APA REPORT
ON USED VEHICLE AFTERMARKET WARRANTIES
March 2004

Methodology

For this report, the APA visited nine warranty companies headquartered in three provinces. APA's team included a former licensed insurance broker in Ontario, a former senior insurance administrator, a former government regulator, an engineering graduate and a consumer advocate. Visits lasted no less than half a day, up to a day and a half, and looked into all major aspects of operating a warranty company. Companies visited ran the gamut from small four-employee operations selling warranties in a single metropolitan market, to the two largest independents in Quebec and Ontario. Because the APA does not have investigative powers, we could not require the companies to provide financial statements, and several said they were concerned about seeing information in a report that might provide a competitive advantage to other companies. Notwithstanding, several companies provided very insightful information backed with numbers from their operations.

APA has a reputation for taking an independent line and coming to the table with a good general knowledge of auto-industry related issues. Most of the warranty companies APA visited appeared to know this, and we appreciated the knowledgeable and sometimes critical eye their executives and management brought to the table. The APA found centres of excellence in the aftermarket warranty industry with a lot of specialized knowledge that has been tested by experience.

Companies Visited:

- A-Protect Warranty Corporation (Toronto)
- Avantage Plus (Terrebonne, near Montreal)
- Coast to Coast Warranty (Hamilton)
- Lyndon-DFS Administrative Services Inc. (Montreal)
- Garantie PPP (Quebec City)
- Garantie Nationale (Montreal)
- Lion’s Gate Warranty (Vancouver)
- Lubrico Warranty (London, Ontario)
- Global Warranty (London, Ontario)

APA also met with the insurance regulator for warranties in British Columbia, the OMVIC Committee studying the extended warranty industry, and Toyota Canada.

Findings

Third-party used vehicle warranties have been estimated to be a $100 million dollar business annually in Canada (source: Lubrico Warranty, London, Ontario 2002). The APA was provided an estimate of $20 million dollars for the industry in Quebec (Plan de protection prolongée, Quebec City 2004). The warranties are sold almost exclusively by car dealers to consumers at the time of sale of a new or used vehicle. It's easier to make the case for the additional outlay on a warranty at time of sale of the vehicle. (There are some companies selling warranty-type products direct to the consumer, but the APA was told they are a very small presence.)

A dealer will offer a warranty beyond the legal requirements of fitness, or freedom from latent defects (Quebec), for the following reasons:

- It creates a higher perceived value for the vehicle.
- It will cover some of the liability and uncertainty related to minimum legal standards of fitness affecting warranty coverage.
- In some cases the dealer is selling the vehicle WITHOUT meeting minimum legal standards of fitness. In those cases, the third-party warranty is a palliative to an *as-is* sale.
- It creates a profit center for the dealer.

Third-party or *independent* company extended warranties are sold through used independent car dealers (not franchised) and the used car departments of new car dealerships. Warranties sold by the automakers or their wholly controlled subsidiaries are not considered by this report, unless they are specifically mentioned. Some dealerships will offer a house warranty that goes beyond legal minimums and may be offered at extra cost. In-house warranties offered by dealers on vehicles they sell are not covered by this report, unless specified.

Warranty repairs can be undertaken in the following manner:

- Dealer’s on-site repair facility
- Authorized repair center, usually an independent garage operating at a separate location that also performs retail repair work
- Warranty company service center

The APA learned that the following characteristics apply to the different repair networks:

Dealers

Most expensive, even with the discount or cost control measures some warranty companies will ask for. Several warranty companies told the APA they pay dealers at the retail rate. Dealers use manufacturer parts, sometimes rebuilt parts, but very rarely used parts. For major breakdowns of powertrain components, a dealer will often have less expertise than specialized independent shops, even in their own brands, because they rarely have to do this sort of work.

For high-technology and high-end vehicles, the dealer is sometimes the only way to go, as the aftermarket has neither the diagnostic tools nor expertise.

Authorized Repair Center

All companies visited use some of these. These are repair facilities that specialize in heavy work like engines and transmissions, and generalist shops for smaller work like starters, alternators, steering racks. A commercial customer discount is offered to the warranty company, equal to 30% off the retail rate.

Warranty Company Service Center

This model was used by the bigger Quebec companies in the early days. The sellers of the warranty owned their own repair shops, the idea being that vertical integration guaranteed revenue from sales and also service. In the 1980s, the warranty business was sometimes perceived as a sideline to grow the garage. In reality this model is much more difficult to operate successfully than it may appear to the uninitiated. Running two operations, both of which require experienced full-time management and oversight, and balancing the competing interests between getting the most repair value and fastest turnaround (required by a warranty company) versus serving outside clientele and making a return that will cover overhead and re-investment (required by a repair shop) have proven elusive. As the warranty side of the business grows, repair volumes exceed the capability of a single repair center. Consequently, most of the warranty companies using this model also have authorized service centers. The APA visited two warranty companies that currently use the model; they are Garantie Nationale and Avantage Plus. Both are regional operations headquartered in Montreal.

Warranty Company Claims Department

Claims people at several of the warranty companies are very involved in the repair, sourcing parts from the lowest-cost supplier, finding cheaper solutions for common problems, hunting down automaker customer satisfaction programs designed to pay for the repair of common problems etc. For repairs sent to independent shops, the APA saw several examples of repairs that warranty companies authorized to correct major engine problems at up to 50% less than retail prices at new car dealers. Despite the price difference, the APA believes the customer would not notice any difference in value or performance of the vehicle afterwards. Parts used are usually remanufactured; they are sometimes new parts from an independent supplier, and sometimes used parts. For common problems, the warranty company may have secured a single source for heavily discounted rebuilt or used components.

Overseeing the repair process is one of the highest value-added services a warranty company will offer the owner of a vehicle that breaks down. This is particularly true of older vehicles, because they tend to be owned by customers with fewer resources and sophistication -- and they presumably break down more frequently. Because there is a larger supply of less expensive parts and repair shortcuts for an older vehicle, there is a greater opportunity to save money with no loss of utility to the consumer. For example, rebuilt engines that retail at prices of $2,500 to $4,500 are routinely sourced by warranty companies in the $1,800 to $3,300 range, and a good used engine would cost even less than that. The discount on transmissions is sometimes even greater, compared to dealer prices. A warranty company that oversees repairs can virtually guarantee a faster repair, because the job is sent to the right people the first time. Any problems that arise are more quickly resolved because the warranty company represents the potential for recurring business to the repair center. As a consequence, the APA is confident in predicting a claim dollar spent by a well-run warranty company on a major repair will go 30% to 50% further than a consumer-paid repair. The savings would be much lower for repairs authorized at a franchised dealer's service facility.

The APA can attest to the value of warranty claims service from real-world experience. As a consumer-based organization, the Association has sought referrals to competent repair facilities and cheaper solutions to repair common problems from the claims departments of well-run warranty companies. The results are impressive.

Relationship with the dealer

The relationship with the dealer can be qualified as a delicate balancing act between interests that are aligned at the moment of sale, and often competing before and after. The warranty company wants to sell the highest number of warranties (called *penetration*) on the largest percentage of vehicles with the lowest claims dollars. The dealer wants to sell the largest number of vehicles, with the lowest reconditioning costs. Both want the customer to eventually return to the dealer for another vehicle, as the dealer is the only distribution channel for the third-party warranty.

Some of the warranty companies the APA visited have sophisticated software that tracks claims not only by dealer and by model of vehicle, but also the specific components on each vehicle. Furthermore, the claims departments of the better run companies are staffed by licensed mechanics, many with more than 10 years' experience. These companies can very quickly spot a spike in claims that is indicative of a dealer who is selling vehicles with pre-existing defects, or performing incomplete reconditioning that results in the vehicle needing repairs soon after it is sold. The APA found that most warranty companies will keep a dealer on their lists even *after* obvious evidence of bad faith (for example, a dealer advising a customer who just bought a car to wait until 30 days are up before making a claim). Warranty companies told the APA that they treat dealers with kid gloves. The dealer is a valuable partner, who is their client. The consumer is a sort of third-party beneficiary. This subtle relationship has some implications for the consumer:

1. The consumer relies on the dealer for advice on what warranty company to take, how much coverage to choose, and what to pay.
2. The dealer body as a whole wants the cheapest basic coverage possible, so that every vehicle can be sold with a warranty included in the selling price. For many companies this means 90-day to six-month coverage limited to the power train and selling for $69 to $150. Every warranty company selling warranties in this price range except A-Protect essentially told the APA that they wished it would disappear as it provides razor-thin margins and imposes heavy limitations on coverage, but they can't do it because of competitive forces. (A-Protect appears to have a different business model, which removes most of the risk from large claims.).
3. Warranty companies tolerate offloading of reconditioning costs by some of their dealers because dealers are hard to replace. Warranty companies do not want to lose a dealer, and will tolerate dubious claims for quite some time. Before dropping a dealer, a warranty company will attempt some form of coaching or persuasion, and possibly a third-party inspection of vehicles sold with warranties either just before or just after the customer takes delivery. In

most cases, consumers are treated less generously if their dealer has a high loss ratio or has recently been dropped by the warranty company; some companies told APA this doesn't happen, but it is a practical consequence for many of the companies. (Carmakers also squeeze franchised dealers whose claims on the factory warranty are too high, but that is even less well known.)

4. A common misconception held by consumers, and encouraged by salespeople when consumers are shopping for a vehicle, is that vehicles are inspected by the warranty company before coverage is issued. The APA experienced this phenomenon several times in the Montreal and Toronto markets while mystery shopping at used car dealerships. The companies visited by the APA acknowledged that there is no independent inspection of a vehicle before warranty coverage is issued. At best there is a dealer self-inspection with a subsequent report to the warranty company. Technically this is an inspection for the warranty company, but it is not an inspection *by* the warranty company.

Relationship with the repair center

Warranty companies told the APA they have no problem finding authorized repair centers. Repair shops are very happy to have the steady source of referrals. If a shop is suspected of trying to pad a bill, it is often fairly easy to check after the fact by reviewing the repair with the consumer. In complicated cases, an inspector will be sent on the spot, but this rarely happens because of the cost and downtime involved. APA was told repeatedly that a repair shop that gets caught is dropped immediately. Unlike dealers, there is no need to "rehabilitate" the repair shop, as most are easy to replace.

All companies visited by the APA told us they paid for repairs within 30 days (some said within 7 days). All acknowledged that repair facilities will give a significant discount to a commercial customer not only on labour, but also on parts. If the parts are complicated assemblies – like engines or transmissions – the warranty companies often have more expertise and buying power than the repair facility. In those cases the garage is required to source from the warranty company's supplier. Some companies pay the garage a markup of around 15% as a handling fee on parts sourced by the warranty company.

The exception to all of the above is warranties sold through franchised dealers. In the past, some companies (e.g. International Warranty, Garantie Universelle) saw the franchised dealer as the jewel in the crown of the distribution network for warranties. Some of the higher-priced warranties still do (e.g.. GE Warranty Business Services, PPP). Franchised dealers traditionally sold the best class of used vehicles (although this is now evolving with the advent of large numbers of lease returns), and had the best in-house reconditioning services prior to sale.

