What is Predatory Lending?

Predatory lending is any lending practice that imposes unfair or abusive loan terms on a borrower. It is also any practice that convinces a borrower to accept unfair terms through deceptive, coercive, exploitative or unscrupulous actions for a loan that a borrower doesn't need, doesn't want or can't afford.

By definition, predatory lending benefits the lender and ignores or hinders the borrower's ability to repay the debt. These lending tactics often try to take advantage of a borrower's lack of understanding about loans, terms or finances.

Predatory lenders typically target minorities, the poor, the elderly and the less educated. They also prey on people who need immediate cash for emergencies such as paying medical bills, making a home repair or car payment. These lenders also target borrowers with credit problems or people who recently lost their jobs. This could disqualify them from conventional loans or lines of credit, even though they have substantial equity in their homes.

Over the past several years, predatory lending practices have been prevalent in the area of home mortgages. Since home loans are backed by a borrower's real property, a predatory lender can profit not only from loan terms stacked in his or her favor, but also from the sale of a foreclosed home, if a borrower defaults.

While the practices of predatory lenders may not always be illegal, they can leave victims with ruined credit, burdened with unmanageable debt, or homeless.

Predatory lending can also take the form of payday loans, car loans, tax refund anticipation loans or any type of consumer debt.

Predatory Lending Practices

While there is some dispute about what constitutes a predatory lending practice, a number of actions are often cited as such — including a failure to disclose information or disclosing false information, risk-based pricing and inflated charges and fees. There are other predatory practices such as loan packing, loan flipping, asset-based lending and reverse redlining.

These practices, either individually or in concert with each other, create a cycle of debt that causes severe financial hardship on families and individuals.

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the initial offer.

Risk-Based Pricing

While all lenders depend on some form of risk-based pricing — tying interest rates to credit history — predatory lenders abuse the practice by charging very high interest rates to high-risk borrowers who are most likely to default.

Inflated Fees and Charges

Fees and costs (e.g., appraisals, closing costs, document preparation fees) are much higher than those charged by reputable lenders, and are often hidden in fine print.

Loan Packing

Unnecessary products like credit insurance — which pays off the loan if a homebuyer dies — are added into the cost of a loan.

Loan Flipping

The lender encourages a borrower to refinance an existing loan into a larger one with a higher interest rate and additional fees.

Asset-Based Lending

Borrowers are encouraged to borrow more than they should when a lender offers a refinance loan based on their amount of home equity, rather than on their income or ability to repay.

Reverse Redlining

The lender targets limited-resource neighborhoods that conventional banks may shy away from. Everyone in the neighborhood is charged higher rates to borrow money, regardless of credit history, income or ability to repay.

Balloon Mortgages

A borrower is convinced to refinance a mortgage with one that has lower payments upfront but excessive (balloon) payments later in the loan term. When the balloon payments cannot be met, the lender helps to refinance again with another high-interest, high-fee loan.

Negative Amortization

This occurs when a monthly loan payment is too small to cover even the interest, which gets added to the unpaid balance. It can result in a borrower owing substantially more than the original amount borrowed.

Abnormal Prepayment Penalties

A borrower who tries to refinance a home loan with one that offers better terms can be assessed an abusive prepayment penalty for paying off the original loan early. Up to 80% of subprime mortgages have abnormally high prepayment penalties.

Mandatory Arbitration

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Protecting Yourself Against Predatory Lenders

The best defense against predatory lenders lies in educating yourself about their deceptive practices. Following is a list of some of the things to watch out for:

Unlicensed Loan Offers

Beware of loan offers through the mail, via telephone or door-to-door solicitations. Reputable lenders typically don't operate in this way. Make sure any lender you work with is licensed.

Promises

Stay clear of lenders who promise that your loan will be approved regardless of your credit history or rating. Get a copy of your credit report, and have some idea of what you should qualify for.

Being Rushed to Sign Papers

Do not let yourself be rushed into the loan process. Study the paperwork, and don't sign anything you don't agree with or understand.

High Interest Rates and Fees

Question high interest rates and fees. Refuse to accept payments you know you cannot afford. Decline any additional services "packed" into the loan, like credit or health insurance. Comparison shop and research how to find the best mortgage rates.

