

**GAP Protection
Offered by the F&I Office in Conjunction with a
Retail Installment Sales Contract**

Written for the AFIP Certification Program

Document Caveats

This paper summarizes the important points an F&I practitioner needs to know about GAP protection offered in the F&I office when the vehicle purchase is financed under a retail installment sales contract (RISC). If the vehicle purchase is financed under a direct financial institution loan, the underlying GAP protection is comparable, but there are important legal differences that are beyond the scope of this material.

GAP protection is a generic term that includes GAP waiver products and GAP insurance products. In almost all states, GAP protection is offered as a debt waiver product, referred to as a *GAP waiver*. Unless otherwise noted, this material solely addresses GAP waiver.

A few states do not permit GAP waivers, and some financial institutions (a.k.a. indirect lenders) will not accept RISCs containing a GAP waiver in certain states and situations. GAP insurance can be offered in any state, so GAP insurance is offered whenever a GAP waiver is not acceptable. A section of this material addresses the principal differences between GAP waiver and GAP insurance.

The underlying protection is the same for GAP waiver and GAP insurance, but there are legal differences, and different terminology must be used. It is critical for the F&I practitioner to understand the offer—whether it is a GAP waiver or GAP insurance—and to use the appropriate terminology.

Important Rules

Not everyone qualifies for GAP protection. The F&I practitioner must understand the eligibility standards, must accurately determine that the vehicle buyer is eligible for GAP protection, and must not enroll a vehicle buyer who is not eligible for GAP protection.

GAP protection applies to a specific RISC. It cannot be offered on a cash sale.

GAP protection is an optional purchase on the part of the vehicle buyer. The F&I practitioner cannot imply or state that the purchase of GAP protection is required to finance the vehicle at the dealership.

It is correct to state that the GAP protection being offered can only be purchased in conjunction with the financing being offered, since the GAP waiver is an addendum to the RISC. It is only offered at the time of the initial financing transaction.

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All GAP protection terminates when the RISC is terminated for any reason. In addition, the vehicle buyer can cancel GAP protection at any time. On termination of the GAP protection prior to the RISC termination date, an unearned fee refund representing the value of the unused GAP protection will be applied to reduce the RISC payoff amount.

Definitions

Actual Cash Value (ACV) is the market value of the vehicle at a particular point in time.

Total Loss is vehicle damage where the cost to repair the vehicle exceeds the ACV. Unrecovered theft is also considered a total loss. A total loss is also referred to as *totaled*.

Primary Automobile Insurance refers to the vehicle owner's underlying automobile policy insuring the vehicle against physical damage and theft. If a vehicle is a total loss or is stolen, the primary automobile insurance claim is settled first. The primary automobile insurer determines the ACV of the vehicle.

Primary Automobile Insurance Proceeds equal the ACV less the primary automobile insurance deductible. The insured chooses the deductible, normally \$250 to \$1,000. The primary automobile insurer pays the proceeds to any lienholder to the extent of any lien on the vehicle; any excess is paid to the vehicle owner.

How a GAP Waiver Protects the Vehicle Buyer

GAP is the most popular debt protection product for vehicle purchases financed at the dealership. It provides an important protection that many vehicle buyers need.

GAP waiver is a two-party contract solely between the dealership and the vehicle buyer. The GAP contractual agreement is contained in a GAP waiver addendum that is attached to and made a part of the RISC. In the event of a total loss to a vehicle or the unrecovered theft of the vehicle, the dealership waives the excess amount the dealership is owed when the RISC payoff amount is more than the primary automobile insurance proceeds. The dealership typically assigns the RISC to a financial institution, at which time the dealership obligations under the GAP waiver are transferred to the financial institution.

The letters **G-A-P** may stand for *Guaranteed Automobile Protection*, or possibly *Guaranteed Asset Protection*, but those words do not have significant meaning. Several of the early developers called the product *TLP*, for *Total Loss Protection*. Most people believe the letters simply represent the *gap* that may exist between the RISC payoff amount and the primary automobile insurance proceeds.

