PERSONAL LOANS 101 AFSAEF

# PERSONAL LOANS 101: **UNDERSTANDING SMALL DOLLAR LOANS**

If you are looking for a small loan, you may not be sure where to turn. Most banks and credit unions do not lend small amounts of money. Payday loans can be expensive and burdensome. An established, more traditional but often lesser known option is an installment loan, which is a small-dollar loan, usually for $500 - $5,000, repaid on a schedule of identical amounts each month.

This brochure is intended to help clear up confusion between traditional installment loans and other types of small-dollar borrowing: car title loans, pawn loans, and payday loans.

Installment lenders have been around for more than 100 years, providing consumers with small loans to buy goods and services. They are community lenders based in cities and towns nationwide.

For decades, installment lenders have been effectively regulated by state agencies. They are subject to and follow all state and federal consumer protection laws. Be cautious of online lenders that do not have offices in your state or are vague about where the company is located. Online lenders based overseas do not always follow U.S. regulations and many are scams.

## INSTALLMENT LOANS

***An installment loan*** is repaid in equal monthly payments or installments. Traditional installment loans are structured to help borrowers meet a financial need within their budget, repay the loan in equal monthly payments and build a positive credit history. Installment loans do not charge penalties for early repayment, or prepayment, and do not require large one-time "balloon" payments.

Installment lenders work with borrowers to create a monthly budget based on your current income and expenses to determine if you will have enough money left after paying your monthly bills and obligations to make your loan payment. The monthly payment is set at an amount you can afford each month. Part of each payment pays off the loan, known as ***principal***, and the other part pays interest.

Installment lenders report your payment behavior with them to credit bureaus, which can help build or strengthen your credit history over time. Regular, on-time payments look good on your credit report and will improve your credit score; late or missed payments will have a negative impact.

# ALTERNATIVE LOAN OPTIONS

## CAR TITLE LOAN

A car title loan, also referred to as an auto title loan or title pawn, is a type of secured credit where borrowers can use their vehicle titles as collateral to secure a loan. These loans are typically short term and tend to carry higher interest rates than many other sources of credit. Car title lenders require that you have both a source of income and a car title without any liens.

***How it works:***

1 The lender holds and often places a lien on the borrower's car title, which means the lender has a legal claim on the car's ownership if the borrower defaults.
2. The borrower gives the lender the vehicle title in exchange for a loan amount.
3. The borrower gives a set of vehicle keys to the lender.
4. When the loan is repaid, the lien is removed; the car title and set of keys are returned to borrower/owner of the car.
5. If the borrower cannot pay the loan, it is either rolled over for another term – with more fees and interest – or the lender will repossess the vehicle, using the keys you gave the lender when you borrowed the money.

## PAWN LOAN

A pawnbroker offers secured loans to people with items of personal property that are used as collateral. Pawn shops require that you own an item that has resale value.

***How it works:***

1. An item is pawned for a loan for a set period of time. This means that the lender takes possession of the item.
2. The person pawning the item may reclaim it by paying the amount of the loan plus the agreed-upon amount of interest.
3. The amount of time and rate of interest is governed by law or the pawnbrokers' policies.
4. If the loan is not paid or extended within the defined time period, the pawned item will be offered for sale by the pawnbroker.

# ALTERNATIVE LOAN OPTIONS

**PAYDAY LOAN**
The Federal Trade Commission defines a payday loan as a cash advance secured by a personal check or paid by electronic transfer.

The Consumer Financial Protection Bureau defines a payday loan as a cash advance having three features:
1. The loans are in small-dollar amounts;
2. Borrowers must repay the loan proceeds quickly (i.e., they are short-term); and
3. They require that a borrower give the lender access to your deposit account (i.e., the borrower gives the lender a post-dated check or an electronic transfer authorization to allow the lender to withdraw money from the borrower's checking account).

Payday lenders have only two requirements for approving a loan: 1) you must have a job and 2) you must have a checking account. They do not underwrite the loan to determine the likelihood of payment. Instead, payday lenders rely solely upon cashing your check or accessing your bank account on the date the loan payment is due.

