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Extended Warranties and Insurance: Consumer Awareness and Perception

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Executive Summary

The sale of extended warranties typically occur within a situational monopoly operating with very limited regulation. Additionally, specific consumer groups that have been identified as being inclined to purchase extended warranties have been found to be uniquely vulnerable in terms of their financial acumen. This research focuses on the confusion that consumers might have related to the similar coverages provided by extended warranties and insurance. The issue is an important one consumers, if incorrectly perceiving extended warranties to be insurance, may similarly presume similar regulatory protection across both products – which would be a significantly flawed assumption on the part of consumers. This research clarifies the perceptions and understanding of extended warranty consumers with respect to the shared similarities of warranties and insurance as well as their actual knowledge of coverages provided under each type of contract.

Using a Likert-scale with response values from 1-7 (where the larger value indicates stronger agreement), we asked 622 individuals that had recently made appliance purchases and who were subsequently offered the opportunity to purchase an extended warranty at the point of sale:

> To what extent do you agree (or disagree) with the following statement:
>
> *Extended warranties are essentially the same thing as insurance*

About 25 percent of the total respondents agreed with that statement in the strongest terms and 63.7 percent chose values of five or higher, suggesting a strong positive predisposition toward a belief that extended warranties are indeed the same thing as insurance.

We also assessed the understanding of the coverages provided by extended warranties and insurance policies of 253 individuals who had recently purchased an appliance from a regional retailer. Respondents were presented with a five question quiz and asked to identify which contract (extended warranty or homeowners' insurance), if either, would apply to a given scenario. The average score for the quiz was 56.8 percent, suggesting that the typical consumer has a poor understanding of the coverages under extended warranties and homeowners' insurance, respectively.

These findings lend themselves to arguments in favor of further clarification as to the differentiation of extended warranties and insurance and the potential need for additional regulatory measures aimed at mitigating the economic inefficiencies associated with the sale of extended warranties.

I. Introduction

The pitfalls associated with the purchase of extended warranties are well known and have been the subject of any number of consumer report warnings. While the fine print, the manner in which they are sold, the typically high profit margins, etc., all are worthy of note, the unique vulnerability of the consuming population is also of interest. Research has found that typical purchasers of extended warranties score relatively low on financial acumen tests, suggesting they may not understand all of the implications associated with the purchase of an extended warranty. Additionally, research has found that individuals with relatively lower economic means are more inclined to purchase such contracts. While the actual purchase of such contracts may make sense for many of those individuals within a theoretical paradigm, the value of any such purchase is often dampened by significantly inflated transaction costs.

Additionally, the debate as to whether extended warranties are indeed insurance (and thus subject to insurance regulation) has percolated for well over 50 years and the issue still appears to be alive and well. The point of differentiation is an important one as it speaks to the character of the regulation that might govern the extended warranty industry. Extended warranties are typically sold within the context of a situational monopoly with relatively little regulation. Coupled with a uniquely vulnerable group of targeted consumers, the extended warranty industry would seem ripe for increased regulation.

This research contributes to that body of understanding in two ways. First, this research assesses the consumer's perception as to whether extended warranties are essentially insurance contracts. To the extent that consumers perceive them to be essentially the same kinds of contracts, consumers might (mistakenly) think that similar levels of regulation, e.g. protection against price gouging, are imposed. Second, our research assesses the general level of knowledge a consumer has related to the coverages provided by extended warranties and insurance. These results will contribute to an understanding as to the level of vulnerability consumers may possess with regard to these two common types of contracts.

In subsequent sections of this paper, we first present background information related to the coverages typically provided by extended warranties and homeowners' insurance, the character of their respective regulation. We then present the results of our research and close with a summary.