What Causes a GAP?

Generally

In many financed vehicle sale transactions, the moment the vehicle is driven off the dealership lot the ACV is less than the debt under the RISC. The vehicle buyer has **negative equity** in the vehicle, i.e. the vehicle is worth less than the amount owed. A surprisingly large percentage of vehicle buyers understand the terms *negative equity*, *being under water*, or *being upside down* on their vehicle RISC. Possibly 50% of new and used financed vehicles leaving the dealership are leaving with negative equity.

During the RISC term, any time the RISC payoff amount exceeds the vehicle's ACV, the vehicle owner has a significant financial risk. If the vehicle were totaled, the owner would owe more on the RISC than the vehicle would be worth, i.e. the vehicle's ACV, which is what primary automobile insurance covers. Such a situation creates a **gap**; the amount of the gap is then immediately due under the terms of the RISC. If the vehicle is totaled or stolen, the vehicle owner is faced with funding the negative equity in order to replace the vehicle.

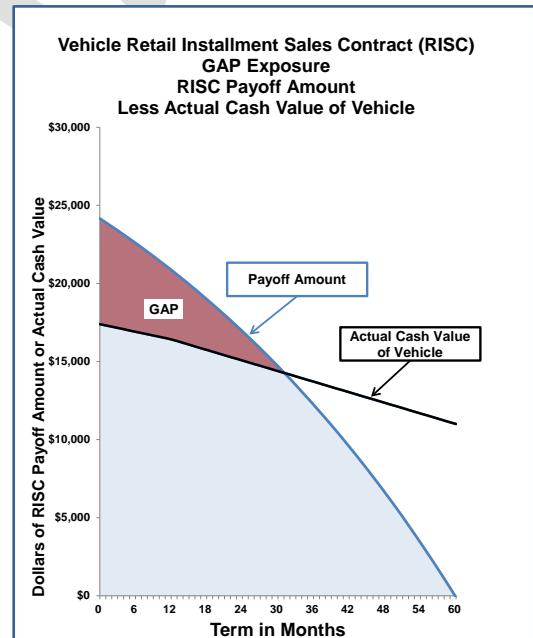
GAP protection is needed; the F&I practitioner should understand the need and be able to communicate the situation easily and clearly to the vehicle buyer. It is one of the easiest sales at the dealership.

New Vehicle Depreciation

For new vehicles, the steep first-year depreciation is an accepted fact of life. After the initial depreciation, the debt reduces faster than the vehicle depreciates, so that the gap eventually disappears at some time during the term of the RISC. **Each transaction has a different pattern at inception, depending on the specific vehicle, the transaction price, and the terms of the financing.** On a new vehicle purchase, the gap typically disappears after one-half to two-thirds of the RISC term has passed. For example, under a 72-month RISC, the gap normally disappears between RISC months 37 and 48. During the actual RISC term, the picture changes over time, based on timeliness of the RISC monthly payments and the actual depreciation of the financed vehicle.

Used Vehicles

All of these observations also apply to the purchase of a used vehicle. For a **newly used** vehicle, the type often sold by a franchised new vehicle dealership, the negative equity situation during the first year of ownership is similar but less pronounced.



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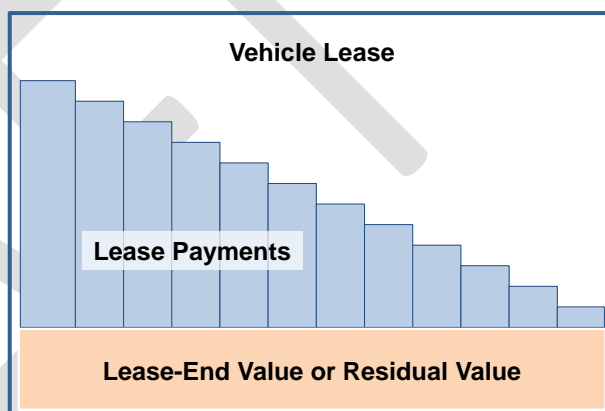
The type of dealership operation and the credit quality of the vehicle buyer can change the GAP exposure dramatically. As the used vehicle transaction moves from a franchised dealership to an independent used vehicle dealership or to a buy-here-pay-here dealership, the GAP exposure may even increase.

