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Extended Warranties in the U.S. Marketplace: A Strategy for Effective Regulation

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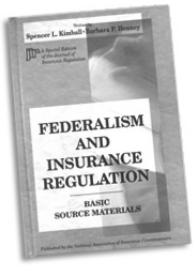

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Extended Warranties in the U.S. Marketplace: A Strategy for Effective Regulation

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Abstract

Extended warranties are common in the U.S. marketplace and are frequently sold as add-on products at the point of sale for an underlying asset whose performance serves as the basis of the contract. While the industry is highly profitable, it has traditionally suffered from significant negative attention in the headlines related to allegations of unfair practices. This paper addresses those issues and provides three key recommendations designed to simplify the contracts and create a more consistent regulatory structure. Those suggestions include: 1) the elimination of the situational monopoly by banning the sale of extended warranties by retailers at the point of sale; 2) the simplification and standardization of extended warranties contractual language; and 3) the enforcement of extended warranties regulation by a central authority. If implemented, those strategies would eliminate the current situational monopolies while preserving the principle of consumer sovereignty when contemplating the purchase of extended warranties.

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Introduction

For more than four decades, various branches of state governments, industry lobbyists, consumer protection groups and others have wrestled with the regulation of the extended warranty (EW) industry. Despite such regulatory attention, allegations of unfair business practices and traditionally high profit margins have persisted (see, e.g., *Warranty Week*, 2005; *Consumer Reports*, 2011; Better Business Bureau, 2011).[1] These allegations suggest that the current regulatory standards governing the EW industry are insufficient and/or inadequate in protecting the interests of the consumer.

Whether by accident or possibly even by design, the EW industry exists as something of a "regulatory orphan." While possessing several insurance-like characteristics (and generally perceived as such by consumers), EWs and their traditional system of distribution also possess some salient characteristics that inhibit regulatory and judicial authorities from recognizing them as insurance. Despite this lack of formal recognition as insurance, the regulation of the EW industry has curiously fallen to the state insurance departments.

This allocation of responsibility has contributed to an environment that represents something of a regulatory quagmire. For example, insurance is regulated at the state level, and thus, lacking strong central (federal) oversight, insurance regulation varies across the states. Additionally, given the significantly differing characteristics of the various industries that sell EWs as "add-on" products (e.g., auto, electrical appliance, homes, etc.), a consistent and functional "one-size-fits-all" regulatory structure would prove challenging under the best of circumstance.[2] Last, the regulation of the EW industry has essentially fallen to the state insurance departments by default, and despite what might constitute a "best effort" on the part of state insurance regulators, the existing conditions conspire in creating an insufficient regulatory response.

Several recent events may provide some guidance in addressing the concerns related to the EW industry. For example, the experience of the United Kingdom's foray into the regulation of its electronic appliance industry's sale of add-on insurance products, including EWs, provides some insight as to potential regulatory solutions. Additionally, the creation of the Bureau of Consumer Financial Protection (CFPB) and its demonstrated interest in the activities of the auto EW industry suggests that the federal government may be willing to encroach into what has traditionally been a state-level regulatory issue. Thus, the responsibility for the regulation of the EW industry in the U.S. would once again seem to be in question.

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1. Sponsored by major warranty and service contract companies, *Warranty Week* (*www.warrantyweek.com*) is an online newsletter and website intended for warranty professionals.

2. An "add-on" sale is the sale of additional goods or services to a buyer. Its purchase is often suggested by the retailer once the customer has made a decision to buy an underlying asset or service.

In light of these recent events and the general state of regulatory affairs in the U.S. EW marketplace, we revisit the issue and develop three specific recommendations that have the potential to mitigate a number of the current negative externalities. This current research differentiates itself from earlier related research on the subject by assuming a distinctly comparative approach that assesses EW regulation in light of existing insurance regulation. Additionally, this research updates and brings into focus the current state of affairs with respect to the regulation of EWs. These findings will be of interest to a broad audience, including: regulators, legislators, consumer protection agencies, public media, EW industry associations, providers of EWs and consumers.

In the next section of the paper, we provide a brief overview of the scope and operations of the EW marketplace in the U.S. Subsequently, we turn our attention to the regulation of the industry and identify aspects of market operations that have been found to be particularly vexing. Our focus then shifts to what regulation might accomplish in light of recent related endeavors and shifts in the U.S. regulatory environment; that is, what kind of regulation might actually be feasible and functional in the current environment? We close the paper with a summary of the general findings and their implications.

