From Deep Fried Bananas to Wholesome Banana Bread?

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Background

Just over 2 years ago, I wrote a paper titled "Deep-Fried Bananas" (DFB) for the on-line Actuarial Summit held by the Institute of Actuaries of Australia (May 2021). It is recommended pre-reading 😊

Just scroll to the bottom of the following link to where it says **read the paper in full**:

[Virtual Summit Shorts: Deep Fried Bananas: From wholesome to gruesome (and back again?) - Actuaries Digital]

The DFB paper attempted to outline the reasons for the demise of an entire segment of the automotive insurance industry - in what became known as the automotive "add-on" insurance market.

"Deep Fried Bananas" is a metaphor for what I saw as the problem with automotive add-on insurances; you start with something fundamentally "good" (an organic banana), but after coating it in batter, deep frying it in animal fat and rolling it out onto a bed of castor sugar, not only have you completely destroyed any goodness in the original banana, but you are selling an unhealthy product, typically at an excessive premium.

In my view, so called automotive add-on insurance was much the same. There is nothing wrong with the underlying offering; but after adding excessive levels of "fat, batter and sugar" (i.e., incentive loadings for distributors which, in turn, changes distributor behaviour), any underlying goodness is lost.

But it did not have to be that way, and it still need not be.

However, as of the date of this paper (November 2023), it seems nobody with any power or influence has had the vision to recognise that other "banana recipes" are possible and, as a result, consumers now arguably have:

- A much-reduced choice of automotive protection products than they did previously.
- Products that provide even less value than the insurance products that became notorious during the public airing of dirty laundry that was the Hayne Royal Commission of Inquiry.
- Little or no ability to buy **insurance** products for automotive protection - just an array of far lower quality "quasi-financial" products, often with little or no security for the "promised" benefits.

What this paper is going to examine is whether there is another solution to this problem that makes things better, not worse, for consumers.

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Disclaimer

Any views expressed or implied in this paper are mine alone and do not necessarily reflect those of my employer nor any other party or entity I might be associated with from time to time.

What are you going to be reading about in this paper?

In this paper I am going to try and convince you that one of the former automotive add-on insurance products has a big future, but **not** as an add-on insurance product[1].

Firstly, I am going to outline why I believe there is no viable future for selling intermediated add-on insurance products through the recently introduced Deferred Sales Model (DSM) process.

This situation leaves a significant void in the market for reasonably priced, high-quality products available to protect consumers from the financial risks associated with motor vehicle ownership.

By all accounts, nature abhors a vacuum.

Secondly, and more importantly, I am going to describe, in reasonable detail, the complete transformation of a former add-on insurance product that addresses the apparent plenism.

Furthermore, building expertise in this product could also give rise to other significant opportunities.

Sounds too good to be true?

Read on.

[1] That's not to say other previously add-on insurance products don't also have a future. But this paper focuses on just one of those (former) products.

Part 1: The demise of add-on insurance

Historical Overview

The DFB paper provided a reasonable historical overview of how add-on insurance became the subject of investigations by the financial regulator, the Australian Securities and Investment Commission (ASIC), from about 2011 onwards.

In short, the DFB paper identified a series of systemic issues with the entire automotive industry that had perhaps not been widely understood, even by ASIC:

- While motor vehicle dealerships might have long been perceived as being "greedy", in over-charging for add-on products generally, they were also under immense pressure from automotive manufacturers to sell more vehicles - and hence to constantly upgrade their premises both in terms of geographical location and the fit and finish. Failure to do so inevitably meant losing their franchised dealer status.
- Upgrading of premises requires significant investment, and investments must be repaid. The pressure to sell more vehicles inevitably meant compressed margins on vehicle sales[2], and so dealerships went looking for other sources of margin. These other sources of margin included insurances, other financial and non-financial products, and various "after-market" products.
- As a result of this pressure from manufacturers, dealerships put increasing pressure on insurers to allow high levels of incentive payments (i.e., commission) to be included in any premium for an insurance product. Given the rules around sales and training, dealerships also wanted these products to be "simple"; a key element of this simplicity being "one price fits many".
- With the dealerships controlling access to the vehicle-and-insurance-buying consumers, insurers who did not comply with the dealerships' wishes simply wrote no business. The dealerships could always find another insurer who was prepared to allow ever higher incentive payments (of various types) and simplistic pricing structures.

By 2015-16, the pressure in "the system" became unbearable; consumers were paying very high prices for insurance (and other) products overloaded with incentive payments to dealerships, the dealerships were desperate for the margin in these products (and so "pressure selling" grew in scope and influence) and these matters ultimately came to the attention of ASIC.

ASIC

ASIC had regulated and investigated the automotive add-on insurance sector for many years leading into 2016 when they started publishing their various reports into the "car yard insurance" (e.g., RP470, RP492).

However, despite clearly identifying significant issues with add-on products, their pricing and distribution, ASIC did little more than "hand wring" for over a decade.

Again, via a metaphor, the DFB paper characterised ASIC's lack of positive action as akin to a traffic police force whose commissioner appeared periodically in the media, bemoaning the unsafe driving practices of drivers on roads that do not have explicit and visible speed limits.

How effective can road traffic signs that say "please drive safely" be?

Define "safe", unambiguously for all combinations of motorists, vehicles, roads, and weather.

Surely, like our actual roads, where speed limits are clearly shown on numerous signs and road markings, and there are fines for breaking the speed limit (and ultimately, loss of licence for repeat

[2] Another feature of the new vehicle market, just 4-5 years ago, was the notion of "cyber cars". The Federal Chamber of Automotive Industries (FCAI) publishes the number of new vehicle registrations in Australia every month ("VFACTS"). The manufacturers monitored sales by their franchised dealers using the VFACTS data as a proxy for the number of new vehicle sales. Franchised dealerships were therefore able to "create" a sale (in the minds of the manufacturer) by registering a vehicle (rather than just selling it). This eroded margins in new vehicle sales even further as these demonstrator vehicles had to be sold at a discount to the list price. This illustrates just how much pressure there was in the "system" to find margin in other products.

infringements), the add-on insurance sector could have been policed in an analogous manner - clear commission/incentive payment limits on sale of products, fines for exceeding the commission limit, and loss of (Australian Financial Services) licence for repeat offenders.

But simple and effective policing has never been the hallmark of ASIC.

As an institution, they cannot even engage in explaining their own (often long-winded and confusing) Regulatory Guides. Their inevitable response to any "please explain or clarify" request is "seek your own legal advice", which means the likelihood of consistent legal advice across the industry is remote; there could be as many different legal opinions as the number of opinions sought.

In no way am I suggesting ASIC caused the situation with add-on insurance; that was also covered in Deep Fried Bananas in reasonable depth. However, ASIC didn't really do much to improve the situation and, in the way of football matches, referees who do not deal with recidivist dirty players end up copping at least as much flack as the perpetrators of the trouble.

The Chair of ASIC was in the (insurance) news recently to proclaim:

It would be hard to find a day when ASIC is not in a State or Federal Court somewhere in the country… we entirely reject assertions that ASIC is a weak corporate regulator. On the contrary, we have been, and continue to be, an active and effective litigator.

My feedback would be there is a big difference between litigating and just plain old (preventative) policing.

Shades of Abraham Maslow here:

If the only tool you have is a hammer, you tend to see every problem as a nail.

Deferred Sales Model

While ASIC did nothing effective to prevent the detriment caused by add-on insurance, they did introduce a raft of new legislation, including the Deferred Sales Model (DSM).

This new legislation (including the DSM) came into effect from 5 October 2021 and has achieved essentially nothing except kill off automotive add-on insurance entirely.

Many might say that is a good thing - but it really isn't anywhere near the best that could have been achieved, and especially if you look in detail at what has remained, largely unaffected by the DSM.

The factors that have made the DSM completely unviable, aside from the pure attritional effect on customer enthusiasm of the (effectively) 5-day pause, include:

- The emails sent to prospective consumers have an ASIC-prescribed subject line for the email which must read something like "**You do not have to buy this product !**"
- Financiers will not now finance add-on insurance premiums, for many conceivable reasons:
    - The Linked Credit Provider provisions under s278 of the Australian Consumer Law (ACL) which make Financiers liable for the wrongful conduct, or indeed insolvency, of a supplier of goods for whom the financier has permitted, if not encouraged, the procurement of finance contracts which facilitate the supply of those goods.
    - Reputational damage from association with add-on insurance products.
    - Regulatory issues and incursions from association with add-on insurance products.
    - Exclusions and/or premium increments from the Financiers' D&O insurers for association with add-on insurance products.
    - The 5-day pause means Financiers would have to re-issue finance documentation if the consumer took up the offer or provide some kind of revolving credit facility to allow them to buy the add-on insurance 5-days hence.
    - The LVR of a finance contract with the financed add-on insurance premium is higher, which increases the risk of the contract being deemed "irresponsible lending".

