Submission to the Australian Competition and Consumer Commission New Car Retailing Industry Market Study Issues Paper

Summary

1 This submission responds to questions raised in ACCC's Issues Paper regarding consumer understanding of warranties and the consumer guarantees under the Australian Consumer Law (ACL).

2 By way of background, the Australian Securities and Investments Commission (ASIC) has been conducting a review of the sale of add-on insurance products by car dealers, with its key findings set out in three recent reports.[1] The findings in those reports have been used to inform the analysis in this submission.

3 The three reports are:

a. Report 470 *Buying add-on insurance in car yards: Why it can be hard to say no* (REP 470);

b. Report 471 *The sale of life insurance through car dealers: Taking consumers for a ride* (REP 471); and

c. Report 492 *A market that is failing consumers: The sale of add-on insurance through car dealers* (REP 492).

4 This submission:

a. Outlines the range of products that can meet the costs of repairing defects in a new car, and the different ways in which obligations under legislation administered by ASIC (the *Corporations Act 2001* (Corporations Act) and the *Insurance Contracts Act 1984* (Insurance Contracts Act) may apply to these products;

b. Summarises ASIC's findings from REP 470 in relation to the complexity of decision-making for consumers when buying cars; and

c. Provides examples of transactions that suggest there was consumer confusion at the point of sale about both the scope of the consumer guarantees, and the consequent overlap in cover under these guarantees and other products.

5 On this basis, it is ASIC's view that:

a. Many consumers are unaware of their rights, and the remedies available to them, under the consumer guarantees; and

b. This results in adverse financial outcomes for consumers who are sold warranties that they do not need because there is a significant overlap between the cover provided by these products and their rights under the consumer guarantees.

[1] 'Add-on insurance' is a term used to describe an insurance product that is 'added on' to the sale of another product which is the main focus for the consumer. Our reviews focused on add-on insurance sold to consumers when they purchase a new or used car.

Range of products available to consumers

6 Questions 11, 12 and 13 of the Issues Paper are directed to the relationship between the consumer guarantees, manufacturers' warranties and dealers' extended warranties. Part 2.1 of the Issues Paper states that consumers have the following avenues through which to seek a remedy:

a. The consumer guarantees – which are set out in the ACL;

b. Manufacturers' warranties – described in the Issues Paper as a promise that the car manufacturer will 'fix any defect at no cost to the consumer so that the car is in a reasonable condition for its age'; and

c. Dealers' extended warranties – described in the Issues Paper as 'a service offered by a dealer, and provided by an insurer, which can extend the coverage provided by the manufacturer's warranty'. However this description in the Issues Paper does not reflect the broader usage of this term. ASIC understands that a dealers' extended warranty typically refers to contracts where the dealer is the contracting party with the obligations to meet the promises under the warranty, and is not limited to situations where the dealer is the distributor of the warranty. Furthermore, dealers' extended warranties are not necessarily contracts of insurance (see paragraphs 30–31).

7 However, two additional classes of products provide similar cover in respect of repairs:

a. Third-party extended warranties – these products provide similar coverage as dealers' extended warranties, but are provided through a contract between the consumer and the third party. They are commonly sold by the car dealer or finance brokers; and

b. Mechanical breakdown insurance (MBI) – this is an insurance product which, in the event of a car failure, covers consumers for the cost of repairing any specified defects that arise from the materials or workmanship of the car.

8 In this submission, the term 'commercial warranties' is used to describe collectively the four products described in paragraphs 2.1(b) and (c), and 2.2 (a) and (b).

9 The operation of dealers' extended warranties as described in the Issues Paper needs clarification in two respects:

a. Some dealers (but not all) manage the risk of having a pool of funds available to meet claims under the warranty by entering into arrangements with a third party under which they pay a sum to the third party for each contract. The third party is responsible for administering and paying claims from the money it receives from the dealer. The third party is usually not an insurer, but even if they were this would not have the effect of making the contract between the consumer and the dealer an insurance policy.

b. Not all dealers' extended warranties are expressed as commencing when any manufacturer's warranty ends. The contract for the dealer warranty may state that it commences on a specified date. For used cars this can be the date of purchase. Where this is the case there can be a period during which the dealer's extended warranty and the manufacturer's warranty are in force at the same time.