Extended Warranties Background

EWs, also sometimes referred to as extended service plans or contracts, are different from other kinds of warranties.[3] An EW is a contract or agreement for a separately stated consideration and/or for a specific duration that obligates one party (the obligor) to perform/provide specific remedies. Such remedies may include the: repair, replacement or maintenance of property or indemnification for repair, replacement or maintenance, for the operational or structural failure due to a defect in materials, workmanship or normal wear and tear, with or without additional provision for incidental payment of indemnity under limited circumstances.

EWs are most commonly sold as add-on products in conjunction with the purchase of an underlying asset that serves as the subject of the warranty agreement. By far, most EW sales are conducted at the point of sale of the

3. For example, manufacturer warranties are considered part and parcel of the initial asset purchase itself, whereas EWs are viewed as distinctly separate transactions. EWs are also to be differentiated from "service maintenance contracts." The latter are contracts where, for a fixed fee, the obligor of the contract agrees to provide regularly scheduled maintenance/service on the asset that is the subject of the EW.

underlying asset within the context of a situational monopoly.[4] In situational monopolies, a seller renders its competition irrelevant.[5]

The sale of EWs is most commonly associated with a number of industries, including: auto original equipment manufacturers (OEM), auto parts, aerospace, computers, telecom equipment, semiconductors and PCB, consumer electronics, medical and science equipment, data storage, peripherals, appliance and HVAC, homebuilders, building materials, and power generators (*Warranty Week*, 2013). Of those industries, auto OEM and computer manufacturers represent more than half of the market EWs (based on claims paid in 2012). Thus, while the general character of the EW contract shares many features across a number of industries, the character of the underlying asset that serves as the basis for the contract and the distribution system employed to actually sell the product may differ significantly. As a result, creating a fully functional "one-size-fits-all" regulatory model stands as a unique challenge.

The consumer demand for EWs is significant, and the business is highly profitable. According to *Warranty Week*, the appliance industry alone sold more than 250 million EWs in 2010, and automotive EWs generated almost as much revenue for auto dealers, administrators and insurance companies as factory warranties consumed.[6] *Warranty Week* (2012) estimates the 2010 revenue of some 109 EW administrators (distributors) to be $11.2 billion at the contract sales level and the revenues of their 32 underwriters (insurers) to be close to $2.9 billion.[7] *Warranty Week* (2005) reports that although EWs typically represent approximately 3% to 4% of total sales in the electronic appliance industry, those contracts might simultaneously represent as much as 30% to 40% of total retailer profits.

Given the significant profit margins typically associated with the sale of EWs, the motive for retailers to promote the purchase of EWs is obvious. Less obvious is the true value of EWs to unsophisticated consumers who represent targets for those selling EWs. Of particular interest are the findings that those least capable of managing their finances and those most financially disadvantaged are most likely to purchase EWs (Huysentruyt and Read [2010] and Chen, Kalra, and Sun [2009], respectively). More broadly, consumers in general demonstrate a poor understanding as to the coverages provided in a typical EW and often confuse those coverages with what might be provided in more familiar homeowner and

4. Although less common, other scenarios are also possible. For example, some EW offerings will subsequently arrive via direct mail soon after the purchase of an asset is made. Alternatively, other marketing contacts may be made at some distant point in the future; e.g., when the manufacturer warranty of the asset is soon to expire.

5. For a deeper discussion of situational monopolies and their regulation, see, e.g., Treblicock (1993).

6. Sponsored by major warranty and service contract companies, *Warranty Week* (*www.warrantyweek.com*) is an online newsletter and website intended for warranty professionals.

7. For a deeper discussion of the various distribution systems employed by the EW industry, see Hayne (2001).

auto insurance policies (Ishida, Kaufman, Langrehr, and Pope, 2013). Because of this confluence of potential profitability and opportunity, in addition to a uniquely vulnerable target population, there seems to be a need for more rigorous regulation of EW transactions.

Regulation

While the principles of free market economics are broadly embraced within the U.S. capitalistic system, seldom do they operate without some degree of regulation. Proponents of regulation commonly cite the following benefits:

- It endeavors to provide for the safety of consumers.
- It seeks to protect the safety and health of the general public, as well as the environment.
- It promotes the stability of the broader economy.

At the same time, regulation may simultaneously incur attendant costs, such as:

- The creation of a government bureaucracy that may inhibit growth.
- The facilitation of the creation of monopolies that result in increased prices to consumers.
- The inhibition of innovation due to over-regulation.

Given the potential benefits as well as possible drawbacks, the regulatory debate is seldom couched in absolute terms but rather, it is typically a question as to the "proper" degree and character of marketplace.

The Regulation of Extended Warranties in the U.S.

