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The Service Contracts Model Act: A Quarter Century and Counting—What Now?

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IMPORTANCE In 1995, the NAIC voted to adopt the Service Contracts Model Act (#685)—an act aimed at providing the NAIC membership with a framework for the regulation of the service contracts industry in their respective jurisdictions. The promulgation of Model #685 was noteworthy for several reasons. Arguably most significant was the fact that Model #685 represented a significant regulatory reach into an industry (service contracts) that was widely and legally recognized as not being an insurance contract—a seemingly clear case of regulatory overreach. However, given the NAIC's lack of formal governmental authority, successful adoption and implementation of Model #685 by NAIC membership was a function of the amenability of multiple entities within a given state, including the state legislature, the state insurance commissioner's office, and the state's service contracts industry itself.

OBJECTIVES This paper provides an understanding of the background and context of the service contracts and insurance industries' intertwined relationship and develops an understanding as to why the NAIC ultimately inserted itself into the service contracts industry regulatory environment. A second purpose of the paper is to identify potential sources of future, feasible regulation of the service contract industry and assess whether the insurance regulatory structure might have a role going forward.

FINDINGS Given the rapidly expanding service contracts market, the limited consideration provided by Model #685 may no longer suffice as a feasible regulatory framework and may warrant further consideration. Potential sources of service contracts industry regulation exist at both the national and local levels, each with their respective benefits and drawbacks. Additionally, the sibling regulatory model currently in place may no longer suffice as a regulatory structure for the service contracts industry.

CONCLUSION AND RELEVANCE After consideration of the current needs of the service contracts industry and the potential varied sources of regulatory oversight, the paper concludes that despite the many misgivings associated with the regulation of one industry by the regulatory body of another sibling industry, the NAIC remains, for the time being, the most feasible source for continued regulatory input for the service contracts industry.

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ABSTRACT

The U.S. service contract industry operates largely as a regulatory orphan; i.e., an industry without strong, focused, or consistent oversight coming from any particular authoritative body. That said, 26 years ago, the NAIC—the U.S. insurance coordinating regulatory body—stepped into that void when it promulgated its Service Contracts Model Act (#685) as a measure for the regulation of that industry. Since that introduction, the service contract industry has almost doubled in size, and is still growing at a rapid pace, while the industry inefficiencies that initially precipitated the NAIC's original action persist. Noting the passage of a quarter century, this paper takes the opportunity to reassess the effectiveness of Model #685 and contemplate viable regulatory options for the service contract marketplace. This paper provides a brief summary of the history of the service contract industry in the U.S., efforts to regulate its behavior, and an assessment as to feasible sources of regulation in the future.

Ultimately, the paper concludes that while not without its weaknesses, a second round of regulatory effort on the part of the NAIC—i.e., a Model #685 2.0—would be the most feasible path of instilling some additional level of regulatory oversight on the service contract industry.

Key terms: Extended warranties, service contracts, vehicle service contracts, Service Contracts Model Act, insurance regulation, National Association of Insurance Commissioners

