Questions and Answers About

Auto Loans

How to help people with poor credit get the best car loan

A Consumer Action Publication

About This Guide

Consumer Action has written this guide with funding from the Bank of America Consumer Education Fund (BACEF) to help community-based organizations communicate with their clients. A free companion brochure for consumers titled “Get a Car Loan That’s In Your Best Interest” is available free and in bulk in English, Chinese, Korean, Spanish and Vietnamese. Visit the Consumer Action web site (www.consumer-action.org) or call 800-999-7981 for free publications, order forms or more information about Consumer Action’s services.

Introduction

Even people with poor credit have options when they seek financing for a new or used car. Yes, late payments and other credit problems usually require you to pay higher interest rates on car loans. But there are major differences in the deals offered by various lenders—by shopping around it's often possible to find a lower interest rate.

Car loans can be obtained from a variety of sources: credit unions, banks, online direct lenders, loan brokers and auto finance companies. Manufacturer-related auto financing companies are prohibited by law from selling loans directly to borrowers, so their loans usually are transacted at auto showrooms and are known as dealer financing.

Even if you have to pay a higher interest rate because of your credit, you can save on the car itself by doing your homework and negotiating a good price on the purchase. Many car buyers pay too much—sometimes thousands of dollars too much—for new and used cars.

Shopping around is the best way to save money on all aspects of car ownership, from the car to financing to insurance. Take your time—don't let anyone fast talk you into a bad deal!

Your Credit History

How does the way I have handled credit in the past affect my ability to finance a car today?

The way you've handled credit in the past has a big impact not only on whether you can get a car loan, but on the interest rate you'll pay. Bad credit means higher interest rates.

No one is going to lend you a large sum of money with a handshake and a pat on the back. When you apply for auto financing—or any kind of credit such as a credit card or mortgage—you will be asked to provide information about yourself that allows the lender to evaluate your ability to repay the loan. Lenders want to know how you have handled credit in the past and they easily can check your credit history by purchasing your credit report from one of the big database companies that track credit information. These companies are called credit reporting bureaus. There are three major national credit reporting bureaus—Equifax, Experian and TransUnion.

Should I get a copy of my credit report before I look for a car?

Yes, you should begin your search for a car only after you've ordered a copy of your credit report. Order your credit report at least two months before you apply for a car loan. (Your credit report will cost about $10.) This will give you time to correct any errors you find. Knowing your credit history will help protect you from shady dealers who claim your credit is worse than it actually is so they can charge you more interest on a car loan.

What is a credit score?

Your credit score is a number that summarizes your creditworthiness. It tells lenders how your credit stacks up against other consumers. You can purchase your score and credit report online at MyFico (**myfico.com**) for $12.95.

Credit scores go from the 300s to above 800. The higher the score, the better. If your score is 720 or above, you are generally considered to have the best credit and reputable lenders will offer you the lowest available interest rates and attractive terms on a car loan. If you have a score below 550, you may be seen as a "subprime" borrower—lenders think you might default on a loan. Remember that each lender sets its own standards, so by shopping around you may find a better deal.

How does my credit score affect the interest rate I can get on a car loan?

Interest rates change all the time, but generally the higher your score, the lower the rate you will qualify for. At the right is a chart that gives examples of how your score may affect the interest rate you will qualify for.

There are also other factors that may influence your ability to get a good interest rate. If you have never had a car loan before, you may be asked to pay a higher rate. If you have good credit but your current debt level is high, you may face a higher rate or outright rejection.

48-Month Used Car Loan	
Score	Interest Rate
720-850	5.697 %
690-719	6.467 %
660-689	8.952 %
625-659	11.765 %
590-624	16.7 %
500-589	15.493 %

Source: MyFico, 8/6/03

What factors affect my credit score?

According to MyFico, a provider of credit scoring systems to many banks and other lenders, payment history accounts for about 35% of your credit score. This includes:

- Account payment information for your credit cards, store credit accounts, installment loans, finance company accounts, mortgage, etc.
- Public records such as bankruptcy, judgments, lawsuits, liens and wage garnishment orders.
- Collection accounts.

