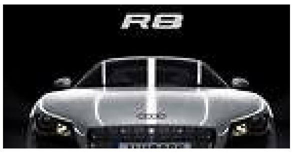
Gap Insurance for Car Loans and Leases

Bob Simon February 18, 2016



Audi R8

Gap insurance or protection covers the difference between money owed on a car and its fair market value. Not everyone needs it.

(Newswire.net -- February 17, 2016) -- For most drivers, ordinary auto insurance policies cover repair or replacement costs for cars damaged or stolen. However, if the car's actual cash value is less than the amount owed on a loan or lease balance, that difference is not covered, and lenders say the driver is upside-down on the car loan. The insurance company won't pay out more than the car was worth before the theft or the damage. Therefor, if there is a shortfall, the driver can cover it with a gap insurance policy, also known as a debt cancellation agreement.

Negative Equity

Cars worth less than amounts owed on them have negative equity, an example of which is a $20,000 loan balance on a car with a $19,000 actual value at time of loss. Assuming a typical $500 deductible insurance policy provision, the insurer pays $19,000 − $500 = $18,500, and the driver is upside-down on the loan with a shortfall or negative equity of $1,500 in paying off the $20,000 loan balance.

Drivers can find themselves owing more than their cars are worth from a variety or combination of factors:

- Long-Term Loans. Long terms mean not only low payments but also slow accretion of equity.
- Depreciation. All cars depreciate, but some more quickly than others, and can be as much as 30 percent of their value within a few months.
- Small or No Down Payment. Buyers who finance all or nearly all the price of the car could be upside-down on their loans right away because new cars depreciate as soon as they become used.
- Borrowing More than the Purchase Price. Borrowers who finance the full purchase price plus tax, license, registration, service plans, and extended warranties may be upside down before leaving the car lot.

Leased Vehicles

Drivers of leased vehicles often owe more money than their cars are worth. Gap, "guaranteed auto protection," insurance pays the difference between what the lessee driver owes and what the car is worth. This coverage should be in place for drivers who decide to lease vehicles.

In car leases, the lessee driver signs up for a term typically up to three years. The lessor dealer calculates how much the car's market value will be at the end of the lease term and how much monthly payments should be based on that value instead of on the car's full cost to the dealer.

Financing is based on the difference between the car's capitalized cost (original price) and the residual cost at the end of the lease term. For example, for a car worth $20,000 at the beginning and $12,000 at the end of the lease term, the lessee would make payments on $8,000 ($20,000 − $12,000) instead of $20,000 if buying the car outright.

Assessing Probable Need

Drivers who, during their loan or lease term, will not owe more than their cars are worth have no need to consider gap insurance. To determine whether a borrower is likely to be upside down and for how long, find the expected car depreciation rate. The Kelley Blue Book can provide current market values for all popular models.

Then, using an online auto loan calculator, determine at what rate equity will accrete in the vehicle. Fill in the loan data and then click the button to display the amortization schedule showing the outstanding balance at any point. Use the two references in tandem to determine the equity or negative equity in the vehicle during the loan term.

Purchasing Gap Insurance

Before buying gap insurance, be sure it would not be redundant. Lessors commonly include the coverage in lease agreements for their own protection, and some car insurance policies provide for it as part of standard coverage.

Gap insurance is available in most but not all states. Normally, drivers acquire gap insurance through lenders financing their purchase, but insurance agents and online vendors also offer it. If purchased from any source other than the driver's regular insurance company, the cost is typically a one-time charge; if from the regular insurance company, the cost will be most likely a small premium surcharge. In that case, it is wise to check periodically whether the gap has closed and the time has come to cancel the gap insurance and its additional expense.

Though all gap insurance may appear to be the same, some do offer more than do others. Some coverages reimburse insurance deductibles, and some offer vehicle replacement even if the value of the car increases over time. Because of such differences, it is not enough to compare by price alone.

Other things to consider when in the market for gap insurance:

- Consistency with pricing on auto loans. Car dealers tend to charge more for gap insurance than some other sources.
- Drivers who buy gap insurance online should find out about the vendor before posting money or providing billing information.
- Gap insurance should cover all types of loss, damage, theft, and natural disaster.
- To avoid any need for gap insurance, make car financing decisions that start out with the lease or loan right-side up rather than upside down.

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