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Navigating the auto loan process

Troubling auto loans

By Ruth Susswein

Buying a car these days—new or used—is a pricier endeavor than before the pandemic, due to increased demand from people avoiding mass transit and supply chain issues for key components used in new cars. The demand for used cars by cost-conscious consumers has outstripped the supply for most of the pandemic. But the price of cars is just one part of the problem—another pothole is financing costs.

More than 85% of new cars are financed, as are 55% of used cars (*https://fortunly.com/statistics/car-loan-statistics/*). The average loan for a new car tops $32,000, according to Lending Tree, and just over $20,000 for those who borrow to buy a used car.

Consumer Reports recently conducted a yearlong investigation into car loans (*https://www.consumerreports.org/car-financing/many-americans-overpay-for-car-loans-a8076436935/*), analyzing more than 800,000 loans from 17 major lenders, and the results are troubling. They found that:

- Car loan interest rates varied dramatically—even for customers with comparable credit scores. Similar borrowers received rates ranging from 0% to a whopping 25%.
- Car dealers and lenders are not just basing loan rates on risk, but on how much they can mark up the rate and get away with it.
- People of color are more likely to be charged higher rates.
- Many borrowers got loans they couldn't afford: 1 in 4 spent more than 10% of their income on car debt.
- Repossessions were common.

Extra interest, just because

Believe it or not, it is legal for auto dealers to tack on a couple of extra points to the lender's interest rate. So, a 6% loan could be offered to you by the dealer at 8.5%. It's called the dealer markup, and the dealer has no obligation to reveal the increase to you. For more on how this works, see "Auto loan markups cost non-white buyers more," on page 3.

Racial discrimination in car lending

Reports of racial discrimination in car lending are not new. The National Fair Housing Alliance (NFHA) attributes much of the problem to unfair dealer markups. NFHA uncovered discriminatory pricing in car buying and financing in its 2018 investigation of auto dealers in Virginia (*https://bit.ly/3ungkR4*). The investigation revealed that nearly two-thirds of the time (62.5%), non-white secret shoppers received more expensive pricing options—for the same car—even though the non-whites were more financially qualified than the white testers.

In 2013, the Consumer Financial Protection Bureau (CFPB) and the Department of Justice ordered Ally Bank to pay minority consumers $80 million for discriminatory dealer pricing.

In a 2021 study of subprime auto loans, the CFPB became suspicious of the significant discrepancy between subprime loans issued by banks versus finance companies. The Bureau found that, on average, banks charge 10% interest on subprime auto loans, while finance company and buy-here-pay-here dealership loans run between 15% and 20% (*https://files.consumerfinance.gov/f/documents/cfpb_subprime-auto_data-point_2021-09.pdf*). The CFPB warned that risk of default does not adequately explain this large a rate gap, but it did not attribute the difference to discrimination.

The CFPB has limited authority over dealer financing. To crack down on discriminatory dealer markups, it had created guidelines for auto lenders. But under the Trump administration, Congress repealed the Bureau's auto lending guidance (*https://bit.ly/3KYmjSf*).

What rate cap?

Some states have laws that limit the interest rate that can be charged on car loans. However, some car loans violate state rate caps, but because of loopholes and confusingly written state laws, the loans remain legal. For example, South Carolina has an 18% interest rate cap, but Consumer Reports discovered that car dealers and lenders can charge "whatever they want" as long as they notify the state in advance. "As of mid-July 2021, dozens of dealers had told state regulators that they may assess 100 percent APRs or more, records show. Four of those have said they may charge interest rates of 300 percent or more."

Some states don't always consider a car loan a "loan," so the interest rate cap doesn't apply.

For more on this maze of costly, confusing financing that ignores state rate caps and rarely verifies borrower income, see "Unaffordable auto loans," below.

About 80% of all auto financing is done through car dealers, according to the National Bureau of Economic Research, even though the most cost-effective financing is often found off the lot. Experts agree: Shop around for financing just like you would for a car. It could mean a difference of thousands of dollars over the life of the loan. For more information, see "Protect yourself from car loan rip-offs," on page 4.

Unaffordable auto loans

By Alegra Howard

The findings of a recent Consumer Reports (CR) investigation found that borrowers were overpaying for car loans by thousands of dollars (*https://www.consumerreports.org/car-financing/many-americans-overpay-for-car-loans-a8076436935/*), obtaining loans they couldn't afford, and—even with similar credit histories—receiving wildly different financing deals for no decipherable reason. The CR investigation based its findings on a data set of 858,000 auto loans from 17 major lenders that included anonymous data about borrowers' credit scores and income.

