Unit 9
Borrowing

Lesson 9A:
The Three C's of Credit

Rule 9: Pay on time and in full.

While borrowing has both benefits and costs, at times it is an indication that something has gone wrong with your financial planning (spending too much and/or saving too little relative to your income). These lessons look at borrowing from both the lender's and the borrower's perspectives and discuss why it is wise to use credit sparingly and manage the use of credit.

Lesson Description

Students play the role of credit providers and assess the creditworthiness of an individual with a loan request and randomly selected borrower characteristics. Students classify those characteristics based on the three C's of credit (capacity, character, and collateral), assess the riskiness of lending to that individual based on these characteristics, and then decide whether or not to approve or deny the loan request.

Standards and Benchmarks (see page 211)

Grade Level

9-12

Concepts

The three C's of credit: capacity, character, and collateral

Credit score

Compelling Question

How do lenders evaluate the risk when making loans?

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Objectives

Students will be able to

- describe the "three C's of credit" (capacity, character, and collateral) and factors used to measure or assess them;
- evaluate the riskiness of lending to an individual based on capacity, character, and collateral; and
- weigh the benefits and costs of approving a loan and make a decision to approve or deny the loan; and
- define credit score.

Materials

- Visual 9A.1: The Three C's of Credit
- Handout 9A.1: Individual Characteristic Cards, with each page cut apart and placed into an envelope labeled with the given category (There are 12 categories.)
- Handout 9A.2: Loan Request Cards, two copies cut into cards and placed into an envelope labeled "Loan Requests"
- Handout 9A.3: Approve or Deny Credit?, one copy for each student
- Handout 9A.4: Assessment, one copy for each student
- 13 Standard envelopes (to use as noted above)

Time Required

45 minutes

Preparation

Place the 12 envelopes with the Individual Characteristic Cards at stations around the room (see Step 7 below).

(***Teacher note:*** *Having multiple stations around the room will help speed up this step by reducing classroom congestion. For example, for a class of 30 there would be three students per group. In this case, it would be helpful to set up three stations with four envelopes each. So, three students from each group would go to one stations to select cards. So, each member of a group would select four cards per station and then return to his or her seat.*)

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Procedure

1. Explain to the students that they will be playing the role of lenders and deciding to approve or deny individual loan requests. Discuss the following:
   - What are some examples of credit or loan providers? (*Answers will vary but may include banks, credit unions, car dealers, credit-card companies, or department stores.*)
   - What are some things people often use credit or a loan to purchase? (*Answers will vary but may include a house, car, an education, medical expenses, or new electronics.*)

2. Explain that lenders expect all the money they lend to be fully repaid with interest. Thus, when deciding whether to make a loan or offer credit, lenders want to know the likelihood that the individual will repay the money. Discuss the following:
   - What information about a person would you want to know before lending that person money? (*Answers will vary. See* Visual 9A.1: The Three C's of Credit *for a list.*)

3. Display Visual 9A.1. Explain that the visual shows the three questions lenders generally want answered before granting a loan. They are known as the **"Three C's of Credit": Capacity, Character, and Collateral**:

   (1) Capacity: What is the individual's *ability* to repay the loan?

   (2) Character: What is the individual's *reliability* to repay the loan?

   (3) Collateral: What *assets* does the individual own that could be sold to repay the loan?

4. Review the factors for each C and then explain the following:
   - Each factor attempts to provide a measure to help answer each question.
   - The results vary from person to person, with a wide range of possibilities.

   Capacity

   - The amount of debt a borrower has relative to his or her income is an indication of "capacity," that is, that person's ability to repay debt.
   - For example, an individual with debt payments that are a large percentage of his or her monthly income would be less able to take on more debt than someone with debt payments that are a smaller percentage of his or her income.

   Character

   - A **credit score** is an indication of "character" because it indicates a person's reputation for paying bills and debts based on past behavior.

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- A credit score is a number based on information in a credit report, which indicates a person's credit risk.
- Credit scores are often called FICO scores. FICO is an abbreviation for Fair Isaacs Company—the first company to develop credit scores.
- Credit scores generally range from 350 to 850, with 350 indicating low reliability and 850 indicating high reliability.
- A low credit score indicates that a person has not been responsible with credit in the past.