The amount of your overall debt accounts for about 30% of your score. The length of your credit history, recently opened accounts and applications for new credit and the credit "mix," such as credit cards, retail accounts and mortgages account for the remaining percentage of your score.

Even if you have an excellent record of on-time payments, your score may be lowered by a short credit history or the fact that you have many retail credit cards. If you have applied for credit recently, your score will drop because new applications mean you might increase your overall debt.

How can I improve my credit score?

It is difficult to give advice about improving your credit score because each person's credit is different. In general, check your credit report to make sure it contains no errors and pay your bills on time. Apply only for credit that you need. Monitor your credit score and credit report at least once every year to ensure that you haven't become the victim of credit fraud.

How long will a negative entry stay on my credit report?

Most negative information, including late payments, collection accounts and credit defaults remain on your report for seven years. Bankruptcies remain for up to 10 years. Unpaid federal student loans remain on your report indefinitely. "Inquiries"—entries triggered when you apply for new credit—remain on your report for two years.

Where can I get a copy of my credit report?

There are three major credit reporting bureaus. Each offers instructions about how to order your report on their web sites and through toll-free phone numbers. There is a $10 charge for your report. If you live in Colorado, Georgia, Maryland, Massachusetts, New Jersey or Vermont you are entitled to one free copy per year.

- Equifax, P.O. Box 105873, Atlanta, GA 30348, 800-685-1111, **www.equifax.com**
- Experian, P.O. Box 2104, Allen, TX 75013, 888-397-3742, **www.experian.com**
- TransUnion, P.O. Box 390, Springfield, PA 19064, 800-916-8800, **www.transunion.com**

If you have been denied credit or turned down for a job, apartment or insurance in the past 60 days, you are entitled to a free copy from the credit reporting agency that supplied the lender with the information. Ask the lender to identify the credit bureau it used.

Can shopping for a car loan hurt my credit score?

It might. The key to doing as little damage as possible is to be aware that when dealers or lenders check your credit, this triggers an "inquiry" on your credit report. These inquiries remain part of your credit report for two years and can cause your credit score to drop. If you contain all of your shopping for an auto loan within 30 days, all auto finance inquiries made during that time will be considered as only one. However, if you visit dealerships recreationally and allow them to pull your credit report continuously, you will negatively affect your credit score.

If the poor credit is of your own doing, only time and improved credit maintenance habits will help. If your credit has suffered due to fraud, you can contact the credit reporting agencies and follow up with them to make sure any errors or fraudulent claims have been corrected.

Budgeting for a Car

How can I figure out how much I can comfortably afford to pay each month on a car loan?

In general, no more than 36% of your take-home pay should go to housing (rent or mortgage) and credit payments, including your car loan. (If you are a homeowner, add your property taxes and homeowner's insurance to your housing total.)

Provide this information:	**Example**	**Your Own numbers**
Annual pay (before taxes):	$32,000.00	
Divide by 12 to get your monthly income:	$2,666.00	
Multiply by .36 to find 36% of your monthly income:	$959.00	
Subtract your monthly housing costs: (Example: $525)	$434.99	
Subtract your monthly credit card payments: (Example: $45)	$389.99	

To figure out what a comfortable monthly car payment would be, follow the guidelines in the chart to the left.

Using the figures provided as an example, a payment of about $324 per month would be comfortable.

When you look for financing, don't tell the salesperson what your target car payment is. Car dealers often manipulate customers who state they can make only a certain payment. The point is to get the best car for the best price—you may be able to do that even by spending half your target figure.

Subtract your monthly student loan payment: (Example: $66)	$323.99	
Subtract other monthly loan payments: (Example: No student loan payment)	No answer	
Available budget for car loan:	$323.99	

I can spend about $324 dollars a month on car loan finance payments. In what price range should I shop for a car?

To answer this question fully, you'd have to know what kind of interest rate you qualify for. The box at the right shows an example using your $324 payment with a five-year loan term (60 months) on a used car purchase.

