Blanket & Self-Insurance vs. CPI

A No-Nonsense Guide to Choosing the Right Program for Your Financial Institution's Portfolio

StateNational

How can lenders best protect their collateral, reduce expenses, and support healthy auto and mortgage loan growth? Growing economic uncertainty and a variety of other factors are leading more lenders to reassess their appetite for risk so they can evaluate and implement programs that protect their portfolios against growing uncertainty as well as find cost savings that can be redistributed to borrowers.

This guide offers a clear and simple look at how self-insurance, blanket, and collateral protection insurance (CPI) programs compare, the relative advantages and disadvantages of each, and how to assess which type of program is best for your organization.

A QUICK COMPARISON OF HOW EACH PROGRAM WORKS

The fundamental purpose of any insurance program is risk-transference. When evaluating different types of insurance products, you'll want to ask questions like: How much risk can you tolerate vs. how much do you want to transfer? What are your goals and objectives? What do you expect in return? Whatever program you chose should address these questions to your satisfaction.

Self-insurance

A self-insured lender assumes all risk and absorbs any losses that occur. The greatest disadvantage of self-insurance is that risk is not transferred. To minimize uninsured losses, some self-insured lenders add follow up procedures such as:

- Requiring evidence of physical damage insurance at the time of loan closing.
- Writing or calling borrowers when evidence of insurance is not received.
- Writing or calling borrowers who receive cancellation notices from insurance carriers.

These procedures are difficult to execute and rarely effective without a mechanism for forced placement.

Blanket

With a blanket insurance policy, lenders pay a premium based on the total number of loans, typically a fixed dollar amount per vehicle or a percentage of the outstanding balance. Although state laws are constantly changing, just over 30 jurisdictions allow the cost of blanket to be passed on to borrowers, regardless of their individual histories. In states that do not allow borrowers to pay the costs of a blanket policy, these costs must be borne solely by the financial institution.

CPI

CPI enables lenders to manage and mitigate risk by transferring the risk of uninsured collateral to an insurance provider. A third-party insurer administers a program, and only borrowers who actually fail to purchase their own insurance pay the cost. CPI is a guaranteed-issue, no-underwriting-required insurance product. A borrower who does not comply with the loan requirement to procure private insurance is “written” regardless of age, driving record, or location of residence. Loan balance is the only criteria for acceptance. Coverage for insurance force-placed in a CPI program offers financial institutions the same protection as would the insurance that should have been procured and maintained by the borrower.

In administering the program, the CPI provider receives a file of all new loans and updates on existing loans in the lender's portfolio and then tracks the insurance status of each loan. The provider confirms which borrowers have not provided adequate proof of insurance and sends appropriate notices alerting them to do so.

If the borrower fails to submit proof of insurance in response to these notices, lending institutions may then choose to place CPI on a noncompliant borrower's loan to protect the lender's interest from damage or loss. The financial institution passes the cost to the borrower by adding the premium to the balance of the loan, and the charge is removed as soon as private coverage is reinstated.

Importantly, by passing the premiums of CPI to uninsured borrowers, it costs financial institutions little or nothing to obtain this protection. While it's impossible to avoid all risk (other than by stopping writing loans altogether), a CPI provider can help you, the lender, find a point of equilibrium at which the protection provided by the program complements the level of risk that your institution wants to assume.

This naturally leads us to our first action item for self-assessment, which we'll cover below: determining your appetite for risk.

WHICH PATH IS RIGHT FOR YOU?

A 6-Step Guide for Financial Institutions

1 Determine the level of risk your institution is willing to assume.

Financial institutions have different appetites for risk. More broadly, they have different core philosophies regarding who should bear that risk. Carefully consider each program within the context of your outlook regarding who is ultimately responsible for bearing the risks and costs of non-compliance.

This is one decision where your stated values as a financial institution are tested through real-world choices that have very tangible outcomes. Different programs demonstrate different values and the effects on your borrowers are felt in dollars. This is perhaps most apparent between blanket policies and CPI, where additional costs due to non-compliance are distributed differently — either across all borrowers or only those who fail to retain insurance.

Effective insurance providers can partner to help you choose the type of product that provides precisely the level of protection you need to complement the level of risk you're comfortable taking on. As State National's Executive Vice President Trace Ledbetter explains, step one

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of assessing or reassessing your insurance arrangement is determining where you stand on risk and what type of policy will demonstrate that position to borrowers.