    - The cost-benefit trade-off of a small increment to the financed amount doesn't stack up - a Financier could put less effort into, and take less risk with, simply issuing another finance contract to another customer (for a far greater financed amount).
- If premium financing is not available, then insurers are faced with instalment plans. However, instalment plans have numerous issues:
    - Instalment payment dishonours, followed by mandated communication to follow up with the consumer to ensure their intention was to lapse the policy (phone calls, emails, texts, letters and recording of all the above in the insurer's IT system as evidence). Often consumers do not respond, at least initially.
    - Consumers finally responding to their payment dishonours and lapse, but typically only when they want to reinstate the policy and lodge a claim. This inevitably leads to an elevated risk of dispute resolution, which is time consuming and costly for insurers, even to defend obviously invalid claims by consumers (who just claim anyway, knowing insurers' aversion to attendance at an AFCA hearing and the sympathetic stance often favouring consumers[3]).
- The amount of documentation that is now required to be issued to the consumer, some of which must be responded to by the (time poor and overwhelmed) consumer.
- The uncertainty for the add-on insurer in knowing whether what they have done in relation to their product design, pricing, documentation provided to consumers and so on will be acceptable to ASIC (who, as above, typically respond with "seek your own legal advice").

The vast majority have waved the "white flag".

To my knowledge, only 2-3 smaller add-on insurers remain standing.

Is it possible to get round the DSM?

In short, for traditional add-on insurance products, no.

Personally, I see no realistic possibility of meaningful business volumes, sufficient to sustain an insurance operation's expenses (especially those related to regulatory compliance) and profit requirements, based around the intermediated sale of these automotive products by dealers or brokers who are paid a commission (i.e., a percentage of the premium charged to the consumer).

In my view, the fundamental issue is in designing new products that must now meet many criteria; criteria which seem to be **increasingly mutually exclusive**:

- Premium finance is essential (as discussed above, instalment plans are not viable). You need to convince Financiers that the product is:
    - a high value proposition for consumers (e.g., a decent loss ratio is generated).
    - not subject to a deferral period (and therefore cannot be an insurance product).
    - unlikely to result in Financiers getting caught out by the Linked Credit Provider rules.
    - unlikely to tarnish the reputation of Financiers.
    - unlikely to result in regulatory action against Financiers.
    - not going to be seen as overt "DSM-avoidance" activity

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[3] There is now also something of a new breed of "ambulance chasers"; businesses set up ostensibly to help consumers navigate the choppy waters of dispute resolution. However, in my view, in many cases, these businesses are facilitating the abuse of the dispute resolution service by encouraging ambit claims and full premium refunds after the policy has expired. Staff employed by these organisations are often former employees of the various Ombudsman services, and so know their way around the dispute resolution process, including its various weaknesses and "loopholes".

The irony with many of these premium refund requests is the consumer claims they had no knowledge they had been sold the policy yet they either have a claims history under the very same policy or they have provided the "ambulance chaser" with their policy details to enable the chase of the premium refund for the policy they allege they never knew they had. The ambulance chaser cannot chase a premium refund if they don't have a policy number and this data is (obviously) not publicly available; it can only have been provided to them by the (apparently unknowing) policyholder.

- Dealers and Brokers are unlikely to respond to a product that does not pay the high level of incentives they can get selling other unregulated products - and often without fear of any form of regulatory intervention.

You cannot have both high incentive rates *and* high loss ratios with the insurer still making a profit.

Many have pondered the above conundrum and

- Nobody yet has a solution.
- Many insurers have exited the segment.

However, dealers and non-insurers have been able to carry on, as usual, with other products.

Non-Insurance Products (not subject to the DSM and no difficulties getting the fee financed)

What remains for consumers post-DSM are a plethora of largely unregulated, non-insurance products (all benefitting from "regulatory arbitrage") including:

- **Service Contracts** - these are mechanical warranties, issued by dealers, under section 763E of the Corporations Act (2001), which gives dealers an *incidental product exclusion*, enabling the dealer to embed a service contract into the primary asset being sold (the vehicle). In the past, dealers have often insured their contractual obligations with an (add-on) insurer, but most of those add-on insurers have now exited the market. It remains a moot point as to whether an insurer can be a "stand alone" automotive add-on insurer and survive on the available revenues from supporting service contracts in this way. ASIC does not currently have direct jurisdiction over Service Contracts (other than the threat that perhaps one day they might).
- **Miscellaneous Financial Products** - these are non-insurance products issued by an entity with an Australian Financial Services Licence (AFSL) but most often not an insurance licence. Inevitably, these products are "discretionary" rather than "contractual". This means the issuing entity is not contractually obliged to pay valid claims, but rather they can pay claims at their discretion. It's not quite as bad as it sounds because any AFSL holder is still regulated by ASIC and so can be subject to complaints either internally (Internal Dispute Resolution) or externally (External Dispute Resolution via the Australian Financial Complaints Authority (AFCA)). There is also the possibility of insuring the discretionary liability (i.e., a wholesale arrangement, as noted above for Service Contracts).
- **Other Products** - this category includes "memberships" which might not deemed to be a financial product. A typical example is "Scratch and Dent" memberships where the consumer pays a joining fee (say $1,000) and then the first $50 of any scratch and dent repair that arises during the term of their chosen membership. The "Scratch and Dent" provider applies strict rules around the maximum size and depth of scratches and dents which may cause some still relatively minor repairs to be completed under the usual comprehensive motor insurance policy rather than the Scratch and Dent membership. These products may also be distributed under the incidental product exclusion (section 763E of the Corporations Act (2001)) and so ASIC does not currently have jurisdiction over these types of products either.

The major issues with these products include:

- There is little or no security for consumers' entitlements - unlike insurance, where insurers must demonstrate continuously to the Australian Prudential Regulation Authority (APRA) that they have sufficient capital to provide for the insured benefits with more than a 99.5% probability, these non-insurance entities are not under a comparable obligation. Any provider of *discretionary* products also has a "get out of jail card" in the event they cannot afford to pay (or deem themselves unable to pay).
- All insurers are signatories to the General Insurance Code of Practice (GICOP) meaning there are strict rules governing the conduct of insurers in their interactions with policyholders, and especially when the consumer is making a claim. While there is nothing stopping a non-insurer from voluntarily complying with the GICOP, I doubt many, if any, actually do.

- The above products are inevitably "community-rated" meaning the price of the product is the same (or similar) across a broad range of underlying risks. For example, a 36-month Service Contract might be embedded into the price of vehicles at (say) $2,500[4] plus government charges for both a smaller Japanese hatchback with 30,000 kms on the odometer and a larger Australian or Chinese manufactured SUV with 90,000 kms on the odometer. This means any purchaser of the Service Contract on the small Japanese hatchback will be subsidising the Service Contract on the larger SUV because:
    - Japanese manufactured vehicles are, on average, far more reliable than vehicles manufactured by any other country, all else equal.
    - Small, simple, and inexpensive vehicles like FWD hatchbacks have less reliability issues than larger, more expensive, and complex vehicles such as 4WD SUVs, all else equal.
    - Vehicles with [30,000] kms on the odometer tend to have less mechanical wear and tear than those with [90,000] kms, all else equal.
    - 4WD vehicles are often driven on rougher surfaces with heavier payloads than their 2WD/FWD counterparts (the 2WD/FWD vehicle might just be an "urban runabout").

  The lack of proper risk-rating of premiums/membership fees, and the resulting poor outcomes it delivers for so many consumers is, in my view, one of the biggest omissions from any discussion and investigation of this segment and its non-insurance "neighbours".

- The above noted non-insurance products may well be as bad as, or worse, than the add-on insurance products highlighted during the Hayne Royal Commission (and in various ASIC reports - e.g., RP470, RP492) in terms of the incentive loadings in the "fee" paid by consumers:
    - Incentives embedded in some "Scratch and Dent" joining fees may be up to 80% of the fee paid by consumers.
    - Retail unit costs for Service Contracts and Miscellaneous Financial Products could be up to 3 times the Wholesale unit cost (meaning the incentive charge is effectively over 66.6%[5] of the fee paid by consumers).

