The Right Tool

A Certified Pre-Owned Program Is a Versatile Implement That Comes In Very Handy as Part of Your Reinsurance Toolbox

By Jackie Banks

There are all sort of benefits and opportunities certified pre-owned programs bring to dealers – CPO units are in demand, certification builds trust and the warranty gives customers peace of mind, to name a few.

But there’s one area that is typically overlooked. Reinsurance can be a hidden gem worth looking into for dealers who sell CPO units.

There are a number of reasons certified pre-owned vehicles provide a handy tool for a dealership’s reinsurance toolbox.

WHY REINSURANCE?

Put simply, reinsurance is a way to get the maximum amount of insurance profits, not to mention investment income and possible tax advantages.

Reinsurance is a mechanism that transfers the insurance profits from CPO vehicles to a dealer’s reinsurance company. The dealer owns a reinsurance company that assumes the risks for the products and receives premium dollars for doing so.

The cost to form and maintain a reinsurance company can be fairly low – $3,000 to $5,000 initially and about the same each year afterward.

Insurance profit equals the premiums less claims, expenses (for example, ceding fees) and premium taxes. That amount is what the reinsurance company gets to keep, rather than it going to an insurance company.

Additionally, the reinsurance company can earn all of the investment income on all the funds.

In general, if a reinsurance company qualifies as a small property and casualty company, the insurance profit is not taxed. The reinsurance company only pays tax on its investment income.

Section 831(b) of the U.S. Internal Revenue Code describes the rules to qualify. The main rule is the annual premium limit – $2.3 million for 2018.

Once you, as a shareholder, take money out of the reinsurance company, it can be treated as a qualified dividend on your individual tax return.

That’s when you choose to take money out. But there is no requirement for you to take money out at a certain time.

That's only a small portion of the tax information that relates to reinsurance companies, and it should not be used as a basis for making any decisions. Consult with a tax advisor to get all of the information you need to help you make an informed decision about a reinsurance program.

IS REINSURANCE RIGHT FOR YOUR DEALERSHIP AND CPO PROGRAM?

Maybe. There are many factors to consider in deciding whether or not to start a reinsurance program. Among them:

Reinsurance is a long-term investment: A reinsurance program should not be seen as a way to generate quick cash flow. But if you are looking for a long-term wealth-building program, reinsurance might be for you.

Insurance profits are earned over the term of the contracts, and the term of CPO contracts can vary.

There are a couple of potential benefits if the CPO warranty term is 12 months or less.

First, the insurance profits are realized quicker. For example, if the CPO warranty term is 12 months, the premium will earn evenly, or pro rata, over the 12-month period.

If the term is 24 months, the premium will earn evenly over the 24-month period. That means that if the term is 12 months or less, all of the premiums will be completely earned out in a shorter period of time.

Second, the shorter the warranty term, the more opportunity there is for an upsell of a vehicle service contract.

Customers will be more inclined to continue coverage by buying a VSC if the vehicle only comes with 12 months or less of coverage. Customers are also more inclined to purchase a wrap to provide comprehensive coverage for the items not covered by the CPO warranty.

It should also be noted that CPO products on used vehicles earn faster than products on new vehicles.

Vehicle service contracts on new vehicles earn very little in the early periods – the manufacturer's warranty is in place. The earnings generally do not start to ramp up until year three.

With used cars, the earnings start immediately and continue to earn evenly over the contract term, though keep in mind, it is still not an immediate cash flow.

Because reinsurance is a longer-term business initiative, dealers tend to use the funds for future needs. Some dealers leave the funds to be used for retirement or as a nest egg for times of need or to be used for other business transactions, such as capital improvements of the dealership or acquisition of additional dealerships.

You must have sufficient volume: Insurance (and reinsurance) will not work with a small book of business.

The term commonly referred to as “the law of large numbers” is what guides insurance programs. If there are only a small number of contracts and there are a handful of claims, you could wipe out all of the premium.

That is also one of the requirements used by the IRS to determine whether the company is an insurance/reinsurance company. The IRS describes it as “risk distribution.”

Because a warranty is on every CPO vehicle, the programs help support higher volumes. Also, as noted earlier, there is typically an increase in the penetration of supplemental VSC sales that also add to volumes.

Generally, you need to have at least 25 to 30 contracts per month or $250,000 of annual premiums to properly support a viable reinsurance program.

Adding other ancillary products can also increase volume and diversify the risk.

You must be engaged: Having a reinsurance company is like having another business. You should commit some time to it.

There will be certain things you will need to do and decisions you will need to make. You should take time to understand the business and the impact on the results.

One key item as it relates to CPO is to make sure inspections are being done on the vehicles and the vehicles are required to meet set reconditioning requirements.

A CPO vehicle typically sells for more than an uncertified vehicle. Those proceeds can be used to cover any repairs discovered by the inspection.

Having proper inspections will raise your customer satisfaction – and make your reinsurance company more profitable.

Be sure to understand the risk and be willing to take recommended loss control actions. An essential mechanism for that is to have periodic performance review meetings with your provider.

During those meetings, the provider will review loss trends, sales, profitability and a variety of other key metrics and information related to your reinsurance company, and should offer some recommended actions.

Examples of those actions include addressing the inspection process to ensure inspections are being completed correctly, increasing premium levels, addressing high cancellation rates and reviewing service department processes to make sure they are not “combing through” vehicles to find things wrong.

You should find a provider with extensive experience and knowledge in order to properly support and manage the business to ensure profitability.

HOW DO I GET STARTED?

If you think reinsurance might be right for you and your CPO program, contact a provider that specializes in reinsurance. But choose carefully – it’s as very important decision since that provider will be not just a product vendor but also your partner and consultant.

The reinsurance provider can work with you to understand your goals and your business. The provider will show you the income potential by providing a pro forma and will explain all of the details, including the steps you need to take to get started.

Note that the pro forma is based on assumptions made by the preparer, so make sure you know what those assumptions are.

What is the loss ratio? What is the volume? What is the investment income rate? Is there an annual growth rate for the volume?

All of those should be reasonably achievable, as they drive the profit amounts shown on the pro forma.

DO YOU ALREADY HAVE REINSURANCE?

If you think you already have a reinsurance program in place, make sure you really do.

There are programs out there marketed as reinsurance programs, when in reality they are merely a profit-share or retro program.

Ask the provider for copies of your reinsurance company's corporate documents, such as the certificate of incorporation and articles of association. If you do not have those kinds of documents, you do not have a reinsurance company.

If you do not have a reinsurance company, you are not getting 100 percent of the profits, you are not getting much – if any – investment income and you are not able to realize the possible tax advantages on the funds.

If you do have an existing reinsurance company, you can work with your CPO provider to have your CPO products reinsured to your existing reinsurance company.

A common myth in the marketplace is that you have to start a new reinsurance company in order to have any of your business with another provider reinsured.

That is not true. If you have a reinsurance company, your reinsurance company can have business reinsured to it from various providers.

It's actually fairly easy to do that. Other than the agreements, the only additional requirement is the reinsurance company must have separate trust accounts for each provider's business and each provider will be the beneficiary of its own trust account.

Reinsurance is an important program dealers should consider – especially dealers with a certified pre-owned program. And if you have a reinsurance toolbox already, or if you decide to get one in the future, CPO products are likely to be a very valuable set of tools to put in it.

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