SOCIETY OF ACTUARIES

Article from:

Small Talk Newsletter

May 2001 – Issue No. 17

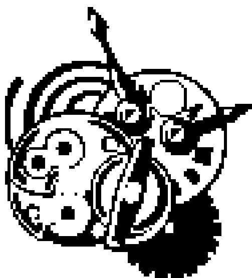
The Other Insurance Products Auto Dealers Sell

by John H. Kerper

Unless you live on Mackinac Island, you've bought a car or truck and been through the one-two sales punch of the car salesman and the finance and insurance (F&I) department. What started as an auto purchase may end up as the purchase of credit life and disability insurance, a vehicle service contract, gap insurance, special financing, undercoating, and other products in addition to the auto. The auto dealer is interested in selling more than autos and for good reason. These extras produce more than half of their profits from auto sales, and insurance sales are a significant source of these profits.

An insurer able to offer the full range of insurance products that an auto dealer sells may have an advantage in getting and keeping the dealer's business. Many small life insurance companies underwrite credit life and disability insurance, and most life actuaries are familiar with these products. Those that have a casualty affiliate may also underwrite vehicle service contracts (VSC) and gap insurance. If a company is in this market, but does not have these casualty products in its portfolio, should it add them? Before answering this question, let's examine the basics of these products.

VSC Basics



VSCs are a contractual promise to repair certain mechanical breakdowns which occur during the contract term. Coverage may be limited to a few component systems (e.g. engine and transmission) or may be "bumper-to-bumper" — covering everything except certain excluded items. A breakdown is defined as the failure of a covered part to perform its function. Some contracts define breakdown as the failure of a covered part to perform within the manufacturer's specifications. Either definition also includes a list of what is not a breakdown. This list usually includes regular maintenance, body and interior damage, failure caused by a pre-existing condition (used cars) or lack of proper maintenance as prescribed by the manufacturer, and failure due to property damage (storm, collision, fire, etc). There is usually a deductible of $50 – $200 per claim, although some VSCs charge a separate deductible per component system involved in the claim. Many insurers also offer a disappearing deductible option which waives the deductible if the vehicle is brought back to the selling dealer for service.

> ***"The auto dealer is interested in selling more than autos and for good reason. These extras produce more than half of their profits from auto sales, and insurance sales are a significant source of these profits."***

The contract term for a VSC can run from 1 month to 84 months. For new vehicles, the term generally runs for a specified number of years from the in-service date or until the odometer reaches a specified mileage, whichever occurs first. Some providers will extend the calendar portion of the term from the VSC purchase date rather than the in-service date for nearly new vehicles — used cars still under the manufacturer's warranty. The typical new car contract runs 5-7 years and for 60,000 to 100,000 miles. The term for used vehicles is the lesser of a specified number of months and miles from the VSC purchase date. The most common terms are for 12, 24, 36, or 48 months with the mileage term at 1000 times the number of months.

Most VSCs are sold for a single fee, which is either paid or financed during the vehicle purchase. Refunds are calculated pro-rata based on remaining months or miles of coverage, whichever is less. The price charged by the dealer is made up of three components — (1) insurance premium paid by the obligor, (2) administrative fees, and (3) dealer markup. It's important to note that the total price charged is unregulated in most states. It's also important to note that component (1)

is the only portion that is paid to the insurer. Components (2) and (3) are not paid to the insurer, nor are they included in premium for purposes of calculating premium tax or risk-based capital. The reason the total fee is not included in premium is that the actual service contract is not an insurance contract. Either the auto dealer or the claim administrator buys the insurance to cover its obligation under the contract.

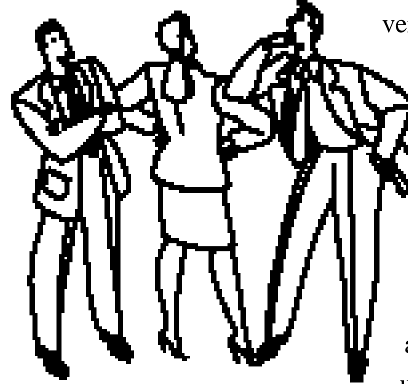
Gap Basics

Gap covers the shortfall between the loan payoff and the book value of the vehicle

or insurance recovery (depends on contract) in case the vehicle is declared a total loss from either physical damage or theft. Most contracts cover all or some of the property insurance deductible and may cover one or two delinquent payments. Some contracts even offer a new car purchase allowance if the insured returns to the selling dealer to buy a replacement. While the term for gap coverage matches the term of the loan, the possibility of a claim is zero, once the book value of the vehicle exceeds the loan payoff.

Like VSCs, the fee for Gap is paid at the time of purchase. The refund method varies by state, with most allowing a rule of 78s amortization due to the declining value of the coverage, but some (e.g., Texas) require pro-rata. Coverage may be offered as a waiver agreement or as an insurance contract to the purchaser, depending on the state. Waiver coverage is similar to VSCs where only a portion of the charge is considered premium and the total charge isn't regulated. Insurance coverage is similar to credit life where the entire amount is the premium and the total rate may be regulated.

Should a Small Insurer Offer These Products?



That's a good question. It is possible to make a good return selling VSCs, but it takes tens, or hundreds, of thousands of contracts and several years of paying claims on those contracts to develop enough experience to confidently rate this business. It also takes an experienced claims administrator that shares in the gain and pain of good and bad results to ensure that the insurer has a fair chance of making a profit. One way to enter this market with less risk is to collaborate with an established insurer that has an in-house administrator for VSCs and a history of profits in this market.

Another possibility is to mimic the manufacturers' extended warranty programs. Under the assumptions that the manufacturers' have adequate experience and are trying to make money, their rates are a reasonable starting place for a new VSC insurer with no experience. Still, a trusted administrator is needed. Hire experienced personnel and start slowly.

As for Gap, this business is relatively immature, but highly competitive. The relative immaturity shows in the simplicity of the rate chart of most carriers. The risk of claim depends on the length of the loan because a longer term leads to a slower decrease in the loan payoff value and a larger gap for a longer period. Also, if the resale value of a vehicle drops relatively quickly from the purchase price, this drop leads to a greater exposure to claim. However, most carriers currently offer the waiver version of this product at a single rate for all terms and vehicles, and the common rate that is charged for this coverage is so low that the profit potential is very limited. This is a product to watch and possibly find a partner to underwrite.

***John H. Kerper, FSA, MAAA, is a consulting actuary at JHK Company in Birmingham, AL. He can be reached at* jkerper@bellsouth.net.**