

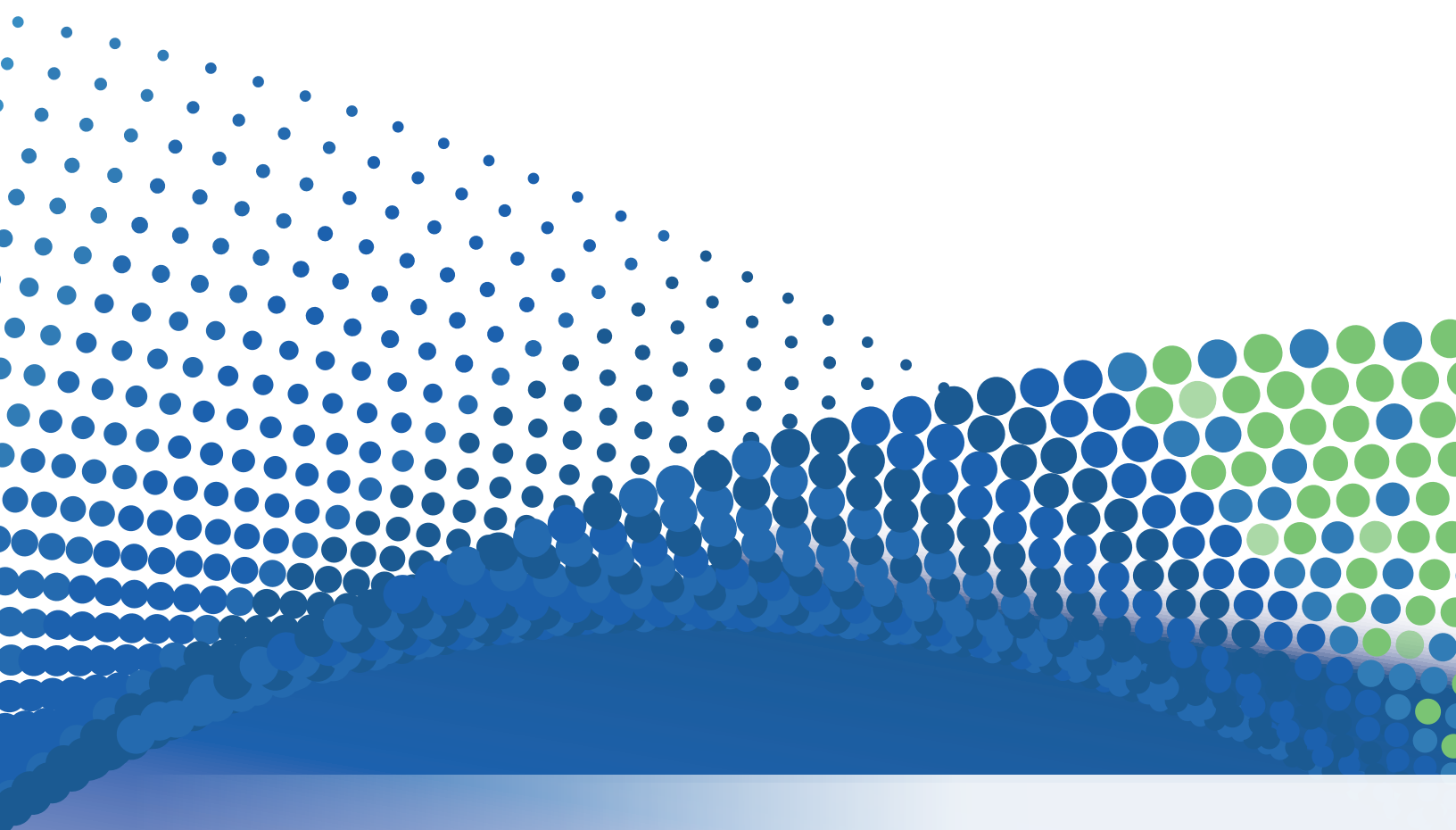


Financial Consumer  
Agency of Canada

Agence de la consommation  
en matière financière du Canada

# AUTO FINANCE:

# MARKET TRENDS



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# Auto Finance: Market Trends

