



THE ASSOCIATION OF BANKS
IN SINGAPORE

Car financing

What you
should
know...

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WHAT YOU SHOULD KNOW....ABOUT CAR FINANCING

This guide will explain to potential car buyers what to look out for when taking car financing under hire purchase eg method of interest calculation, effective interest rate, early redemption. The recent amendments to the Hire Purchase Act will also be explained.

A. Car Financing Under Hire Purchase

When you obtain a car loan from a bank, you are entering into a "hire purchase". This is an extended repayment scheme for the car. You can use the car once you have paid a deposit for the car, signed the hire-purchase agreement and paid an instalment in advance, but the bank owns the car until you have paid up all amounts owed.

All hire-purchase transactions are governed by the Hire Purchase Act (HP Act). The HP Act was amended in 2004, and the amended act, which came into force on 1 November 2004, will only affect HP agreements signed on or after that date. All agreements signed before 1 November 2004 will still be governed by the pre-amended HP Act.

B. Pre-amended Hire Purchase Act (For car owners with loans taken before 1 November 2004)

The pre-amended HP Act still governs car owners who have bought their cars on hire-purchase before 1 November 2004.

The HP Act governs all car loans for cars with a value of up to \$55,000, excluding the value of the Certificate of Entitlement (COE). Under the pre-amended HP Act, it is mandatory for interest on car loans (for car value up to \$55,000) to be computed on a flat rate basis. Under this method of interest computation, interest amount is computed upfront as a lump sum based on the flat rate of interest and added to the loan amount to derive the monthly instalment. This means that the interest rate is fixed throughout the loan and therefore the amount of your monthly instalment, remains the same throughout the duration of the loan (See illustration 1 below). This protects you against interest rate fluctuations. For cars with a value above \$55,000 which are not covered under the HP Act, these will be explained in a later section.

Illustration 1 - Computation of Interest Payable/ Monthly Instalment

Suppose you take out a loan of \$30,000 over 5 years at a flat interest rate of 2.6% p.a. The computations would be as follows:

- (i) Total interest payable over 5 years
 $\$30,000 \times 2.6\% \text{ p.a.} \times 5 \text{ years} = \$3,900$
- (ii) Monthly instalment
 $(\$30,000 + \$3,900) / 60 \text{ months} = \565

Early repayment

Your Hire Purchase Agreement requires you to pay all the principal and interest that have been computed, over the entire loan period. However, if you repay the outstanding loan before the loan period ends, you will receive a rebate on the interest. This rebate is a refund of the interest previously computed upfront and added on to the loan, but has not been earned by your bank because you settled the loan early. The rebate is calculated using the Rule of 78 formula. (See illustration 2 below). The pre-amended HP Act does not provide for a penalty or additional charges to be imposed for early redemption.

Illustration 2 - Computation of early settlement amount under HP Act

Suppose you took out a car loan of \$30,000 over 5 years at a flat rate of interest of 2.6% p.a. If you repay your entire loan after making 25 monthly instalments, the computation is as follows:

Original Car Loan Amount	\$ 30,000.00
Add Interest for 5 years (see Illustration 1 (i))	<u>\$ 3,900.00</u>
Principal + Interest	\$ 33,900.00
Less : Instalments Paid (\$565 x 25)	(\$14,125.00)
Less: Rebate of Unearned Interest using Rule of 78*	(\$ 1,342.62)
Total Amount Payable to Bank to fully redeem the Car Loan	\$ 18,432.38

**Formula Used for Rule of 78*

$$R = \frac{n(n+1)}{N(N+1)} \times TC = \frac{35(35+1)}{60(60+1)} \times \$3,900.00 = \$1,342.62$$

Where : R represents the interest rebate;

n represents the unexpired loan tenor expressed in months;

N represents the original loan tenor expressed in months;

TC represents the total amount of interest over the loan tenor

HP Agreements not covered by HP Act

If the car value excluding the value of COE is above \$55,000, the HP Agreement is not covered by the HP Act, but instead governed by terms mutually agreed by the parties. In such a case, interest can be calculated on a flat rate basis or any other basis eg monthly rest or variable rate loans. For early settlement of such cars not covered by the HP Act, a penalty fee / additional charges may be imposed. Please see illustration 3 for computation of early settlement of a loan not covered by the HP Act (where interest is calculated on a flat rate basis). You should ask your bank or finance company how interest on your loan is being calculated.

Illustration 3 – Computation of early settlement not covered by HP Act (Interest on flat rate basis)

Assuming you took a car loan of S\$60,000 over 5 years at a flat rate of interest of 2.6% p.a. If you repay your entire loan after making 25 monthly instalments, the computation is as follows:-

Original Car Loan Amount	\$ 60,000.00
Add Interest for 5 years (\$60,000 x 2.6% p.a. x 5 years)	<u>\$ 7,800.00</u>
Principal + Interest	\$ 67,800.00
Less : Instalments Paid (S\$1,130 x 25)	(\$28,250.00)
Less: Rebate of Unearned Interest using Rule of 78*	(\$ 2,685.25)
Add: 20% Penalty Fee (for illustration only)	\$ 537.05
(Please check with your bank on the amount of penalty fee as this may vary from bank to bank)	
Total Amount Payable to Bank to fully redeem the Car Loan	\$ 37,401.80

C. Amendments to the HP Act (For car owners with loans taken after 1 November 2004)

The HP Act was substantially amended in 2004. The amended Act, which came into effect on 1 November 2004, will affect HP Agreements signed on or after that date.

