ADVERTISEMENT

THE SOMETIMES RISKY BUSINESS OF EXTENDED-TERM CAR LOANS

The 8-Year Loan—A Cautionary Tale

Four years ago Farah bought a new car for $30,000.

To keep her payments affordable ($366/month), she financed the purchase over 96 months (8 years) at 3.99%.

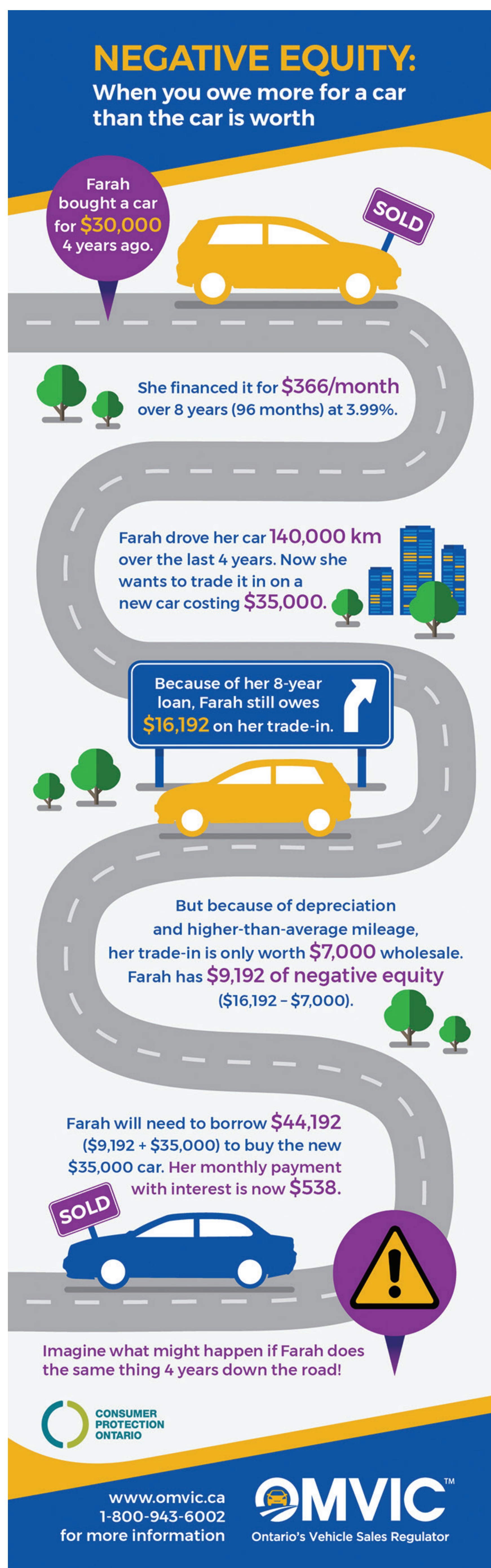
Farah is a commuter and has driven her car 140,000 km over the last four years.

Now, with her car out of warranty and looming repairs becoming a concern, she has decided to trade it in on a new $35,000 car.

Because of her 96-month loan, Farah still owes $16,192 on her trade-in.

But because of depreciation and higher than average mileage, Farah's trade-in is only worth $7,000, meaning she has $9,192 in negative equity ($16,192-$7,000).

So Farah will need to borrow $44,192 ($9,192 + $35,000) to buy the new $35K car.



All Too Common
According to Ontario's vehicle sales regulator, OMVIC, Farah's story is actually very common. "When we ask dealers what percentage of customers with trade-ins have negative equity, most tell us it's 30 to 50 percent," said John Carmichael, OMVIC's CEO and Registrar.

How Did We Get Here?
Not long ago, four to five-year car loans were the norm. But today, banks and vehicle manufacturers make it possible for consumers to finance a vehicle over seven to eight, even nine years. That's a significant length of time for a product that begins depreciating the second it's driven off the lot. Vehicles that would have been completely unaffordable two decades ago now seem to be financially attainable.