- The credit quality of the vehicle buyer drops; the likelihood of having a GAP increases; and an amount-financed-to-value ratio of 200% or more is possible.
- The determination of ACV at the time of a claim becomes more subjective.

A positive GAP risk trait of the used vehicle transaction is that the large first-year vehicle depreciation has already occurred, so the pattern of vehicle depreciation is far less steep and is more predictable.

Leased Vehicles

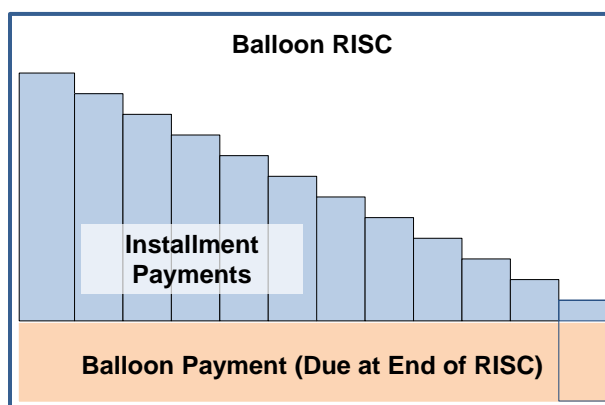
A GAP-type risk exists on leased vehicles because of lease termination charges. Almost all leases require *early termination charges* if termination is made prior to the end of the lease term. In addition, there may be other termination charges, such as excess miles driven, excess wear and tear, and cost to repair damage to the vehicle. Of course, these other charges do not apply when the vehicle is totaled or stolen.



Often, a lease will include GAP protection by waiving the lease early termination charges in the event of total loss or unrecovered theft. If GAP protection is not included, optional lease GAP waiver protection can be offered.

Balloon RISC Purchases

Some vehicles are purchased with a **balloon RISC** that requires a specified number of level monthly installment payments, such as 47 or 59. A larger single payment (the "**balloon**" payment) is due at the end of the series of installment payments and constitutes the 48th or 60th payment.



If the vehicle is totaled or stolen, the buyer is in the same position as a vehicle buyer with a traditional level monthly payment RISC in that the RISC payoff amount is immediately due. If the RISC payoff amount is greater than the ACV of the vehicle at the time of loss, a gap exists.

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GAP Protection Benefits

Basic Benefit. The basic GAP benefit is a **waiver** of the *RISC payoff amount* less the *primary automobile insurance proceeds*, if such calculation results in a positive number.

Adjustment to RISC Payoff Amount. The *GAP benefit payoff amount* determination starts with the RISC payoff amount on the payoff date, less any *amounts added* to the RISC after the GAP waiver effective date. Amounts added are for items such as delinquent monthly RISC payments (defined as payments remaining unpaid more than 60 days after the due date), RISC late charges, or premiums for collateral protection insurance. Then, the GAP benefit payoff amount is reduced by the value of F&I protection products that can be canceled for an unearned premium refund, such as a vehicle service contract or credit life and disability insurance, and any other protection product or service where a refund is available.

Deductible Benefit. Many GAP waivers will waive an additional amount equal to the primary automobile insurance policy's deductible, with a dollar limit that is commonly \$500 or \$1,000. Some state laws specify the limit that may be waived in that state, and a few do not allow waiver of the deductible at all.

Delinquent Payment Benefit. Some GAP waivers will waive an additional amount equal to the portion of the gap represented by delinquent RISC payments, with a limit on the number of delinquent payments that will be waived, most commonly two delinquent payments.

