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SFA Research Feature

Surging Auto Insurance Premiums Impact Credit and Affordability

March 1, 2024

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Insurance premiums inflation: A surge with momentum

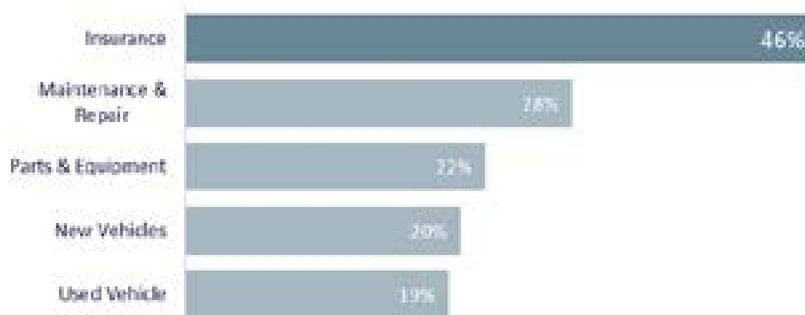
Securitization experts take note — rising auto insurance premiums are putting the squeeze on consumers and adding a persistent headwind to the already declining credit performance of the $1.6 trillion in underlying auto loans. As headline inflation has moderated, the insurance premium category has surged, and it's likely to continue to outpace other auto-related expenses for some time. Auto insurers continue to raise premiums in response to higher vehicle prices, rising costs of parts, and expensive repairs driven by inflation. This presents both an affordability and a credit challenge, which is particularly pronounced for low-income families and younger borrowers, a fact that is already manifesting in auto loan performance data.

Furthermore, experts predict that despite a projected stabilization in new and used vehicle prices (albeit at elevated levels), insurance premiums are anticipated to continue their upward trajectory. This article delves into the underlying causes of these premium hikes, explores the factors contributing to their likely persistence, and analyzes how that is affecting credit and affordability.

Auto insurance premium inflation outpacing headline CPI

Insurance premiums are not the most expensive cost component of owning a car, but they still represent a significant expense. According to Bankrate data, the average insurance premium is now $168 per month, or $2,014 per year. That's about 17% of the estimated $12,000 it takes to own and operate a car nowadays. Since December 2020, car insurance premiums have risen 46%, outpacing all other major cost categories associated with owning and operating a car or truck. This unusually rapid pace of increase in insurance premiums began to accelerate just after a pandemic-era respite and has continued apace even as the general inflation rate has abated.

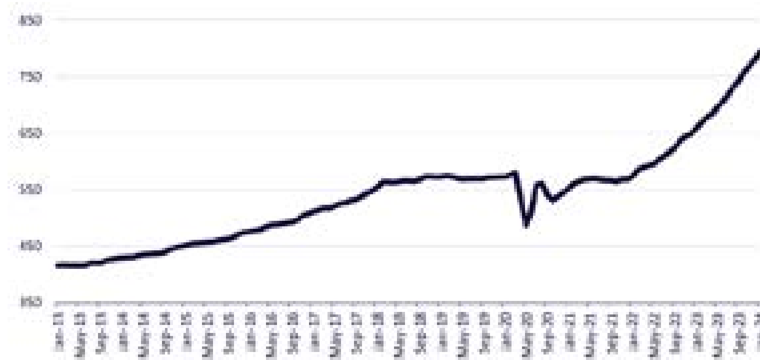
The Rise in Insurance Premiums Has Outpaced Other Cost Increases Since December 2020



Source: Bureau of Labor Statistics

The Bureau of Labor Statistics called out vehicle insurance premiums in the January 2024 CPI report. On a month-over-month basis, premiums rose 1.8% in January. On a year-over-year basis, they rose 20.6%, by far the largest jump in vehicle-related CPI expenditure categories, many of which fell over the same 12-month period. In fact, you have to go back to December of 1976 to find a higher annual jump in premiums (22.4%).