Introduction

In 1995, the NAIC voted to adopt Model #685—an act aimed at providing the NAIC membership with a framework for the regulation of the service contract industry, also commonly referred to as extended warranties.[1, 2, 3, 4] The promulgation of Model #685 was noteworthy for several reasons. Arguably most significant was the fact that while Model #685 explicitly noted that service contracts were not insurance, it subsequently advocated for the regulation of service contracts by the insurance regulatory system. Thus, we have the recognized regulatory authority of one industry asserting its authority over another nonaffiliated industry—a seemingly clear case of regulatory overreach. With the adoption of Model #685 and explicit, or tacit, acceptance by the legislative branches of the NAIC's state membership, the U.S. insurance regulatory system was ensconced as a *de-facto* regulating body over the service contract industry, albeit with virtually no actual enforcement authority. As one might expect, this extension of regulatory oversight was met with some confusion and skepticism from some corners. In an endeavor to clarify the NAIC's rationale for its action, 10 years after the adoption of Model #685, the former subgroup chairman of Model #685 took the unusual step of issuing an affidavit aimed at clarifying the motives for the original promulgation of Model #685, stating: "… It [service contracts] was determined to be a product that should be regulated and that while not insurance, could be most efficiency regulated by State Insurance Departments."[5] While perhaps accurate in sentiment, what was not explicitly recognized is that the broader public chronically confuses service contracts with insurance contracts; the public essentially considers both products to emanate from the insurance industry. While neither industry enjoys a particularly positive image with the public, consumer protection organizations and the popular media have historically painted a particularly negative image of the service contract industry. At the same time, the insurance industry has invested significantly in its efforts to improve its public image over recent decades. Thus, consumer confusion and a continued business-as-usual attitude by the service contract industry has, to some degree, contributed to the persistent negative perception of the insurance industry in a "guilt-by-association" perspective on the part of the public. In the hopes of modifying the service contract industry's behavior, the NAIC promulgated Model #685. Now, a bit more than a quarter century removed from the formal adoption of Model #685, we find that while the service contract market has grown significantly,

1. The NAIC is the U.S. standard-setting and regulatory support organization created and governed by the state insurance regulation departments of its members. Notable is the fact that while NAIC members have formal regulatory standing in their respective jurisdictions, the NAIC does not possess formal governmental authority at the state or federal levels to direct activities in its members' respective jurisdictions. The NAIC focuses on several key market functions, including insurer and producer licensing, product regulation, market conduct, financial regulation, and consumer services.

2. Service contracts are not to be confused with manufacturer warranties, which are part and parcel of the sale of the underlying asset that forms the basis for the contract, or maintenance contracts, which provide for regularly scheduled maintenance of the underlying asset.

3. The complete text of Model #685 is available online at *content.NAIC.org/sites/default/files/inline-files/MDL-685.pdf.*

4. The vote for adoption was unanimous with the lone exception of the Illinois member.

5. The affidavit effected in Alabama and executed by Michael Bownes, the then chairperson of the Model #685 subgroup, was accessed through a request made to the NAIC Research Library.

and continues to do so, it still ostensibly represents the same negative connotations for the insurance industry.

Was the promulgation of Model #685 a mistake? Was it warranted? Was this regulatory incursion even legal? This paper provides the reader with an understanding of the background and context of the service contract and insurance industries' regulatory relationship and develops an understanding as to why the insurance industry felt compelled to insert itself into the regulatory environment of the service contract industry. A second purpose of the paper is to identify potential sources of future, feasible regulation of the service contract industry and assess whether the insurance regulatory structure might have a role going forward. Participants in both the insurance and service contract industries should find this discussion of interest. However, it is the state insurance regulators, especially those in the insurance industry at both the state and federal levels, who will likely find this paper of acute interest.

Background

First emerging in the U.S. during the late 1930s and early 1940s, service contracts are now commonplace in a variety of markets, such as automotive, electrical appliance, and jewelry.[6] With revenues having increased by over 50% during the 2008–2018 decade (Warranty Week, 2018), Allied Market Research (2021) anticipates another surge when 2019 revenues of $49 billion are expected to reach $59 billion by 2028; i.e., a compound annual growth rate of 4.6% over the 2020–2028 period. Holding a 37% market share based on revenues, the vehicle service contracts (VSCs) segment alone is expected to increase to $45 billion by 2024, a 28% increase over its 2018 levels (Colonnade Advisors, 2017).[7]

Along with the steady growth of the service contract industry over the latter portion of the 20th century, came a debate as to whether such contracts were in fact insurance contracts and if so, whether they would be more properly regulated under the insurance umbrella. Up to that point, the service contract markets were largely regulated by local jurisdictions in an ad hoc fashion with little to no unifying oversight. Indeed, potentially related federal regulation was careful to specifically *exclude* service contracts from its purview, instead focusing more specifically on *manufacturer* warranties.[8] The consistent growth of the service contract industry, along with its seemingly steady hum of negative attention in consumer protection publications, was likely viewed in a less-than-positive light by the insurance industry. With its relatively more cohesive and organized industry infrastructure, the insurance marketplace has been actively engaged in concerted efforts to improve its public image. At the same time, the

6. In addition to the dominant vehicle service contracts (VSCs) segment, other major markets include: consumer electronics (15%); PC original equipment manufacturers (OEMs) (10%); jewelry (7%); home warranties (6%); appliances (3%); furniture (3%); and mobile phones (19%). Market share of industry revenues are presented in parentheses. Source: Warranty Week (2018).

