Activity #1: How Interest Works

PART 1

Most people want more money than they have. Hundreds of years ago, businesses figured out a way to make profits by letting people spend more money than they have. In modern days, there are two common ways that businesses do this. The first way is done by banks and finance companies. They let you borrow money if you promise to pay them back the money you borrow—along with a “little extra”—in the future. That “little extra” that banks, finance companies, pawn shops, home improvement companies, and other companies charge for lending you money is called interest.

There is a second way that businesses make money by letting you spend more than you have. Department stores, car dealers, rent-to-own stores, credit card companies, and many other types of businesses let you buy something now and pay for it later. When companies let you buy things that you pay for in the future, it is called giving credit. These companies also charge interest.

PART 2

Businesses make a lot of money on interest. As long as they believe that you will be able to pay back the money you owe, many businesses want to give you as much credit as they can. People who have high-paying jobs are able to get lots of credit without paying a lot of interest. That’s because the companies know that they will be able to get their money back, even if they have to take these people to court. People with good jobs and a good credit history can get credit cards where they pay as little as 5% per year to borrow money.

People who do not have much money and people who have had trouble repaying loans in the past have a hard time getting low credit rates. Businesses call these people bad credit risks. Many businesses don’t like to lend them money, because they are afraid that they will have trouble getting it back. But there are some businesses that will lend money or give credit even to people they know are bad credit risks. In fact, they make it very easy for almost anybody to get credit. They can be very friendly, and even treat people with the kind of respect they don’t get from banks. But they don’t charge 5% interest, instead they charge a lot more.

Pawnshops in Georgia can legally charge as much 188% per year for lending money. This means that if you borrow $100 dollars from a pawn shop, in one year, you will owe them $288. Some pawnshops break the law and charge even more. Rent-to-own stores don’t call what they do charging interest, but it comes out the same way. If you get $200 worth of furniture at a rent to own store, you might end up paying more than $700 before you own it. Now do you understand why these businesses are nice even to people they consider bad credit risks?