Interest Grows in the Long Loan

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Would you finance a car for seven years? Or sign for a loan whose last payment was a blockbuster that could be more than the car is worth?

Don't laugh; neither is as financially risky nowadays as it might sound, and more people are going those routes. Growing numbers of car buyers are taking out longer loans to buy cars and many are opting for "balloon"-type loans to have lower monthly payments for three or four years.

A surprising 84 percent of new car loans being taken this year are for longer than 48 months, according to the Consumer Bankers Association, a trade group. That number of loans is up 14 percent just in the past three years.

Most used car loans are for more than 48 months and they, too, are getting longer.

The reason for increasing loan terms is, obviously, to lower payments. Take this example: The monthly payment at 5.25 percent interest on a $20,000 loan for 60 months is $380. But the payment drops to $324 if the loan is for 72 months and $285 if the buyer opts for an 84-month loan seven years.

Also increasing is the average amount financed $21,779 for new cars, up 10 percent in three years, and $16,542 for used cars, up almost 15 percent as consumer tastes continue to shift into larger, more highly equipped and expensive vehicles.

"It's really scary from a personal finance standpoint," said Mary S. Butler, senior editor of cars.com, an information Web site owned by six media companies, including Newsday's parent Tribune Co. "In a recessionary economy, obviously people's incomes aren't keeping up with the vehicles they're purchasing."

Driving the changes are factors both positive and negative for consumers. On the upside: low interest rates, which reduce the cost of financing and make the longer-term loan not as financially foolhardy as it might otherwise be because of huge interest payments.

Nationally, according to the Web site Bankrate.com, interest rates for a 60-month new car loan average about 5.25 percent annually, a figure that has dropped by about 1 percent since the beginning of the year. Used car loans average about half a percentage point more.

Also driving the change good for consumers, bad for carmakers are cut-rate

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financing deals, which, along with widespread rebates of thousands of dollars, result from a car market that's been weak since the start of the recession in the spring of 2001.

Those cut-rate loans have moved a lot of metal; the finance subsidiaries of the major carmakers are writing 49.2 percent of new car loans these days, says Art Spinella, auto analyst for CNW Marketing/Research in Bandon, Ore. That's up from 30.4 percent just five years ago. The gain in market share has come at the expense of banks, finance companies, credit unions and other sources, such as relatives, he says

Another positive change for consumers: improvements over the years in the quality and durability of cars. Among other things, that helps ensure that the car will outlast the loan.

Then there are negative factors at play: cars are more expensive nowadays. Yes, those rebates and other sales incentives have eased the pain, but the average-priced new car, including finance charges, cost $25,197 in the first quarter of this year, according to a study by Detroit-based Comerica Bank.

And one other negative for car buyers: the withdrawal from New York State since May of several major institutions that write leases, including the financing subsidiaries of General Motors, Ford and Honda. The reason is a legal concept called "vicarious liability." Under state law, the owner of the car - such as a financial institution holding the lease - can be sued for damages if the car is involved in an accident.

Some of the bloom had been taken off the leasing rose before, though, because of competition from low-interest loans and because of a decline in residual values - the projected value of cars at lease end - because of a market glut of late-model used cars.

Said Bob Kurilko, vice president for product development and marketing for the auto information Web site edmunds.com, "You've seen lease payments go up but [the carmakers] understand that leasing is an important marketing lever."

Carmakers and dealers like leasing because it brings buyers back for new vehicles every three or four years and helps sell more expensive vehicles. So, dealers and lenders say the withdrawal of those leasing institutions is hurting them and eliminating an option for consumers. "I've lost a lot of deals because the payments are too high," said Walter Malmstrom, owner of Malmstrom "Suzuki Isuzu in West Islip. He says more than half his customers leased.

The aforementioned "balloon" loan is, for some buyers, taking the place of a lease. The two are remarkably similar, with monthly payments a lot lower than a conventional loan's and the hassle- saving ability to simply bring the car back where you got it and walk away with the balloon loan the car owner is selling the car, either to the bank or privately, not exactly turning it in

There are important differences, though. The person who finances via a balloon note owns the car and pays sales tax on the full purchase price. The consumer who leases pays sales tax only on that portion of the car's value that the lessee is, in effect, purchasing.