  These incentive loadings dwarf even those identified in the above noted ASIC reports.

You might also reasonably wonder what exactly you are getting for your money when so much of what you pay is gifted away in incentive payments to the dealerships.

Product Intervention Order

On 5 August 2020, ASIC issued a draft Product Intervention Order (PIO), "*Product Intervention, Add-on Motor Vehicle Financial Risk Products*", apparently with the intention of defining the broad classes of both insurance _and_ non-insurance financial products that would be subject to

- The Deferred Sales Model (DSM)
- Substantive conditions on the products, their sale and subsequent loss (ratio) performance
- Reporting and various other obligations (e.g., related to refunds)

in what might have been seen as ASIC finally recognising that setting clear rules for all market participants, as well as leveling the playing field as it relates to "regulatory arbitrage", would be beneficial for all market participants - products issuers, product distributors, and consumers.

However, with absolutely no explanation whatsoever (to this day, over 2½ years later), on 9 March 2021, ASIC withdrew the draft PIO but proceeded to implement the DSM as it applied to add-on *insurance* only.

That is, issuers of non-insurance, add-on financial and non-financial products (e.g., service contracts, miscellaneous financial products, and other memberships - as noted above) were not captured by the DSM that applied from 5 October 2021.

[4] You just know it will be $2,499 though, don't you?
[5] This number would look about right without the decimal point - the devil really is in the detail.

In other words, ASIC somehow, and on some basis, must have decided that:

- Add-on insurance products *were* detrimental to consumers; *and*
- The non-insurance financial products described above *were not* detrimental (and/or it was all too hard to do anything about it, even if they thought they were detrimental).

How can insurance products make a comeback?

It is effectively the act of paid intermediation that drives these classes of business into the add-on insurance bucket and hence the mandated DSM.

In my mind, most of these automotive insurance products continue to have the potential to offer financially "nutritious" protection from the unexpected, and the value proposition is not difficult to perceive.

However, the distribution model must be entirely different. I believe the terminology these days is "disrupted".

It must be a direct-to-consumer offering

From my perspective, the only plausible possibility is for insurance products to be distributed directly to the consumer (e.g., from a website). For various reasons, this is not going to be straightforward.

The Objections

These are perhaps the most likely hurdles or, in sales parlance, "the objections" (in no particular order):

- These products have an unenviable reputation for being poor value - this reputational damage might be difficult to overcome. Consumers (and consumer advocates) may just reject the products despite any attempt to entirely reconfigure and transform them.
- With extended warranty, there remains the issue of potential or perceived overlap with the OEMs' obligations under Australian Consumer Law (ACL), irrespective of the OEM warranty.
- Most consumers have no idea how to assess the wide spectrum of quality of these products - i.e., their prices and coverage (and hence value for money), and generally struggle with the process of getting appropriately educated and informed. Modern concentration spans are very short - we are all so distracted and busy these days.
- Consumers with an appetite for such products need to be directed to that website with some combination of brand awareness and Search Engine Optimisation (SEO), which can be costly, or it needs to be a website where many such consumers might already be actively thinking about their needs in relation to a vehicle (e.g., one of the major automotive sales websites) or perhaps both.
- The supply of insurers who have appetite for these classes has dwindled significantly, and those that remain (or have related businesses that play in the neighbouring non-insurance segment) may find their network of dealers and brokers in either the insured segment, or that neighbouring non-insurance segment, do not (or would not) appreciate the competition /cannibalism from a direct-to-consumer offering.
- The major automotive sales websites all have heavy revenue streams from advertising dealers selling vehicles. These same dealers also generate income from selling either service contracts or other miscellaneous financial products (as above). Accommodating these direct-to-consumer insurance offerings on their vehicle sales website may therefore cause conflict with their dealer customers.
- Risk selection is very important for some classes - e.g., warranty. If there is no way of filtering out and/or pricing poor risks, then anti-selection is inevitable.
- For all but the very lowest premiums, funding the premium could be problematic, especially when comprehensive motor insurance and mandated bodily injury insurance will be priority purchases for motorists.

- Financiers may still be nervous about these products, even in a new and completely legal guise.
- What is no longer spent on intermediaries might now have to be spent on SEO, branding, marketing, and advertising. It is moot whether this alternative spend will be lower (or indeed any more effective).

Many do not even have to go right through the above bullet points to conclude that there are probably easier pathways to success.

It won't be easy but…

… I am a believer in these products (and I'm not the only one).

I really believe there is a suite of underlying "organic bananas" that just needs the right "recipe" to make these products, not just palatable, but a really "tasty" offering.

The potential market

There are almost 20 million vehicles on Australian roads, many of them heavily financed[6] over multi-year terms, and each is driven an average of 12,000 kms - 15,000 kms per year.

That is a lot of exposure to the risk of

- Mechanical and electrical failures.
- Total loss events where the comprehensive motor insurance payout is inadequate.
- Changes in personal circumstances that could jeopardise individuals' credit scores.

These risks have been recognised by consumers in the past. Many of these products were previously bought by consumers, ostensibly to reduce these very risks.

Those same needs remain. The offerings that meet those needs just need to be much better.

However, if such a product suite is to exist, in my view, it will need many, if not all, of the following features

i. It must be an **enticing** offering - the value in the products must be almost self-evident and it must address a readily identifiable need. Consumers need to be able to imagine very easily being caught up in a set of unexpected, but not unforeseeable, circumstances where the product unambiguously responds and saves them from an obvious financial burden.

ii. It must be affordable *and* **value for money**. The largest proportion of the premium pool must be "returned" to the pool of consumers in the form of claim payments (i.e., the loss ratio must be reasonably high) and via any related services (e.g., insurer expenses for sourcing spare parts and arranging speedy repairs).

iii. It must be a **simple** product in the sense that consumers do not have to read a "50-page" Product Disclosure Statement (PDS) to have even a half chance of understanding when they will be able to claim successfully (or otherwise) and what they will get in the way of benefits when their claim is accepted. No tricky "fine print" thanks.

iv. When consumers do claim, they have the right to expect a **high standard of service** from people who work for the insurer and from any related party. This relates to the quality of any workmanship, the timeliness and responsiveness of the insurer, and the way they are communicated to (i.e., clearly, with all due courtesy and empathy, given the circumstances of making a claim are already stressful and unpleasant for the insured).

v. **Highly visible and positive consumer feedback** to continually reinforce the message back to the target markets around the above desirable attributes, to draw in new customers.

Now let's see if I can convince you that it can be done…

[6] Information that came to light during the Hayne Royal Commission of Inquiry suggested around 90% of Australian vehicle purchases were subject to some form of direct or indirect finance - including borrowing against the equity in the family home. See also ASIC's paper CP279 (March 2017).

Part 2: Developing and transforming a product

To illustrate the development / transformation of such a product, I will use **extended warranty** as the example from here forward[7].

The critical elements to address are

1. Does the product meet a need?
2. Is there a market for the product?
3. Is the product value for money?
4. Is the product easy for consumers to understand?
5. What does good service look like?

The following examines these critical elements in more detail.

1. Does extended warranty meet a need?

If your vehicle develops a mechanical or electrical issue that needs repairing, it can be stressful.

It takes time to find a repairer and make a booking, and it costs money to get it repaired.

The cost of the repair is uncertain - the uncertainty is firstly around which component(s) on the vehicle has (have) failed and secondly in how capable and honest the repairer is in

- diagnosing the problem
- identifying and sourcing any spare parts needed
- rectifying the issue in a timely manner

Many will have experienced repairers who replace parts unnecessarily as they "experiment" with how to fix the problem. There are few who can afford to tolerate this outcome.

Most consumers do not have sufficient knowledge to choose an appropriate repairer. Customer reviews may be sparse or non-existent, or indeed unreliable. Most will choose a repairer near to where they live or work and hope for the best.

A warranty insurance policy can help in this situation on three fronts:

- Once the warranty premium is paid, there is considerable certainty around repair costs (usually nothing further to pay).
- The warranty insurer arranges for the vehicle to be assessed for repairs - they know which repairers (nearby) have the skills and reputation to do the job well *and* at a reasonable price.
- The warranty insurer will get priority service from the repairer because they provide repairers with a steady stream of work. The vehicle will be booked in and repaired much sooner, and the repair will be done to a high standard. Repairers want the steady stream of business from insurers, so they aim to please the insurer's customers.