## 1. Purpose

The Financial Consumer Agency of Canada (FCAC or the Agency) recently conducted research in the auto-lending space to better understand market conduct, the regulatory framework, and growing microeconomic risks. This report focuses on the auto loans offered by federally regulated lenders and the risks posed to consumers by extended-term loans. It offers a high-level summary of FCAC's research findings, and how the Agency plans to respond to the risks identified.

## 2. Auto finance: Background

Automobiles are the nonfinancial asset most widely held by consumers in Canada. Outside of the country's largest cities, vehicles are less of a luxury and more of a necessity. Automobile ownership can open up economic opportunities, by allowing Canadians to pursue employment further from home. Many Canadians need vehicles to care for their families. According to Statistics Canada, households spend an average of more than \$10,000 annually on private transportation, and this spending is vital to local and national economies.

Canadians brought home 1.9 million new vehicles in 2015, setting a record for the third consecutive year. The Agency recognizes that strong sales are vital to the automotive industry, which employs more than 120,000 people in manufacturing, and supports another 280,000 jobs across the country, typically at relatively high wages.

Record sales have been accompanied by a significant expansion of Canada's auto finance market, which has nearly doubled in size over the past eight years, from roughly \$60 billion to \$120 billion. The expansion of consumer debt in auto loans has outpaced that of all other forms of household credit, including mortgages.

Prior to the financial crisis (2007-08), the financing arms of automobile manufacturers were the dominant providers of auto financing in Canada and a greater number of consumers used leases to acquire new vehicles. When automakers pulled back during the crisis and subsequent recession, leasing declined and federally regulated financial institutions (FRFIs) acquired a more prominent share of Canada's growing auto finance market.<sup>1</sup>

When the time comes to purchase a car or truck, most Canadians will need to borrow money. It is therefore important to ensure that consumers have access to an auto finance market that is functional, fair and competitive. While the market appears efficient, the trends toward more extended-term loans and growing consumer leverage are of concern, particularly at a time when consumers are already carrying high levels of debt. Today, more consumers are drawing payments out over periods of 72, 84 and 96 months, rather than opting for more traditional loan terms of 60 months/5 years. The six-, seven- and eight-year loans significantly increase consumers' borrowing costs and negative equity risks.

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<sup>1</sup> Bank of Canada. (December 2014). "Financial System Review."

FCAC conducted a targeted review of auto finance during the summer and fall of 2015. The review gathered information from Canada's large banks, as well as several smaller lenders that are focused on the auto lending market. The Agency looked at market trends, emerging risks and industry practices, and collected specific information about market conduct, customer-facing disclosure, policies and procedures, compliance frameworks, dealer monitoring, and organizational structure. Particular attention was given to the information consumers receive about the terms of their auto loan as part of the initial disclosure, as well as to issues that could potentially impact consumers, such as negative equity and non-prime lending.

## 3. Research Findings

### 3.1. Indirect auto loans: How the market works

During indirect auto loan transactions, dealers act as intermediaries between consumers and financial institutions by facilitating credit agreements. Of the record-setting number of new vehicles purchased by Canadian consumers in 2015,<sup>2</sup> more than half will be indirectly financed by FRFIs.<sup>3</sup>

A consumer's first discussions about financing a vehicle purchase are usually with the dealer's sales representative. As part of these conversations, the sales associate determines whether the consumer requires financing and, if so, discusses potential financing arrangements broadly. The dealer is primarily concerned with establishing the monthly amount that the consumer is comfortable paying. The dealer also obtains the consumer's consent for credit score inquiries and collects other financial information for the loan application, such as annual income, employment status, and housing costs.

