



# EXTENDED WARRANTIES: Road to Disaster or Recipe for Success?

BY FRANK LENK

Today's consumers take it for granted that obvious flaws in the products they purchase will be put right at the manufacturer's expense. They're also willing to safeguard major purchases at the extra expense of an extended warranty. But the system that provides that coverage is complex, and oftentimes problematic.

**EXTENDED WARRANTIES** are a huge industry unto themselves, and it would be impossible to summarize the workings of that industry in a few pages. But it is worth highlighting some of the major issues that affect this important component of the retail world.

How are warranties administered? How are they regulated? How successful are they at their intended function? And, most conspicuously, what happens when they fail?

## SIZE AND SHAPE

It's important to note that the term 'warranty' is commonly used to refer to two very different services. Heather Gray, Equity Partner with Toronto-based Clyde & Co. explains.

**Product warranties** are offered by manufacturers. They cover initial product defects and later malfunctions. These days, they typically run from one-to-three years. Regardless of how repair or replacement is handled, the manufacturer foots the bill.

**Extended warranties** are purchased separately by the consumer. They may cover not only product failures, but also things like accidental damage, or even loss or theft, thus shading into coverage that would be considered 'insurance.' Extended warranties are typically backed by large insurers, but they may also be provided by larger retail chains themselves.

This distinction is basic, and it has important legal and practical ramifications. Product warranties are largely the province of manufacturers. So our focus will be mainly on extended warranties, which are both a source of revenue and of administrative concern for retailers.

Extended warranties are a big business. Earlier this year, *Warranty Week* reported the total 2017 U.S. market for "consumer protection plans" was worth US\$44.7 billion. This represented a relatively minor decline of US\$250 million compared to 2016. (The Canadian market is estimated at roughly 10% of this size.)

Vehicle service contracts were the largest single chunk of the total: 37%, valued at US\$16.7 billion. They were also the largest factor in the overall decline, down by US\$300 million compared to 2016. The next three largest categories were: mobile phones, at 19% of the total; consumer electronics at 15%; and PC OEM warranties at 10%.

Looking at this business through the other end of the telescope, a 2016 study by The Warranty Group found that 54% of consumers bought extended coverage for exercise machines, 41% for major appliances, 32% for digital cameras,

28% for mobile phones, and 22% each for computers and tablets.

Eric Arnum, Editor of *Warranty Week*, points out that extended warranties are obviously most important with products that don't fall into the 'throwaway' category. For example: cars, major appliances, garden equipment, computers, and (so far) smartphones.

Below a certain sticker price, there's little reason to buy an extended warranty. The cut-off point is ever-changing. For example: a decade ago, TVs and laptop PCs were perceived as high-priced items, vulnerable to damage and costly to repair. Today, with low-cost models available for a few hundred dollars, consumers are becoming less inclined to purchase coverage.

The desire for coverage isn't just based on dollar value. Arnum points out that people have become less reliant on their personal computers alone, and this, too, has helped reduce the impetus to buy extra service plans. Today, smartphones are becoming more commoditized and less expensive, so we can anticipate a similar decline in demand for extended coverage.

### CONSUMER SKEPTICISM

Apart from these general trends, consumers may be getting increasingly leery of the value proposition offered by extended warranties. In a 2011 article, the *Globe & Mail* reported that the cost of extended warranties was about 80% profit. The cost also tended to be more than that of the likeliest repairs, even on (then) relatively exotic items such as plasma TVs.

*The Washington Post* summed up some of the concerns in an article this spring, entitled "Why extended warranties are hardly ever a good deal." It pointed out that the average dishwasher repair costs roughly the same as an average three-year extended dishwasher warranty.

It doesn't help that the Internet abounds in warranty horror stories. We've all read news reports of major manufacturers releasing a faulty product, then only reluctantly doing a recall only when compelled by massive publicity. There are also endless anecdotes about how consumers have been tripped up by caveats in the fine print of their policy.

There's no doubt that the terms of extended warranties can be both vague and complex. It's not always clear whether "three-year" extended coverage is in addition to the original product warranty, for a total of, say, four years, or if it merely extends coverage to a total of three years. And it's not always obvious what's covered:



Best Buy's Geek Squad focuses on offering end-to-end peace-of-mind versus being focused just on urgent repairs and costs.

water damage, but perhaps not fire; accidents but not theft.