> “One of the very first things that should factor into the thought process when evaluating these different paths — self-insurance, blanket, or CPI — **is a philosophical decision at its core.** Specifically, who should bear the cost of risk and loss due to a person’s non-conformance with your loan agreement? Should that be the institution, all borrowers of a financial institution, or just those borrowers who are not in compliance with your loan agreement? **Make a decision on your broader view for who bears the risk** and make sure the path you choose is one that aligns accordingly.”
>
> **TRACE LEDBETTER**
> *Executive Vice President, State National Companies*

2 Consider market drivers, costs, and broader economic conditions.

Defaults and subsequent repossessions are an unfortunate part of the lending business. Unforeseen circumstances can turn even long-time customers into delinquent borrowers. With indirect lending, the chances of default are even greater.

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Unfortunately, not all borrowers maintain the physical damage insurance coverage on their vehicles that the terms of their loans require. **Nationwide, nearly 15 percent of all drivers are uninsured.** Additionally, borrowers who become delinquent are far more likely to be without required physical damage insurance than those who are current.

Now for the worst part: most repossessed vehicles have unrepaired damage. A State National study of three large auto loan lenders found that as many **as 97 percent of repossessions were damaged, with physical damage averaging $1,390 per vehicle.**

Every lender has to decide how to protect its loan portfolio from this kind of risk, choosing between either self-insurance or risk-transfer (insurance) mechanisms. In self-insurance, lenders absorb the risk of loss and may or may not administer an insurance follow-up program internally. The risk and uncertainty of self-insurance, therefore, leads most lenders to look to a third party to protect loan collateral.

Since both blanket policies and CPI provide third-party insurance protection, how can you determine which one is right for your loan portfolio?

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Cost is one factor, and often the most significant. In essence, a blanket policy is a “cost plus” policy, with the lender trading dollars with the insurance company that must cover both the cost of claims plus the insurer’s expenses. Therefore, the direct cost of the blanket policy to the lender will continue to increase as loan business grows. The cost of a blanket policy on a growing book of business will increase regardless of whether or not a policy’s loss ratio—the ratio of claim payments lenders receive to premiums they pay — worsens.

Some states allow lenders to directly charge the cost of blanket insurance to customers, while others do not. Regardless, any costs and expenses lenders incur must either be passed to borrowers indirectly or impact the lender’s loan portfolio negatively.

The added cost of blanket insurance can weaken the lender’s competitive edge in the market. The best borrowers can shop and take their pick of lenders, especially on indirect loans, on which lenders compete for business more directly and auto manufacturers subsidize the market. Naturally, consumers are most likely to choose a lender with lower rates and fees — one that is not building the cost of a blanket policy premium into the loan cost.

In contrast, CPI policies add no up-front fees to a loan and only charge premium to individual borrowers who do not obtain or maintain required coverage. Additionally, in some circumstances, lenders can receive an administrative reimbursement under CPI that actually defrays any cost of the program and further protects the bottom line.

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Options in CPI programs also provide coverage for both hard and soft dollar costs beyond pure physical damage repair costs. These options can include towing coverage, mechanics lien coverage, waiver of actual cash value (where a claim is settled for the cost of repair or loan balance), and "skip coverage" for when vehicles cannot be recovered and the entire outstanding loan balance is paid.

Finally, some credit analysts are predicting that challenging economic conditions are likely to cause auto repossessions to increase in the coming years, even for prime portfolios. Since many repossessions have damage, the increase in paid claims under a blanket policy will cause renewal premiums to skyrocket. Because the cost of CPI is borne only by noncompliant borrowers rather than the lender, the relative value of a CPI program versus blanket will actually increase in direct proportion to the number of charge-offs.

> **"Do you really want to absorb more losses moving into a potentially slowing economy where leveling wages and greater unemployment will likely lead to more repossessions and charge-offs? Financial institutions need to make a fundamental decision regarding risk in the future. Do you want to take on more risk or less?"**
>
> **TRACE LEDBETTER**
>
> *Executive Vice President, State National Companies*

In short, investing the time and energy in determining which insurance product will enable, rather than inhibit, loan growth can have a significant bottom-line impact.

3 Consider how an insurance product leverages new technology to improve administration and reduce borrower noise.

Misconceptions and little-known details of how some insurance products compare to others can reveal significant differences related to administration and borrower noise. The unique monitoring component of modern CPI products is one such detail that has made it increasingly attractive to many financial institutions.