An example provided for Newsday by Joseph Butera of Malmstrom who, just for simplicity's sake is using the list price and ignoring dealer discounting demonstrates how complex a consumer's decision can be in deciding how to finance. If you could lease it in New York from Bank One, one of the dealership's affiliate lenders, a 2003 Suzuki XL-7, an SUV priced at $23,900, can be had for $282 a month for 48 months. That assumes a good credit rating and $3,000 cash up front that covers a down payment plus sales tax for about half the value of the car. Want to buy the car at lease end? It'll cost $9,082, plus sales tax.

Finance the same car with a balloon note for 48 months at 4.79 percent and the payment increases to $305 a month. That assumes the same $3,000 down payment and full payment up-front of the sales taxwhich is how much the lease, obviously, even though Butera has subtracted a $2,000 manufacturer rebate from the purchase price a rebate that's available only if you buy.

The final, balloon, payment: $9,082. Don't have it? You can sell the car to the bank at that price (less any extra wear and tear or mileage charges), sell it yourself to someone else if you think you can get more for it or keep the car and refinance it.

If you were to use the cash rebate on that XL-7 to pay most of the $2,091 sales tax, put down the same $3,000 but finance the car with a conventional $23,056 See fix-tominc. 48-month loan at 4.79 percent, the monthly payment would be $483, says Butera.

Ack! Is it any wonder leasing was so popular?presenting the monthly payments as a guide to which is the cheapest way to go is misleading; if you could lease the car at rates quoted, you would either need to have over $9,082 in cash to purchase the car at the end of the lease, or then have to finance that amount, resulting in additional interest. If you opt to turn the car back in, you have now spent $16,536 over the past 4 yrs and own nothing to show for it. With a traditional loan, you have paid $26,184 over four years, but you received a $2,000 cash rebate, so it would come out to $24,184, which is less than the lease-plus-buy option ($25,618) without even financing the $9,082 at the end of the lease. But beyond everything else, these figures are confusing to read through. Is there a way we could sum up each option, so the reader could see what the actually cost would be at the end of the lease, balloon and regular loan options Lenders and car dealers say balloon loans are an inferior substitute for consumers because of the higher sales tax payment.

Robert Vancavage, president of the 1,100-member New York State Automobile Dealers Association, based in Albany, says there's yet another downside: that large final payment remains on your credit report as a debt. It's not a panacea, he said of the balloon alternative.

Edmunds' Kurilko says also that lease payments tend to be lower than balloon payments because, as owner of the vehicle, the lender can write off its depreciation and pass those tax benefits on to consumers.

As in a lease, the monthly payments for a balloon note depend in part on the projected value of the vehicle when the balloon comes due. Ideally, it comes out even: the projected value at lease end proves accurate and the lending institution can then sell the car without taking a loss. In both cases lenders are in effect guaranteeing the value of the car because they are agreeing to take back the vehicle at a predetermined price, if that is the customer's choice.

In both cases, though, the consumer who trashes the car will pay the piper in the form of excess wear and tear charges.

Butler cautions buyers, though, about opting for either one — balloon or lease. In her view, they're simply ways for people to drive vehicles they can't afford.

Some carmakers are offering conventional loans interest-free or at rates well below average. What could be better than zero? Nothing. But in some cases, when the rebate is good and the savings on interest isn't that great, it's better to finance conventionally.

Another factor to consider here: the carmakers' finance arms typically restrict those cut-rate loans to consumers with good credit scores often 750 or above on the so-called "FICO" scale, which ranges from 300 to 850 and is produced by Fair, Isaac & Co. of San Rafael, Calif. Those scores are calculated by companies like Equifax, based on a consumer's past performance in paying bills.

A person with a very low score might not qualify for standard interest rates; those folks might be steered to what's known in the industry as the "subprime" market where borrowers considered high-risk can obtain financing but at much higher interest rates.

Butler also takes a dim view of six- and seven-year loans, which exceed virtually all manufacturer's warranties.

A final note: more and more automakers are offering cut-rate loans on certain late-model used cars as well as new ones. Combine that with weak prices because of the glut, and a late-model used vehicle might be the best bargain out there.