The effect of credit crunches on insurance purchases

Insurance purchases are mostly affected after a financial crisis. **Dr Shinichi Kamiya** of **Nanyang Business School**, **NTU**, explains that this is so because banks would shift their portfolios away from private credit, thereby creating a credit crunch. This results in a drop in consumer purchases for items such as automobiles and houses and hence insurance purchases of these items.

Financial crises tend to disproportionally reduce insurance purchases in post-crisis periods. Immediately after the 2008 US subprime mortgage crisis, an excessive decline in non-life insurance consumption was reported by the National Association of Insurance Commissioners (NAIC).

In a 2008 survey, it found that 8% of respondents made changes to their auto insurance policies – reducing coverage, falling behind on payments or cancelling policies. 6% made changes to their homeowner policies, with 4% cancelling their policies.

Three years later, the association conducted another survey. More than half of the respondents saved on car insurance premiums by reducing coverage or switching to a cheaper policy without changing coverage. Close to 40% drove less and approximately 20% reduced the value or the number of their vehicles. Approximately 20% of drivers reduced their car insurance coverage. The reports suggest that the mortgage crisis reduced not only exposure to risks but also the degree of auto insurance coverage.

Post-crisis declines of insurance purchase persists despite quick economic recovery

Our research finds that the US private auto premium level in 2012 remained at 88% of the 2006 level.

This long-lasting post-crisis trend is consistent with lower insurance consumption in Malaysia, Singapore and Thailand after the Asian banking crisis of the late 1990s, which lingered on despite a quick recovery of economic output. Thus, post-crisis declines of insurance purchases cannot be fully explained by a general economic slowdown.

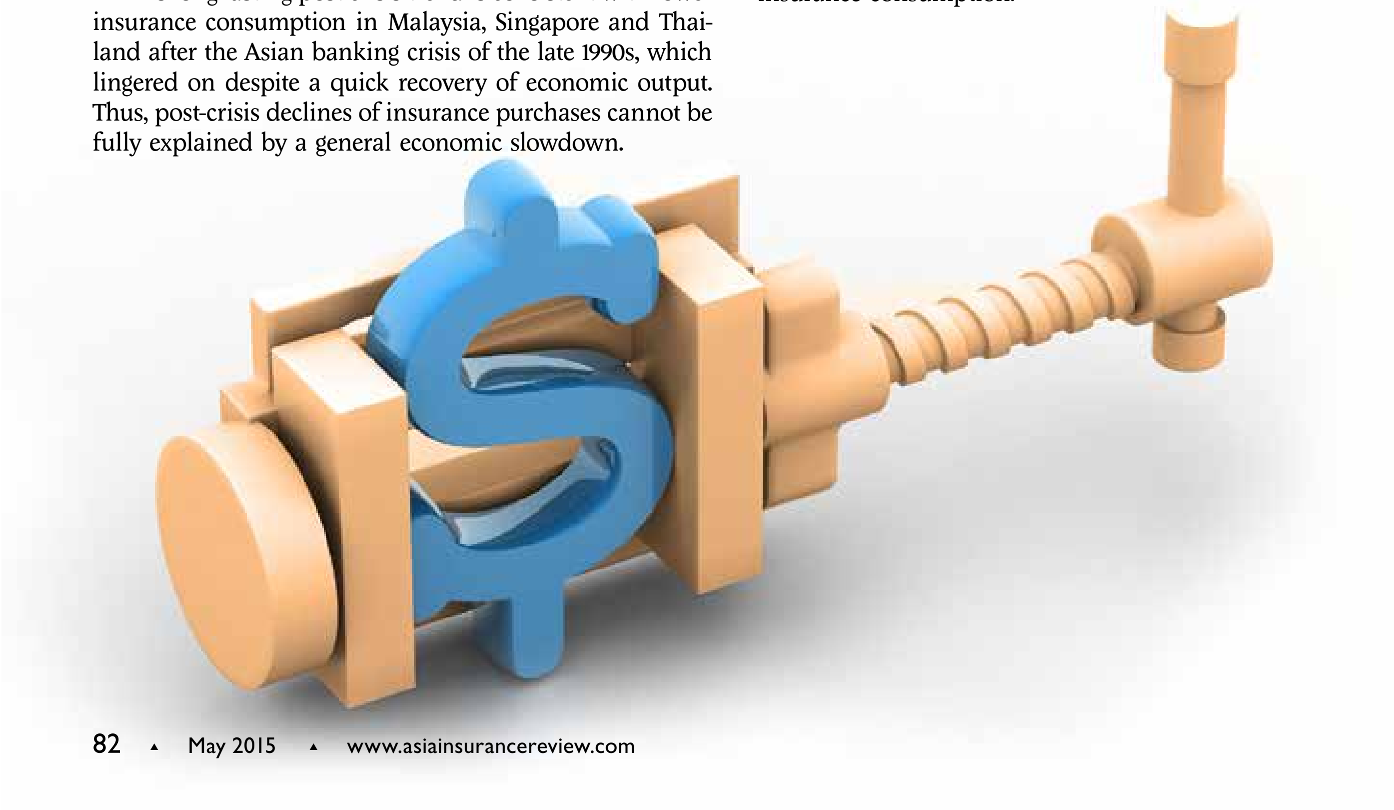
Auto loans crunch

A plausible explanation for this phenomenon is that risk exposure is excessively reduced through a credit crunch. Personal spending on cars relies heavily on the availability of auto loans to smooth out household cash flow.