II. Background

A. Extended Warranties Defined

An extended warranty is a contract that provides limited indemnification for the breakdown of the underlying asset due to wear and tear, breakdown, and/or defective products or craftsmanship. In contrast to insurance which commonly relies on financial indemnification for covered losses, extended warranties typically "indemnify" the contract holder via repair or replacement of the damaged property. Extended warranties are typically sold at the point of sale of the underlying asset, although other distribution systems also exist. Causes of breakdown that are often specifically excluded include, acts of God, intentional damage, etc. Some state insurance regulators have approved the inclusion of accidental damage from handling, rental car and towing, power surge, and other coverages in addition to the standard coverage for defects in materials and workmanship. Extended warranties have terms and conditions which may not match the original terms and conditions of the manufacturer's warranty. For example, extended warranties may not cover anything other than mechanical failure from normal usage. Exclusions commonly include commercial use, "acts of God", owner abuse, and malicious destruction.

The sale of such warranties are traditionally associated with a number of specific 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. Of those industries, auto OEM and computer manufacturers represent about half of the market.

B. Extended Warranty vs. Insurance: Consumer Confusion

The arrival of annuities in the 1960s sparked significant debate as to whether they were insurance and thus, subject to insurance regulation. Numerous court decisions and scholarly endeavors opined on the issue and delineated various standards by which insurance might be defined. With the advent of extended warranties in the 1970s the debate reignited in an effort to clearly identify whether extended warranties were indeed insurance and thus, subject to insurance-like regulation.

While case law on the matter is inconsistent across jurisdictions, ample support does exist that concludes that extended warranties are indeed, *not* insurance. In that same vein, the National Association of Insurance Commissioners (NAIC) formally concluded in 1995 that extended warranties were not insurance. While seemingly definitive, the NAIC subsequently promulgated model regulation for adoption by its state members aimed at the regulation of extended warranties. The model regulation was inconsistently adopted by the various states.

But the matter still remains wholly unresolved; academics still commonly refer to extended warranties as add-on insurance products. Additionally, the current sale of mechanical breakdown insurance (MBI) in the auto insurance marketplace once again muddies the water – especially for consumers. With the exception of a few nuanced differences, MBI contracts function in virtually the same manner as extended warranties but are fully recognized as insurance – and regulated as such. Thus, while legal circles may have reached their peace with the issue, consumers may still struggle with the differences – and those differences are important as they are the key points of differentiation that determine whether extended warranties become subject to insurance regulation. As an industry, insurance is typically regarded as one of the most highly regulated industries and thus, the categorization of extended warranties as insurance would come with significant regulatory implications.

C. Consumer Vulnerability

In addition to the challenges associated with navigating the complexities and application of contractual language, specific populations have been found to be predisposed to purchase extended warranties and their ability to navigate complex financial contracts has been found to be deficient. Research has found that consumers with relatively lower wealth are more likely to buy extended warranties. Those findings should not come as a surprise as those with limited wealth would benefit relatively more from insurance than would more wealthy individuals should a covered claim occur because the negative impact on the wealth of the individual would be less to the wealthier person. However, while insurance might possess more value to a less wealthy person, the traditional high profit margins associated with extended warranties dampen the value such contracts might have. Additionally, research has found that low income earners possess less financial acumen than do relatively higher income earners. Given the complexities of the contractual language and the situational monopolistic setting in which extended warranties are sold, individuals relatively more inclined to purchase extended warranties (at inflated prices) are placed at a significant disadvantage.

III. Research

A. Research Framework

Our research addresses two specific issues. The first is the consumer's perception as to whether extended warranties and insurance are essentially one and the same. The consumer's perception on this matter is significant because it may reveal the assumed level of regulatory protection afforded extended warranties. Insurance is widely understood to be highly regulated but the regulatory environment of extended warranties are far less familiar to the typical consumer. Thus, the answer to this query may shed light on a flawed understanding of the regulatory protections and reasonable expectations for contractual performance with respect to extended warranties. The second query assesses the consumer's actual understanding of the basic protections afforded the owner of an extended warranty and a standard homeowners' insurance contract. Given the many contractual similarities and the fact that both contracts often provide for repair or replacement for the same damaged property e.g. personal property, autos, etc. albeit for differing perils, the correct application of contract coverage can be a daunting task for some.

