Low car payments can hurt you

What you should know about leasing and long-term auto loans.

With the average cost of a new vehicle now around $30,000, it's no surprise that car loans are getting longer and longer. Some banks now offer car loans with pay-back terms that run for as long as eight years. While long-term loans translate into lower monthly payments, they can cost you more in several other ways.

HIGHER INTEREST, MORE RISK

A longer loan means higher interest costs. That's because you're making payments for a longer period of time, and longer loans often have higher rates.

To find out how much more you might pay, the Money Lab calculated the difference between 48-month and 72-month loans on a $32,765 car, with a negotiated price of $30,520. As the table below shows, the longer loan will cost you about $1,600 more, assuming a 10 percent down payment. If you put 0 percent down, the difference climbs to more than $1,800.

And longer-term loans are more risky. That's because cars depreciate over time, with the quickest loss in the early months. So unless you make a substantial down payment or have a high-value trade-in, your new vehicle initially will lose value faster than you're paying for it.

Owing more than the car is worth is known as being upside down. At some point as you pay off the loan, you'll no longer be upside down and will begin building equity in the vehicle. But the longer the loan, the longer it takes for that to happen. If you decide to trade in the car during that upside-down period, you'll probably get less than what you still owe on the loan. And the vehicle's depreciated value is typically the maximum amount your insurer will pay you if your car is seriously damaged or stolen. If you're within the upside-down period, that amount won't be enough to pay off the remaining loan balance.

As the graph on the facing page shows, the upside-down period on a 72-month loan with no down payment lasts until about the 30th payment, based on our $30,520 purchase price, current loan rates, and average depreciation. For a 48-month loan, the upside-down period lasts only about a year.

THE CATCH WITH LEASES

Another way people lower their monthly payments is by leasing. But if you think that makes leasing less costly, think again. The first thing you should understand about leases is that whether you acquire the vehicle with a loan or a lease, you're borrowing the entire value of the vehicle, minus any down payment or trade-in. And you'll be charged monthly interest on that amount reduced by what you pay back along the way. There's the rub.

With leasing, instead of paying off the entire car, your payments are based only on the projected depreciation. That's because, unlike with a loan, you're not building equity in the vehicle, which you must return when the lease is over.

So over a 48-month lease, for our example, instead of paying off the entire net cost of the vehicle, you'd pay back only about half, which results in much lower monthly payments. And because you'd be paying back less, that leaves a greater amount subject to a finance charge month after month. It's true that you'll lay out much less cash, but with a loan you get to keep the car. And if you take into account its value, the loan typically ends up costing less.

The biggest saving grace for leasing is the sales-tax break you get in most states compared with buying the car. In most states, leasing customers pay tax on the monthly payment instead of on the entire cost of the vehicle. But some of

Comparing car loans

This chart compares the cost of various loans for a car with a negotiated price of $30,520. Assuming a 10 percent down payment, you'd pay a total of $1,637 more for a 72-month loan than you would with a 48-month loan. Putting 0 percent down adds even more to the cost of the 72-month loan.

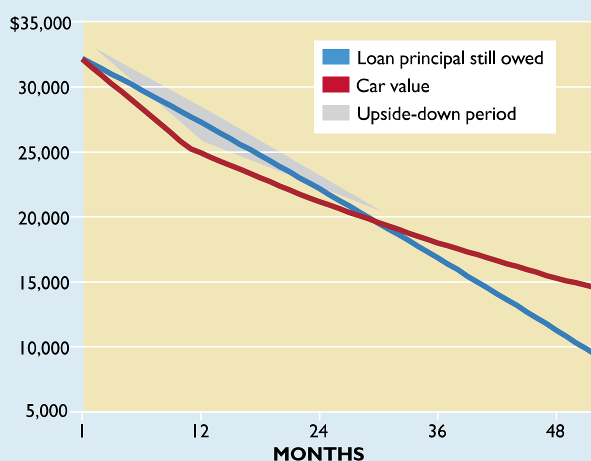
Loan (months)	Down payment	Interest rate	Monthly payment	Total cost
72	10%	3.99%	$462	$36,339
48	10	3.39	659	34,702
			Difference	$1,637
72	0%	3.99%	$510	$36,724
48	0	3.39	727	34,918
			Difference	$1,806

Based on loan rates from CapitalOne.com in mid-October 2012. Assumes 6.85% sales tax.

that benefit is offset because, unlike with a loan, the finance charges are taxed as well. In Illinois and some other states, lessees must pay sales tax on the full vehicle cost, just as if they had made a purchase. But only in a period of very low interest rates would the tax savings under a lease offset the higher finance charges. That almost happens in the example in the chart below. But even in that case, once you factor in a $500 lease-acquisition fee, the lease ends up costing more. And any disposition fee would drive the cost higher.