Credit History	Interest Rate	Amount Financed	Monthly Payment
Average	5.55%	$17,000	$325.11
Fair	7.89%	$16,000	$323.58
Poor	15.95%	$13,250	$321.86
Very Poor	20.95%	$12,000	$324.30

How can I find out the amount a dealer pays for a car?

To find a new car's "invoice price"—the amount the dealer pays—visit **CarsDirect.com**, which lists dealer invoice prices. The price you see at the dealership is the "sticker price." If you know the dealer's invoice price, you can bargain from the bottom up instead of from the sticker price down, as salespeople would prefe you to do.

Getting Pre-approved

Should I get a pre-approved loan before shopping for a car?

Yes. If you shop around for a loan from banks, credit unions and online lenders, you'll be ready to drive a hard bargain. If the dealer offers a better rate, you can go with it instead of taking the pre-approved loan.

What does it mean when a car sale is subject to financing?

When you sign a contract to buy a car using borrowed funds, the contract should read "subject to financing." Don't take the car home while the dealer wraps up the financing. After the dealer runs your credit report and goes through the process of approving you for a loan, there's a good chance you'll be told they couldn't get the financing. You could wind up paying a higher interest rate or be asked to make a bigger downpayment. When this happens, you have few options other than accepting the higher rate—especially if you've taken possession of the car.

How long do I have to pay off a car loan?

Most car loans are offered from three- to six-year terms. Loan terms are expressed using months, such as 36 months (three years) or 72 months (six years). The shorter the loan term, the higher your monthly payments will be. But the shorter the loan term, the less interest you'll pay over the life of the loan.

Calling All Car Loans

Where can I get auto financing?

Banks, credit unions, finance companies, savings and loans institutions, online lenders, auto dealers and manufacturers offer auto loans.

Finding financing outside the dealership may take more time and effort but you can save money and separate financing discussions from the often confusing encounters with car salespeople.

Some lenders let you select a car and then apply for the loan. When you pick up the car, the money is transferred to the dealer. Other lenders supply you with a blank check—subject to a funds limit and an expiration date—that you can take to the dealer.

Look for lenders who offer fair rates tied to your credit history. A lender that specializes in loans to people with damaged credit is not necessarily going to lower its interest rates for people with decent credit, so try local banks and credit unions as well as online lenders like E-Loan before you consider subprime lenders or dealership financing.

What is subprime finance company?

Subprime lenders specialize in making high-interest-rate loans to people with damaged credit—so-called "subprime borrowers." Subprime lenders argue that their high prices are justified by the risks they take in lending to people with bad credit.

Subprime lenders are not always fly-by-night companies—the largest ones are publicly traded corporations. Such companies make income not only off finance charges but also from late fees and "add on" services like credit life insurance, roadside assistance and extended warranty protection. Because many consumers accept add-ons without realizing they have the right to refuse them, auto buyers may end up with a loan that's larger than the fair market value of the car.

What is a "buy here/pay here" car dealer?

This term is used for a practice engaged in by independent storefront operations that sell used cars. These dealers often serve a poor clientele ignored by even subprime lenders. The cost of the cars sold by these dealerships is low—on average about $4,000. Most of these dealers don't rely on credit reports to screen applicants. Borrowers pay installment payments directly to the dealership. The payments are not reported to credit reporting bureaus so the buyers don't have a chance to build credit.

Buy here/pay here dealers rarely offer good deals. They often sell unreliable cars "as is" with no guarantees that the cars are free from defects. They usually require a very large downpayment—often equal to 50%-75% of the purchase price of the car—and expect the balance to be paid in weekly or bi-weekly installments over the course of no more than one year.

Are interest rates different for used and new cars?

Rates are higher for used cars than new ones. As a general guideline, rates increase about one percentage point for every two years the car has aged.

Is the institution that offers the lowest rate my best choice for a loan?

Not always. Many factors can affect the cost of a loan, including closing costs and the amount of the required downpayment. And there may be other aspects to consider, such as convenience. You may want an institution that allows you to deduct payments automatically from your checking account or allows easy 24-hour access to your account via phone or the Internet or provides better customer service.

