Auto Loans

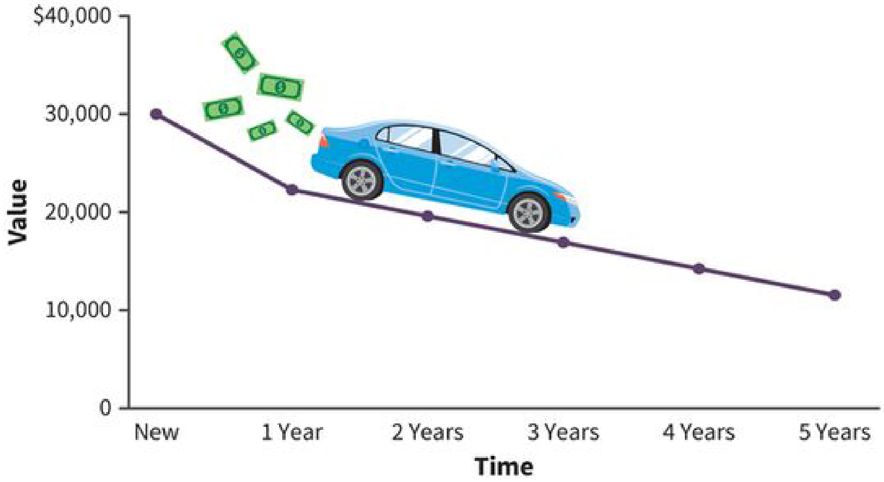
by Sophia

WHAT'S COVERED

In this lesson, you will examine a vehicle-acquisition strategy that relies on an auto loan. You will learn how a vehicle can make you more productive and how strong agility and technology skills can help ensure you have access to one that is best for you. Specifically, this lesson will cover:

1. The Value of an Automobile

Many people rely on an automobile to get to school and work and thereby maximize their employment opportunities. The problem is that automobiles tend to decrease in **value** (the combination of the price paid and the quality of the item purchased) over time. This is called **depreciation**. Eventually, use assets, such as automobiles, will no longer work well and will need to be replaced. The following line graph shows how quickly cars depreciate in value over time (note that a similar pattern of depreciation would occur for vehicles costing more or less than $30,000).



The benefit of a reliable automobile is particularly high in communities that lack sufficient public transportation. In addition to better job opportunities, owning a car might also help to reduce other costs. For example, you may be able to commute to less expensive housing, shop at lower cost stores, and avoid paying for other transportation costs. These savings can be substantial and may make a vehicle a financially beneficial purchase.

Productivity: Why Employers Care

Employers want and need their employees to arrive on time. Less time at work and the stress of running late can lead to a decrease in productivity. An individual who cannot contribute fully at work will have a harder time finding and maintaining employment.

TERMS TO KNOW

Value
The combination of the price paid and the quality of the item purchased.

Depreciation
A term used to describe the decline in value of a used asset.

2. Steps in Purchasing an Automobile

The illustration below highlights the steps you should take when deciding to purchase a vehicle. The process shown here can be used when purchasing either a new or used vehicle.

2a. Determining Transportation Needs

Let's review these steps in a bit more detail. The first step is to determine your transportation needs. Questions to ask include: Why do you need a car? How far will you be driving each week? Will you be carrying additional people, tools, or other equipment? If you have children or plan to have children in the next two to three years, what would be the safest and easiest-to-use vehicle? Your answers to these questions will help identify what, if any, type of vehicle is needed.

2b. Deciding What You Can Afford

When determining how much you can afford (Step 2), you have a few options:

- Withdraw the money directly from savings and pay cash for the car.
- Use a combination of cash for a down payment and borrow the remainder with a loan.
- Borrow the entire purchase price of the car with a loan.

The table below can be used to help organize the information needed at this step in the process.

KEY CONCEPT

The total available amount for a car payment each month is your excess cash flow minus the costs of ownership.

Excess monthly cash flow available for vehicle payment and maintenance	$
Less: Gas	–$
Less: Insurance	–$
Less: Maintenance	–$
Less: Repairs	–$
Amount remaining for automobile loan payment	$
Plus: Income earned from vehicle ownership	+$
Maximum amount that can be allocated for payment	$

Using the previous table as a guide, assume that Stefanie knows that she has $400 in excess cash flow available per month. She is thinking that a two-year-old Honda Civic would be an ideal car to own.

- After doing some calculations, she determines the following monthly car ownership expenses: $50 for gas, $75 for insurance, $20 for maintenance, and $25 for repairs.

HINT

Some states also charge personal property taxes on vehicles so be sure you know your state's laws.

- She doesn't anticipate any additional income from owning the car.
- The amount that Stefanie can spend on a monthly car payment is $230, as shown in the following table.

Table: Stefanie's Affordability Calculation

Excess monthly cash flow available for vehicle payment and maintenance	$400

Less: Gas	−$50
Less: Insurance	−$75
Less: Maintenance	−$20
Less: Repairs	−$25
Amount remaining for automobile loan payment	$230
Plus: Income earned from vehicle ownership	+$0
Maximum amount that can be allocated for payment	$230

Agility: Skill in Action

Consider if you needed a car like Stefanie. You found your dream car but the monthly payment is more than you can afford. How could strong agility skills help you make some changes to your other monthly expenses so you could afford the higher payment?

2c. Shopping for an Automobile Loan

Step 3 is to shop for a loan (see Hint). You should limit your loan shopping to a two-week period so that the impact of multiple credit inquiries made during this time will be minimized.