Early on in the evolution of product warranties (including both manufacturer and EWs), the federal government endeavored to intervene in what many complained was an industry riddled with unfair trade practices. The Magnuson-Moss Warranty Act (passed in 1975) was designed to "improve the adequacy of information available to consumers, prevent deception, and improve competition in the marketing of consumer products..."[8] The primary means by which the act endeavored to achieve its regulatory goals was through disclosure requirements. However, the ability of the act to significantly affect the market inefficiencies associated with the sale of EWs was questionable, as consumer complaints continued unabated.

8. The text of the act (Public Law 93-637) is available online at *www.gpo.gov/fdsys/pkg/STATUTE-88/pdf/STATUTE-88-Pg2183.pdf*.

At the same time, significant debate had begun as to whether EWs were insurance.[9] Given the significant parallels shared by EWs and the coverages provided by homeowner insurance, comparisons were imminent. An affirmative decision would likely call for the regulation of EWs in a manner similar to that of insurance, which is widely recognized as one of the more heavily regulated industries. This outcome would represent a significant deviation from the historical general lack of regulation of the EW industry.

After years of special hearings, the NAIC weighed in with its determination in 1995 that EWs were, indeed, *not* insurance. While lacking formal governmental status, the NAIC's *de facto* position as the coordinating body among the state insurance commissioners held significant sway with state and federal legislators. Also implicit in the NAIC's position was that EWs were *not* subject to insurance regulation. This moment of clarity was short-lived, however, as the NAIC soon thereafter introduced the *Service Contracts Model Act* (#685) aimed at the regulation of EWs, an act that brought the regulation of the EW industry under the umbrella of state insurance regulators. (The details of the act are discussed in the next section of the paper.) The NAIC's stated rationale was that EWs "should be regulated and that while not insurance, could be most efficiently regulated by the State Insurance Departments" (Alabama, 2005). Thus, it would appear that the NAIC believed that sufficient parallels existed across EWs and insurance such that the existing state-level insurance regulatory structure could comfortably accommodate the regulation of EWs.

While the NAIC's assessment as to the similarities and differences of EWs and insurance may be accurate, the presumption that it should be regulated by states and in a similar fashion as insurance may not have been warranted. The NAIC's position also implied the abdication of federal regulation.

While the rationale for the abdication of the direct regulation of the U.S. insurance industry at the federal level is well documented[10], similar debate and contemplation were not extended to the EW industry. While beyond the scope of this paper, an investigation into the rationale for this uncontested abdication of regulatory responsibility would seem worthy of separate analysis.

The assumption of regulatory authority over EWs by state insurance departments ushered in a system of inconsistent and fragmented regulation. Arguably, three key factors contributed to this situation. First, the regulation of

9. Issues central to the definition and test of insurance for legal purposes are summarized in Denenberg (1963) and Hellner (1963). McLemore (1975) provides a discussion of those definitions and tests as they relate specifically to EWs.

10. The history of insurance regulation has been marked by federal versus state tensions and accommodations reaching back for more than 100 years. A defining moment occurred in 1944 in the case of the *United States v. South-Eastern Underwriters Association* (322 U.S. 533) when the U.S. Supreme Court ruled the Sherman Act applied to insurance and in doing so, held that insurance could be regulated by the U.S. Congress under the Commerce Clause. Subsequently, Congress enacted the McCarran-Ferguson Act of 1945, which limited antitrust laws' applicability to insurance and assured state authority would continue to regulate insurance at the state level. This arrangement continues today. For further discussion related to federalism and the regulation of the U.S. insurance industry, see Randall, 1998.

EWs was turned over to a system of state insurance regulators, which could take varying approaches to the regulation of the EW industry. Second, state insurance departments are, indeed, insurance departments. As such, the attention afforded to the regulation of the EW industry may be significantly less in comparison to that allocated to the insurance industry as the regulation of the EW industry does not represent a core job responsibility for them nor are they likely to be incentivized for these additional responsibilities. Thus, the fact that proposed model EW regulation (discussed below) that the NAIC formulated is limited and seemingly only cursory in nature when compared to the far more rigorous regulation of insurance should come as little surprise. Third, while the character of a given EW contract may share many similarities across the industries in which they are sold, the characteristics of the underlying asset that serves as the basis of the contract may differ dramatically in terms of character and value. Consider, for example, the differences evident when comparing the value of an electrical appliance and a home—both subjects of EW contracts. Consider also the differing character of the point-of-sale for these underlying assets; the condition in which someone purchases an automobile differs dramatically from the purchase of a home.

The confluence of these conditions contributes to an almost intractable national marketplace with a multitude of variables where a truly consistent and functional regulatory system would almost be impossible to fashion. And that is the environment that currently exists with respect to EW regulation.

