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THE LAST WORD

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Do the homework before buying a car

Wow, COE prices are so high it looks impossible to buy a car.

It wasn't always like that. In Jan 2010, COEs for small car, large car and open categories were $20,000. That was only five years ago but it seems like a lifetime. Now, COEs are $64,000 for small cars (under 1,600 cc), and $72,000 for large cars and the open category (which is used mostly to buy large cars).

"It's too much", you say. "I am priced out of the market!"

Maybe not. For an easy solution to the problem, consider a used car. They are available at all prices, even under $10,000, although those are for nine-year old cars with COEs that are about to expire.

If you pay more – like $20,000 – you can get a COE with two or three years left. Pay still more – like $30,000 – and you can find cars with five years left on the COE. These are reasonable cars which look like new. While most things in Singapore are efficiently priced, you can still find a used-car bargain. Part of the reason, I think, is we don't like risk, so people are willing to pay a premium to buy a new car, which comes with a two, three or five-year dealer's warranty. It eliminates nearly all the risk of buying a car. This makes used cars underpriced since many don't carry warranties, especially if sold by the owners. Even for dealers, used car warranties are short, like three to six months. This added risk of "going naked" (without a full warranty) is discounted into the lower used car price.

Where to get the money?

How about financing? Well, you can still get a car loan and it's easier than you think. It will probably cover 60 per cent of the car's cost with five years to repay. A typical car loan rate is around 2.55 per cent for a flat-rate loan, which translates to a 5.0 per cent effective rate. Why two interest rates? It is standard in the industry to advertise one rate (the flat rate) and charge another (the effective rate). It's always been like that and is highly misleading. For example, if the flat rate is 2.55 per cent for a five-year car loan, you are really paying an effective interest rate of 5.0 per cent. That's almost double!

Why do that? Why do banks deceive borrowers by telling them the cost is about half of what they really pay? The best explanation I have heard is: "It's that way because that's the way it is!" It's not a great explanation but it's the banks' way of saying flat rates are standard in the industry. When quoting the flat rate, however, banks must also disclose the true cost, the EIR. That seems like a good solution, but the EIR is often in a footnote or a small font. Sometimes, like when talking to a loan officer at a bank or finance company, they only mention the flat rate. If you ask, they may tell you that is what you pay even though it's not.

How interest rates work

Don't confuse the flat rate with simple interest, which is also misleading but less so. It fails to consider the interest on interest – called compounding – which doesn't make much difference. For example, the simple interest on credit cards charging two per cent per month is 24 per cent per year while the more correct compound rate is 26.8 per cent.

That's misleading but the difference between flat and effective rates is much more. As shown earlier, it is almost double since a flat rate of 2.55 per cent is really a 5.0 per cent EIR on a five-year loan.

The reason is that flat rates don't consider that almost all loans – including car loans – pay off the principal borrowed over the term of the loan, like five years for most car loans. Only one other type of loan routinely advertises flat rates, which is personal term loans, so watch out for those too. For all other loans, like our all-important home loans, do it correctly and quote the effective interest rate. One more financing tid-bit. Car dealers typically have a conflict of interest but keep you in the dark about it. They receive kickbacks for recommending a bank for you to take your car loan. The dealer will even help you fill out the paperwork but never mention that they receive thousands of dollars for recommending that bank and doing the minor paperwork.

Some of the kickback is used to lower the car's price, but it's still a bad deal for borrowers. Recently however, Citibank has announced it won't do that but will go to the borrowers and offer low interest rates directly. It seems that everyone would flock to Citibank, but that's far from certain since car dealers will try to keep this source of profits for themselves. Anyway, good luck to Citibank in their noble effort.

Dr Haverkamp is an economist and adjunct faculty member at Singapore Management University. In his weekly series, he shares simple tips on how you can make your money work harder for you.

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