CPI for Insurance Premiums Has Risen Precipitously



Source: Bureau of Labor Statistics. 1982-1984 = 100

Premiums have yet to peak

The auto insurance industry is facing significant challenges as inflationary trends and their impacts on insurance costs continue to escalate. At the same time, the industry is grappling with the increasing complexity of modern vehicles, contributing to rising labor costs and longer repair times. For example, in January 2024, the CPI for motor vehicle repairs rose 7.9% compared to a year ago, much higher than the 3.9% increase in the broader, core CPI (excluding food and energy) over the same period. This has led to a rapid increase in auto insurance losses, according to a 2023 report from the American Property Casualty Insurance Association (APCIA). The report states, "Auto physical damage loss ratios quickly went from the short-lived, long-term low of 45.2 in Q2 of 2020 to a 20+ year high of 77.1 in Q3 of 2021, peaking at 84.6 in Q3 of 2022."

Insurance claims inflation has outpaced increases in premiums, contributing to substantial underwriting losses for private U.S. property casualty insurers. According to the same APCIA report, "property casualty insurers' premiums for personal auto increased just six percent for the year, far below the 24 percent rate of escalating losses." This dynamic is not sustainable and strongly suggests that there is momentum behind this trend of increasing premiums.

Private passenger auto insurance saw the highest direct loss ratio among major lines of business in 2022, with a significant increase from the previous years. Higher accident frequency and claim cost severity have increased, pushing loss ratios to new highs. People are driving fewer miles but getting into more — and more expensive — accidents. Riskier driving behavior is indeed contributing to the higher costs. Data shows a higher incidence of distracted driving, speeding, and driving under the influence since the pandemic, which has led to an increase in auto-related fatalities. The rise in auto insurance claims is further exacerbated by the increasing cost of medical care, higher legal settlements on injury claims, natural disasters, and a rash of auto theft rates, including thefts of catalytic converters.

Motor Vehicle Fatalities Rise With the Higher Incidence Of Riskier Driving Habits

Source: Bureau of Transportation Statistics and U.S. Department of Transportation.

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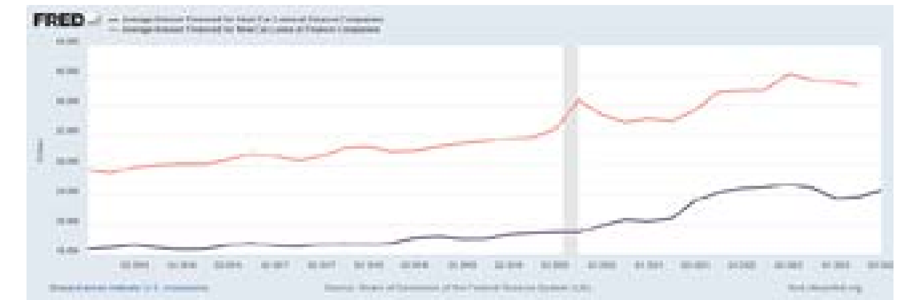
The confluence of inflation, riskier driving behavior, and increasing claims severity has not gone unnoticed by the insurance industry. Again, according to the APCIA, premium increases have not been keeping up with escalating losses. The report notes, "U.S. private passenger vehicle damage claim severity (i.e., the average cost per claim for property damage liability and collision) increased nearly 50 percent from 2018 to 2022, impacted by rising auto repair and labor costs, inflation, and theft rates, among other things. Over the same period, average bodily injury claim severity increased 40 percent, reflecting an acceleration in medical inflation, legal system abuse, and a sharp increase in deadly motor vehicle accidents."

The recent slowdown in the pace of headline inflation should help so long as the trend continues. Nevertheless, the recalibration of premiums has lagged these increased costs, so it seems reasonable to assume persistent hikes in premiums as insurers recalibrate their business models. Insurers will need to price their premiums to ensure they are covering losses and return expectations.

Credit and affordability implications

The rapid rise in insurance premiums is not happening in a vacuum. Loan rates, monthly payments, and loan sizes — just off their peak in 2022 — remain very high. Naturally, affordability is taking on increasing prominence as the associated costs of vehicle ownership crowd out other forms of consumer spending. A recent report from the national insurance agency Jerry showed that rising insurance premiums have been placing financial strain on Americans' budgets in the last twelve months, prompting many to cut back on spending in other areas.