How do dealers' rates on loans compare to other institutions?

Dealers' advertised rates compare very well, but many of the ads for low—or "zero"—interest rates are designed only to lure you into the showroom. Once you visit the showroom, many dealers play "bait and switch" with cars and finance offers. All offers—even advertised ones—are dependent on your credit history. If you have poor credit, you are not going to qualify for low-rate loans, no matter what the ads say.

Games Dealers Play

If I get a loan at the dealership, does the dealer make a commission on the interest rate?

Yes. Dealers see financing as just another product—they take a cut of all financing deals they arrange. Sometimes the dealer's cut can add substantially to the cost of your loan (see next question). If you get a loan from a bank that you are referred to by the dealer, it may have a higher interest rate than if you applied directly to that same bank.

What is the "dealer mark up" and how does it affect the price of car loans?

Car dealers often "mark up" (or increase) the interest rates they get from auto lenders or other finance companies. The dealers can pocket the difference or split it with the financing companies. When this happens, car buyers pay thousands of dollars more than they need to. Most buyers don't realize that they are paying more because the mark up is rolled into the final interest rate. If car buyers ask about the difference between the quoted rate and any advertised rates, salespeople tell them that they don't qualify for the lower rates.

The best way to avoid a dealer mark up is to get your credit score online at **MyFico.com** ($12.95). Call some lenders, including your bank and credit union, and **E-loan.com** online, to see what rates you qualify for. When you visit the dealerships, this information will help you negotiate a better rate.

What is meant by an "upside-down" car loan?

This term is used when a borrower owes more on an auto loan than the car is worth. This can happen because of the rapid depreciation of certain automobiles or when you choose a very long loan term in order to get the lowest payment possible. To avoid being stuck with an upside-down loan:

- Make a large downpayment—25% or more is a good idea.
- Don't be stubborn about finding a low monthly payment if it means you have to stretch out your loan. Limit auto loan terms to four years or fewer if possible.
- Buy a used car. New cars lose up to 40% of their value in the first two years. You'll pay more interest for a used car loan, but your car will not lose its value as quickly.
- Keep your car for a long time. If you sell your car before the loan is paid off, the proceeds may not be enough to repay the remaining balance on your loan.

Is it possible to negotiate the terms of a loan?

Loan fees and interest rates can usually be negotiated. You'll have more chance at success if you've done your homework by researching rates and getting quotes from other institutions. If you don't like the deal you are offered, walk away.

How should I respond to auto salespeople when they overwhelm me with sales pitches?

Car salespeople often confuse people—sometimes on purpose. Fast talking is part of the job. Step back and insist that the negotiation concentrate on one thing at a time: the price of the car, your trade-in (if any) and financing. It's easy to get talked into a bad deal or even tricked when there is too much information being thrown at you. If a salesperson is too pushy, visit another dealership.

Rebates and Incentives

What does it mean when an auto dealer offers "rebates"?

Rebates are widely advertised price reductions offered during slow sales periods or on overstocked models. Rebates give you cash back after you close the deal.

What is a "dealer incentive"?

Dealer incentives are discounts passed on to the dealer by manufacturers. On some models, dealers may offer incentives that are not advertised to the public. Dealers have a choice whether or not to pass the savings on to the customer.

Sometimes salespeople are not aware of the availability of incentives. To make sure you learn about such deals, speak to the sales manager. Check auto magazines and web sites such as **Edmunds.com** for news of current incentive programs.

Is it better to opt for low-cost financing instead a rebate?

Do the math to find the better deal. Often dealers give a choice: low-cost financing or a rebate. **Edmunds.com** has a free calculator to help you make the decision whether to go with a low interest rate or cash back. On its home page directory, look for the Auto Loan Calculators.

If you get financing outside the dealership, you may get both the rebate and a low interest rate. If you think you are going to sell the car before the life of the loan expires, it may be better to take the rebate, which gives you the savings up front.

Can I apply the rebate to the downpayment?

Yes, some dealerships allow you to apply the rebate as part of your downpayment. A larger downpayment also decreases the amount you will pay in interest or allows you to shorten the length of the loan.