While conventional wisdom says that blanket policies are easier to administer than CPI because they cover all loans by default, a certain percentage of borrowers will, unfortunately, not purchase and maintain the insurance required by their loan contract if requirements are not rigorously enforced. Without the ability to monitor the loan portfolio, the number of uninsured drivers will increase over time and losses will rise. Because insurers must recover not just losses, but also expenses, every $1 increase in claims filed can result in nearly a $2 increase in premium.

CPI, by comparison, utilizes monitoring technology to minimize the touchpoints needed to identify the often small fraction of genuinely uninsured individuals, thereby greatly reducing borrower noise in the process.

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To achieve this, premier CPI insurers offer online systems that give lenders instant access to borrowers' insurance records, customized management reports, billing options, and other information. Ideally, this online information is updated in real-time, rather than in overnight batches.

At State National, for example, we've automated electronic data interchange (EDI) to provider automatic updates when a borrower's insurance is renewed, thereby eliminating manual data entry and lowering the chances for unnecessary notices and placement errors caused by acting on out-of-date information. Lenders also receive monthly reporting of premiums earned and claims paid.

“There's nothing more frustrating to a borrower when 48-hour processing times lead to a notice being sent when it shouldn't. That's how you create borrower noise in the first place and it's why 100 percent of the insurance we receive is updated before a notice is ever sent. The ability to process all insurance before you send a notice is critical. The feedback we receive from borrowers suggests this goes a long way in making people feel respected and that their experience was a positive one. No matter what the issue is, the questions are the same: Are people treated in a way that aligns with the type of experience the financial institution wants to provide to its borrowers? Do they understand exactly what they need to do to resolve an issue? That's what defines a successful outcome.”

TRACE LEDBETTER

Executive Vice President, State National Companies

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A good tracking system does more than ensure that each loan has proper coverage: it also gives lenders warning that an “A” credit rating may be slipping. Borrowers who have let their insurance coverage lapse often have other financial problems. Notification of lapsed coverage presents lenders the opportunity to work with a borrower to keep the loan viable and prevent losses that come with problem loans.

In addition to the challenge of monitoring borrowers’ insurance when a lender chooses a blanket policy, there are many hidden administrative tasks and costs of blanket coverage that raise overall expenses without effectively adding to the bottom line or reducing risk. These include spending time answering questions about blanket insurance fees added to loans at origination, contacting borrowers, analyzing the best way to pass on or absorb the costs of a blanket policy, and renegotiating insurance contracts. Simply needing to track and assess fees on every loan can drive administrative costs 20 to 50 percent higher than with other options, such as CPI.

Even in moments where borrowers’ frustration and stress make such an outcome extremely challenging, a portfolio protection provider that has industry-leading systems and processes in place can still consistently score in the mid-90th percentile for borrower-reported quality of experience — strong evidence that these measures have a direct positive impact on borrowers in moments where frustration and stress make such an outcome extremely challenging.

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The direct benefits extend to financial institutions as well. All borrower correspondence and communications are fully transparent and available for institutions to monitor — not only to ensure quality interactions, but to gain useful intelligence for subsequent interactions.

As Trace Ledbetter explains, the remaining low-level borrower noise is addressed through a comprehensive escalation and resolution process with the goal of solving issues quickly and completely.

> **“Inevitably, there is always some borrower noise — there are complaints that need to be addressed through effective complaint escalation and resolution processes. Complaints can come from a number of channels. They can come directly from the borrowers through the contact center, they can come through the department of insurance, or from the financial institution. Having a well-rounded complaint escalation process where each and every complaint is centralized and escalated quickly to resolution eliminates a lot of the frustration.”**

TRACE LEDBETTER

Executive Vice President, State National Companies

4 Recognize the overall impact on you and your borrowers.

Insurance programs by nature generate some level of feedback from customers affected by them. When determining which product will minimize feedback and demonstrate borrower-focused values, it's important to measure and balance borrower noise concerns with your appetite for risk to identify which product offers the best fit for you.

- **Today's leading insurance products and programs are designed with an understanding of the importance of your borrower relationships.** As we explain in detail later, new tools and processes have significantly streamlined administration, leading to positive borrower-reported experiences in otherwise challenging circumstances.

