Financing Your Car Purchase

Financing a car purchase involves two concepts you should understand completely – the interest rate and the term of the loan.

Once you've determined the car or truck that will meet your transportation needs while offering the lowest fuel, maintenance, repair, and depreciation costs, the final factor to consider is financing. In an ideal world, you would be able to purchase the car with cash and completely eliminate financing costs. If that's not an option, you're added financing cost is driven by the *interest rate* of your loan and the *term* of your loan.

Interest Rate

Obviously, lower interest rate loans are less expensive than higher interest rates loans, but what interest rate should you pay? Interest rates are determined by a variety of factors, including your credit rating and choice of lender. While many car dealerships offer car financing, dealerships tend to offer significantly higher interest-rate loans than banks or credit unions. One strategy car dealers follow is to ask what you would like your monthly payment to be, and then they simply lengthen the term of the loan to meet your payment goal while keeping the overall cost of the car high (and charging you thousands in additional interest).

It is best to obtain financing approval from a bank or credit union *before* shopping for your car. That way, you can concentrate on getting the best price for the car without the confusion of financing. You'll have a budget and monthly payment already established, putting you in a better negotiating position.

When shopping for a loan, get a few competing quotes on a car loan – interest rates can vary considerably between financial institutions. If you have little credit history or a history of credit problems, you may be able to receive a lower interest rate if you have a cosigner on the loan. A cosigner is a person with established credit who would be responsible for making the car payment if you did not.

Term of the Loan

An often overlooked factor is the term (or length) of the loan. Car loans are generally between three and six years in length – the shorter the term of financing, the lower the overall financing cost. For example, if you are financing $15,000 of a car purchase at 15% interest over three years, your total interest expense would be $3,719 over the life of the loan. Financing the same purchase at the same interest rate over six years would yield an interest expense of $7,836 – more than

twice as much. So why would anyone ever choose the more expensive option? Cash flow - the monthly payment of the three year loan is $520. The monthly payment of the longer term loan is $317. So in order to save that $4,117 in financing charges, you would have to pay an additional $203 per month. Even though the overall costs are higher, financing for a longer period lets you "afford" a more expensive car.

Plan B

Let's look at the purchase from another perspective, the perspective most people consider when making a major purchase – what you can buy for a maximum monthly payment. In the example above, the payment under the shorter-term loan was over $500 per month.

But what if you could only afford the $317 payment? You have a couple of options – you could choose to pay more in interest and finance over a longer term or you could finance a less expensive car over a shorter term. A three year loan with a $317 monthly payment limit would cover a debt of $9,000 with a total interest expense of $2,231. Whether you could find a suitable vehicle for $9,000 is a decision only you can make. But choosing to finance the lower amount over a shorter term would <u>save over $5,500 in interest charges</u> compared with the higher price financed over a longer term – but with the exact same monthly payment. You would also save in sales taxes and depreciation, though your repair costs may be higher.

Finally, another concept to understand is the "upside down" loan, when you owe more on your car than it's worth. This undesirable situation is much more likely with a longer-term loan, effectively meaning that you would have to pay your lender in order to sell the car.

You total car expense (payment plus fuel, insurance, and maintenance) should be no more than 15-20% of your take home pay, and ideally even less.

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