However, the franchised dealership is a demanding master. It requires all repairs to be sent to its expensive service facility, and wants a better class of warranty coverage with higher claim limits and included parts, and hence, more exposure for the warranty company. A couple of warranty companies observed that the franchised dealer will insist on retaining 100% of the repair business on warranties it sells, yet when claims are not approved with a smile, the franchised dealer has no equivalent loyalty. A franchised dealer can always raise the specter of switching horses to another warranty company, or reverting to the automaker's used vehicle warranty program. The franchised dealer's service department is run independently from the used car sales department and sees the warranty as a revenue opportunity. A number of the warranty companies visited by the APA for this study preferred to sell through the less glamorous owner-staffed used car dealer; this includes used car dealers with in-house service facilities that may be authorized to perform some warranty repairs.

Regulatory and Business Environments

In this section the APA reviews the regulatory and business environments in three provinces that cover the range of environments for warranty companies operating in Canada.

British Columbia

Legislative Framework for New and Used Car Warranties in BC

In this section an overview of the legislated and regulatory requirements for the provision of new/used car and product warranties in British Columbia will be provided. B.C. was chosen because it is the third-largest market for used automobiles after Ontario and Quebec. It was deemed to be typical of other jurisdictions (i.e. Alberta, Saskatchewan and Manitoba) that regulate car warranties as insurance products. Readers are cautioned that the regulatory requirements may vary from jurisdiction to jurisdiction, but the basic premise – that these products must be underwritten by insurance companies – is similar in all four jurisdictions.

In all four jurisdictions (BC, AB, SK, MB) the regulatory provisions governing insurance companies are applicable. This includes the provision of adequate financial reserves and ongoing reporting requirements to the regulatory body charged with overseeing financial institutions (including banks). These jurisdictions control entry into the new and used car warranty market at point of entry and have powers of review over rates and business practices.

The following section provides an overview of the regulatory environment for new and used car sales and focuses specifically on the underwriting, marketing and sale of product warranty and vehicle warranty insurance in British Columbia.

Motor Vehicle Industry in B.C.

The motor vehicle industry has been in existence in the province for more than 80 years. There are approximately 1,700 licensed motor dealers, 7,000 salespersons, and 5,000 other employees. In terms of commerce, motor dealers contribute more than $10 billion to the annual economy and remit more than $1.5 billion in taxes annually.

The Motor Dealer Council of British Columbia (MDC) is a new non-profit organization delegated by the Province of B.C. to administer and enforce the Motor Dealer Act and its regulations. The MDC oversees consumer protection and regulates dealers and their sales representatives. The MDC is implementing a new process where all licensed motor dealers will be required to ensure their staff involved in retail vehicle sales complete a licensing process. As one of the first examples in the province of a "delegated administrative authority," it represents an alternative administrative structure for the delivery of public service by the provincial government.

The transition to having a delegated administrative authority regulate the motor dealer industry both legislatively and administratively began when the provincial government amended the Motor Dealer Act and other consumer protection statutes to allow for the creation of the MDC.

The MDC registered as a not-for-profit society on July 21, 2003 and worked with the Ministry of Small Business and Economic Development to ensure an effective transition on April 1, 2004. The MDC plays a major role in the regulation and licensing of motor dealers and the related areas of consumer protection applicable to motor dealers. More specifically, the government has mandated the MDC to assume greater responsibility for some or all of the following:

- licensing
- standard setting and enforcement
- complaint resolution
- consumer protection
- public industry education.

The Motor Dealer Customer Compensation Fund protects consumers in their dealings with motor dealers. It allows consumers who purchased new and used motor vehicles or extended warranties through a dealer to claim up to $20,000 where the loss was a result of motor dealer business failure, dishonest behavior or failure to provide clear title by a dealership.

Examples of dishonest conduct include failure to disclose information about the vehicle as required by law, deliberate misrepresentation of information related to the vehicle, or misuse of funds. All registered BC motor dealers contribute $300 annually to the fund. A board appointed by the provincial government administers the fund.

The provincial government retains responsibility for all policy and legislation governing the licensing of motor dealers including any future changes to the Motor Dealer Act.

Background on Legislated Requirements
for Vehicle and Product Warranties

The initial regulatory framework for regulating car and product warranties is provided in BC by the *Financial Institutions Act (FIA)* which went into effect on Sept. 15, 1990. Additional regulatory provisions specific to new and used car and product (i.e. rust proofing) warranties went into effect on April 23, 1998.

Though not much original documentation remains from 1990, the original impetus for this legislation appears to derive from the proliferation of companies offering these types of products and services in the mid 1980s, and the bankruptcy of a number of high profile third-party warranty companies. The consumers who bought these products and services were left without recourse to recuperate fees or to have legitimate claims serviced. In addition, concerns related to the claims and business practices of third-party providers became an issue. Third-party providers had fewer incentives than manufacturers or retailers to ensure the customer fully understood the implications of buying a warranty.

Insurance Company Incorporation

In order for an entity to conduct insurance business in B.C., it must apply for authorization from the Financial Institutions Commission (FICOM). Different rules apply for the authorization of extra-provincial companies (regulated by the federal government), societies, reciprocal exchanges or captive insurers. Warranty companies wishing to do business in B.C. might opt to meet these requirements.

The FIA outlines a two-step process for the authorization of a new insurance company. It must apply and receive consent to incorporate, and it must apply and receive a Certificate of Business Authorization. Prior to receiving its Certificate of Business Authorization, the insurance company is not permitted to carry on insurance business (i.e. sell insurance products) in British Columbia.

Information required for incorporation includes:

1. The proposed memorandum of incorporation and proposed articles.
2. A notice of the company's required office and records office.
3. Completed Personal Information Returns for each subscriber who would own or control 10% or more voting shares in the company.
4. Completed Personal Information Returns for each of the proposed directors and senior officers.
5. A comprehensive business plan that demonstrates the subscribers possess the financial and managerial capability to properly carry on insurance business.

In addition, the type of business (general, life or both) must be described, and detailed CVs of the directors must be provided. A five-year pro-forma balance sheet, income statement and cash flow projection must also be included. An actuarial opinion on the reasonableness of the business plan must be provided including scenario testing showing the results of key assumptions on the base case business plan and the minimum capital test or minimum capital surplus requirements test for each year.

FICOM assesses whether the company will operate the insurance company in a prudent and appropriate way. The completed application form is presented for review to the Superintendent of Insurance and Commissioners for review. Once FICOM is satisfied all requirements have been met, a recommendation is made to the Minister of Finance to incorporate the insurance company in the province.

The assessment criteria primarily relate to the application being in compliance with the FIA and attendant regulations. The Minister must not consent to the incorporation if he has not received a report from FICOM, or "believes any person who owns 10% or more of voting shares, or any of the proposed directors or senior officers is an individual who, *in the public interest* ought not to be in a position to control or influence a British Columbia insurance company." This broad public interest provision allows the Minister to refuse to incorporate a business if he has reason to believe the incorporation will not be in the public interest. Though not specifically defined, factors that could be considered in the public interest would include previous business history, bankruptcies, and criminal convictions.

The second step in the process involves obtaining business authorization from FICOM. A FICOM memo (INS-04-001) indicates this application must be made within one year of incorporation of the company. The memo also lists the materials that a company must provide and includes:

1. A completed application for business authorization.
2. An updated list of directors and senior officers (Personal information returns).
3. A list of the members of the following committees:
    a) Audit Committee
    b) Investment and Lending Committee
    c) Conduct review Committee.

4. A copy of the written policies and procedures for each committee.
5. A copy of the minutes of all Board of Directors' meetings, including the meetings of its committees, since the incorporation date.
6. Evidence of Insurance in an approved insurance compensation plan.
7. Audited financial statements, including a copy of the company's audited opening balance sheet.
8. Interim financial statements ending the month preceding the application.
9. A copy of all insurance policies and endorsements.
10. A copy of all reinsurance agreements and an explanation of the net retention level of various risks.
11. A copy of any management agreements.
12. An explanation of any material changes made to the business plan.
13. A non-refundable application fee of $2,500.

FICOM reviews the company's application to ensure that the company meets FICOM's requirements. A critical component of the review is the capital adequacy of the firm. FICOM must be satisfied the financial institution's capital base is adequate and is at least equal to the minimum requirements set by regulations, as follows:

- General Insurance Company – The minimum capital base for a general insurance company is the amount determined by multiplying the total amount of premiums received by the insurance company in the preceding 12 months, less premiums paid by the insurance company to obtain reinsurance, by 33.33%. Where this amount is less than $3 million, *the amount that constitutes adequate capital for that insurance company is $3 million.*
- Life Insurance Company – The minimum capital requirement for life insurance is $5 million.
- General and Life Insurance – The minimum capital requirement for general and life insurance business is $10 million.

In addition, all insurance companies must have at least five directors, of whom at least one-third must be unaffiliated directors. The majority of directors must be persons who ordinarily reside in Canada and at least one director must ordinarily reside in B.C. Each director must also meet the qualification provisions of Section 138 of the *Company Act.* Moreover, the company must provide proof of membership in an approved insurance compensation plan.

An insurance company must submit its audited financial statements with the application. Interim financial statements ending the month preceding the application (including a balance sheet and income statement) must also be submitted with the application. Finally, an insurance company must submit its proposed plan of operation to FICOM and this plan must be feasible. The plan must describe how the business will be carried on in the province, and must provide an updated pro-forma balance sheet, income statement, and cash flow projections (including assumptions). The plan also must include an actuarial opinion on the reasonability of the projections and the Minimum Capital Test for a general insurance company or Minimum Continuing Capital Surplus Requirements for a life insurance company for each year of the plan.

If it appears that the company has met the necessary requirements, an on-site review may be conducted to evaluate whether the company has the necessary systems, management structure, control processes, and compliance management systems in place to carry on business with the public. If FICOM is satisfied the company has met all necessary requirements and is ready to offer insurance to the public, FICOM may issue the company the Certificate of Business Authorization. The average assessment takes three months. FICOM communicates regularly with the applicant throughout the application process.

Once approved, the company must continue to meet a wide range of reporting requirements on an ongoing basis. The regulatory system influences the market by setting the bar fairly high for those companies wishing to undertake business in this area. Entry controls are designed to ensure no one enters the business without adequate capital.

Warranty Insurance (Product + Vehicle)

On April 23, 1998, the *Insurance Company Exemption Regulation, Insurance Classes Regulation* and *Insurance Exemption Regulation* were amended to clarify the regulatory framework for Warranty Insurance. Information for this section of the report is derived from the Ministry of Finance bulletin INS-98-002.

Definitions

Product warranty and vehicle warranty insurance are defined in the *Insurance Classes Regulation* as follows:

"**Product Warranty Insurance"** means insurance, not being insurance included in or incidental to any class of insurance, against loss of or damage to personal property other than a motor vehicle, that is <u>contracted between the purchaser of the property and an insurer whereby the insurer undertakes for a specific period to assume costs of repair or replacement.</u> These products include those offering protection or coverage related to fabric and rust proofing.

"Vehicle Warranty Insurance" means insurance, not being insurance included or incidental to automobile insurance, <u>against loss or damage to a motor vehicle arising from mechanical failures, that is contracted between the purchaser of the motor vehicle and an insurer whereby the insurer undertakes for a specific period to assume costs of repairs, towing fess, car rentals and accommodation as a results of a covered mechanical failure.</u> These insurance products include those related to repairs and services related to motor vehicle breakdowns.