- **The premiums customers pay for force-placed insurance are often no greater than those they would pay if they carried the insurance required in their contract.** With the right insurance product, policies can be tailored to meet the risk tolerance of an institution at a price point that's often less expensive than standard insurance in the open market.

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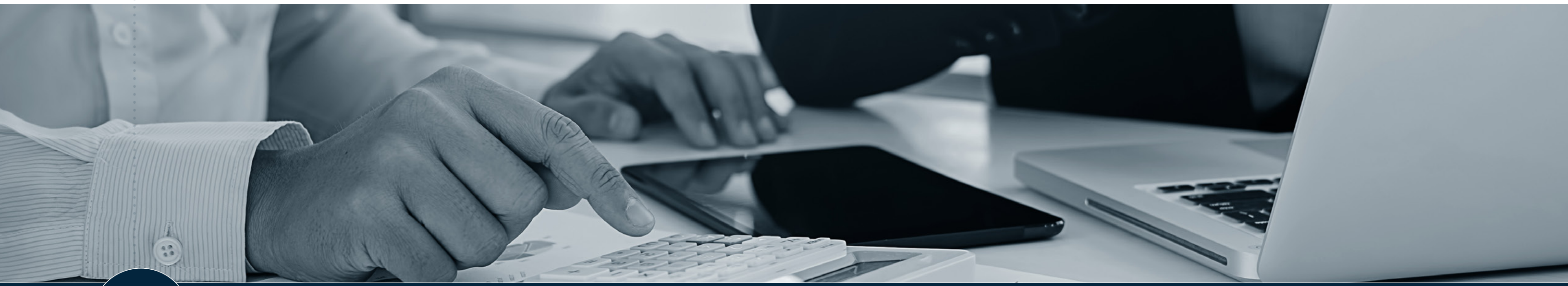
- **Many concerns voiced by financial institutions regarding the impact of some insurance products on borrowers aren't borne out in the real world.** For instance, some institutions fear that the cost of force-placed insurance could alter the risk profile of the borrower, resulting in an inability to make increased monthly payments and, ultimately, repossession. However, our own historical data reveals that few repossessions are actually caused by coverage being force-placed. In fact, many lenders find that products like CPI can actually be a predictor, rather than a cause, of larger loan problems. By monitoring exposures and identifying trends within a loan portfolio, financial institutions implementing a sophisticated CPI program often find that CPI's value far outweighs customer concerns.

Effective insurance products provide risk transfer and loan portfolio protection but can vary significantly in how they establish cost arrangements. For example, blanket policies offer a "cost plus" arrangement, wherein the lender effectively pays the cost of claims and the insurer's expenses through premiums. In contrast, only delinquent borrowers pay premiums under a CPI program. From a pure cost-benefit standpoint, the net effect can be either positive or negative depending on which type of program is in place.

The best insurance product will indemnify financial institutions for damage to vehicles they repossess, whether or not repairs are made before the vehicles are remarketed. A well-run program will combine the broadest coverage, and therefore the highest claim payment, with the people and technology needed to deliver outstanding customer service.



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> “In general, **cost is the number one factor driving financial institutions to switch from blanket insurance to CPI**. In addition to either passing costs through to borrowers or absorbing them, many institutions find they must raise rates regardless of claims, making them less competitive in the long run.”