Vastly different financing deals

CR found that borrowers with nearly identical credit profiles—whether subprime (credit scores below 620) or super-prime (720 or higher)—were offered vastly different financing options. Borrowers with super-prime credit scores weren't always given the lowest annual percentage rate (APR). In fact, the data show that thousands paid more than 25% APR—a rate typically reserved for the most risky borrowers.

The investigation found an example of two borrowers in California who were buying a 2017 Chevrolet Trax SUV. Both borrowers had prime credit scores (between 660 and 719) and both earned between $5,000 and $5,500 a month. While each borrower financed $18,000, one borrower received a loan with a 4.9% APR, while the other received a loan for 14.1% APR. That's about $7,000 more over the life of the loan. The report concludes that interest rate-setting practices are largely dependent on what many dealers and lenders "think they can get away with" and have less to do with one's credit score.

Lending experts recommend that borrowers spend no more than 10% of their income on an auto loan. Yet CR's findings show that nearly one quarter of borrowers studied spent more than 10%, risking serious financial repercussions. Loans were typically approved with little concern for affordability. According to the data, lenders verified consumers' income only 4% of the time.

Hidden fees, inflated rates

Another unscrupulous practice found by CR—purposeful miscalculation of interest rates—hides fees and the real APR from buyers. Consumer advocates say that add-ons, like vehicle service contracts and gap insurance, should be considered part of the APR calculation so that buyers have a clear understanding of the total cost of financing over time. The practice of adding these optional products to the loan amount instead of to the APR enables the lender to avoid revealing the true (higher) cost of the financing. When CR recalculated the APR to include fees and optional ancillary products for one Georgia buyer, the rate jumped from 28% to 71.8%.

If you choose to buy additional services or insurance products, pay for them with cash—don't add them to the loan. (Gap insurance pays the amount left on your car loan or lease that exceeds the amount your auto insurance is willing to give you if the vehicle is "totaled." You can purchase gap insurance directly from insurance companies and avoid overpriced dealer products.)

Avoidable state rate caps

The U.S. doesn't have federal interest rate limits on consumer goods and state laws pertaining to auto loans are complicated and riddled with loopholes (*https://bit.ly/3Gntv7i*), allowing lenders to avoid state rate limits while remaining inside the law. For example, Florida has an 18% interest rate cap on auto loans between $4,000 and $25,000, but the cap is eliminated when a dealership negotiates the loan. Oregon's 36% rate cap exempts dealer-arranged financing from the limit. South Carolina has an 18% interest rate cap, but lenders and dealers can charge whatever annual percentage rate they like as long as they notify the state in advance. CR found examples of four borrowers in the state being charged an APR of 300% or more.

Another loophole: where the loan originates. Even if your state has a solid interest rate cap, if the auto loan you secure is underwritten in another state—for example, where the lender is located—some states, like Arkansas, allow the lender to exceed the cap or, if no cap exists, charge whatever they want.

Some lenders argue that exceeding state rate caps allows them to provide car loans to needy, but risky, borrowers.

When a loan is not a loan

CR discovered a Florida case where a consumer sued a lender for charging 27% APR on a car loan when the state rate cap is 18%. The judge ruled that the loan was "not a loan," according to one Florida law that allows car dealers to charge higher interest rates than other lenders.

Three-quarters of auto financing is handled by car dealers. National Consumer Law Center attorney John Van Alst explains that this financing is technically not a loan. It's "an extension of credit" called a retail (or motor vehicle) installment sales transaction. Some states calculate interest based on the age of the car, others on the amount financed. These differences, even within the same state, can affect whether a state rate cap applies to a car loan or not.

Van Alst recommends that consumers simplify the highly complex financing process as much as possible. He suggests that buyers separate car purchasing from car financing. "Dealers are much better at juggling all of these transactions—from sales and financing to add-ons like gap insurance" to ensure that the dealership profits as much as possible from the financing arrangement, which is the real bread and butter of car sales. He recommends that car buyers arrange for financing outside of the dealership by comparing rates from banks or credit unions. For more suggestions, see "Protect yourself from car loan rip-offs," on page 4.

Auto loan markups cost non-white buyers more

By Monica Steinisch

Credit and loan pricing practices often unfairly disadvantage borrowers of color, resulting in less favorable terms than those extended to white consumers. In auto lending, unequal pricing frequently comes in the form of a loan markup—additional interest that the lender authorizes the dealer to charge over and above the lender's quoted interest rate. Typically, the lender prohibits the dealer from disclosing the markup to the consumer, and the added interest (profit) is split by the lender and the dealer, according to the National Consumer Law Center (*https://bit.ly/3g8WuRw*).

