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Focus on FINANCE

Cars and Cash: What To Know Before You Go

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"If you think nobody cares if you're alive, try missing a couple of car payments."
—Earl Wilson

Depending on where you live, it may not be necessary to have a car; but obtaining a driver's license, and eventually your own car, is a rite of passage for many young people. The freedom and responsibility that come with having your "own wheels" marks a transition into adulthood. Owning a car may make you less dependent on others for transportation and give you greater flexibility with your schedule; but, as the Earl Wilson quote suggests, if you owe money on your car, then the car dealer, bank, or credit union that gave you the loan will hold you responsible for paying it back. In this essay, we'll examine some aspects of financial preparedness. Financial preparedness, including understanding the importance of establishing credit, will help you make good decisions when shopping for and financing a vehicle.

Financial Preparedness

It's vital to have your finances in order before purchasing a car. If you can't afford car payments, insurance, maintenance and repairs, fuel, and other expenses, then it's best not to buy one. How will you know if you can afford to buy and own a car? Using a budget is a great way to start. A budget can help you track your monthly income and expenses so you'll know how much you can spend on transportation. You want to own the car, not the other way around. This sounds simple, but people (such as car dealers) frequently attempt to make car buying an emotional decision. If you fall in love with a car, you are likely to spend more than you planned. While it may feel good to buy your own vehicle and drive it off the lot, car buying is ultimately a business transaction. Being in a state of financial stress because you've spent too much and can't afford or even enjoy the vehicle is not worth it. Using a budget can help minimize the chance of finding yourself in this predicament.

In addition to your budget, you may want to consider using an affordability calculator to determine a car price that is managable for you.[1] Of course,

GLOSSARY

Contract: An exchange, promise, or agreement between two parties that is enforceable by law. For example, a car buyer agrees to pay the amount financed at an agreed-upon interest rate for the length of the contract.

Co-signer: A joint, or secondary, borrower. Another repayment source, the co-signer is legally bound to pay the debt if the primary borrower does not. If a primary borrower has minimal or marginal credit, a co-signer may help the borrower obtain a larger loan or more favorable loan terms than the borrower would on his or her own.

Credit report: A loan and bill payment history kept by a credit bureau and used by financial institutions and other potential creditors to determine the likelihood that an individual will repay any new loan.

Interest: The price of using someone else's money. When people place their money in a bank, the bank uses the money to make loans to others. In return, the bank often pays interest to the account holder. Those who borrow from banks or other organizations pay interest for the use of the money borrowed.

Interest rate: The percentage of the amount of a loan that is charged for a loan. Also, the percentage paid on a savings account. The interest rate is used to calculate the amount of interest paid on a loan.

Opportunity cost: The value of the next-best alternative when a decision is made; it's what is given up.

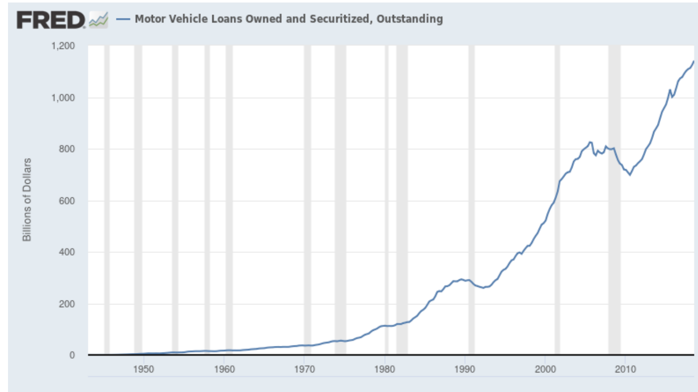
Repossess: To retake possession of something when the buyer fails to make payments.

what you can afford depends on a number of factors, including your income, the cost of insurance and other outlays associated with ownership, and, frankly, how important a car is to you. These considerations are about **opportunity cost**. Depending on what a person has to give up, having a car may not be worth it. Some people adjust their budgets in certain areas to afford a nicer vehicle, while others adjust their car budget to afford nicer or additional items. Some financial experts suggest keeping your car budget at around 20 percent of your annual income—a somewhat arbitrary and flexible amount. If you make $25,000 per year, for example, you might spend about $5,000 for a car. As far as cars go (pun intended), a price of $5,000 is not a lot of money, but it could keep your transportation expenses a relatively small part of your budget. Obviously, there are many variables in a budget, such as whether you live at home, live with a roommate, or pay for other expenses like food and utilities; but again, having and using an accurate, updated budget is the best way to know if you can afford a car.

