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Part III of III

Managing Non-Life-Insured Products Sold Through Auto Dealers

by John H. Kerper

Introduction

Auto dealers offer several insurance and insured products through their finance and insurance (F&I) departments other than credit life and credit A&H. Vehicle service contracts (VSCs), Gap, and Finance Reserve are three other products offered by F&I departments that are often insured by property & casualty insurers. We have examined VSCs and Gap coverage thus far in this three-part series. This third and final installment covers Finance Reserve.

Background

When an auto dealer originates the loan used to purchase a vehicle from the dealership, that dealer usually is not the financier of the contract. Either a bank or finance company will fund the loan. The dealer typically offers the car purchaser a higher interest rate (the "sell rate") on the finance contract than that which is available to the dealer (the "buy rate"). This difference or spread provides income to the dealer, the excess of the customer payment (at the sell rate) over the payment required (at the buy rate).

For example, if the amount financed is $20,000, the term is 60 months and the dealer buy rate is 5.00%, the applicable annuity factor is 52.9907 and the monthly payment is $377.42. However, if the dealer offers, and the customer accepts, a rate of 7.00%, the annuity factor is 50.5020 and the monthly payment is $396.02. The extra monthly payment of $18.60 is income to the dealer. It is customary for the finance company to make a lump sum payment to the auto dealer rather than monthly payments. This lump sum is the excess payment multiplied by the buy rate annuity factor. In this example that amount is $18.60 x 52.9907 or $985.59. This lump sum origination fee is commonly called the "finance reserve".

Because the dealer gets paid up front, in the case that the loan terminates early (via pre-payment, refinance, repossession, or total loss), the finance company must recover the unearned portion of the finance reserve that it paid the dealer. It does this via chargebacks. In order to avoid financial uncertainty for the auto dealer, the finance companies will waive all chargebacks* in exchange for a reduced up-front fee. Typical reductions ranged from 20% to 35%.

*Actually, loans that terminate before three payments are made are charged-back at any rate, to reduce the risk that dealers make loans that are highly likely to be refinanced or repossessed.

Product Basics

In the mid-1990s, some product innovators saw an opportunity to use an insurance product to provide the same financial certainty to the auto dealer using an insurance

program. A typical finance reserve insurance program will have the following features:

- Dealer receives 100% of the fee from the finance company and is subject to chargebacks
- Dealer pays insurance company a portion of the insured finance reserve as a premium
- Insurance company reimburses dealer for chargebacks of insured finance reserves that occur after a specified number of payments are made on the underlying finance contracts (generally three as in the finance company program that was replaced)

There are two common program variations — participating and non-participating. A participating program usually includes a premium charge equal to the finance companies' fee reductions, a portion of which is set aside in a claim fund for each dealer from which claims (chargebacks) are paid and to which interest is credited. Any excess funds remaining in this fund are paid to the dealer (either as earned according to a schedule or as contracts mature). The non-participating program costs less and does not involve

dealer participation in a claim fund. In either case, the dealer, not the retail finance customer, is the insured.

Rates: The entire amount paid to the insurer is premium. Since retail customers are not involved in this insurance transaction, premiums are not refundable.

Reserves: Since Finance Reserve Insurance is sold for a single premium, the unearned premium reserve represents the bulk of required reserves. The same NAIC requirements that apply to VSC and Gap unearned premium also apply to Finance Reserve Insurance, namely that the aggregate reserve held must equal or exceed the larger of three quantities for each year of issue (3 year-old and older contracts can be aggregated): (1) the amount of insurance premium refundable to contract holders, (2) premium multiplied by future expected claims and expenses, divided by total expected claims and expenses, and (3) the present value of expected future claims and expenses. Claim reserves include both claims in course of settlement and IBNR. Claim notification usually occurs only once each month for each dealer and would include the prior month's loan termination statements from each finance company serving the dealer. Thus usual reporting lag is about 2 months, but a significant percentage of incurred claims (10% – 20%) will trickle in for the next several months after actual loss.