Loans for New and Used Vehicles Are Near All-Time Highs

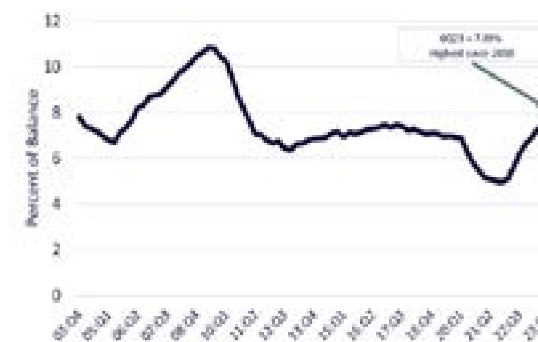


Source: FRED, Federal Reserve Bank of St. Louis

The rising cost of premiums hits harder those who need a loan or who lease their vehicles, because lenders and lessors typically require *full* coverage, including liability and collision, which is as much as three times the average liability-only minimums. For borrowers, keeping up with these premiums is critical. If a policy lapses, lenders will "force place" a full coverage policy, which typically has a higher premium than owed by the borrower. Of course, premium inflation is especially pernicious for those in the lower income brackets, who have less financial flexibility, and for young drivers, for whom insurance premiums are already markedly higher due to their riskier demographic profile.

Household budgets are getting squeezed and it is showing up in the credit performance data. Amid a strongly growing economy, full employment, and low debt service leverage, auto loan delinquencies are on the rise. In the latest quarterly Household Debt and Credit report from the New York Fed, the 30-day delinquency rate for autos was 7.69%, the highest it has been since 2010. Not surprisingly, the youngest stratifications of borrowers by age, Millennials and Gen Z, show the highest and steepest rises in auto loan delinquencies.

Auto Loan Transition Into Delinquency (30+)



Source: New York Fed Consumer Credit Panel/Equifax

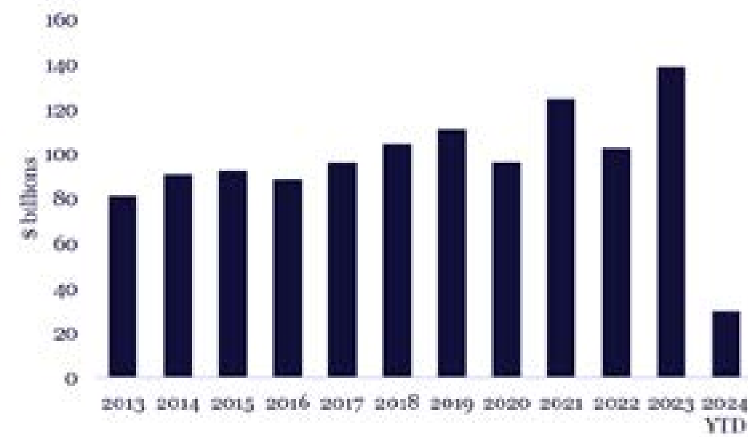
Youngest Borrowers Are Struggling the Most Auto Loan Transition Into Serious DQ(90+) by Age

Source: New York Fed Consumer Credit Panel/Equifax

Securitization professionals grow wary

Securitization professionals are watching the situation carefully. Securitization remains an important and sizeable segment of the real economy, particularly the automotive finance industry. According to the Structured Finance Association, about 15% of the $1.5 trillion in outstanding auto loans are securitized. Concern is growing as delinquencies rise. While the issuance of asset-backed securities (ABS) has been robust lately, there is a mounting apprehension regarding credit risks.

U.S. Auto Securitization Issuance Remains Robust



Source: Finsight

The significant surge in delinquencies is particularly evident in securitized deals backed by non-prime borrowers and those with concentrations of loans originated in 2020 and the first half of 2021, a period of comparatively looser underwriting standards. Notably, last year's increase in auto loan delinquencies led to the downfall of two non-prime auto loan originators and securitizers, American Car Center (ACC) and US Auto Finance Inc. (US Auto).