It Can Get Worse! The Snowball Effect
In the example, Farah will borrow nearly $45,000 for a $35,000 vehicle—a vehicle that will begin depreciating as soon as she takes delivery. Obviously her monthly payments will increase significantly; her borrowing costs will also rise; and if the snowball effect of negative equity is considered—imagine what might happen if Farah does the same thing four years down the road—it's a borrowing practice that could eventually prove disastrous.

Shop for the Car, Not the Payment!
It seems many consumers who agree to extended-term auto financing are focused on short-term gratification rather than potential long-term consequences. "They can buy the car of their dreams, often with no money down, for a monthly, bi-weekly or even weekly payment that seems affordable," explained Carmichael. Increasingly, these types of consumers are finding themselves with negative equity when it's time to trade in and purchase another car. "That means much higher payments and greater borrowing costs. And while OMVIC may not regulate vehicle financing, we want to help consumers make informed vehicle purchases, even with regards to financing."

Determine if an Extended-term Loan is Right for You!
Before agreeing to an extended-term car loan consumers should consider:

• How long they keep vehicles. Do they usually trade them in before paying them off? This often leads to negative equity.
• What would happen if the vehicle was stolen or destroyed and there was negative equity involved? Insurance companies will reimburse the vehicle's value, not necessarily what is owed on the purchase loan. Note: some dealers sell insurance that pays off the negative equity in these situations.
• How much they drive. Will the vehicle reliably last the term of the loan?
• The overall cost of the loan. Longer terms may mean lower monthly payments, but they also usually mean higher overall costs of borrowing.

Additional Considerations, Questions and Tips When Arranging Auto Financing
The majority of consumers borrow money for a vehicle purchase. Some choose to use a personal line of credit or arrange financing at their own financial institution, but many have the dealer arrange financing.
Having the dealer arrange financing often makes sense—dealers have access to numerous lenders that may provide terms or rates unavailable elsewhere. But this doesn't mean consumers shouldn't carefully consider what is being offered and take steps to ensure they are getting the best possible finance rate and terms.

Understand Your Creditworthiness
The terms and interest rates available to a buyer are based primarily on the vehicle being purchased and the buyer's creditworthiness (credit score). Consumers who know their credit score can negotiate the best possible rate and terms! Consumers can learn their credit score by contacting a Canadian credit bureau:
Equifax Canada – www.equifax.ca
TransUnion Canada – www.transunion.ca

Compare Lenders
Consumers should ask their own banks about the terms and rates they offer to compare with the dealership's rates.

Are All Credit Offers the Same?
If the dealer is arranging financing, he/she may submit a consumer's loan application to one or more financial institutions or lenders; therefore, the consumer could be approved by multiple lenders, potentially on different terms or at different interest rates.

Consumers should ensure they know who their application was submitted to. If the application was submitted to multiple lenders, consumers should ask to see the terms/rate each lender offered. Important note: Multiple credit applications can negatively affect a borrower's credit score!

It is also important to understand that dealers are commonly paid a fee, often called a reserve, by lenders for arranging financing; these fees can vary significantly. Loans with higher interest rates often provide dealers with higher reserves. Consumers therefore need to make sure they are getting the best financing rate and terms possible, not necessarily the rate/terms that provides the dealer with the most lucrative fee.

Credit Applications — Verify the Information's Accuracy
Credit applications at dealerships are often completed electronically. It is important that the information provided in the application be accurate. There have been instances of dealers (and/or consumers) inflating incomes or minimizing debts in an effort to get an application approved. This is not only unethical, it is illegal. Consumers should therefore ask to carefully review the information on the application before allowing the dealer to submit it. Consumers should also request a copy of the loan application.

Loan Agreements/Contracts
It is common to sign the actual loan agreement/contract when taking delivery of the vehicle. Consumers should carefully read the entire agreement and ensure the terms and rate on the contract match what was promised. If a dealer or salesperson makes a verbal promise related to financing, GET IT IN WRITNG on the contract. This provides transparency and protection.

Know Your Car-Buying Rights!

For more tips on how to protect yourself and ensure a positive car-buying experience, visit *www.omvic.ca*

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