All contracts which undertake to indemnify another person for a loss by:

- **repairing** a product or vehicle,
- **replacing** the broken parts of a product or vehicle, or

- **reimbursing** the cost of repairs made to the product or vehicle

are contracts of product warranty insurance or vehicle warranty insurance which can *only be underwritten by an insurance company* that is authorized to carry on general insurance business in the province of British Columbia. The regulations do not permit third-party companies to offer this type of product or service unless the policies are underwritten by insurance companies.

Policy documents surrounding the *Financial Institutions Act*, which came into force in 1990, indicate that the intention of the new legislation was, and continues to be, to capture third-party warranties as insurance products and require they be offered by regulated insurance companies.

With respect to insurance retailing, the regulations adopted at the time the new *Financial Institutions Act* came into force provided that third-party insurance could be sold by an employee or commissioned sales representative of a motor vehicle dealer, as long as the dealer held a restricted insurance agent's (vehicle warranty insurance) license obtained by March 1, 1991. Third-party administrators and motor vehicle dealers selling vehicle warranties carry a license issued by the Insurance Council of B.C. Vehicle warranty products underwritten by the manufacturer or a retailer can be sold by employees or others without meeting the insurance requirements of the Insurance Council of B.C.

Under the *Insurance Company Exemption Regulation,* manufacturers and retailers are exempted from the requirement to be authorized to carry on general insurance business. In other words, manufacturers and retailers are permitted to underwrite their own product or vehicle warranty insurance contracts.

The exemption in Section 11 reads as follows: "Section 75 of the Act does not apply to a manufacturer or a retailer who provides warranty insurance or product warranty insurance which is solely incidental to the sale of the vehicle or product by the manufacturer or retailer, as the case may be."

For the purposes of administering this exemption, FICOM is of the view that:

- a manufacturer is one who by labor, art, or skill transforms raw material into some kind of finished product or article of trade; and
- a retailer is one who buys articles in gross or merchandises in large quantities and sells same by single articles or in small quantities.

New and used car dealers can issue their own warranties on any products they sell within the exemption provided by Section 11 of the *Insurance Company Regulation.* Under B.C. regulations new and used car dealers can issue their own warranties on any products they sell within the exemption provided by the regulations. A third-party warranty would still have to be issued by an authorized insurer.

The exemption *does not* apply to affiliated companies or subsidiaries of the manufacturer or retailer. In other words, GMAC financing cannot offer the warranties as being insured products (see section on Future Regulatory Requirements).

New and used car dealers can issue their own warranties on any products they sell within the exemption provided by Section 11. No performance bonds or reserves are required. A third-party warranty sold by a dealership would have to be issued by an authorized insurer.

In conducting this study, officials of the regulatory agencies do not believe this exemption to be problematic, whereas the B.C. based third-party warranty company interviewed for this study is concerned that all B.C. consumers might not be afforded the same level of protection contemplated by the legislation.

Marketing and Sale of Warranties

Sale and solicitation of product warranty (i.e.: rust proofing) insurance can only be undertaken by:

- an individual who is licensed by the Insurance Council of British Columbia as either a general insurance agent (level 2 or level 3) or salesperson (level 1); or,
- a person whose only insurance related activity is in conjunction with warranty insurance sold incidentally to the sale of the product by that person or that person's employer.

Sale and solicitation of vehicle warranty insurance policies can only be undertaken by:

- an individual who is licensed by the Insurance Council of British Columbia as either a general insurance agent (level 2 or level 3) or salesperson (level 1); or,
- an individual who is an employee or commercial sales representative of a motor vehicle dealer whose only insurance related activity is in connection with vehicle warranty insurance sold incidentally to the ordinary business of the motor vehicle dealer.

The motor vehicle dealer must have previously: a) obtained a restricted insurance agent's (vehicle warranty insurance) license from the Insurance Council of British Columbia; and, b) provided the Insurance Council of British Columbia with a written list of names of the employees or commissioned sales representatives whom it has designated to solicit warranty insurance business in a manner which is incidental to its ordinary business.

The Insurance Council of British Columbia sets guidelines for the conduct of its licensees, including those who hold a restricted insurance agent's (vehicle warranty insurance) license.

Administration of Warranty Insurance Programs

Under B.C. regulations a company may administer a product warranty insurance or vehicle warranty insurance program only *on behalf of an authorized insurer* (see previous section). However, such a company and its employees (who solicit or sell the product and/or vehicle warranty insurance policies) must be licensed as general insurance agents or salespersons by the Insurance Council of British Columbia. Lions Gate maintains this registration and licensing is critical to ensuring the protection of consumers and would like to see similar provisions extended to other jurisdictions in Canada.

In B.C., a warranty company that is neither a retailer nor a manufacturer must be authorized to act as an insurance company if it is issuing product or vehicle warranty insurance contracts. Third-party administrators will sometimes establish a warranty product and find an insurer to issue the contract. Government officials indicated that they were not aware of any problems with third-party administrators finding insurance to insure the warranty products.

Enforcement of Warranty Insurance Provisions of Legislation

FICOM enforces the provisions of the *Financial Institutions Act.* FICOM has no jurisdiction regarding the form of contract issued in another province. British Columbia requirements will apply to any contract issued or sold in B.C., regardless where the purchaser lives. FICOM's jurisdiction extends only to the insurers it regulates. FICOM has no jurisdiction regarding the activities of intermediaries or those exempt from regulatory requirements.

Neither FICOM nor the Insurance Council can intervene in the event of a disputed entitlement to benefits under a warranty insurance contract. However, both can take action regarding inappropriate market practices by those subject to their respective jurisdiction.

The legislation defines certain activities as inappropriate but does not provide remedies other than prosecution of an offence that is a breach of statutory provisions. Amendments to many of the market conduct provisions have recently received first reading in the Legislative Assembly. The proposed amendments include the power to levy administrative penalties in some circumstances.

In the event of a bankruptcy or an insurance company vacating the market, the requirements are normally established by the primary regulator. In the case of inter-jurisdictional insurance companies, this would be the federal regulator in the Office of the Superintendent of Financial Institutions. FICOM would be looking to ensure the business is run off in an orderly manner and that the position of all British Columbia policy holders “remains unimpaired.”

FICOM does not specifically review warranty insurance contracts in the ordinary course of business. It will investigate when a complaint has been filed that alleges an unfair form of contract. The Superintendent can prohibit the use of a form of contract that is deemed unfair, misleading, or deceptive. The Superintendent does not become involved in monetary judgments that might be launched by consumers against the insurance carriers.

The Insurance Council will discipline licensed dealers and agents if a pattern of inappropriate behavior emerges. The Council has the power to suspend and revoke licenses. The Motor Dealers Council will sanction dealers. The MDC is empowered to recover funds paid from the Motor Dealers Customer Compensation Fund to a consumer for a loss that was a result of motor dealer business failure, dishonest behavior or failure to provide clear title by the dealership. A dealer will not be permitted to sell vehicles if it has not reimbursed the Fund. The APA did not request information on how often these provisions had actually been applied.

Future Regulatory Provisions

New legislation amending the *Financial Institutions Act* was given royal assent on May 20, 2004. It is expected that the legislated amendments will be brought into effect in the fall of 2004, along with a number of amendments to the existing regulations. The government is considering whether further exemptions to the insurance retailing requirements should be adopted by regulating a number of areas, including vehicle and product warranties. The basic elements of the legislation that require the sale of third-party warranties to be underwritten will not change; however some consideration is being given to making the regulations more flexible.

One issue under consideration is whether motor vehicle dealers should still have to obtain an insurance license in order for them or their staff to sell third-party warranties. Some manufacturers that use a subsidiary to offer product warranties want additional flexibility to extend the exemption to the warranties offered by the subsidiaries. Some of the policy issues that have yet to be resolved include the responsibility for the parent company to honor the warranties offered by the subsidiary, and the appropriate rules for disclosure.

Summary

There is a large difference between this regulatory model and those in other jurisdictions without an insurance regulatory model, or the mixed insurance and trust model prevailing in Quebec. B.C. treats vehicle and warranty products as insurance, requiring them to be underwritten by insurance companies authorized to conduct business in B.C. As such, except for the dealer exemption, those wishing to sell warranties attract the requirements typically found in regulating the insurance industry.

There are extensive reporting requirements upon application and ongoing monitoring in order for these companies to continue to do business in B.C. In addition, the licensing requirements that include training on disclosure and due diligence seem to have eliminated the worst abuses seen in other jurisdictions (Ontario comes to mind). Officials were not able to cite instances where a major bankruptcy or firm leaving the market resulted in consumers not having warranties being honored.

There is an important caveat: Information is not readily available to assess whether complaints from consumers are actually lower in B.C. than in other jurisdictions subject to this study. This is because responsibility for overseeing a portion of the industry (car dealers) has recently been transferred from the Ministry of Small Business and Economic Development to the Motor Dealers Council (MDC). Prior to the creation of the MDC, complaints reported to the Ministry about dealers and repair practices in the automotive industry outnumbered by a significant amount those reported in other regulated industries (such as travel). However, there were few complaints brought regarding warranties and warranty products. Time will indicate whether the new system of regulating car dealerships will improve the car industry as a whole.

Prior to the implementation of the *FIA*, vehicle and product warranties were not regulated in the province. The B.C. system does seem to contain checks and balances for the sale and marketing of vehicle and product warranties, when compared to jurisdictions with little or no regulatory requirements. The entry requirements for insurance companies – including the FICOM initial review, a requirement for adequate reserves (minimum $3 million for a general insurance company), and ongoing monitoring – seems to have stabilized the warranty market to consumers' advantage. By requiring all third-party vehicle and product warranties to be underwritten by established insurance companies B.C. has not witnessed the same number of entries and departures, and debatable practices that have manifested themselves in other jurisdictions.

Alison: move to Ontario section if it is still needed: We were also astonished to discover that dealers in Toronto actively promoted the companies that appear to offer the most restrictive warranties and have the poorest underwriting. (See summary charts from APA Retailing Investigation, Appendix 15).

Ontario

Toronto proved to be a colourful and sometimes bizarre market in which to shop for a used car warranty. Used car dealers told APA's mystery shoppers that Lubrico Warranty, the industry leader in independent used car warranties, "doesn't pay." This is not consistent with APA's mystery shoppers' experience. Our mystery shoppers were offered 3-year/unlimited mileage powertrain warranties on tired 10-year-old vehicles with 200,000 km for $300. We learned that apart from a basic third-party warranty on the power train, vehicles were being sold "as-is" with no further guarantees from the dealer.

The smaller warranty companies appear to believe that Lubrico Warranty is leading Ontario Motor Vehicle Industry Council, the dealer regulator, by the nose. The APA attended meetings where the Lubrico representative appeared instead to be *holding his nose* over some of the compromises one of OMVIC's advisory committees was prepared to accept.

In Ontario the APA found all the major companies selling basic coverage for under $100. These same companies said it costs $50 or more in administrative costs for paperwork, commissions, and other start-up fees to set up a warranty contract. In Toronto, to a far greater degree than Montreal, the APA found the $69 and $99 warranty reigns supreme. And in Ontario most warranty companies do not publish suggested retail prices, allowing dealers to reportedly mark up some of the less expensive warranties by 400% or more.

In Ontario, the APA learned how to sell a warranty for $69 or $99 and still make an acceptable return – a miracle of seemingly Biblical magnitude.

