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Bylined Article

Debt Disasters: Extra-Long Loans Come at Steep Price

Most of us can't afford to buy houses and cars in cash. But while financing may be a fact of life, make sure your loan doesn't come back to bite you.

One potential pitfall is the growing popularity of extended-term loans. These are loans that stretch the standard 30-year mortgage to 40 years, or the common 3-to-4-year car note to as much as nine years. If you're short on cash and eager to own, these long-life loans present an enticing way to lower your monthly payment. But there's always a catch – your total out-of-pocket cost will be much higher when all is said and done. Viewed with a critical eye, these loans can look downright ludicrous.

Monstrous Mortgages

As interest rates rise, it costs you more to borrow money. So the dream house you thought you could afford might scoot just out of reach if interest rates were to shoot up a point. That's when some buyers turn to untraditional loans like the 40-year mortgage. With an extra ten years to pay back the loan, your monthly payments may drop back into your comfort zone.

Extending the mortgage on a $200,000 house from 30 years to 40 years might save you around $100 a month. Sounds tempting, until you consider the huge increase in interest charges (see the following chart). With a 40-year loan you'd end up paying a lot more money – almost $100,000 more – to buy the same house! And the drawbacks don't end there.

	Amount financed	**Interest rate**	**Monthly payment**	**Interest paid**	**Total cost**
30-yr. mortgage	$200K	6.0%	$1,199.10	$231,676.38	$431,676.38
40-yr. mortgage	$200K	6.0%	$1,100.43	$328,205.09	$528,205.09

With much more interest to pay, a larger percentage of your monthly payments will go toward paying down interest, and less toward principal. The result is that you build equity much slower with a 40-year mortgage, so it takes longer before you actually "own" a significant portion of the house. If, like most buyers, you decide to sell the house before the loan expires, you'll have less of a down payment for your next home. Worse, if housing prices drop in your area, you could have "negative equity," where you owe more on the house than it's worth on the market.

Finally, in the uncommon scenario that you keep the house for forty years, you'll likely be making payments into your retirement years when you'd rather be mortgage-free.

For most homebuyers, the cons of a 40-year mortgage will outweigh the pros. If you're still seeking lower payments, there are a host of other financing options that might help you meet a similar goal with fewer consequences, including adjustable rate mortgages and special programs for first-time homebuyers. In general, if you have to rely on "creative financing" to afford the home you want, it may be time to consider less expensive houses or rethink homeownership until you can make a larger down payment.

Alarming Auto Loans

The nine-year auto loan is another relatively new offering that makes it easy for you to take home a shiny new car today. The benefits and drawbacks are virtually the same as the 40-year mortgage, just on a smaller scale.

By spreading the loan over several more years, your payments drop, so you can either pocket some extra cash every month or upgrade to a more expensive vehicle. But don't fall under the spell of that new car smell. In most cases, this deal is rotten.

Just as with the extended mortgage, adding extra time to your auto loan increases your interest charge. Take a look at the next table. Financing a $25,000 car for nine years will cost about $5,000 more in interest charges than a four-year loan!

	Amount financed	**Interest rate**	**Monthly payment**	**Interest paid**	**Total cost**
4-yr. auto loan	$25K	7%	$598.66	$3,735.49	$28,735.49
9-yr. auto loan	$25K	7%	$312.66	$8,766.95	$33,766.95

And the argument against longer-term car loans may be even stronger than the home example, because, unlike real estate, new cars always depreciate quickly. A standard rule of thumb says that new cars lose about 15-20 percent of their value every year. That means if you don't pay off at least 20 percent of your loan in the first year, there's a good chance you'll owe more to the bank than your car is worth. That's bad news, because it means you'll lose money if you choose to (or need to) sell the car before you pay it off. Similarly, if your car is stolen, most insurance companies only pay to replace the car at its present value, which again leaves you in debt to the bank.

This predicament is called being "upside down" on your loan. The longer your loan term, the worse the problem can get. But following a few simple guidelines can keep you on the right side of the road.

First, consider buying a used car instead of a new one, since used vehicles depreciate less rapidly. Even if you're set on buying new, try to make a down payment of at least 20 percent and pay the taxes and fees upfront, so you borrow less money and pay less in interest. And finally, don't take out a loan for longer than you intend to keep the car. "Drive it til' it dies" is a mantra that will save you money in the long term.

If you're unsure about the best loan option for your budget, a financial advisor can help steer you in the right direction. And no matter what you're shopping for, always remember there are two sides to every financing equation -- as your payments go down, your total cost almost always goes up.

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