NO PREP

Understanding Credit

How Interest Rates and Payments Impact Your Finances

Includes: Student reading, case study, differentiated questions, teacher key

Name: Period: Date:

Understanding Credit: How Interest Rates and Payments Impact Your Finances

Credit is a critical tool in the financial world, offering both convenience and risk. Learning how credit works, particularly APR (Annual Percentage Rate), minimum payments, and compound interest, is key to making informed decisions and avoiding financial pitfalls. This reading breaks down the basics of credit cards, explains how interest accumulates, and uses real-world examples to illustrate the consequences of poor credit management. Using a credit card means borrowing money from a lender to make purchases. The principal balance is the amount you borrow, and lenders charge interest as the cost of borrowing. The Annual Percentage Rate (APR) shows how much interest you'll pay over a year, though it's applied monthly or even

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The Trap of Minimum Payments

Every credit card requires a minimum payment, usually 2–3% of the balance, to keep the account in good standing. While this seems manageable, paying only the minimum stretches debt over years and significantly increases the cost. Consider a $1,000 balance with a 20% APR. If the minimum payment is $25, it could take over five years to pay off the balance, costing more in interest than the original debt. Minimum payments are designed to keep borrowers in debt longer, generating profits for lenders.

Compound Interest: How Debt Grows

Compound interest charges interest on both the original balance and any previously accrued interest. Most credit cards calculate interest daily or monthly, meaning balances grow faster over time if not paid off quickly. For example, a $500 balance with an 18% APR compounds daily. After a year, the total debt can exceed $590 if no payments are made. Compound interest highlights why paying off balances promptly is crucial to avoid escalating debt.

Key Information: Payment Strategies Table

Strategy	Starting Monthly Payment	Time to Pay Off	Total Interest Paid	Total Cost
Minimum Payment	$35	Over 7 years	$1,200	$2,300
Pay Double Minimum	$70	2.5 years	$300	$1,400
Pay Full Balance	$1,100	1 month	$0	$1,100

Case Study: Alex's Credit Challenge

Alex, a recent high school graduate, receives their first credit card with a $1,500 limit. Excited by the freedom, Alex uses the card for a $900 laptop purchase and $200 in smaller expenses. By the end of the month, Alex's total balance is $1,100, and the card's APR is 22%. With limited income, Alex decides to pay the $35 minimum. After the payment, the remaining balance is $1,065, and the lender charges interest on this amount. The next month, Alex's balance grows to $1,085. Over the next year, Alex continues to make minimum payments, but the balance barely decreases due to accumulating interest.

1. How does Alex's decision to make only minimum payments affect their financial situation?

_____

_____

2. What could Alex do to avoid getting trapped in credit card debt?

_____

_____

Multiple Choice

1. What does APR stand for?

    a) Accumulated Payment Rate

    b) Annual Payment Rate

    c) Annual Percentage Rate

    d) Average Percentage Rate

2. Which of the following is a consequence of paying only the minimum payment?

    a) Avoiding interest charges entirely

    b) Accumulating more interest over time

    c) Eliminating your balance quickly

    d) Reducing your debt much faster

3. How does compound interest work?

    a) It charges interest on the principal and previously accrued interest.

    b) It adds interest to only the original principal amount balance.

    c) It reduces the amount owed a little more with every payment you make.

    d) It applies a fixed interest rate each month consistently.

Matching

Write the letter of the correct definition on the line next to each term.

Term	Definition
1. ___ APR	A) Original amount borrowed
2. ___ Compound Interest	B) The most the lender allows you to borrow
3. ___ Principal Balance	C) Cost of borrowing money annually
4. ___ Credit Limit	D) Smallest amount required monthly
5. ___ Minimum Payment	E) Interest calculated on previous interest

Fill-in-the-Blank

1. The cost of borrowing money on a credit card is represented as the _____.

2. Paying only the _____ amount extends the time required to pay off debt.

3. _____ interest grows the balance by adding interest to previous amounts.

Short Answer

Answer each question in 2-4 complete sentences.

1. Why is it important to pay more than the minimum payment on a credit card?

_____

_____

_____

2. How does compound interest increase the total cost of credit card debt?

_____

_____

_____

3. What strategies can you use to avoid paying excessive credit card interest?