NEIGHBORHOOD TRUST FINANCIAL PARTNERS

Predatory Debt:
A New Definition and Why it Matters

Executive Summary

Neighborhood Trust's new definition of predatory debt is a debt product that exploits borrowers by capitalizing on their urgent financial needs and is characterized by: excessive cost, excessive or hidden fees, hidden or misleading repayment structure, weak underwriting, trapping mechanisms, exploitative targeting, and/or poor lender credibility.

Our objective with this redefinition is to systematically identify the wide range of debt products that carry a higher-risk of causing financial harm to consumers than other products on the market. We are interested in broadening the perception of what constitutes predatory debt, beyond just the products that skirt usury laws or lending regulations. This redefinition incorporates existing definitions across the field as well as our Financial Coaches' expertise.

In this brief, we discuss why redefining predatory debt is important, what our new definition is, how we're applying it to identify predatory products in the market, and how these products show up in our client credit report data. Clients we serve through our TrustPlus worker financial health solution have a median income of $42,000, carry a median of $32,000 in non-real estate debt, and on average have a subprime credit score at baseline.

Our key findings include:

- Over half (55%) of our clients have predatory debt at baseline. Among them, 94% had at least three products we identified as predatory.
- Clients with predatory debt have a median of 5 late payments, while clients without any predatory debt have a median of 0 late payments.
- Several products that we identified as predatory are among the 10 most common products on our clients' credit reports.
- Clients who reported higher levels of financial distress were more likely to carry predatory debt.

We hope that this new definition supports the work many of our peers are already doing to disrupt the harm of these legal but high-risk products, and mobilizes anyone who is learning for the first time about the scale of the damage these predatory debt products are causing.

Why is redefining predatory debt important?

We set out to redefine predatory debt because so many of our clients are struggling to get their heads above water due to overwhelming, burdensome debt. But not all debt products are created equal: some carry a particularly high risk of causing financial harm due to high costs or by trapping borrowers in debt cycles, while other products can be helpful for affordably bridging a cash flow gap, covering an emergency expense, or consolidating other expensive debts. Developing a working definition of predatory debt enables us to parse out these groups to more effectively help our clients prioritize tackling the most burdensome debts.

Additionally, we believe that existing frameworks for defining predatory debt are underestimating how common predatory products are in the market, and are therefore also underestimating the scale of the pain these products are causing. For example, when many of us think about predatory debt, payday loans are likely the first example to come to mind. This is understandable given that payday loans alone "drain more than $2.2 billion in fees each year from borrowers who have an average annual income of approximately $25,000." In many cases they meet all of our criteria, namely trapping mechanisms and excessive cost with typical APRs of 300% or more. Payday loans indisputably hurt the people facing the greatest financial precarity. However, due to their widespread, high-profile harm, there has also been great progress to better regulate payday loans.

Meanwhile, a slew of other predatory products are successfully evading the level of scrutiny that payday loans receive, yet still profiting off of the urgent financial needs of vulnerable consumers. For example, fintechs account for most of the recent growth in unsecured lending to subprime borrowers, and many of them use tactics characteristic of predatory debt products such as hidden fees, weekly payments or misleading repayment terms.

By redefining predatory debt we aim to capture these new, evolving tactics to prevent these lenders from continuing to avoid detection. Then, with the ability to identify the full swath of these products, we can better assess the full scope of the debt crisis and tackle it more effectively.

What is Neighborhood Trust's new definition of predatory debt?

We define[1] predatory debt as a debt product that exploits borrowers by capitalizing on their urgent financial needs and is characterized by excessive cost, excessive or hidden fees, hidden or misleading repayment structure, weak underwriting, trapping mechanisms, exploitative targeting, and/or poor lender credibility.