Products within ASIC's jurisdiction

10 ASIC regulates products that meet the definition of financial product in the Corporations Act. The Corporations Act provides several definitions of a 'financial product', including a 'facility through which a person manages financial risk'.[2] Our view is that extended warranties are generally financial products because they are facilities through which consumers manage the financial risk of the cost of repairing defects arising in a car.[3]

11 However, an extended warranty will not be a financial product if it falls within the 'incidental product exemption' under s763E of the Corporations Act. This exemption applies to financial products that meet either of the following definitions :

a. It is an incidental component of a facility that also has other components, and the purpose of that facility when considered as a whole is not a financial product purpose; or

b. It is a facility that is incidental to one or more other facilities, and the purpose of the product and those other facilities when considered as a whole is not a financial product purpose.

12 The application of s763E will depend on the individual circumstances of a product, including its terms and the way it is offered or provided to consumers. We have set out our views on the operation of s763E in ASIC Information Sheet 198 *Extended Warranties* (INFO 198). In summary, ASIC considers that:

a. In relation to manufacturers' warranties – the incidental exemption is likely to apply. The warranty is more likely to be considered as incidental to the car purchase, and so to ensuring that the car is of a particular quality.

b. In relation to dealers' extended warranties – the incidental exemption may apply, but it is less likely to apply where the customer is able to choose between different levels of coverage, where the product provides cover for losses or expenses that are not related to the quality of the car, or where the product is offered to the customer some time after the sale of the goods that are covered by the warranty.

c. In relation to third-party extended warranties – the incidental exemption is unlikely to apply as the third party will typically have no interest in the goods other than as a result of the extended warranty.

13 It is noted that the scope of the incidental exemption in relation to warranties has not been determined or tested through litigation.

14 The Corporations Act specifically provides that contracts of insurance are financial products.[4] This means that the incidental product exemption does not apply to MBI policies, even where they might otherwise fall within the terms of the exemption.

[2] Section 763A.
[3] See ASIC Information Sheet 198.
[4] Corporations Act s 764A(1)(d); ASIC Act s 12BAA(7)(d).

15 Each of these kinds of warranty and warranty insurance products may also be financial products for the purposes of the consumer protection provisions in Div 2 of Part 2 of the ASIC Act. The definition of ‘financial product’ in the ASIC Act does not include the ‘incidental product’ exemption, and accordingly the wider range of warranty products may be covered by those provisions. ASIC and the ACCC have in place delegations of power in relation to warranties due to consumer protection provisions applying under both the ASIC Act and the ACL.

Application of the Corporations Act and the Insurance Contracts Act

16 Providers of manufacturers' warranties and dealers' extended warranties will generally regard themselves as falling within the incidental exemption, and therefore do not consider the licensing and conduct obligations under the Corporations Act when providing these products.

17 Conversely, providers of third-party extended warranties will usually, but not invariably, hold an Australian financial services (AFS) licence, and have a compliance structure in place to meet the obligations applying to such licensees.

18 This means that, relevant to the ACCC's inquiry, providers of third-party extended warranties and MBIs will generally be subject to additional regulatory requirements, including holding an AFS licence, membership in an approved external dispute resolution (EDR) scheme and disclosure requirements. The differences are summarised in the table below.

Product	Hold an AFSL	EDR Membership Requirement	Disclosure Requirements
Manufacturers' Warranty	No	No	No
Dealers' Extended Warranty	No	No	No
Third-party Extended Warranty	Yes	Yes	Yes
Mechanical Breakdown Insurance	Yes	Yes	Yes

External Dispute Resolution obligations

19 AFS licence holders must ensure they are members of an EDR scheme that covers complaints made by retail clients in relation to the financial services provided: Corporations Act ss912A(2)(b), 1017G.

20 Consumers who have a dispute in relation to a claim under a third-party extended warranty or an MBI are therefore able to have it considered by an EDR scheme without the cost and time of litigation.