Markups legal, discrimination not

For the most part, auto loan markups are legal, though there may be limits on how much extra interest can be charged. For example, many lenders cap the dealer's markup at 2.5%. The California Car Buyer's Bill of Rights limits the dealer markup to 2% over the loan amount for terms of more than 60 months, and to 2.5% over the loan amount for 60 months or less (*https://www.dmv.ca.gov/portal/car-buyers-bill-of-rights-ffvr-35/*). Some lenders and states, however, allow markups that are much higher.

Despite being generally legal, the federal Equal Credit Opportunity Act (ECOA) prohibits credit industry practices that result in discriminatory pricing based on race, color, religion, national origin, sex, marital status or age. In the case of car loans, the ultimate cost of the financing is at the dealer's discretion, increasing the risk of pricing disparities based on factors not related to creditworthiness.

As Consumer Federation of America reported in its 2018 issue brief on unfair auto loan markups (*https://bit.ly/3rgmWz2*), while some white borrowers also pay more than they should, discriminatory dealer markups are particularly problematic for African American and Latino borrowers. The Center for Responsible Lending found that African Americans and Latinos are not only more likely to be subject to interest rate mark-ups, they're also more likely to be subject to higher markups, regardless of credit history or shopping strategy (*https://bit.ly/3HhlpOx*).

Lender discrimination penalized

A number of cases and actions bear out the findings of loan markup investigations. In Coleman v. GMAC (*https://www.nclc.org/images/pdf/litigation/closed/gmac-faq.pdf*), plaintiffs contended that African Americans and Hispanics who purchased automobiles through GMAC paid higher prices for credit because they received higher markups. GMAC agreed to a settlement that included, among other terms, the requirement that the company launch a diversity marketing initiative.

In late 2013, Ally Financial, under a Consumer Financial Protection Bureau (CFPB) and Department of Justice (DOJ) order, agreed to pay $98 million to settle accusations that it discriminated against minority borrowers who were charged more than white customers for auto loans by car dealers (*https://bit.ly/3KZ2Alx*).

In mid-2015 and early 2016, the CFPB and DOJ resolved actions with American Honda Finance Corporation (*https://bit.ly/3IOTuWI*) and Toyota Motor Credit Corporation (*https://bit.ly/3AM2j0A*), respectively, under which both companies agreed to change their pricing and compensation system to substantially reduce dealer discretion and the risk of discrimination. Each agreed to pay more than $20 million in restitution to affected borrowers, including, in Toyota's case, "thousands of African-American and Asian and Pacific Islander borrowers who paid higher interest rates than white borrowers for their auto loans, without regard to their creditworthiness."

CFPB efforts thwarted

The CFPB successfully penalized auto lenders who had been discriminating through loan markups based on guidance the agency issued in 2013. In it, the CFPB explained that lenders that offer auto loans through dealerships are responsible for unlawful pricing when dealer markups have a discriminatory effect on minority borrowers. The bulletin provided clear guidance to indirect auto lenders on how to comply with fair lending laws.

Five years later, in April 2018, anti-regulation Republican lawmakers in Congress, in concert with the Trump administration, used the Congressional Review Act to undo the guidance. Senator Richard Blumenthal (D-CT) said, "This truly repugnant resolution ignores the unacceptable, undeniable truth that consumers' interest rates are regularly marked up based on their race or ethnicity—a disgusting practice that continues to run rampant across the country."

How borrowers can protect themselves

The best way to avoid discriminatory dealer financing is to shop around before you set foot on a car lot. Check your credit report for errors and access your credit score through your bank or credit card company (*https://www.ficoscore.com/where-to-get-fico-scores#OpenAccess*). Then contact banks and credit unions where you have accounts, and other reputable lenders, to get preapproved for a loan. (Bankrate [*https://www.bankrate.com/loans/auto-loans/rates/*] provides rate comparisons and tips.) Offers from multiple lenders will give you an idea of what rate you qualify for and put you in a stronger position to negotiate with the dealer on both price and financing.

Protect yourself from car loan rip-offs

By Ruth Susswein

Given the auto dealer industry's powerful influence over auto financing, there are few strong laws to protect car buyers from unjustified auto loan interest rates. However, these tips can help you get a fair car loan.

Shop around

Before you set foot in a car dealership, shop around for the best interest rate you qualify for. Banks often offer better rates than car dealerships. Contact your bank or credit union and ask to be "preapproved" for a car loan (*https://www.creditkarma.com/auto/i/preapproved-for-car-loan*). Check with other lenders, too. You'll learn the interest rates available to you and how much money you can borrow. Know your credit score before you bargain with a car dealer. If the dealer can beat the rate you're preapproved for, then you and the dealer have something to talk about. (Note: *Prequalified* means the lender has done a basic review of your creditworthiness and is likely—but not guaranteed—to approve your loan application; *preapproved* is a commitment to give you a loan.)