Despite a strong labor market, which is typically closely correlated with consumer credit performance, delinquencies have continued to rise. If this trend persists without abating, it is reasonable to anticipate a reduction in issuance volume and an expansion of credit spreads. These developments could have detrimental knock-on effects on affordability.

Lenders respond

Lenders, of course, aren't standing still. They have been mitigating credit risk by tightening underwriting standards for the past seven quarters and asking for higher down payments. Meanwhile, loan terms for used vehicles are at a record high (66.4 months) as lenders stretch out the repayment period to bring down monthly payments. Credit professionals know that this tactic tends to increase credit risk. That said, loan terms on new vehicles, though still relatively high at 65.4 months on average, have come in since peaking during the start of the pandemic, a credit-positive change. Consequently, sales volumes remain below where they were prior to the pandemic. That is to say, the negative and restrictive credit environment appears to be constraining the economic activity of vehicle sales.

Longer Loan Terms for Used Vehicles Is Credit Negative

Source: FRED, Federal Reserve Bank of St. Louis

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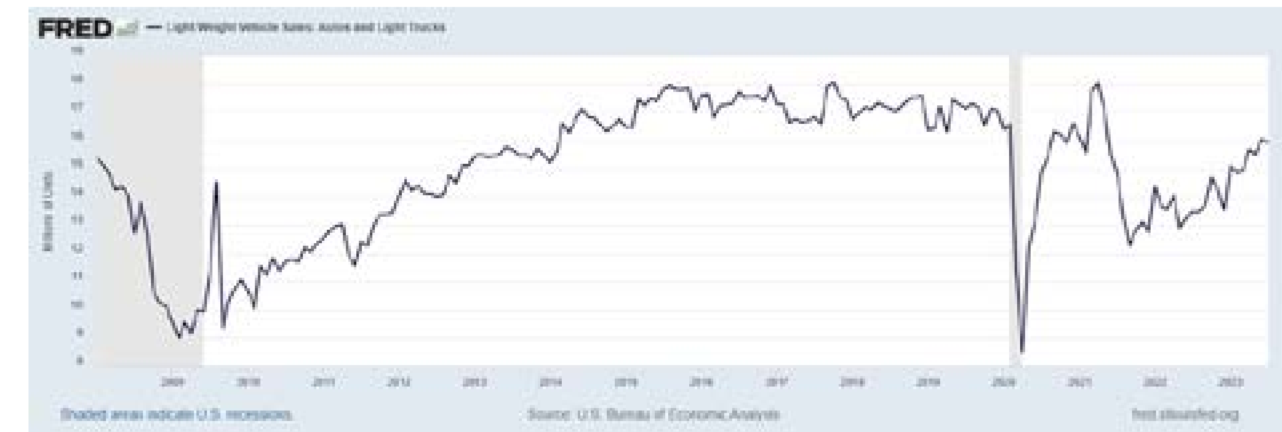
Auto Sales Volumes Remain Lower Than Pre-Pandemic Levels



Source: FRED, Federal Reserve Bank of St. Louis

Conclusion

As premiums outpace headline inflation, the complexities of modern vehicles, coupled with increased repair and replacement costs, contribute to a worrisome trajectory for the auto industry. Despite a recent slowdown in headline inflation, the recalibration of premiums has lagged rising costs, suggesting a more persistent upward trend. This phenomenon not only impacts the financial landscape of individual consumers, particularly those in lower-income brackets and younger demographics, but also reverberates in the broader credit arena. The strain on household budgets, highlighted by the surge in auto loan delinquencies, underscores the urgency for insurers to adapt their business models and for policymakers to address the implications of rising premiums on affordability and credit stability. As the auto insurance industry grapples with these challenges, finding sustainable solutions becomes imperative to ensure a balanced and equitable future for both insurers and policyholders alike.