So, a warranty can save you time, money, and stress, and get you back on the road sooner.

However, if your vehicle is already outside of the manufacturer warranty period, you may no longer have any protection against unexpected mechanical or electrical failures.

At the end of the day, comprehensive motor insurance caters largely to the risk of "external" repairs (body panels, bumpers, etc.) whereas extended warranty caters to the risk of "internal" repairs (i.e., the electrical and mechanical components).

The need for extended warranty is therefore immediately comparable to the need for comprehensive motor insurance - your vehicle cannot function properly if it needs significant repairs.

An identifiable need is therefore indisputable if you no longer have any existing protection (e.g., your manufacturer warranty has expired).

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[7] I believe similar reasoning could support the other product types previously known as "add-on" insurance

2. Is there a market?

As noted at the end of Part 1 of this paper, there are almost 20 million vehicles on Australian roads, and each vehicle is driven an average of 12,000 kms - 15,000 kms per year.

With most vehicle manufacturers now offering 5-year manufacturer warranties on new vehicles (with some offering 7-years, while others are still stuck on 3-years), and with consumers buying over 1 million new vehicles per annum for the past 5 years, it seems reasonable to suggest that, at this preliminary point, there are somewhere between 13m - 15m used vehicles on Australian roads without any remaining manufacturer warranty coverage.

This certainly suggests a sizeable potential market for extended warranty products.

The addressable market will continue to be refined later in the paper, as we introduce and discuss some key issues relating to

- Australian Consumer Law (ACL)
- The draft Product Intervention Order (PIO) introduced by ASIC in August 2020
- Different types of coverage ("inclusion" versus "exclusion")

I will return to these matters below.

3. Is it value for money?

Not all vehicles are created equal, and especially not when it comes to reliability and the cost of repairs.

The more important reliability and repair risk factors that drive warranty premium rates are:

- **The manufacturer** - some do it better than others and the Japanese are the undisputed masters of manufacturing reliable vehicles (and many other things besides) at reasonable prices. Despite the anecdotal reputations for quality, with few exceptions, European vehicles are generally the least reliable vehicles *and* the most expensive to repair. Some of this is undoubtedly due to European OEMs generally leading the way in high performance and with implementing new technology. Model proliferation may also be an issue for European OEMs (with a vast array of engines, fuels, and platforms).

- **The complexity of the vehicle** - as more mechanical and electrical features are added to vehicles, so there are more things to break down. When technology is newer, it tends to be more unreliable. Over time, manufacturers engineer the faults out of these components so it may matter whether your vehicle was an early example of a series and/or whether the known issues have already been addressed prior to you buying the vehicle.

- **The age and odometer when you buy the vehicle**. In general, older and/or higher mileage vehicles have a greater level of pre-existing wear and tear, and tend to break down more frequently than newer, lower mileage vehicles, all else equal.

- **The service history on the vehicle**. Vehicles that have been fully serviced and maintained in accordance with the manufacturers' requirements are, on average, significantly more reliable than those that have an incomplete or non-existent service history.

- **The likely usage of the vehicle** - vehicles that are likely to be driven harder (e.g., performance oriented) or over rough terrain (e.g., 4WDs) have increased risk of developing mechanical and electrical faults.

- **The duration (i.e., term) of the warranty**. The longer the period of coverage required, the higher the cost of the warranty.

What the above bullet points mean is that the true cost of a warranty can vary very widely from one vehicle to the next.

Just like (highly risk-rated) comprehensive motor insurance premiums vary widely with vehicle characteristics, location, driver age and driving history (and so on), it is clear that not all vehicle warranties should be priced equally.

The lack of risk-rated pricing in this segment has been a key driver of poor value for many past warranty customers - warranties sold by dealers are generally "community rated", which is nothing more than a cosy sounding euphemism for "one price fits all".

As noted earlier, if you charge the same premium for a small, 2WD Japanese hatchback with 30,000 kms on the odometer as you do for a large Australian or Chinese manufactured 4WD SUV, with 90,000 kms on the odometer then, make no mistake, the owners of small Japanese hatchbacks will be cross subsidising the owners of the larger SUVs.

If value for money is to be provided to *all* purchasers of warranty products, in my view, they must be appropriately risk-rated. Community rating of warranty insurance makes as much sense to me as community-rated comprehensive motor - i.e., none.

However, risk-rating is good for insurers too.

Community-rated premiums also tend to invite anti-selection - this is the situation where consumers with higher risk (on the above noted factors) are more likely to want to buy the community-rated insurer's product (and the lowest risk customers are less likely to buy it).

Evidence of anti-selection occurs when the insurer examines their portfolio of risks and finds they are:

- Overweight in higher risks (e.g., European branded vehicles).
- Underweight in lower risks (e.g., Japanese branded vehicles).

relative to known benchmarks.

For example, analysis of VFACTS new vehicle sales data over the past 10 years clearly highlights that:

- More than 50% of vehicles on Australian roads have Japanese domiciled OEMs.
- Less than 20% of vehicles on Australian roads have European domiciled OEMs.

If an extended warranty insurer's portfolio has (say) 30% Japanese vehicles and 40% European vehicles then they are almost certainly affected by anti-selection and it is likely their premium rates will be under increasing upward pressure (which, ironically, only exacerbates the problem).

This is the time-honoured anti-selection spiral.

Most extended warranty insurers I am aware of have collected rich and detailed data on the vehicles they have covered over the past 20 years and **the process of developing risk-rated pricing and then delivering a risk-rated product into the market is almost identical in principle and execution to the pricing and delivery of comprehensive motor insurance** (i.e., via highly automated decisioning and underwriting, with limited "manual" referrals).

For example

- If the insurer has collected the unique vehicle reference key from one or more of the major vehicle data providers (e.g., Glass, Redbook) using the VIN or registration plate (as for motor insurance - via MotorWeb) then the insurer can "look up" all manner of vehicle attributes to see which of these are influential in driving extended warranty claims experience.

- If the insurer has also been recording the start and end date of the policy[8], and the dates any claims are made (and the amounts paid) and they can link all of that back to the vehicle key then a highly risk-rated premium basis can be developed.

[8] Noting that the warranty can expire "early" when any kilometre limits are breached (and it can be difficult for an insurer to monitor the exact point in time when this occurs). However, this is an increasingly minor issue as manufacturers now offer either very high or unlimited kilometre limits.

Such an analytical exercise is "meat and drink" to an actuary with the requisite data manipulation and statistical modelling expertise.

You might reasonably wonder why this hasn't occurred already.

It has been attempted but dealers and brokers have shown significant reluctance to adopt risk-rated pricing of add-on insurance products because it adds complexity to their process of selling it.

Some industry insiders have suggested to me that dealers simply like to mentally "keep score".

If a dealer knows they sell warranties for $1,995 and commission is 50%, then they only need keep score of how many warranties they've sold that month, and they know they got the best part of a grand in commission on every sale. i.e., "20 sales means ~$20 grand".

In my view, this nexus is (over-)ripe for disruption.

4. Simplicity

There's an often-repeated line on the (sadly now defunct) British Top Gear television show, that if you have to provide a long-winded explanation of why a car is "cool" then that automatically means it's "un-cool".

Many a desirable vehicle has ended up on the wrong side of the "cool wall" for these reasons.

In my view, it's the same with these products.

The benefits must be clear and unambiguous, there should be no "gotcha" detail in the fine print and the product should respond largely as expected. No mousetraps.

Coverage

At this point we need to consider the two main coverage types for an extended warranty product:

- Inclusion warranty
- Exclusion warranty

In my experience, the key differences between these coverage types are not well known (and hence not well understood) by most consumers.

In what follows, I hope to illustrate to you that the type of coverage drives product quality absolutely.

Inclusion Warranty

Inclusion warranties are those where the list of covered components is on an "inclusion list".

If the component is **not** on the inclusion list, it is **not** covered.

The problem with an inclusion list is that, to a non-expert eye, it may appear quite comprehensive.

However, modern vehicles are complex machines with a great many components and there is the risk of shock at claim time when the policyholder discovers that either:

- their failed parts are not on the inclusion list; or
- there is a low claim cap on the coverage for those parts which means the consumer must make a substantial co-contribution.

This is not simplicity.

It is also an unexpected and unpleasant surprise. The consumer thinks they have bought protection against the risk of unexpected repair costs but the response from an inclusion policy is often disappointing.