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1. Our definition incorporates components from other prior definitions of predatory debt / lending including from: the American Bar Association, CFPB, NJ Division of Consumer Affairs, FDIC, The Federal Reserve Board, the National Association of Consumer Advocates. Our definition also incorporates expert contributions and vetting from our in-house Financial Coaches, as well as input from our academic research partners at the Social Policy Institute at Washington University. There is no consensus in the field on a unifying definition, so we sought out a range of definitions and perspectives to ensure our definition was comprehensive, grounded in the existing literature, and attuned to the lived experiences of our clients and Coaches.

The goal with this definition is to identify product features and lenders that put low-income consumers' financial security at greatest risk—even if a given product is not inherently predatory for all consumers.

This definition therefore seeks to reflect a broad set of products that are more likely to harm consumers' financial health than better alternative products. It's not limited to describing debt products that violate lending laws.

Example

Credit card ABC has an **excessively high APR**. A user with consistent, sufficient income who always pays their statement in full might never come to find this product predatory, because they'll never pay any interest on their balance. But a user with **lower, volatile income** who's more likely to **carry a balance** will struggle with the **snowballing interest** charges on this high-interest card. Credit card ABC is therefore predatory by our definition because it **puts lower-income users at a higher-risk of financial decline** than other, lower-interest cards available on the market.

Guided by our research, we further defined the criteria reflected in our overarching definition of predatory debt as follows:

- Excessive cost is defined as having an APR above a given threshold, based on the type of debt product (credit card, personal loan, student loan, auto loan, mortgage).
- Excessive or hidden fees are defined as those that are above market-rate, such as high annual fees or high loan origination fees; or fees that are hidden from borrowers until an event triggers an excessively expensive outcome, such as extreme late payment fees or prepayment penalties.
- Hidden or misleading repayment structure is defined as repayment terms that inhibit borrowers' ability to understand the true cost of borrowing. For example, not disclosing APR, retroactive interest charged after a promotional period, weekly loan payments that make borrowers think the loan is affordable, or a "tip" structure that masks high APRs by advertising 0% interest but charging fees and requesting costly tips at the point of borrowing.
- Weak underwriting is defined as no or limited assessment of ability to repay the debt. This practice increases risk of default and damage to borrowers' credit, increasing their dependence on predatory lenders.

- **Trapping mechanisms** are defined as product features or terms that encourage borrowers to fall into a cycle of reborrowing. These might include frictionless UX that enable continued borrowing (such as one-click to rollover balance into a new loan), short repayment terms that result in a need for additional credit, low minimum payments that encourage borrowers to repay slowly while interest accrues, interest-only loans, or the option to reborrow loan without a cooling off period.

- **Exploitative targeting** is defined as marketing or sales efforts that target particular geographic areas, demographic profiles, or credit profiles who are unlikely to qualify for prime lending and are therefore more susceptible to exploitation; AND / OR target consumers at the point-of-sale, when they are more vulnerable to exploitation.

- **Poor lender credibility** is defined by a history of misleading or defrauding consumers, and/or a history of disbursing debt products that meet other predatory debt criteria.

How can we apply this definition to identify particular products as predatory?

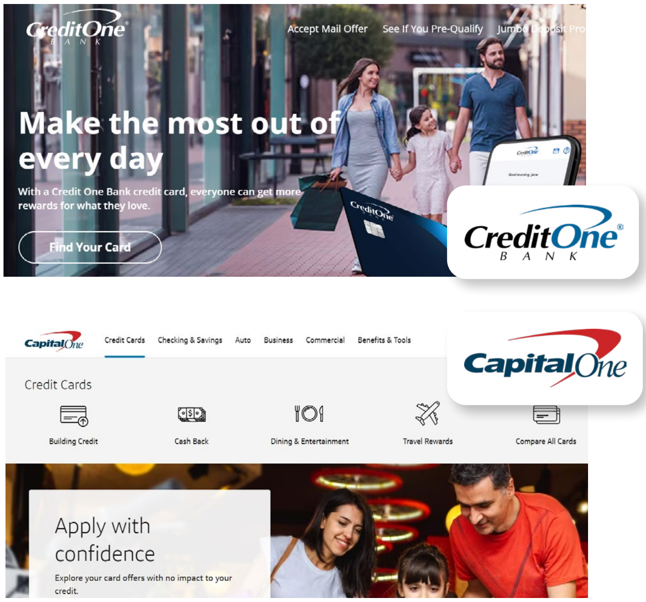
Using our definition, we generated a list[2] of predatory credit card and personal loan products found on TrustPlus clients' credit reports. We identified 126 predatory credit card and loan products, which represented 54% of all lenders reflected on clients' credit reports.

