and fees. The monthly payment is the amount needed to pay off the mortgage over the length of the loan and includes a payment on the principal of the loan as well as interest. There are often property taxes and other fees included in the monthly bill. The fees are comprised of various costs you have to pay up front to get the loan. The down payment is the up-front amount you pay to secure a mortgage. The larger your down payment, the better your financing deal will be. You'll get a lower mortgage interest rate, pay fewer fees, and gain equity in your home more rapidly.

Mortgage payment: The payment a borrower makes each month toward the purchase of a home.

Mortgage term: The agreed-upon amount of time to pay off a mortgage.

Opportunity cost: The loss of potential gain from other alternatives when one alternative is chosen.

Principal: The amount of money you deposit in your account to begin saving, or the original amount of money borrowed.

Secured loans: For secured loans, which are often used for an influx of cash, you must provide collateral in the form of a liquid asset, like a savings account, or property. For example, once you have a car or home, you could use the property and your equity in it as collateral for a secured loan, giving you access to funds you can use for a number of things.

Student loan: A loan offered to students for education-related expenses that must be repaid.

Unsecured loans: An unsecured personal loan doesn't require you to put up any collateral (like a car) for the loan. If you don't repay it, the lender can't claim collateral as compensation. But there is something you risk if you default on either unsecured or secured loans — your credit. Lower credit scores could make it more difficult to get approved for other types of credit.