Are you eligible for a rebate only when you pay the manufacturer's suggested retail price?

No, rebates should be applicable to the final negotiated price of the car.

Do I get a tax break with a rebate?

Rebates don't reduce the amount of sales tax you'll owe. However, you won't have to pay income tax on your rebate.

Can I really drive away with a car for "zero money down" as advertised?

No. You should expect to pay one or more loan payments, a security deposit and loan or processing fees. This can easily total $1,000 or more.

Buy or Lease?

Is it a good idea to lease a car?

Leasing rarely makes as much financial sense as buying a car, especially if you shop carefully to find a good used vehicle. Car leases come with strict rules—you are limited in how many miles you can drive without a surcharge and you must keep the car clean and undamaged.

Leasing costs you more in the long run, because at the end of the lease you don't own the car. But leasing still attracts many car shoppers because on the same car monthly leasing fees are lower than monthly financing payments. **Edmunds.com** offers free online calculators to compare leasing and buying costs by model.

Choose the Right Car

If I can afford a new car, why buy a used one?

Buying a used car makes sense even if you can afford a new one. The reason is that new cars lose up to 20% of their value the day you drive them off the lot. When you buy a recent model used car, you'll save at least that much, if not more. When you buy a two-to-three-year-old car you get a practically new car for about two-thirds the price of a new one. (Make sure to have the car checked out by an independent mechanic before you buy it.)

Is there any way to find out the history of a new or used vehicle?

Yes. An online service called **Carfax.com** offers reports on any car if you have the Vehicle Identification Number (VIN). Ask the dealer or seller for the car's VIN. For about $20 you can check out as many cars as you need to within a period of a few weeks. The credit reporting bureau Experian has a similar database, **Autocheck.com**. You will be able to find out if the car was returned to the manufacturer because it was defective, if it was a rental car or if it has a history of theft, accidents or odometer fraud.

The dealer wouldn't let me take the used car I was interested in to my mechanic—do I have any recourse?

Having a used car checked out by an independent mechanic before you buy it is the most important thing you can do to protect yourself from buying a lemon (defective car). There is no law that forces a seller to let you have the car evaluated. The seller's refusal is a bad sign in itself. Offer to have a mechanic come to the seller's place to evaluate the car. If the seller still refuses, walk away—there are plenty of other cars for sale.

Resources

"The Car Book" by Jack Gillis is published annually with updated information on safety ratings, dealer prices, fuel economy, insurance premiums, maintenance costs and state lemon laws.

Car Talk (**http://cartalk.cars.com**) is a site devoted to solid advice about buying, driving and repairing cars by Tom and Ray Magliozzi of the popular Car Talk radio show and newspaper column.

Carfax (**www.carfax.com**). For a small fee, you can use the Vehicle Identification Number (VIN) of any car to learn more about its background.

The Center for Auto Safety (**www.autosafety.org**) is a national membership-based advocacy group dedicated to vehicle safety.

"Don't Get Taken Every Time" by Remar Sutton (Penguin Press) is a book that exposes all the ways that auto dealers try to trick car buyers out of their money. Find it at your local library.

Edmund's (**www.edmunds.com**) is a web site offering extensive information about new and used car purchasing, including shopping and buying tips and detailed behind-the-scenes information.

The Kelley Blue Book web site (**www.kbb.com**) is the free online version of the reference book of the same name that gives you access to the value of new and used cars. Find the book at your local library

The Motorist Assurance Program (**www.motorist.org**) is an organization that works to improve communication and trust between the auto repair industry and customers.

The National Highway Traffic Safety Administration (**www.dot.gov/affairs/nhtsain.htm**) is a federal government agency charged with reducing deaths, injuries and economic losses caused by motor vehicles. The site offers information on auto safety recalls.

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Consumer Action provides advice and referral on consumer issues. Leave a message anytime and a counselor will call you back. Chinese, English and Spanish are spoken. You can e-mail Consumer Action (hotline@consumer-action.org) or visit our web site (www.consumer-action.org).

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