The products we identified included credit cards offered by Credit One and First Premier Bank, which are emblematic of how insidious predatory products can be. Among our clients, Credit One is the 3rd most common credit card lender and First Premier is the 9th most common.

Despite being around for decades (both were founded in the 1980s shortly after lenders began using FICO's scoring algorithms), each of these companies have continuously evolved over the years to evade regulations, bury consumer complaints, and appeal to subprime borrowers.

2. To generate this list, we first compiled a list of all the lender tradelines reflected on our clients' credit reports over the last 12 months. We also developed quantitative thresholds for the criteria that we are currently best equipped to measure and that we believe to be most harmful: excessive cost, exploitative targeting, and poor lender credibility. We then determined whether each product tradeline met one or more of the criteria using our determined thresholds. Lastly, we had our Financial Coaching team vet the list of predatory products that was generated post-labeling to confirm it aligned with their tacit knowledge of which products are predatory.

Credit One

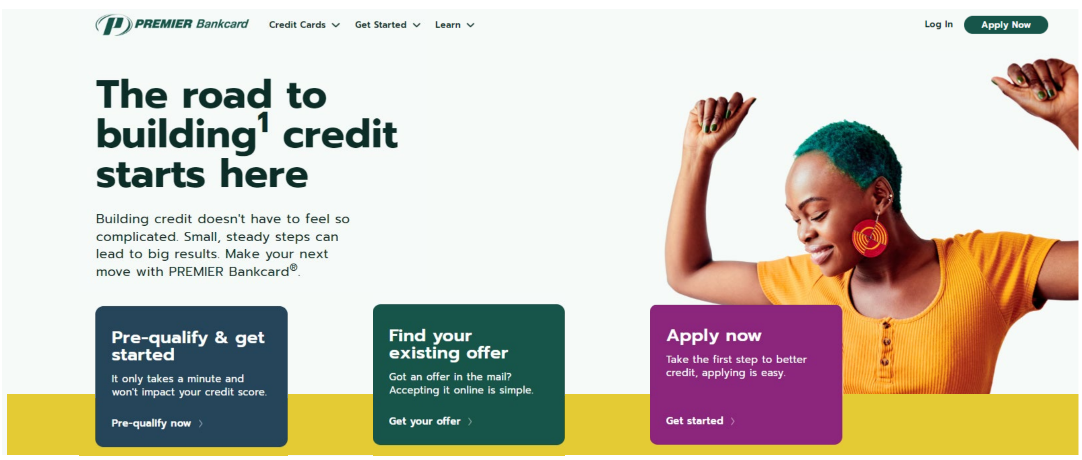


Credit One manipulates a false sense of trust by mimicking the branding and logo of Capital One, a nationally recognized mainstream bank.

In addition to using manipulative branding, Credit One extracts profits primarily via fees rather than high APRs, making it even harder for consumers to assess the true cost of their products.

Their "credit building" card available to those with lower credit scores comes with an annual fee of $99. And they've been known to charge fees to increase credit limits and even to pay credit card statements, both of which are typically free services.

First Premier Bank



First Premier Bank offers a colorful, inviting homepage with a seemingly supportive message, marketing their products as helpful "credit building" tools for subprime consumers.