Financing Basics

There's a lot to learn and understand in using credit wisely. A general understanding of credit terminology will help you get ready to take the leap, as will an understanding of some basics of using credit to buy a car. If you need to borrow money to get a car, you'll first have to establish credit history or borrow with a **co-signer** who has a credit history. Paying bills on time helps establish good credit history, which will qualify you for a loan. You can start building credit by taking a small loan with a bank, having a line of credit attached to a checking account, or using a credit card from a favorite store. If you pay bills on time and in full every month, you'll have positive items of record on your **credit report** and a better chance at getting a car loan. If saving money for a car, you may be able to buy one without a loan, which would keep your monthly expenses down. If it's necessary for you to borrow money, saving for a down payment can reduce the amount you finance—that is, the principal. The more you put down, the smaller the principal and the lower the payment. Borrowing money will cost you. Lenders charge **interest** for the use of money. With little credit history, you may have to pay a higher **interest rate**, too, because the lender is taking a risk you won't

Figure 1
Motor Vehicle Loans Owned and Securitized, Outstanding



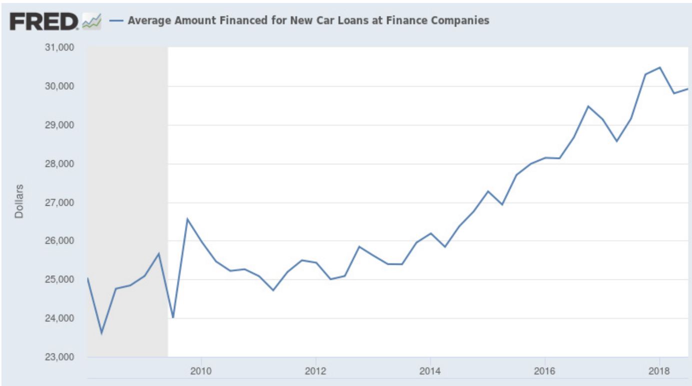
SOURCE: FRED®, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MVLOAS, accessed December 21, 2018.

be able to pay back the loan. Sometimes, banks and other lending institutions require an additional person to guarantee, or co-sign, your loan, in the event you can't make the payments. This person takes on the risk that if you stop paying, he or she is responsible for fulfilling the terms of the purchase **contract**. Asking a person to co-sign a loan means sharing a serious financial obligation, so you should discuss it thoroughly. There is potential for personal relationships to suffer if something goes wrong with the loan. In the case of car loans, the car itself is collateral. If you stop making payments, the lender may **repossess** the vehicle, which is something to avoid.

You don't have to finance a car; but if you do, you're not alone. As Figure 1 shows, the trend is for auto loan balances to increase over time, with some exceptions during recessions. People now owe more than $1.1 trillion dollars in car loans.[2]

