

# Price of Risk

Trace how repayment risk shapes loan interest rates.

**SS.8.FL.4.4** "Explain that lenders charge different interest rates based on the risk of nonpayment by borrowers. Describe why the higher the risk of nonpayment, the higher the interest rate charged by financial institutions..."

NAME \_\_\_\_\_

DATE \_\_\_\_\_

## 1 READ AND MARK \_\_\_\_\_ Read it twice

**YOUR JOB** Underline statements that tell why a borrower may be risky or low-risk, and circle each phrase that connects more or less risk to a higher or lower interest rate so you can trace the lender's reasoning.

### How Lenders Set Rates

- ① When a financial institution lends money, it expects to be paid back with interest. Interest is the price a borrower pays for using the lender's money. Before approving a loan, the lender estimates the chance that the borrower will miss payments or fail to repay. This chance is called risk of nonpayment. Lenders use information such as a borrower's income, debt, payment history, and the size of the requested loan. These details help lenders decide what interest rate to offer.
- ② Borrowers who seem more likely to miss payments create a larger possible loss for a lender. The lender may charge these borrowers a higher interest rate. The higher rate helps the institution cover the added chance that some money will not be repaid. It also encourages careful lending instead of treating every borrower as equally likely to repay. A high rate does not mean a borrower will definitely fail to pay. It means the lender judges the chance of nonpayment to be greater than for a lower-risk borrower.
- ③ Consider two people seeking similar car loans. Jordan has steady income, low existing debt, and a record of on-time payments. Casey has irregular income, several unpaid balances, and recent late payments. A lender is likely to see Casey as carrying more risk of nonpayment and may offer Casey a higher interest rate. Jordan is likely to receive a lower rate because the lender expects repayment to be more likely. When loan amounts and other terms are alike, the lower rate usually leads to less interest paid over the loan.

**2 ANSWER WITH EVIDENCE** \_\_\_\_\_ Use the passage

**1** What does risk of nonpayment mean? Name two kinds of information a lender can use to estimate it.

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**2** Why might a lender charge a higher interest rate to a borrower with more risk of nonpayment?

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**3** Which borrower, Jordan or Casey, is more likely to be offered a higher interest rate? Use two details from the passage to explain.

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**4** If two loans have the same amount and other terms, how does a lower risk of nonpayment affect the interest rate and the interest paid?

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**3 YOUR TURN** \_\_\_\_\_ Your own words

Invent two people applying for similar loans. In 3 or 4 sentences, describe details that make one person lower-risk and the other higher-risk, then identify who should receive the higher interest rate and explain why.

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**PART 1 • READ AND MARK**

Underline statements that tell why a borrower may be risky or low-risk, and circle each phrase that connects more or less risk to a higher or lower interest rate so you can trace the lender's reasoning. Accept any marking that follows this job and points at the right text.

**PART 2 • ANSWERS**

| # | QUESTION                                                                                                                               | ANSWER                                                                                                                                                                                  |
|---|----------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1 | What does risk of nonpayment mean?<br>Name two kinds of information a lender can use to estimate it.                                   | <b>It is the chance that a borrower will miss payments or fail to repay. Lenders can consider income, debt, payment history, or the requested loan size.</b>                            |
| 2 | Why might a lender charge a higher interest rate to a borrower with more risk of nonpayment?                                           | <b>The higher rate helps the lender cover the greater chance that some of the money will not be repaid.</b>                                                                             |
| 3 | Which borrower, Jordan or Casey, is more likely to be offered a higher interest rate?<br>Use two details from the passage to explain.  | <b>Casey is more likely to receive a higher rate because Casey has irregular income, unpaid balances, and recent late payments. These details suggest a greater risk of nonpayment.</b> |
| 4 | If two loans have the same amount and other terms, how does a lower risk of nonpayment affect the interest rate and the interest paid? | <b>Lower risk is likely to lead to a lower interest rate, which usually means less interest paid over the loan.</b>                                                                     |

**PART 3 • YOUR TURN (SAMPLE ANSWER)**

Nora has a steady job and has paid her bills on time, so her risk of nonpayment is lower. Eli recently missed several bill payments and has no steady income, so his risk is higher. Eli should be charged a higher interest rate because the lender faces a greater chance of not being repaid.

Accept reasonable borrower details that show different repayment risks. The response must correctly connect higher risk to a higher interest rate and lower risk to a lower interest rate.