The Next Financial Crisis: Sub-Prime Car Loans

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by Mark Martella

Imagine you are 65-years-old, retired, with a monthly Social Security income of $660 and need a new car. How much do you think you will be able to borrow and what payment would a bank approve? For Mirna Lopez, she was able to get a new car with an $809.00 monthly payment. How you may ask? Well, according to a December 2019 Wall Street Journal article by Ben Eisen and Anna Maria Andriotis, Ms. Lopez was able to buy a used 2018 Nissan Pathfinder because the dealership submitted a **false loan application** and stated that she made **$7,833 a month**! Ms. Lopez did not see the final application and apparently did not understand the amount of her payment. Like many of the clients that I meet, they wind up defaulting after about six months and then face a huge deficiency judgment once the car is repossessed and sold at auction.

Sub-Prime Car Loans in Default

According to the New York Federal Reserve's quarterly report on consumer debt for the quarter ending September 30, 2019, the total debt on car financing was $1.3 trillion dollars, up from 740 billion in 2009. Also, according to the New York Fed, sub-prime loans are going to default at a rate of 8% after just six months. A sub-prime loan is defined as a loan given to someone with a credit score of 300 to 600. There are currently $8 billion dollars of auto loans in default as of the end of the third quarter of 2019.

How is it possible for people to get these crazy car loans? As with the "no documentation mortgages" in the early 2000's, only 7% of auto loan applications are verified. More specifically, according to the WSJ article, used car lenders like CarMax and Allied Financial verified less than 1% of their loan applications. Therefore, with the combination of either the borrowers lying about their income or the dealerships, people are able to get cars that far exceed their ability to afford the payments.

Car Loan Crisis

One of the reasons why we have this looming car loan crisis is because **the dealerships now make more on financing than they do on selling cars**. In fact, I have been told that certain local dealerships will not allow you to buy a car with cash but require you to get a loan. This change is due in part because the profit margin on selling cars has diminished so much that referring loans to lenders is much more lucrative for dealers. That's why dealers are happy to offer 60-inch TV's or a free cruise with every new car purchase.

A second reason why we face this crisis is because consumers assume that if a bank is willing to lend them the money for the purchase of a car, it means they can afford it. However, when applications are inaccurate due to the dealer or the borrower, the assumption that they are getting the loan because they can afford it is faulty.

Financial Literacy

Ultimately, I believe the loan problem exists not only with cars but with other consumer products and is due to the lack of financial literacy. Even assuming everything is accurate and verified, just because you are approved for a car loan or mortgage, does not necessarily mean that you can **reasonably afford the payment** if you do not take into consideration your other expenses. Income is relative. An annual income of $80,000 for a childless couple is a lot more money than the same income for a couple with four children and a senior parent living with them. In addition, if a family does not have a budget and does not project their real expenses each month, they can never really know what they can afford.

How Much Should I Spend on a New Car?

When clients ask me what they should spend on a new vehicle, I first tell them that they should **NEVER BUY A NEW CAR.** Depending upon the new car that you purchase, it may drop anywhere from 10-20% as soon as it is driven off the lot. I recommend buying a car that is 1-2 years old with under 20,000 miles so that the major depreciation has already been taken off the price of the car. Also, unknown to many consumers is that if you buy a 1-year-old vehicle, you are still entitled to the original warranty from the date the car was put into service. Therefore, you are still getting some of the benefits of purchasing a new car without the added price.

What Should My Monthly Car Payment Be?

I advise clients never to spend more than 5% of their gross monthly income on a vehicle payment. For example, if you have a gross income of $5,000 a month, your monthly car payment should never be more than $250. Unfortunately, I often see couples with income of $50,000-$60,000 with combined car payments of over $1,000 a month. When an emergency happens, expenses are paid on a credit card accruing anywhere from 18-29% interest. Many clients are meeting with me to discuss their bankruptcy options because they do not have an emergency fund to cover unexpected expenses, they rely on credit cards, and they have ridiculous car payments. Throw in the loss of a job, a divorce, or a serious illness, and the problem is only exacerbated.

Financial Education

The only way for American consumers to get off this treadmill of debt is through financial education. If you are a parent, you should be teaching it at home as it is not being taught in our schools. As a parent, you should call your local school board and start demanding financial literacy education in our schools [but not classes taught by large national banks who will inevitably begin the brainwashing of the "reasonable" use of credit.]

Tips for Buying a New Car

In the end, if you are in the market for buying a vehicle, keep these tips in mind: (1) never buy a new car; (2) your payment should never be more than 5% of your gross monthly income; and (3) know exactly how much car you can afford before going into a dealership. **Do not let them coerce you into spending more than you can afford.** You will find it is amazing how quickly the price comes down once you stand up to walk out of the dealership.

Questions About Car Financing

If you have questions about vehicle financing, budgeting, bankruptcy, or other financial issues, please contact me.

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