The consumer's credit credentials, chosen vehicle, and transaction details are usually entered into an online portal system (e.g., DealerTrack, RouteOne). Using the portal, dealers can send the proposed loan transaction to multiple lenders at the same time. There are approximately 50 prime and non-prime lenders in the market. Lenders review the loan application and then decide whether to offer the consumer one of their credit products. The terms of the proposed loan (e.g., interest rate range, term length), are based on the consumer's creditworthiness and the characteristics of the vehicle they are purchasing (e.g., new or used).

When multiple lenders compete for a loan, the dealer often decides which offer is presented to the consumer. The size of the commission, or the reserve,<sup>4</sup> is one of the factors dealers consider when deciding which lender's product is offered to the consumer. For some loans, lenders pay dealers a lump-sum commission, based on the year and price of the vehicle purchased. In other cases, lenders provide dealers with a range of interest rates and offer commissions based on several factors, including the rate of interest charged to consumers. In general, when consumers buy more car, dealers earn higher reserves for arranging the financing.<sup>5</sup>

2 See *DesRosiers Automotive Consultants*. (November 2015). "Canadian Sales Report." Retrieved from <http://www.desrosier.ca/pdfs/sales.pdf>

3 See *Moody's Investor Service*. (October 2014). "Canadian banks' accelerated auto lending drives risk of credit crash in downturn" and *CGA Canada*. (2011). "A driving force no more: Have Canadian consumers reached their limits." Retrieved from [http://www.cga-canada.org/en-ca/ResearchReports/ca\\_rep\\_2011-06\\_debt-consumption.pdf](http://www.cga-canada.org/en-ca/ResearchReports/ca_rep_2011-06_debt-consumption.pdf)

4 Dealers earn a commission when they act as intermediaries between consumers and financial institutions to facilitate auto loans. The commissions are paid by the financial institution. In the industry, these commissions are commonly referred to as the "the reserve."

5 One exception is subvention financing, which does not typically involve reserves or commissions. From time to time, most automobile manufacturers will offer promotional interest rates to consumers, usually for a limited time and on certain vehicle models. Subvention financing is based on an arrangement between financial institutions and automobile manufacturers. The financial institution provides preferred lending rates to manufacturers and, in return, manufacturers offer promotional interest rates to consumers. Manufacturers are required to send the financial institution funds to cover any difference between their promotion rate and the preferred lending rate offered by the financial institution.

It is important to note that, although dealers typically decide which loan is offered to consumers, they cannot modify the credit agreements. The terms of the auto loan are determined by the lender. Two documents are typically presented to consumers at the time of purchase: a bill of sale, for the purchase of the vehicle, and a conditional sales contract (CSC), for the credit product. CSCs are written and branded by financial institutions. Immediately after consumers expressly consent to the terms and conditions of the CSCs, they may be free to drive away in their new vehicle, if they can produce proof of insurance. Funds to cover the loan amount and the reserve are generally sent to the dealer within 24 to 48 hours. Several days later, consumers receive a “welcome letter” from the lender.

**3.2. Microeconomic risk: consumer indebtedness**

**3.2.1. Buying “too much” car**

Consumer groups, market analysts, and at least one large manufacturer have suggested that longer terms are encouraging consumers to buy more vehicle than they can afford. Consumers focus on monthly payments and neglect to compare the overall cost of different types of vehicles or different types of financing. This “new affordability” has contributed to greater demand and record sales. Excessive outlays on vehicles could aggravate microeconomic risk (at the household level), especially since many households are already highly indebted.<sup>6</sup>

Total transaction prices for new vehicles are rising more than twice as fast as average monthly payments, because the average term of car loans continues to grow. According to data gathered by the research firm J.D. Power, the average transaction price for new vehicles in Canada rose approximately 14 percent to \$34,190 between 2010 and the second quarter of 2015. During this same period, the average monthly payment for consumers in extended-term loans (ETLs) increased only 7 percent, from \$485 to \$518.<sup>7</sup> For consumers more generally, the average monthly payment increased only 3.8 percent, from \$522 to \$542 per month.