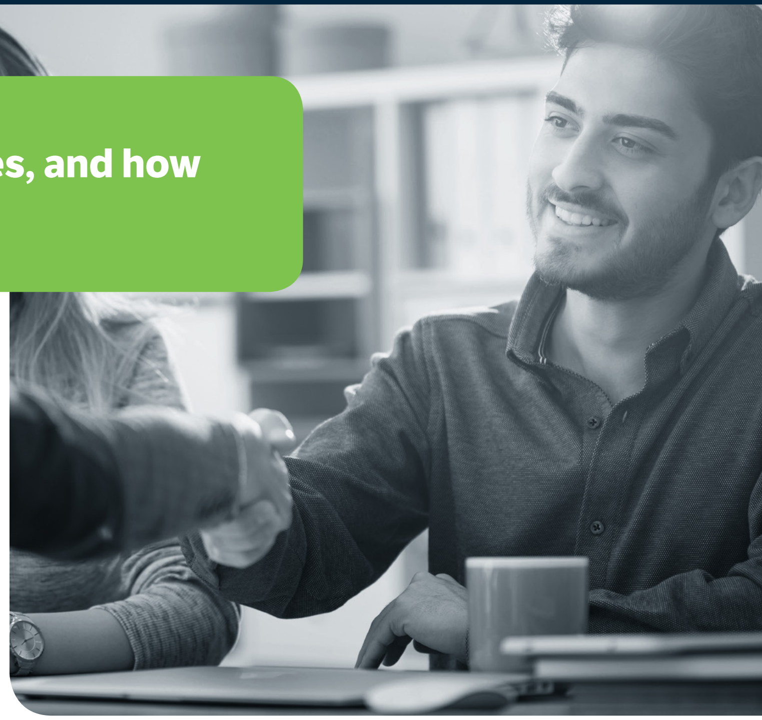
LOREN SHELTON

Vice President of Insurance Solutions, State National Companies

What lenders gain with a sophisticated portfolio protection program:

- An effortless program of collateral protection at almost no cost to the lender or insured borrowers
- Prompt, fair payment on all covered claims with risk assumed by the provider
- Extra lender coverage options, such as towing coverage, mechanics lien coverage, waiver of actual cash value, and skip coverage
- Freedom from yearly increases in blanket insurance premiums
- Reimbursement of administrative costs
- Incentive for uninsured borrowers to become insured

5 Analyze your losses, their sources, and how they impact your bottom line.



To compare the potential impact of one insurance product versus another, you need to dig in and perform a detailed analysis to understand where your losses are, where your charge-offs are coming from, and how many charge-offs you're experiencing.

This assessment alone often reveals that a large portion of these losses could be covered with an insurance product for which a blanket policy or CPI is often a natural fit.

> "For financial institutions, it's important to understand where losses are coming from and work with a provider to determine how much of that burden could be alleviated through an insurance product, whether it's a blanket policy or CPI. There's often a significant bottom-line impact on charge-offs and delinquencies. In many situations, adding or changing your insurance program directly results in fewer losses. Charge-offs improve, **enabling a financial institution to make more money available to its borrowers.**"

TRACE LEDBETTER
Executive Vice President, State National Companies

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In addition to understanding current losses, it's also important to recognize the signals that indicate it may be time to reorganize your portfolio and look for a more effective insurance solution. Climbing loan losses or charge-offs should both be immediate red flags. Perhaps less obvious, and specific to those with existing blanket or self-insurance policies, are risks associated with unforeseen events such as natural disasters, which can leave lenders on the hook to cover a potentially massive portion of those expenses when costs exceed typical blanket policy caps, or the entire expense if self-insured, virtually overnight.

Other less-than-obvious examples include loan programs geared toward first-time buyers or others that pose a greater overall risk. Coupled with a natural disaster, economic downturn, or other event, loan losses can quickly compound into a serious problem.

How CPI tracking goes a step further in directly eliminating risk for financial institutions

Simply by being trackable, CPI has an enormous advantage over blanket insurance policies, as it can identify where true risks exist or indicate a clear lack of proof of such risks.

When tracking is first enabled after CPI implementation, many institutions learn that roughly 30 percent of a typical portfolio will not show evidence of insurance. In truth, a large portion of these individuals are very likely insured, unbeknownst to the financial institution (which is also unaware of their risk profile). When tracking is initiated with the prospect of the lender placing a policy on that individual's loan, borrowers are given a financial incentive to respond.

State National's firsthand experience has demonstrated that the roughly 30 percent with unknown coverage will likely respond to notifications and submit their insurance information, usually shrinking the group to about eight percent — those that, at any point in time, genuinely do not have current insurance. With a full-fledged CPI program, that eight percent often reduces to one percent or less. Time and time again, State National has seen CPI be the motivating force for this group to obtain insurance, eliminating that additional risk from the financial institution's risk profile altogether.

6 Consider how the right insurance product can naturally complement growth goals.

Growth has been (and will likely continue to be) a primary organizational objective for financial institutions.

As State National's Loren Shelton explains, some insurance products offer solutions geared specifically to protect the growth strategy many financial institutions take to expand, namely through indirect lending.

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"When financial institutions need to grow, lending often becomes more aggressive. This can lead to more indirect lending, which often means taking on more risk. The potentially higher interest rates from indirect lending still come with a higher risk of loss. **Missing the mark on pricing interest can lead to a big challenge, especially with mergers and acquisitions.** When such a move immediately increases the number of loans under the organization, aggressive lending can lead to an expectation of perhaps three to four times the losses—especially when poor paperwork or procedures further complicate the problem. In short, **any number of challenges can happen that can quickly change the underlying math driving their decisions** and it often leads many who were self-insuring to move to CPI."