The following advice typifies the level of support and assistance available to consumers who are shopping for a third-party used car warranty in Ontario:

Consumers should research the company offering the warranty through traditional means including Ministry of Consumer and Business Services offices, courts (do an on-line search of court decisions using company name), Better Business Bureaus, consumer associations and, if possible, previous customers. The consumer should request a copy of the full contract and vehicle inspection report *before* purchasing a new/used vehicle warranty. A consumer should confirm with the insurance company that policies offered under various brand names are actually underwritten by the insurance companies. Reputable dealers will have no problem with these requests and will encourage consumers to contact the third-party administrator or insurance company offering the coverage. The consumer should become familiar with the terms and conditions of the coverage being offered and understand the exclusions. If the price seems too good to be true chances are the warranty will not meet consumer expectations for coverage in the event of a breakdown:

"Remember, you get what you pay for. Extended-warranty companies are in the business of paying out less in clams than in premiums received. A $59 warranty cannot possibly provide you with the coverage you might expect.

*"Be aware of claim limits, caps, exclusions, fees and that third-party warranty companies may replace your failed component with a 'used' part." (*Toronto Star, Jan. 10, 2004)

This sort of whimsical information, with totally impractical precautions, is what consumers in Ontario receive from such authoritative sources as the head of the Toronto Automobile Dealers Association.

Let's take a closer look at some of the pitfalls a warranty buyer faces in Ontario: You'll find the BBB and CAA logos prominently on warranty contracts in Ontario, including uninsured programs with restrictive claim limits as low as $650. The APA was told that auto clubs pick up the warranty company's towing business in return.

Existing databases in government files are incomplete, and usually by the time the BBB or a government ministry has put a warranty company on a watch list available to the public, it is skirting insolvency or has left the business.

Most dealers are reluctant to provide a copy of the full warranty until after you sign an offer to purchase the vehicle. By then, it's too late to back out of the sale. If the dealer has brochures, they're very sparing about information on restrictions in coverage.

Regarding which warranty company to use, the consumer depends on the dealer, who has a relationship with no more than a couple of companies and is usually pushing one of them. As the APA discovered in Toronto, the advice the consumer receives at the time of sale regarding warranties is frequently misleading or incomplete. Several non-franchised dealers did not recommend Lubrico, the acknowledged industry leader, and actively promoted less-well-backed, uninsured warranty companies. Why they did, the APA does not know, as some of these same dealers sported Lubrico plaques or promotional materials, and Lubrico also offers a $69 warranty.

The $69 dollar warranty (priced as low as $59 in one Toronto Star article) is an industry problem about which many of the warranty companies complained to the APA. Who is behind the insatiable appetite for these warranties? According to the warranty companies, it is the car dealers. The dealers want a cheap product they can include in the price of their vehicles, which allows the dealer to mark up the warranty by 400%-500%. Including the warranty in the price of the vehicle is a practice the warranty companies encourage with their basic warranties, as it increases their penetration. Would a dealer reveal that he really paid only $69 or $99 for a warranty to a consumer who asked? No way.

Dealers are the warranty company's customer: they're the ones who chose how much or little to spend on warranty protection, what to coverage to buy and which warranty company will get the business. A consumer will usually follow the dealer's advice. In order to discourage some of the more egregious examples of overselling, some warranty companies publish suggested retail prices for their warranties on their web sites, with a built-in mark-up of 30%-40%. This safeguard appears to be limited to companies selling more expensive warranties via the franchised dealer network (PPP in Quebec is an example). The APA learned that the companies that do not publish suggested retail prices sometimes use that as an argument to sign up new dealers by letting them know they can set the price to whatever they want.

Claim Limits, Caps, Exclusions, Fees

Here we enter into the arcane world of warranty contracts. To read the average warranty contract, you need the technical knowledge of how a vehicle works, a basic knowledge of contract law equivalent to that of a second year law student, and perfect vision – or a good set of glasses. As the CEOs of two warranty companies told the APA, the contracts are drafted in such a way that the company would rarely pay a claim if the exclusions were applied to the letter.

The following examples of exclusions in warranty contracts that would confound a consumer are taken from the A-Protect warranty, but are typical of clauses found in other agreements:

- Limitation no. 4: A-Protect does not cover any used parts. (Presumably, all the parts on a used car are used parts.)
- Limitation no. 5: Problems existing prior to purchase of the vehicle and normally covered. (This is a problem between the warranty company and the dealer, for which the consumer should not be penalized.)
- Limitation no. 7: Any mechanical breakdown caused by a defect that the manufacturer has publicly announced and customer has failed to do so. (Meaning unclear)

From Garantie Nationale's warranty contract, the toughest exclusion of them all:

- Clause 6: Notwithstanding any other provision of this application, G.N. is not obligated to approve or pay for the replacement or the repair of any part or any labour costs.

In some cases the warranties are drafted in a language that is grammatically incorrect. Some Ontario warranty companies have an exclusion that covers "all seals and gaskets used to obtain oil."

The Inexpensive Warranty

Here is how you can make money selling a $69 power train warranty in Ontario:

1. Set the repair limit very low, say $650, which you the warranty company and the dealer both know is too low to pay for even one powertrain repair.
2. Set the deductible fairly high, up to $100 per claim, and exclude some components routinely required for a repair, such as fluids and certain gaskets.
3. Negotiate a discount with the repair center, but do not pass this on to the consumer. For example, a repair shop would normally discount a rebuilt engine priced at $2,400 retail to $1,800 for a commercial account like a warranty company. The repair shop shows the customer a bill for $2,400 less a discount of $650, equivalent to the repair limit in the warranty contract. The consumer pays the "balance" of $1,750 that exceeds the repair limit, plus his deductible. The hitch? No money has actually changed hands between the warranty company and the repair facility.

In some cases, which were reported second-hand to the APA, we were told the warranty company charges the repair shop a referral or service fee for the repair. In that case, the warranty company actually *makes* money each time there's a large claim! For this model to work to the advantage of the warranty company, you need low claim limits (up to $1,000, but $650 is best) and large repairs (the discount on small jobs would not be large enough to exhaust the $650 claim limit). This is the business model that makes some of the low-low warranty prices profitable. The APA was told by all the insured warranty companies that the insurer would never accept institutionalized kickbacks from repair shops. Until it learns otherwise, the APA assumes that the practice is limited to some non-insured warranty companies operating in Ontario.

Insurance for Third-Party Warranty Contracts

The consumer has no reliable way of determining whether a company has insurance in Ontario. The idea of checking for insurance coverage sounds easy, but in practice it is not. In the past, the APA has discovered that third-party warranty companies have misrepresented the nature of the security they provide to cover claims on their warranties. This includes under-insuring their warranties by having very high deductibles before insurance coverage applies, misrepresenting garage insurance or a dealer bond as equivalent to warranty contract insurance, and selling two classes of warranties, one insured and the other not, without indicating which class a particular warranty falls into. In some cases, warranty companies have allowed insurance underwriting to lapse without changing promotional materials in a timely manner to indicate that coverage no longer exists.

Checking for insurance coverage of warranty contracts is so tricky in an unregulated environment that even experienced alley cats like the Used Car Dealers Association of Ontario can get into trouble. In 2003, the UCDA failed to include Lions Gate Marketing, a B.C.-based warranty company, on its list of insured warranty companies operating in Ontario. The UCDA was not satisfied, based on the information supplied by Lions Gate that the contracts met UCDA's standards for insurance. Lions Gate sued the UCDA in British Columbia. The APA supported the UCDA's right to evaluate warranty companies, stating in an affidavit that:

> *"Ultimately, not only dealers, but also consumers benefit from the efforts of the UCDA to perform the due diligence which they themselves could not reasonably be expected to carry out."*

To their enduring credit, the principals of Lion's Gate did agree to meet with the APA for the purposes of this report while the litigation was pending. (Lions Gate has since won at trial and the case is being appealed). Based on the information provided by Lion's Gate, the APA is convinced that coverage is more than sufficient to be included on the APA's list of insured warranty contracts. So we have a curious situation in which a consumer association is supporting a trade association's right to evaluate warranty companies, but arrives at a different rating for the warranty company that is challenging the trade association's rating. This is one example among many of the need for a comprehensive solution in Ontario.

Insurance for Third-Party Warranties: An Opposing View

According to Victor Tsatskin of A-Protect Warranty Corporation based in Concord north of Toronto, an uninsured warranty company *cannot get insurance*. And when an insurer does back a warranty company, the agreement is exclusive to that company and no competitor need apply. Insurance for contracts would add to the cost of doing business, and would be reflected in increased warranty prices. A-Protect believes that if insurance became mandatory, several companies would be forced to leave the business. The problem, says Tsatskin, is that insurance is effectively unavailable at any price for many warranty companies.

A-Protect says that the risk of insolvency among uninsured warranty companies has been grossly inflated, a sort of bogeyman used by one or two insured warranty companies in Ontario to market their expensive products and bend the ear of the regulator. The A-Protect representatives challenged the APA, stating that the more spectacular insolvencies all concerned *insured* warranty companies that went out of business, including International Warranty, Thermoguard, and North American Warranty. Lately Wynns, which claimed to be insured, has pulled out of Ontario. A-Protect challenged the APA to find out who was getting their claims settled by Wynns' insurance carrier. (Actually, the APA has observed the biggest problem collecting is with trust account regimes. Plans that are truly insured are usually easier to collect from, and totally uninsured companies usually don't leave anything to collect.)

After reviewing some other options, Tsatskin said a reserve fund for unearned premiums would be feasible. A reserve of 50%-70% was discussed. An alternative suggested by Tsatskin would be for warranty companies to pay an annual fee into the Ontario dealer compensation fund.

Insurance was perceived by A-Protect as a big marketing advantage for the competition because it is recommended so strongly by OMVIC (as does the UCDA). The upcoming OMVIC guidelines on disclosure of warranty information by dealers at the time of sale were perceived as another shot against the uninsured warranty companies, because dealer advertising and the warranty contract or application will have to clearly include whether a warranty is insured or uninsured.

Quebec

Quebec has a mixed system for third-party warranties, adopted in 1985 after a series of insolvencies plagued the industry. A company selling a third-party warranty must hold a license. The company has the option of:

- Insuring each warranty contract to a minimum of $1,500 to cover repairs

(or)

- A trust account with reserves calculated as a percentage of revenue sales, and a performance bond. The reserve amount is determined by an actuary, whose report is part of the annual license renewal. Reserves are typically set in the 50%-60% range of the remittance from the dealer to the warranty company.

An automaker selling its extended warranties on used vehicles of the same brand is excluded. However, an automaker selling warranties for other brands of vehicles would have to comply, as it is considered to be a third party.

In Quebec, 18 companies are currently licensed to sell third-party warranties. The majority have chosen the trust account model.

The APA was given the following reasons:

- The trust system is inexpensive. (The APA was quoted an annual expense for the actuarial report of $5,000 to $20,000.)
- The trust system is easy to set up. The required $100,000 bond is not onerous.
- Insurance is very difficult to obtain.
- Insurance is also expensive, and companies using the insurance model price themselves out of the non-franchised used car dealer market.