Repair often requires delivery of the product to a service location. Even if shipping is covered, it's a hassle, and means doing without the product for an extended period. And there's often a dollar limit to the repairs that will be made, after which the provider may consider the policy terminated even if it hasn't run its full calendar term.

There are legal rules about all these things, but few are obvious to the average consumer.

Earlier this year, the U.S. Federal Trade Commission (FTC) notified Sony, Microsoft, Nintendo, Asus, HTC, and Hyundai that their "warranty void if removed" stickers were illegal under the 1975 *Magnuson-Moss Warranty Act*. Under the Act, consumers have a right to open their device, even if it means scraping off the sticker. And the warranty must be honoured even if the product has been used with other brands of accessories, or repaired with aftermarket parts.

Every negative report only serves to emphasize the adversarial relationship between vendor and purchaser. Consumer trust in the whole warranty framework may be reaching low ebb.

A study by MyVoucherCodes early this year offers a hint as to the degree of disillusionment. It found that UK millennials are more willing than older consumers to replace a broken product rather than make a claim on the manufacturer's warranty. The study estimated that one-fifth of British consumers didn't even check their warranty before replacing products, and that electrical

goods valued at about £423m were being thereby needlessly abandoned every year.

One automotive warranty provider, Obvi Inc., spoke out recently, pointing out that over-priced car warranties "just don't make sense," and that too many tend to offer coverage that expires before major breakdowns become likely (between 120,000 and 160,000 km). The op-ed also complained that most policies don't transfer on dealer trade-ins, breaking any continuity in the customer's investment.

*The Washington Post's* advice was for consumers to skip the extended warranty and put the money into their own "repair-or-replace" savings account. This approach not only saves the profit margin on an extended plan, it provides simultaneous coverage for all the family purchases rather than just one specific product. (which may not turn out to be the one that breaks).

## THE STORY

- ▶ Extended warranties are a huge business, governed by varying provincial legislations.
- ▶ Plans can avoid regulation as 'insurance' if they're properly structured.
- ▶ Consumer confidence in warranties is eroding and needs to be rebuilt.
- ▶ Warranties are a priceless opportunity for building long-term customer loyalty.



Heather Gray, Equity Partner with Toronto-based Clyde & Co., says the key question with extended warranties is if a plan is likely to fall under regulations governing 'insurance.'

Ironically, consumers probably need the security of extended coverage now more than ever. And retailers of every kind need the customer relationships that well-structured coverage can build. In fact, there are opportunities for entirely new types of coverage.

Arnum points to one new type of plan that has been emerging lately. In 'hot' states, such as Arizona, Texas or California, food refrigeration and air conditioning are becoming literally a matter of life and death. This is helping to fuel the rise of so-called 'home warranties.' At prices on the order of \$500/year, these cover not the home itself, but its indispensable appliances. Consumers are ready to pay for the assurance that someone will be promptly on-site to fix a broken air conditioner, or fridge.

These kinds of blanket coverage can be particularly valuable to specific groups of consumers: single parents, for example, or people who live alone and work all day, or the elderly. To some degree, the new 'home warranties' will compete with the more traditional extended warranty plans available at retail. But there's clearly a broad spectrum of possibilities.

Arnum is particularly enthusiastic about Best Buy's Geek Squad as a paradigm for expanded coverage – not focused merely on costs, or even urgent repairs, but providing convenient end-to-end peace of mind. "It's not just break-fix," says Arnum. "That's the future: not just 'please and thank-you' on the phone."

**LEGAL DISTINCTIONS**

The legalities governing extended warranty coverage can be tricky for retailers to master. It's particularly important to understand the way different types of coverage are regulated.

Michael Bailey, President of Superior Warranty, a consultancy that advises businesses on the design of warranty plans, points out that the laws governing the extended warranty business vary from province to province, and are often not enforced as stringently as one might expect. This tends to put the onus on manufacturers and retailers to ensure that their programs are compliant, and fiscally sound.

