Managing Non-Life Insured Products Sold Through Auto Dealers
Part 2 – GAP

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, gap and financing are three other products offered by the F&I department that are often insured by property & casualty insurers. We will examine each of these products separately in a three part series. This second installment covers GAP.

Product Basics

Coverage: Gap is similar to credit life and credit A&H because it pays the car loan in the event of certain contingencies. 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.

Who is insured? Coverage may be offered as a waiver agreement (most states) 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 is not regulated. Insurance coverage is similar to credit life where the entire amount is the premium and the total rate may be regulated.

Rates: GAP is generally sold for a single premium that is either paid or financed at the time the vehicle is purchased. In the case of waiver coverage, the price charged by the dealer is made up of 3 components – (1) insurance premium, (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) & (3) are not paid to the insurer, nor are they included in premium for purposes of calculating premium tax or risk-based capital.

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.

Reserves: Since Gap is sold for a single premium, the unearned premium reserve represents the bulk of required reserves. Claim reserves include both claims in course of settlement and IBNR because claim notification often occurs several days to months after actual loss. The same NAIC requirements that apply to VSC unearned premium also apply to Gap, 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 times future expected claims and expenses, divided by total expected claims and expenses, and (3) the present value of expected future claims and expenses.

Managing Gap

Why is there a gap? The gap, or positive difference between the loan payoff and the book value of the car, is a result of several factors, including:

- Previous gap from a trade-in that gets rolled into the new loan as a result of the dealer increasing both the value of the trade-in and the purchase price by an amount sufficient to pay off the previous loan
- Loan amortization which is slower than the depreciation of the vehicle's book value, especially with finance programs that don't fully amortize such as leases and balloon notes
- Dealer extras that don't increase the book value of the car by as much as they cost
- Other insurance coverages with refund values that amortize faster than the loan

Considering the above, it's clear that an insurer's exposure to a gap claim for a given vehicle can range from almost zero (e.g., used car purchased at book with no extras, 10% down and 36 month financing) to very high (e.g., new sports car with all the extras, credit insurance and VSC, payoff of loan on trade-in, nothing down and a 5 year balloon note). Also, the likelihood of a total loss varies considerably based on the type of vehicle and the driver's characteristics. However, most carriers currently offer the waiver version of this product at a single rate for all terms and vehicles, perhaps with a surcharge for long terms or leases. Simplistic pricing for non-homogenous coverage only works when the coverage is automatic, but Gap coverage is voluntary. The F&I specialist must sell the car buyer on this coverage and the sale is much easier when the gap is obvious as in the sports car example above. So long as the rate structure remains this simple, anti-selection is a real problem.

Is there an alternative? The most accurate rate structure for Gap would include provision for both the amount of real coverage and the probability of claim. This structure would require a rate that varied by vehicle and/or driver characteristics which is applied to the estimated amount of coverage. Since future book values are only an estimate, the projected coverage based on them is also an estimate. This approach may be reasonable for an auto insurer that chooses to enhance it's policies to include Gap coverage, but it certainly complicates the sale of stand alone Gap in an auto dealership. Exposure to claim under Gap coverage is similar to that under credit life because both have the same end result – that the debt is fully paid if the covered event (total loss of vehicle / death) occurs. The primary difference is that credit life pays off the entire loan while Gap pays the excess of the loan above the value of the vehicle at the time of loss. Therefore, a rating approach similar to credit life using a single rate multiplied by exposure may be a reasonable compromise between the anti-selective one-rate-fits-all and a comprehensive structure that includes both amount of exposure and risk classification.

Estimating Exposure

If a deductible and delinquent payments are covered, the estimated exposure at the end of month t is:

$$Exposure_t = Max(0, LoanPayoff_t - VehicleBookValue_t - refunds_t + deductible + payments)$$

The total exposure under the contract is the sum of each monthly exposure. Using the estimated vehicle book value as of the loan maturity date from an industry source such as the Auto Lease Guide (ALG) and the book value at the purchase date, estimate the book value at each month-end using linear interpolation. Since new car book values often have a steep drop in the first year, include the estimated book value in 12 months from the same industry source as a third point to refine this interpolation. If there are other insurance coverages that have a refund value, the refund values can be estimated using the refund formula for each coverage as of the end of each month.

The above formula should be relatively easy to add to an F&I system because all of the input values are available or readily derived from values used in preparing financing documents. The only additional piece of information needed is the rate per exposure unit.

Estimating Claim Frequency

If an insurer has been writing Gap coverage for a few years and has had a sufficient number of claims, it is possible to derive a claim frequency per covered month. Covered months include all months during which the exposure is greater than zero; therefore, it is necessary to estimate the exposure for fully amortizing loans to determine if it is positive in each month. Since the final payment for a lease or balloon note is based on the vehicle's book value at the end of the term, it's reasonable to assume that all leases and balloon notes have a gap (positive exposure) in each month. An alternate approach, and a good check on the previous procedure, is to use the average frequency of total loss on insured and financed vehicles from company data or a service bureau.

Administration

GAP is relatively easy to administer because there's only one premium, there can only be one claim and claim frequency is low. However, the insurer should gather enough information at application, during policy issue and for claims and refunds to facilitate exposure and claim studies. This information should include:

- Vehicle information: selling dealer; make, model & year; book value of the vehicle at purchase and at loan maturity
- Loan characteristics: Type – fully amortizing, balloon, lease; effective date; initial amount; term; payment; balloon amount, if any; interest rate
- Coverage characteristics: coverage limit; deductible covered; delinquent payments covered

- Claim information: date of loss; cause of loss (theft, accident); net claim; loan payoff; insurance recovery; book value as of loss date; deductible / payments covered
- Refund information: refund date; amount of refund

Summary

Gap is easy for consumers to understand and insurers to administer, but is a relatively immature and highly competitive product. The relative immaturity shows in the “one or two rates fit all” rate charts of most carriers. Gap should be a good product for insurers in auto dealer market, but it needs a market leader to redefine the rating scheme so that the underlying risk is better reflected in the rate charged before it becomes an attractive product to underwrite.

Next installment: Finance Reserve