AS SEEN IN CANADIAN AUTOWORLD

The Hindenburg, Chernobyl, gap insurance and Farm Film Report

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The Hindenburg and the Chernobyl Nuclear event have become synonymous with things blowing up – like going down like a lead Zeppelin or adding 'ed' to Chernobyl, a verb for disastrous outcomes. And although we should never make light of any event where lives were lost, nonetheless for those of us in the insurance industry we use these events as comparisons for programs that fail. Thinking back (and I am showing my age or experience) I recall the days of International Warranty and FADA Guard and like those blowing up they are akin to the GAP Insurance programs of today.

GAP (Guaranteed Asset Protection) covers the difference between the Balance due on a vehicle loan and the insurance settlement provided by a primary insurer when a vehicle is deemed a total loss by fire, theft, accident or flood damage. In the industry we all know this difference as negative equity and it's no secret that being upside down is rampant and it's launched the need for GAP insurance and it's become one of the best-selling products in the business office today; people really need protection from negative equity.

Every GAP program in Canada is under pressure and prices have been trying to keep pace with market conditions. However, a perfect storm is happening. and like Chernobyl, GAP is a ticking time bomb getting close to blowing up. Once the reactor was shut down it set off a sequence – caused by graphite tips in the cooling rods and design flaws in the reactor – that set into motion rapid overheating, steam production and Reactor Number Four soon exploded. And the Hindenburg, filled with an explosive hydrogen, needed only a single static electrical spark to blow up.

What is blowing up GAP?

Well – negative equity – and that of course is why GAP was created and is bought so prolifically. Then automotive lending practices changed and banks began lending based on an individual's ability to pay (vs capping loans to the value of the asset) – then banks, under pressure to lend and fill the void left behind when leasing stalled soon extended finance terms from 60 months to 72, then 84 and now 96 months. As a result, more and more negative equity happened i.e. rolling negative equity from previous financed vehicles into a new loan. Now we see loans that are actually two-and-a-half times the value of the vehicle being financed (i.e. a $62,500 loan for a $25,000 car). And in some cases, we've seen loans added with student loans, consumer credit card debt or other higher interest loans and consolidated into automotive conditional sales agreements – and GAP Insurance is sold to pay off the difference.

The landscape of negative equity in the Canadian auto book has changed drastically. When GAP was first designed and priced, a matrix based on amount financed and term would generate a cost, and it worked. However, as time passed GAP insurers counted on the historic practices that banks were lending within a fixed ratio to the value of the car – but like Chernobyl and The Hindenburg, no one anticipated the design flaws built into their modeling.

However, we now know that by simply changing a matrix to combat unanticipated lending practices, with loans 250 – 300 per cent of the value financed (Loan to Value or LTV) will not work. In the insurance industry we refer to an increase in this ratio as an increase in our "severity", or another way to look at it, as our "average loss". And, the other insurance factor to consider is the frequency of the average loss happening (how many times out of 100 a vehicle is written off). With air bags, sensors, electronics in bumpers, radar and parking cameras and the like, the frequency of deeming vehicles a total loss has, like the severity, skyrocketed.

It goes without saying that a $62,500 loan for a $55,000 car (114 per cent LTV) over 72 months is a completely different risk than a $62,500 loan on a $25,000 car over 72 months (250 per cent LTV). A matrix generated price is like using graphite tipped rods or a hydrogen filled aircraft; a term and loan amount does not equate to GAP risk in the Canadian auto lending world – it generalizes it, and if we were to continue to use a simple loan amount and term pricing model (without pricing valueless lending), the program will blow up.

So, what is the answer in creating a sustainable GAP program in Canada? The only way I see this to be done, with any continuity, would be to price the premium based the LTV risk and factor the frequency data available for each group of vehicle value (new and used) – as an example a $17,500 used car is riskier because these cars are written off far more frequently than a $50,000 new car.

To end with some humour for a sobering topic – I can't help myself and think back to one of my favourite TV shows, SCTV (Second City TV) and a bit Joe Flaherty and John Candy did as Big Jim McBob and Billy Sol Hurok called The Farm Film Report. You might not remember the Report but you might remember – "it blew up reeeeeal good!" Google The Farm Film report and watch the episode with Andrea Martin as Bernadette Peters.

GAP, "it blew up reeeeeal good!" I miss that show. CAW

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