Clyde & Co's Gray notes that for the past 10 years, a large part of her practice has been providing advice to Canadian companies regarding the sale of extended warranties. Her work touches on many product categories, including motor vehicles and portable electronics.

The key question, she says, is whether or not a particular plan is likely to fall under regulations governing 'insurance.' Those rules tend to be quite stringent, requiring a full regime of licensed brokers, agents and adjusters, under the relatively strict control of the Insurance Act, administered by a Superintendent in each province.

Of course, any extended warranty plan tends to resemble an insurance policy. But in practice, there are many specific legal exemptions. For example, most jurisdictions allow manufacturers – as well as their affiliates and subsidiaries – to offer coverage on their own products.

In BC, for example, there's an exemption for "product warranty insurance," covering OEMs or their subsidiaries that are essentially "standing behind their product," as opposed to offering a separate service. In Manitoba, there's a specific

exemption for car coverage, in the form of a license for which individual dealerships must apply. (In the U.S., the situation is similarly complex, with each state having its own detailed rules.)

If a plan is deemed not to be considered 'insurance,' it would fall under a province's Consumer Protection Act, administered by groups such as the Financial Services Commission of Ontario (FSCO).

Various types of service contracts could fall somewhere in between. "There is no one-size-fits-all answer," cautions Gray. Businesses large or small that need to know where their plans fall on "the compliance scale" should seek the services of someone like Gray. "We see all shapes and sizes," she says.

Given the complexity and expense of compliance, Bailey cautions that many small and mid-sized retailers probably have plans that are not fully in tune with the legal framework. This may not be a problem until things go wrong, as in a bankruptcy.

Gray notes that the companies that approach her are those that are predisposed to getting the legalities right. So it's hard for her to assess the extent of non-compliance. However, she does feel that compliance in general has been "gaining traction" over the past five-to-seven years.

"We're getting more calls, both from existing businesses and those just coming into the country," she says. At the same time, she feels that regulators have been paying increasing attention to the warranty market. There's probably work that still needs to be done.

The legal situation continues to evolve globally. In Europe this year, the new Insurance Distribution Directive (IDD) aims to impose new controls on all forms of insurance. It would require mandatory professional training of staff, and improved disclosure of terms to prospective purchasers. These new procedures are expected to roll out in parallel with those imposed by the new General Data Protection Regulation (GDPR) protecting consumer privacy.

Arnum notes that, as with privacy, the European approach is considerably more stringent than in North America. Retailers are required to take back products that fail to last a "reasonable" amount of time. Canada, says Arnum, falls between the "cowboy mentality" of the U.S. and the tightly regulated environment of Europe.

**COVERAGE CATASTROPHES**

Compliance with legal or financial guidelines helps protect both consumer and vendor. Nonetheless, exceptions can slip under the radar.

The Canadian Consumer Handbook, jointly produced by the federal and provincial governments, is a great resource for learning more about the different kinds of warranties that are available to consumers.

The screenshot shows the 'Canadian Consumer Handbook' website. The main heading is 'Warranties'. Below it, there is a section for 'Manufacturer's Warranties' which includes a definition: 'A manufacturer's warranty is a written assurance to the purchaser of a product, promising to replace or repair it, if necessary, within a specified period. You should find out about the terms of this kind of warranty before you buy, particularly if the item you're buying is of significant cost to you. Questions you could ask include: How long is it good for? Where will I have to go to obtain warranty repairs? Do they cover parts and service, or just one or the other?' Below this, there is a note: 'Often, manufacturer's warranties are not valid from one country to another. For instance, if you buy electronics during a visit to another country (or buy from a foreign retailer over the Internet), you may be buying a product with a manufacturer's warranty that doesn't protect you at home in Canada even if the same product is available for sale in Canada. The same is true when buying automobiles abroad, as we discuss in more detail below.'



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Bailey recalls various cases where inadequate coverage has become a problem. For example, one company in the 1990s touted products with “lifetime extended warranties,” when the company went bust shortly afterward, there was no outside financial backing to continue the coverage.

Of course, the definitive example of warranty failure is now the Sears Canada bankruptcy of 2017, which left hundreds of thousands of Canadian consumers with coverage that abruptly became worthless.

Ironically, Arnum notes that “the tragedy of Sears” was exacerbated by the company’s greatest strength: its enviable degree of integration.

