Building Your Future

Chapter 3: Auto Loans

Did You Know….

According to the Department of Labor's Bureau of Labor Statistics, the annual cost of car ownership and operation is 17% of the average household's expenditures, ranking second only to the cost of housing.

Key Terms:

- Trade-in value
- Book value
- Incentives
- Lease
- Purchase

What You'll Learn

There are many factors to consider when purchasing a car. Given the potentially significant costs, it is important to consider a wide range of factors when selecting a vehicle and determining how you'll pay for it. By learning about concepts such as trade-in and book value and knowing how to analyze dealer incentives, you'll be able to determine whether leasing or purchasing is the more sensible, cost-efficient method of obtaining a car.

Car Buying Basics

When it comes to buying a car, most people don't have enough money on hand to pay cash for the vehicle they want. Since this is a major purchase, you should look for ways to save money while still obtaining the car that best meets your needs. When purchasing a car, there are some terms that you should understand in order to get the most for your money and select the financing that is most cost-effective.

Many car buyers have a used car they want to trade in to the dealer for the new car they wish to purchase. While the used car is not worth as much as it was when it was new, it still has some value. Many times the **trade-in value** of a used car is called the **book value**. Pricing information can be found through various sources, such as guides like the Kelley Blue Book (www.kbb.com) or

trade-in value
amount the dealer gives you for the car you're providing as partial payment for the car you wish to purchase

book value
how much a particular car is worth based on its condition, mileage and other factors

Career Link

Car owners are required to carry liability insurance; this insurance is an important factor in determining a vehicle's overall operating cost. In addition, many lenders require collision and comprehensive insurance coverage as a condition of receiving a loan to purchase a car. Actuaries develop car insurance pricing plans to help encourage careful driving. They determine how to adjust car insurance prices to reflect various kinds of risk factors.

services such as Edmunds (www.edmunds.com). These and other similar resources offer a starting point for determining book value.

incentives
factors such as special finance rates, rebates or other offers designed to encourage buyers to purchase a vehicle

New car dealers sometimes offer **incentives** to encourage people to buy. Incentives can include discounts, credits, reduced interest rates or reduced down payment requirements, and should be compared by the buyer to determine which one will save him/her the most money on the vehicle.

Try It!

Examples and Practice

Suppose you are buying a new car. The dealer's price on the car is $20,000. The trade-in value on your four-year-old used car is $7,000. You have $1,000 cash to use as a down payment. In addition, there are special incentives being offered by the manufacturer. You can select either 1.9% financing over the course of the loan, which is 48 months, or you can elect to receive a rebate of $4,500 cash back on the vehicle, applied to the amount due at purchase. If you choose the cash back offer, you can take a loan from your bank, which has quoted you a rate of 6.5% on a 48-month loan. Whichever option you select, you will still need to get a loan to pay for the vehicle.

Create a spreadsheet like the one below and use it to determine the total cost of the car under both incentive scenarios. (If you have completed the chapter on buying a home, you'll notice this spreadsheet looks exactly like the one created for a home loan.) When computing the interest portion (Column E) of your monthly loan payment, remember to multiply the previous month's ending loan balance (Column H) by the loan interest rate (Column B) and divide by 12 since these are monthly calculations.

Answer these questions:

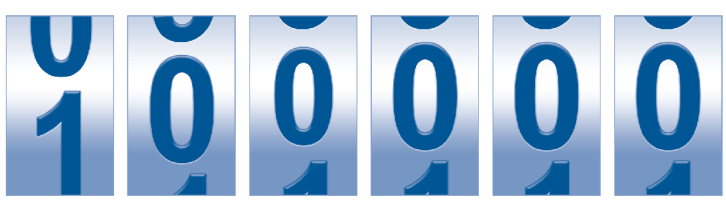
- *Calculate your total cost of the car after your down payment and trade-in. This is the amount for which you'll need a loan under either scenario.*
- *What is the total cost of the car for each incentive scenario?*
- *According to your calculations, which incentive is more economical—the low interest rate or the cash rebate? Why? Explain.*