HINT

Before you contact any lenders, make sure that you have reviewed your credit report for any errors that could potentially drag your credit score down. Remember, an inaccurate report can cause you to pay more in interest or disqualify you from obtaining a loan.

- Every time car dealers run a credit report on you (they often do this before allowing you to take a test drive), an inquiry will show up on your credit report.
- Not only will dealers know where you have been shopping, they'll know if you are actually qualified to buy.

Because you know the maximum payment that you can afford each month (Step 2), two other variables will determine the loan amount that you qualify for:

1. The interest rate.
2. The loan term or repayment period.

Assuming the monthly payment amount is fixed based on your budget, two rules then apply when searching for an auto loan. First, the lower the interest rate, the more you can borrow (or the higher the interest rate, the less you can borrow). Second, the longer the loan term, the more you can borrow. But remember – you will also pay more interest. **The key variable to negotiate in an auto loan is the lowest interest rate possible.**

- You should obtain at least three loan offers from different banks and credit unions before going to a dealer.

- You'll need to submit to a credit check at each bank or credit union because that is the only way to know exactly what interest rate they will charge.
- By doing this, you can get preapproved for a loan and find out the specific loan amount and terms for your car purchase.

2d. Researching and Identifying the Best Vehicle

Once you're preapproved for a loan, you'll know the price range of vehicles that are appropriate for purchase. You can then move to Step 4, researching and identifying the best vehicle models. You can find information about used vehicles' reliability and repair histories online (see Hint). You can also obtain ratings of fuel efficiency, cost to insure, and likely repair issues. Doing research will help you identify specific vehicles to look for in your local market.

Strong technology skills can ensure you can easily access and review the important vehicle information above. Your skills can also help you look at key factors like pricing at different dealers, special finance deals, and warranties.

HINT

There are many useful online research tools to help you find the best vehicle to meet your needs. Here is a list of just a few:

- Consumer Reports performs independent testing and ratings of new vehicles. You can access ratings online with a subscription or for free through most local library portals.
- The Insurance Institute for Highway Safety (IIHS) and National Highway Traffic Safety Administration (NHTSA) perform crash testing and other safety assessments. Access free safety ratings for most new and used vehicles on their websites.
- Carfax and AutoCheck provide vehicle history reports, which include information on major accidents, recalls, title information, ownership data, and more.
- Other sources for research on car ratings and reliability include J.D. Power, Edmunds.com, and Kelley Blue Book.

2e. Obtaining Insurance

Once you have identified specific vehicles (year made, manufacturer, and model), you can complete Step 5 of the purchasing process by contacting your insurance company to find out what it will cost to insure your potential new ride. Your credit score can also impact the cost of your insurance, with higher credit scores resulting in lower insurance costs. Automobile insurance is discussed in greater detail in a later lesson.

WATCH

Are you into saving money? Automobile insurance companies offer you several ways to lower your insurance premiums. Check out this useful video tip for obtaining lower cost auto insurance.

2f. Negotiating the Price

Step 6 involves locating your car and negotiating a price.

- Yes, you can negotiate! The seller needs to sell the car more than you need to buy it.
- Be sure to make your search area as large as possible so that you can find the best options.
- Auto dealerships can be good places to look for used cars.
- The best values generally come from private sellers advertising in online classified services or through the local newspaper or national classified companies.

3. Buying Versus Leasing

Although many personal finance experts recommend purchasing a used car rather than a new car, you also have the option of leasing a vehicle.

- A **lease** is a financial agreement between you and the dealership where you agree to pay a certain price for the right to drive the car for a set period of time.
- Car leases typically last around three years.
- Nearly all leases limit the miles that can be driven yearly to about 12,000.
- At the beginning of the lease, there are lease inception fees, which include title fees, acquisition fees, security deposits, and other fees.
- At the end of the lease, you may purchase the car and pay a purchase fee, or you may return the car to the dealership and pay a disposition fee.

Lease payments are much lower than loan payments, and you get to drive a new car every few years. However, with a lease, at the end of the lease period, you have not accumulated any equity in the car and you don't own anything.
Equity is the value of the asset less any debt associated with that asset. When you buy a new or used car, after making payments for three years you will have built up considerable equity in the vehicle and own a valuable (albeit depreciating) asset.

TERM TO KNOW

Lease
A financial agreement between you and the dealership where you agree to pay a certain price for the right to drive the car for a set period of time.

Equity
The value of the asset less any debt associated with that asset.

SUMMARY

In this lesson, you learned there are many factors that go into **the value of an automobile**, whether you're **buying or leasing** a new or used vehicle. If you decide to **purchase an automobile**, there are a number of **steps** that you should follow:

1. **Determine your transportation needs**. How far will you be driving? Do you need to carry equipment or passengers? Do you need a car to get to work? Without it, can you be a productive employee?
2. **Decide what you can afford.** Identify excess cash flow and subtract your cost of auto ownership. Will you need to use your agility skills to adjust your budget?
3. **Shop for an auto loan**. If you plan on borrowing, search for low interest rates and know the loan repayment period.
4. **Research and identify the best vehicle**. Use your technology skills to check popular online research sources for new or used cars.
5. **Obtain insurance**. Determine the cost to insure your new ride.
6. **Negotiate the price**. Remember, the seller needs to sell the car more than you need to buy it!

TERMS TO KNOW

Depreciation
A term used to describe the decline in value of a used asset.

Equity
The value of the asset less any debt associated with that asset.

Lease
A financial agreement between you and the dealership where you agree to pay a certain price for the right to drive the car for a set period of time.

Value
The combination of the price paid and the quality of the item purchased.