7. While a rigorous review of the structure and operations of the service contract industry is beyond the scope of this current paper, Hayne (2001) provides a good description of the various distributional models employed within the industry. Warranty Week and Colonnade Advisors also serve as sources for regularly published summaries and focused reports related to the service contract industry.

8. See the McCarran-Ferguson Act and the Magnuson-Moss Warranty Act.

comparatively fragmented and less organized service contract industry has been less engaged on that front.

Over this same time period, the courts were busy adjudicating related case law, and legal scholars, with an eye on differentiating service contracts from insurance, have been engaged in significant discourse in describing exactly what constituted an insurance contract (Hellner, 1963; Dennenberg, 1963; McLemore Jr., 1975).[9] The formal debate as to the differences, or lack thereof, between insurance and service contracts was a byproduct of the broader public's same confusion; consumers largely failed to differentiate between the two products, resulting in a negative contagion effect from the perspective of the insurance industry, which is discussed more fully below. Thus, while the NAIC may have indeed been correct in its position statement that while not insurance, the insurance regulatory infrastructure was best positioned to regulate the service contracts industry. What is less clear are the motives for the involvement of the state insurance regulators in the regulation of the service contracts industry.

Are Service Contracts Insurance?

At the crux of this question is the fact that the consuming public generally perceives service contracts to be insurance contracts, and as such, consumers presume that the contracts offer similar services and are similarly regulated, which is a flawed assumption. While similar in some respects, service contracts differ from insurance contracts in a few fundamental, albeit nuanced, ways. For example, insurance contracts require that "accidents" be the source of covered damage while specifically excluding damages caused by defect and/or wear and tear. Conversely, service contracts traditionally limit their coverage to defects and damage *caused* by wear and tear.[10] Because of differences like these, insurance and service contracts are typically differentiated in the eyes of the legal system and have allowed service contracts to escape insurance-like regulation.[11] As noted above, the broader debate has been the subject of significant legal, academic, and legislative scrutiny for many decades leading up to the eventual promulgation of Model #685. As defined by Model #685, a service contract is:

> … a contract or agreement for a separately stated consideration or for a specific duration to perform the repair, replacement, or maintenance of property for the operational or structural failure of any motor vehicle, residential or other property due to a defect in materials, workmanship, or normal wear and tear.

Model #685 goes on to specifically note that service contracts are *not* insurance. That said, even 26 years after the adoption of Model #685, the debate still resurfaces occasionally as an unsettled matter in case law litigation.[12]

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9. Samini (1993) provides a good summary of the then shifting legal environment on the subject.