The (limited) benefits of inclusion warranty need a lot of explaining.

I'm with the Top Gear guys - that makes them "un-cool".

Furthermore, if you deconstruct the body of consumer complaints made about extended warranties over the past 5 - 10 years, almost always the complaints centre on some form of **inclusion** warranty product whose response at claim time was disappointing.

Inclusion warranties are often branded "3-Star" (or less). Watch out.

I am not generally in favour of inclusion warranties.

Exclusion Warranty

In my view, exclusion warranties are the best and perhaps the only product type to be offered.

Exclusion warranties are on the same basis as manufacturer warranties. That is, there is a short (and relatively familiar) list of excluded components, which are generally consumable or serviceable items (e.g., brake pads, oil filters, tyres) and these are not covered by any warranty, even the OEM's.

Otherwise, everything else is covered.

Most exclusion warranties will make an attestation that the warranty covers the same items as the Original Equipment Manufacturer (i.e., OEM) warranty.

Exclusion warranty is, in fact, the only true extension of the manufacturer warranty and so deserves the moniker "extended warranty".

The major downside to exclusion warranty is that it gets increasingly difficult to offer it on older, higher mileage vehicles. Exclusion coverage is comprehensive, there is no policy excess, and once a vehicle is sufficiently aged and worn, it just isn't viable to offer exclusion warranty on such a vehicle at a premium rate that is in keeping with the ongoing (and declining) value of the vehicle.

In general, "5-Star" exclusion warranty can be offered on vehicles up to about 10-years/120,000 kms, provided they have at least a reasonably complete service history. The designation "5-Star" generally means there is no cap on individual claim amounts.

Slightly lower grade exclusion warranty ("4-Star") generally assigns an individual claim cap (e.g., $5,000) for vehicles that are perhaps caught between 10-years/120,000 kms and (say) 12-years/160,000 kms.

The $5,000 cap protects the insurer from the failure of major components at a time in the vehicle's life when it is increasingly expected, and also helps keep the premium rate in proportion to a vehicle value that continues to depreciate.

Note that the coverage is still exclusion warranty, non-excluded parts are still covered, it's just that if a repair runs to more than $5k the insured must co-contribute the balance.

However, to put the $5k cap in perspective, because the warranty insurer is always able to source very competitively priced labour and parts, void of time wasting and "experimentation", the average claim size in a typical exclusion warranty portfolio has been $1,600 - $1,800 over the past few years; that is, the $5k cap is about 3 times the average claim cost, so the coverage provided by a 4-Star product is still substantial.

If these same repairs were arranged and carried out under the directive of non-expert consumers, it is highly likely that average repair costs would be significantly higher.

I will return to this very theme later in this paper when discussing and defining "value".

In the case of vehicles beyond the 12-years/160,000 kms barrier, in my view, exclusion warranty is far less viable. Typically, this is where inclusion warranty could play a role, provided it was sold/explained correctly, and so long as consumers understand the coverage is limited.

But do the majority of consumers read their Target Market Determinations (TMDs)?

The often-quoted argument by consumer advocates, that the consumer is better off putting the cost of the (inclusion) warranty towards a newer vehicle, arguably has some truth in this situation.

5. What does good service look like?

A great product can be completely undone if the accompanying service is rubbish.

These tenets are fundamental to any long-term successful business, so there is nothing overtly specific to warranty insurance here. As has been emphasised throughout this paper so far, just do a mental comparison with the comprehensive motor insurance market.

The insurers that provide good service make sure that:

- They are adequately resourced to cater to call volumes - like comprehensive motor, warranty claim frequency is relatively high (typically 15% - 20% per annum) so an inadequately resourced call centre is going to quickly lead to a "pile-up" of frustrated customers (noting their patience was already worn down by the mechanical/electrical failure of their vehicle).
- The people on the phones know what they're talking about - there is no point having somebody working at the warranty call centre who knows very little about mechanical and electrical issues with motor vehicles, and the matter will only be exacerbated if they are not at least reasonably fluent and coherent in spoken English.

Customer reviews and feedback will generally be as adversely affected by a frustrating call centre experience as they will by a poor and/or delayed repair.

A solid history of highly visible and positive feedback about your products and services on a well-known consumer feedback website is probably the best marketing material possible.

Product summary

The above discourse highlighted that the need for extended warranty (for "internal" repairs) is directly comparable to the well-established need for comprehensive motor insurance (for "external" repairs), as well as the need for

- High quality coverage (i.e., "exclusion" warranty)
- Risk-rated premiums (to reduce anti-selection risk and drive value for money for *all* consumers)
- Good quality service throughout the claim process that drives positive feedback.

If these elements can all be incorporated into a product and service package, then an extended warranty offering constructed in accordance with the above could be a very compelling offering.

Other important matters to ensure the product is ready for consumption

There are a number of other important matters to be fleshed out further to ensure a market-ready product can be generated.

These matters include (in no particular order of importance):

1. How to reach customers
2. Re-branding the product
3. Avoiding overlap with consumers' rights under the ACL
4. Ensuring product quality and viability
5. Anti-selection risk
6. Overcoming lack of information and data
7. Refining the addressable market
8. Policy term
9. Cost pressures on parts and repairs

1. How to reach customers?

I indicated earlier in this paper that, at the current time, consumers are undoubtedly not hunting on-line for extended warranty coverage (or indeed any of the other automotive products previously characterised as "add-on" insurance).

Consequently, I suggested earlier that one place where target consumers could be reached is on the major on-line automotive sale websites. I will examine this briefly, later in this paper.

I also suggested that an insurer wishing to attract customers with an extended warranty offering might have to spend up large on SEO, branding, marketing, and advertising.

*However, I have come to believe that existing **comprehensive motor insurers'** customer bases would be the most fertile source of new extended warranty business, subject (of course) to satisfying all the usual Design and Distribution Obligations (DDO) under these newer regulations*.

As I have been trying to emphasise in earlier sections of this paper, as I see it, comprehensive motor insurance deals to the "external" repair risk for a vehicle while extended warranty could deal with the "internal" repair risk.

It also begs the question:

Why would comprehensive motor insurers want to continue to leave a sizeable proportion of the total repair risk opportunity on their insured vehicles (i.e., the "internal" portion) completely off the table?

Surely, it is not such a radical or far-fetched idea that comprehensive motor insurers and their large pools of (hopefully) satisfied and trusting customers, should also have, or start to develop, an appetite for offering insurance for the risk of uncertain "internal" repair risk, just as they insure the uncertain "external" repair risk?

How many home buildings insurers are there out there that have no interest in insuring the contents?

Conversely, how many homeowners out there want to insure their buildings but not their contents?

Most comprehensive motor insurers have well-developed branding, marketing, and advertising programmes which could very readily be leveraged to raise awareness and appetite for the untapped "internal" repair component of the overall repair risk with their insured vehicles.

2. Re-branding the product

Perhaps the first step in the process is to give the coverage a new name.

Given the past, "Extended Warranty" is probably about as appealing as "Chateau Chernobyl".

I'll leave that exercise to the re-branding experts but for the purpose of this paper I will re-brand the (sub-) product as **Vehicle Breakdown Insurance** (VBI).

However, I also note that there is potentially an "angle" on this (sub-)product that suggests that the "Comprehensive" in Comprehensive Motor Insurance is not particularly appropriate if the product continues to exclude coverage for the repairs the vehicle might need in the event of mechanical or electrical failure.

Indeed, the term "comprehensive" is likely inherited from the UK product because of the inclusion (in the UK) of bodily injury cover. However, in Australia (and NZ) this is not the case either.

So, perhaps a marketing angle on introducing VBI into the mix is about highlighting to the market just how "un-comprehensive" Comprehensive Motor Insurance actually is, meaning a new consolidated product could be branded "**Complete Motor Insurance**" (or similar) so as to highlight the partial nature of existing "comprehensive" coverage.

Of course, there is the risk that the inclusion of a VBI coverage contaminates existing offerings in the eyes of regulators and CROs.

However, many of the **objections** noted earlier can also be addressed:

3. Avoiding overlap with the ACL

The draft PIO issued by ASIC on 5 August 2020 ("*Product Intervention, Add-on Motor Vehicle Financial Risk Products*") effectively signalled to the wider community what ASIC apparently saw as the implicit "expiry" of the OEMs obligations under the Australian Consumer Law (ACL) as it relates to extended warranty (see **Part 5, section 12** of the draft PIO).