Benefit Limits. Most GAP waivers have limits on the amount of the benefit, including

- A maximum dollar limit per benefit, such as \$50,000
- A limit on the amount of the indebtedness that is included in the benefit calculation, such as 120% of National Automobile Dealers Association (NADA) value, Black Book value, or Manufacturer's Suggested Retail Price (MSRP). The percentage commonly varies from 120% to 150%.

Sample GAP Benefit Calculation Worksheet		
A	RISC Payoff Amount as of Date of Loss	\$20,000
B	Actual Cash Value	\$16,500
C	Salvage, Other	\$0
D	Primary Automobile Insurance Deductible	\$500
E	Primary Automobile Insurance Settlement $[B - C - D]$	\$16,000
F	Basic GAP Benefit $[A - E]$	\$4,000
G	Any Amounts Added to the RISC after GAP Waiver Effective Date	\$0
H	Amounts Recoverable by Cancellation of F&I Protection Products	\$600
I	Primary Automobile Insurance Deductible Benefit	\$500
J	GAP Delinquent Payment Benefit	\$0
K	Preliminary GAP Benefit before GAP Benefit Limits $[F - G - H + I + J]$	\$3,900
L	Amount Preliminary GAP Benefit Exceeds GAP Benefit Limit	\$0
M	Final GAP Benefit $[K - L]$	\$3,900

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GAP Plus. Another feature found in GAP waivers is referred to as the *Plus* benefit or *GAP Plus*. It provides \$1,000 (or other defined amount) to be applied to reduce the purchase price of a replacement vehicle that is purchased from and financed at the original selling dealership. This is a separate benefit that is not a part of the GAP benefit calculation.

Benefit Requirements and Exclusions

Eligibility for Benefits. Several conditions must be met for a GAP protection benefit to be approved:

- A gap must exist.
- Acceptable proof of loss must be provided, such as a police report.
- The primary automobile insurance policy covering the vehicle must be in force at the time of the underlying event. If no primary automobile insurance is in force, the NADA retail value may be used to establish the ACV for calculating a GAP benefit.
- The claim under the primary automobile insurance policy must be settled, and the benefits must be applied to reduce the RISC payoff amount.

Exclusions. Losses resulting from the following situations are usually not covered:

- War
- Fraud
- The vehicle's use during criminal acts
- Excess wear and tear
- Racing
- Damage occurring while vehicle is outside the United States.

Eligibility/Underwriting Provisions for GAP Protection

GAP waivers at the dealership protect the traditional array of automobiles, CUVs, SUVs, and light duty trucks. GAP protection is available on many other "vehicles," including recreational vehicles, motorcycles, marine equipment, and ATVs.

Most vehicle buyers are eligible to purchase GAP protection, but all programs have certain eligibility requirements. These are typical criteria:

- **Maximum RISC Term in Months.** GAP protection is usually available only on RISCs with terms equal to or less than a maximum, such as 72 or 84 months.
- **Maximum Amount of RISC.** GAP protection is usually only available on amounts financed up to a maximum dollar amount, such as \$50,000 or \$100,000.
- **Type of Vehicle.** Certain types or entire classes of vehicles may be ineligible, such as recreational vehicles.
- **Use of Vehicle.** Some vehicles are ineligible and certain uses of the vehicle void the GAP protection. For example, vehicles used for commercial purposes are typically ineligible, and using a vehicle for commercial purposes voids the GAP protection. The non-commercial-use exclusion is an important exclusion that must be communicated to the

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vehicle buyer. Most RISCs contain a question (or check box) asking if the vehicle will be used for commercial purposes.

- **Time of Sale.** The GAP protection must be purchased before the vehicle is delivered.
- **Personal Insurance.** The vehicle must have acceptable primary automobile insurance in effect before the GAP protection becomes effective.