LOREN SHELTON
Vice President of Insurance Solutions, State National Companies

WHAT TO LOOK FOR IN A TRACKED CPI PROVIDER

1 Accurate tracking and insurance placement.

Borrowers understandably get angry when insurance is force-placed unnecessarily. Because the premium is added to the borrower's monthly loan payment, financial institutions must send a refund if it turns out the coverage was force-placed in error.

Look for a provider that sends timely, polite, and clear notices to borrowers, and reacts quickly when proof of insurance is provided. Ask the provider for references — or find them among your financial institution peers — and ask for their CPI refund rate.

2 Instant access to up-to-date account status.

You need to be able to answer borrowers' questions quickly and accurately. This requires having online access to up-to-date account status for every borrower, including any communications the CPI provider has sent or received on the account.

Streamlined claims service. 3

A CPI claims process that requires pages of faxed documentation just to file a claim is unlikely to yield quick decisions or payments.

Claims that require weeks or months to resolve can cause delinquent loans to get further behind. The delay can also stall a financial institution's effort to get a vehicle out of expensive storage, among other hassles.

These three elements are rooted in technology. You should seek a CPI partner with modern integration and automation capabilities.

MAKING AN INFORMED CHOICE

While self-insurance and blanket policies are still common among financial institutions, CPI is a fundamental part of a comprehensive risk management strategy to protect your auto loan business. With today's tight auto loan margins, consumer credit woes, and the particular perils of indirect lending, it has never been more critical to consider how this strategy can impact you and your borrowers.

Increasingly, the surest, fairest, most effective way to insure against loan portfolio losses is CPI. No other risk management mechanism can claim a similarly positive impact on your bottom line, and no other risk-transfer strategy is more effective and efficient than CPI, given the tools used to power it.

For example, Richfield Bloomington Credit Union (RBCU) in Richfield, Minnesota, originally went with a blanket policy because they thought the lack of tracking would make their program easier to manage — but increasing losses made them realize they were putting their entire credit union at risk.

Like RBCU, more lenders are discovering that blanket and self-insurance policies provide neither the cost savings nor the ease of administration they anticipated. The tracked CPI programs of today are overcoming these challenges while offering more robust protection in uncertain economic conditions. Sophisticated CPI programs are safeguarding financial institutions against losses, while also reducing charge-offs — **often by as much as 30 percent or more.**

As the leader and only insurer specializing in CPI, State National can help you understand where your financial institution stands to benefit most and offer you an efficient, effective, and easy-to-manage program that reduces risk, protects your loan collateral, and maintains valuable relationships with borrowers.

Action items to consider

- Determine how long it's been since you've analyzed your institution's risk level — not just today, but 12 to 24 months in the future — and, if necessary, refresh your figures.
- If you're currently not tracking the insurance requirements of your borrowers, contact an insurance provider who can work with you to calculate how much a tailored insurance product could save in charge-offs to distribute back to your borrowers.
- Have an in-depth conversation with your collections team to better understand what they're experiencing so you can accurately forecast future loan trends and act accordingly. Are they seeing fewer or greater skips and repossessions over time? Are 30-, 60-, and 90-day delinquencies falling or rising? These are all important precursors to potential risks.
- Consider what other interdepartmental analyses could contribute to a more complete risk profile. Areas such as lending, loss mitigation, or other impacted special services could offer valuable insight that could be used to more accurately forecast the future.
- Connect with a leading CPI provider to learn where you stand to benefit most from the various insurance options available to you. An effective provider will be equipped with financial models to help you determine which program is right for you.

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State National has specialized in collateral protection insurance for over 45 years, offering programs created exclusively for clients in the financial services industry, including credit unions, banks, and other specialty lenders. The programs State National provides have been time-proven to safeguard your portfolio against loss and to provide the protection you need to expand your loan portfolio. Our fast and fair claims settlement, unmatched service, timesaving technology, and financial rating of “A” (Excellent) from independent authority A.M. Best have made us the first choice for successful lenders nationwide.

Learn what’s possible with collateral protection insurance from State National. Call 1.817.265.2000 or contact us online.