

## Resources

- [Decision Centers](#)
- [Save Money](#)
- [Learn to Budget](#)
- [Manage Debt](#)
- [Find Deals Online](#)
- [Travel For Less](#)
- [Save on a Car](#)

## Article Index

## More Tools

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**Liz Pulliam Weston**

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[Article Index](#)

[Finance Q&A](#)

[Tools Index](#)

[Site Map](#)



## The Basics

### Do you owe more than your car is worth?

**Borrowers who are 'upside down' on their loans can face serious consequences if the car is stolen or totaled -- or if they try to trade it in. Here are 4 ways to avoid trouble.** advertisement

By [Liz Pulliam Weston](#)

If you bought a new car recently and didn't pay cash, chances are pretty good you're driving a vehicle you can't afford.

Most new-car buyers are "upside down" on their purchases, meaning they owe more than the cars are worth. And that puts them at significant financial risk.

Consider:

- Forty percent of new-car buyers have loans on their trade-ins that exceed the cars' value, according to Edmunds.com, with an average negative equity of \$2,220. Factor in the depreciation that happens the minute you drive a car off the lot, and it's safe to say a majority of new-auto buyers are upside down, says Edmunds.com Vice President Bob Kurilko.
- A whopping 84% of all new-car loans are for terms in excess of four years, according to Power Information Network, an affiliate of car research firm J.D. Power and Associates. That's up from 76% three years ago and a far cry from the 1980s, when a four-year loan was considered long. The lengthier the loan, the more time you need to "break even" so that you owe less than the car itself is worth, says David McKay, Power Information Network's director of automotive finance.
- Incentives on new cars are exacerbating the problem by driving down the price of old cars at a faster-than-usual clip. Every \$1,000 rebate on a 2003 vehicle trims \$500 to \$600 off the price of the year-old model and another \$300 to \$400 off the 2001 version, McKay says. By depressing values, these incentives make it even harder to get your head above water on your loan.

## Serious financial trouble

People who owe more than their cars are worth can find themselves in serious financial trouble if their vehicles are stolen or totaled. Insurance companies will send a check for their estimate of

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the cars' worth, typically a figure somewhere between the dealer trade-in value and what the vehicle would fetch in a private-party sale. That means you could find yourself without wheels and still owing thousands to your auto lender.

Those who lose their jobs can find themselves in a similar pickle. They may not be able to afford their payments, but they can't easily get rid of the car without trashing their credit.

You can protect yourself against these situations by buying specialized insurance, guaranteed auto protection, to cover yourself in case of theft or accident, and credit unemployment insurance to make the payments if you lose your job.

Being underwater on a car, though, is a symptom of a deeper problem: overspending.

Most people who buy more car than they can afford tend to focus only on the monthly payment, not realizing how much they're paying over the life of the loan:

- Finance a \$25,000 loan over three years and you'll pay a little over \$1,000 in interest, using the prevailing average rate of 2.68%.
- Stretch the loan to six years and the average rate shoots up to 7.99% -- and the total interest cost to \$6,551.

No idea of the real cost

Add to that the fact that few people who buy a new car have any idea how much it will cost them in insurance, gas, maintenance or repairs. What seemed affordable in the showroom quickly becomes an enormous financial burden.

"They get home, and they realize they can afford to buy a car," says Edmunds.com's Kurilko, "but they can't afford to buy dinner."

Financial planners typically advise against using borrowed money to buy anything that loses value. Since most people don't save enough to pay cash for their vehicles, planners typically recommend limiting debt with a 20% down payment and a loan for no more than three or four years.

Such constraints all but guarantee you won't spend much, if any, time underwater on your loan. But they also mean handling bigger payments and buying less expensive cars, which doesn't go over well with today's ready-to-overextend buyers.

"People graduate from college and they want the BMW 3 series," says Mary Butler, senior editor of Cars.com. "Starting salaries haven't risen that much, so something's got to give."

Being sensible about car debt doesn't mean you'll never have a decent vehicle. But you do need to be smarter about your car purchases. As McKay puts it, "If you can't afford to put more money down, then buy less car."

“We as Americans don’t like it,” he adds, “but sometimes you have to say no.”

That could mean stepping down to a less expensive new model, or taking advantage of a buyer’s market in used cars.

#### Falling older car prices

Those incentives I mentioned earlier, along with a huge number of former lease vehicles being returned to the market, have hammered prices on older cars. At the same time, used cars “are lasting long, and they’re in better shape” than ever before, McKay says.

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The advertisement features the LendingTree logo in red and blue, followed by the text 'HOME EQUITY' in a blue box. Below this, it says 'Get up to 4 Home Equity offers in minutes.' with a 'Start' button. At the bottom, it asks 'Want Banks to Compete Over You?' and shows a group of five diverse people in business attire.

Many automakers and dealers now offer warranties and certification programs for used cars, along with attractive interest rates. Some of the financing deals recently listed on Cars.com include 4.9% loans on 1998 to 2004 Acuras and Hondas and 3.9% for used Ford Explorers.

Whether you opt for new or used, here are some strategies to ensure your next car deal will be a better one:

- Know how much cars really cost before you buy. Edmunds.com has a “True Cost to Own” feature that factors in all the expenses you’ll face in the first five years of ownership, including insurance, maintenance, gas and repairs.
- If you’re underwater, protect yourself. The premiums for guaranteed auto protection, or GAP, insurance vary widely, so shop around. Many insurers offer GAP as an add-on to your regular policy, typically for a monthly premium of \$10 to \$25. Dealers, banks and credit unions also offer the coverage, either as an add-on to your loan or as a one-time fee that can range from \$100 to 5% of the value of your car.
- Don’t get a loan for longer than you plan to own the car. Walking into a dealership when you owe money on your trade-in is like painting a big target sign on your head. You’ll probably end up with a higher-than-average interest rate on your next car, and the dealers will know you’re a sucker who can be counted on not to be able to control your spending.
- Keep the car at least a year after you pay off the loan. That way you can save the money you used to spend on car payments so that you’ll have a decent down payment for your next car. If you keep your car even longer, you might find that you can actually -- surprise, surprise -- pay cash for your next vehicle and kiss those interest costs goodbye.

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