**Figure 1: Presentation of an extended-term loan to a consumer**

<b>Option A</b>		<b>Option B</b>
Economy Car		Mid-Size Sedan
\$16,000	<b>versus</b>	\$32,000
36 month term		72 month term
3% APR		3% APR
\$465/month		\$486/month

Industry analysts suggest that the availability of ETLs means that consumers have more options when financing a new vehicle. According to J.D. Power, consumers are increasingly choosing to purchase more vehicle with longer-term loans (Option B – Figure 1), as they can now afford the monthly payments. The monthly payments on extended-term loans for more expensive vehicles are often roughly the same as those for economy-class vehicles financed over conventional terms.

<sup>6</sup> For analysis of elevated levels of Canadian household indebtedness, and the contribution of auto loans to this broader trend, see *Bank of Canada*. (June 2014). “Financial System Review.”  
<sup>7</sup> Extended-term loans (ETLs) are defined as auto loans with terms that exceed 5 years or 60 months.

Stakeholders have raised concerns about the potential risks associated with current trends. They have expressed concern over the increased borrowing costs, consumer indebtedness and negative equity risks associated with larger loans over extended terms. The interest charges for Option B above (i.e., \$3,000) are four times greater than those for Option A (i.e., \$750). As the market value of their vehicle declines, consumers who choose Option B will be exposed to more negative equity early in the second year, when negative equity tends to peak. These consumers will still have negative equity five years into their loan, which means that they are more likely to have to refinance debt into their next auto loan.

### 3.2.2. Negative equity and extended-term loans

Consumers are increasing their exposure to negative equity risk, as they choose to finance vehicle purchases with extended-term loans (ETLs). The industry defines ETLs as auto loans with terms of six years or more. There are a number of other factors that contribute to negative equity risks as well, such as consumer behaviour, purchase price, and interest rates. However, term length is the most important factor contributing to growing negative equity risks.

The average loan term for new vehicle purchases has increased by nearly two months every year since 2010, reaching 74 months in 2015. ETLs now make up approximately 60 percent of the auto loan portfolios of Canada's largest lenders. And demand is still growing. Indeed, ETLs are the fastest growing category of auto loan for all of the larger lenders interviewed. According to the banks, more than 70 percent of new auto loan bookings have extended terms.

Statistics compiled by J.D. Power show that the share of consumers trading vehicles with negative equity has risen 50 percent over the past 5 years: from 20 percent in 2010 to 30 percent in 2015. Although significantly more consumers are carrying negative equity when they break their existing auto loans, the average amount of negative equity carried by consumers who are underwater has not changed substantially but has hovered around \$6,700.

While consumers are opting for longer loan terms, they are not necessarily waiting longer to break their current loans. Most continue to break their auto loans during the fourth year. Because the average term now exceeds 72 months, these consumers are breaking their loans before they have eliminated negative equity and begun accumulating positive equity. In a more traditional 60-month term, consumers begin accumulating positive equity during the fourth year.

Vehicles depreciate rapidly over the first year of use, and the portion of each loan payment dedicated to interest is larger during those first two years than it is later in the term. Consequently, negative equity tends to peak early in the second year.

This is illustrated in Figure 2, which analyzes the purchase of a new sport utility vehicle (SUV) in 2016, bought for roughly \$35,000 and financed with an interest rate of 4 percent.<sup>8</sup> In a standard 5-year loan, the consumer would start accumulating positive equity halfway through the fourth year, or roughly 42 payments into a 60-month loan term. Their negative equity risk would peak early in the second year at \$9,000, because of rapid depreciation during the first year.

