(Almost) Everything You Want to Know About the New Consumer Leasing Rules

The Consumer Leasing Act covers consumer leases of four months or more where the value of the lease is for $25,000 or less. In October, 1997 new disclosure rules in Regulation M take effect which provide more information to help consumers make choices and comparisons among leases. In the end, however, leasing remains a complicated transaction and information asymmetry may remain a problem for consumers.

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To Lease or Not to Lease?

Most consumers want to know, "Should I buy or should I lease?" And the answer most consumer educators give is, "It depends." Indeed, it does depend on many variables, including:

family finances -- how much money you have for a down payment and other up front costs as well as how much you can afford for monthly payments;

driving and car care habits -- how many miles you usually drive in a year and how well you maintain your car;

how long you usually keep your cars -- if you change cars every 2 to 3 years and "always have a car payment" or if you keep your cars a long time after the last loan payment and like not having those monthly payments;

your willingness to take the risk for the future value of the car -- when you lease, the lessor assumes the risk, but when you own, you take on the risk of the value of the car when you go to trade or sell it; and

your preferences for ownership -- when you lease a car, you're paying to use it, not own it.

In 1996, 29 percent of new cars were delivered as leased cars, up from 5.3 percent in 1987. The car leasing industry estimates that in 1997, nearly one-third of new cars will be leased. The average term of a lease was 36 months; 98 percent of leases in 1996 were for 4 years or less. Most leases had a mileage allowance of between 12,000 and 15,000 miles per year, although there are some special low mileage and high mileage leases available to consumers.

In a survey of over 6,000 lessees, CNW Research reported that in 1996, the average lessee was between 40 and 41 years old and had a household income of $67,200 (CNW, 1997). Over two-thirds (68 percent) had a college degree and over half (57 percent) were male. Nearly two-fifths (39 percent) were first time lessees; the remaining 61 percent were repeat lessees. Most lessees (70 percent) made a down payment on their leases, averaging $1,925; one-third traded in a car.

When asked why they were leasing, 46 percent said the most important reason for leasing was to get a lower monthly payment. It is true that, *ceteris paribus*, a monthly lease payment is lower than a loan payment for the same car. Nearly one-fourth (23 percent) said they leased because of the chance to have a lower or no down payment and 21 percent said they were leasing in order to drive a nicer car than they could afford to buy. First time lessees were asked who recommended leasing to them, and one-third (34 percent) said that they were influenced by advertising; 21 percent indicated that a business associate recommended it, and 21 percent said the dealer recommended leasing.

Components of Lease Payments

As consumers move from buying cars to leasing cars, they need to learn a whole new vocabulary and a whole new calculus for car financing. (In the following section, required disclosures under the new regulations for the Consumer Leasing Act appear in bold type (Regulation M, 1996).) The starting point for a lease cost calculation is the **gross capitalized cost:**

Gross Capitalized Cost = price of car + dealer installed options + service contracts + insurance that is capitalized + prior credit or lease balances + freight + other fees that are capitalized (vs. paid up front or elsewhere in the lease)

The next step is to determine if there are any **capitalized cost reductions:**

Capitalized Cost Reductions = down payment + trade-in allowance + rebates and subtract these from the **gross capitalized cost** to arrive at an **adjusted capitalized cost:**

Adjusted Capitalized Cost = Gross Capitalized Cost - Capitalized Cost Reductions

Consumers have some room to negotiate amounts in these components of the lease. Certainly they can negotiate the price of the car, as well as the value of any trade-in they may have. And they should be willing to ask about dealer incentives and rebates available to them.

The next key component of a lease calculation is the estimate of the **residual value** of the car at the end of the lease. Unlike the price of the car, this value is not likely to be negotiable. **Residual values** are set by the lessor and based on sources such as the *Automotive Lease Guide*, the *Kelley Blue Book for Leases,* or lessor fleet data. **Residual value** is usually calculated as a percent of the sticker price of the car (the manufacturer's suggested retail price or MSRP), regardless of the price the consumer has negotiated.

