



Auto Loans Managing Your Auto Loan

How Car Loan Interest Works

By **Amaan Almeida**, Automotive Editor - June 19, 2009

Learn the basics of financing, how car loan interest is calculated, how simple and compound interest works, what to expect for typical interest rates.

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If you're thinking about buying a new car, you should know how **car loan interest** works. This article will explain how car loan interest works so that you can get the best rate for your new car.



What Is Financing?

Financing is when a borrower takes out a loan, which is a type of debt, to pay for something that costs more than what they can pay for at one time, like a car. When a borrower asks for a loan, once approved, the lender will give the borrower a certain amount of money with a promise of repayment from the borrower. With a car loan, the borrower pays this loan back in certain installments.

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A loan is given to the borrower with an interest rate. This is extra money that the borrower will be paying to the lender as payment for providing the borrower with the money for the car. For example, if the car costs \$19,000, the borrower could eventually pay \$22,000 by the end of the transaction. This is how lenders make money.

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How Car Loan Interest Rates are Calculated

How car loan interest rates are calculated can be a very important thing to know when you are looking for a car loan. However, it is actually a difficult thing to understand, which is why most lenders have a card or sheet with the following factors, giving them the information without having to calculate it by hand.

- **Credit history.** The biggest factor in the calculation of used car loan rates is the borrower's credit history. The credit history is then transformed into a credit score that tells lenders how likely you are to pay back the loan.
- **Types of interest rates.** The two types of interest rates used are the simple interest rate and the compound interest rate. The simple interest rate is calculated using only the amount of principle owed, while a compound rate uses both the amount owed and the interest rate owed. So with a compound rate you are paying interest on the interest.
- **Debt-to-income ratio.** Debt-to-income ratio is how much of the consumer or borrower's gross monthly income goes towards paying other debts like housing and food. In the US, at this time, the debt to income ratio for securing a loan is usually 28/36.

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So in order to calculate the interest rate you will pay on a car, you will need to know the type of interest, the amount of the loan, the borrower's credit score, the amount of the down payment if any, and the debt to income ratio. To get how much your car loan should be, use a [car loan calculator](#).

How Simple Interest Works

Simple interest is the most common type of interest on loans for a car. Simple interest is when interest from the principal for earlier periods is not calculated into the following periods. This type of loan is usually used for short term loans.

How Compound Interest Works

Compound interest is a little trickier to figure out. This interest is calculated for every single period of the principal and also all of the interest that built up previously. Interest may be calculated on a yearly rate, semiannually, quarterly or continuously. Compound interest is basically a series of side-to-side simple interest contracts. The interest that accrues in each time period is calculated into the main bulk of the loan for the earlier time period.

Compound interest can make a very big difference in the gain of debt. The end of loan period can leave the borrower having paid much more in interest than they would have with a simple loan rate.

Rule of 78

With the Rule of 78, if you don't pay the loan off early than the contract states that a simple interest loan rate and a Rule of 78 loan rate will be the same. You will pay exactly the same amount in each way of calculating interest. But if you pay your loan off before the contracted date, with the Rule of 78, you will pay more interest than you would have if you had a simple interest loan rate. So if at all possible, Rule of 78 loans should be avoided.

Average Car Loan Interest Rates

When shopping for a new or used vehicle, you need to find out the **average car loan interest** rate paid by other buyers to determine if you're being offered a good financing deal or not. The rate of interest offered on your car loan depends on your monthly income and your credit score, apart from other factors. The higher your credit score, the better the rate of interest offered. Choosing a fixed rate car loan has its own advantages. The main benefit of such loans is that you can lock in a low rate of interest for the tenure of your loan. However, each auto loan quote offered by banks and lenders has its own terms and conditions. You need to read these clauses and make an educated choice, to avoid losing a huge sum of money over the years.

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Knowledge Is Power

Do some research online and determine the current prime interest rate. The prime interest rate is usually dictated by the federal government, depending on economic conditions. If the prime interest rate is low, it is usually a good sign to apply for a new car loan. Credit unions and banks will likely have a similar interest rate that reflects the low prime rate. If prime rates are high, it would be best to wait for interest rates to subside before making your purchase.

When in the market to buy a new car, remember that dealers often represent the best option for financing your vehicle. They serve as middlemen between the buyer and the car manufacturers. Be wary of 0% interest offers when buying a new car, as this usually requires a large down payment or extended loan terms that would translate to a higher interest rate overall. Loans of up to 7 or 8 years with low down payment plans are

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popular these days to entice the buyer to make a purchase, but this would translate to higher monthly payments and a higher interest rate overall.

Determining Loan Terms

It would be best to consider a shorter loan term of 3 to 4 years, as this is the right balance between paying for your new car and the overall depreciation that the car would incur over its intended service life. This would make the car easier to sell, as remaining service life is still acceptable compared to a 7 or 8 year loan term, with the car past its depreciation value by the time the loan is finished.

New car loan rates are also dictated by the amount of down payment you are willing to part with. Again, consider the fact that 0 down payment offers of new car dealers are designed to entice the buyer to sign on the dotted line, absent in the knowledge that the deal would require high monthly payments and increased interest rates. A sufficient down payment would be a good sign to lenders, as this represents a low risk scenario, wherein the buyer is willing to part with a significant amount of money despite the presence of a loan approval. It is good to save some money first for a down payment which translates to a lower loan amount, lower monthly payments and low interest rates. It would be bad to rush in making the decision and ignoring the option of a down payment.

Having a high credit rating is a good sign of acquiring a low interest rate for a new car loan. The capability to pay is a risk factor seriously considered by lenders and is good way to get a favorable rate. A low credit rating is not a bad sign overall, but it would be best to fix your credit first before applying for a loan. Bad credit will usually translate to a higher than normal interest rate.