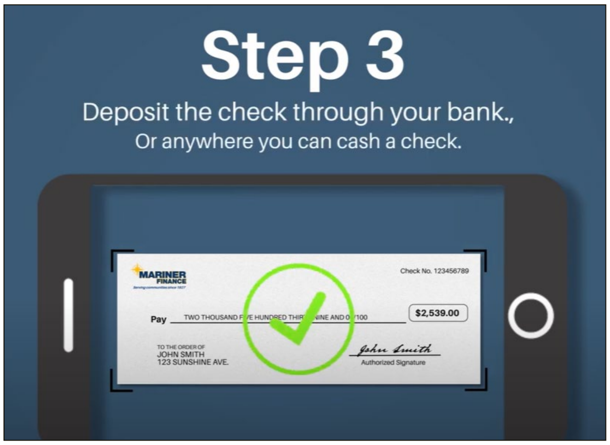
But hiding in the fine print for their unsecured card? A maximum starting credit limit of $700, an account opening fee of $55-$95, an annual fee of $50-$125 in addition to a monthly fee up to $10, and a flat-rate 36% APR—the legal limit in many cases. Even their secured card has an annual fee of $50, even though the required security deposit of $200 is equal to the maximum credit limit. First Premier also has a long history of documented predatory behavior and lawsuits.

In addition to predatory credit cards, we identified an array of predatory personal installment loan products that tend to advertise "quick money," but come with above market-rate APRs and excessive fees.

Mariner Finance, for example, mails unsolicited loans to consumers in the form of "checks" so that when a recipient "cashes" it they're on the hook for an expensive loan they didn't even apply for.

Several of the products we identified are offered by lenders who have been sued by the FTC or CFPB for misleading consumers and/or failing to abide by their cancellation policies, such as **OneMain** and **MoneyLion**. Many of these lenders are also engaging in rent-a-bank schemes to circumvent local interest rate limits by "laundering their loans" through banks in other states with higher interest rate caps.

Mariner Finance



A screengrab of Mariner's own video tutorial about what to do if you receive one of their checks in the mail.

Products offered by these primarily online companies with glossy, digital interfaces, may look and feel very different from the brick-and-mortar payday lenders and pawn shops that exemplify "predatory lending," but are nonetheless causing very real financial harm among low-income communities. Online lenders have become expert at legitimizing their product offerings by masking costs behind new, misleading features and flashy web / app design. And marketing teams have figured out how to reach people with irresistible offers at their most desperate moments, when they are most vulnerable to exploitation.

While we started by applying our definition to credit report data, there is more work to do to identify the many other products on the market that meet at least one of our criteria but may not be reflected on credit reports. For example, **SoLo Funds** is a fintech company that "positioned itself to be a lending solution for those who find themselves cash-strapped in emergency situations" according to Bloomberg. However, lawsuits from a number of states and the CFPB, as well as a class action lawsuit, are shedding light on their use of predatory practices to exploit these "emergency situations." "Per the suit, SoLo Funds led customers to believe they were signing up for an interest free-loan, but most borrowers ended up paying high fees masked in the form of 'tips,'" some of which translated to APRs of over 1000%. Users also reported that the option to opt-out of tipping was buried deep in the app, making it immensely difficult to avoid paying. These revelations mean that Solo Funds' loans meet at least two of our criteria for predatory debt: excessive cost and hidden or misleading repayment structure.

What does Neighborhood Trust's client data tell us about predatory debt?

When we applied our redefinition of predatory debt to our clients' credit report data, we found that:

- Over half (55%) of our clients have predatory debt at baseline. Among them, 94% had at least three products we identified as predatory. This finding—that it's really unlikely to only carry one predatory product, but very likely to carry three or more—showcases how cyclical and debilitating these products can be.