The **residual value** is subtracted from the **adjusted capitalized cost** to determine the **depreciation,** the decline in the car's value through normal use over the term of the lease:

Depreciation = Adjusted Capitalized Cost - Residual Value

From this, you can see that the higher the residual value, the lower the depreciation (or the lower the residual value, the higher the depreciation). **Depreciation** is the major component of the monthly lease payment. If you plan to turn in the car at the end of the lease, you would want to minimize the depreciation; thus you want to find a deal with a high residual value. On the other hand, if you think you might want to purchase the car at the end of the lease, you might want to pay more on depreciation during the lease so there is a lower cost to you at the end of the lease. Also, since depreciation rates are usually higher for the first one or two years of a car's economic life, the relative costs attributable to **depreciation** are higher for two year leases than for leases lasting three or four years (when depreciation rates are a bit lower) (see Devorak, 1996).

Another key component of a lease calculation is the cost of money, given as a **rent charge** on the new disclosure form. The **rent charge** is analogous to the interest or finance charge on a loan or credit agreement, although in some leases, the **rent charge** may include other charges as well as the cost of funds, so the comparison is not exact.

Although the **rent charge** reflects the cost of money, there is no "lease rate" disclosure that can be compared to an APR in a loan or credit agreement. It is the case that most leases have too many variables to arrive at a unique solution to the question of "what is the lease rate?" In most instances, the true lease rate depends on what options the consumer exercises at the end of the lease (e.g. to turn in the car and "walk away" or to buy the car if there is a purchase option). In fact, the new regulations discourage lessors from advertising or promoting a lease rate. If a lease rate is given, it must be accompanied by the statement that:

This percentage may not measure the overall cost of financing this lease.

The **rent charge** is the one number on the lease disclosure form that consumers will have the most difficulty verifying. It is also one place in the lease where dealers may try to practice "overaging" -- charging a higher rent charge than required by the lessor and keeping the difference as extra profit.

Consumers may hear about "money factors," which are marginally related to interest rates. A money factor is given as a decimal (e.g. .0032). The usual metric is to take the "money factor" and multiply by 2400 to arrive at a ball-park estimate of the interest rate on the lease (e.g. .0032 * 2400 = 7.68). Some lessors use multiple factors to arrive at the rent charge, which further complicates the problem of verification for consumers.

Adding the **depreciation** and the **rent charge** gives you the total of the **base payments:**

Base Payments = Depreciation + Rent Charge

and dividing the **base payments** by the number of months in the **lease term** gives you the **base monthly payment:**

Base Monthly Payment = Base Payment / Lease Term

There are a number of other fees or charges that can be added to this **base monthly payment** to create the **total monthly payment.** For example, many states and localities add a sales or use tax to leases in lieu of the sales tax paid on a purchased car. In states with personal property taxes, lessors may require that monthly amounts be paid into an escrow account:

Total Monthly Payment = Base Monthly Payment + Sales/Use Tax + Other Monthly Fees

Other Disclosures

The new leasing regulations borrow the "Fed Box" from Truth-in-Lending and highlight four key pieces of information at the top of the form: the amount due at lease signing, the schedule of monthly payments, other charges (not part of the monthly payment or due up front), and the total of payments.

The amount due at lease signing is further broken down into capitalized cost reduction, first monthly payment, refundable security deposit, title and registration fees, and other fees due up-front. Parallel to this is a list of how those amounts will be paid: trade-in allowances, rebates and non-cash credits (dealer incentives), and amounts paid in cash. This itemization was developed to counteract problems of "disappearing" down payments and trade-ins.

Another disclosure highlighted on the new form is a notice about early termination. Consumers may end leases early for a variety of reasons: the car may have been stolen or destroyed; the consumer may be transferred (this applies especially to military lessees); or the consumer simply may have grown tired of the car. However, a lease is a contract, and getting out of any contract may be costly. Consumers may be liable for the balance due on the lease, plus any fees and charges necessary to process the end of the contract. As the disclosure states:

> **You may have to pay a substantial charge if you end this lease early. <u>The charge may be up to several thousand dollars.</u> The actual charge will depend on when the lease is terminated. The earlier you end the lease, the greater this charge is likely to be.** (note: bold and underline are part of the required disclosure)

Lessors must also disclose standards for excess wear for both cosmetic (dings, dents, upholstery stains) and mechanical wear (for example, how much tread must be left on the tires when you return the car). Lessors must also disclose the mileage limitation (most leases currently limit lessees to 12,000 to 15,000 miles), and the per-mile charge for mileage over the limit. In general, most lessors advise that if you think you are likely to exceed the miles proposed in the lease, you "buy" extra miles up-front (usually reflected in a lower residual value).

If you have an option to purchase the car at the end of the lease, this must be disclosed along with the price you will pay. If the lessor charges a fee to exercise this option, the fee must also be disclosed.

