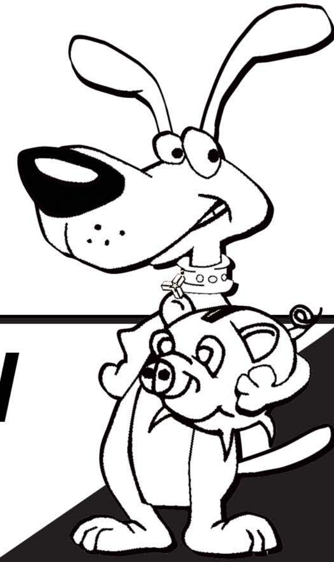
INTEREST

& Collateral



When you get a loan from a bank, the bank will ask you to pay back more money than you borrowed. This extra money is called “interest.” The bank uses money from interest payments to pay their employees and pay for other items needed to keep the bank running.

Interest is calculated by adding an agreed upon annual percentage rate to the loan balance. As the borrower makes their payment each month, a portion of the money pays the interest, and the rest is subtracted from the loan balance. This process is repeated each month until the loan is paid off.

In addition to interest, some loans may require the borrower to offer an item of value as “collateral” if they are unable to pay the loan back. For example, if your parents use a loan to buy a car, the car is the collateral on the loan. If they cannot make the payments on the loan, the car will be given back to the bank. The bank will then sell the car in order to pay off the remaining loan amount.

Definition:

Interest: Annual percentage rate added to a loan balance.

Collateral: An item of value that can be collected if the borrower cannot make their payments.

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It's Role Play Time!
Learning about money can be fun, especially when you get to do hands-on activities.

In this activity, we will learn how interest is added to loan payments using our awesome Digitz Dollars and Dimes.

Step 1: Help your child color and cut out the Digitz Dimes below and the Digitz Dollars on the next page.

Step 2: Explain to your child: When someone receives a loan from a bank, they agree to pay back the loan over a period of time with an agreed upon interest rate. This interest is added to the loan each month, so a portion of each loan payment goes to pay the interest.

Step 3: Using the Digitz Dollars, give your child a $10 loan from you to buy something. Let them be creative as they decide what to buy and why they need the money. Explain to your child that they must pay back the loan in $1 increments.

Step 4: Give your child the Digitz Dimes and explain that with each $1 payment they make to the bank, they must also pay 10 cents in interest.

Step 5: Once all payments are made, show your child that the $10 loan cost them a total of $11 because of the interest that accrued.

All About Collateral

As you are discussing the repayment of the loan with your child, remind them that – depending on the loan agreement – the item they used the money to purchase may be listed as "Collateral" on the loan. This means that the bank may take the item back if your child is not able to make their payments on time.

For example, if your child used the loan to buy a toy car, and then forgets to make his payments, you can take his car back and sell it to get back the $10 you let him borrow.

Color in the **Digitz Dollars** and them cut them out along the dotted lines. These dollars can be used for the role playing exercise in the “Loan Process” lesson series.