The Service Contracts Model Act

The NAIC stands as an informal advisory body comprised of the various state insurance commissioners. In that capacity, it has the opportunity/responsibility to develop and promote the adoption of model legislation and regulation by its constituents. In that spirit, in 1995 the NAIC promulgated the *Service Contracts Model Act* (#685) for consideration and adoption.[11] The stated goals of Model #685 are to:

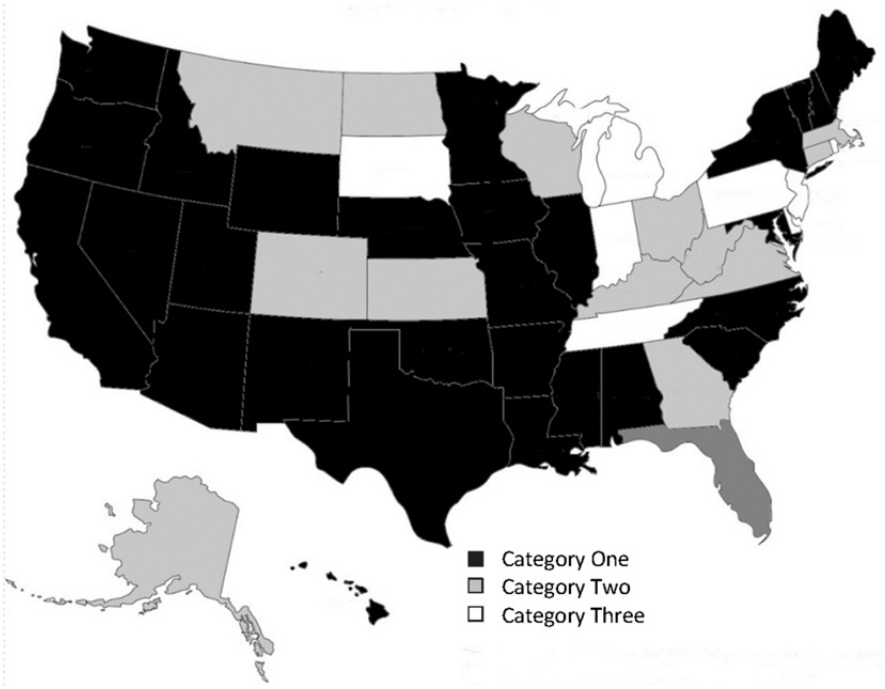
- Create a legal framework within which service contracts may be sold.
- Encourage innovation in the marketing and development of more economical and effective means of providing services under service contracts, while placing the risk of innovation on the providers rather than on consumers.
- Permit and encourage fair and effective competition among different systems of providing and paying for these services.

The adoption of Model #685 at the state level was uneven across its membership. Complicating any characterization of the adoption of Model #685 by

11. The complete text of the *Service Contracts Model Act* (#685) is available online at *www.naic.org/store/free/MDL-685.pdf*.

a given state is the fact that state regulators may adopt specific aspects of a model act for some industries (e.g., auto) while eschewing those same standards for yet another industry (e.g., electrical appliances). That said, Myer (2003) suggests that many state adopters of Model #685 were solely focused on their application of those standards to the auto EW marketplace. Given those disclaimers, Schmitz's (2012) survey of EW regulation identifies three categories of adoption based on the degree to which a given state aligns its regulation with that proposed by Model #685 (graphically depicted in Figure 1).

Figure 1:
State-Level Adoption of the *Service Contracts Model Act* (#685)



Category One: Complete service contract oversight based on Model #685. Twenty-eight states have taken this approach and have adopted a comprehensive version of Model #685 for service contracts in at least one area (motor vehicle, residential or appliance service contracts). In addition to the legislative authority listed, many states have promulgated administrative rules and regulations to supplement the legislation.[12]

12. Jurisdictions in Category One include: Alabama, Arizona, Arkansas, California, Hawaii, Idaho, Illinois, Iowa, Louisiana, Maine, Maryland, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New Mexico, New York, North Carolina, Oklahoma, Oregon, South Carolina, Texas, Utah, Vermont, Washington and Wyoming.

Category Two: Partial service contract oversight. Thirteen states have adopted a more limited scheme of regulating service contracts by simply excluding service contracts from falling under their respective insurance codes, but not otherwise setting out the full array of registration and the financial responsibility requirements contained in the statutory provisions of Model #685.[13]

Category Three: No applicable legislation or an indication from state regulators or legislators that service contracts do not constitute insurance and are unregulated or regulated in a very limited manner. These eight jurisdictions provide limited guidance on the regulation of service contracts. Absent any specific authority, it would appear that the state insurance code would apply by default, especially the provisions concerning what constitutes a contract of insurance or conducting the business of insurance in the jurisdiction.[14]

Finally, Florida merits specific discussion due to its comprehensive licensure process of service agreement companies. Specific provisions apply to appliance service agreements, motor vehicle service agreements and residential service agreements. According to Schmitz, Florida's approach is by far the most comprehensive regulatory approach in the country. The net effect of this regulatory structure is that regulation of EW programs is difficult, confusing and anything but uniform.