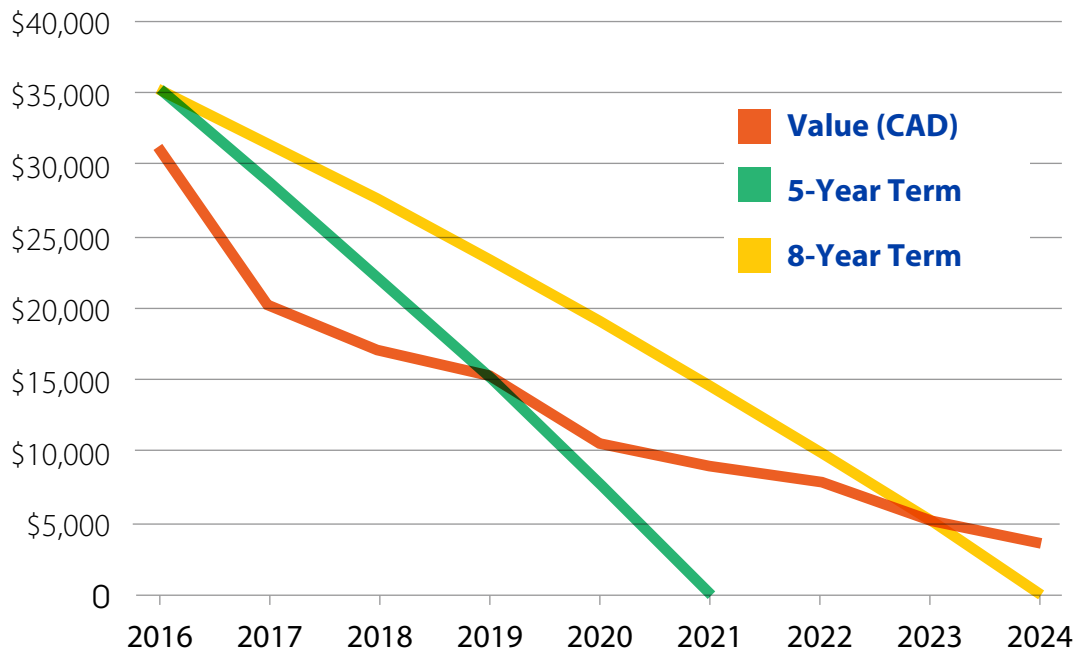
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<sup>8</sup> The SUV depicted in Figure 2 is one of the top-selling vehicles in Canada. The name of the brand and model have been removed from this report, because this chart is intended to serve only as an illustrative example. The consumer paid roughly \$35,000 for the vehicle, including 13% HST, which is close to the average transaction value of new vehicle purchases in 2015. The depreciation schedule is based on FCAC calculations, using the Canadian Black Book's average trade-in value and 20,000 kilometers of driving per year, which is the average amount of mileage consumers put on their car or truck each year, according to the Canadian Automobile Association (CAA).



If consumers financed the same purchase in an 8-year loan, they would not begin acquiring positive equity until the end of the seventh year, after making roughly 80 payments. Their negative equity position would peak early in the second year, but they would be approximately \$12,000 underwater. Furthermore, halfway through the fourth year, when consumers in standard loan terms begin accumulating positive equity, consumers in a 96-month loan are still roughly \$9,000 underwater.

**Figure 2: Long-term negative equity**



Sources: *Canadian Black Book*, FCAC calculations

There is a risk that a growing number of consumers will get caught on an “auto-debt treadmill,” as they break their loans before they have accumulated positive equity and refinance negative equity positions into new ETLs. This issue has been raised by analysts at Moody’s, consumer groups and the Ontario Motor Vehicle Industry Council (OMVIC). Consumers are opting for longer loan terms, but many have not adjusted by holding on to their vehicles long enough to begin accumulating positive equity.

**3.2.3. Increased risk of loss for consumers and lenders**

Lengthy periods of negative equity could increase microeconomic risk, particularly for consumers with larger auto loans or those who find themselves perpetually underwater. Consumers with negative equity usually have less financial flexibility if their economic situation changes.