21 However, consumers who have a claim rejected under either a manufacturer's warranty or a dealer extended warranty will generally (depending on the terms of the contract) not be able to lodge a complaint with an EDR scheme. They will therefore find themselves in the same

position as consumers who have problems in having their vehicles repaired under the consumer guarantees. As the Issues Paper states:

> many consumers are having difficulty enforcing their consumer guarantee rights to obtain remedies from dealers and manufacturers for defective cars. Consumers may choose to pursue their claim through a consumer tribunal or the court system, including by joining a class action.[5]

Disclosure obligations

22 Product issuers and persons who make recommendations in relation to financial products are required, under the Corporations Act, to provide a consumer with a Product Disclosure Statement (PDS). A PDS must contain sufficient information to enable a consumer to make an informed decision about whether to purchase a financial product.

23 This means that a PDS does not simply include the terms of the contract between the consumer and the provider but also has other information that can assist a consumer in deciding whether or not to buy the product. Providers of a third-party extended warranty or an MBI are therefore required to provide information about the risks and benefits of a product.

24 ASIC Regulatory Guide 168 *Product Disclosure Statements (and other disclosure obligations)* (RG 168) provides guidance on what providers should include in a PDS. ASIC has stated:

> To minimise the risk that a PDS is misleading or deceptive because of the way that it is presented, the product issuer should consider giving prominence to …information about significant product features which, while they are not unusual, may lead to a significant financial impact for a consumer

25 A risk that arises in relation to third-party extended warranties and MBI policies is that there will be an overlap between the cover offered under the financial product and the consumer's rights and remedies under the consumer guarantees.

26 ASIC has not undertaken a detailed review of the disclosure documents for third-party extended warranties and MBI policies. However, we are aware that at least some providers include information that describes the following matters:

a. Statements that the consumer will have additional rights under the ACL; and

b. Statements that the consumer's rights under the ACL may overlap with those provided to them under the third-party extended warranty or the MBI policy.

27 This information is typically provided as a statement of fact, without providing examples or commentary that would assist the consumer to appreciate how their rights under the consumer guarantees may operate in practice.

[5] Page 11.

28 For the reasons discussed in detail above, ASIC's view is that this form of disclosure is unlikely to be effective in assisting the consumer to make an informed purchasing decision, particularly in deciding not to purchase the warranty or MBI.

Obligations under the Insurance Contracts Act

29 Contracts of insurance, and the parties involved in such contracts, must comply with additional requirements set out in the Insurance Contracts Act. This means that insurers offering MBI policies are, for example, under a duty to act with the utmost good faith in respect of any matter arising under or in relation to the insurance contract. Additionally, in certain circumstances the Insurance Contracts Act prevents insurers from relying on particular exclusion clauses that have been included in an insurance contract. For example s46 of the Insurance Contracts Act provides that in certain circumstances an insurer may not rely on a provision 'that has the effect of limiting or excluding the insurer's liability under the contract by reference to the condition, at a time before the contract was entered into, of the thing'.

30 The Insurance Contracts Act does not address the question of whether an extended warranty is a contract of insurance. This will depend on the characteristics of each contract, based on its terms and the risks covered under the contract.

31 Some providers of dealers' extended warranties seek to ensure that their product is not a contract of insurance by including a specific term that gives them the discretion of whether or not to accept a claim, irrespective of whether it otherwise falls within the terms of the contract. This is because there is judicial authority that where the consumer only has the right to have their claim considered by the other party, but not to have it paid, this will not be an insurance contract.[6]

The sales process for add-on products

32 This Section responds to Questions 11 and 12 of the Issues Paper, which asked:

> *11. When purchasing a new car, what information is given to consumers about their consumer guarantee rights? What information are consumers given about the terms and conditions of the manufacturers' warranties or the dealers' extended warranties? Who provides this information? How is this communicated?*
>
> *12. What information is given to consumers about the interaction between their consumer guarantee rights, the manufacturer's warranty and, where relevant, the dealer's extended warranty? … How is this communicated?*

33 REP 470 analysed qualitative research on consumer experiences when buying add-on insurance through car dealers. The research did not specifically examine conduct at the point of sale in relation to consumer guarantees. However, it is relevant to the ACCC's inquiries as:

[6] *Medical Defence Union Ltd v Department of Trade* (1979) 2 All ER 421, 429, cited in *New South Wales Medical Defence Union Ltd v Crawford* (1993) 11 ACSR 406, 456.

a. It identified a range of factors in the car sales process that inhibit good decision-making by consumers; and

b. To the extent these factors apply to the purchase of add-on products they are also likely to apply to consumers in relation to the operation and scope of the consumer guarantees.