As noted above, extended warranties are commonly sold in any number of industries, e.g. auto, home, HVAC appliance, etc. In order to implement the second of our research questions we needed to be specific with respect to the underlying asset of the respective warranty and insurance contracts because cross comparisons, e.g. an appliance extended warranty being compared with an auto insurance policy, lack comparability. We chose to survey individuals who had recently purchased an appliance from a regional retailer and who had typically been offered the opportunity to purchase an associated extended warranty. For the sake of comparability, we quizzed those individuals as to their knowledge of the coverages such extended warranties might include as compared to typical coverages provided by a homeowners' insurance policy – which commonly offers coverage's for personal property such as appliances. To provide the reader with appropriate context, the next section of this report summarizes the coverages available in the "typical" homeowners' insurance policy.

B. Homeowners' Insurance Policy Coverage

While the trigger for coverage under extended warranties are relatively straightforward, insurance contracts are typically significantly more complicated. Subject to other miscellaneous clauses and conditions of the contract, three critical elements need to be met in order for a personal property loss to be covered under the typical homeowners' insurance policy. First, the loss has to be the result of a covered "occurrence." Second, the loss must be caused by a covered peril. Third, none of the exclusions can be invoked.

"Occurrence" is a defined term in homeowners' insurance contracts and means "an accident, including continuous or repeated exposure to substantially the same harmful conditions, which results, during the policy period, in: bodily injury or property damage." While the term "accident" is *not* a defined term within the realm of insurance, its typical interpretation implies that the occurrence was an "unforeseen and unplanned event or circumstance" from the perspective of the insured. That definition is a seminal point of differentiation when endeavoring to differentiate insurance coverage from extended warranty coverage. The core "perils" covered by extended warranties are wear and tear and product defect - neither of which meets the definition of an accident. In particular, wear and tear is not deemed to be an accident but rather, an expected outcome after a period of use.

According to the NAIC, almost 90 percent of the U.S. homeowners' insurance market insures personal property under what is called "named peril" coverage. As identified by the Insurance Services Office (ISO), the 16 specifically identified "named perils" include:

- Lightning or fire
- Hail or windstorm
- Damage caused by aircraft
- Explosions
- Riots or civil disturbances
- Smoke damage
- Damage caused by vehicles
- Theft
- Vandalism
- Falling objects
- Volcanic eruption
- Damage from the weight of snow, ice, or sleet
- Water damage from plumbing, heating, or air conditioning overflow
- Water heater cracking, tearing, and burning

Coverage is subject to not being specifically excluded. Typical exclusions found in "named perils" homeowners' insurance policies include

- Flood
- Earth movement
- Ordinance or law (some coverage may be provided in your policy)
- Water damage (sudden and accidental water damage is automatically included)
- Power failure
- Neglect
- War

- Nuclear hazard
- Intentional loss
- Government action
- Collapse (some coverage may be provided in your policy)
- Mold, fungus, or wet Rot (some coverage may be provided in your policy)
- Birds, vermin, rodents, or insects
- Wear and tear, or deterioration

Thus, the mutual exclusivity of coverage by extended warranties and homeowners' insurance policies are clear. Breakdowns due to wear and tear and product defect (traditional warranty perils) will not meet the definition of occurrence for the purposes of insurance and are not included in the list of covered named perils. Additionally, wear and tear is specifically excluded in the typical homeowners' insurance policy. Conversely, extended warranty coverage often specifically excludes damages caused by "accidents."

C. Consumer Perception

1. Survey Details

In late 2010, we surveyed 622 individuals who had recently been offered the opportunity to purchase an extended warranty subsequent to a purchase they had made. The opportunity to purchase the extended warranty was made at the point of sale. Of our pool, 288 had purchased at least one appliance from a regional Midwest appliance retailer while the remaining 334 individuals had recently purchased an auto from a major national auto manufacturer.