Fees and Refunds

The cost for GAP protection is a single fee payable at the inception of the GAP protection. The GAP fee charged for GAP protection covers the entire term of the RISC.

The cost of the protection is added to the total transaction costs in the RISC. It is typically included in the section listing the cost of add-ons such as vehicle service contract, GAP waiver, paintless dent repair, tire protection, roadside service, and credit-related insurance. In other words, the GAP fee is a part of the total amount financed.

The same GAP fee rates are generally charged for all vehicles of broad classifications, such as all new vehicles at a franchised dealership, but the GAP fee (in dollars) may vary with the RISC's term in months, normally expressed in bands, such as \$500 for loans of 61-72 months.

If the vehicle buyer cancels within thirty days after the GAP protection effective date, the vehicle buyer will receive a full refund of the GAP fee, but the refund will be applied to reduce the amount owed under the RISC. After thirty days, the amount of the refund will be an unearned fee refund that will be applied to reduce the amount owed under the RISC.

If the RISC is terminated prior to the scheduled RISC maturity date, the vehicle buyer will receive a refund of the unearned portion of the GAP fee under the same rules as a voluntary termination of GAP protection. The amount of the refund will be an unearned fee refund that will be applied to reduce the RISC payoff amount.

The typical refund equals the unearned fee at the time of cancellation less a processing fee, such as \$50. The unearned fee is usually based on a common amortization method, such as pro rata unearned fees, Rule of 78 unearned fees, or a special GAP protection earnings curve. Some GAP waivers do not provide a refund on early termination, except for a cancellation within sixty days of the effective date or a repossession of the vehicle. The refund will generally be based on the minimum refund standard applicable in the state in which the GAP protection was sold, but some financial institutions insist on different methods that may produce a higher unearned fee refund.

Role of Financial Institutions in GAP Protection

Once the buyer signs the RISC, the dealership immediately sells/assigns the RISC to a financial institution, which becomes the assignee. Each dealership will have financing arrangements with three or more financial institutions. The goal of the dealership is to have one GAP protection form that can be used for all of its financial institutions. The obvious advantage to the

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dealership and the F&I staff is the simplicity of having only one GAP waiver's terms and conditions that can be offered to all vehicle buyers.

Such a goal may not be achievable. A growing trend among financial institutions has been to require specific language and forms, plus additional options and costs for various credit risks and terms. Dealerships have found it necessary to accept additional options and forms, thereby creating a demand for organization and control to manage the various GAP protection forms effectively.

Large dealerships and dealer groups have stronger bargaining power with the financial institutions to demand one standard form, but then, they also have arrangements with a larger number of financial institutions to deal with. Most dealerships must now manage several GAP protection product options in spite of a strong need for one product and one form.

Each financial institution will have rules on the amount of money it will finance on each transaction. The principal component of the amount financed is the **RISC payoff amount at purchase**, which equals

- Total cost of the vehicle (the agreed upon vehicle cost, taxes, and accessories, such as GPS, rustproofing, paint sealant, truck bed liner, and window tinting)
- Less, the down payment.

A lender will finance a percentage of the **value** of the vehicle.

- For a new vehicle, **value** means dealership MRSP, or the NADA trade-in value on certain program vehicles. Depending on the credit quality of the buyer, the financial institution will normally lend 120% of **value**, plus up to 30% of **value** for refundable add-on items, which could result in a total amount-financed-to-value ratio of up to 150%. MRSP *may* be defined to include delivery charges, and it is often difficult to determine if it does.
- For a used vehicle, value means NADA retail value or Kelley Blue Book value.

Sample Amount-Financed-to-Value Calculation Worksheet		
A	Value of Vehicle at Purchase	\$20,500
B	RISC Payoff Amount at Purchase	\$25,625
C	Amount-Financed-to-Value Ratio (%) before Add-on Items [B / A]	125%
D	Refundable Add-on Items – (GAP, Vehicle Service Contract)	\$4,100
E	Amount Financed in RISC [A + D]	\$29,725
F	Amount-Financed-to-Value Ratio (%) [E / A]	145%

Regulation of GAP

GAP Insurance

Insurance is a state-regulated product. Each state has insurance laws that define or describe insurance and set the rules for any party soliciting or insuring risks in that state. Insurance laws vary dramatically among the fifty states.