Finally, the disclosure must contain language that refers consumers to other pages of the lease for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interest the lessor may have.

Shopping for a Lease Deal

<u>Subventions and Incentives</u>

Lessors -- the owner of the car who "rents" it to the consumer to use -- may be a car dealer, a bank, a credit union, a "captive" finance company (Ford Motor Credit, GMAC, Toyota Credit, etc.), or another finance company (e.g. G.E. Capital). Car dealers usually have several different sources of leases that can be used in consumer leasing, one of which is usually the "captive" finance company. Consumers should ask dealers to show them the lease costs associated with various lessors in order to get a comparison of the terms and conditions of the lease.

These different lease funding sources may offer different incentives, called subventions in the leasing industry, to dealers. Some deals may offer to subvent the capitalized cost reduction in the form of a rebate (see column 1 in Table 1); others may subvent the residual value or the lease charge (Durkin, 1996). Notice that in all the cases in Table 1, the cost of the car starts out the same and the base monthly payment ends up the same. But if a consumer thought that he or she might want to buy the car at the end of the lease, the deals in column 1 and 3 would be "better," since the residual value (which is usually the purchase option price) is lower. If the consumer was shopping on interest rate charges, he or she might be drawn toward lease #3 (with an implicit 0% interest), even though it turns out to be on a par with the other two deals.

The three columns in Table 1 also make another point -- you may start out from the same point and end up at the same place, but you can get there through different routes. This complexity in leasing calculations is one of the reasons consumers need to be careful when comparison shopping for leases.

<u>Buy versus Lease Comparisons</u>

Many consumer publications on leasing and most leasing organizations publish some sort of "buy versus lease" comparison (see, for example, Kranitz, 1997). Consumers need to pay attention to what the comparison includes, and, very often, what it excludes. Most comparisons focus on differences between a lease and a loan; a few include a cash sale or a single payment lease.

Comparisons include -- or exclude -- assumptions about personal discount rates, interest rates on a loan, what happens at the end of the lease or loan, and how long you keep the car, depending on the point the source of the comparison is trying to make. Varying the interest or discount rate can make the decision to lease look more or less favorable. For example, a five percent discount rate may lead do a very different decision than a ten percent discount rate. Consumers need to study these comparisons carefully and consider their own situations and preferences.

Advertising

We know from the leasing survey cited above that when lessees were asked who recommended leasing to them, one-third (34 percent) said that they were influenced by advertising. The new regulation includes some rules governing advertising, but it is still the case that consumers must read ads carefully. If an add contains a "triggering term" (the amount of any payment, the number of required payments, or a statement about any capitalized cost reduction [down payment]), then the ad must also:

- state that the transaction is a lease;
- indicate the total amount due at lease signing;
- indicate the number and amount of monthly payments;
- state whether there is a purchase option;
- state the residual value or the method of determining the lessee's liability at the end of the lease.

If the ad appears on television or radio, it may list a toll-free number for additional information instead of making these disclosures.

Consumers need to learn the how that "low,low monthly payment" is affected by the assumptions about capitalized cost (including what equipment and options are on the car), mileage limits, dealer rebates, down payments, and residual values. These values are all interdependent and can affect the monthly payment as well as the overall value of the offer.

Conclusion

Leasing is not for everyone, but it can be a good deal for some consumers if it fits with their tastes and preferences. If consumers understand that leasing is different from buying; if they understand all up-front, ongoing, and end of lease costs before they sign the lease; if they shop and compare lease offers and negotiate amounts in the contract; and if they know their rights and responsibilities in their lease agreements, then leasing can be a win-win situation for both consumers and the marketplace.

References

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Endnote

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Table 1
Subvention/Incentive Patterns

	1 Subvent Rebate	2 Subvent Residual	3 Subvent Rent Charge
1. Gross Cap. Cost	$20,000	$20,000	$20,000
2. Cap. Cost Reduction	- 3,500	- 2,000	- 2,00
3. Adjusted Cap. Cost	16,500	18,000	18,000
4. Residual Value	-12,000	-13,500	-12,000
5. Depreciation	4,500	4,500	6,000
6. Rent Charge	+ 1,500	+ 1,500	+ 0
7. Total of Base Monthly Payments	6,000	6,000	6,000
8. Lease Term	÷ 24	÷ 24	÷ 24
9. Base Monthly Payment	$ 250	$ 250	$ 250