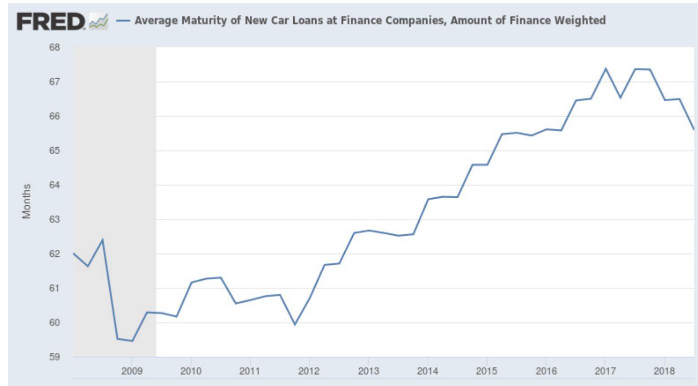
It's increasingly common for people to finance their vehicle by making monthly payments: About 85 percent finance new cars, and about 53 percent finance used cars.[3] Many people rely on cars for transportation for almost everything they do, including work and school. Remember, though, that while cars get people to work and school, they cost money to operate and maintain. And vehicles, especially new ones, are expensive purchases. While necessary for many people, cars almost never appreciate—that is, almost never go up in value. Almost all car manufacturers have a financial arm, called a finance company, providing loans to dealerships for the

Figure 2
Average Amount Financed for New Car Loans at Finance Companies



SOURCE: FRED®, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/graph/?g=mt9M, accessed December 21, 2018.

Figure 3
Average Maturity of New Car Loans at Finance Companies, Amount of Finance Weighted



SOURCE: FRED®, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/graph/?g=mta9, accessed December 21, 2018.

vehicles they purchase and loans to consumers for the same reason. Consumers often use financing through these companies when purchasing a new car. We'll learn more about obtaining financing in the next section. For now, look at the FRED® graph in Figure 2, which shows the average amount of a new car loan at finance companies. You can see the average was nearly $30,000 in September 2018.

Some banks and finance companies offer excellent deals, but let's put a $30,000 car loan into perspective: Even at 0 percent interest for 60 months, the payment would be $500 per month for five years. A car loan can be a large portion of one's budget for a long time. In fact, the term length on auto loans—that is, the length of time someone takes to pay back an auto loan—continues to rise along with the amount borrowed. Figure 3 shows that this upward trend reaches averages of over 67 months in three quarters. A loan continues if you sell the car, and, unfortunately, even a total loss in an accident won't end a loan.

With such a large dollar amount and long-term commitment, it's important to be financially prepared and to choose a vehicle wisely. There are costs and benefits to buying new or used vehicles. For example, some people buy used cars because they cost less than new ones, but there may be more risk in having to repair a used vehicle. Wanting to avoid potential mechanical problems they have to fix, other people prefer to buy new vehicles.

With a new car, the manufacturer's warranty will be in place for a longer period should trouble arise. On the other hand, brand new cars are more expensive and depreciate, or lose value, very quickly in the first year or two. Depreciation makes it difficult to sell the car for as much as you paid for it or owe on it. People use the phrase "upside down on the loan" to describe the condition in which the amount you owe on your loan is more than the current value of the vehicle. This applies to car shopping because many people trade in cars for new or newer cars while they still owe money on their current one: It means combining the debt from the current car with the new debt from the new car. It's important to be aware of this when car shopping because you will pay interest on anything added into a loan.

If you want to take a loan for a car, it's a good idea to seek financing before you go car shopping. When you research financing ahead of car shopping, you can be in a position to negotiate a better deal when trying to get a loan. For example, you can complete a preliminary application at a bank, credit union, or other trustworthy financial institution and be pre-qualified to spend a certain amount with a fixed term and a set interest rate. Knowing this information, the dealership may be more willing to work with its own finance company, or other banks, to get you an even lower rate. Keep in mind, car salespeople ultimately want you to buy a vehicle and will work to make that happen. There are also many other things to keep in mind as you shop, negotiate the price, and finance a car. The following points are worth considering, but they do not make an exhaustive summary, so it's important to do more research.