Any manufacturer warranty in relation to the motor vehicle to which the motor vehicle purchase, motor vehicle loan or motor vehicle lease relates must have:

a) expired; or
b) less than 12 months cover remaining; or
c) less than 10,000 kilometres cover remaining; or
d) less than 20% of the kilometres-driven limit cover remaining.

Comprehensive motor insurers already have a clear idea of the odometer reading on any vehicle and the automotive data reference firms (e.g., Glass, Redbook, etc.) will be able to provide data to identify what the standard OEM warranty period (time and odometer based) is for any given vehicle.

In other words, it would be relatively straightforward to either restrict or allow the sale of VBI cover in accordance with the draft PIO, and therefore reduce the risk that any insurer was deemed to be selling a product that duplicated any coverage the consumer already had under the ACL.

Aside from the frustratingly vague descriptions of when a consumer might (still) be eligible for coverage under the ACL, it is also notable that many of the same vehicles sold new in Australia, are also sold new in many other countries, but in Australia (and New Zealand) the manufacturer warranty periods provided on those **same vehicles** (in most cases, 5 years or more) are, to my knowledge, the longest of anywhere on the planet.

In my view, *the risk of selling an insurance product with overlapping coverage under the ACL is unlikely to be a significant risk if the insurer selects and rejects applications for VBI coverage in accordance with **ASIC's draft PIO**, issued 5 August 2020*.

4. Product Quality

As above, stick exclusively with genuine exclusion coverage and product quality will never be an issue.

Such products will also comfortably exceed any relevant criteria noted in **Part 5, section 13** of the draft PIO.

The terms of a mechanical risk product:

a) must not overlap with the period or terms of coverage of any manufacturer warranty or statutory warranty;
b) must provide coverage for a period of at least 12 months;
c) must not have a maximum individual claim amount of less than $2,000;
d) must confer on the holder of the product a right to cancel the product at any time during the period of coverage and, if the right is exercised, to oblige the product issuer to refund any monies paid by the holder to the product issuer on a pro-rata basis that corresponds to the remaining period of coverage that would have applied but for the cancellation;
e) must not include a requirement for the motor vehicle to be serviced by the person from whom the vehicle was purchased or leased or any of their associates;
f) for new motor vehicles or used motor vehicles less than 10 years old must not include a requirement for the vehicle to be serviced that is more onerous (including more frequently) than that specified in the manufacturer's warranty that covered the vehicle;
g) must not contain a requirement requiring the holder of the product to pay an amount to a third party on cancellation of the product

5. Anti-selection risk

In my view, there are two key sources of anti-selection risk with a VBI product:

1. Community-rated premiums.
2. No assessment of the individual vehicle prior to offering coverage.

Risk-rating

The first source of anti-selection risk can be dealt with by developing risk-rated premiums (as discussed extensively above) and continuing indefinitely to evolve and refine the risk-rating process.

It has never been done to my knowledge, but insurers could also start collecting **driver attributes** (and **location**) data for VBI risk.

It seems plausible to me that if comprehensive motor insurance premiums are higher at younger ages (and lower at older ages) that a similar effect might be true for VBI risk as well, given that:

- Older drivers probably take better care of their vehicles (they certainly drive them less aggressively, on average). Older drivers tend to be more risk averse and are also more likely to have the financial means to maintain vehicles in better condition.
- Older drivers might not have such adventurous lifestyles as younger drivers - meaning older drivers tend to spend less time on dusty, pot-holed 4WD tracks and salty, sandy beaches (etc.) and so the risk of damage to vehicle componentry is commensurately less.

In the end, robust statistical analysis of claims experience by driver and location attributes will indicate whether risk varies significantly across the levels of such variables.

Vehicle assessment prior to VBI purchase

This is an area where insurers need to be very careful. In my view, a dishonest or misrepresented declaration of the vehicle's mechanical/electrical condition at policy inception would be very difficult (and costly) to prove.

One plausible solution is to partner with a (mobile) Mechanical Inspection Service (MIS) provider.

While you cannot insist a consumer use your chosen partner MIS provider (third line forcing is illegal), you can offer consumers an almost irresistible incentive to use your partner MIS provider.

One plausible option is to offer any consumer a full (i.e., 100%) rebate of the partner MIS cost (typically $250 - $300) if and only if they purchase your VBI product ***and*** use your MIS partner.

Otherwise, no rebate applies with any other MIS providers.

The only obvious area of care required is to ensure it is abundantly clear that the consequences of cancelling the VBI at any time after having received the MIS cost rebate will result in the MIS cost rebate amount being *deducted* (in full) from any refundable VBI premium.

If you fail to do this, many consumers will simply buy the VBI coverage and cancel shortly thereafter, just to get a free MIS. The availability of the "free" MIS will be all over the internet in short order.

Most MIS providers "score" the vehicles they inspect. Consequently, an insurer might develop criteria for accepting or rejecting an application for VBI along the following lines:

- If the score is above "90" (i.e., any identified faults are either minor or cosmetic) the vehicle has day one coverage for the policy term with no additional conditions applied.
- If the score is above "75" (i.e., there are some material faults, but overall the vehicle is largely sound) then the consumer must either rectify the identified material faults within the first 90 days, at their own expense (with receipts), to receive ongoing coverage for the same faults later in the policy term, or accept that the policy will not provide coverage for those faults at any time (i.e., akin to an exclusion for "pre-existing conditions").

These things do add complexity to the buying process and ultimately insurers will have to discern for themselves the cost-benefit trade-off around the financial consequences of dishonest representation of mechanical condition versus the costs and complexities of reducing the risk of it arising (e.g., via an inspection service).

This process is effectively a "substitute" for the 90-day statutory warranty provided by dealerships. The statutory warranty helped ensure dealers were only selling vehicles they believed to be mechanically sound.

6. Lack of prior experience with the VBI class

Some comprehensive motor insurers have previously played in the automotive add-on insurance market and so will have experience, data and (decommissioned) IT systems they could potentially resuscitate.

However, appropriately skilled staff may have already moved on when these classes were abandoned (and perhaps claims data is also now outdated).

Alternatively, comprehensive motor insurers (with or) without that background could partner with [add-on] insurers (or similar) who will now be struggling with selling any insurance business under the DSM but nevertheless have up-to-date data (from which to develop risk-rated pricing), IT systems, and suitably qualified staff to manage warranty claims and policies.

Such a partnership could be based on out-sourcing of claims and policy administration services to the existing warranty specialist and, if the partner entity is also an APRA-regulated general insurer, potentially a quota-share or co-insurance share of the VBI premium.

7. Refining the addressable market

Analysis of VFACTS new vehicle data over the past 10 years shows that Australians have bought over 10 million (non-Heavy Commercial) vehicles, of which around:

- 54% were manufactured by Japanese domiciled OEMs.
- 16% were manufactured by European domiciled OEMs.
- 2% were manufactured by US domiciled OEMs (not including GM/Holden and Ford).
- 28% were manufactured elsewhere (including Korea, China, and Australia).

Australians have therefore been buying vehicles at a rate of more than 1 million per annum for over 10 years. With population growth and eventual restoration of supply chains this is only likely to increase.

Most manufacturers now offer at least a 5-year manufacturer warranty, although the European OEMs have been slower to respond (from early 2020 onwards) and, in some cases, still only provide 3 years.

If the addressable market for VBI is going to comply with ASIC's draft PIO (noted earlier) and meet reasonable limits as to exclusion coverage viability (i.e., up to 12 years/160,000 kms) then it seems reasonable to expect that the addressable market is those vehicles aged around **5 - 12 years old**; currently around **8 million vehicles**, with more than **4 million** of these being the **Japanese** brands.

That is a sizeable new segment by any measure and, assuming a long-term **25%** penetration rate, at an average annual premium per policy of **$500** before government charges (this is a low-side average premium estimate), this could potentially add at least 8m × 25% × $500 = **$1 billion** of GWP to annual Australian general insurance revenues.

8. Annually renewable or multi-Year?

Historically, VBI has been sold most often with a 36-month term, followed by a 24-month term.

However, insurers may prefer the coverage to be provided on an annually renewable basis. The arduous reporting requirements of multi-year business under the new financial reporting standard alone (AASB17) could drive a focus on annually renewable VBI.

Making VBI annually renewable also means it can naturally "dovetail" with the comprehensive motor insurance renewal and can therefore be re-presented to customers regularly as faith builds in the (sub) product (or indeed faith builds in the "Complete" Motor Insurance concept).