Blank Spaces in Documents

Do not sign any documents that contain blank spaces. Read loan documents carefully, and have them checked by a trusted friend or a lawyer, if possible.

Legal Protections

Federal laws protect consumers against predatory lenders. Chief among them is the Equal Credit Opportunity Act (ECOA). This law makes it illegal for a lender to impose a higher interest rate or higher fees based on a person's race, color, religion, sex, age, marital status or national origin.

The Home Ownership and Equity Protection Act (HOEPA) protects consumers from excessive fees and interest rates. Loans that are considered "high cost" are subject to additional disclosure requirements and restrictions.

In addition, 25 states have anti-predatory lending laws, and 35 states limit the maximum prepayment penalty that a homeowner is required to pay.

Loan Churning a Problem

One of the most common practices among predatory lenders is loan churning, where borrowers are forced into a relentless loan cycle in which they are constantly paying fees and interest, without noticeably reducing the principal amount owed on the loan.

Loan churning usually works like this: The lender makes a loan the borrower can't afford. The borrower fails to pay the loan back on time, so the lender offers a new loan that includes another set of fees and interest. The loans – churning – happen within one month of the first loan and that consumers using payday loans borrow an average of 10 times a year. The interest and fees amount to $2.1 billion for borrowers.

Borrowers often end up paying $450 in interest alone for a $350 principal because of loan churning. It is commonplace among predatory lenders and something consumers with a poor credit history should be on guard against.

Prepayment Penalties

Another practice among predatory lenders is to include a prepayment penalty on loan agreements, especially those involving subprime mortgages or car loans.

A prepayment penalty is a fee charged to borrowers who repay a loan before its due date. It usually happens when borrowers are refinancing to take advantage of a more affordable interest rate. Prepayment penalties are meant to discourage borrowers from paying off a loan early because it deprives the lender of interest they expect to receive for the life of the loan.

Prepayment penalties vary from lender to lender. Many are for 2% of the amount owed. Others are for the equivalent of six months of interest on the loan. Most prepayment penalties are based around the number of years you have been paying the mortgage and usually expire after three years.

The Truth In Lending Act requires lenders to provide a disclosure form to borrowers that includes a box that the lender must check if a prepayment penalty is in play. The wording on the form says a penalty "may" be charged and that wording often confuses consumers. Some people will read that to mean "may not" or simply skip over it in hopes that it will not ever be enforced.

The smarter practice is for the borrower to ask the lender for details on the amount of the penalty and how long the prepayment period is.

Subprime Loans

Subprime loans are made to borrowers with a poor credit history and a high chance of defaulting on repayment. They are popular again and creating debate on whether extending high-interest credit to mostly poor consumers is a good thing for the economy.

The credit reporting firm Equifax classifies subprime borrowers as people with credit scores under 650. Equifax says that more than 50 million consumer loans worth more than $189 billion were made to subprime customers, and 68% of the money ($129.5 billion) went to people wanting car loans.

Car buying is up 59% over the last five years and subprime lending gets most of the credit. It is a complete turnaround from the terrible reputation subprime lending earned in the early 2000's when it primarily was used to buy homes.

Subprime mortgage lending peaked in 2005 with $625 billion in loans, leading to the economic collapse in 2008. Subprime lending for home mortgages in 2014 was just $4 billion.

Some consumer advocates are worried a repeat of loan default crisis is coming, but non-bank lenders like Lending Tree are taking the lead this time and claim they have new algorithms that accurately identify people who can afford the loans.

Many states have laws preventing high interest rate loans. The Consumer Financial Protection Bureau is looking at requiring lenders to consider borrowers' ability to repay before extending loans, similar to what it already does with credit card debt and home mortgages.

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Bill "No Pay" Fay has lived a meager financial existence his entire life. He started writing/bragging about it in 2012, helping birth Debt.org into existence as the site's original "Frugal Man." Prior to that, he spent more than 30 years covering the high finance world of college and professional sports for major publications, including the Associated Press, New York Times and Sports Illustrated. His interest in sports has waned some, but he is as passionate as ever about not reaching for his wallet. Bill can be reached at bfay@debt.org.

← Truth in Lending Act – Consumer Rights and Protections

Federal Trade Commission Act →

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