The most important amendment for car buyers is the method of interest computation. Interest rate is no longer mandated to be computed on a flat rate basis. Banks are free to quote interest rates on a flat rate basis or any other basis eg monthly rest or variable rate. If interest is quoted on a flat rate basis, the Rule of 78 will continue to be used to calculate interest rebate for early settlement. Also, in the case of early settlement of the loan, banks are allowed to levy an additional charge for early settlement. You should ask your bank on the terms and conditions of the loan and the method of interest computation before taking up the loan.

The table below summarizes some of the major changes to the HP Act.

Particulars	HP Act Before 1 Nov 04	HP Act After 1 Nov 04
Cars valued up to \$55,000 without COE a. Interest Rates b. Minimum Deposit c. Interest Rate on overdue payments d. Early settlement e. Penalty/additional charges for early settlement	a. Mandatory to be on flat rate basis. b. Minimum 10% of the car price. c. Fixed at 3% over local banks prime rate. d. Interest Rebate based on Rule of 78 (please see Illustration 2). e. No penalty / additional charges for early settlement	a. Banks are free to quote interest rates on flat rate basis or any other basis, eg monthly rest. b. No minimum deposit requirement c. Not fixed. Banks to decide. d. If interest rate is computed on flat basis, interest rebate based on Rule of 78 applies (see Illustration 2). For interest rate on any other basis, please check with your bank. e. Banks are allowed to charge a fee for early settlement. This is to cover some of the costs incurred by banks whenever a loan is repaid early. There is no typical amount charged so you should check with your bank on the additional charges you are liable for.
Cars valued more than \$55,000 without COE a. Interest Rates b. Minimum Deposit c. Interest Rate on overdue payments d. Early settlement e. Penalty for early settlement	HP Agreements are not covered by HP Act. a. Banks are free to quote interest rates on flat rate basis or any other basis, eg monthly rest. b. No minimum deposit requirement. c. Banks to decide. d. If interest rate is on flat rate basis, interest rebate and Rule of 78 applies (see Illustration 3). For interest rate on any other basis, please check with your bank. e. Banks may charge a penalty fee for early settlement (see Illustration 3). This is to cover some of the costs incurred by banks whenever a loan is repaid early. There is no typical amount charged so you should check with your bank on the additional charges you are liable for.	

D. Comparing interest rates between banks

As interest rates may not be quoted on the same basis, always compare the Effective Interest Rate (EIR). This reflects the actual interest cost of your loan. If your loan is quoted on a flat rate basis, ask the bank for the EIR.

Illustration 4 - Effective Interest Rates

A car loan of \$60,000 repayable over 5 years at a flat rate of 2.6% p.a. has an EIR of 5.092% p.a.

A car loan of \$60,000 repayable over 7 years at a flat rate of 2.6% p.a. has an EIR of 4.992% p.a.

The EIR is higher than the nominal flat rate charged because flat rate computations charge interest as a lump sum upfront and do not give any consideration to the monthly principal repayments made throughout the loan period. Note also that the loan period affects the EIR even when the nominal flat rate is the same.

Under the monthly rest method of interest computation, the quoted rate of interest is the effective rate, as interest is computed based on the reduced balance every month.

E. Car financing worksheet (flat rate basis)

For comparison purposes, you should ask your bank/car dealer to complete this worksheet. As this worksheet is for computations on a flat rate basis, please check with your bank if your car loan is computed on a monthly rest basis.

Loan information

a) Loan amount \$ _____

b) Interest payable
(Principal x Interest rate x Loan period)
\$ _____ x _____ % p.a. x _____ years \$ _____

(Effective Interest Rate is _____ % p.a.)

c) Total amount payable (a) + (b) \$ _____

d) Monthly repayments \$ _____
(Total amount payable / Loan period in months)

Please note that completing a worksheet does not constitute a loan offer by the bank.

F. Important questions to ask your bank

1. What is the method of interest calculation for the loan?
2. What is the effective interest rate (EIR)?
3. What happens if I redeem my loan early? Is there any notice period required?
4. Is there any penalty fee for early redemption?
5. If I opt for early redemption, will I have to give up any benefits which I received from the bank when I applied for the loan?
6. Is there any rebate if I redeem early? If so, what is the rebate amount?
7. What other fees and charges will I be incurring? Eg processing fee (application, assignment)

Remember: A loan is a legal and financial commitment. Always feel free to ask your bank for more information before you commit yourself.