	A	B	C	D	E	F	G	H
1	**Month**	**Loan Interest Rate**	**Loan Payment**	**Principal**	**Interest**	**Principal + Interest**	**Cumulative Interest**	**Loan Balance**
2	1	1.9%	$259.82	$240.82	$19.00	$259.82	$19.00	$11,759.18
3	2	1.9%	$259.82	$241.20	$18.62	$259.82	$37.62	$11,517.98
4	3	1.9%	$259.82	$241.58	$18.24	$259.82	$55.86	$11,276.40
5	4	1.9%	$259.82	$241.96	$17.85	$259.82	$73.71	$11,034.44

New vs. Pre-Owned

When buying a car, one of the first decisions you must make is whether to purchase a new car or a pre-owned (used) vehicle. There are advantages to each. New cars offer the latest in technology, features and design and typically have a warranty; however, they also cost more, and typically lose some of their value as soon as they leave the lot. A used car is generally less expensive, but it may lack certain features you are seeking; it may not be in the best shape; and it may have high mileage, limited items covered by warranty, and a history of repairs or problems. When considering whether to purchase a new or used car, you must consider all of these things along with what you can comfortably afford.

And don't forget about the "hidden" costs of car ownership. Paying for the car is only part of the cost: you must also keep in mind that you will need to pay insurance premiums, maintenance costs, repair costs, the cost of gasoline, and taxes and licensing fees. These expenses can add up to thousands of dollars each year, so you should include them in your calculations when deciding what you can realistically afford.



lease
paying only a portion of the vehicle's sales price and returning it to the dealer at the end of the specified time

purchase
paying the car's full price and keeping it as long as you want

Leasing vs. Purchasing

If you've decided that it's time for a new car, you'll also need to decide whether you want to **lease** the car or **purchase** it. There are several differences between the two in areas such as ownership, maintenance, payments, and more; the chart below presents the pros and cons of each option.

Lease vs. Purchase: Pros and Cons

LEASE		PURCHASE	
Pros	*Cons*	*Pros*	*Cons*
• *Usually little or no down payment required* • *Fewer up-front, out-of-pocket fees (ex: sales tax)* • *Lower monthly payments* • *New car every few years* • *No chance of being "upside down," or owing more on the car loan than the car is worth* • *Allows you to have a more expensive car* • *Some dealers will cover regular maintenance* • *Tax advantages if used for a business*	• *You always have a car payment* • *You never own the car* • *Mileage restrictions (usually 12,000-15,000 per year) and fees for overages (usually 15-25 cents per mile)* • *Higher insurance coverage costs* • *Charges for excess wear and tear* • *Higher credit score requirements* • *Depending on your state, you must be at least 18 to lease a car*	• *You own the car after you make all the payments (usually 48-60 payments)* • *Can own the car for as long as you want* • *Can drive as many miles as you want* • *Insurance costs are usually lower*	• *Down payment required* • *Up-front, out-of-pocket costs (ex.: sales tax)* • *Higher monthly payments* • *Can end up "upside down," or owing more on the car loan than the car is worth* • *Loan limits for the price of the vehicle (usually not more than $30,000 allowed)* • *Have to pay for vehicle maintenance*

Try It!

Examples and Practice

Use the data from the **Auto Loans: Lease vs. Purchase Worksheet** provided by your teacher to answer the questions below.

- *Based on your data from the worksheet, do you think you would prefer to purchase or lease a vehicle? Why?*
- *What type of person is better suited to leasing than to buying? What kind of lifestyle do they have, what kind of work might they do, and what are their financial goals? What about people who are better suited to buying?*

Independent Practice

You want to purchase your first car. You can either buy a new car or a pre-owned, low-mileage car. Using the data on the **Independent Practice Worksheet** provided by your teacher, determine which car you will select. Be prepared to share your decision and the process you used for making it.