

Room for Recovery

By Randy E. Dumm, James M. Carson, L. Lee Colquitt, and George D. Krempley

By understanding how vehicle characteristics impact their auto salvage rate of recovery, insurers can reduce claims costs.

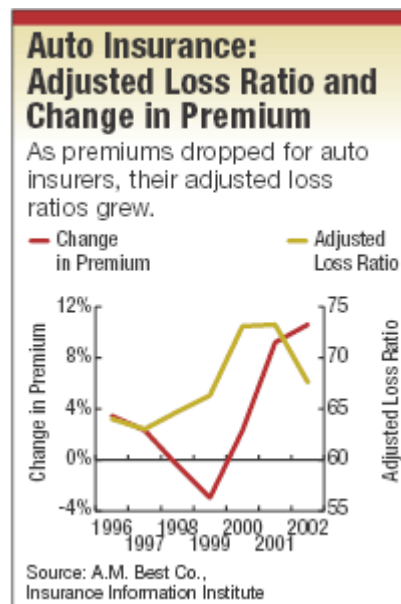
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Automobile insurers operate in an increasingly intense environment of price competition. Although prices in the auto insurance marketplace have been rising recently, several characteristics of the industry's structure make intense competition more or less inevitable. Several hundred carriers are active in the auto insurance market. The largest writers of auto coverage were relatively untouched by Sept. 11th-related losses and tend to have large and underutilized capital bases, heightening competitive pressures for growth. Auto insurance also affords very little opportunity for product differentiation, and new product features introduced by one carrier tend to be copied almost immediately by competitors. Any attempt to build competitive advantage on the basis of superior product quality is difficult to sustain.

The barriers to entry are relatively minor: Capital requirements are low, and technology and expertise are generally available in the open market and can be obtained with only minimal difficulty. In addition, Conning Research & Consulting reports that auto insurance is a mature market and will produce a less than stellar performance over the next five years. Part of the reason for the predicted low return on surplus is that insurers have not made sufficient progress in controlling expenses when compared with other industries.

Despite the competitive pressures, the auto insurance market remains crowded. Today, multiple sources of competition are at play: insurers that traditionally have been active in the auto insurance sector, insurers that have been active in other segments of the insurance industry (such as Lutheran Brotherhood), and financial institutions that recently have entered the auto insurance marketplace. Additionally, insurers are faced with the potential loss of business to firms that self-insure their auto insurance exposures.

All of these factors place additional pressure on auto insurers to price competitively. During most of the period from 1996 to 2000 auto insurance premiums either grew at a decreasing rate or declined. However, loss ratios during this time increased from 64 in 1996 to more than 73 in 2000. Although prices in the auto insurance marketplace have been rising, competition is expected to limit these price increases and thus limit insurers' financial gains in this area as well. The years 1998 and 1999 provided the first declines in auto insurance written premiums since 1973. That trend is now reversing as auto insurance premiums rose at a rate of 9.2% in 2001 and 10.6% in 2002. Another 9% to 10% increase is expected in 2003.



Insurers are responding to this increased level of competition in several ways, one of which is controlling claims costs. Since both subrogation and salvage recoveries reduce losses paid, improved salvage recoveries are directly reflected in lower net losses. Given that insurers reap approximately \$3 billion a year from the auto salvage marketplace, any improvements in this area are likely to result in substantial savings to an insurer.

A recent auto salvage study by the authors examined the relation between vehicle types and loss types and salvage recovery performance and demonstrated that differences in salvage recoveries do indeed exist between insurers. The ability to competitively price auto insurance depends on the insurer's success in estimating net losses. With a deeper understanding of how vehicle characteristics ultimately impact the dollar amount of recoveries, the insurer can adjust its premium schedule accordingly. In turn, better information on the drivers of salvage recoveries will assist insurers in making better decisions regarding whether to repair or total their vehicles.

Where Do the Cars Go?

Insurers use two primary methods to dispose of totaled vehicles. The first and most frequently used method is to dispose of vehicles through an auction process. The other primary method used is to sell salvage directly via contract. The responsibility of the salvage auction is to make the market between automobile salvage sellers (primarily insurers) and buyers. Vehicles usually are sold on a live auction basis, but some salvage auctions are now conducted via the Internet. Under the salvage contract method, insurers enter into a contractual agreement with salvage dealers or salvage pools. Under this arrangement, the value of the salvage is predetermined based on a percentage of the vehicle's actual cash value. Although these are the two primary methods, several additional ways to dispose of salvage also exist, including sealed bids, direct sales to insureds, and the insurer's own auctions.

The study examined 66,760 vehicles that were sold through a salvage pool arrangement during 1998 by 55 insurers. Salvage performance can be measured in a variety of ways. In this study, gross rate of recovery (as opposed to net rate of recovery, which includes expenses involved in the salvage process) is used, and is defined as follows:

$$\text{GRR} = \text{Salvage Price of Vehicle} / \text{Actual Cash Value of Vehicle}$$

The charts on page 68 illustrate the top 10 cars ranked by gross rate of recovery, the gross rate of recovery by vehicle type and age, the gross rate of recovery by vehicle and damage type, and the distribution of salvaged vehicles of the top five and bottom five insurers ranked by gross rate of recovery, as determined by the study.