Car Shopping

There's a saying that you should never ask a barber if you need a haircut. Buying a car can be similar. Remember, just as you are trying to get a great deal on a car, car dealers want to make as much profit as they can. Salespeople are professionals and know the ins and outs of the car business. It's beneficial for consumers to become somewhat familiar with the process, too. Imagine what would happen if you went to a car dealership with no idea what type of vehicle you want, no idea of the price you can afford, and no financing arranged. Do you think the dealership would be able to help you pick out a car? Absolutely, but you may drive away with a sinking feeling while thinking to yourself, "What did I just get myself into?" Buying a car will go more smoothly if you already know what you're looking for in a vehicle. You can decide this long before you go car shopping. Narrow down your search for cars by deciding which basic features you want, the price range that fits your budget, details such as fuel mileage, and, if you're buying a used one, the number of miles on the car. Generally, the more miles are put on a car, the more it loses value. The more features a car has, the more you can expect to pay. Sunroofs, leather interior, heated seats, and premium stereo equipment increase the price you'll pay for the vehicle. The features also affect the insurance cost. Once you've narrowed your search, and before shopping for a car, avoid a potentially unpleasant surprise by finding out how much the insurance will cost. Keep in mind, if you have a car loan, nearly every lender will require comprehensive and collision coverage, which will also increase the total cost of insurance.

Where and When to Shop

Researching cars is relatively easy with the internet. A lot of information has become more readily available, including car prices. You can find price information from online auto auction sites and various dealerships' online inventories. Bear in mind that location can affect car prices, too. Some people elect to buy cars online to avoid or limit having to negotiate or haggle with a car dealer, but most people still buy cars in person. For consumers, access to information, particularly the ability to compare many dealerships' inventories, has made car buying more transparent. Prepared with valuable information, you'll be ready to start your search in person.

If circumstances allow, the more time you have and the sooner you begin to research and shop for cars the better. If you can be patient, you're more likely to get a better deal. This is because you'll be able to go to multiple dealers, look at different cars and prices, and allow yourself to leave and go somewhere else. In addition, dealerships usually have sales goals for the month, quarter, and year. As these end dates approach, you and the salesperson are more likely to have additional room to negotiate better deals because manufacturers pay dealers based on how much they sell in a given month or quarter. You may be able to negotiate more easily midweek, too, when there are fewer customers, than on the weekend when dealerships tend to be busier.[4]

Know the Numbers

Sometimes car dealers try to get customers to focus on a monthly payment amount rather than a car's price.[5] The car's price, the interest rate, and the length of a loan, called the term, all matter. Manipulating payment amounts is easy by adjusting the length of the loan. If you don't pre-qualify, the dealer may be able to "get you approved," making it sound like he or she is doing you a favor, but it's possibly at a higher interest rate. Sometimes finance managers lengthen the term of a loan to make it appear like an acceptable deal, but you could end up paying hundreds or even thousands more in interest over the life of the loan. If you are trading in a vehicle with a purchase, it is a good idea to find out the amount the dealer is willing to offer for your trade-in separate from the price of the car you're buying. Separating the trade-in from the price of the car you're buying allows you to see the numbers without having to filter out additional, sometimes confusing, information.[6]

Staying focused on your budget and knowing how much you're willing to spend will help you get the best deal possible. As you work toward finalizing a deal, the salesperson will likely offer things such as stereo upgrades, extended warranty options, and even premium floor mats. Remember, any "extras" the salesperson suggests and that you add into a loan will cost you more in interest, too. Buying an extended warranty, for example, typically adds a significant amount to a loan, as well as additional interest. It doesn't hurt to ask the salesperson to negotiate some extras outside of a loan at no charge to you. Sometimes, dealers can reduce certain fees, include new tires on a used car, or offer free oil changes or other extras. Do your homework, and the math, before buying anything extra. Get help comparing loan packages using online tools such as Bankrate[7] and Myautoloan,[8] among others. You can be ready to buy using these and previously mentioned tools and sources of information.

Conclusion

Owning a car can be a transition into adulthood and offer new freedom, but preparation, for both financing and shopping, is paramount. Developing a budget, including knowing how much you're willing to spend on a car and how much the insurance, fuel, and other expenses will cost, will give you a realistic financial picture before you go shopping and help prevent the experience from becoming an emotional decision. Establishing good credit will help you obtain a loan at a reasonable interest rate. A pre-approved loan from a bank or credit union, rather than the dealer, can give you negotiating leverage when you start shopping. Most dealerships will try to work with their own finance companies to earn your business. Buying a car can be simultaneously exciting and stressful, but being prepared financially and knowing what you want after gathering information at the beginning will put you in a better position to negotiate a deal and get you on the road. ■

Notes

[1] Cars.com. Car Affordability Calculator; https://www.cars.com/car-affordability-calculator/, accessed December 12, 2018.