For example, consumers in an auto loan with positive equity can respond to a job loss or new expense by selling their vehicle, breaking their loan and using the surplus funds to purchase a smaller vehicle or other means of transportation. Consumers with negative equity must raise funds to cover the shortfall before they can sell their vehicle and break their loan. The size of the shortfall will peak early in the second year, but longer terms increase the probability that consumers will face unforeseen events during the life of the loan.

When consumers are carrying more negative equity, the probability of loan loss increases, and the size of the potential loss also increases.<sup>9</sup> The gross loss ratio is at least twice as high for ETLs as for auto loans with conventional terms, according to the banks and other lenders interviewed by FCAC.<sup>10</sup>

It is worth noting that consumers who have purchased more vehicle than they can afford may not necessarily default or even fall behind on their payments, but it could jeopardize their ability to keep up with other credit obligations. Consumers whose budgets are stretched too thin by auto-loan obligations may be less resilient in the event of an economic downturn. In the United States, credit bureaus have found that consumers prefer to fall behind on other credit obligations, such as their mortgage or credit card, rather than miss an auto-loan payment.<sup>11</sup>

### 3.2.4. Impact on future financing

If consumers continue to choose loans that require them to carry large amounts of negative equity, they can find themselves unable to obtain financing. Several sources have suggested that the current trend towards more ETLs is unsustainable over the long term.

There are limits on the number of times consumers can roll over negative positions before they begin exceeding lenders' risk threshold. Lenders are comfortable with their ability to price the risk associated with financing several thousand dollars in negative equity from a consumer's previous auto loan in a new loan. However, it is much more difficult to roll over negative equity positions a second time, and almost impossible to roll them over a third time.

When consumers look to refinance negative equity from a previous auto loan, it increases the loan-to-value (LTV) ratio for the new loan. Auto loans with LTV ratios in excess of 135 percent are generally considered higher risk, according to a recent report by Moody's Investor Services.

In the future, rising interest rates could increase the potential for a credit crunch in the auto finance market by putting more upward pressure on LTV ratios. It is already difficult to refinance negative equity a second time, and it would be even harder should interest rates rise above the current historically low rates.

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9 See *Bank of Canada*. (June 2015). "Financial System Review."

10 Term length is salient, but there are other factors that contribute to the probability of loss as well, such as credit score and loan-to-value ratio. Researchers at the Office of the Currency Comptroller have demonstrated that loans aged 5 years and over carry significantly higher probabilities of default. The economic costs associated the defaults of older loans are also greater. See Guo, Z, D. Wu and X. Zhao (March 2015) "Determinants of auto loan defaults and implications on stress testing," Social Sciences Research Network. Retrieved from <http://dx.doi.org/10.2139/ssrn.2591361>

11 Contrary to received wisdom, recent analysis has found that consumers in the United States are placing a higher priority on auto-loan obligations than other types of credit. See *TransUnion*. (2012). "Payment hierarchy analysis: A study of changes in consumer payment prioritization from 2007 to 2011."

### 3.2.5. Increased risk of fraud and of burying negative equity

During phases in the credit cycle when consumer indebtedness is high, there is greater potential for fraud. Interest rates are low, and demand for credit is strong, but debt-to-income ratios are high, and many consumers will not meet their lender's criteria. This can create pressure to revise a borrower's credit credentials to help close an automobile sale.

Some observers have reported that "little white lies" or "soft fraud" are becoming more commonplace. Soft fraud refers to the practice of inflating a consumer's stated income, underestimating their housing costs, or exaggerating the status of their employment by increasing the number of years they have been in the job or using a more prestigious job title (e.g., sales manager instead of sales associate). Soft fraud can have very serious impacts on consumers, jeopardizing their employment or saddling them with debts they cannot afford.