In 2007, the annual average loan-to-value ratio in the US for car loans from auto finance companies was approximately 95% for new car loans and 100% for used car loans. Thus, when loan supply is reduced in a credit crunch, car purchases fall correspondingly.

In a financial crisis, banks tend to shift their portfolios away from private credit toward safer investments. In the case of the 2008 crisis, US banks tightened standards for consumer loans from the first quarter of 2007 to the fourth quarter of 2009, with a peak of 67% of domestic banks tightening standards in the third quarter of 2008.

A declining auto loan debt balance during the period echoed the tightening of lending standards. The auto loan debt balance started declining in 2007, reaching approximately 80% of pre-crisis levels by the end of 2009. It remained at that level from 2010 to 2011 and has started to recover only recently. Thus, many households, especially subprime auto loan applicants, might need to give up purchasing a new car because they could not get loans. Consequently, credit tightening on auto loans reduces auto insurance consumption.



Less auto loans, less auto purchases, less auto insurance bought

The impact of the credit crunch would be larger for markets where private auto insurance makes up a larger share of overall premiums.

Firstly, the auto loan market could be more volatile than that for mortgage loans, which are supported by government guarantee schemes. For instance, auto loan debt responded to the banking problem more quickly than mortgage loan debt. It was reduced proportionately much more than mortgage loans in the US after the subprime crisis.

Secondly, the fact that credit scores are used for rating purposes explains why subprime auto loan applicants who tend to be rejected amid credit tightening would be policyholders who tend to pay a larger premium.

Thirdly, credit tightening would cause households to postpone replacing current vehicles with new vehicles. This change of purchase patterns also negatively affects auto insurance purchase.

Finally, vehicles purchased with auto loans tend to come with requirements for auto insurance with sufficient coverage to reduce default risk.

Thus, a reduction in auto loans could have a large impact on auto insurance purchases.

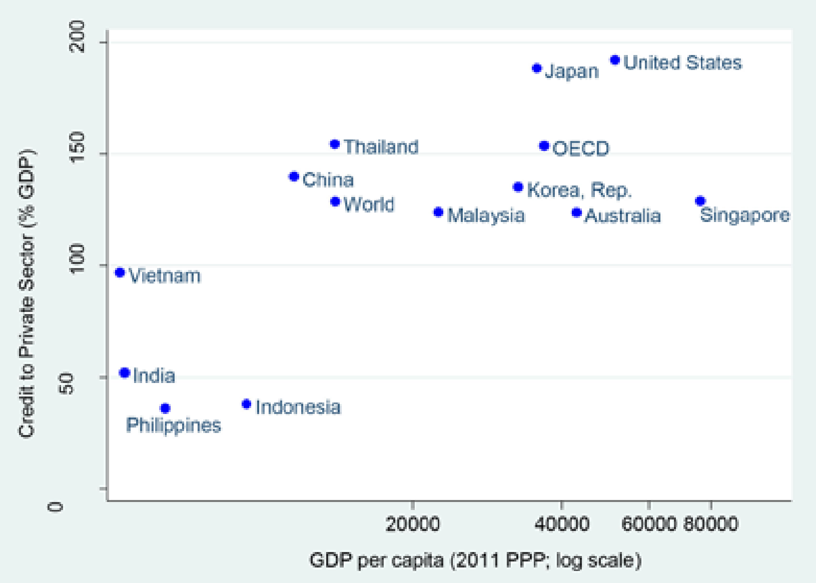
Housing prices plays key role

Our study bears implications to the Asian insurance market.

Figure 1 shows the relationship between the level of credit provided to the private sector as a percentage of GDP and GDP per capita in 2013. The plots indicate that credit increases as output per capita increases. However, the level of credit to the private sector varies significantly by country.

For instance, Japan, Thailand, China and Vietnam are higher than average, meaning that insurance markets in those countries could be more severely affected than other countries when a credit crunch erupts.

Figure 1: Credit to Private Sector vs. GDP per capita



To explain the occurrence and severity of a credit crunch, housing prices plays a key role. The credit channel that links housing prices with consumption predicts that declining housing prices, with the potential for higher default probabilities and worsening balance sheets, cause homeowners to face greater credit rationing or obtain credit at a higher price.

Our research suggests that, if it takes time for housing prices to recover, both the auto loan market and auto insurance purchases could suffer significantly. The argument may be extended to other lines such as homeowner's, mortgage insurance and commercial insurance. But how a credit crunch affects aggregate insurance purchases depends on the portfolio of business lines.

Dr Shinichi Kamiya is Assistant Professor at Nanyang Business School, NTU.

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