There was a 30.5 percent pickup rate (88 individuals reported purchasing an extended warranty) for extended warranties among those purchasing appliances while there was a 53.9 percent pickup rate (180 individuals) for automobile purchasers. The average price of the appliance purchased was $840 and the average extended warranty cost was $130. The average cost of the auto purchased was $24,586 and the average cost of purchased warranties was $1,455.

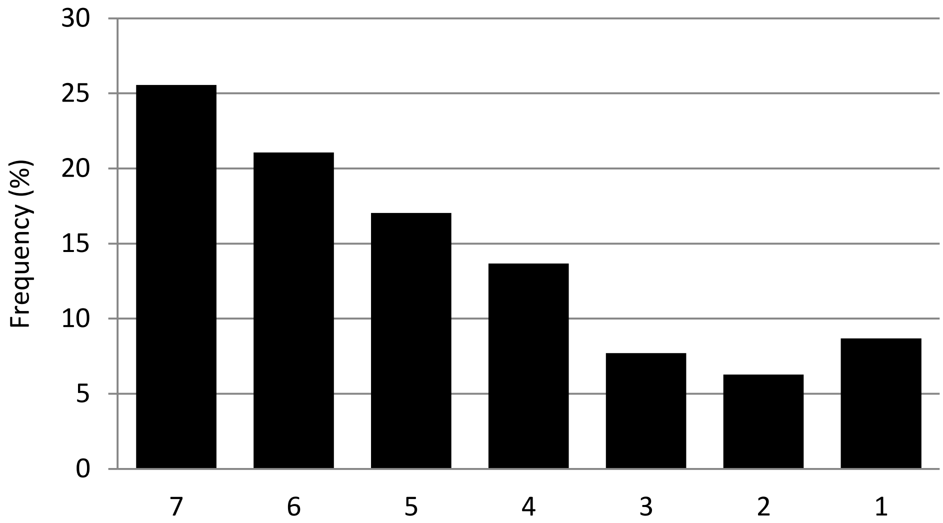
Using a Likert-scale with response values from 1-7 (where the larger value indicates stronger agreement), we asked 622 individuals that had recently made appliance purchases and who were subsequently offered the opportunity to purchase an extended warranty at the point of sale:

> To what extent do you agree (or disagree) with the following statement:
>
> *Extended warranties are essentially the same thing as insurance*

2. Results

For the purposes of presentation we aggregate the responses of the two pools. About 25 percent of the total respondents agreed with that statement in the strongest terms and 63.7 percent chose values of five or higher, suggesting a strong positive predisposition toward a belief that extended warranties are indeed the same thing as insurance. Conversely, about nine percent strongly disagree with that statement. Figure 1 below presents the complete results in graphic format.

Figure 1. Extended Warranty Perceptions of the Consumer



Also of interest is the fact that those who actually purchased extended warranties were relatively more inclined to view them as insurance; purchasers of extended warranties were more resolute in their opinion that extended warranties are essentially the same thing as insurance.[1]

D. Consumer Confusion

1. Survey Details

The appliance survey pool identified above were also presented with a short five question quiz designed to assess the respondent's knowledge of the coverages typically provided by extended warranties and homeowners' insurance. Of that pool we obtained 253 usable responses.

The respondents were provided with the following background information and were then asked to identify whether coverage (if any) would be provided by a "typical" homeowners insurance policy or possibly by a generic extended warranty contract.

> *For the following questions, please assume that you bought a TV three years ago that included a three year manufacturer warranty on parts and services.*
>
> *Additionally, you bought an extended warranty contract at the time of the TV purchase that essentially extends the coverage of the manufacturer's warranty for another three years after the original manufacturer warranty expires. Assume also that you have a homeowner's insurance policy that covers the usual kinds of property damage included in such contracts.*
>
> *Now assume that you have had the TV for three years and that the manufacturer's warranty has recently expired and consider each of the following unrelated scenarios*

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[1] A statistical mean value comparison of the two groups found a statistically significant difference (at the 0.001 level of significance).

and identify which contract/s (if any) might likely offer you some coverage in the situation.

