Finance

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It all comes down to money. We all have a wish list of amazing vehicles that we'd like to own, but without finance, they remain as dreams.

If you've just won a lottery you've got a wonderful opportunity to make a real fool of yourself in a very short time. The Ferrari salesman will be your best friend in the world until he's got your money, then he'll quickly lose interest, and as you quickly lose the rest of your money, you'll probably lose most of your other new friends as well.

For the rest of us who don't have millions to play with, we have to make do with the best vehicle that we can afford, and leave dream cars to some later date.

Long before you walk into a car sales yard or car fair you should sit down and work out what you can afford. Whether you are borrowing the whole amount from a parent, a bank or finance company, entering a hire purchase agreement or simply paying over all the cash you can gather together, the vehicle you get will always be limited by what you can afford. You're wasting everybody's time if you're looking at vehicles that are beyond your means.

Poor people who wander blindly onto car dealers' lots and sign up on the biggest car in the yard often end up having to give it back when the finance company declines their hire purchase application. That's because finance companies don't finance dreams, they finance realities. They're in the business of loaning money, and have to pretty quickly work out who's likely to pay and who's not. Therefore, if you get declined for finance by a finance company, they might be doing you a favour.

Lending institutions are not charities. They exist by lending out money and charging interest on this money. The amount of interest usually reflects the risk. Upmarket companies loan money at low interest to people who have good security such as a house. In the event that the loan is not repaid, then the lending institution can take the house. At the other end of the scale, if you're trying to borrow money for a car but don't have a very good credit record then you are going to pay a much higher rate of interest, because the risk that you won't pay back the money is so much higher.

As we said before, reputable lending institutions that turn you down for a loan might be doing you a favour. Some finance companies specialise in loaning money to people who are bad credit risks; many of these companies are effectively loan sharks. They charge a staggeringly high rate of interest and they tend to be pretty ruthless when it comes to getting their money back. Our advice is: if a bank or reputable finance house turns you down for a loan, then lower your sights.

Just as there are good and bad people, there are good and bad lending institutions, but they all have one thing in common: they exist to make money by lending you money. Most of them claim to be friendly & accommodating, but the best you can hope for is that they'll be professional and ethical. You skip a couple of loan payments and you'll find out just how friendly and accommodating they are.

What distinguishes a good lending institution from a bad one is the way in which they expect to be paid. The good ones won't lend you money if they believe that you can't easily repay it.

The bad lending institutions tend to be focused on poorer or more naive people. They lend them money knowing perfectly well that many of their customers won't be able to keep up the payments. Because lending institutions exist to make money, if they can't make their money from lending it out to reliable people at low interest rates, then they'll lend it out to unreliable people at high interest rates. High interest rates are harder to pay back, so this increases the risk still further. The bad lending institution knows this, of course, which is why they won't lend money unless they think they can get it back in other ways. Usually this means that they won't lend money unless they have a hefty deposit and/or a guarantee of payment from someone who owns property.

This means that when the high risk customer stops making payments, the finance company simply repossesses the car and starts legal action against the guarantor. Sometimes they adopt standover tactics as well. In poor areas it's very common for a person or family to allow themselves to be conned into a vehicle that is far beyond their price range. The reputable finance companies won't touch the deal, so the family ends up getting a loan from a company that specialises in financing (and ripping off) poor people. The finance company gets a hefty cash deposit (which would probably have been enough to purchase a rough but reliable car), then loans the rest of the money at a horrible interest rate. Three months or so later, when the payments stop coming in, the finance company repossesses the car, which they then auction off and keep the money. If there's still money owing – and there usually is – the finance company then starts legal action against the guarantor. Unless the guarantor can come up with the money reasonably quickly, he or she may lose their home.

People on a budget often make the mistake of thinking that spending more money gets you a better vehicle. That's not always true, but more important, it's not always possible. As we mentioned above, the worst thing a poor person can do is get an expensive vehicle on expensive finance. If you get turned down for a loan by half a dozen mainstream banks and finance companies, then maybe you should stop and reconsider what you are doing.

Either apply for a smaller loan, or simply get all the cash together that you can manage, and buy a cheap car for cash. That old Toyota Corolla that's been in one family since 1979 may not be the newest model, but providing it will pass a safety check, it should get you around until you can afford something a bit more modern. But remember, only a fool buys a car that hasn't been thoroughly checked out by a competent mechanic. If you can only afford a cheap car, then you really need to make very sure that your 'bargain purchase' doesn't turn out to be a lemon.

If you think you're a reasonable credit risk then you should approach a lending institution long before you start looking through the car ads. Ask them how much they would be prepared to loan you. Even if they are prepared to loan you a lot of money, it doesn't mean that you have to take the whole lot. There's a general rule that says that you have to spend a reasonable amount of money to get a reasonable car, but that doesn't mean that if you spend a lot of money that you'll always get a better vehicle.

Why? Because at the upper end of the market, most of a car's price is based on non-essentials, such as appearance and luxury. Spending $50,000 on a luxury European car is not necessarily going to get you twice as good a vehicle as a mainstream Japanese car for $25,000. In fact, the opposite might be the case. The head of Mercedes Benz recently apologised for the poor quality of some recent cars. Further, a recent survey of German consumers rated Japanese vehicles as more reliable than German models.

Everyone deserves luxury at some time in their lives. If you've just received an inheritance, sold a business or retired, then maybe you can afford to splash out on that dream car you've always wanted. We have no problem with that. However, if, like most people, you're struggling with a family, home & career, then you should buy a car that is going to enhance your life in other ways. Dream cars tend to be expensive, unreliable and costly to service and repair. Mainstream family cars tend to be cheaper to buy, more reliable and much cheaper to service and repair. If you were giving advice to someone else who was on a budget, which type of vehicle would you recommend? •