Transcript

Helping Your Child Understand How Loans Work

Most high schoolers understand the basic concept behind borrowing money—that you have to pay it back. But they might not understand how debt actually works.

In this video, we'll take a look at some ways you can help your teen understand some of the mechanics of how debt works.

You can begin by explaining the basics: Most teens probably know that debt is money owed by a borrower to a lender, but they might not understand how interest rates can affect a loan and what a borrower's responsibilities are.

Consider using an example that's relevant to your teen's life to explain this. Let's say she's been dreaming of buying a car. If she doesn't have enough money saved to cover the cost up front, she might apply for an auto loan from a lender to help her purchase the car.

But a loan isn't free money—it actually costs money too. Explain to your teen that when she takes out a loan, she'll have to repay it over a certain amount of time—typically in monthly installments—and she'll have to pay interest and sometimes additional fees to her lender too. (That's how a lender can make money in exchange for lending money to borrowers.)

Each month her loan payment will go toward paying down the "principal" – that's the original amount of money she borrowed—and the interest she's charged. Interest is usually calculated as a percentage of the remaining principal, so over time, as she pays off more of the principal, she'll pay less in interest.

So you can explain that if she were to take out a loan for a car, even if her monthly loan payments were affordable, she would end up paying more than the original cost of the car over time, because she'd also be paying interest.

As you're explaining the concepts, it can be helpful to walk through a specific example using a basic loan calculator.

Consider a few things your teen might want to purchase with debt- like a car or a large credit card purchase.

Once you have the amount of the loan, plug it into the calculator and take a look at what his monthly payments might be and how much interest he could end up paying in total over the life of the loan. Try looking at a few different interest rates so he can see how lower and higher interest rates affect what he pays each month and in total. While playing with the calculator, he can also look at how borrowing less by saving more toward the purchase up front will also reduce what he pays.

Now, your teen should also know that there are consequences if he doesn't make loan payments on time. In some cases it can lead to late fees and a higher interest rate, which could mean he'll end up paying a lot more over time. It can also have a negative impact on his credit score.

And if he doesn't make payments on his loan, it could go into default. When a borrower defaults on a loan there are serious consequences. Sometimes the asset purchased with the loan—like a car or a house, can be repossessed by the lender. A default can also significantly hurt his credit score.

Explaining that your teen’s record with debt will stay with him over time can help him understand the importance of making good borrowing decisions. Just like a transcript showing good grades can help your teen get into college, a high credit score and a history of paying debts and bills on time can help your teen get approved for loans— and possibly for lower interest rates—in the future.

On the other hand, having a lower credit score can make it difficult to be approved for loans or rent an apartment and lenders might charge a higher interest rate. That’s because lending money to someone with a low credit score can be more of a risk. A lender or landlord might not get their money back.

By teaching teens the simple mechanics of debt, you’ll help them understand the cost of borrowing money and prepare them to use debt responsibly.

And ultimately, if your kids are good at managing debt, they’ll be in a better position when the stakes are higher.