Collateral

- Collateral is property required by a lender and offered by a borrower as a guarantee of payment on a loan. Also, a borrower's savings, investments, or the value of the asset purchased that can be seized if the borrower fails to repay a debt.
- For example, a borrower who owns many other assets such as stocks, bonds, or real estate would be able to sell some of those assets to repay a loan if necessary. As such, lenders will see the loan as less risky than a loan to someone with few or no assets.
- How might the three C's affect each other? (*Having a favorable rating on one C may help you have favorable ratings on others; for example, capacity may make collateral more likely.*)

5. Tell the class that they will now use this type of background information to make some lending decisions.

6. Divide the class into 10 groups as evenly as possible (it is not necessary for the groups to be of equal size).

7. Have each group randomly select one card from each of the 12 Individual Characteristic envelopes placed around the room at 12 stations. The groups must decide which group members will go to each station so that only one card is taken from each envelope.

8. After all groups have selected their 12 Individual Characteristic cards, have one member of each group come to the front of the room and randomly select a card from the Loan Requests envelope held by the teacher.

9. Instruct the groups to spread out their cards.

10. Distribute a copy of *Handout 9A.3: Approve or Deny Credit?* to each student. Instruct the groups to complete Part A of Handout 9A.3. Allow time for students to complete the activity and then review the answers.

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Handout 9A.3: Approve or Deny Credit?—Part A Answer Key

Capacity

Annual Household Income
Years Working for Current Employer
Education
Monthly Debt Payments as a % of Monthly Income

Character

FICO Score
Years Living at Current Address
Criminal Record
Length of Credit History

Collateral

Short-Term Financial Assets
Long-Term Financial Assets
Equity in Home
Market Value of Other Real Assets

11. Instruct the students to individually complete Part B of Handout 9A.3. After a few minutes, instruct the groups to compare their answers, discuss any differences, and come to an agreement on the rating given for each of the three C's.

Handout 9A.3: Approve or Deny Credit?—Part B Answer Key

Each individual characteristic has five levels of risk that decrease from the top to bottom rows of the original, uncut Handout 9A.1 as follows: high risk, high-medium risk, medium risk, medium-low risk, and low risk. Handout 9A.1, however, offers only three options: low, medium, and high. To get an overall rating for each individual characteristic, students should think about how they would rate each of the four individual characteristics that make up the given "C" and how important they believe each characteristic is relative to the others in that category.

12. Instruct the groups to discuss and complete Part C of Handout 9A.3.

(***Teacher note:*** *Should a group ask for more information about the individual such as age, character references, past loans, and so on, explain that although lenders would value such information, it is not possible to get complete information for everyone, so they have to work with the information they have.*)

Handout 9A.3: Approve or Deny Credit?—Part C Answer Key

It is unlikely that all three of a group's C's are "low risk" or "high risk," which would make the decision fairly easy. Instead, groups will be faced with a mix of risk levels and will have to weigh lower risk factors against higher risk factors. They should also consider the size and nature of the loan: Lending $2,000 is very different from lending $150,000.

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13. Invite groups to report their loan request and whether they approved or denied the loan and why.

    (***Teacher note:*** *Consider using the video "Understanding How a FICO Credit Score Is Determined" as a follow-up. It provides an overview of credit reports and credit scores in less than six minutes; https://www.stlouisfed.org/education/continuing-feducation-video-series/episode-1-understanding-how-a-fico-credit-score-is-determined.*)

Closure

14. Discuss the following:

    - What have you learned that may help you get a loan or credit some day? (*Answers will vary, but students should recognize that they are in control of their own individual characteristics: The lower their risk levels, the easier it will be for them to get a loan or credit.*)

Assessment

15. Distribute a copy of *Handout 9A.4: Assessment* to each student and allow time for students to work (or assign as homework).

    Handout 9A.4: Assessment—Answer Key

    1. Given an individual with the characteristics above, evaluate how likely it is that this person will repay the loan in each of the three categories. Give a rating of "low risk," "medium risk," or "high risk."