Learning from the Study

In an environment of intense price competition, auto insurers stand to benefit from any competitive advantage that they can obtain. By improving performance in the area of claims management, and more specifically, auto salvage, an insurer could realize substantial savings and consequently have a more competitively priced insurance product. The benchmarking information provided by this study allows insurers to gauge their relative performance in this area.

Auto Salvage Study Results

These charts offer information from a sampling of 55 auto insurers. Auto writers can use the results to compare their auto salvage numbers to determine if claims costs can be reduced. By understanding how vehicle characteristics impact the dollar amount of recoveries, insurers can estimate their net losses more accurately and price premiums more competitively.

Distribution of Salvaged Vehicles for Top and Bottom Insurers Ranked by Gross Rate of Recovery

The highest gross rate of recovery of any insurer in the study is 22% and the lowest is 15%, demonstrating a need for improvement in auto salvage among insurers. The study also shows the average vehicle age of the top five insurers is one year less than the bottom five insurers.

Rank	Insurer ID	GRR	Age	Luxury	Distribution of Vehicle Type			
					Cars	Trucks	SUVs	Vans
1	A	0.22	7.4	0.11	0.72	0.20	0.07	0.01
2	B	0.21	5.2	0.13	0.77	0.12	0.06	0.05
3	C	0.21	6.1	0.07	0.64	0.15	0.11	0.10
4	D	0.21	7.3	0.04	0.71	0.16	0.07	0.06
5	E	0.21	6.3	0.04	0.57	0.26	0.08	0.09
Average		0.21	6.4	0.08	0.68	0.18	0.08	0.06
51	AA	0.16	7.30	0.15	0.91	0.04	0.03	0.02
52	BB	0.16	7.87	0.06	0.76	0.13	0.08	0.04
53	CC	0.16	7.55	0.10	0.76	0.12	0.08	0.05
54	DD	0.16	8.11	0.04	0.81	0.12	0.03	0.04
55	EE	0.15	8.88	0.07	0.84	0.11	0.02	0.03
Average		0.16	7.94	0.08	0.82	0.10	0.05	0.04

Note: From sample of 55 insurers

Top 10 Cars for Gross Rates of Recovery

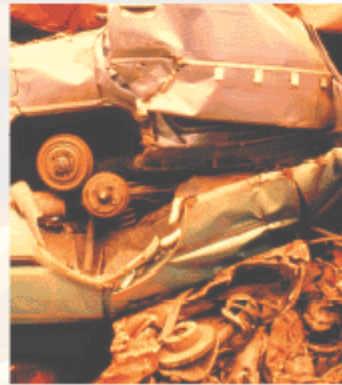
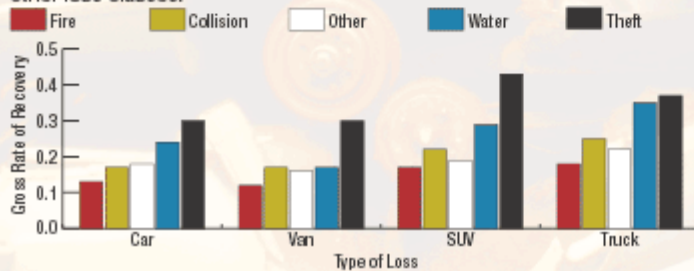
Luxury cars and high performance sports cars bring auto insurers the most recoverable dollars when sold via salvage auction.

Rank	Make	Model	N *	Gross Rate of Recovery
1	Lexus	L Series	85	0.35
2	Lexus	GS Series	37	0.31
3	Chevrolet	Impala	50	0.30
4	Lexus	S Series	41	0.27
5	Lexus	ES Series	114	0.27
6	Chevrolet	Corvette	162	0.26
7	Infiniti	Q45	39	0.26
8	Porsche	911;940	39	0.25
9	Toyota	Corolla	1,964	0.25
10	Toyota	Camry	1,687	0.24
Average				0.28

* N = number of cars in sample for each category

Gross Rate of Recovery by Vehicle and Damage Type

Theft losses have the highest gross rate of recovery for all types of vehicles because they generally have less damage than vehicles in other loss classes.



The study shows that the average gross rate of recovery for automobiles ranges from 17% to 25%, depending on the type of vehicle. The results indicate that newer vehicles, trucks, and loss by theft are characteristics of vehicles associated with higher gross rates of recovery. Thus, insurers whose books of business include higher proportions of these types of vehicles would be expected to have higher average gross rates of recovery. The study found that the top five insurers ranked by gross rates of recovery have rates of either 21% or 22% and the bottom five have gross rates of recovery of either 15% or 16%. The distribution of car type and car age for the top and bottom five insurers is consistent with findings suggesting that the age and type of vehicle have a substantial effect on an insurer's gross rate of recovery. Armed with the benchmark information for gross rates of recovery from this study, insurers are able to gauge their relative performance with respect to auto salvage and determine whether or not there are potential opportunities to reduce their overall claims costs.

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