***How it works:***
1. The borrower writes a personal check or authorizes an electronic transfer for the amount of the loan plus a fee, in exchange for cash.
2. On the specified date – usually two to four weeks later – the borrower either pays the loan balance with cash, extends the loan, enters an extended payment plan, or the lender deposits the borrower's check. If you do not have enough money in your account when the payday lender deposits the check, you will be responsible for any returned check or insufficient fund fees.

Payday loans do not provide a manageable payment schedule, instead requiring a large, one-time payment of the full amount borrowed plus a fee and/or interest on a set date, usually your next payday. Partial payments are usually not permitted. A payday loan that cannot be repaid in full on the date due is typically rolled over into a new loan, often trapping borrowers in a cycle of debt.

# DIFFERENCES BETWEEN INSTALLMENT LOANS AND OTHER SMALL-DOLLAR LOANS

Installment loans are greatly different from car title, pawn, and payday loans, from how they are structured to how they are treated by credit bureaus. The differences are summarized in a quick reference table below.

| | **Installment Loan** | **Payday Loan** | **Pawn Loan** | **Car Title Loan** |
|---|---|---|---|---|
| Determines Your Ability to Repay the Loan | YES | NO | NO | NO |
| Paid in Affordable, Equal Monthly Amounts | YES | NO | NO | NO |
| Paid Off with One-Time Balloon Payment | NO | YES | YES | YES |
| Penalty for Early Repayment | NO | SOMETIMES | NO | NO |
| Reports Payment Behavior to Credit Bureaus | YES | NO | NO | NO |
| Requires Collateral | SOMETIMES | YES | YES | YES |

# DIFFERENCES BETWEEN INSTALLMENT LOANS AND OTHER SMALL-DOLLAR LOANS

Payday lenders, like car title lenders and pawn shops, only give you money in exchange for an item – a check, car title, or valuable item such as a gold watch. These items are known as ***collateral***, which you will lose if you do not repay the loan on time.

In the case of car title loans, the lender can put a lien on your car title, and take the title and a copy of your car key until you repay the account balance. Late payment can result in repossession of your car.

In a similar way, pawn shops take possession of an item you own as a pledge of the loan repayment. If you fail to repay the pawn loan when due, the item may be sold. Installment lenders sometimes require collateral, and can also repossess the item for non-payment.

Positive payment history with most car title, pawn and payday lenders does not get reported to credit bureaus, so you cannot improve your credit report with these loans. You may have good standing with the lender you deal with, but this relationship is not shared with the broader lending industry.

# WHAT FEDERAL LAWS SHOULD I KNOW?

**TRUTH IN LENDING ACT**
Requires creditors to give you written disclosures of important terms of the credit agreement, such as APR, finance charges, monthly payment amounts, payment due dates, total amount being financed, length of the credit agreement, total amount required to repay the loan and the consequences of not making a monthly payment.

**FEDERAL TRADE COMMISSION'S CREDIT PRACTICES RULE**
- Requires creditors to provide a written notice to potential co-signers about their liability if the other person fails to pay;
- Prohibits late charges in some situations;
- Prohibits creditors from using certain contract provisions that the government found to be unfair to consumers; and
- Prohibits a creditor from using certain household goods as collateral for a loan.

**EQUAL CREDIT OPPORTUNITY ACT**
Prohibits the denial of credit because of your sex, race, marital status, religion, national origin, age, or receiving public assistance.

**FAIR CREDIT REPORTING ACT**
- Gives you the right to learn what information is being distributed about you by credit bureaus;
- Requires creditors to ensure the accuracy and integrity of information furnished to credit bureaus.

**FAIR DEBT COLLECTION PRACTICES ACT**
Prohibits third-party debt collectors from using unfair or deceptive practices to collect overdue bills that your creditor has forwarded for collection.

# GOVERNMENT RESOURCES

**Federal Trade Commission**
www.ftc.gov
877-FTC-HELP (382-4357)

**Consumer Financial Protection Bureau**
www.consumerfinance.gov
855-411-2372

**National Association of Attorneys General**
State-by-state listing of attorneys general
www.naag.org/current-attorneys-general.php

AFSA EDUCATION FOUNDATION
*Brightening Your Financial Horizon*

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