How long are you upside down?

This chart shows about how long you'd be upside down on a 72-month loan with no down payment for a car with a negotiated price of $30,520. You'd owe more than the car is worth until around the 30th month of the loan. In contrast, with a 48-month loan, you'd begin building equity in the vehicle by around the end of the first year.



PERPETUAL PAYMENTS

One of the worst things about leasing is that it could start you on a cycle of having to get a new car every few years, leaving you constantly paying depreciation when it's at its highest. And because it's difficult to compare the cost of leasing with buying, you won't even realize how much extra you're paying. Lease again and again, and those extra costs add up.

Auto dealers love it when your attention is focused on the monthly payment. That's because you're less likely to be thinking about the total cost of the vehicle. By manipulating the length of the loan, the dealer can overcharge you for the vehicle, add hundreds or even thousands of dollars in extras—such as undercoating and a service contract—and still give you the low monthly payment you crave. Never mind that you'd be paying much more overall than you would have if you'd negotiated a fair price and rejected all those unnecessary add-ons.

Another concern is that long-term loans can leave you with a perpetual car payment. By the time you pay off the vehicle, you may well be ready for the next one. That, along with a mortgage, student loan, or other long-term financial commitment makes life complicated if you lose your job or get sick, or if any other calamity affects your finances. It only gets worse if you're upside-down on the loan.

WHAT TO DO

When dickering over a new car, concentrate on the vehicle price, not the monthly payment. And don't let the dealer sneak any add-ons into the contract. Concentrating on the price not only saves you money but shortens the upside-down period, since a lower price means having to borrow less to start with.

One way to make sure you won't get distracted by monthly payments or anything else is to find out how much car you can afford before going to a dealership. You can do that by using an online loan calculator, such as the one you'll find at Bankrate.com. (Click on "Calculators" at the top of the page.)

To use the Bankrate calculator, you must have the following information:

▶ **Amount borrowed.** Figure out how much cash you can put down and, if you have one, the value of your trade-in. Of course, the larger your down payment, the better off you'll be. You can research car prices and trade-in values in the Consumer Reports annual car issue each April and by going to such websites as ConsumerReports.org, Edmunds.com, and KBB.com.

▶ **Current loan rates.** You can get current loan rates at Bankrate.com or by going to the websites of banks and credit unions or online banks such as Ally. The best rates are reserved for those with good credit scores. If you're in doubt about yours, try prequalifying for a loan by contacting one or more lenders.

▶ **Loan term.** You might want to try entering different terms and variables into the auto-loan calculator you're using to find out what the monthly payments will be and whether they fit into your budget. If you can't afford to buy the vehicle without taking out a loan that's longer than 48 months, you probably should consider purchasing a less expensive model. (Even if you're able to swing a 48-month loan, you might still be stuck paying off the vehicle after its bumper-to-bumper warranty has expired.)

Of course, paying cash is best. You'll eliminate the risk of being upside-down and you'll save the financing costs. If you're financially strapped or just budget-conscious, avoid leasing. It's typically the most expensive way to acquire a car. $

Leasing vs. buying

This chart compares a 48-month lease with a 48-month loan. It's based on a new vehicle with a negotiated price of $30,520 and average depreciation. It assumes you put 10 percent down and pay a $500 lease-acquisition fee. It doesn't include an end-of-lease disposition fee, which could add hundreds more to the cost of the lease.

Cost variables	Loan	Lease
Monthly payment	$659	$348
Total cost	$34,702	$19,767
Retained value of vehicle	$15,494	$0
Net cost	$19,208	$19,767
	Difference	$559