I would also expect that, much like comprehensive motor insurance, "new business" will tend to perform worse than "renewals", and the objective would be to focus on retention as much as attracting new business.

Notably, a renewing policy need not be subject to ongoing MISs either. The past 12 months' claims experience arguably tells you more about vehicle reliability than a MIS (and is certainly more convenient and lower cost).

Insurers may also wish to consider the claims experience over the past 12 months in forming a view around the renewal premium. While I would not recommend any form of No Claims Discount scheme be applied to VBI (as you want policyholders to feel free to make valid claims), it does make reasonable sense to consider how to respond to particularly heavy claims experience in the prior 12 months with the renewal premium to be offered (if any).

It therefore needs to be clear to renewing customers that continuing coverage is not guaranteed

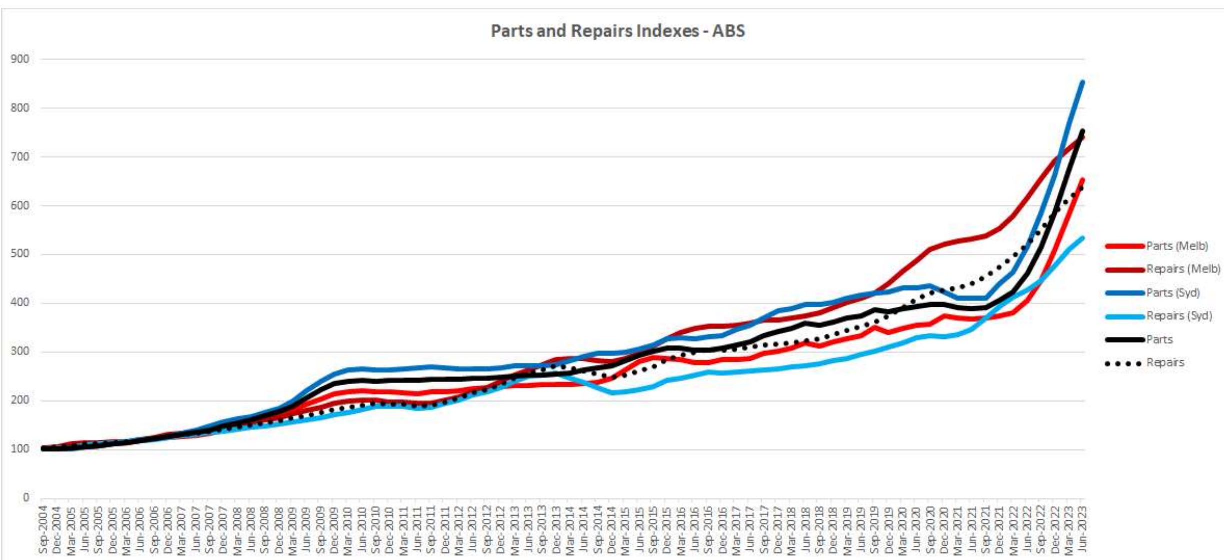
- The vehicle may exceed age and odometer thresholds (which could trigger either a step down from "5-Star" to "4-Star", or expiry of eligibility for coverage)
- If the claims experience in the prior 12 months is particularly heavy, renewal may not be offered

9. Cost pressures on parts and repairs

It might not be too long before customers start to see the benefits of VBI cover.

The following chart is produced from quarterly CPI data (6401.0) published by the Australian Bureau of Statistics (ABS) as of 30 June 2023 in the following series:

- A2328687K and A2328732K for Sydney motor vehicle parts and repair costs
- A2328692C and A2328737W for Melbourne motor vehicle parts and repair costs



It is clear from the above chart that cost escalation in motor vehicle parts and repair costs in the wider market has risen dramatically over the past two years, and especially over the **past 12 months** with

- Parts prices rising by an average of around **64%**
- Repair costs rising by an average of around **22%**

In general, while I would expect that existing extended warranty providers would have been able to contain cost escalation well within the above levels, primarily because of

- Widespread use of good used spare parts (typically provided with a 3-month guarantee)
- The warranty providers' ability to secure better parts and labour costs than stand-alone consumers as a result of providing repairers with a steadier stream of repair work

I would still expect existing premium rates or service contract fees to be under significant pressure.

The ABS do not clarify whether parts costs in their indexes (indices?) above relate solely to **new** parts, but the price of new spare parts has been the subject of much discussion and raised eyebrows at various times over the past 5 - 10 years[9].

In the current inflationary environment, one would have to wonder whether new automotive parts pricing is among the mix when reference is made to businesses taking the opportunity to ride the inflationary wave, and price gouge to boost corporate profits.

A key issue with the viability of VBI might therefore be socialising the acceptability of using good used spare parts on vehicles aged primarily in the 5 - 12 years old vehicle age range.

It could also be argued that good used (or reconditioned) spare parts are more aligned with the insurance principle of indemnification, as opposed to [over-priced] new parts.

Conclusion - ensuring the product is ready for consumption

I believe there is a veritable VBI void (and, as above, "nature abhors a vacuum").

Existing comprehensive motor insurers could readily fill that void with an **annually renewable** exclusion VBI product. Partnering with existing VBI expertise is a straightforward pathway to offering VBI cover.

Regular circulation of offers of VBI with existing comprehensive motor renewal notices and within existing advertising campaigns would seem to be an obvious route to this potential market.

Making VBI an annually renewable product also avoids many of the more burdensome reporting requirements under the new financial reporting standard for general insurers, AASB17.

What about the automotive sales websites?

It also seems plausible that automotive sales websites are suitable places for consumers to buy VBI cover. Any consumer looking for a "new" vehicle will inevitably be thinking about car insurance, pre-purchase inspections and whether the vehicles they like are reliable.

However, as noted above, these websites are also heavily patronised by dealers selling cars, and these dealers also have their own non-insurance warranty (and other product) offerings. Whether this would trigger any kind of dealer boycott of the website is moot - at the end of the day, are there any dealers that can afford **not** to be advertising vehicles on the major automotive sale websites?

However, I'd expect some hesitancy from these websites all the same. Why disturb the peace?

On the other hand, the approach outlined in this paper to risk assessment could potentially push a lot of revenue towards an affiliated vehicle inspection service (at $250 - $300 per inspection) and the website's dominant position may mean that, overall, the proposition stacks up for the website provider.

Value measures

I noted in my Deep-Fried Bananas paper that while loss ratio provided some indication of value, it was not, in all situations, the full picture. VBI is certainly one class of business where the "value" indicated by the loss ratio is not the complete picture.

I noted above that (new) parts prices have been shown on many occasions to be excessive.

The ABS parts and repair cost indexes shown above, and the notable Suncorp example highlighted in the December 2017 ACCC report, should make it clear that Australian consumers pay a hefty price for new spare parts (and repairs).

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[9] A well-publicised case study noted by the ACCC in December 2017 outlined how an insurer (Suncorp) deconstructed the level of "price gouging" in automotive OEM parts pricing. The insurer purchased a basic new vehicle for around **$21k** (fully assembled) and then proceeded to purchase every component part of that vehicle separately. The total cost of parts came to around **$114k** (for a fully dis-assembled vehicle). A **very** expensive kitset.

See s5.3, p140 in [New car retailing industry market study - final report | ACCC]

Now consider the situation where the engine light comes up on the dashboard of an older vehicle (aged 5 - 12 years old) and diagnosis confirms the vehicle needs a new catalytic convertor.

Catalytic convertors can be expensive parts because they contain platinum and palladium (precious metals).

Outcome 1

The owner of the vehicle, who does **not** have VBI, contacts the OEM's franchised dealership for a quote for the repair and the dealership advises the cost of the new part including fitment is $5,000 plus GST (and they have an appointment available in 3 **weeks'** time).

Franchised dealers do not generally source and sell used parts (and they are always busy).

Outcome 2

The owner of the vehicle, who does have VBI, contacts their VBI provider who, in turn, contacts their parts and repair network who then sources a good used part from a recently written-off newer vehicle and advises they can fit this good used part (with a 3-month guarantee) for less than $1,000 within 3 **days**.

Impact on loss ratio

Had the VBI provider supplied and fitted the new part for $5,000, the VBI provider's loss ratio would have received a substantial boost.

Instead, the loss ratio only saw a $1,000 contribution to the numerator.

Does this mean that the owner of the vehicle in Outcome 2 got a poor value outcome?

