

# VEHICLE FINANCING BASICS

This document is a high-level overview of the vehicle financing process, including definitions of key terms. Key terms are defined at the end of this document.

## THE VEHICLE FINANCING PROCESS

### *Applying for Credit*

As part of shopping for a vehicle, the consumer must decide how to pay for the vehicle. Sometimes, he or she will pay in cash; other times the consumer will obtain a direct loan from a bank or credit union. Quite often, consumers will apply for financing through the dealership's Finance and Insurance (F&I) Department. The F&I Department will ask the consumer to complete a credit application, which may ask for information such as:

- Name;
- Social security number;
- Date of birth;
- Current and previous address(es) and length of stay;
- Current and previous employer(s) and length of employment;
- Occupation;
- Sources of income;
- Total gross monthly income; and
- Financial information on current credit accounts and debt obligations

The F&I Department also will obtain the consumer's credit report, which details information about current and past credit obligations, payment record, and data from public records, such as bankruptcies.

After this package of information is complete, and sometimes after the dealer has completed the transaction with the consumer, the F&I Department may submit it to various financial institutions that may offer to buy the retail installment sale contract (RISC) or lease from the dealer. These financial institutions may include large banks, credit unions, captive (manufacturer-owned) finance companies, independent finance companies or smaller community banks.

The dealer then typically sells the RISC or lease to an assignee of its choice, presumably taking into consideration the offers from other potential assignees. Competition among prospective

assignees helps keep dealers' costs low and benefits consumers by helping to make cost-effective financing available.

The American Financial Services Association encourages consumers to shop around for the best financing terms available to them.

### *Ancillary Products*

During the course of negotiating a purchase or lease, the dealership may offer other products and services that may be referred to as additional, add-on or ancillary products. These products are strictly optional and must be presented as such. They can include credit insurance, an extended service contract, guaranteed auto protection and other products that may assist consumers, depending on their particular situation. The cost of ancillary products is generally added into the amount due under the RISC or lease.

### *Post-Vehicle Sale*

After the consumer has completed the paperwork, including signing the RISC or lease and electing or declining any ancillary products, and has driven off the lot in their new vehicle, the dealer transmits the RISC or lease to the assignee (if there is one) and receives payment for the contract.

The consumer then makes payments to the assignee. Occasionally, however, consumers fail to pay and default on their obligations. The assignee may then be forced to repossess the vehicle, which causes the assignee to suffer a substantial loss.

### *Securitization*

Assignees may obtain funding by utilizing their own funds, collateralizing their portfolios of RISCs and leases with banks, or securitizing RISCs and leases. Securitization generally increases liquidity in the marketplace, diversifies the pool of risk for investors, and lowers the cost of capital for financial institutions that purchase RISCs and leases.

AFSA believes the securitization process is absolutely essential to maintaining a healthy, free flow of credit. Without it, credit would be available only to exceptionally qualified consumers, and the cost of credit to those who could get it would increase.

## DEFINITIONS OF KEY TERMS

**Annual Percentage Rate (APR)** is the cost of credit expressed as a yearly rate.

**Assignee** is the bank, finance company, credit union, or other person that purchases a retail installment sale contract or lease agreement from a dealer.

**Assignment** is the transfer of rights held by the Dealer to a financial source such as a bank, finance company or credit union.

**Captive Vehicle Finance Company** is a manufacturer-owned financial institution with the purpose of providing financing to customers buying the manufacturer's product.

**Creditor** is a person or organization that regularly extends credit that is subject to a finance charge or is payable by written agreement in more than four installments (not including a down payment) and to whom the obligation is initially payable.

**Credit Insurance** is optional insurance that pays the scheduled unpaid balance if the insured dies or the scheduled monthly payments if the insured becomes disabled, or in some cases, unemployed. The cost of optional credit insurance must be disclosed in writing and, if the consumer wants it, the consumer must sign for it.

**Dealer Finance Income** is the portion of the finance charge that the dealer retains when it assigns a retail installment sale contract.

**Extended Service Contract** is optional protection on specified mechanical and electrical components of a vehicle that may be available for purchase. It supplements any warranty coverage that is provided with the vehicle.

**Finance Charge** is the cost of credit expressed as a dollar amount.

**Guaranteed Auto Protection (GAP)** is optional protection that pays all or a portion of the difference between the amount owed on a vehicle and the amount received from an insurance company if the vehicle is stolen or destroyed before the credit obligation is satisfied.

**Lessee** is an individual who enters into or is offered a consumer lease.

**Lessor** is a person who regularly leases, offers to lease, or arranges for the lease of vehicles under a consumer lease.

**Motor Vehicle Retail Installment Sale Contract (RISC)** is a contract for the sale of a vehicle between a dealer and a vehicle buyer in which the buyer agrees to pay the purchase price of the vehicle in installments over time. The vehicle dealer is the original creditor. The dealer typically later assigns the contract to a financial institution (see the definition of assignee, above), though not all RISCs are assigned.

**Securitization** is the process by which an entity creates and sells a tradable financial instrument in the form of an asset-backed security (ABS) by pooling financial assets, such as RISCs and leases.

**Wholesale (Buy) Rate** is the discount rate that determines the price an assignee pays to buy a retail installment sale contract from a dealer.