



## Focus on **FINANCE**

### Do You Want an Extended Warranty with That?

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#### GLOSSARY

**Coverage:** How much risk or liability is protected with an insurance policy.

**Deductible:** An amount you must pay for expenses before the insurance company pays. The deductible amount is specified by the terms of the insurance policy.

**Premium:** The fee paid for insurance protection.

**Probability:** The likelihood or chance of an event occurring.

**Risk:** The chance of loss.

“Do something today that your future self will thank you for.”  
—Sean Patrick Flanery

When planning for the future, it’s important to factor in the potential for mishaps to occur. One thing many people choose to do is set money aside in the form of insurance should there be an unforeseen mishap. To protect themselves from a financial setback resulting from an accident or other natural hazard, most consumers purchase home and car insurance policies. These policies provide **coverage** that protects your home and vehicle. In addition to home and car insurance, some individuals decide to purchase another form of coverage for more normal “wear and tear” issues. Extended warranties, also known as service contracts, protect consumers from problems with their homes, cars, or even appliances that might arise and that are not covered by traditional insurance. These warranty plans can cover repairs when the dishwasher breaks or a car’s brakes wear out. Providers of service contracts claim they will pay the cost of these repairs in exchange for the **premiums** consumers pay to receive insurance protection.

When it comes to purchasing an extended warranty, there are a wide variety of providers out there, so it is important to do some research before signing a contract. (See boxed insert, “Protect Yourself from Auto Service Contract and Warranty Scams.”) One thing to also consider is self-insuring, which is putting the money you would pay for an extended warranty into an emergency fund. Then you would have the money from the emergency fund available for any possible issues with your home, a car, or an appliance. And if your car or appliance has a long life with minimal repairs, you can put the money toward buying a new one when it finally wears out.

Whether you buy an extended warranty plan or not first depends on how comfortable you are with risk. Those who are more willing to accept personal risk may be much less interested in an extended warranty than those who are less willing to accept personal risk. When a consumer decides to purchase a car or an appliance repair service contract, the premiums each person pays are placed into a collective fund maintained by the provider. In the event of a necessary repair, the extended warranty company pays

### Protect Yourself from Auto Service Contract and Warranty Scams

The following sites provide additional information from the Federal Trade Commission and the Federal Communications Commission for avoiding auto warranty scams:

<https://www.consumer.ftc.gov/articles/0054-auto-service-contracts-and-warranties>

<https://www.fcc.gov/consumers/guides/beware-auto-warranty-scams>

Additionally, the following site provides some tips and questions to ask to avoid an auto warranty scam:

<https://www.idaholegalaid.org/node/1792/how-steer-clear-auto-warranty-scams>

for the repair or replacement of the consumer's insured item. With insurance protection, the **risk** of something going wrong with an appliance or a car is held not just by the consumer, but also by the extended warranty provider. That said, the service contract provider calculates the **probability** a bad event will occur to determine the price a person will pay for insurance. Extended warranty companies must charge their buyers more than what they will likely need in coverage so that the provider makes a profit.

When looking at extended warranty plans, there are many things to consider, including both benefits and costs. The following are some of the benefits:

- **Peace of mind:** By transferring some of the risk of potential repairs to an extended warranty provider, you can have peace of mind in case something goes wrong.
- **Ease of finding a repair person:** When you have a car or an appliance repair service contract, you do not have to find a repair person. Instead, the warranty provider will find someone to fix your items for you.
- **Potential savings:** If you have a costly repair that is covered under your service contract, it is possible that it will cost you less than if you had paid for the repair out of pocket.

On the other hand, the following are some costs to extended warranties that should be considered before signing a contract:

- **Maintenance standards:** Many companies have maintenance standards that must be met for you to receive coverage for repairs or replacements. If a disagreement arises between you and your provider over what "maintained" means, the provider has the power to decide. In some cases, the provider can deny your claim. Also, when purchasing a used car or previously owned home, you have no idea what the previous owners did in terms of "maintenance." Because you're unaware of how items have been taken care of in the past, your claim can be denied by the warranty company because of previous ownership.
- **Double coverage:** Oftentimes, appliances and cars are already covered by a manufacturer's warranty. In addition, some credit cards already provide you free extended coverage when you use the card to make purchases. When buying an extended warranty plan, you may be paying for coverage you already receive for free.
- **Lack of freedom in choosing a service or repair provider:** When your household appliance or car breaks down, it can be nice to save time by having a service provider send a repair person. But if you like to decide who fixes your appliances or cars yourself, you have little to no freedom under a service contract; the provider chooses the repair person for you. If you dislike the repair person or the service they provide, you might not have the option of selecting someone to do the work. The rules of an extended warranty likely require that you use the repair person the provider selects.
- **Length of wait:** Many service contract providers take a long time to make repairs happen, and sometimes the job isn't completed correctly the first time. According to a 2018 Consumer Reports survey, 17 percent of those with an appliance repaired under an extended warranty said it took an unreasonable amount of time for it to be fixed, compared with 9 percent of individuals who paid for repairs themselves. Additionally, it will take even longer if the repair is not done correctly the first time. When it comes to accuracy of the repair, 23 percent of those with a service contract said it took more than one attempt to have their appliances fixed properly versus 15 percent of those who paid to have it repaired themselves.<sup>1</sup>

### Even with a Service Contract, Repairs Aren't Always Free

According to the Federal Trade Commission, some service contracts require consumers to pay a **deductible** or fee each time service work is done, so extended warranty companies do not always provide free service.<sup>2</sup> In addition, when replacing an appliance or auto component, the service provider may give you only the depreciated value of the item in a payout. These values might be based on the age of the appliance or car and would not provide enough money to cover the full cost of the repair. It is also important to make sure you are not being charged interest on an extended warranty plan; for example, sometimes the cost of the extended warranty is rolled into people's auto loans. Including the warranty in the loan means that a buyer is paying interest on the price of the extended warranty, making it even more expensive.