       Capacity: *Low risk*

       Character: *High risk*

       Collateral: *High risk*

    2. Which factors support *approving* this individual's loan request?

       This person has a relatively high income, has been at her current job for an acceptable period of time (6 years), has a college degree, and has a low percentage of debt payments relative to income (10%).

    3. Which factors support *denying* this individual's loan request?

       This person has a low credit score, has lived at her current address for a short period of time, has one felony, and has very little collateral.

    4. Would you approve or deny this individual's loan request?

       Approve / Deny (Circle one.) Explain your decision.

       Students should deny this loan request. Although the person scores well on capacity, she lacks character and collateral.

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Visual 9A.1: The Three C's of Credit

Capacity

What is the individual's *ability* to repay the loan?

Factors include the following:

- Amount and sources of income
- Steadiness of income (e.g., years with same employer and/or stable dividend income)
- Amount of monthly living expenses (including debt, alimony, or child-support payments)
- Number of dependents
- Level of education and training

Character

What is the individual's *reliability* to repay the loan?

Factors include the following:

- Credit score (which measures an individual's credit risk based on his or her bill-payment history, length of using credit, and credit balances as a percent of his or her credit limits and other measures)
- Years living at the same address
- Criminal record
- Quality of character references

Collateral

What *assets* does the individual own that could be sold to repay the loan?

Factors:

- Amount of financial assets (e.g., savings, stock and bond holdings, and/or a 401(k) account balance)
- Market value of real assets (e.g., land, home(s), car(s), boat(s), electronics, jewelry, antiques, and/or precious metals)

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Handout 9A.1: Individual Characteristic Cards (page 1 of 12)

Annual Household Income **Wages/salary:** $10,000 **Other:** $0	**Annual Household Income** **Wages/salary:** $10,000 **Other:** $0
Annual Household Income **Wages/salary:** $25,000 **Other:** $100 interest	**Annual Household Income** **Wages/salary:** $25,000 **Other:** $100 interest
Annual Household Income **Wages/salary:** $50,000 **Other:** $3,000 rental income	**Annual Household Income** **Wages/salary:** $50,000 **Other:** $3,000 rental income
Annual Household Income **Wages/salary:** $75,000 **Other:** $6,000 alimony	**Annual Household Income** **Wages/salary:** $75,000 **Other:** $6,000 alimony
Annual Household Income **Wages/salary:** $125,000 **Other:** $20,000 dividends	**Annual Household Income** **Wages/salary:** $125,000 **Other:** $20,000 dividends

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Handout 9A.1: Individual Characteristic Cards (page 2 of 12)

Years Working for Current Employer 0.5 years (6 months)	**Years Working for Current Employer** 0.5 years (6 months)
Years Working for Current Employer 2 years	**Years Working for Current Employer** 2 years
Years Working for Current Employer 4 years	**Years Working for Current Employer** 4 years
Years Working for Current Employer 8 years	**Years Working for Current Employer** 8 years
Years Working for Current Employer 15 years	**Years Working for Current Employer** 15 years

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Handout 9A.1: Individual Characteristic Cards (page 3 of 12)

Education No high school diploma	**Education** No high school diploma
Education High school graduate	**Education** High school graduate
Education Some college or vocational training	**Education** Some college or vocational training
Education College graduate or occupation licensure	**Education** College graduate or occupation licensure
Education Professional degree (MBA, PhD, CPA, MD, etc.)	**Education** Professional degree (MBA, PhD, CPA, MD, etc.)