34 The research undertaken in REP 470 was based on the consumer experience at the point of sale, identified through five focus groups and 13 interviews in Melbourne and Sydney with consumers who had recently been sold add-on products with the purchase of a new or used car.

35 REP 470 used behavioural economics to analyse the way in which consumers made decisions. In summary, behavioural economics draws on the fields of psychology and economics to explain how and why people—including consumers—think and behave in certain ways. It is increasingly used by governments, academics and businesses to explain why consumers sometimes make decisions or take actions that are not in their best interests when choosing and using financial products, which can lead to them suffering considerable losses.[7]

36 REP 470 identified several behavioural biases that inhibit the ability of consumers to fully understand and make informed decisions about add-on products. These factors may affect the ability of consumers to understand information that is given to them about their rights under consumer guarantees, including when a consumer is deciding whether to purchase an extended warranty which provides overlapping cover. Two of these biases are discussed in detail below as particularly relevant to consumer guarantees: decision fatigue and information overload.

37 If the consumer experience regarding add-on insurance products is comparable to their experience towards the consumer guarantees, then ASIC's analysis suggests that even if a car dealer informs a consumer about the consumer guarantees (or about the fact that an extended warranty or MBI policy may provide cover which overlaps with rights under the consumer guarantees), there are difficulties for consumers in comprehending or processing such information, or using it to make better financial decisions.

Decision fatigue

38 REP 470 found that consumers buying motor vehicles often experience decision fatigue after making a series of decisions, which can result in later decisions not being of the same quality as early decisions.[8]

39 ASIC's research found that the offer of add-on insurance could be made at the end of a long day. The consumer was likely to have already made many decisions that day (colour of car, what extras to include, how to finance), making it more likely that they would be experiencing the negative effects of decision fatigue when being asked whether or not to buy add-on insurance products.

[7] FCA, Occasional Paper No. 1 *Applying behavioural economics at the Financial Conduct Authority*, April 2013.

[8] R F Baumeister, ‘The psychology of irrationality: Why people make foolish, self-defeating choices’, *The psychology of economic decisions—Volume 1: Rationality and well-being*, I Brocas and JD Carrillo (eds), 2003, pp. 1–15.

40 Many consumers explicitly described the impact of fatigue on them:

> *It's like a conveyor belt of decision making, you're on that belt.*
>
> *And then you're too tired. At the end of the process you're tired. You just want to get out of there, so you just agree. It could be that you have some kids screaming. I had my kids with me too.*
>
> *I suppose I got there about 8.30–9.00 [in] the morning, until at least about 4 pm … I was exhausted … I had to say to them—'Look, I've got absolutely nothing against you but we need to stop this now.'*

41 These findings are relevant to the ACCC inquiry as they suggest that if information about consumer guarantees is only provided to the consumer towards the end of the sales process then the consumer is less likely to absorb that information or use it to inform their decision-making in relation to the commercial guarantees.

Information overload

42 ASIC also considered the issue of information overload in REP 470. Consumers can experience information overload when faced with complex decisions or lots of information—that is, the amount of information consumers have to process can adversely affect how they process that information and weaken the use of their critical decision faculties.[9]

43 ASIC's research found that consumers were offered add-on insurance products at or about the same time they were presented with a number of other decisions (e.g. how to finance, what after-market products to purchase). One consumer said:

> *The guy doing finance, went through everything like the extras like paint and leather protection, which I got, the extra plastic protection on the windows for smokers, which I didn't get, a few other bits I didn't get, then he gave me the insurance options one by one. He asked if I wanted certain insurance and if I didn't know what that was he would explain it—like gap insurance, I didn't know what that was at the time so he explained it.*

44 Many consumers reported feeling overwhelmed by having to make multiple decisions at or around the same time and were confused about what each product actually was. This process led consumers to experience information overload: they were provided with a significant amount of information and asked a lot of questions about what add-on insurance they might want after having already received a lot of information about vehicles and finance.