### 3.2.6. Inadequate information provided to consumers

Consumers do not have the information they need to make responsible decisions involving negative equity. They can limit their risk by choosing a less expensive vehicle, making a larger down payment, or choosing a shorter term. However, few are able to weigh the risks of negative equity against the benefits of an ETL. The benefit of longer loans is obvious: lower monthly payments. Negative equity is less tangible, and most consumers are unaware of the potential risks and their unintended consequences.

Industry stakeholders report that few consumers take negative equity risks into account when choosing between different auto financing terms. In addition, consumers receive no information about future exposure to negative equity risk and the options for reducing it. The initial amount of negative equity rolled over by consumers is typically disclosed in the dealer's bill of sale and the conditional sales contract (i.e., credit agreement). More importantly, consumers' exposure to negative equity over the life of their auto loan is not disclosed on any subsequent documentation they receive.

## 4. Non-prime auto lending

### 4.1. Market overview

Approximately one-quarter of Canada's auto finance market is non-prime.<sup>12</sup> Definitions vary by lender, but in general, when consumers have a FICO or Beacon credit score below 670, they are classified as non-prime.

The non-prime credit market can expand economic opportunities for young consumers with thin files and for new Canadians with no credit bureau file. Access to non-prime auto loans is also crucial for a large number of Canadians whose credit has been damaged as a result of job loss, divorce, injury or sickness.

### 4.2. High-cost borrowing and limited choice

Consumer groups have raised concerns with FCAC about the high interest rates that prevail in the non-prime auto finance market. When high interest rates are combined with longer terms, consumers can find themselves with loans that cost twice as much as the vehicle they bought.

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<sup>12</sup> See *Bank of Canada*. (December 2014). "Financial System Review."

Consumer groups have also cautioned FCAC that non-prime consumers may have a weaker bargaining position when they attempt to finance automobile purchases. They usually need to have their auto loan approved before they begin shopping for a vehicle. Because non-prime consumers often feel fortunate to have obtained financing, they might believe that their choices are limited to the handful of vehicles offered to them. This can put non-prime consumers in a position where they feel pressured into buying more car than they can afford.

**Figure 3: Prime and non-prime loan cost of borrowing comparison**

<b>Prime Loan</b>		<b>Non-prime loan</b>
Minivan		Minivan
\$21,000		\$21,000
84 month term	<b>versus</b>	84 month term
<b>3% APR</b>		<b>25% APR</b>
\$278/month		\$532/month
<b>Interest costs \$2,300</b>		<b>Interest costs: \$23,000</b>

**4.3. The negative impact of new technologies on non-prime borrowers**

New technologies such as GPS tracking devices and ignition immobilizers have dramatically reduced the time and cost associated with seizing vehicles from delinquent borrowers. It is important to note that federally regulated banks do not employ this technology. However, some non-prime consumers are required to agree to the installation of these devices to obtain an auto loan. In addition to the cost of installation, these consumers also pay the monthly fees to cover third-party monitoring services.

The technology is unregulated, and consumers have no formal recourse if it is used in a way that puts them at risk, such as immobilizing the borrower’s vehicle in a remote location. Concerns have been raised that some lenders are not effectively managing the use of this technology. Some consumers have complained that lenders have repossessed their vehicle before the borrower can prove that payments were duly made.<sup>13</sup>

**4.4. New trends: the “buy-here-pay-here” auto financing model**

Industry stakeholders report that a growing number of Canadian automobile dealers are providing more of their own “in-house” financing to consumers. “Buy-here-pay-here” (BHPH) dealers specialize in financing their used vehicles to subprime or deep subprime consumers.<sup>14</sup> This type of business is largely unregulated and data is limited. These dealers generally obtain a small business loan (e.g., \$200,000) and make a limited number of direct loans available to potential purchasers. In some cases, dealers operate separate lots that lend directly to non-prime consumers.