Negotiate

Now that you're armed with valuable information, remember the haggling is not over. Once you've negotiated the best price you can for the car it's time to negotiate on rate. The interest rate is not set in stone. So again, shop around. Let the dealer make his pitch without revealing the rate you've been preapproved for elsewhere. Even if your credit is imperfect, know that the financing is a separate negotiation from the car sale. Remember to negotiate on your trade-in as well. Try Edmunds's appraisal tool (*https://edmu.in/3geqf3e*).

Know the total cost

These days the average car loan is for six years, according to Edmunds. The longer the loan term, the lower the monthly payment, but the more you'll pay in interest. Before accepting any loan terms, ask for the total you'll be paying over the life of the loan, not just the monthly amount.

Get it in writing

Should you opt for dealer financing, be sure to have a signed contract before you leave the dealership. Some dealers have been known to contact buyers days later, claiming the financing fell through, but that they can get you the deal at a higher interest rate. If you've got the agreement in writing, they can't coerce you into paying more.

Read the contract carefully—*before* signing—to be sure there is no fine print that might cost you extra money (such as optional add-on products [*https://www.nclc.org/issues/auto-add-ons-add-up.html*] or unnecessary insurance).

Know your rights

The Truth in Lending Act requires lenders to tell you the loan's annual percentage rate (APR) and the total cost of interest and fees over the life of the loan, before you sign a contract.

The Equal Credit Opportunity Act (ECOA) makes it illegal for a lender or dealer to discriminate based on race, religion, national origin, sex, marital status or age. If you believe you were denied a loan or unfairly charged a higher interest rate because of discrimination (*https://bit.ly/3Gh4M48*), you can file a complaint with the CFPB (*https://www.consumerfinance.gov/complaint/*), the FTC (*https://reportfraud.ftc.gov/#/*), and your state attorney general's office (*https://www.naag.org/find-my-ag/*).

Check out the CFPB's "Auto loans" page (*https://www.consumerfinance.gov/consumer-tools/auto-loans/answers/*), which covers key terms, your buying and lending rights, and much more.

How high an auto loan rate can go depends on your state's laws (*https://pocketsense.com/maximum-interest-rates-allowed-auto-loans-22416.html*), but in some states rate caps do not apply to car loans or to certain types of lenders. One shining example of consumer protection is the state of Illinois, which passed a tough law last year capping interest rates at 36%. That law even includes the price for add-ons, like vehicle service contracts and gap insurance, in your overall financing cost. The Illinois cap applies to loans from car dealers.

What agencies protect you from car loan rip-offs?

The Consumer Financial Protection Bureau (CFPB) oversees the largest banks, credit unions and auto finance companies. The Bureau requires these large lenders to disclose all financing terms, lend fairly, and report accurate information about the loan to credit bureaus (*https://bit.ly/3ujemRQ*).

The Federal Trade Commission has authority over car sales, leasing and advertising.

State attorneys general enforce state consumer protection and fair lending laws that generally include auto lending and sometimes specific lending traps, like "yo-yo" financing—the practice of denying you the rate you negotiated and forcing you into a higher rate after you made a deal.

Car leasing tips

By Alegra Howard

For some drivers, leasing a car is more appealing than buying. As with auto loans, it's important to focus on the whole cost of the lease (including downpayment, interest and fees)—not just the monthly payment. Here are some things to keep in mind before you lease:

- **Check the annual mileage allowance.** If you drive more than allowed under your lease's terms (typically between 10,000 and 15,000 miles a year), you'll be charged for every extra mile you drive (anywhere from 20 to 30 cents per mile)—a cost that can add up quickly.
- **Shop around for gap insurance.** Gap insurance will cover the difference between your outstanding loan balance and what your auto insurance pays if the car is totaled. Many car dealers include gap insurance in the lease, but you may find a much cheaper policy from an outside insurance broker or bundled with your auto coverage.
- **Know the residual value of the vehicle.** This is the es-

timated value of the vehicle at the end of your lease that's set by an industry expert and isn't typically negotiable. If you decide to purchase the car once the lease expires, this is the amount you will pay. Shop around to make sure you're not being given an inflated quote for the future value of the vehicle.

- **Negotiate.** Almost every part of a lease is negotiable—even if the dealer states otherwise. Feel free to haggle over the capitalized cost (the amount being financed with a lease), the money factor (financing cost based on your credit) and the mileage allowance. Compare offers with what other dealers would charge. Fees that you can negotiate or try to have waived include the security deposit, the down-payment, the buy-out price, advertising fees, and shipping and delivery charges.
- **Termination fees can be waived if you're a servicemember.** While breaking a lease is costly for most, members of the military can be granted a lease termination without penalty under (*https://bit.ly/3IX-UWpX*) the Servicemembers Civil Relief Act for circumstances like deployment.

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