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Handout 9A.1: Individual Characteristic Cards (page 4 of 12)

Monthly Debt Payments (as a % of monthly income) 70%	**Monthly Debt Payments (as a % of monthly income)** 70%
Monthly Debt Payments (as a % of monthly income) 50%	**Monthly Debt Payments (as a % of monthly income)** 50%
Monthly Debt Payments (as a % of monthly income) 30%	**Monthly Debt Payments (as a % of monthly income)** 30%
Monthly Debt Payments (as a % of monthly income) 20%	**Monthly Debt Payments (as a % of monthly income)** 20%
Monthly Debt Payments (as a % of monthly income) 0%	**Monthly Debt Payments (as a % of monthly income)** 0%

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Handout 9A.1: Individual Characteristic Cards (page 5 of 12)

FICO Score 450	**FICO Score** 450
FICO Score 550	**FICO Score** 550
FICO Score 650	**FICO Score** 650
FICO Score 750	**FICO Score** 750
FICO Score 800	**FICO Score** 800

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Handout 9A.1: Individual Characteristic Cards (page 6 of 12)

Years Living at Current Address 0.5 years (6 months)	**Years Living at Current Address** 0.5 years (6 months)
Years Living at Current Address 2 years	**Years Living at Current Address** 2 years
Years Living at Current Address 4 years	**Years Living at Current Address** 4 years
Years Living at Current Address 8 years	**Years Living at Current Address** 8 years
Years Living at Current Address 15 years	**Years Living at Current Address** 15 years

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Handout 9A.1: Individual Characteristic Cards (page 7 of 12)

Criminal Record One felony	**Criminal Record** One felony
Criminal Record One major misdemeanor	**Criminal Record** One major misdemeanor
Criminal Record Two minor misdemeanors	**Criminal Record** Two minor misdemeanors
Criminal Record One minor traffic violation	**Criminal Record** One minor traffic violation
Criminal Record None	**Criminal Record** None

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Handout 9A.1: Individual Characteristic Cards (page 8 of 12)

Length of Credit History No credit history	**Length of Credit History** No credit history
Length of Credit History 1 year using a store credit card	**Length of Credit History** 1 year using a store credit card
Length of Credit History 3 years using a major credit card	**Length of Credit History** 3 years using a major credit card
Length of Credit History 6 years using a major credit card and paying a car loan	**Length of Credit History** 6 years using a major credit card and paying a car loan
Length of Credit History 12 years using a major credit card and paying a mortgage	**Length of Credit History** 12 years using a major credit card and paying a mortgage

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Handout 9A.1: Individual Characteristic Cards (page 9 of 12)

Short-Term Financial Assets $0	**Short-Term Financial Assets** $0
Short-Term Financial Assets $250 in checking account	**Short-Term Financial Assets** $250 in checking account
Short-Term Financial Assets $1,000 in savings account	**Short-Term Financial Assets** $1,000 in savings account
Short-Term Financial Assets $5,000 in money market deposit account	**Short-Term Financial Assets** $5,000 in money market deposit account
Short-Term Financial Assets $10,000 in 1-year certificate of deposit	**Short-Term Financial Assets** $10,000 in 1-year certificate of deposit

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Handout 9A.1: Individual Characteristic Cards (page 10 of 12)

Long-Term Financial Assets $0	**Long-Term Financial Assets** $0
Long-Term Financial Assets $5,000 in savings account	**Long-Term Financial Assets** $5,000 in savings account
Long-Term Financial Assets $10,000 in U.S. Treasury bonds	**Long-Term Financial Assets** $10,000 in U.S. Treasury bonds
Long-Term Financial Assets $50,000 in an IRA	**Long-Term Financial Assets** $50,000 in an IRA
Long-Term Financial Assets $150,000 in a 401(k) account	**Long-Term Financial Assets** $150,000 in a 401(k) account

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Handout 9A.1: Individual Characteristic Cards (page 11 of 12)

Equity in Home –$20,000 (mortgage balance > value in home)	**Equity in Home** –$20,000 (mortgage balance > value in home)
Equity in Home None (renter)	**Equity in Home** None (renter)
Equity in Home $20,000	**Equity in Home** $20,000
Equity in Home $50,000	**Equity in Home** $50,000
Equity in Home $100,000	**Equity in Home** $100,000

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Handout 9A.1: Individual Characteristic Cards (page 12 of 12)