The largest warranty company in Quebec and acknowledged leader is Le Groupe PPP Limited. PPP is franchised car dealer owned, and for years sold only through new car dealers in Quebec. That has changed recently, and PPP now sells to the largest independent used car dealers. PPP uses the trust fund model; it sells a variety of products and services to auto dealers that go beyond auto warranties. PPP is headquartered in Quebec, with a strong management team that has many years of experience and huge industry knowledge. Oddly, in the current relatively quiet period for warranty company complaints in Quebec, PPP is the one that generates the most complaints at the APA. Dealers told the APA that PPP's claims department appears to be overloaded, and that it takes a long time for approvals. The handful of consumer complaints sent to PPP appears to show they are resolved slowly.

PPP was the only non-insured warranty company the APA visited for this study (including the Ontario companies) that said it could easily make the transition to insurance. PPP hasn't done it, primarily – the APA believes – because of the cost. PPP says that if it expanded outside Quebec, insurance would probably be considered for credibility reasons in the marketplace, and obviously for compliance in the four western provinces.

Quebec's Office de la protection du consommateur

The OPC was described as a well-intentioned but sometimes erratic 800-pound gorilla. The companies all saw the need for a regulator. Most wished the OPC were more present in the enforcement of standards on the used car market. We were told that the single most significant consumer measure in Quebec in recent years was the recording of mileage by the public insurance corporation (SAAQ) with every vehicle transfer. By way of example, Avantage Plus noticed the number of vehicles with 200,000 km increased significantly after the initiative was implemented, while the number of nine-year-old vehicles showing 130,000 km or less dropped. This was a very positive outcome for Avantage Plus, as they claim they had previously been slipped cars with as much as 400,000 km!

Companies sensed that the OPC had become more passive in the late 1990s (OPC was subject to severe cutbacks in that period). A couple of companies noted that the OPC did not use outside experts with the necessary actuarial and financial skill sets, and that this worried them, because alarm bells might not ring if a competitor was engaging in risky practices. Two companies said they would welcome more frequent visits from the OPC, on the assumption that that would signal more attention was being paid to the industry.

OPC's investigation service was described as flexible and creative, but lacking the support and adequate resources from senior administration. One company told the APA that it would have had to pay 30% in annual fees for a performance bond after an industry-wide crisis in the warranty industry in the mid 1990s; the OPC accepted instead to take the full amount of the security in lieu of a performance bond, and actually invested the money in an interest bearing account. According to the warranty company owner, instead of paying an annual fee for a bond, he now receives 3%-4% interest on the account! Another said it consulted the OPC and received very helpful advice on what to look for in an actuary, how to find one, and what it could expect to pay.

Trust vs. Insurance Model

Among the companies that had chosen the insurance model, the APA learned that there is a world of difference between insurance and a trust account. The insurer visits the location several times a year, has in-house experts, and insists on higher standards for drafting of warranty contracts.

After the Garantie Universelle fiasco, APA was told there no way you could empty a trust account the same way (i.e. by regular bank withdrawals with no topping up during the year). Laurentian Trust, which oversees some trust accounts in Quebec, was described as very precise, with monthly payments reconciled to each contract.

Potential trouble areas in Quebec

Warranties Masquerading as Other Services

A policy is needed to deal with companies that claim to sell extended warranties on oil additives, when in fact they amount to mechanical protection. By providing a warranty against mechanical failure if you use a particular oil additive for the engine and transmission, the company is essentially providing a third-party warranty that should be covered by the Consumer Protection Act requirements. The APA was told that Wynns, an oil additive company, operated for years in Quebec without complying with extended warranty requirements and have now left the market. How do you monitor claims performance if the company is not licensed and has no address in Quebec? (by way of example, a brochure from BG MAP Services from Kansas, selling a lubricant warranty in Quebec).

Barriers to Entry Too Low

The $100,000 bond required for new entrants in their first two years should be raised to $250,000. At the current level it may not be enough to pay off claims. The Véri-chèque situation: a company incorporates a new entity in the second year of operation subject to only the $100,000 bond. This way it gets around the cash reserve requirement. There is a danger of mixing revenue from the second company to pay for claims from the first.

(Garantie Universelle tried, and may have succeeded, in doing the same thing before becoming insolvent in the 1990s. It appeared to operate two separate entities out of its head office in some years. At the time, the APA did not understand why.)

Toyota operating illegally for four years. It didn't register as a third-party warranty company, thereby reducing its cost of doing business. Toyota did not present a risk of insolvency, but another company observed that it was not paying for the cost of doing business nor their share of the industry oversight fee. (The APA learned that Toyota is fully insured.)

Several companies would like OPC to intervene to eliminate the lowest class of warranties. They openly admitted that the industry does not have the will to clean up its act in the face of pressure from the auto dealers who want a cheap product. Basic warranties are priced too low and coverage not always sufficient. *"Look at the prices,"* they say. We were told warranties sold for as little as $69: *"How are you going to warranty a car for $1,500 when your basic coverage costs $69?"* The APA learned that the practice of preparing two bills, one for the garage and a higher one for the consumer that shows a fake discount, exists in Quebec; although the APA did not see actual paperwork that showed the practice.

Companies stated that the minimum claim limit should be $1,500 or $2,500, with a moderate deductible (say $50 or $100 per visit). It was suggested that this could be done by regulation to ensure a level playing field.

Monitoring new entrants

The APA was told that government, being a generalist (travel, funeral arrangements) does not understand the warranty business sufficiently.

The OPC allows new American and Ontario companies to operate without insurance or a reserve fund for 2 to 3 years before requiring compliance with regulations in Quebec. That allows new entrants to charge very low prices, to the detriment of the industry as whole. Following the initial period, they can exit the market or close the business if they do not wish to meet regulatory requirements.

One non-insured warranty company suggested a floor price for extended warranties ("a starting point") and an evaluation of a warranty company's business plan prior to granting a permit. This, presumably, would resemble the requirement for entry into an insured market like British Columbia and would signal a major change in Quebec.

One company would also like to see the establishment of a centralized car dealer registry to prevent dealers from gouging and dropping warranty companies

Universal Warranty

This company operated in Quebec under the actuarial trust account system permitted in that province. In the last three years it was in operation, an actuary in the United States with no other Canadian clients reduced the mandatory reserve for unearned premiums progressively over three years from almost $2 million to $600,000, and nobody at the provincial regulator blinked at annual license renewal. In the last year of operation, the trust account required under the provincial Consumer Protection Act was emptied to pay claims with no indication that the trust administrator had required topping up or blocked successive large monthly withdrawals. The company went bankrupt in 1995, leaving less than $10,000 in its trust account, and a $100,000 bond. The actuary was found guilty of professional negligence in the accomplishment of his duties by the Canadian professional body, but the decision does not affect his ability to do business in the U.S. When Universal Warranty went bankrupt, the company principal also filed for bankruptcy and spent the winter on his yacht which he moved to Florida. Within two years of his release from bankruptcy, his declared net worth was over 1 million dollars.

At the request of Quebec's Consumer Protection Office, the APA and Option consommateurs filed class actions against the warranty company. The APA sued its auditor, its actuary and the trust account administrator. An out of court settlement was agreed upon in principle in spring 2004, and consumers can expect about 25 cents on the dollar from the defendants.

Detailed Reports: Site Visits

1. **Coast To Coast Services Inc., Ontario**
2. **Lions Gate Marketing, Omni Warranty Corp., Ontario**

Coast To Coast Services Inc.

1945 King Street East
Hamilton, ON
L8K 1W2
www.coasttocoast.ca

Attending for Coast To Coast:
Mr. W.N. (Bill) Wereha, President

Attending for the APA:
Mr. George Iny, President
Mr. Ron Corbett, former insurance broker in Ontario
Mr. Les Stein, former insurance agent

Background

Coast to Coast, led by Bill Wereha, has been in business for 13 years. Mr. Wereha previously worked with Global Warranty and owned a used car lot and a garage. He has 40 employees at head office, and 20 sales representatives around the country. Mr. Wereha's wife and brother hold administrative positions at the firm.

Coast to Coast has 28,000 active warranty contracts. It sold 2,680 warranties in April 2004 from 870 dealers, but does business with upward of 1,000 dealers. Individual dealers send anywhere from one to 20 new contracts to Coast to Coast each month. Coast to Coast sells to new (for their used cars that don't fit into a manufacturer program) and used car dealers. It conducts business in all provinces except Quebec and Saskatchewan, but is planning to enter the Quebec market soon. Coast to Coast might consider expanding to nearby U.S. states like New York, Michigan and Ohio.

Coast to Coast's office is open 9 a.m. to 5 p.m., Monday through Friday. Staff meet up to three times per week either in groups or as a whole to discuss technical matters. Parts suppliers and manufacturers are also invited to give presentations at these meetings. The claims phones are open from 9:00 a.m. to 8:00 p.m.

Mr. Wereha wants warranty holders to be greeted by a real person, and says only eight callers out of 1,000 receive a busy signal when they call.

Coast to Coast has had its own computer programmer since it started, and has developed proprietary programs tailored to its operations.

Coast to Coast wants to be the biggest "Dealer Services" company in Canada, and welcomes any opportunity to be a supplier to a dealer Finance and Insurance department. It will supply finance and insurance software and training to the dealer.

Warranties

Eighty percent of its contracts are for the Powertrain Advantage Plus+ warranty. Coverage is available for as little as three months or 3,000 km, to 48 months or 80,000 km, with a maximum contribution of $600 per claim at the low end, to $2,500 at the high end. Numerous upgrades are available on all warranties, including higher per claim maximums, deductible waivers, and seals and gaskets coverage. Coverage for air conditioning, and Hi-Tech coverage is offered on 12 month/20,000 km warranties and above.

Coast to Coast does offer more comprehensive Optima Used, Optima New, and Optima Wrap warranties. Dealers pay $59 for the cheapest Advantage Plus+ warranty, and $649 for the most expensive. A dealer can pay up to $1,878 for a high-content Optima New warranty.

Coast to Coast levies a surcharge on Optima warranties on specified vehicle makes and types. Mr. Wereha sees a bumper-to-bumper warranty on a used car as a fiscal disaster, and noted that some of the larger bankruptcies in the warranty field have been firms offering comprehensive warranties. Mr.Wereha has suggested retail prices, but dealers are not compelled to follow them. Mr. Wereha would like to set retail margins for dealers selling its products. Coast to Coast discovered that the retail price charged by an individual dealer had been 10 times what they had charged that dealer for the policy.

Coast to Coast also offers a few non-warranty products, including a Sign and Drive North-America wide Roadside Assistance plan, and an Emergency Travel Medical Insurance plan for travel outside your home province for up to four days at a time.

Insurance for Warranties

Coast to Coast was insured by Kingsway from 1998 to June 2003, but switched to American Bankers Insurance Company of Florida when Kingsway discontinued trading in a number of insurance categories. The transition was orderly, with Kingsway still running off their book of business with Coast to Coast. Relations between the two firms are said to be good. American Bankers Insurance is licensed in all provinces in Canada. Coast to Coast never received a rebate from Kingsway during its time with them, but may get a 3% rebate from American Bankers. Coast to Coast plans to enter the Quebec market fully insured, but a confused regulatory climate in Saskatchewan has blocked its efforts to open there thus far.

American Bankers Insurance was acquired by Fortis Inc. (the U.S. division of Fortis NV), in 1999. At that time, it and another Fortis Inc. firm were renamed Assurant GroupSM. Though it retained 35% of the common stock, Fortis divested much of its investment in AssurantSM through an Initial Public Offering which took place on Feb. 5, 2004. The new company is now called Assurant Inc. Assurant has its own division providing warranties and extended service contracts for consumer electronics, home appliances and motor vehicles. One of its major clients in Canada is the Future Shop. The Credit Life and Disability Insurance available to car dealers through Ontario Auto Dealers Services Ltd., an Arm of the Ontario Auto Dealers Association, is underwritten by the Assurant Group.