The respondent was then presented with each of the scenarios below and asked to choose the "best" answer for each scenario among the following choices:

- Both
- Extended warranty
- Homeowners' insurance policy
- Neither

2. Scenarios

1. You wake up one morning and the TV doesn't work; no outward sign of any damage or accident – it simply doesn't work. Which contract/s (if any) might likely offer you some coverage in the situation?
2. The TV no longer works after your home experiences an electrical power surge. Which contract/s (if any) might likely offer you some coverage in the situation?
3. Your brother is watching the Superbowl on the TV at your home and his favorite team loses. In a fit of rage, he kicks the TV and accidentally breaks it. Which contract/s (if any) might likely offer you some coverage in the situation?
4. You are watching the TV and you find that you are suddenly unable to change channels, i.e. the TV is unresponsive to the remote control and any attempts to manually change the channel. Despite turning the TV on and off many times, the problem persists. Which contract/s (if any) might likely offer you some coverage in the situation?
5. Your TV is broken when your dog accidentally knocks it off its stand. Which contract/s (if any) might likely offer you some coverage in the situation?

3. Results

Table 1 presents the five scenarios, the correct answer (with the percentage of respondents answering the question correctly in parentheses), and the associated rationale for the correct answer. It is important to note that any number of variations on a theme exist with respect to homeowners' insurance contracts and extended warranties and we are asking the respondent for their opinion without providing them a succinct standard against which they might assess their answer.

Table 1. Scenarios, Response Results, and Rationale

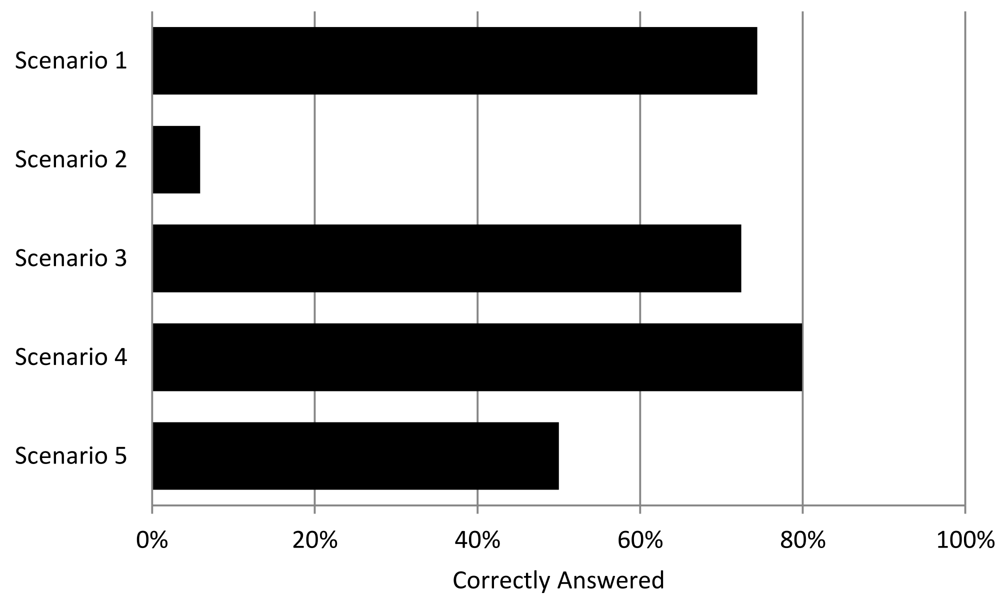
Scenario	Response Results	Rationale for the Answer
1. You wake up one morning and the TV doesn't work; no outward sign of any damage or accident – it simply doesn't work. Which contract/s (if any) might likely	Extended warranty (75%)	No apparent accident, thus insurance would not apply. A product defect would be the most likely explanation and thus, a valid extended warranty