10. For further discussion of the nuanced differences please see Casey and Gillum (2017) and Casey and Gillum (2019).

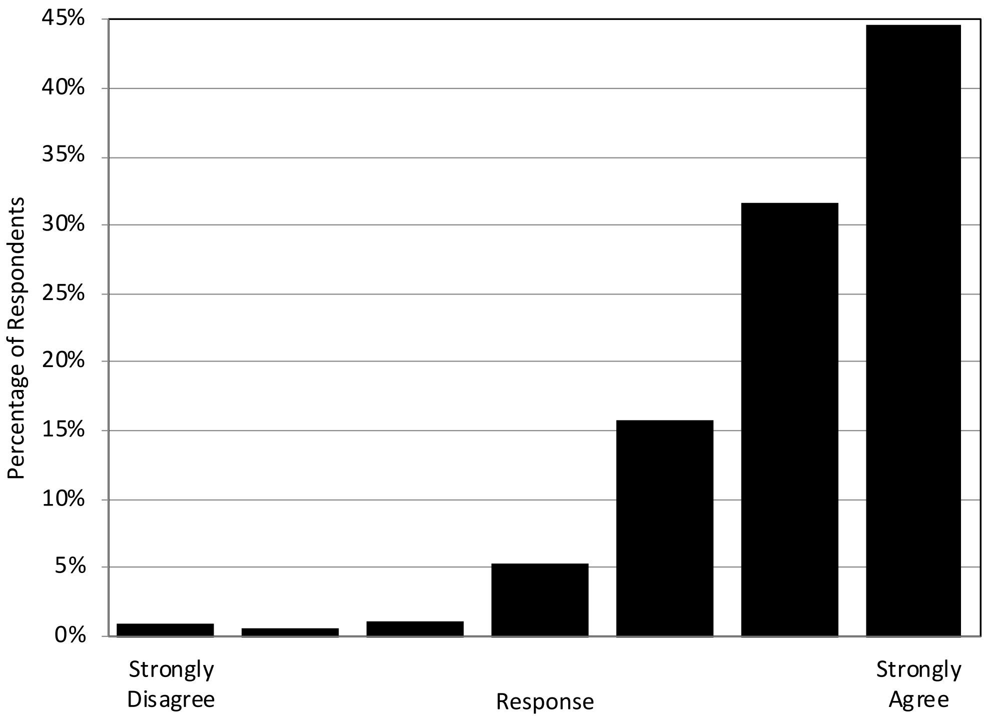
11. For further discussion related to the regulation of the insurance industry, please see Grace and Klein (2009).

12. As a case in point, see West Virginia's federal court decision in the *Bare v. Innovative Aftermarket Systems LP* decision (2017 U.S. Dist. LEXIS 68746, S.D.W.V. May 5, 2017), where the tenuous ability to differentiate between service contracts and insurance is being slowly eroded.

Legal, Legislative, and Consumer Confusion

Thus, within the current legislative and legal realms, service contracts and insurance are generally perceived to be separate products. That said, the same perception is not shared by the broader public. Indeed, in one of the few studies on the matter, Ishida et al. (2013) asked 300 new car buyers who were presented with the option to buy an associated VSC whether VSCs and insurance are the same thing, and an overwhelming majority of the participants—92%—agreed with the statement. Presenting the results on a Likert scale from one to seven (see Graphic 1) where one was "Strongly Disagree" and seven was "Strongly Agree," the mode response value was a seven.

Graphic 1: Are VSCs and Insurance the Same Thing?



Source: Ishida et al. (2013).

The insurance industry could quickly dismiss this point of confusion if it were not for the implications of the negative perception of the service contract industry. While consumers believe service contracts and insurance are essentially one and the same; service contract regulation pales by comparison. Whereas the insurance industry is functionally regulated by a complex system of state-level regulatory offices, replete with tomes of legal and regulatory guidance, along with a virtual army of bureaucrats implementing the system, Model #685 includes but seven pages of regulatory suggestions without any formal system of implementation, other than the insurance industry regulatory system's willingness to allocate its time and resources to it.[13]