Insurance was tough to arrange, but not impossible. Insurance covers each dollar stated on the warranty. Mr. Wereha notes that claims data is examined by him, his actuaries, and the insurance company's actuaries every month. Claims reserves in the area of 65 percent (money that can't be put in trust and earn income for Coast to Coast) are held by the insurance company. Uninsured firms would have this as working capital, and a large bond, like that acceptable in Quebec, would not be as capital intensive. Mr. Wereha says his insurer caps his profit on a warranty at $150, but he makes far less on his basic warranty. Of the $59 collected from a dealer for the basic warranty, the sales rep gets $4, Mr. Wereha gets $10 and the insurer gets the balance. Mr. Wereha says that designing your product correctly and pricing it right are the only ways to make money if your warranty company is insured. He says the insurer won't allow Coast to Coast to make that much money. The major players - Lubrico, Global, and Coast to Coast - are all insured, but insurance is not a guarantee that a consumer will be fully indemnified if a warranty firm collapses (for example: Guardall paying out at 25 cents per dollar of obligation). Mr.Wereha says he would welcome an opportunity to assist other warranty firms in arranging their affairs to help them became attractive clients to an insurer.

Legislation

Warranty companies fall under provincial legislation, and each province has unique requirements and their own way of doing things. Also, Mr. Wereha says, the provinces are strapped for cash and don't have the resources to begin to be doing what they need to do. He expressed concern that intervention by various jurisdictions would result in a "License Grab."

Mr. Wereha also noted that there are some strange requirements for sales people and adjusters. Alberta classifies warranties in the "Boiler and Machinery" category, and requires a Level III Adjusting License, a designation that would allow an individual to adjust a major disaster, like a CN Tower-type collapse, just for sending a client to the right place to have their transmission rebuilt.

Mr. Wereha would like to see a national standard set for extended warranty companies, with sales reps and adjusters working in the industry being subject to more intelligent regulations. For instance, requiring claims officers to be adjusters, and deeming dealers to be insurance agents is an administrative burden with no benefit. He would also like set retail margins to cap dealer profits on his product.

Terms and Conditions in Warranty Contracts

Competition is fierce in the extended warranty business, and all the companies find it necessary to offer a basic warranty that is cheap enough for the car dealer to include with the purchase of a used car. Mr. Wereha states that the companies are doing something they know they shouldn't be doing (i.e. selling things for lower than their reasonable cost), but they all keep doing it.

Dealers will change extended warranty companies over a $1 difference in price, and the companies are well aware of it. Coast to Coast's cheapest warranty has a face value of $600 per claim, with a $90 deductible. Competition is particularly tough in large urban areas like Toronto, where dealers don't need repeat business as there is always another buyer available. Coast to Coast prefers to deal with dealers in smaller centres, where a good reputation and repeat business are important.

Coast to Coast's application is straightforward, listing the various coverage levels available, as well as noting options, such as a deductible waiver. The back of Coast to Coast's applications note that warranty documents should arrive within 60 days of inception. It instructs customers to call on its 1-800 number if not received within the time limit. This protects a warranty customer from a dealer who pockets the fee but does not send in the application. There is no activation fee. The applicant's responsibilities are also clearly spelled out, including a stipulation that an oil and filter change be done every three months or 5,000 kilometres (whichever comes first) at a licensed repair facility. Coast to Coast also states that the vehicle covered by the warranty must be maintained in accordance to the manufacturer's recommendations (except for the aforementioned oil/filter change stipulation). Coast to Coast also requires proof-of-service cards to be filled out and returned to them by registered mail. Coast to Coast's warranties can be transferred for a fee of $90, but few people with the cheaper warranties bother doing so.

Coast to Coast allows customers to have their vehicles repaired at a garage of their own choice, but places its phone number prominently on the application in the hope clients will call it first. Coast to Coast would like to control the claim if possible, and can direct the client to a reliable garage if asked. Their deals with garages can be as much as 25 percent less than retail. Mr. Werehas says that if Coast to Coast suspects that the garage the customer has taken their vehicle to is trying to pass is dubious claim, they will try to convince the owner to pull the car out. Coast to Coast states it will do all it can to satisfy the customer, even on a $600 per occurrence warranty. Even if the customer is paying much of the repair, Coast to Coast says its pricing for the repair can save customers money and get quality work done.

Coast to Coast makes its money on the warranty itself, and does not get kickbacks and/or co-op funding from its garages for work performed. Mr. Wereha said that franchised new car dealers often charge a higher garage rate for warranty work than for regular work, so he discourages repairs from being done there. Coverage for repairs begins once the warranted car rolls off the dealer's lot. If, however, there is a problem very soon thereafter, he prefers that the car return to the dealer rather than, say, a franchised new car dealer of the same make. He may send a mechanic out to report on the car, which costs him $100 to 150. Dealers in bigger centres sometimes sell a higher-limit warranty on a junk car because they know it is going to fail and they don't want to pay for repairs prior to sale. Diagnostic checks are not covered unless the repair is related to the diagnosis.

Claims
The insurance company keeps about 65 cents in reserve for every of every dollar taken in, and pays out roughly 64 cents of what they take in.

The claims manager has many years of experience: she worked in customer service as a service advisor at franchised auto dealers; and as a customer service manager at a multi-national retailer. It is the job of the claims people to find out the truth behind the claim, and to settle it. Most claims are settled within seven days of receipt at head office, with all claims settled within 15 days.

Claims costs are closely monitored, and claims cheques require two signatures. Claims are adjusted in a neutral fashion. Mr. Wereha states that if a dealer has a bad history with Coast to Coast, or no longer deals with it, the warranty holder will not be treated poorly.

The company protects itself by doing actuarial analysis on all cars, and putting some in a higher-risk category, for which it charges more. Mr. Wereha says that the company does not want to provide high-end coverage to high-end cars as it is a good way to lose your shirt. Coast to Coast likes to have a good mix of average vehicles on its books. It won't try to compete with a manufacturer's warranties as their cost structures are lower, with a whole Windstar said to cost Ford only $5,000, including tooling. Some known expensive items are excluded, like the glove box lock on GM C/K series pickups that costs $700 to replace, horn buttons that require the air bag to be replaced too, and some remote trunk releases.

Franchised dealers will consider the third-party warranty primary, and will fight tooth and nail with the third-party warranty company, but may not even ask the manufacturer if coverage is available. Mr. Wereha says that franchised dealers sometimes tell warranty company customers that a particular part would be covered under a factory warranty, but often no such warranty is available on the car purchased.

Despite a reticence to offer a bumper-to-bumper warranty, Coast to Coast is offering its comprehensive Optima Wrap warranty that extends full coverage to the limits of a manufacturer's powertrain warranty. This is the case for both Chrysler and Hyundai, which both have long powertrain warranties.

Vehicles, Actuarial Analysis

Thorough actuarial analysis on various cars have led to the following conclusions: Components will most often fail between 120,000 kilometres and 160,000 kilometres, but the 180,000 to 200,000 kilometre range has fewer claims as many items have already been replaced. Japanese cars are the least troublesome, but are expensive to put right if a major component like an engine or transmission fails. The vehicles are ranked as follows.

1. Honda
2. Acura
3. Nissan
4. Subaru
5. Mazda
6. GM
7. Ford
8. Chrysler

Coast to Coast Recommendations for Consumers

- Buy certified.
- Get a second opinion – have the vehicle inspected at another garage.

Lions Gate Marketing and Omni Warranty Corp.

Suite 200
355 Burrard Street
Vancouver, B.C.,
V6C 2G8
(604) 806-5300

Attending for Lions Gate:
Mr. Adam Hill, President and CEO
Mr. Richard Vanderhaeghe, Vice-President, Claims
Ms. Pippa Elliot, Marketing Manager

Attending for the APA:
Sean McAlister, Orca Transportation Safety Group

Background

Lions Gate Marketing (LGM) is a full service warranty company headquartered in Vancouver. It markets a wide range of warranty and insurance products for new and used automobiles, motorcycles, recreational vehicles, snowmobiles, boats and all terrain vehicles. The company also offers credit insurance, chemical treatment and anti-theft insurance products. These products are sold across Canada under, respectively, the “Secure,” “Protected Payment Plan,” “EcoShine,” and “AutoArm” brand names. The company has been operating under its current structure for the past 6 years.

Omni Warranty Corp (Omni) is a sister company to LGM and acts as an administrator and promoter of warranty products for a number of insurance companies and clients, including LGM. All warranty products are underwritten by major Canadian insurance companies including: The Co-operators, The Sovereign General Insurance Company, and The Old Republic. LGM also represents London Life and Great-West Life for its credit insurance products.

The other major warranty companies operating in B.C. include: First Canadian (Alberta based), Industrial Pacific Alliance, Coast to Coast, Global and Lubrico.

Mr. Hill indicated that the latter three companies compete primarily for the used car market (defined as those vehicles with no original manufacturer warranty remaining) while Lions Gate focuses on the new car market (vehicles with a portion of original manufacturer warranty still in effect).

Messrs. Hill and Vanderhaeghe have extensive experience in the insurance and automobile fields. Mr. Hill was managing director of CRC, which marketed and administered the GE Capital program, a company that has withdrawn services in the used car warranty market but is continuing to process claims and honor the warranties sold to consumers. Mr. Vanderhaeghe was employed by CRC and, later, GE Capital and has 10 years of automotive experience as a licensed technician as well as 10 years of experience in technical claims adjusting and claims management. Ms. Pippa Elliot is a marketing specialist who has joined the team to further advance the branding of the company products. Between them they have over 30 years of experience in the insurance, claims and auto repair business.

As a B.C.-based company, LGM offers its products in most markets across Canada except Saskatchewan and Quebec. The company does not sell warranties in Saskatchewan in part because the insurance regulator requires the administrator to undertake the responsibility of “licensing” each dealer that sells its product. Omni is not a car dealer and believes it is inappropriate to try to regulate dealer behavior by forcing warranty companies (or its administrator) to license its dealers. Furthermore, the cost of licensing each dealer in Saskatchewan is borne by the administrator.

LGM is well established in its chosen markets throughout Canada. It has two offices: Vancouver and Toronto. Also, Omni has built client relationships with other companies that sell warranties in all provinces of Canada. Accordingly, Omni has offices in Vancouver and Montreal to ensure it can provide professional bilingual services.

Messrs. Hill and Vanderhaeghe said that they are concerned about the negative image that has been associated with car warranties. They say that the recent spate of bankruptcies and the absence of effective regulatory controls in Ontario is a major challenge that should be addressed. The companies that are properly financed and capitalized, which have adequate reserves and have established good risk management and claims practices, are being hurt by the less reputable companies that are able to enter the market. Mr. Hill indicated a willingness and desire to participate on any government task force seeking to create better consumer protection legislation in the field of automobile warranties.

The company employs 30 employees, with 14 responsible for sales (LGM) to dealers and four adjusters within Omni's team responsible for processing claims. The primary business focus is providing warranties for new vehicle franchise dealerships, with a lesser focus on used car dealerships.