[2] FRED®, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MVLOAS, accessed December 21, 2018.

[3] Zabritski, Melinda. "State of the Automotive Finance Market"; https://www.experian.com/content/dam/marketing/na/automotive/quarterly-webinars/q3-2018-safm-v2.pdf, accessed December 12, 2018.

[4] Vincent, John M. https://cars.usnews.com/cars-trucks/how-to-negotiate-the-best-price-on-a-new-car, accessed December 14, 2018.

[5] Vincent (see footnote 4).

[6] Vincent (see footnote 4).

[7] Bankrate.com. Auto Loan Calculator; https://www.bankrate.com/calculators/auto/auto-loan-calculator.aspx.

[8] Myautoloan.com; https://www.myautoloan.com/myautoloan-home.html.

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Federal Reserve Bank of St. Louis *Page One Economics*®:

"Cars and Cash: What To Know Before You Go"

After reading the article, answer the following questions:

1. What does it mean to finance a vehicle?
   a. Save up for it and pay for it in cash.
   b. Borrow money and make payments.
   c. Pay someone to use his or her car.
   d. Have money taken from your annual pay.

2. Which of the following statements about using a budget is true?
   a. A budget helps ensure car buying can be an emotional decision.
   b. A budget is not an effective way to track income and expenses compared with other ways.
   c. A budget can help you determine what amount you can afford to spend on an item.
   d. A budget is set and inflexible after planning for expenses such as cars, rent, food, and entertainment.

3. If you need to borrow money to get a car, which of the following will you have to establish first?
   a. Interest
   b. Principal
   c. Credit report
   d. Credit history

4. At what percentage of your income do some financial experts suggest keeping your car budget?
   a. 10 percent
   b. 20 percent
   c. 30 percent
   d. 40 percent

5. Which of the following statements is true?
   a. The less money you put down for a loan, the smaller the principal and the lower the monthly payment.
   b. The less money you put down for a loan, the larger the principal and the lower the monthly payment.
   c. The more money you put down for a loan, the larger the principal and the lower the monthly payment.
   d. The more money you put down for a loan, the smaller the principal and the lower the monthly payment.

6. What does a co-signer do?
   a. A co-signer works for a bank to ensure people have good credit.
   b. A co-signer is required to make the payments if a borrower stops making them.
   c. A co-signer lends a borrower the funds for a down payment.
   d. A co-signer repossesses a vehicle if a borrower stops making the payment.

7. Which of the following is a division of a car manufacturer that lends money for car purchases?
    a. Bank
    b. Co-signer
    c. Credit union
    d. Finance company

8. Which of the following statements is true?
    a. No specific times of the week, month, or year are better than any other times to shop for a car, because dealerships usually have enough salespeople.
    b. All car-buying information is available for consumers on the internet, including prices and options. There's no negotiation involved in car buying.
    c. If time permits, to help get a good deal, it's best to look at multiple car dealers, research different cars and prices, and allow yourself to leave a dealership for another one.
    d. These days, most customers buy cars online because they want to avoid having to negotiate and haggle with a car dealer in person.

9. Which of the following statements is true?
    a. It is important to focus on a monthly payment amount rather than a car's price.
    b. Manipulating a monthly payment amount is easy to do by adjusting the length of the loan.
    c. When you "pre-qualify" for a loan, you limit the financing options available from a car dealer.
    d. Look at a new vehicle's price, your trade-in value, and all the extra options together in one car loan package.

10. If you add anything into a loan, it will
    a. increase the principal and increase the total interest paid.
    b. increase the principal and decrease the total interest paid.
    c. decrease the total interest paid and lengthen the loan.
    d. decrease the total interest paid and shorten the loan.