How Much Are People Really Paying?

Although the rate of interest offered varies according to an individual's personal details and financial capability, most people are offered a 7 percent rate of interest. Thus, if you wish to borrow \$16,000 to \$20,000 from a bank or a lending institution, you could end up paying anything between \$300 and \$550 on a four year new car loan. The used car loan rate of interest also amounts to nearly 7.72 percent. However, when shopping for a loan, you need to contact at least 3 lenders to find out the interest rate you qualify for.

Although some buyers choose the dealer's 0 percent APR financing option, it's beneficial to do your research and compare auto loan quotes to find out how much you will end up paying on your new or used car purchase. Remember to also take into account taxes, fees and any additional costs.

People with Bad Credit

Although most people manage to lock in a fixed interest rate of anything under 7 percent, people with bad credit are offered significantly high rates of interest. If your FICO score is under 680 points, you could be charged a rate of interest that's as high as 22 to 30 percent. However, if your score is on the border, you should consider making a high down payment to qualify for lower interest rates. Alternatively, consider refinancing your loan, as several banks offer good refinancing options. This is the best way to pay low interest rates when your credit score is bad. You should also work at improving your credit score before considering a refinanced loan.

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Getting the Car of Your Choice

You need to be well prepared before setting foot into a dealership. Consider obtaining a pre-qualified loan to use it as a good negotiation tactic when discussing financing options with the dealer. Some dealers may also offer you a sizeable rebate on the car you wish to purchase. Do your calculations to find out if it's really worth taking the rebate or settling for a low rate of interest. Even if the dealer negotiates a good selling price, you may not be getting a good deal if the dealers profit stems from your auto loan payments. How much interest you should expect to pay on your car loan will depend on the following criteria:

- **Length of the loan.** The length of time you will be given to pay off your car loan can be anywhere between 36 and 72 months. Generally, the longer the duration of the loan, the lower the interest rate. But since interest is paid based on how long you are lent the money for, this usually means you will have to pay a higher total sum.
- **Credit score.** The deal that the financial institution offers you will also depend on your credit score. A bad credit score usually means you have been known to have problems paying off debts in the past. So the financial institution will probably give you a higher interest rate as insurance against other people with your score not paying off their debts.

- **Specific rates.** The lowest car loan rates are usually around 8% of the amount you are lent. This is for people with a good credit score who will pay off their debt after only a short time. If you have bad credit or you want to take as long as you can to pay off the loan, the best car loan rates you can expect may be as high as 12% to 14%.

Auto Loan Comparison Guidelines for New and Used Car Loan Interest Rates

Used car loan interest rates tend to vary considerably from new car loan rates. The reasons for this include the quality and resale values of the cars, amongst other things as well. Still, a number of other factors will help to improve the payments that you make on your loan, so it's a good idea to recognize all of the various factors that come into play to determine those rates and payment levels.

In addition to the resale value of the car, which tends to go up or down alongside the loan interest rate, it's important to recognize that the supply and demand for the car can help to change that rate as well. For instance, if the new car that you're looking to buy has very few vehicles on the market but a great demand, people may be more willing to spend a greater amount of money on interest rates in order to buy the vehicle, and you'll have to do the same in order to make the purchase.

Your own credit score and personal financial history are also major factors that help to determine the total amount of money that you'll have to spend on the vehicle repayment as well. Generally speaking, the worse your credit score is and the more trouble you've had paying for previous purchases on time, the higher the interest rates will be for your used or new car loan payments.

CarsDirect Finance Services

If you're seeking car loans to pay for a car, you may consider getting a loan through [CarsDirect](#). We help more credit-challenged consumers than other website in the country. We work with a network of dealers who specialize in this area of financing. The dealer has access to a number of financial institutions and will shop around to find you the best deal. Simply fill out a quick and easy application, and you'll be on your way to getting your new car and avoiding having to deal with car title loans. The service is free and absolutely no obligation is required.

Getting the Best Car Loan Interest Rate

The following steps will help you get the best car loan rate on your next purchase:

- **Check for special financing rates.** If you are shopping for a new or certified pre-owned car, most manufacturers offer special finance rates on these vehicles. You can learn more about special auto loan financing rates by contacting a dealership or doing some research online. These rates provide no- or low-interest auto loans, but they are only extended to the most well-qualified buyers. Whether you contact a dealership online, over the phone or in person, ask about credit score requirements for special loans, so you can have an idea of what you may or may not qualify for.
- **Check bank rates.** Use a website like [Bankrate.com](#) to get an idea of the interest rates available through traditional banks. If a manufacturer does not have a special interest rate available on a vehicle, your best rate will likely come from a major lender like Chase, Bank of America or U.S. Bank. [Bankrate.com](#) compiles a daily average of new and used car rates, as well as information on loans for borrowers with some bumps in their credit.
- **Demand the "buy rate".** Once you arrive at a dealership to get your new car, make sure that the rate and the terms match what was agreed upon with the salesperson. The finance and insurance office, where you complete your financing paperwork, is a major source of profit for all dealerships. Most profit is made by way of marking up the interest rate. The loan interest rate is offered to the dealership at a "buy rate." The dealership can mark up the rate given to the customer and retain the difference as additional profit. If a finance manager says that the rate has changed from what was agreed upon, ask to be quoted the buy rate. In some cases, rates do rise for unexpected reasons and changes at the lender, but ask to see proof of this change in writing from the lender.

Following these steps can help you get the best rate when shopping for a new or used car. Just be sure to know your credit score and what type of rate to expect before visiting

the dealership.

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Armaan Almeida is the Editor-in-Chief of the New Car Pricing Insider blog and publishes daily incentives on new cars in addition to newsworthy articles pertaining to the auto industry.

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