Regulatory Deficiencies

While Model #685 specifically addresses a handful of market issues in meaningful ways (e.g., obligor capitalization, disclosure requirements, etc.), noticeably lacking is any endeavor to mitigate the market inefficiencies typically associated with the situational monopoly in which most EW transactions occur. This same limitation was evident in the Magnuson-Moss Warranty Act's failure to address arguably the chief complaint of consumers: inflated prices. Perhaps not surprisingly, the EW industry still finds itself regularly mired in negative headlines due to allegations of unfair business practices (e.g., Better Business Bureau, 2011; *Consumer Reports*, 2011) and is the subject of legal scrutiny (e.g., Missouri Attorney General's Office, 2011).

While enhanced disclosure requirements (heavily referenced in both the Magnuson-Moss Warranty Act and in Model #685) are not a solution uniquely associated with situational monopolies, such regulation does work to mitigate informational inequities between the seller and the consumer. However, many behavioral economists have concluded that enhanced disclosure simply does not work, at least not for add-on insurance products such as EWs (Camerer, Issacharoff, Loewenstein, O'Donoghue and Rabin, 2003; Schwarcz, 2010; Baker and Siegelman, 2013). As Ben-Shahar and Schneider (2011, p. 651) explain:

13. Jurisdictions in Category Two include: Alaska, Colorado, Connecticut, Georgia, Kansas, Kentucky, Massachusetts, Montana, North Dakota, Ohio, Virginia, West Virginia and Wisconsin.

14. Jurisdictions in Category Three include: Delaware; Washington, DC; Indiana; Michigan; New Jersey; Pennsylvania; South Dakota; and Tennessee.

> [M]andated disclosure rests on false assumptions: that people want to make all the consequential decisions about their lives, and that they want to do so by assembling all the relevant information, reviewing all the possible outcomes, reviewing all their relevant values, and deciding which choice best promotes their preferences. These assumptions so poorly describe how human beings live that mandated disclosure cannot reliably improve people's decisions.

Thus, while mandated disclosure would seem to be a necessary condition for feasible regulation of EWs, it is not sufficient. Arguably, more acute regulatory problems relate to inflated prices and price discrimination.

While aftermarket EW products are often freely available in the marketplace (although many customers are not aware of this fact), few customers are familiar with EW alternatives at the point of sale of the underlying assets that serves as the basis for the EW. At the point of sale, customers are frequently at a distinct informational disadvantage compared to a salesperson who has received specific training in selling EWs and who hones those skills multiple times every single day. As a result, sellers of EWs are able to ask for (and often get) prices far exceeding the actual cost of a given EW. Indeed, *Consumer Report* (2011) states that it is not uncommon for retailers to include a 100% commission for the sale of an EW. [15]

Lacking specific regulation, situational monopolies also allow for price discrimination, the charging of different prices for the same product or service. Thus, the seller is able to extract maximum rents from each customer that he/she engages, irrespective of the actual cost of the product. While utility theory predicts a nicely ordered rationality with respect to demand and what a theorized consumer might pay for a given product, behavioral economists have found significant demand side anomalies; the motives of consumers to purchase EWs (and what they are willing to pay) frequently deviate from theorized models.[16] The market inefficiencies associated with the sale of EWs are obvious. Given the variation in the character of the underlying assets and industries that sell EWs, the question becomes: Can EWs ever be regulated in an efficient and uniform manner?

15. Sovern (2006) examines the economic motivations for firms to inflate transaction costs and explains why the practice is particularly objectionable in an economic sense. He argues that lawmakers/legislators should adopt a norm barring the unnecessary inflation of consumer transaction costs and describes tests that lawmakers can employ to implement such a norm.

16. See, e.g., Shoemaker and Kunreuther (1979); Johnson, Hershey, Meszaros and Kunreuther (1993); and Hsee and Kunreuther (2000). Also, for similar discussions related specifically to EWs, see Rabin and Thaler (2001); Chen et al. (2009); Baker and Siegelman (2012; 2013).

