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Credit Catch-22

By Catherine Siskos

For buyers with no borrowing history, getting a car loan can be a challenge.

Debt-free and with a secure job managing a McDonald's franchise in Asheville, N.C., Rob Smith was expecting to get the green light from Volkswagen Credit for a $15,000 car loan. But when the salesman tried to check Smith's credit report, he couldn't find one. Smith, 24, had never had a mortgage, a car loan, a bank loan or even a credit card. As far as the major credit bureaus were concerned, he didn't exist. "I didn't realize I needed to establish credit to get credit," he says.

And Smith was laboring under some other handicaps. Dealers assume first-time car buyers are flighty, explains Mark Rowe, general sales manager for Henna Chevrolet, in Austin, Tex. "They change jobs. They live at home but are about to move out. They have no history for lenders to gauge how they'll repay."

Even using a credit card responsibly for a few years may not be enough. "If you've never had a car loan, the dealer may still turn you down," says Jeff Ostroff of CarBuyingTips.com.

Smith's contract on a used 2001 VW Jetta might have ended up in the shredder, but his college degree put him in the driver's seat. He qualified for Volkswagen Credit's College Graduate Financing Program, which got him his car and a better interest rate--6.99%--than he could have qualified for on his own. Most lenders would have charged Smith between 11% and 21%, if they had approved him at all.

In addition to Volkswagen, Chrysler, Ford, General Motors, Honda, Hyundai, Mitsubishi and Toyota all offer programs that enable recent or soon-to-be graduates with little or no credit history to lease or buy a car at a reasonable interest rate if they finance the purchase through the manufacturer. Any credit history you have must be favorable, with no late payments or defaults. Some carmakers, such as Chrysler, Ford and Toyota, even throw in a $400 rebate.

Buyers with established credit can usually find better rates on their own through a bank or credit union. But for first-time buyers, the reverse is often true. The carmakers' financing subsidiaries grade a customer's credit from A to D. An A customer qualifies for the lowest interest rate, currently about 6%, and the occasional 0% deal that's reserved for the most creditworthy buyers. A C or D customer won't get special financing and can expect to pay between 11% and 17%. Under a college-graduate program, a first-time buyer, who ordinarily might rank somewhere in the lower two tiers, automatically jumps to A or B status.

Windows of opportunity. Carmakers are hoping that young car buyers will become lifelong customers. But their generosity has limits. The programs apply only to grads who have been out of school for two years or less, although graduates with advanced degrees are also eligible. Ford has the stingiest time frame: You must buy a car within 120 days of receiving your degree. Most manufacturers restrict the size of your car payment to between 15% and 25% of your gross monthly income.

The actual interest rate you get depends on your ability to haggle. Just like other buyers, you'll have to negotiate the car price and the loan terms separately. "Car financing is not just a service that dealers perform," says Ostroff. "It's a product they sell you."

Of course, they'll also try to sell you accessories and add-ons--such as an extended warranty, rustproofing and undercoating--that you don't need. Modestly priced new cars cost between $11,000 and $16,000. Financing a $15,000 car with a 20% down payment, or $3,000, costs $287 a month on a 7% loan over 48 months. Adding $4,000 of extras increases your monthly payment by almost $100.

Some extras you can't avoid--such as taxes, tags and registration fees--so you must crank in their cost when figuring how much you can pay for a car. For example, sales tax in California can go as high as 8.25%, adding $1,240 to the price of a $15,000 car. Figure on another couple of hundred dollars for registration and other state fees.

You can include the cost of taxes and tags in your loan, but under the college programs, the total can't exceed the car's suggested retail price. The roughly $1,500 for taxes and tags on Smith's indigo Jetta didn't increase his loan because he put $2,500 into the deal, money he raised by raiding his savings and trading in the 12-year-old BMW 525 he had inherited from his parents. The monthly payment on his $15,000 loan is a manageable $313, about 18% of his gross monthly income.

On top of that, he pays $600 a year for insurance. On average, car-insurance premiums range from about $470 a year in Iowa to just over $1,000 in New Jersey, according to the National Association of Insurance Commissioners (tack on an extra 20% if you're under 25, the age at which car-insurance rates begin to decline).

Double-digit rates. If you don't qualify for the college-graduate financing programs, be prepared to pay double-digit interest rates. In addition to your credit score, a lender will also consider your ability to repay the loan, based on your income and any outstanding debts, and how long you've been working for an employer or living at your current address (if it's less than six months, don't bother to apply). No more than 45% of your gross income should go toward paying off total debt from student loans, credit cards and the car loan you're seeking.

You may qualify for more favorable terms if you make a down payment of at least 20%. That's a good idea anyway, because most new cars lose 20% of their value within the first year. If you sell the car, trade it in or total it in an accident, you could easily end up owing more than the car is worth.

What if the lack of a down payment and sky-high interest rates put the car you want out of your reach? You know the answer: Consider a used car that costs less and requires a smaller loan. You may still have to jump through a few hoops. Some lenders require that you borrow at least $5,000 and that the car be less than four years old before they'll approve the loan.

Having a parent co-sign may clinch the deal and get you a lower rate. But that should be a last resort. "Your behavior on that loan will be reflected on your parents' credit history," warns Steve Rhode, president of Myvesta, a credit-counseling service. The co-signer is on the hook for the entire loan amount and has the most to lose. If you lose your job or get into an accident and are unable to make the payments, the lender "will go after the person with better credit," says Rhode.

Reporter: Christine Pulfrey

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