Sub-prime Auto Loans? Getting Ready for the Next Wave of Defaults

December 31, 2007 - In the 1970's, a typical auto loan was 36 months long and most people kept their cars until well after being paid off. But by the late 1980's the duration of automobile loans was getting longer. Today, it is not uncommon to find loans that are 72 months (7 years) long and a few lenders have begun experimenting with 84 months. The reason for extending the duration of loans is simple. The longer the loan, the lower the monthly payments. But the trend is having some unintended consequences that look a lot like the current problems with sub-prime mortgages. If so, it could be that purchasing a new car will become a lot more difficult in the coming year.

Car dealers and manufacturers have been pushing the trend towards longer loans. They know that people often make their purchasing decisions based on their monthly expenditures rather than on total cost of the purchase. This means that if they can hold the monthly payment down, they can get you to buy a more expensive car.

And if you are a consumer shopping for a new car, some of the deals being offered may sound too good to pass up. 0% financing of some models. If you owe more on your trade-in than its worth, no problem. They can just roll the additional amount into your loan. All you have to do is sign on the dotted line.

But it is this "ease of purchase" that is leading many consumers into situations that they are mired in debt and owe more money on their vehicles than they are worth.

Unlike the 1970's, the average auto loan today is a little over 5 years in length. But the average person only keeps their car for 36 months. This means that a lot of people who are trading in their cars, still owe money on them. And a growing number owe more than the car is worth.

Unfortunately, many people owe more on their car than they can sell if for from the day they drive it off the lot. Here is an example of how you can find yourself in such a situation.

Let's say you purchased a car 36 months ago and you are now ready to trade it in. You paid $30,000 for the car, put nothing down on it, paid 5% interest on the loan and the term of your loan was 72 months. Your monthly payment is $483 and the current value of your car is $14,000. You want to purchase the latest model year of the very same car. The current price is $33,000.

Since purchasing your current car, you have made $17,388 in payments. Of that, $12,888 went towards the principle on the loan. The rest went towards interest. This means that the current amount you owe on your car is $17,112. This is means that you owe $3,112 more than the $14,000 that the car is actually worth.

This would be a good time to walk away from this deal and continue to make the monthly payments on your three year old car. Pay it off, and then consider buying new if you absolutely have to.

In our example though, the consumer continues to move forward with the purchase. The dealer is offering special financing at 1.99% for 84 months. So the consumer agrees to finance $36,112 with no down payment. This amount is the sum of the cost for the new car ($33,000) and the amount still owed on the trade-in ($3,112). At 1.99% interest, the new monthly payment is actually slightly lower than the old one. It is $461. There is only one problem, if this consumer loses their job tomorrow, they won't be able to sell the car because they owe more than it is worth from the day it was driven off the lot.

This pattern has been repeated time and again around the United States for several years now. And there are a lot of people who now owe a lot more money on their cars than they could sell them for. If this isn't bad enough, auto loans have be repackaged as securities and sold on the secondary market for a number of years now. This is exactly the same situation that led to the mortgage market meltdown last August.

Lenders have taken the attitude that they don't care how much you owe, just how much you can pay each month. This type of voodoo economics will work over a short period, but it will fall apart like a house of cards over the long run. Eventually, some borrowers will simply walk away from their auto loans because it makes economic sense for them to do so. This has already begun to happen. Automobile repossessions are up in 2007.

ACCESS is urging the FED and Congress to look at this situation closely and begin to think about some form of measured regulation before there is a credit crisis in the automobile sector. Such a crises could have far reaching effects on the economy, causing problems for manufacturers, suppliers, and employees of some of the largest companies operating in the US.

by Jim Malmberg

Note: When posting a comment, please sign-in first if you want a response. If you are not registered, click here. Registration is easy and free.

{moscomment}