Adopting Regulatory Goals and Strategies for Extended Warranties

Within the framework of the public interest theory of regulation, government regulation exists to correct some of the shortfalls of the free market economy; e.g., market failures such as monopoly power and externalities.[17] Common goals associated with regulation under the public interest theory include:

- Encouraging competition where feasible.
- Minimizing the costs of information asymmetries by obtaining information and providing operators with incentives to improve their performance.
- Providing price structures that improve economic efficiency.
- Establishing regulatory processes that provide for regulation under the law and independence, transparency, predictability, legitimacy, and credibility for the regulatory system.

The NAIC adopts an even more paternalistic perspective when it declares the fundamental reason for regulation is to protect the public by seeing to it that fair competition exists while protecting buyers from anticompetitive or unfair practices (NAIC, 2011). Notwithstanding these aspirations, regulatory authorities have apparently stopped short in their efforts on multiple occasions.

The Potential for Change

Recently, two unrelated events may serve as the harbinger of change in the U.S. EW marketplace. Suffering from similar EW market inefficiencies in its electronic appliance industry, through the efforts of its Competition Commission, the UK implemented significant regulatory changes to that market with some positive effects. Also, within the U.S., the recently created CFPB has demonstrated a significant interest in the operations of the business practices, including the sale of EWs, in the auto dealership industry. The fact that this interest comes at the federal level represents a distinct break from the current situation where EW regulation takes place at the state level.

17. The public interest theory of regulation stands in contrast to a second major theory of regulation commonly referred to as capture theory that postulates those charged with the regulation of a given industry for the benefit of society act instead for the benefit of the industry. For a deeper discussion of these theories, see, e.g., Stigler (1971); Posner (1974); and Levine and Forrence (1990).

The UK Experience

The UK EW marketplace shares seminal similarities with that of U.S. For example, both traditionally operate within a situational monopoly and suffer from similar negative experiences; e.g., allegations of unfair sales tactics and price discrimination. The two markets also differ in a significant respect. While the UK regulatory model is dominated by a centralized regulatory power at the national level, U.S. EW regulation is dominated by state-level regulation.

Under the auspices of the Office of Fair Trading (OFT), the Competition Commission undertook the responsibility for the regulatory assessment of the sale of EWs associated with the nation's electronic appliance industry.[18] Ultimately, the UK passed legislation titled *The Supply of Extended Warranties on Domestic Electrical Goods Order 2005*, which introduced four new significant regulatory standards/mechanisms intended to mitigate informational asymmetries and other issues associated with the sale of EWs in the electronic goods marketplace.[19] Key recommendations include the:

- Creation and maintenance of an online "EW exchange," where pricing information would be freely available to the customer. [20]
- Obligation of the retailer to provide an offer of an extended warranty that could be accepted at any time during the first 30 days after the purchase (so the consumer could think about it).
- Requirement that warranties be cancellable with full refund rights for the first 30 days and on a pro rata basis for the life of the warranty.
- Obligation of the retailer to provide an informational booklet at the time of the sale that would explain to the consumer how to get an extended warranty from an independent third party provider.

In their assessment of the UK's Competition Commission's conclusions, Baker and Siegelman (2012) expressed skepticism as to the ultimate effectiveness of the legislation. They suggest that the reform measures ostensibly merely serve as enhanced disclosure mechanisms and cite recent OFT commentary as evidence

18. The role of the OFT (*www.oft.gov.uk*) is similar to that of the U.S. Consumer Protection Agency (*www.usa.gov/topics/consumer.shtml*). The OFT has established a Web page that provides an overview of the review and its conclusions (*www.oft.gov.uk/OFTwork/markets-work/warranties#.UhY3apJONZu*). Additionally, the Competition Commission has published the major reports and findings of its investigation online at *http://webarchive.nationalarchives.gov.uk/+/http://www.competition-commission.org.uk/inquiries/completed/2003/warranty/index.htm*.

19. For more details, see the actual legislation titled, The Supply of Extended Warranties on Domestic Electrical Goods Order 2005 at *www.legislation.gov.uk/uksi/2005/37/contents/made*.

20. For more details, see "UK's First Extended Warranties Price Comparison Website Launched Following OFT Action," available online at *www.oft.gov.uk/news-and-updates/press/2013/52-13#.Ugogv5K1HL8*. The actual online site may be accessed at *www.compareextendedwarranties.co.uk*.

of the ineffectiveness of that regulation.[21] In contrast to those expectations, the Competition Commission reports generally positive outcomes in its 2012 report titled "Review of the Restrictions on Agreements and Conduct (Specified Domestic Electrical Goods) Order 1998 and Associated Undertakings."[22] Among other findings, the Competition Commission states that the vast majority of industry respondents to its follow-up survey said that "the retail level of the DEGs [domestic electrical goods] market had changed significantly since the 1997."