<sup>13</sup> Desson, C. (2015). “Auto lenders quietly install a digital repo-man,” *The Toronto Star*. Retrieved from [http://www.thestar.com/business/2015/01/14/auto\\_lenders\\_quietly\\_install\\_a\\_digital\\_repoman.html](http://www.thestar.com/business/2015/01/14/auto_lenders_quietly_install_a_digital_repoman.html)

<sup>14</sup> Definitions of these categories vary by lender, but typically subprime borrowers have credit scores between 620 and 550, and deep subprime refers to consumers with a credit score below 550.

The BHPH business model is more established in the United States, where it has been the subject of controversy. Issues cited include non-compliance with the initial disclosure rules under the *Truth in Lending Act* (TILA), and misinformation or insufficient information about the cost of borrowing.

In addition, there have been reports of poor customer service in the United States. BHPH dealers often lack the customer service infrastructure and the expertise of large financial institutions or smaller lenders that specialize in auto finance. Consumers complain about limited payment options, lack of redress and general difficulty servicing their loans.

Finally, there have been claims that some BHPH dealers have built their businesses on high rates of repossession and resale. In other words, some BHPH dealers extend high-cost loans expecting their consumers to default. The low cost of repossession then makes it profitable to seize, refurbish and resell vehicles. There is more research on this subject in the United States,<sup>15</sup> but consumer representatives have raised this issue as a potential concern for the Canadian market as well.

## 5. Improving consumer protection and education

FCAC will use a three-pronged approach to improve consumer protection and education. First, the Agency will focus its supervision efforts on indirect auto loans offered by federally regulated banks to improve the disclosure provided to consumers.

Second, the Agency has [developed education material](#) to help consumers make more responsible decisions when financing automobile purchases. The materials include information on financing options, the importance of budgeting and shopping around, and the risks associated with negative equity.

Finally, FCAC will work with provincial and territorial governments to help provide consumers with the information they need to make responsible choices when the time comes to finance an automobile purchase.

## 6. Conclusion

Buying a car or truck is a significant event in a person's life. For most Canadians, automobiles are the second largest asset they own, after their home. Automobile loans are an important part of the debt carried by most households, which is why FCAC closely monitors trends in the auto finance market.

Financing an automobile purchase can be complex, yet consumers spend more time researching the type of automobile they wish to purchase than on the specifics of the financing arrangement. FCAC advises consumers to draw up a household budget and gather information about different types of automobile financing before they visit a dealership or take a test drive. Particular attention should be given to the term of the loan, as consumers may not fully appreciate the risks associated with making car payments over terms of 72, 84 and 96 months.

First, extended-term loans are more costly, requiring borrowers to pay more interest over a longer period. They are especially costly for consumers who are required to pay the higher interest rates associated with non-prime auto loans.

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15 See Bradley, C., S. Burhouse, H. Gratton and R-A. Miller. (2009). *Alternative Financial Services: A Primer*, *FDIC Quarterly*, 3(1) and *National Alliance of Buy Here, Pay Here Dealers* (2008) "Industry Benchmarks/Trends." Retrieved from <http://sgcaccounting.com/Resources/BHPHBenchmarks2008.pdf>

Second, longer terms increase negative equity risks. When consumers owe more than their vehicle is worth, they may be more vulnerable to the impact of unforeseen events such as job loss, illness, or an accident in which the vehicle is a total loss.

Third, rolling negative equity into a new car loan can lead to more costly credit obligations and it may put consumers on an “auto-debt treadmill” in which they are perpetually servicing debt associated with the vehicle they drive, or used to drive.

Finally, extended-term loans are more difficult to budget for as well. Consumers appear more likely to buy more vehicle than they can afford when they can spread payments out over longer terms. It is also harder to predict whether the payments will still be affordable—or, whether the vehicle will still meet their needs—seven, eight or even nine years down the road.

FCAC will ensure that indirect auto loans from federally regulated banks comply with applicable federal consumer protection laws. In addition, the Agency will work more closely with provincial and territorial authorities to provide consumers with the information they need to make responsible choices. Lastly, FCAC’s consumer education material will help consumers safely navigate the often complex market of automobile financing.



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