Every state permits GAP protection to be offered as GAP insurance, subject to that state's laws, regulations, and other regulatory pronouncements. While the regulatory rules regarding GAP insurance are not oppressive, they are constraining.

- An insurance company must issue an insurance policy or certificate of insurance. That insurance policy must be filed and approved in each state.
- The rates are subject to rate regulation. In many states, the insurer needs only to provide actuarial justification of the rates it proposes to charge. GAP insurers are permitted to have rate differentials or contractual limitations based on Amount-Financed-to-Value or other rating distinctions if the rating plan has been filed and approved.
- The approved GAP insurance rate is the rate that must be charged to the consumer. The dealership does not have leeway in varying the cost to the vehicle buyer.
- The dealership may be required to get a corporate license to offer GAP insurance.
- In some states, the F&I practitioner offering GAP insurance may have to be licensed to offer GAP. While obtaining this individual license generally involves submitting a simple application and paying a fee of \$10-\$50, the dealership is always challenged to keep every F&I practitioner's paperwork up to date.

There is good news though. As of September 2011, the general consensus is that only three states require GAP protection to be offered only as GAP insurance: Montana, Nevada, and Oregon. Other individual state limitations, however, do exist, such as the District of Columbia's prohibition on financing the cost of a GAP, i.e. a GAP waiver can be sold but not financed.

GAP Waivers

For twenty years, there have been arguments within individual states over whether a GAP waiver constituted the business of insurance. State-by-state, the GAP protection industry has lobbied for a regulatory pronouncement that a GAP waiver is not considered insurance in that state.

Generally, the GAP protection product industry and most other industries prefer having no explicit law or regulation, but the GAP protection industry has actually worked to pass specific laws applying to GAP. The trade-off is accepting rules and regulations regarding the way the protection is offered for the certainty of knowing there is no question that a GAP waiver is not insurance.

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A GAP trade organization, the Guaranteed Asset Protection Alliance (GAPA) was formed in 2006 for the purpose of promoting fair and uniform state regulation of GAP waivers. It represents all parties involved in offering GAP protection. GAPA has been in the forefront of gaining overt regulatory pronouncements that GAP waivers are not insurance.

GAP waiver laws and regulations are not extensive pronouncements. The primary rules address full disclosure of the terms and conditions by the dealership and written acceptance of the purchase by the vehicle buyer.

The real “regulation” of GAP protection products comes from the financial institution that becomes the assignee of the RISC. The large financial institution assignees specify certain conditions about the GAP protection provisions or other aspects of the GAP transaction. If a dealership wants to assign its RISC containing GAP protection to a particular financial institution, the dealership must accept the GAP waiver conditions set by that financial institution.

For various reasons, several financial institutions require that the GAP protection in certain states be an insurance product, although the state regulatory pronouncements appear to permit GAP waiver protection. Other aspects of the financial institutions’ rules are all similar, but they are not identical.

Aspects of GAP protection commonly addressed by financial institutions’ rules include:

- All GAP protection forms used in the transaction must receive prior approval by the financial institution.
- The GAP protection purchase must be voluntary and evidenced by a signed statement.
- Fees and terms of GAP protection must be disclosed.
- The GAP protection fee cannot exceed a prescribed amount.
- A pro rata refund must be provided over the entire term of the RISC and any cancellation fee cannot exceed \$50 (sometimes no cancellation fee is permitted).
- No insurance terminology can be used in a GAP waiver; a *finance charge* cannot be called *interest*.
- The primary insurance deductible must be covered up to \$1,000 or the state limit if lower.