Predatory Lending Warning Signs Guide

Chapter 7.2: Choosing the Right Source of Credit

About This Guide

This guide will help you identify warning signs of predatory lending and find safer alternatives when you need to borrow money. Predatory lenders target vulnerable borrowers with deceptive practices that can lead to a cycle of debt.

What Is Predatory Lending?

Predatory lending refers to unfair, deceptive, or fraudulent practices of lenders during the loan origination process. These lenders impose unfair and abusive loan terms on borrowers, often through aggressive sales tactics, taking advantage of borrowers' lack of understanding of financial terms, and outright deception.

Warning Sign #1: Excessive Interest Rates and Fees

Legitimate lenders charge reasonable interest rates based on risk and market conditions. Predatory lenders charge rates far above market rate, sometimes disguising them with fees or complicated structures.

Example: Payday loans often carry APRs of 400% or higher when converted to an annual rate. A $500 two-week loan with a $75 fee (typical for payday loans) equals an APR of 391%.

What to look for:

- APRs over 36% (many experts consider this the upper boundary of responsible lending)
- Fees that aren't clearly disclosed upfront
- Multiple types of fees (origination, processing, administrative, etc.)

- Prepayment penalties that make it expensive to pay off the loan early

Warning Sign #2: Pressure Tactics and Urgency

Responsible lenders give you time to review loan documents and compare options. Predatory lenders use high-pressure sales tactics to rush you into decisions.

> **Example:** "This special rate is only available today," or "You need to sign now because someone else is waiting for this loan approval."

What to look for:

- Pressure to sign documents without reading them thoroughly
- Reluctance to provide copies of documents before signing
- Claims that "special rates" or "limited offers" will expire immediately
- Discouragement from seeking advice from family, friends, or financial counselors

Warning Sign #3: Balloon Payments and Loan Flipping

These structures mask the true cost of borrowing by starting with low payments that suddenly increase, or by encouraging repeated refinancing that generates more fees.

> **Example:** A loan with payments of $200/month for 11 months and a final balloon payment of $5,000 in month 12, or a lender who contacts you before your loan is paid off offering to refinance for "better terms."

What to look for:

- Payment schedules with significantly larger final payments
- Loans structured with artificially low initial payments that increase later
- Encouragement to refinance repeatedly for small amounts of additional cash
- New loan offers that primarily pay off old loans but add new fees

Warning Sign #4: Unnecessary Add-ons and Insurance

Predatory lenders often pack loans with expensive add-on products that provide minimal value to the borrower but increase the lender's profit.

Example: Credit insurance that costs $1,500 on a $10,000 loan but has significant limitations on when it can be used.

What to look for:

- Credit life or disability insurance that's presented as mandatory
- Service contracts or warranties with high fees
- Membership fees for "discount clubs" or similar services
- Insurance products with narrow coverage but high premiums

Warning Sign #5: Loan Terms That Change at Closing

Responsible lenders honor the terms discussed during application. Predatory lenders may switch terms at the last minute, hoping borrowers won't notice or will feel too committed to back out.

Example: You're promised a 5% interest rate during discussions, but the final loan documents show 7.5% or include fees not previously disclosed.

What to look for:

- Interest rates higher than initially quoted
- New fees appearing in final documents
- Loan amount different than requested
- Changes to loan term (length) or payment structure
- Blank spaces in contracts that could be filled in later

Cost Comparison: Predatory vs. Responsible Lending

The table below shows the dramatic difference in cost between predatory and responsible lending options for a $1,000 loan:

Loan Type	Interest Rate/Fee	Term	Monthly Payment	Total Repayment	Total Cost (Interest + Fees)
Payday Loan	$15 per $100 borrowed (391% APR equivalent)	2 weeks (often rolled over)	$1,150 lump sum	$1,150	$150 for 2 weeks ($1,950 if rolled over for 6 months)
Auto Title Loan	25% per month (300% APR)	30 days (often rolled over)	$1,250 lump sum	$1,250	$250 for 1 month ($1,500 if rolled over for 6 months)
High-Cost Installment Loan	100% APR + $100 origination fee	6 months	$222	$1,332	$332
Credit Union Personal Loan	12% APR	12 months	$89	$1,068	$68
Credit Card (average rate)	18% APR	12 months	$92	$1,104	$104
Credit Union Payday Alternative Loan	28% APR + $20 fee	6 months	$175	$1,050	$50

Alternatives to Predatory Loans

Alternative #1: Credit Union Loans

Credit unions often offer small-dollar loans with reasonable terms and are more willing to work with borrowers who have less-than-perfect credit.

Features:

- Interest rates capped at 18% for most credit unions
- Payday Alternative Loans (PALs) with APRs around 28%
- Loan amounts from $200-$2,000
- Terms from 1-12 months
- May require credit union membership (typically $5-25 to join)

Alternative #2: Community Development Financial Institutions (CDFIs)

CDFIs are specialized financial institutions that serve low-income communities and people who lack access to traditional financing.

Features:

- Small personal loans with reasonable interest rates
- Financial education and credit counseling
- Flexible qualifying requirements
- Focus on helping borrowers build credit

Alternative #3: Payment Plans for Bills

Many service providers offer payment plans rather than paying late or turning to high-cost loans.

Options:

- Contact medical providers about interest-free payment plans
- Ask utility companies about budget billing or hardship programs
- Negotiate with creditors for modified payment terms

- Work with student loan servicers on income-driven repayment options

Alternative #4: Local Assistance Programs

Many communities have emergency assistance programs that can help with essential expenses.

Resources:

- United Way's 211 service - connects to local resources
- Community action agencies
- Religious organizations with assistance programs
- Emergency rent and utility assistance programs
- Food banks to reduce grocery expenses

Alternative #5: Employer-Based Options

Some employers offer financial assistance or early access to earned wages.

Possibilities:

- Payroll advances
- Earned wage access apps (like DailyPay or PayActiv)
- Employee emergency funds
- Employee Assistance Programs with financial resources

Building Emergency Funds to Avoid Predatory Loans

The best protection against predatory lending is having your own emergency savings. Even small amounts can help avoid high-cost borrowing.

Emergency Fund Building Checklist:

Set up automatic transfers to a separate savings account

- ◻ Start with saving just $5-10 per week
- ◻ Save tax refunds and other windfalls
- ◻ Consider a round-up savings app that saves spare change
- ◻ Keep emergency funds in a separate account to avoid spending them
- ◻ Aim for $500 initial goal, then work toward 1-3 months of expenses

What To Do If You're Already In A Predatory Loan

If you're currently in a predatory loan, there may be ways to escape the cycle:

1. **Contact a nonprofit credit counselor** - Organizations like the National Foundation for Credit Counseling (NFCC) offer free or low-cost help
2. **Research state protections** - Many states have laws limiting payday and title loans
3. **Consider refinancing with a credit union** - Ask about PALs or debt consolidation options
4. **Check if the loan violates any laws** - Some predatory practices are illegal and loans may be unenforceable
5. **Prioritize paying off high-cost debt** - Even making sacrifices in other areas can save money long-term
6. **File a complaint** - Report predatory practices to the Consumer Financial Protection Bureau (CFPB) at consumerfinance.gov/complaint

Know Your Rights

Under federal law, lenders must disclose:

- The APR (Annual Percentage Rate)
- The finance charge (total cost of credit)
- The amount financed
- The total of payments
- Payment schedule
- Whether there are prepayment penalties

If a lender doesn't clearly provide this information, be cautious and consider it a red flag.