

# POWERFUL SOLUTIONS

## For maximum F&I profitability

### Loss Ratios, Actuaries, and Risk Aversion

A loss ratio is defined as the ratio of the claims paid by an insurer to the premiums earned. A firm's loss ratio is 50% when they have \$50,000 worth of incurred losses versus \$100,000 in earned premium. Actuaries are the folks who compile and analyze these statistics and use them to calculate insurance risks and premiums. Risk aversion certainly occurs when the level of benefit provided by the coverage nears or exceeds the 100% level (i.e. incurred losses surpass earned premium). This occurs, for example, when a driver's insurance company decides to cancel a policy due to too many and/or too large of a claims history.

We're all familiar with this and probably know someone who may even have had personal experience here.

Why are we reviewing this material?

Auto manufacturers are certainly not immune to the market forces at work here. The actuaries compare their data with the needs of the marketing personnel to determine what factory warranty coverage will be offered with a new vehicle sale. Once it is established that a particular warranty offering is sufficient to withstand competitive forces within the industry, as well as the threshold of risk aversion, the term and mileage limits of the full mechanical, powertrain, and other coverages are determined.

The bottom line here is that most automakers have determined, for example, that not only do they offer the levels of "factory" warranty coverage that they do to meet the demands of competitive market forces, but also to remain within risk tolerance guidelines. In other words, beyond a certain point they no longer want to assume the responsibility of paying for the parts and labor necessary to effect repairs to certain components. It is, at this point, they have become risk averse.

We may feel that our new vehicle buyers are more risk averse than those purchasing pre-owned. After all, they are purchasing a vehicle with full "factory" coverage. But is this really the case?

Risk aversion could easily be dictated by available cash-on-hand to deal with the needs created by unexpected repair costs. Today's high-tech vehicles are more costly than ever to diagnose, purchase parts for, and repair. Does our new/used vehicle purchaser's level of risk acceptance suddenly pick up where the factory's ends? Are our used vehicle purchasers truly less risk averse than those buying new, particularly when you consider the length of the average used vehicle loan today? Does anyone gladly fork-over potentially thousands of dollars (almost always at the worst possible time) to keep their vehicle on the road and functioning properly?

If the experts who build these vehicles have decided to draw the line at a specific point, perhaps the reasons for this should be considered too.

Think about it. Are you expressing these sentiments to your customers in your own words? Has the question been posed in a thought provoking way? Are we leaving our guests to draw their own conclusion that perhaps the reason a full mechanical warranty, as provided by the manufacturer, ends when it does is for no other reason than that is all they have to offer to remain competitive? Why does the full mechanical coverage (which may cover over 5000 items) end, typically, far earlier than the powertrain coverage? Could it be that they become risk averse regarding all those additional components far earlier than those that are covered by the powertrain only?



The answer is plain to me....

Give it a try.

Good luck and good selling!