	offer you some coverage in the situation?		would be the most likely source of coverage.
2.	The TV no longer works after your home experiences an electrical power surge. Which contract/s (if any) might likely offer you some coverage in the situation?	Neither (6%)	This is neither wear and tear nor a product defect and thus, extended warranty coverage would not apply. While the incident is accidental from the perspective of the insured, power surges are not a covered peril under “named perils” homeowners’ policies.
3.	Your brother is watching the Superbowl on the TV at your home and his favorite team loses. In a fit of rage, he kicks the TV and accidentally breaks it. Which contract/s (if any) might likely offer you some coverage in the situation?	Neither (73%)	This is neither wear and tear nor a product defect and thus, extended warranty coverage would not apply. While the damage is accidental from the insured’s perspective, the peril is not a covered peril under “named perils” homeowners’ policies.
4.	You are watching the TV and you find that you are suddenly unable to change channels, i.e. the TV is unresponsive to the remote control and any attempts to manually change the channel. Despite turning the TV on and off many times, the problem persists. Which contract/s (if any) might likely offer you some coverage in the situation?	Extended warranty (80%)	No apparent accident, thus insurance would not apply. A product defect would be the most likely explanation and thus, a valid extended warranty would be the most likely source of coverage.
5.	Your TV is broken when your dog accidentally knocks it off its stand. Which contract/s (if any) might likely offer you some coverage in the situation?	Neither (50%)	This is neither wear and tear nor a product defect and thus, extended warranty coverage would not apply. While the damage is accidental from the insured’s perspective, the cause of the damage is not listed among the covered perils.

The percentage of respondents answering correctly for each respective question are presenting in graphic form in Figure 2, below. The average quiz score was 56.8 percent.

While only 50 percent of the respondents were able to correctly respond to Scenario five and Scenario two proved to be particularly vexing as only six percent of the respondents were able to correctly note that neither contract would apply.[2] Suffice to say, consumers seemly struggle with their understanding of the application of the coverages provided by these two kinds of contracts.

Figure 2. Percentage of Correct Answers



IV. Summary

In light of the general vulnerability of specific consumer groups and the significant lack of regulation of the sale of extended warranties, this research endeavors to clarify the confusion consumers seem to possess with respect to the nuanced differences of extended warranties and insurance. Our research was conducted using online survey instruments that surveyed individuals who had recently purchased either an auto or an appliance and were presented with the opportunity to purchase an extended warranty associated with that purchase. Two survey issues were addressed. The first related to the respondent's opinion as to the similarity of extended warranties and insurance. The second asked the respondents to complete a five question quiz that tested their knowledge of the coverages provided by extended warranties and/or homeowners' insurance policies.

The results revealed that consumers generally perceive extended warranties to be essentially the same as insurance. The issue is an important one as it may suggest that the consumer (erroneously) anticipates insurance-like regulation over extended warranties. To

[2] While the "named perils" as defined by the Insurance Services Organization serve as our basis for coverage assessment, we also recognize that some insurers are now including include "electrical surge" as an additional covered peril. In an effort accurately portray the results of our survey in light of the possibility that the peril of electrical surge is more commonly found in recent years, we also summarized the quiz results with Scenario two excluded. When excluded, the quiz score for the survey was 68.9 percent.

the contrary, the sale of extended warranties frequently occur within a situational monopolistic setting with virtually no price regulation. The results also find that the consumers possess a poor understanding as to the coverages presented by extended warranties and homeowners' insurance. Thus, a population already found to lack financial acumen is also found to possess a weak understanding of the coverages provided through extended warranties and insurance.

These findings lend themselves to arguments in favor of further clarification as to the differentiation of extended warranties and insurance and the potential need for additional regulatory measures aimed at mitigating the economic inefficiencies associated with the sale of extended warranties.