



## Personal Finance: Understanding Interest

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Who said: “Compound interest is the eighth wonder of the world”?

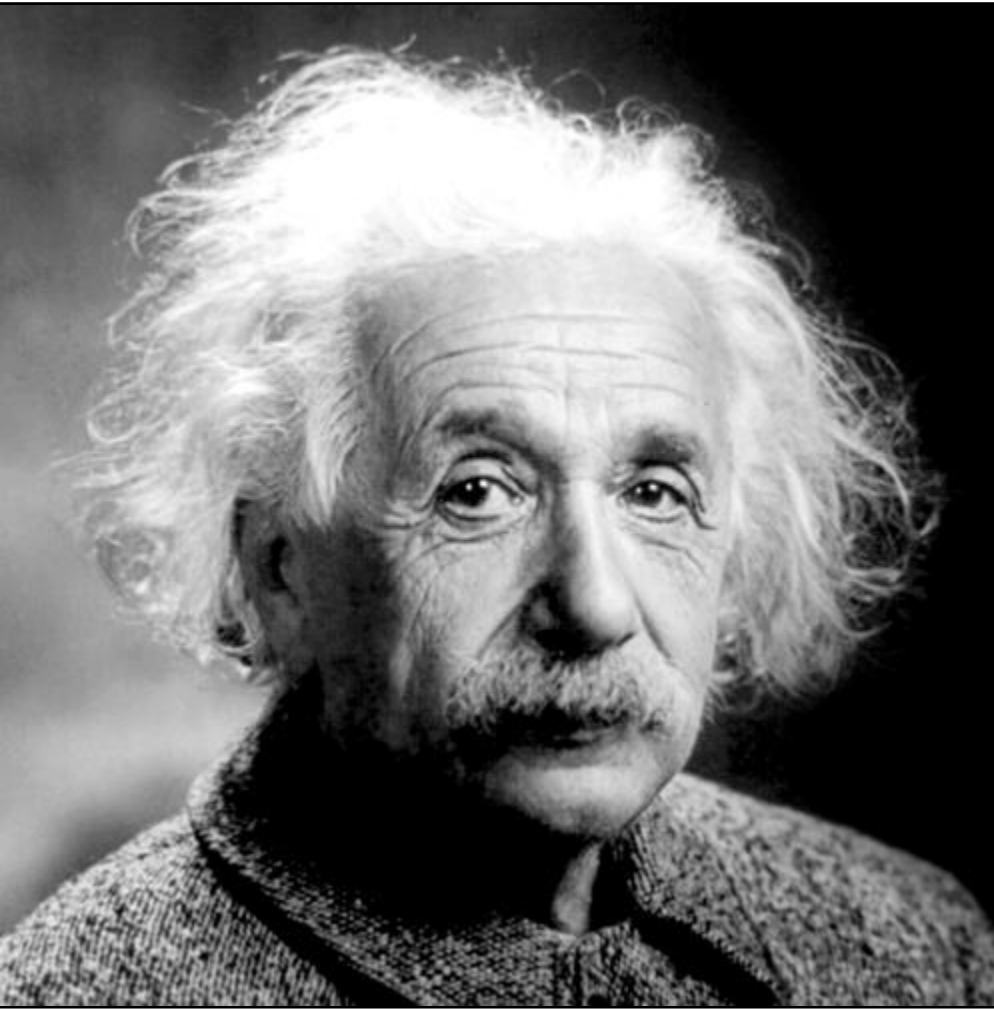


# Lesson Objective

Students will learn what interest is and how it works.



# Interest



“Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who doesn't ... pays it.”

*-Albert Einstein*



# Interest Definitions

- **Interest:** The fee charged by a lender for money borrowed.
- **Principle:** The amount of money borrowed.
- **Time:** The period of time by which a loan is repaid or interest is figured.
  - Ex: Monthly or Yearly
- **Interest Rate:** The percentage applied to the principle by which interest is calculated.
- **Payment:** An amount paid.



# Interest Definitions

- **APR:** Annual Percentage Rate: The interest rate for the whole year.
- **Nominal APR:** the simple interest rate (for a year)
- **Effective APR:** The fee + compound interest rate (calculated across a year)



# Interest

- If a friend comes and asks to borrow money, will you loan it to them?
- What if it was a friend of a friend that wanted to borrow money?
- What if it was a complete stranger?
  - What would it take for you to lend money to a complete stranger?

**Interest** is the reason that banks and other lenders are willing to lend money to complete strangers. They agree to lend money, but in return the borrower agrees to pay the lender a percentage of the principle borrowed.



# Interest

For Example:

Jim wants to buy a car but he doesn't have enough cash to pay for it. He talks to his bank and they agree to lend him \$20,000 if he will agree to pay them back within 3 years with interest on the principle he borrowed.

With this arrangement, Jim can buy his car and the bank makes money for letting him use their money.

- **Jim's actual cost** for buying the car:  
 $\$20,000 \text{ borrowed} + \$1,500 \text{ interest} = \$21,500$
- **Bank's income** for lending the money =  $\$1,500$



# Interest

Interest works in reverse as well. When you lend money to the bank (in the form of a deposit into your savings account), the bank uses your money to make loans. In return, you get a portion of the interest they make. You see this through the interest your account earns each month.







# Review:

1. What is interest?
2. Why are banks willing to lend money?
3. What is an interest rate?



# Review:

1. What is interest?

*The fee charged by a lender for money borrowed.*

2. Why are banks willing to lend money?

*They make money off of the amount they lend.*

3. What is an interest rate?

*The percentage applied to the principle by which interest is calculated*