45 Two consumers described the experience in the following terms:

> *If you go home … you have got time to think. You have got time to go, 'Ah, do I need that?' You do get overwhelmed and tired by all the … like the*

[9] T Paredes, 'Blinded by the light: Information overload and its consequences for securities regulation', Washington University Law Quarterly, vol. 81, 2003, pp. 417–485.

> *insurance lady, I think she went for 10 minutes just like a one-way street … It's part of their tactic I think.*
>
> *… it was a bit overwhelming, you know, all the features and options and all the tech terminology and also I guess the complexity of all the different options.*

46 The extent and nature of information overload consumers may experience is demonstrated by the range of documents they are provided with when they buy a vehicle. Consumers may be provided with documents in relation to:

a. The contract of sale for the motor vehicle;

b. Changes in car registration or ownership and personal property securities registration;

c. Compulsory third-party insurance (CTP), third-party property insurance, and comprehensive insurance;

d. Servicing and engine maintenance requirements, including authorised servicing agents;

e. Applying for finance, and subsequent disclosure and contract documents from the lender;

f. Add-on insurance options, including consumer credit insurance, guaranteed asset protection insurance, tyre and rim insurance, and mechanical breakdown insurance;

g. Other after-market products, such as paint protection, windscreen protection, and roadside assistance; and

h. For used cars – a pre-delivery condition report.

47 The impact of information overload on consumers meant they had a limited or inaccurate understanding of basic matters such as what products they had purchased, how much they paid for them or what they were covered for. One respondent commented:

> *I don't have a clue about what I am covered for. I am really embarrassed and if we didn't have the car accident, I would know even less than what I know now and I still don't know*

48 Given that consumers report having only a limited understanding of the add-on insurance products they purchased, ASIC's view is that it is likely that consumers will have a similarly poor understanding of both:

a. The scope of the consumer guarantees (irrespective of whether disclosure is oral or in writing, or both); and

b. The interaction between these guarantees and any commercial warranties they have been provided with.

Other issues

49 There are two other issues that inhibit consumer understanding of the way in which consumer guarantees operate.

50 The first is the lack of precision in the scope of the consumer guarantees, in particular the end date of the guarantees. This means that their operation is more abstract and difficult to conceptualise for the consumer.

51 The second is that the act of a car dealer in offering a consumer an extended warranty or an MBI policy may suggest to a consumer that the scope of the consumer guarantees is more limited than is the case, or otherwise they would not be offered this product. Some consumers described themselves as being 'nervous' and 'anxious' when entering the dealership. This makes it more likely that if the car dealer states that an extended warranty or an MBI policy would provide good or important cover the consumer will assume that this cover is not already provided under the transaction or under the consumer guarantees. Consumers may therefore be unlikely to take positive steps to correct such a suggestion by inquiring about the possibility of overlapping coverage. As one respondent in REP 470 commented:

> *Oh, my God, and you feel so stupid and we were clueless. We didn't even know what questions to ask.*

Limitations in consumer understanding about consumer guarantees

52 This Section responds to Question 13 of the Issues Paper, which asked:

> *13. What are consumer perceptions of consumer guarantees, manufacturers' warranties and dealers' extended warranties? How do these influence a consumer's decision to buy a new car?*

53 This Section:

a. Explains the overlap in coverage which can exist between the consumer guarantees and the commercial warranties, and also within the commercial warranties; and

b. Provides examples of individual transactions where consumers purchased products that demonstrate they were confused or unaware of the overlap between manufacturers' warranties and extended warranties.