Market Value of Other Real Assets Old furniture and appliances: $500	**Market Value of Other Real Assets** Old furniture and appliances: $500
Market Value of Other Real Assets Old car: $4,000	**Market Value of Other Real Assets** Old car: $4,000
Market Value of Other Real Assets Car and electronics: $10,000	**Market Value of Other Real Assets** Car and electronics: $10,000
Market Value of Other Real Assets Car, boat, and jewelry: $25,000	**Market Value of Other Real Assets** Car, boat, and jewelry: $25,000
Market Value of Other Real Assets Car, gold coins, and 10 acres of land: $50,000	**Market Value of Other Real Assets** Car, gold coins, and 10 acres of land: $50,000

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Handout 9A.2: Loan Request Cards

Loan Request $2,000 for a laptop computer	**Loan Request** $6,000 for a Caribbean vacation
Loan Request $10,000 credit limit on a new credit card	**Loan Request** $15,000 for 1 year of college tuition
Loan Request $20,000 for home renovation	**Loan Request** $20,000 for a fishing boat
Loan Request $25,000 for a newer-model car	**Loan Request** $50,000 for medical expenses
Loan Request $100,000 to start a new business	**Loan Request** $150,000 for a house

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Handout 9A.3: Approve or Deny Credit?

Name:____________________________________

Part A

1. Record the loan amount requested: __________________________________
2. Record the information from each Individual Characteristic card in the appropriate category below. (Hint: There should be four items in each.)

Capacity: ____

____

____

____

Character: ____

____

____

____

Collateral: ____

____

____

____

Part B

3. Given an individual with the characteristics above, for each category and using the following scale, rate the risk of this individual not repaying the loan as low risk, medium risk, or high risk.

Capacity: ___________________________________

Character: ___________________________________

Collateral: ___________________________________

Part C

4. Which factors support *approving* this individual's loan request?

5. Which factors support *denying* this individual's loan request?

6. Would you approve or deny this individual's loan request? **Approve** **Deny**
Explain your decision. (circle one)

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Handout 9A.4: Assessment

Name:___________________________________

Directions: Use the information below to assess the capacity, character, and collateral of a potential borrower and then answer the questions.

Loan Request: $60,000 for a new sport utility vehicle (SUV)

Capacity

Annual household income: $80,000

Years working for current employer: 6 years

Education: College graduate

Monthly debt payments: 10% of monthly income

Character

FICO score: 400

Years living at current address: 2 months

Criminal record: 1 felony

Length of credit history: 6 years using a major credit card

Collateral

Short-term financial assets: $200 in checking account

Long-term financial assets: $1,000 in savings account

Equity in home: None (renter)

Market value of other real assets: Old car ($3,000)

1. Given an individual with the characteristics above, evaluate how likely it is that this person will repay the loan in each of the three categories. Give a rating of "low risk," "medium risk," or "high risk."

   Capacity: ______________________________

   Character: ______________________________

   Collateral: ______________________________

2. Which factors support *approving* this individual's loan request?

3. Which factors support *denying* this individual's loan request?

4. Would you approve or deny this person's loan request? Explain your decision. **Approve** **Deny** (circle one)

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Standards and Benchmarks

National Standards for Financial Literacy

Standard 4: Using Credit. Credit allows people to purchase goods and services that they can use today and pay for those goods and services in the future with interest. People choose among different credit options that have different costs. Lenders approve or deny applications for loans based on an evaluation of the borrower's past credit history and expected ability to pay in the future. Higher-risk borrowers are charged higher interest rates; lower-risk borrowers are charged lower interest rates.

- Benchmark: Grade 4

    4. Borrowers who repay loans as promised show that they are worthy of getting credit in the future. A reputation for not repaying a loan as promised can result in higher interest charges on future loans, if loans are available at all.

- Benchmark: Grade 12

    3. Loans can be unsecured or secured with collateral. Collateral is a piece of property that can be sold by the lender to recover all or part of a loan if the borrower fails to repay. Because secured loans are viewed as having less risk, lenders charge a lower interest rate than they charge for unsecured loans.
    5. Lenders make credit decisions based in part on consumer payment history. Credit bureaus record borrowers' credit and payment histories and provide that information to lenders in credit reports.
    6. Lenders can pay to receive a borrower's credit score from a credit bureau. A credit score is a number based on information in a credit report and assesses a person's credit risk.

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