Managing Finance Reserve Insurance

A significant portion of the early termination risk is avoided by requiring that at least three payments be made before a specific finance contract is covered under a Finance Reserve Insurance contract. Other means commonly employed to manage the exposure to early terminations include:

- Limiting the allowable rate spread on insured contracts (e.g. excluding all finance contracts if the spread is greater than 3.0%)
- Excluding finance contracts below a certain level of credit quality
- Excluding contracts beyond a certain term or charging different rates (as % of finance reserve) by term

The rationale behind the first two of these risk management techniques are intuitive; high spread contracts are likely to be refinanced as soon as the buyer realizes lower rates are available from another source (i.e. credit union or bank) and low quality loans are, by definition, more likely to default. In either case, the loan terminates and the finance reserve is subject to chargeback.

Excluding finance contracts beyond a certain term (or differentiating rates) requires more analysis. First let's look at the exposure to claim.

> *"The exposure to claim for each finance contract is the sum of the potential claim for each month, or the sum of the monthly unamortized balances of the finance reserve."*

Estimating Exposure

If a finance contract terminates, the claim amount due to the policyholder is the unamortized balance of the finance reserve (the amount of the chargeback). There are two components needed to determine this amount — the unamortized balance of the "finance reserve loan" and the excess of the loan payoff at the sell rate versus buy rate. Using the earlier example, if the finance contract terminates at the end of the 10th month, the unamortized balance of the finance reserve loan of $985.59 after 10 months (5.0% interest and monthly payment of $18.60) is $837.92. The payoff amount of the loan required from the borrower is $17,131.94 (sell rate — 7.0%), but the payoff amount at the 5% buy rate is $17,003.33. Therefore, the unamortized balance of the finance reserve at the end of 10 months is $709.30; i.e., $837.92 – ($17,131.94 – $17,003.33).

The exposure to claim for each finance contract is the sum of the potential claim for each month, or the sum of the monthly unamortized balances of the finance reserve (using zero for the initial months in which no claim is possible). Since the premium usually is a percentage of the finance reserve, it is convenient to express the exposure as a multiple of the finance reserve by dividing the exposure by the finance reserve so that the premium can be related to the exposure.

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Again using the same example, the sum of the unamortized balance at the beginning of months 4 through 60 is $18,516.18 and the multiple of the finance reserve is 18.79.

What if the loan was the same, except that the term was 36 months? Or 48 months? Or 72 months? In those cases, the exposure as a multiple of the finance reserve would have been 10.19, 14.44 and 23.23 respectively. If these exposures are discounted using the buy rate (to account for the time value of money), the discounted exposure multiples for 36, 48, 60 and 72 months are 9.73, 13.62, 17.49, 21.35. Changing the buy rate or the spread will change these multiples, but not much (the spreadsheet used to do these calculations is available by request to *jkerper@bellsouth.net*). Thus, the term of the loan has a significant impact on the exposure to claim under the contract. Also note that the increase in exposure is slightly faster than a linear increase (e.g. compare the increase from 36 to 72 months — it is more than double).

Estimating Claim Frequency

If an insurer has been writing Finance Reserve Insurance for a few years, it is possible to derive a monthly claim frequency. An alternative source for claim estimates is cancellation data for credit life insurance, although that rate would tend to overstate loan terminations because a borrower who cancels credit insurance is not necessarily terminating the loan. In either case, the insurer is likely to find that the cancellation rate, beyond the initial three to six months, is relatively constant from month to month regardless of term.

Because exposure to claim increases with term, claim frequency doesn't vary much by term and the ultimate cost of claims is the exposure times frequency of claims, it is now clear that loan term should be incorporated into the rating scheme for this coverage. However, the rating structure is still constrained by the rates available to the auto dealer directly from the finance companies.

Administration

Most of the administrative work for Finance Reserve Insurance is done by the finance companies and provided on the monthly statements that they send to the auto dealer. New loans with amount, rate and term and finance reserve as well as terminated loans with the chargeback amount are shown on these statements. However, the finance companies are not likely to provide this information in a form that the insurer can use easily (i.e. electronic files) because the insurer has replaced the finance company for this coverage. So all of the pertinent information must be entered from the statement into the insurer's administration system. As an added benefit, the insurer could perform checks on the finance company data to ensure that the finance reserve and chargeback calculations are accurate. In effect, administration of this coverage does not involve much more than recording information from the statements and monitoring results to ensure that the rates charged are adequate.

Summary

Finance Reserve Insurance is chargeback protection insurance for the covered dealer and is a replacement for a similar coverage traditionally provided by finance companies. So long as finance companies overcharge for this coverage, insurance companies have an opportunity to provide a profitable service to their auto dealer clients.

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