More specific to the U.S. marketplace, Huysentruyt and Read (2010) suggest two reform measures that more specifically target the situational monopoly experienced in the EW marketplace:

- Requiring retailers to give consumers a choice among extended warranty providers at the point of sale.
- Allowing retailers to sell only extended warranties that were selected through a competitive bidding process conducted "on behalf of consumers."

Again, Baker and Siegelman (2012) express their skepticism as to the effectiveness of such proposals. They argue that allowing retailers to manage the presentation of EW alternatives essentially puts the "fox in the hen house" and, thus, renders the first idea moot. While the notion of a competitive bidding process is initially appealing, if the retailer is incentivized to influence EW buying behavior; e.g., because some EWs offer higher commissions, then the process would be compromised.

More recently, Baker and Siegelman (2013) have developed a three-step regulatory strategy to the add-on insurance problem:

- Subject to mitigating reasons, the sale of the insurance along with the base product should be banned.
- If a ban is not feasible, then regulators should endeavor to create an online market through which customers might purchase an EW. No commissions should be paid to retailers for such purchases. However, retailers might be compensated for their service in providing access to the online sight through a regulated flat-fee system.
- If neither of the above solutions is deemed feasible, then the regulator should engage in price regulation.

21. See the OFT's commentary titled, *Evaluating the impact of the Supply of Extended Warranties on Domestic Electrical Goods Order 2005* (*www.oft.gov.uk/shared_oft/reports/Evaluating-OFTs-work/oft1024.pdf*).

22. The complete report can be found online at *www.competition-commission.org.uk/assets/competitioncommission/docs/2011/domestic-electrical-goods-review/120201_degs_final_decision_excised.pdf*.

Thus, their proposal rolls out a flexible solution where the situational monopoly is essentially banned as a first option. Lacking that, they envision an online solution that eliminates the potential for excessive remuneration for the retailer. In a market where the first two solutions are rendered infeasible, Baker and Siegelman (2013) suggest that regulators should engage in price regulation.

The Consumer Financial Protection Bureau

The relatively recent creation of the CFPB (under the auspices of the Dodd-Frank Wall Street Reform and Consumer Protection Act) has introduced an element of uncertainty into the existing regulatory structure of the EW industry.[23] Despite the lack of a clear mandate to pursue matters associated with the sale of EWs (Casey, 2013) and despite the specific protections afforded the auto dealership industry, the CFPB has issued subpoenas to participants in the auto lending industry seeking information related to its sale and distribution of EWs (among other financial contracts) (Sidel and Ziebel, 2013).[24]

Given the protections afforded the auto dealership industry and the seeming lack of an oversight mandate to include EWs, the CFPB's interest is no doubt cause for some concern within the industry. While it is still too early to fully comprehend any regulatory implications of this interest, it is seminal, nonetheless. Given the historically relatively weak state-level regulation of EWs, interest coming from the federal level could lead to unknown outcomes.

In an interesting twist of fate, while the formal differentiation of EWs and insurance has long-served to protect the EW industry from insurance-like regulation (despite being regulated by state insurance departments), that same recognition now exposes the industry to federal level regulation under the CFPB. The CFPB's regulatory domain specifically excludes financial contracts (such as insurance) that are already subject to prior federal regulation, such as the McCarran-Ferguson Act (1945).

These developments hold portent significance not only for the auto dealership industry, but also for the broader EW industry. While historical regulation at the state level has resulted in relatively weak and fragmented policies, interest at the federal level holds the potential of more comprehensive and uniform regulation of the EW industry.

23. The content of the Dodd-Frank Wall Street Reform and Consumer Protection Act is available online at *www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm*.

24. For a discussion of those protections, see section 124 Stat 1376 12 U.S.C. § 5519(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Pub. L No. 111-203.

Extended Warranty Regulatory Recommendations

Given the discussions and experience presented above and with due consideration of the current legal and regulatory environment in the U.S. marketplace, we propose three primary philosophical mandates for the regulation of the EW marketplace:

- Eliminate the situational monopoly.
- Simplify contractual language.
- Seek consistency in regulation.

First and foremost, we believe that the situational monopoly can (and should) be dismantled as its existence promotes the negative inefficiencies in the EW marketplace. We concur with the earlier suggestions banning the sale of EWs at the point of sale with the understanding that the ban *pertains only to the retailer*; the financial motives and opportunity for the retailer to profit from the sale of EWs must be eliminated. We believe the creation of an online "EW exchange" (monitored and vetted by an appropriate regulatory entity) would provide for consumer sovereignty while eliminating any motive for retailers to engage in questionable business practices. A healthy aftermarket EW industry already exists and could be even more competitive with the addition of EW providers that currently only distribute their product through retailers.[25] Certainly, in this age of portable digital communication devices, most individuals have virtually immediate access to any online site that may present such alternatives. Additionally, retailers could be required to provide customers with information on how to access such an exchange or possibly even provide access at the point of sale. In exchange for this service, the retailer could be compensated based on some form of pre-determined flat-fee arising from the purchase of an EW. An important point of differentiation from the system currently employed in the UK is that the management responsibility for the site should rest with a regulatory body, as opposed to the participants in the EW market—as is the case in the UK model.