Sears Canada was well known for the superiority of its warranties. Where some companies might reluctantly repair a three-year-old fridge, Sears would fix it on-site, or cart it away at its own expense and replace it and then extend the original warranty to the new unit. Sears’ coverage was so good, says Arnum, the company’s research showed that customers who had a break-fix event were *more* likely to be satisfied than those who had no breakdowns at all.

Sears’ seamless coverage was possible largely because the company didn’t act only as a retailer. It was also effectively a manufacturer, with popular house brands (e.g. Kenmore) produced for it by major manufacturers. It did its own repairs. And it provided its own product warranties, as well as extended warranties through its own insurance arm.

When the organization collapsed, there was no fallback, no independent third party to provide continuity. Arnum notes that product warranties often “go down with the ship.” But in the case of Sears, the extended warranties sank as well.

Failure of continuity is the eternal fear with extended warranties. Arnum notes that the crash of 2008 created a danger that automakers would default on car warranties. The government bailout specifically included bailout of those warranties.

When the crash is big enough, it creates its own market opportunities. In January, membership-based retailer DirectBuy announced that it would be beefing up its support for Sears Canada customers who’d been left without warranty coverage. The company stated that it had acquired “certain assets” of Sears, including “replacement parts and warranties,” and said it would be “increasing hiring efforts for former Sears Canada employees in its warranty department.”

“These customers paid for additional protection on their major purchases and now that protection is worthless, as Sears did not maintain



Sears Canada built a reputation for offering great warranties and services, but when the retailer claimed bankruptcy in 2017, it left hundreds of thousands of customers with coverage that became worthless since there was no independent third-party to provide continuity.

a reserve account to protect their warranty customers,” said Dylan Astle, COO of DirectBuy. “We now have an opportunity to help those customers that purchased those extended warranties that are now void.”

### MARKET EVOLUTION

Redundancy and overlap are accepted features of the warranty market. For example, *Warranty Week* notes that mobile phones like the iPhone are covered in three ways: through service contracts sold by retailers, by extended warranties sold by Apple on its own products, and by insurance plans sold by phone companies (this being the largest segment).

PCs are covered by service contracts from retailers and by contracts sold by the OEMs. Service plans are a sub-category unto themselves, characterized by an emphasis on service and support, as opposed to repair and replacement. Major appliances may be covered by service contracts, but also through home warranties.

Technology is moving to clean up some of the complexity. There’s now a wide range of apps available for both Android and iOS that can scan product serial numbers and receipts, and help consumers track their purchases and warranty coverage.

There’s also a hidden feedback loop that can help improve basic product reliability. Larger retailers can put pressure on manufacturers to remedy product flaws. Extended warranty providers may seek reimbursement from manufacturers, which can also be a strong influence on product quality.

Retailers of all sizes need to remember that extended warranties are much more than just a

source of rich profits. As Sears showed before its collapse, they can be the key to long-term customer relationships, and a way of building not just repeat business, but fierce consumer loyalty.

Arnum suggests that warranties can really show the character of a retailer, large or small. He gives the example of his barber: having found one he trusts, he’s kept going back for years. With a car, he says, it’s just as important to find a trusted repair shop as it is to choose the right make and model. Consumers need to choose all their retailers this way.

“The name of the game in retail now is survival of the fittest,” warns Arnum. Amazon can always offer the best price, and it’s no-questions-asked return policy is impossible to beat. But bricks-and-mortar retailers can go far beyond those criteria. Warranties are a unique way for retailers to distinguish themselves.

“Prices matter,” says Arnum, “but if you play that game, you become interchangeable. It’s a losing game.” He emphasizes that the retailer’s sights must remain fixed on “cementing the customer relationship.”

The secret, as ever, is customer service, in the widest sense. That needs to include solid warranty support, but it can go far beyond, to include support via phone or Web, and after-sale assistance with setup, upgrades, expansion, security updates, or replacement components.

Sears Canada has shown both the positive and the negative potential. When warranties are allowed to collapse, the public catastrophe can be damaging to an entire marketplace. But when they’re handled well, they can help retailers build priceless consumer loyalty and long-term success. **wh**