### You May Not Even Use It

According to a 2014 Consumer Reports survey, 55 percent of extended car warranty users didn't use their contract for repairs.<sup>3</sup> It also might not be possible to use your service contract when you do need repairs; if your extended warranty provider goes out of business, you may have paid for a warranty you cannot use.

Let's look at the cost of a repair using a service contract versus putting the money you would have spent on a warranty plan into a savings account or emergency fund. Say you buy a new car and are wondering if you should buy a service contract. According to the same (2014) Consumer Reports survey, the average initial cost of an extended car warranty is \$1,214. For survey participants, the median amount extended warranty users received for repairs was \$837.<sup>4</sup> When subtracting the amount they used for repairs from the average cost of the warranty,

the typical consumer overpaid for their service contract by \$377. In addition, there were likely some consumers who did not use the extended warranty coverage at all. Instead of taking the chance of paying for an extended warranty for car repairs you may not need, it could be better to place the money you would have spent on an extended warranty into an emergency fund for when issues do arise.

### Conclusion

While having some peace of mind when faced with a large, costly repair or having the ease of service providers being picked for you can draw you into purchasing extended service contracts, it might be better to take care of your appliance and car repairs yourself. For a limited number of consumers, an extended warranty might help save money in the case of an expensive repair. However, many consumers end up paying the premiums but use the warranty service for repairs that cost less than the premiums, or they end up not using the warranty service at all. Before sealing the deal for a service contract on a home, a car, or an appliance, be sure to read the fine print and weigh the benefits and costs. ■

### Notes

<sup>1</sup> Consumer Reports. "Extended Warranty Buying Guide." April 25, 2018; <https://www.consumerreports.org/cro/extended-warranties/buying-guide/index.htm>.

<sup>2</sup> United States Federal Trade Commission Consumer Information. "Extended Warranties and Service Contracts." August 2012; <https://www.consumer.ftc.gov/articles/0240-extended-warranties-and-service-contracts>.

<sup>3</sup> Consumer Reports. "Extended Car Warranties: An Expensive Gamble." February 28, 2014; <https://www.consumerreports.org/extended-warranties/extended-car-warranties-an-expensive-gamble/>.

<sup>4</sup> Consumer Reports, 2014. See footnote 3.

Name \_\_\_\_\_ Period \_\_\_\_\_

Federal Reserve Bank of St. Louis *Page One Economics*®:**“Do You Want an Extended Warranty with That?”****After reading the article, answer the following questions:**

1. Extended warranties or service contracts
  - a. highlight the chance of loss from an event.
  - b. pay for expenses before the insurance company pays.
  - c. identify how much risk or liability is protected with an insurance policy.
  - d. protect from problems that might happen and that are not covered by traditional insurance.
2. With an extended warranty, you may still have to pay a
  - a. deductible.
  - b. warranty fee.
  - c. risk premium.
  - d. standard fee.
3. What is the fee people pay for insurance protection?
  - a. Coverage
  - b. Deductible
  - c. Premium
  - d. Risk
4. Insurance coverage refers to
  - a. how much risk or liability is protected with an insurance policy.
  - b. an amount paid for expenses before the insurance company pays.
  - c. the likelihood or chance of an event occurring.
  - d. the chance of loss.
5. Risk is the
  - a. amount of premium paid for a policy.
  - b. coverage required to insure a car or house.
  - c. likelihood or chance of an event occurring.
  - d. chance of loss.

6. What is the amount a person must pay for expenses before the insurance company pays?
  - a. Coverage
  - b. Deductible
  - c. Premium
  - d. Risk
  
7. The likelihood or chance of an event occurring is called
  - a. coverage.
  - b. deductible.
  - c. premium.
  - d. probability.
  
8. Which of the following are potential benefits of extended warranties?
  - a. Peace of mind, ease of finding a repair provider, and potential savings
  - b. Maintenance standards, double coverage, and length of wait
  - c. Lack of freedom in choosing a service provider, peace of mind, and potential savings
  - d. Free repairs, less time spent searching for a repair person, and length of wait
  
9. Which of the following are potential costs of extended warranties?
  - a. Peace of mind, ease of finding a repair provider, and potential savings
  - b. Maintenance standards, double coverage, and length of wait
  - c. Lack of freedom in choosing a service provider, peace of mind, and potential savings
  - d. Free repairs, less time spent searching for a repair person, and length of wait
  
10. Those who are more willing to accept personal risk are more likely to save each month for unexpected events rather than purchase an extended warranty.
  - a. True
  - b. False