**Cost of Credit Worksheet** **Teacher Guide**

The objectives of this worksheet are:

1) to offer a simple mathematical example illustrating the cost of credit; and

2) to stimulate a discussion on how and why small businesses use credit.

(Upgrade: July 2016)

The table below compares the different type of credit (or debt) that small businesses use.

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| --- | --- | --- | --- | --- | --- |
| **Type of Debt** | **Typical 2016 Interest Rates** | **Origination Fee\*** | **Available to Small Businesses?** | **Effort to Complete an Application** | **Best Use** |
| Secured Line of Credit | 6 – 15% | 0 – 3% | Sometimes | Substantial | To purchase equipment the business will use for a long time |
| Unsecured Line of Credit (Credit Card) | 18 – 30% | No | Usually | Easy | Make a quick purchase the business needs urgently when cash is not available; to help a small business maintain operations during a period of slow sales |
| Online Credit | 24 – 60% | 0 – 12% | Almost Always | Minimal |

\* - an origination fee is the percentage of a loan a bank charges when a small business receives a loan. Origination fees add to the cost of the loan.

For the purposes of this simple example we’ll ask you and the students to assume that this is an “interest payment only” loan. The small business would pay the interest due each month, and then pay the full principal amount in a lump sum at the end of the loan.

**Scenarios**

Scenario 1: Your small business wants to borrow $80,000 for a truck and equipment necessary to expand your company.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Type of Debt** | **“Interest Only” Loan Terms** | **Amount Borrowed** | **Months Loan Outstanding** | **Origination Fee Paid** | **Monthly Interest Payment** | **Total Fees, Interest and Principal Paid** |
| Secured Line of Credit | 6% annual interest rate (0.5% per month);  3% origination fee | $80,000 | 24 | $2,400  3% x $80,000 | $400  $80,000 x .005 | $92,000  ($400 / month x 24 months) + $2,400 fee + $80,000 principal repaid |
| Credit Card | 24% annual interest rate (2% per month);  no origination fees | $0 | $1,600  $80,000 x .02 | $118,400  ($1,600 / month x 24 months) + $0 fee + $80,000 principal repaid |
| Online Credit | 30% annual interest rate (2.5% per month);  5% origination fee | $4,000  5% x $80,000 | $2,000  $80,000 x .025 | $132,000  ($2,000 / month x 24 months) + $4,000 fee + $80,000 principal repaid |

Scenario 2: Your small business must borrow $20,000 for 2 months until your sales pick up during the Holiday season.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Type of Debt** | **Loan Terms** | **Amount Borrowed** | **Months Loan Outstanding** | **Origination Fee Paid** | **Monthly Interest Payment** | **Total Fees, Interest and Principal Paid** |
| Secured Line of Credit | 6% annual interest rate (0.5% per month);  3% origination fee | $20,000 | 2 | $600  3% x $20,000 | $100  $20,000 x .005 | $20,800  ($100 / month x 2 months) + $600 fee + $20,000 principal repaid |
| Credit Card | 24% annual interest rate (2% per month);  no origination fees | $0 | $400  $20,000 x .02 | $20,800  ($400 / month x 2 months) + $0 fee + $20,000 principal repaid |
| Online Credit | 30% annual interest rate (2.5% per month);  3% origination fee | $600  3% x $20,000 | $500  $20,000 x .025 | $21,600  ($500 / month x 2 months) + $600 fee + $20,000 principal repaid |

**Discussion Questions**

1) Which is the most expensive form of credit in each scenario?

*The credit card and online credit are clearly more expensive. Small businesses (and individuals as well) should try to avoid using these very expensive forms of debt for long-term purposes.*

*For longer-term debt the secured line of credit is clearly the least expensive form of credit. But remember: many small businesses will not qualify for secured bank debt. Why:*

1. *because the company has not been in business long enough for the bankers to feel comfortable loaning them money;*
2. *because the owners may not have enough personal money to offer the bankers a personal loan guarantee;*
3. *because the small business owner may be intimidated by the complex and difficult loan application and may fail to apply.*

2) An online credit company says: “We don’t charge interest on your funds – we only charge a monthly fee.” Does this mean that they’re lending you the funds “interest free?”

*NO. The funds are not interest free. Whether a company calls the amount they charge “interest” or “fees,” this is still the monthly cost they’re charging your small business for the cost of the money they’re lending you. A lending company that calls its charges “fees” instead of “interest” is still charging you a cost for the money you’re borrowing. And the cost of borrowing money from online credit companies is greater than the cost of credit that credit-worthy businesses can obtain from their bank.*

3) Which is the “best” form of credit in each scenario?

*The secured line of credit is clearly the lowest cost form of credit when the small business will be using the debt over a long period.*

*When the debt is for a shorter period, the cost of each type of debt is roughly the same. Then factors like “which type of debt is easiest to apply for” and “which type of debt is most convenient to use” become more important.*

*The danger: if a credit line you intend to use for a short period of time remains unpaid, then the interest payments quickly add up to something very expensive.*

4) Why do small businesses use more expensive forms of credit?

*Good reasons would be: a) it’s a convenient way to finance a short-term need (like building up inventory in advance of the holiday season, or paying over-time this week on a contract that will end up paying the company lots of money at the end of the month); and b) the company can use the funds when they need them, pay them back and not be charged an origination fee.*

*Bad reasons would be: a) the owner is intimidated by the long and complex application form for the secured line of credit (which is why completing this type of application is a requirement for the Micro-Enterprise Credential); and b) they didn’t realize how expensive the credit card or online debt would be.*

5) What can a small business do to lower its cost of credit?

*1) Shop for a better deal than the first deal they find. 2) Negotiate with the bank, credit card company or online lender for a better rate (you can always at least try to negotiate – nothing lost by trying!). 3) Find ways to save enough money to eliminate the need for credit.*

6) When might it be better to seek equity capital instead of using debt?

*When a small business is considering a major expansion or some other long-term use of money, it may be better to see investors (especially Angel Investors) who might be willing to provide equity that doesn’t require a monthly interest payment.*

*Many small businesses will not be able to attract Angel Investors or Crowdfunding. In those cases, small businesses have to be very careful in determining whether or not credit is the right way to fund their growth.*