PERSPECTIVES

EXPLORING MARKET INEFFICIENCIES IN TOTAL LOSS CLAIMS

A Growing Challenge with Negative Equity

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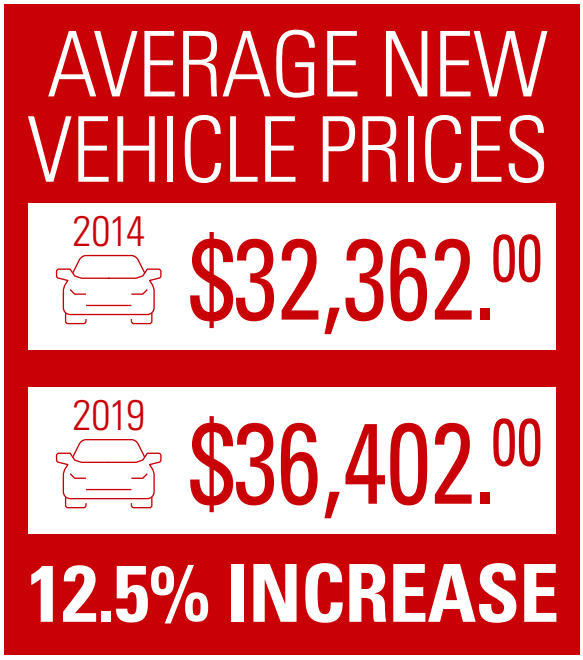
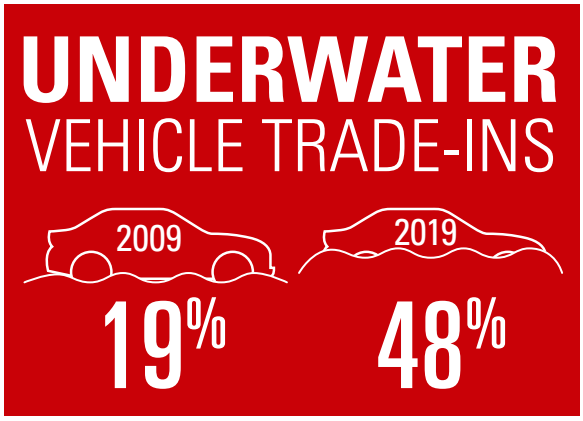
Shifting market trends with respect to automotive lending, equity, and total losses have led to rising inefficiencies in the processing of total loss claims that can prove costly on a large scale.

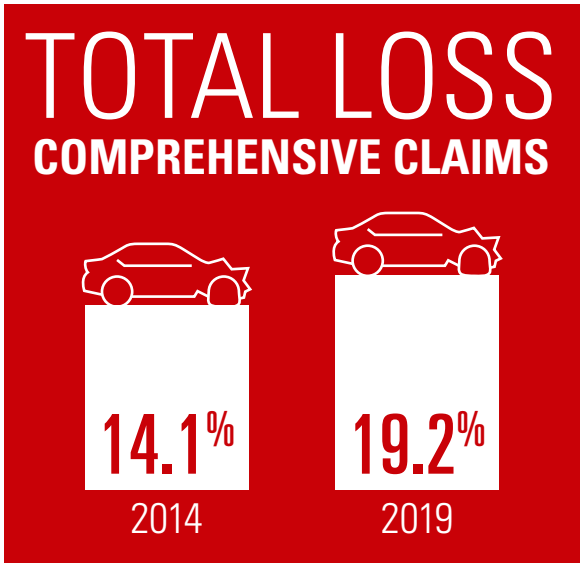
It is no surprise to those in the automotive and insurance industries that vehicles have become more expensive in recent years which has led to an uptick in the average length of auto loans. According to Experian, in the third quarter of 2019, the average new car loan length was 69.3 months, with 73.2% of all new auto loans lasting longer than 60 months, and 32.2% of all new auto loan terms exceeding 72 months in length.[1] An important contributing factor to longer loan terms has been higher prices and increasing loan amounts. The National Automotive Dealers Association (NADA) found that the average price of a new vehicle in 2019 was $36,402, which is quite a jump from even 5 years earlier in 2014 when prices were at $32,362, representing a 12.5% increase over that timeframe.[2] For comparison, inflation over that time period was roughly 8.4%, suggesting that in real terms average car prices outpaced inflation by about 4%.[3] In fact, the average auto loan size amount has increased by 26.3% over the past ten years through April 2019, where it sat at $22,739 per loan. Furthermore, the average new car loan size for all new vehicles was $32,480, while the average used car loan amount was $20,449.[4] Additionally, from 2014 – 2019 while real wages increased by a modest 7%, there was a 23.5% increase in consumer spending on motor vehicles and parts adjusted for inflation.[5] Given that new car prices are outpacing inflation, and consumer spending on vehicles and parts is far outpacing wage growth, it appears that consumers have adopted a strategy of longer loan terms and higher loan amounts.