Warranty Programs

LGM offers a wide range of products and services through its dealer network to consumers. For the purpose of this study the focus will be on products offered for automobiles, though it is worth noting the same basic components are covered on the other vehicle warranties and additional benefits – including towing, loss of use, and travel expenses – are common to all warranties.

Car warranties can be divided into two groups: new and used vehicles. For the purposes of identifying premium charges or rates, the company defines a new vehicle as one that is still within the original manufacturer's warranty term. The company also offers a limited liability warranty product for older used cars, which means coverage payout is limited to a maximum value per claim.

The Secure Drive suite of warranty products can be purchased for either new or used vehicles. To be eligible for a new car warranty price rate, the vehicle must be within the original manufacturer's warranty term. Vehicles must have at least one month and 1,000 kms of comprehensive factory warranty to qualify for new vehicle coverage. The terms of the warranties offered range from a low of four years or 80,000 kms to a high of 100 months (8.3 years) or 200,000 kms.

In addition, four different types of comprehensive coverage plans are available. The Secure Drive Basic plan provides for mechanical repairs on the engine, turbocharger/supercharger (factory installed only), transmission (standard/automatic), transfer case and drive axles. Seals and gaskets are included in the coverage.

The Secure Drive Plus plan covers all the components listed under the Basic program but, in addition, provides coverage for steering, brake, electrical, fuel delivery, air conditioning, front and rear suspension and cooling systems. The package also provides enhanced electrical system coverage for many power items such as windows, door locks, mirrors, seats, headlamps, antennas and sunroofs. The coverage also extends to automatic climate control programmers, instrument clusters, mileage computers, distributor, gauges, and cruise control. Again, seals and gaskets are covered. As is true for Basic, if a component is not listed in the coverage section, it is not covered.

The Secure Drive Elite plan offers the highest level of coverage and will pay for costs to repair or replace any breakdown other than what is specifically excluded in the exclusion section of the contract. Elite covers all items covered by the first two plans (Basic and Plus) and also covers emissions and airbag system components. Essentially, under the Elite plan, everything is covered except what is specifically excluded.

A variation on the Elite plan is the Secure Drive Wrap plan, which will pay for the cost of repair or replacement for any breakdown including listed emission and supplementary restraint (airbag) components. This plan is only offered on vehicles that have a minimum 3 years/60,000 km comprehensive and 5 years/100,000 km manufacturer's power train warranty. The only components that are excluded are those eligible for coverage under the manufacturer's extended power train warranty, and items specifically identified as not being covered in the insurance contract. The company does cover oil, transmission or coolant fluids for approved repairs.

The company's promotional materials define what is and what is not covered by the plans. Examples include glass, trim items, fuses, batteries, brake pads, mufflers and oil changes or other recommended manufacturer servicing. The complete list of excluded items is contained on the contract for the coverage policy. Again, this is different than some of the other companies in this study.

Purchase of any of the four plans also qualifies the consumer to receive additional benefits including 24 hour non-accident roadside assistance. This service includes: towing, jumpstarting, flat tire changes, vehicle fluid delivery (e.g.: fuel and cost of fluids is extra), lock out service (key cuttings and replacement are extra), and concierge service (family notifications, reservation changes, ATM locations etc.) The benefit is available 24 hours a day, 365 days a year anywhere in Canada and the United States provided the consumer calls a 1-888 number and receives authorization from the company. Certain restrictions apply. For example a $75 maximum applies to each benefit, and some benefits are limited to one claim per year. No deductible applies to these benefits.

In the event of a covered breakdown, a rental vehicle benefit of up to $50 per day to a maximum of $450 is available to purchasers of the Plus, Elite and Wrap plans only

Commercial-use vehicles are eligible for the warranty plans but the premium charged is twice the standard rate. Consumers have the option of selecting the deductible. It can be $0, $50, $100 or $250. Mechanical breakdowns or conditions present at the time of contract/policy purchase are not covered. Omni requires dealers selling its warranty products to inspect any pre-owned vehicle and ensure it is in good working order before offering a warranty product with the vehicle. Additionally, under the Selling Dealer Agreement, the dealer agrees not to submit claims to correct pre-existing conditions, or which may reasonably be assumed to have existed at the time the warranty was sold.

In order to compete with some of the smaller, less-established warranty companies in some markets, LGM does offer a limited warranty for older vehicles. The Secure Drive LTD plan provides protection for essential power train components. Vehicles that are less than 13 model years old and with less than 200,000 kms may qualify for this warranty. Plans providing coverage from three to 36 months are available. As the name implies, these warranties are limited by having a maximum per-claim limit of $1,250 or $2,500, as selected by the consumer. Consumers can purchase optional coverage which covers seals and gaskets, steering, brakes, electrical, air conditioner and fuel delivery systems. Rental car and 24-hour roadside assistance coverage can also be purchased. These warranties are all underwritten by a major Canadian insurance company. Retail parts and labor rates are paid for approved repairs. Company officials indicated that these warranties are offered only to provide their dealer network with a solution for older model vehicles. The company does not intend for the LTD plan to become a higher producing product.

Rate Setting, Price of Warranty

As demonstrated by larger warranty companies subject to this study, the rates or premium charged to the consumer vary depending on the claims experience and the age and mileage of the vehicle. This is a critical point. In order to remain solvent a warranty company must have a detailed understanding of the costs of repair in order to ensure the rates charged are compensatory.

The pricing scheme for the various warranties offered by LGM takes into account differences in reliability of the insured vehicles and the costs of repair. This was absent in a review of the pricing of some of the other warranty companies visited for this study. The company, similar to an insurance company, manages its risk (or cost to repair) by using a classification scale based on five different rating categories. The claims experience with different manufacturers and models of vehicles will determine the rate or premium to be paid by the consumer for the warranty coupled with the mileage and duration of the coverage sought.

The suggested retail prices for the warranties range from a low of $1,520 for a 4 year/80,000 km warranty for a vehicle rated in Class 1 (excellent claims history) to $8,272 for a 7 year/160,000 km warranty for a Class 5 vehicle (poor claims history or expensive to repair). The ability of a warranty company to properly evaluate and assess the risk associated with the warranty offered and price accordingly is a key factor in assuring the long term viability of a warranty company.

Terms and Conditions in Warranty Contracts

A review of the provisions contained in the contract indicate that the products and services sold by LGM use language typical of insurance contracts. The terms, conditions and exclusions are spelled out between the insurance company (the underwriter of the policy) and the consumer. The consumer will find language in the contract similar to that contained in their automobile and home insurance policies.

All contracts issued by the company come with the name of the insurance company providing the coverage displayed prominently on the front page along with the policy number. The Western Canada version of the contract indicates the premium to be paid while the Ontario contracts indicate only a price. Consumers can verify the policy is in effect by contacting Omni. An address and telephone number is provided for both Omni and the insurance company.

Information on how to initiate a claim is also clearly spelled out in the policy that a consumer will receive at time of purchase. A customer assistance card with the toll-free claims hotline number for registering a claim and for engaging the 24-hour roadside assistance benefit, if selected by the consumer, is provided at time of sale.

The responsibility for the consumer to have regular maintenance performed to the manufacturers' specifications and the requirement to keep proof of maintenance are also clearly spelled out in the contract and consumer welcome letter. The policies contain a provision saying that liability for any single repair is limited to an amount less than the current value of the vehicle, or in aggregate the total of the benefits to be paid do not exceed the retail price paid for the vehicle, as shown on the contract.

The company will not cover breakdowns that are the result of fire, theft, vandalism, explosion, riot, floods, earthquakes, acts of God, etc. Neither will the company cover breakdowns that are as a result of racing or abuse by the consumer. These provisions are typical of the same provisions used in standard automobile insurance contracts. Repairs that are required as a result of an accident (covered by standard automobile insurance) are also excluded.

Claims

A review of the claims process with company officials indicated the responsibilities of the dealer or repairing facility and the consumers are clearly laid out in the contract. The steps the consumer must take to file a claim are highlighted in bold, including the responsibility to pay the deductible, if applicable. The repair facility must then seek authorization before initiating a repair. The consumer has the option to have the company either reimburse himself or the repair facility. The consumer is encouraged, but not obligated, to have the vehicle returned to the selling dealer for service.

The policy covers breakdowns that occur anywhere in Canada or the United States. The consumer is requested to provide a copy of the warranty to the servicing facility and the facility is directed to contact the claims department. The claims department is open from 6 a.m. to 4:30 p.m. Pacific Standard Time, Monday through Friday. The adjusters have extensive automotive repair and insurance backgrounds. On average, 20 to 30 claims are processed and authorized each day.

Pre-signing Procedure for Customers with Existing Vehicles

If a customer already owns a vehicle and wishes to purchase a warranty, Omni requires a comprehensive inspection. The inspection covers all major components and systems. The inspection sheet contains three categories: Pass, Needs Service, Re-inspection /Pass. The obligation is on the dealer to ensure that the vehicle is fit before sale. Items identified with a diamond symbol (i.e.: noise or smoke in engine, or noise/vibration in driveshaft) may render the vehicle ineligible for Secure Drive coverage. The inspection sheet must be provided to Omni along with a copy of the warranty contract sold. The dealer must certify that all items marked Pass or Re-inspection/Pass are in good mechanical condition. If the work has been done at an outside shop, the dealer must certify that the repairs have been completed to the dealer's satisfaction. Information on the inspection facility and the inspecting technician is also required, as is a customer declaration. The declaration requires the consumer to acknowledge that conditions that exist on the vehicle (indicated by Needs Service) are not covered and are the responsibility of the consumer. This clearly establishes the responsibility for repair, something which was absent from a number of other warranty program contracts reviewed in this study.

Omni officials said the inspection report is required to establish the risk associated with each vehicle and to manage the company's claims costs. They said it provides the consumer with greater confidence in the condition of the vehicle they are buying. The report provides more information than most provincial inspection program reports, which typically only focus on minimum standards for safety components in order to pass (For those jurisdictions that require an inspection prior to resale). OMNI believes the inspection their inspection system encourages the dealer to offer a better product to the consumer.

Managing Its Dealer Network

LGM has 555 dealers offering its products across Canada. The company manages its dealer network and the quality of service provided in a number of ways. Before engaging a dealer, the company conducts research on the facility. This typically involves an inspection of the facility and a review of customer service records. In certain jurisdictions, it also requires a dealer to be licensed with any respective insurance council before it can represent LGM's products.

Omni manages its dealer network through a Dealer Agreement that imposes conditions and obligations. The company also tracks claims by each dealer and monitors customer satisfaction. If a dealer maintains an acceptable claims history, the dealer will be authorized to self-authorize its own claims up $1,000 per breakdown. The Dealer Agreement specifies all approved claims documentation must be submitted within 10 days of completion of the repair. The contract also establishes performance targets for sales, loss ratios (claims), and customer satisfaction. The Dealer Agreement may also be cancelled with notice if Omni discovers the dealer has been "deceptively inaccurate" in the submission of claims. Omni officials say they review claims with authorized dealers on an ongoing basis, and have no hesitation in revoking a dealers' permission to sell their products if a pattern of consumer complaints and excessive claims emerges. The company said it would not risk its good corporate name or the name of the insurers underwriting the policy. Being able to manage the dealer network and influence dealer behavior through internal controls is another aspect of more mature and well established warranty companies.