54 The period of cover provided under the consumer guarantees and the commercial warranties can be summarised as follows:

a. The consumer guarantees – commence on the date of purchase with no specified end date;

b. Manufacturers' warranties – typically commence on the date of registration and run for a specified number of years (typically three years, however, some manufacturers provide up to seven years), or when the vehicle has driven a specified number of kilometres;

c. Dealers' extended warranties – are commonly sold with used cars rather than new cars, and run for a specified number of years or kilometres, commencing on the date of purchase;

d. Third-party extended warranties – are sold with both new and used cars and run for a specified number of years or kilometres; and

e. MBI policies – are sold with both new and used cars and run for a specified number of years. ASIC's review has found that they usually include a term specifically providing that they commence on the date when the manufacturer's warranty terminates. For new cars this can mean that the MBI policy starts in three to seven years from the date of purchase.

55 These arrangements mean that dealers' extended warranties do not necessarily start at the end of the manufacturer's warranty. This is not the case with MBI policies, given that the MBI expressly commences on expiry of the manufacturer's warranty. There is therefore no risk of overlap between a manufacturer's warranty and an MBI policy.

56 There is, however, a risk of overlap between a manufacturer's warranty and both dealer or third-party extended warranties in the following circumstances:

a. In relation to new cars – where the consumer is provided with a manufacturer's warranty and is also sold a third-party extended warranty where cover commences from the date of purchase; and

b. In relation to used cars – where the vehicle is still covered by the manufacturer's warranty (for example, it is only one year old) and the consumer is also sold either a dealer or a third-party extended warranty where cover commences from the date of purchase.

57 ASIC has not undertaken a review of this market sector to identify the extent to which sales of this type may be occurring. ASIC has identified inconsistent practices as to whether the warranties commence on the date of purchase or when the manufacturer's warranty terminates.

58 In relation to new cars ASIC has found some individual examples of these outcomes, set out in the following Table, where consumers were sold a third-party extended warranty with the sale of a new car.

Type of car purchased	***Cost of warranty***	***Period of cover under third party warranty***	***Period of cover under manufacturer's warranty***
Great Wall	$6500	5 years	5 years
Toyota	$3000	3 years	3 years
Holden	$2500	3 years	3 years

59 These transactions show that:

a. Consumers can pay significant amounts for a third-party extended warranty; and

b. Consumers may not obtain any additional period of cover under a third-party extended warranty relative to that offered under the manufacturer's warranty.

60 ASIC also identified a transaction in relation to a used vehicle where the consumer was sold a dealer extended warranty where cover commenced on the date of purchase. However, the age of the car meant that it was still covered by the manufacturer's warranty, so that the consumer was being sold a product with overlapping coverage. ASIC's view is that consumers are more likely to be confused or uncertain about the scope of the consumer guarantees and manufacturer's warranty, and may incorrectly assume that because it is second-hand they do not have covered under either of these.

61 Given the cost of the warranties and the extent of the overlap in cover between a manufacturer's warranty and a dealer or a third-party extended warranty the consumers in these transactions:

a. Were unaware or confused about the need for a warranty; and

b. Therefore also unaware or confused about the scope of the consumer guarantees and their impact on the need for a dealer or a third-party extended warranty.

Refunds and rebates

62 ASIC's review of dealer or third-party extended warranties suggests that car dealers benefit in the following ways from their sale:

a. It shifts the responsibility for repairs to a third-party (in the case of a dealer extended warranty – the third party who has to meet claims from the payment made to them by the dealer); and

b. It provides another revenue stream either through the profits earnt on the sale of the dealer extended warranty or the commission earnt from the sale of third-party extended warranties.

63 To maximise these benefits it is common for both dealer and third-party extended warranties to specifically exclude having to make any refund or rebate to the consumer if they want to cancel the policy before its term expires.

64 In one transaction reviewed by ASIC the consumer was sold a third party extended warranty at a cost of $4,000 when they bought a used car from a dealer. The vehicle was written off in an accident two hours after purchase. The provider of the warranty refused to provide a refund, even though it was no longer on risk. It did offer to transfer the benefit of the warranty to the replacement vehicle provided through the consumer's comprehensive insurance policy. This did not assist the consumer as they had decided to use the payment from the comprehensive insurer to purchase a new car covered by a five year manufacturer's warranty.

65 An absence of any right to a rebate has significant consequences for consumers, who may only learn after the date of purchase that they have rights under the consumer guarantees, and then find that they are unable to receive a refund where they decide to cancel a dealer or third-party extended warranty that overlaps with these consumer rights.