

When 1.9% Sounds Too Good to Be True

Low, low interest rates advertised by many automobile manufacturers — 1.9% to 4.9% — often sound too good to be true! If they sound too good to be true, they usually are. In the fine print of the ad, one learns the rate is on “selected” models or that the rate is good for only 24 months.

Even if you still like the “selected” model and term of the loan, there is another common practice used by some financing institutions (never your credit union) you should understand. It’s called the Rule of 78s. This is a loan agreement that contains a legitimate (but not very fair) prepayment penalty. And you will never be told about it when you sign the contract. This rule gets its name by adding the numbers 1 through 12 (for the number of months in a year), to get 78. With a one-year loan, you will pay 12/78 of the year’s interest in the first month, 11/78 the second month and so forth.

This becomes particularly ominous on a 48 or 60 month loan. During the first year of this loan you will have paid most of the interest due over the life of the loan. If you decide to pay the loan off early or refinance the loan at a lower rate, you have lost a great deal of money. The net effect of this type of auto loan is really a higher interest rate if it is figured on a simple interest basis. Credit unions only use the simple interest rate APR to calculate consumer loan rates. Therefore, credit union rates may sound higher, but are generally lower!

Low-interest financing also is costlier to the consumer when it is offered in lieu of a rebate. A reduction in interest rate saves much less than a cash rebate. You would have to find a 4-year loan at 5% APR (simple interest) or less to beat a \$1000 rebate on \$12,000 borrowed. It’s always to your advantage to take the rebate, bargain the price of the car down, and finance through your credit union.