Not remitting the premium for the policy remains a possibility with some dealers. A good company will notice fairly rapidly if there is a discrepancy between the number of contracts provided and those returned for coverage. A repeated pattern of this practice results in the dealer agreement being cancelled. A regulatory requirement for numbered contracts would assist in controlling this abuse.

Customer Complaints

The company puts a premium on customer satisfaction and is very proud of its reputation for prompt and fair settlement of claims. They say that they have never been sued. Omni will settle with the consumer on a claim, then take remedial steps with the dealer. Omni says that the insurance companies that underwrite their products will not accept poor customer satisfaction scores.

As an incentive to both dealers and consumers to control repair costs, Omni offers a Secure Loyalty Credit program. The company allows consumers to cancel their contract/policy within 30 days for a full refund if they are not completely satisfied and on pro-rata basis after 30 days. Moreover, for a fee of $100 the policy can be transferred if the consumer sells the vehicle. Consumers who have bought a new vehicle Secure Drive contract/policy with coverage of 60 months or longer, or consumers who have bought a pre-owned Secure Drive contract/policy with a term of 36 months or longer and have not submitted claims during the duration of the coverage, are entitled for a dealer credit of the purchase price paid for the contract/policy. Omni indicated this builds dealer and consumer satisfaction with their products.

Reforms Needed in Warranty Sector

Company officials said that they are concerned about the negative reputation of car warranties in North America. They said that abuses are most critical in jurisdictions that are unregulated or have poor regulations. They believe a level playing field needs to be established for the situation to improve.

Omni said that warranty companies offering dealers one- and two-year powertrain coverage for as little as $99 probably do not have a good handle on their prices and costs. The price does not adequately ensure adequate reserves to cover future claims costs for the duration of the warranties sold. They say that this forces less scrupulous companies to engage in questionable business practices – such as denying coverage on legitimate claims – thereby opening the door to fraud and deception. They expect this to exacerbate dealer and consumer complaints with warranty companies. These problems were viewed as being acute in jurisdictions where a warranty company is permitted to establish itself without proper capital, collects the premium, and reviews and pays claims. In Western Canada every car product warranty must be underwritten by an insurance company and consequently many of the abuses documented in the Ontario/Quebec markets relative to contracts and bankruptcies have not been experienced.

Company officials said many companies are claiming to be insured in Central and Eastern Canada. They suggest that the insurance may not apply to the policies sold, but rather is a form of business insurance to pay claims if the warranty distributor goes bankrupt. In this scenario a warranty company experiencing financial difficulties may not pay the premium for this type of insurance, or find that the insurance company requires a much higher premium at time of renewal. If this were to occur, the insurance might lapse or not be renewed and the consumer, dealers and regulators would be none the wiser. In the event of bankruptcy, the consumer's contract would be worthless.

In reviewing various regulatory alternatives, the company believes that meaningful reforms will only be achieved when warranties are treated as insurance products. They are fully supportive of reforms that would require every warranty contract (in all provinces) to be underwritten by a legitimate and well-funded insurance company. This would enhance consumer protection. Before they can underwrite a product, insurance companies must be properly capitalized to cover risks. In addition, the insurance model allows legitimate insurance companies to buy reinsurance from other companies. Reinsurance is the process where an insurance company seeks out another insurance company to share the risk associated with the policies issued by the primary insurer. The reporting and financial requirements associated with establishing an insurance company guarantees performance on the consumer warranty contracts/policies.

Company officials said that moving to an insurance-based regulatory model for warranty companies in the Ontario markets would be problematic, given the proliferation of smaller existing companies. They suggested that a reasonable transition period would be two years for all warranty products to be underwritten. Moreover, two years would permit companies unable to have their contracts underwritten as insurance to wind up their business and leave the market.

Company officials said that Omni does comply with current Quebec requirements, but indicated the hybrid system adopted in Quebec could be improved if an insurance regulatory model were pursued exclusively. They said the financial reporting requirements under various existing jurisdictional legislation for insurance companies would provide early warning and notice for companies experiencing difficulty. The aftermarket vehicle warranty industry would be put on a more stable footing, as insurance companies would be able to draw on reserves from other books of insurance business to ride out the peaks and valleys in claims. Moreover as companies became more familiar with the business, pricing of premiums would stabilize to reflect the real risk of offering this type of insurance product. Most insurance legislation in Canada requires the premiums to be compensatory to cover the risk assumed.

Lions Gate and Omni Recommendations for Consumers

In the absence of major changes:

- Full disclosure necessary, including a requirement to indicate the presence, nature and type of insurance that is attached to each car warranty.
- Each contract should contain the name of the insurance company underwriting the contract, the policy number and a telephone number where the dealer or consumer can confirm the policy is in place

• A requirement to make a public disclosure when insurance has lapsed or has not been renewed.

An Automaker's View of Security for Extended Warranty Contracts

A Discussion with Toyota Canada

Attending for Toyota:
Pierre Millette, Corporate Counsel
Peter Bond, Vice President (Retired)

This section concerns companies that offer protection against mechanical breakdown, *including* those related to an automobile manufacturer or importer.

All the domestic and major European and Japanese brands offer house-brand extended warranties on the new and used vehicles sold by their dealers. In addition, some of these warranties are also available for used vehicles from competing brands.

The information that follows comes from Toyota:
Toyota offers between 20 and 25 variations of ECP mechanical protection coverage at any given time. Plans differ on the basis of duration, components covered, and deductibles. Basic extra coverages in addition to mechanical breakdown include roadside assistance, emergency locksmith, and emergency gas. Some plans also feature a tire warranty and auto club-style travel assistance. Some plans are specifically aimed at lease customers, offering full coverage after the basic 3 year/60,000 km warranty expires until the end of the lease, or for a year after the lease to enhance the attraction of the vehicle at lease end. Toyota allows consumers to purchase an extended warranty up to one year after the delivery of the new vehicle.

Toyota views its ECP mechanical protection as a form of insurance, operated by a separate division at head office with a different financial structure than the basic warranty. Basic warranty claims are ultimately charged back to Toyota's Japanese parent. ECP claims are funded by the plan. Warranty work is paid for at time and labour allowances set by Toyota, with parts at discounted prices. According to Toyota, this results in a 30% discount overall from retail repair rates. ECP repairs are paid at the dealer's retail or "door" rate for labour, with parts at the full retail price. ECP uses the more generous Chilton labour time estimates. According to Toyota, the extra labour and parts allowances are necessary to be competitive with the aftermarket extended warranties that Toyota dealers can also offer on new and used Toyota products.

For many years, ECP warranty contracts were pre-printed and left with the dealer. Processing was done by an outside party and it could take up to 48 days to process an application or request to transfer coverage when a vehicle was sold. Apparently, improvements have been implemented in recent years to streamline the process.

Toyota recommended International Warranty as its preferred choice for extended warranties, after the parent company in Japan expressed no interest in getting into the business. IW was an insured aftermarket warranty product, and Toyota Canada recommended it to dealers and consumers alike as the preferred choice, eventually removing the IW logo and branding it as a Toyota product. IW's contracts were fully insured by Commonwealth Insurance. A similar model was chosen by other auto importers, including Hyundai, Volkswagen, Nissan, Mazda and, finally, Honda.

The IW Toyota business relationship went well from 1981 to 1986, at which time IW sold to different interests in a leveraged buyout. In 1987, Toyota learned the new owners had been dropped by Commonwealth and they were now operating without insurance. Toyota did not have confidence in the new president of IW chosen by the new investors after the sale, and eventually discovered he had been involved in a fraud in California.

Toyota scrambled to come up with a solution in 1986-88, including appeals to provincial regulators. Alberta, headquarters to IW and to APA's knowledge the first province to rule that mechanical protection warranties had to be insured, was of little help. Quebec's Office de la protection du consommateur took the position that Toyota (and the other automakers who marketed similar IW programs) were on the hook to consumers, on the basis of the representations they had a made and a Civil Code doctrine similar to the concept of agency.

On Dec. 31, 1987, New Year's Eve, Toyota and the other automakers stepped in to IW's shoes by signing an Assumption Agreement, with provincial regulators from several provinces present. In hindsight, it proved to be only the end of the beginning, rather than the beginning of the end.

An early report from the receiver appointed to review IW's financials found the following:

  $18.3 million, contracts underwritten by Commonwealth Insurance
+ $ 2.3 million, Elite Insurance
<u>+ $28.8 million, Trust Accounts</u>
= $49.4 million Total

Toyota inherited 80,000 to 90,000 IW contracts, with little of the information needed to administer them and a potential liability conservatively estimated by the APA at $20 million to $30 million. Hyundai, the second-largest retailer of IW warranties, was not far behind in total exposure. The first lawsuits were filed in Alberta to obtain copies of IW's computer data and software to continue processing claims. After that there were monies to be collected from the insurers. The biggest headache concerned the trust accounts IW had set up in the period when it operated without insurance. Large sums (the amount was not disclosed to the APA) had disappeared from the accounts due in part to sloppy oversight by the trustee. Toyota's Peter Bond, a retired Senior Vice President with responsibility for the warranty portfolio at that time, informed the APA that the litigation arising out of the International Warranty insolvency continues in Alberta over the recovery of monies held in trust – this in 2004 for a company that became insolvent in 1987!

Toyota's position is that the fully insured plans are the only way to go. Toyota began with Liberty Mutual, eventually switching to Prudential Insurance and today is with Employers Re-Insurance, which is GE Capital's insurer. Experience taught Toyota that the management team at a warranty company is of critical importance: Toyota Canada will only recommend a company over which it has full control – otherwise "you have no control over your future."

The trust fund model, one of the two options allowed by legislation in Quebec – and permitted due to a lack of specific legislation prohibiting it in six provinces – was rejected out of hand by the two Toyota executives consulted. Experience gained in the IW failure showed that trust reserve accounts are frequently set too low by actuaries to cover the full amount of the exposure. Actuaries have been known to create imaginary surpluses by undervaluing potential claims. In the IW case, Toyota discovered potential conflicts of interest between the warranty company and the actuary – the latter had an office next door to IW, in the same building, and performed other work for them. Toyota determined that oversight of trust accounts by the provincial regulator and the trustee was ineffectual, and the opportunity for excessive drawdowns of trust accounts too great. Unlike Commonwealth and Elite, who settled quickly and wanted to maintain a system to process claims, the missing money in trust accounts has proven very difficult to determine and recover – and is in fact still the subject of litigation.

In 1992, after five years of manufacturer-supported administration, ECP was still underfunded by $5 million – a manageable amount for an auto manufacturer or importer, but very large for an independent warranty company. Working with every advantage, including the most reliable brand of cars and trucks in the world (and hence lowest repair frequency), an established national dealer network, with administrative support, IT infrastructure, and office space from Toyota Canada, it still took Toyota more than seven years to top up the plan.

Toyota believes that warranty plans in which the dealer has an investment in the warranty company, or is in some other way tied to the warranty company (PPP in Quebec, the now defunct Fada Gard in Ontario), are open to abuse. Toyota dealers selling the ECP and in good standing are self-authorized for repairs up to a certain amount (say $2,000), to reduce delays and inconvenience to the customer.

Transfer fees

Transfer frees were dropped in new contracts sold after March 1994. According to Toyota, after you grow to a certain size, collecting transfer fees becomes an administrative burden that outweighs the return. A provision is made when pricing new contracts to cover the cost of transferring a certain percentage of warranties.