I don't believe so, either now or in the future. Right now, the insured got a part that was in keeping with the age of the vehicle.

As a result, there will not be anywhere near the upward pressure on VBI premiums because of "over-repairing" the older vehicle with an over-priced new part.

Furthermore, had the (un-insured) owner in Outcome 1 sought to access the used car parts market themselves, they are highly unlikely to have:

- Found a suitable part.
- Managed to get the part fitted for less than what the VBI provider achieved ($1,000).
- Got their vehicle back on the road within 3 days.

In other words, the insured owner in Outcome 2 got "value" from the VBI provider on a number of fronts:

- The repair was cheaper than they could have achieved as a stand-alone consumer.
- The VBI provider was able to source and fit a suitable part in just 3 days because the VBI provider's repairer network will prioritise both the sourcing of parts and their fitment over non-VBI work because the VBI provider sends the repairers a steady stream of ongoing work.

Notably, none of this expertise or convenience in sourcing and fitting the good used part feeds into the numerator of the loss ratio, nor does the lower repair cost contribute to the numerator of the loss ratio in the way fitting the new part would have.

The practice of sourcing and fitting the good used part also keeps future VBI premiums lower.

Note that I am not suggesting that the loss ratio is a completely worthless metric for assessing value.

However, the above examples show that the loss ratio is not the full picture and that other factors also need to be considered in forming an overall assessment of "value".

Perhaps the following schematics summarise the choice of "Value Ratio" best?

$$\text{Value} = \frac{\text{What I } \textbf{\textit{get}}}{\text{What I pay}} \qquad\qquad \text{Value} = \frac{\text{What I } \textbf{\textit{need}}}{\text{What I pay}}$$

One definition of "value" | A **better** definition?

Given the overheads and uncertainty with offering the product, in my opinion, a sound VBI offering could provide a circa **40%** loss ratio and still be reasonable value for money.

If the VBI provider was also consuming **25%** of the premium on overheads (i.e., included in "services" in the above not-to-scale schematic), most of that 25% would ostensibly be for the direct benefit of insured consumers (i.e., arranging lower cost and more expedient repairs that help keep future VBI premiums affordable) and, in any case, the 65% of premium in total is still likely to be less than repair costs the consumer could arrange for themselves (with no price put on convenience).

The balance of the premium could contribute to SEO, branding, marketing, and advertising (and, of course, providing an appropriate return on capital for the insurer).

As a new product, issued and consumed in a different way to predecessor products, there are also the inevitable "unknown unknowns" to be wary of.

While not discussed in any depth in this paper, I also note that annual VBI cover is **not** capital intensive:

- The expected claim frequency is comparable to comprehensive motor.
- The expected average claim size is much lower than comprehensive motor.
- There is very little accumulation risk - OEMs retain the risk for product recalls and the like (and insure their exposures accordingly with Product Recall Liability Insurance).
- Annually renewable VBI therefore ought to be classified as Category A risk under APRA's GPS 115 (although GPS 001 suggests it is Category B - per the previous bullets, I believe this classification is incorrect)
- Further to the previous bullet, I do not believe a VBI provider would need any catastrophe or aggregate reinsurance, but they might well consider the possibility of individual large claims and the need for a per claim excess of loss cover (in the absence of any policy limits - which takes away from the replication of the manufacturer warranty coverage). However, this may well be tied to the VBI provider's appetite for more exotic vehicles (largely European).[10]

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[10] I once got involved with a claim that resulted in a replacement gearbox for an exotic European vehicle. The part in isolation was over $60k, meaning if somebody had lowered it onto a skateboard it would have attracted Luxury Car Tax (at that time) all on its own. No doubt that same part today would exceed the new LCT threshold.

It doesn't have to end there…

Related Opportunities (and possibly a bigger opportunity set than annually renewable VBI)

As noted earlier in this paper, many automotive OEMs have only recently started offering much longer factory warranty terms, typically 5-7 years.

However, with mechanical (and electrical) reliability generally declining with age, and OEMs not previously providing blanket coverage out to 5-7 years, many OEMs (especially non-Japanese) may find their repairer networks are overwhelmed in future (if not already) and that their franchised and other dealers do not have the systems and processes to cope with a continuous torrent of warranty claims on older vehicles whilst also providing a uniformly high quality repair service to their customers.

At this point, automotive OEMs may look to partner with a business (e.g., an insurer) that has the requisite expertise in warranty claims management.

OEMs may also develop an appetite for an underwritten product to get the additional warranty claims liabilities (from the longer warranty period) off their balance sheets (and onto an insurer's).

Similar comments apply to what used to be termed the "Approved Used Warranty", an OEM-backed used vehicle warranty. These offerings could easily be resurrected.

If OEMs did look to the insurance market for support (or were encouraged to consider that support), the obvious place to start is with those providers who have a proven track record of delivering high quality warranty products and services to consumers. There are well-known consumer feedback websites in Australia that constantly show who consumers are currently happy with.

As also noted earlier in this paper, a stand-alone VBI product could also be offered from an automotive sale website. Arguably, this provides an insurer with yet another opportunity to also capture the usual comprehensive motor insurance business from the vehicle purchaser (and to then renew indefinitely with the "complete" motor insurance offering).

Plenty of healthy alternatives to the proverbial DFB.

Wholesome Banana Bread?

Hidden in plain sight?

What has been outlined in this paper is an entirely new market for comprehensive motor insurers that is somewhat analogous to home building insurers suddenly realising they can also insure the contents.

The comprehensive motor insurer already has a rich vein of existing customers, many of whom may be looking for, or are highly amenable to start thinking about, "internal" repair cover for their vehicle as well. All the more so if they have experienced the highly elevated repair costs in the past 12 months.

An existing, satisfied comprehensive motor customer is more likely to look at a new offering from their current insurer than elsewhere. It's convenient and they already have a relationship with the insurer.

The addressable market for an exclusion VBI product is estimated to be around **8 million** used vehicles nationally (aged **5 - 12 years**), with over 4 million of those being Japanese-branded. Japanese-branded vehicles are notoriously reliable and would attract the lowest premiums in a risk-rated market. I estimate this "new" market to have a potential new premium pool in excess of **$1 billion** annually.

Any VBI providers that capture the Japanese corner of the market (with risk-rated premiums) will also put the unregulated, dealer service contract warranty segment under even more pressure - the dealer warranty market has very little risk-rating and relies heavily on Japanese vehicles cross subsidising most other vehicles to remain viable. This could ultimately drive more business to the risk-rated VBI provider.

The point at which a vehicle is bought, when any consumer is thinking explicitly of "external" repair cover, is an opportune time to get them to also consider "internal" repair cover. However, if there is an appropriate selection process (e.g., relying upon a vehicle inspection report), then VBI can be purchased at any time the vehicle is eligible (largely by virtue of age and odometer).

I'd expect existing comprehensive motor insurers to see most potential in an **annually renewable** offering (while the vehicle remains eligible) but, like comprehensive motor, VBI is likely to generate better experience from a renewal book than from new business. Annually renewable business also circumvents some of the more burdensome financial reporting requirements under the new accounting standard, AASB17.

Appropriate risk selection processes, that are not excessively complex, are more likely to be about risk mitigation than risk elimination. There is a trade-off between mitigating anti-selection risk (with an inspection, etc.) and too much complexity in the buying process (which may put the buyer off).

Making customers aware of the new "internal" repair coverage could also be integrated relatively seamlessly within existing branding, marketing, and advertising programmes for comprehensive motor insurance to provide **complete** vehicle protection from the risk of *all* uncertain repair costs. Including a VBI "flyer" with any renewal notice for the comprehensive motor insurance is an obvious route to new VBI customers and should help build familiarity and faith in the product.

Any comprehensive motor insurer that has no prior expertise in, or data history for, VBI could readily team up with an existing add-on insurer or related provider and plug the necessary gaps:

- Developing risk-rated pricing and highly automated underwriting/decisioning processes
- Managing claims and policies

I'd expect existing add-on insurers to be very open to joint ventures in this regard.

Without restricted access to customers, there is no pressure from third parties (e.g., dealers) to

- pay excessive commissions and other incentives (and hence destroy customer value)
- attempt to maintain unsustainable pricing practices (such as community rating).

It's not add-on insurance, it's not subject to the DSM, and so regulators and consumers should not object to a well-constructed, well-priced product that provides clear value to its Target Market.

Put those "squashed bananas" to good use and make some "wholesome banana bread".