GM FINANCIAL Learning Center

Own Your Car – Don't Let Your Car Own You

What is negative equity? And why are industry experts suddenly paying closer attention to this trend?

The purchase incentives offered by the auto industry, such as "no money down" and "zero-pecent interest," can be seen as both good and bad. "The auto industry offered these incentives in order to save the industry from a recession during the post-Sept. 11 time period," says Steve Bowman, Chief Credit and Risk Officer for GM Financial, an auto finance company that does business with auto dealers in the United States and Canada. "The good news for the auto industry is that the plan worked. The down side is that they enticed one million people who had not intended to make a purchase into buying a vehicle."

"One of the most important things a consumer can do to avoid negative equity is to make sure he or she is educated when it comes to the car-buying process."

Steve Bowman, GM Financial Chief Credit and Risk Officer

Due to the aforementioned incentive-based vehicle purchases, as well as longer-term auto finance contracts and more consumer debt, many Americans now have negative equity and are considered to be "upside-down" in their auto loans – meaning they owe more on their cars than the cars are worth. In fact, expert sources, such as Automotive News, Edmunds.com and J.D. Power and Associates, have estimated that up to 40 percent ofconsumers who walk into an auto showroom are upside-down in their current auto debt.

"For most people, their two largest monthly expenses are their residence and automobile," says Bowman. "As an individual consumer's debt increases, it's logical that he or she would want to reduce the cost of these major payments. One way to achieve this goal is to seek a more affordable car payment by extending the length of the auto finance contract, but there's a price to pay for that lower payment."

As an example, when a car-buyer commits to a 72-month finance contract, the payment (if all other factors remain equal) can be up to 10 percent lower per month than a 60- month contract. While the consumer may feel he or she is getting ahead of the game by securing a lower payment due to the longer term, here's how negative equity comes into play: the consumer pays more in interest because the finance contract is longer. Each payment is applied to interest first and principal second, so the principal is reduced more slowly in a longer-term contract. The consumer may get a lower payment, but he or she also gets a vehicle that takes longer to pay off and ultimately costs more over the life of the contract. Meanwhile, the vehicle is depreciating at the same rate regardless of the length of the finance term.

According to AAA, the average term for a car contract has jumped from 48 months to 63 months in just five years. Previous industry polls also state that a consumer will trade in his or her car approximately every three years. Here's where negative equity truly comes into play. With a longer auto finance contract, the consumer owes more at the three-year point in the contract – often more than what the car is worth. The remainder of the unpaid balance (after applying the trade-in value) must be paid off or, in most cases, rolled into the consumer's new finance contract. Add tax, title and license to that negative equity, along with the price of the new car, and you're financing more than the car is worth. For example, a car-buyer can walk out of a dealership with $25,000 in auto debt and a car that was only worth $21,500 to begin with. That means they have negative equity of $3,500 from the start.

Consumer Tips for Avoiding Negative Equity

The Power Information Network, a division of J.D. Power and Associates Inc., states that consumers who enter a deal with negative equity pay an average of $93 a month more in car payments than those who enter a deal with equity.

So how can you avoid negative equity when it's easier than ever to drive a new car off the lot? Here are some tips for entering your next car purchase with equity:

- **Pay at least 10 to 20 percent down.** This builds equity and reduces your interest payments.
- **If you have a simple interest finance contract, pay a little extra with each car payment.** The extra money goes straight to the principal of the loan (rather than the interest), and allows you to pay your auto debt off faster. Note: If you have a precomputed finance contract, paying more than your actual payment will not reduce the interest you owe, so be sure to determine your contract type before you enhance your payments.
- **Finance for fewer months, if possible.** The shorter your contract term, the more equity you will have in your car when you decide to trade it in.
- **Seek annual percentage rates and financing terms from multiple sources.** Comparing financing offers from different resources such as banks, credit unions and finance companies may help you get the best deal in the long run.
- **Buy used.** The greatest majority of a vehicle's depreciation occurs during the first two years, with the wholesale value plummeting by 30 to 40 percent. By buying a used car, you avoid that initial drop in the value of the vehicle and may lessen your chances of becoming upside-down in the loan.
- **Don't roll "old car" debt into a new loan.** If you are upside-down on your car, keep it if it gets you where you want to go.
- **Be an educated consumer.** Know your used car's equity and value before you take it in to trade. In addition, do your homework via the newspaper, Internet and other publications. Know a fair price for the car you want to buy.
- **Don't rush.** Purchasing a new car is exciting, but you may be better off if you step back and analyze the numbers, ensuring you don't purchase based on emotion.

Most industry experts agree that negative equity is a serious issue, even though it has been around a while. "Negative equity is not new to our industry," says Bowman. "One of the most important things a consumer can do to avoid negative equity is to make sure he or she is educated when it comes to the car-buying process. Before you ever visit a car dealership, research financing options and determine fair trade-in and purchase values for your current and prospective vehicles. And, most of all, take your time. Buying a car is one of the largest financial investments most people make, so review the final contract carefully and don't settle for less than the deal you want."

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GM Financial provides auto finance solutions through auto dealers across the United States and Canada. GM Financial is a wholly-owned subsidiary of General Motors Company ("GM") and is headquartered in Fort Worth, Texas. GM Financial has approximately 3,300 employees in 16 credit centers across the U.S., our FinanciaLinx subsidiary in Canada and four geographically dispersed customer service centers in North America to service our 700,000 active customers. GM Financial has approximately $10 billion in auto receivables and $500 million of leased vehicles.

Information cited in this article was obtained from the following sources in 2006:
Grant's Interest Rate Observer
Automotive News
AFSA: Understanding Vehicle Financing
AAA: http://www.aaa.com
USA Today: http://www.usatoday.com
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