Second, research has clearly shown that consumers are generally confused as to the coverages provided by EWs, and specific populations (e.g., lower income and less educated) are frequently identified as being particularly vulnerable (Chen *et al*., 2009). In the current EW marketplace, the freedom of EW providers to include complex and opaque contractual wording neuters any effort to reduce symmetries of information through enhanced disclosure mandates. Thus, we would encourage regulatory entities to simplify EWs by imposing some level of

25. Some current online providers of aftermarket extended warranties include SquareTrade Protection Plans (*www.squaretrade.com*) and Protect Your Bubble (*us.protectyourbubble.com*). Both offer a wide array of EWs for electronic and home appliances, iPads, etc. Similarly, AA Auto Protection (*www.aaautowarranty.com/index.asp*) offers aftermarket EWs for autos.

standardization of coverage and language. One template for the needed detail in the definitions and disclosures of the EW terms, coverages and costs could be the Truth in Lending Act regulations.[26]

Our last suggestion relates to both simplification and consistency. We propose that regulatory authority for the EW marketplace be centralized, for example, with the CFPB or some other body.[27] Despite the contractual similarities that insurance and EWs share, insurance regulators (at both the federal and state levels) have demonstrated no interest in raising the level of EW regulation to that afforded the insurance industry; EWs have been relegated to "step-child status" within the insurance regulatory system. The NAIC's endeavor to provide some modicum of regulatory oversight for the EW industry simply has not worked, and a new regulatory vision is recommended.

Summary Implications

This paper summarizes the regulatory history of the EW marketplace in the U.S. in light of economic regulatory theory and notes the general inability of earlier regulatory approaches to mitigate the identified negative market inefficiencies. Our review covered research of both behavioral and regulatory economists in the identification of traditional solutions to the problems in the EW industry. These reports described the degree to which the typical consumers of EWs represent a vulnerable and/or poorly informed population.

Ultimately, this paper generates three key regulatory solutions that, if implemented, would alter the situational monopoly that serves as the typical framework in which EWs are sold and establish additional measures to reduce asymmetries of information and understanding among customers. Those suggestions include the:

- Elimination of the situational monopoly by banning the sale of EWs by retailers at the point of sale.
- Simplification and standardization EW contractual language.
- Enforcement of EW regulation by a central authority.

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26. The FDIC has issued its Regulation Z Compliance Manual – August 2012 to determine if mortgage lenders are meeting the specific and detailed requirements of the TILA (*www.fdic.gov/regulations/compliance/manual*). The FDIC has also issued similar rules of compliance for the Equal Credit Opportunity Act, another name for the TILA, Regulation B, covering credit card and home-equity loan lending (*www.fdic.gov/regulations/laws/rules/6500-200.html#fdic6500101#fdic6500101*).

27. For example, the Federal Trade Commission (FTC) stands as a feasible federal regulatory alternative. The stated mission of the FTC is to:

- Prevent business practices that are anticompetitive or deceptive or unfair to consumers.
- Enhance informed consumer choice and public understanding of the competitive process.
- Accomplish this without unduly burdening legitimate business activity.

While simple in concept, in order for these strategies to be effective, regulatory authorities and/or legislative bodies would need to demonstrate significant commitment to the efforts. That said, regulation seldom comes without attendant costs. As mentioned earlier, regulation may be accompanied by unintended market frictions such as the inhibition of market growth and/or innovation. The costs associated with the implementation of standardized contractual language and the development of the necessary infrastructure for distribution will not be inconsequential. At the extreme, regulation might decrease competition, which could result in increased prices to consumers. Thus, in and of itself, regulation is not necessarily a panacea to the inefficiencies evident in the EW industry but rather, "appropriate" regulation may be expected to result in commensurate consumer benefits.

The recently expressed interest of the CFPB in the activities of the auto EW industry have introduced an element of uncertainty to the regulatory environment, an uncertainty that surely cannot be welcomed by the EW industry. Involvement at the federal level would increase the likelihood of a regulatory system that is consistent and comprehensive and would quite likely threaten the traditionally high profit margins enjoyed by the EW industry. Given this, the CFPB should anticipate some, possibly significant, level of resistance from the EW industry.

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