- 69% of the credit cards found on our clients' credit reports met our criteria for predatory debt. A majority of the cards in this group driving this high percentage were retail credit cards, which met our criteria for exploitative targeting. Excluding retail cards, 16% of credit cards met our criteria for predatory debt. 29% of personal loans were flagged as predatory using our criteria.

- Clients who reported higher levels of financial distress were more likely to carry predatory debt:
    - 32% of clients who reported "completely agreeing" with the statement "I am just getting by financially" carried predatory debt, relative to only 17% of those who disagreed with the same statement.
    - 9% of clients with a CFPB financial well-being score of 0-37 (low financial well-being) and 20% of those with a score of 38-57 (medium financial well-being) carried predatory debt, compared to only 3% of those with a score 58-100 (high financial well-being).

The financial profiles of those with at least one predatory debt with a non-zero balance relative to those with no predatory debt balances on their credit reports differed in a few key ways—highlighting the greater unaffordability and cyclical nature of predatory debt.

Financial Profile Metric	With Predatory Debt	Without Predatory Debt
Average Credit Score	**619**	636
Median Non-Mortgage Debt	**$32,812**	$6,170
Median No. of Late Payments	**5**	0

Most tracking to-date of predatory debt has been focused on payday and auto title loans, and has not included credit card or loan products like those identified above. Prior research has found that payday and auto title loans primarily target and impact low-income communities, people of color, women, and those with less education. These patterns are driven by a host of factors, but at the center are generations of systemic sexism and racism in the labor market, government programs, the financial industry and the education system. Together, these systems perpetuate poverty among these demographic groups, making them more vulnerable to and dependent on predatory financial services.

Therefore, we were surprised to find that, when we disaggregated the data by race, predatory credit cards and personal loans were similarly prevalent within each racial/ethnic group among our clients. While most of Neighborhood Trust's clients are Black or Latino/a as a result of systemic racism and structural poverty, 60% of Black or African American clients, 60% of Latino/a clients, 61% of Asian American clients, and 63% of White clients have predatory debt at baseline. We hypothesize that this finding suggests that the predatory debt products we examined primarily differ by economic status more so than by race, given that our clients largely share the same economic status. This finding may also be partially attributable to the increase in online lending and decline in brick-and-mortar shops, which have a history of targeting communities of color.

Additionally, we found that the median balances and minimum monthly payments of predatory and non-predatory tradelines did not differ significantly. Though these amounts appeared similar, we know that predatory debts cost more over time due to high-interest, high fees and the high risk of reborrowing. These costly features are not captured on credit reports, highlighting how difficult it can be to identify predatory products.

In future briefs, we will dig deeper into specific product types such as retail credit cards, rent-to-own products, Buy Now Pay Later, predatory subprime credit products and Earned Wage Access products.

What can I do?

We hope that this new definition and criteria supports the work of our peers in the field of financial health, empowerment and security.

- **Direct service providers**, such as financial coaches or case workers, can incorporate this work into their service delivery to help equip their clients with more information about what characteristics and product features to note when selecting a debt product.

- **Researchers** can deepen their understanding of the variation that exists within the debt market and the role different product and lender types can play in exacerbating or mitigating financial harm.

- **Advocates** can push for better consumer protections against this broader swath of predatory product features.

- **Lenders** can positively influence the debt market by ensuring their products are non-predatory and making them more meaningfully accessible to borrowers who need them most. By better meeting the needs of low-income consumers, lenders can have positive individual impact and also draw profit away from predatory lenders at the market level.

- **Consumers** can increase their scrutiny of exploitative marketing tactics to better avoid getting lured into debt traps.

Together, we hope to collectively generate the changes needed to improve low-income consumers' financial lives.

Please help us spread the word about this new way of redefining predatory debt!

Copy the message below to share with your network:

Check out Neighborhood Trust's newest piece on predatory debt, and why redefining it is so important for advancing low-income consumers' financial security: https://neighborhoodtrust.org/insights #predatorydebt #creditcarddebt #predatoryproducts

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