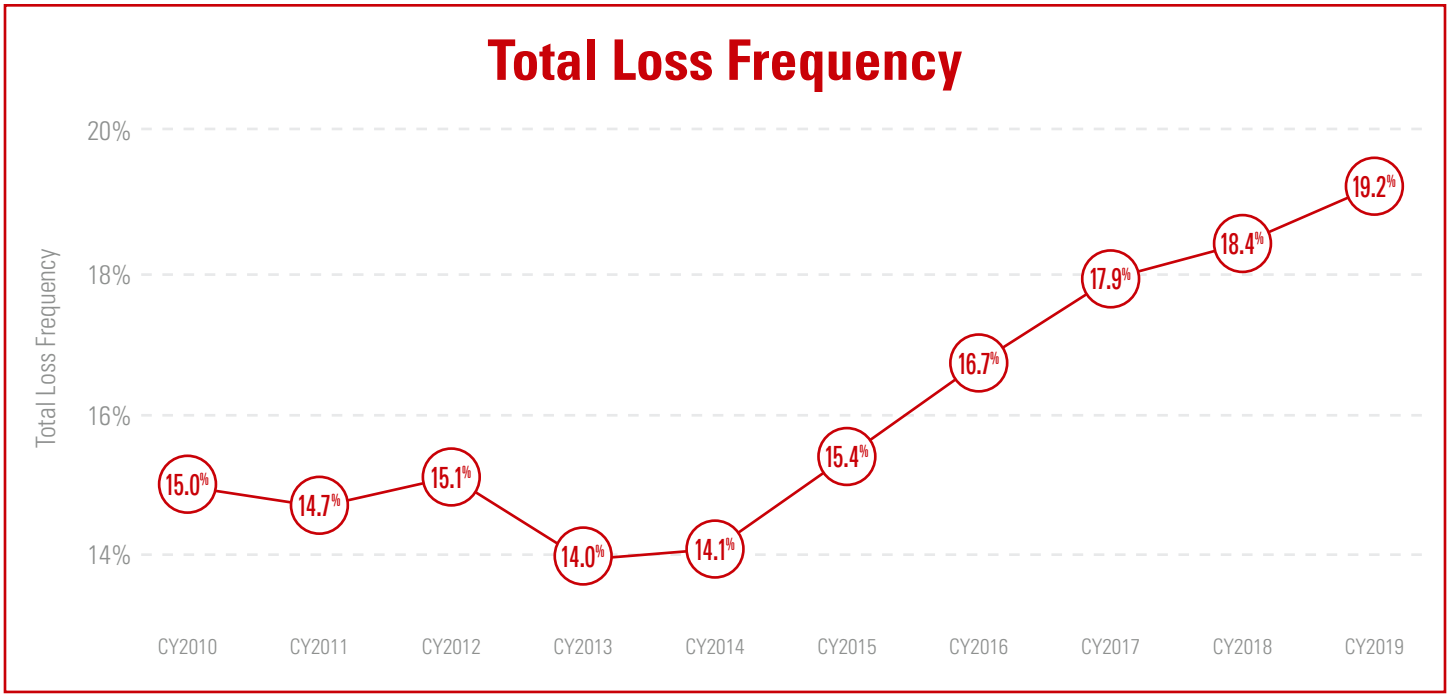
The side effect of an increase in average vehicle prices and an extension of loan length is a rise in vehicles with negative equity loans driving around on our roads. By one estimate in 2019, roughly 48% or one-in-two vehicles traded-in were facing a negative equity situation. This is a sizeable increase from the 19% of owners that traded-in vehicles with "underwater" loans in 2009.[6] While there has already been a large increase in this number, this percentage only stands to increase with the combination of higher vehicle prices, longer loan terms and larger loan amounts in the face of persistent vehicle depreciation.

So, what do these trends have to do with total loss claims? The harsh reality is that these trends point to an increasing number of total loss vehicles facing the complications of negative equity and loan payoff challenges. In 2014, the percent of comprehensive claims that were deemed to be total losses was 14.1%, which is a number that has grown to 19.2% in 2019, as noted in the figure below.[7] The rise in total loss frequency over the years can be linked to a host of market changes including more vehicle miles traveled, older vehicles, new and expensive hard-to-repair technology, and challenging weather events.[8]









Additionally, in the third quarter of 2019, 85.4% of new vehicles and 54.7% of used vehicles were acquired with financing, and of the total loss vehicles between 60 – 70% have loans that still need to be paid off.[9,10] So here is the potentially concerning conclusion, if consumers are buying more expensive cars, by taking out larger and longer loans, they are thereby increasing the risk of becoming "underwater" on their loans. Simultaneously, if the percent of vehicles deemed to be total losses has been rising, it stands to reason that the likelihood of consumers, banks, and insurers being forced to resolve the complex situation of totaling vehicles with negative equity is increasing.

So where is the market inefficiency? At its core, totaling negative equity vehicles is becoming a more common occurrence. In a situation of positive equity, the total loss settlement and lien payoff process begins with the insurance company determining the actual cash value (ACV). A check of the approximate ACV, taking into account mileage and condition, will go directly to the lienholder. If the car was worth more than the loan amount, then the owner would likely have funds to go toward a replacement vehicle. However, in the negative equity case, complications ensue as the ACV will not cover the full amount of the loan. Thus, arrangements must be made between the owner, the lienholder or lender, and the insurance carrier to pay off the loan and transfer the title to the insurance carrier, all while the original owner decides whether to pay off the remaining loan balance in excess of the ACV or roll that balance into a new loan for a replacement vehicle.

This is called "a process" for a reason. According to IAA data, the average time IAA is in possession of a vehicle can range from 45 days to 90 days from start to finish given the typical, manual, labor-intensive process of settlement.[11] Market inefficiency lives in this process due to time. The longer the process, the more labor resources that are required, the more negotiation between stakeholders, the more value depreciates, and the longer a consumer stays out of the market for a new vehicle leading to customer retention issues for lenders and providers. **IAA has sought to address this inefficiency with the IAA Loan Payoff program which has been able to reduce the average loan payoff process time by 12 days for positive equity vehicles, and by 21 days for negative equity vehicles on average.**

In short, the combination of increasing total loss frequency with rising instances of negative equity on vehicles stands to further perpetuate the market inefficiencies involved in the total loss settlements and lien payoff process.

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