Consumer Perception

As noted above, neither the insurance industry nor the service contract industry is held in particularly high esteem by the consumer. Rudden (2018) found that consumer trust of insurance companies is relatively low, with 38% of those surveyed reporting that they trusted insurance companies only a little, 26% not very much, and 17% having no trust at all. Gallup's Honesty and Ethical Standards survey (Reinhart, 2020) asked about consumer perceptions regarding the trustworthiness of over 200 occupations, and it found that insurance agents finished almost at the bottom of the list, tied with federal senators, and only trivially more trusted than members of the U.S. Congress (Congress) and used car salespeople. This negative perception of the industry is not a recent development, but rather, it has been evidenced over many decades (de Bettignies et al., 2006). INSEAD reports, "… it is also undeniable that the (insurance) industry suffers from a negative image in the public opinion; on closer inspection, it appears that the image of the insurance industry in the public opinion is blurred, if not squarely bad." With respect to the service contract industry, consumer reports, better business bureaus, state attorney general offices, and broader public media have all negatively reported on the industry's inflated prices and questionable contract value (Consumer Reports, 2011; Consumer Reports, 2012; Bartlett, 2018; Jensen, 2021). Nowhere has that negative attention been more focused than for VSCs, the largest industry segment of service contracts. Federally sponsored consumer watch-dog groups routinely warn against purchasing VSCs. See the Consumer Federation of America (CFA)/North American Consumer Protection Investigators (NACPI) (2016) annual *Consumer Complaint Survey Report* explicitly warning its readership to, "Resist pressure to buy extended warranties or other expensive add-ons when you purchase a car. They're usually not worth the cost and don't provide much more protection than you already have under the (manufacturer) warranty and your insurance coverage." Indeed, when discussing the value of VSCs, money expert and radio talk show host, Dave Ramsey stated, "The fact is, extended warranties are overpriced. That's the reason people sell them, because they make a bundle on them in commissions. I don't recommend buying extended warranties, ever" (Bartlett, 2018). Colonnade Advisors (2013) notes that the distributor markup on the sale of VSCs is often as high as 100%. Given these margins, it is perhaps not surprising to find that dealerships' Finance

13. For the convenience of the reader, the table of contents of Model #685 includes:

Section 1:	Scope and Purposes
Section 2:	Definitions
Section 3:	Requirements for Doing Business
Section 4:	Required Disclosures—Reimbursement Insurance Policy
Section 5:	Required Disclosures—Service Contracts
Section 6:	Prohibited Acts
Section 7:	Recordkeeping Requirements
Section 8:	Termination of Reimbursement Insurance Policy
Section 9:	Obligation of Reimbursement Insurance Policy Insurers
Section 10:	Enforcement Provisions
Section 11:	Authority to Develop Regulations
Section 12:	Separability Provision

and Insurance (F&I) departments are commonly auto dealerships' most profitable source of income.[14] Thus, while both industries struggle with their respective public image, the service contract industry would seem to have been uniquely singled out by consumer protection groups for its usury pricing and business practices.

The State of Service Contract Regulation Since the Adoption of Model #685

The actual adoption of Model #685 proposals by the NAIC membership has been inconsistent; state regulatory offices picked and chose various aspects of Model #685 to adopt while ignoring other elements (Schmitz, 2012; Marro & Smart, 2012; Lunt, 2016; Casey & Gillum, 2019). Lunt characterized the state-by-state adoption process as falling into one of the following four general categories:

- Broad adoption of Model #685 elements by the departments of insurance (DOIs) in more than 30 states.
- Exclusionary regulations where service contracts and the obligors that provide them are usually still under the oversight of the DOI, but specific service contract laws either remove or reduce the burdens of compliance. A few states have adopted this approach.
- Limited or no regulation. Laws are silent or unclear. A very limited number of states have adopted this approach.
- Quasi-insurance, where service contracts are regulated as if insurance. This approach has been adopted only by Florida.[15]

In a similar vein, Myers (2003) suggests that many state-level adopters of Model #685 were solely focused on their application of those standards to the VSC marketplace, as opposed to a broader application to the state's entire service contract marketplace. Some suggest that as few as seven states fully adopted Model #685 (Marro & Smart, 2012). Suffice to say, in addition to a fragmented pattern of adoption by the NAIC membership, assessment of those patterns of adoption by various investigators has also been somewhat inconsistent. Given the widely divergent character of the industries selling service contracts (e.g., auto, home warranty, jewelry, etc.), these inconsistencies should not be surprising; there is little reason to think that a one-size-fits-all formula would be effective across these significantly divergent markets.

Now, 26 years since the adoption of Model #685, despite the industry's poor reviews, a significantly larger and still growing service contract industry, and a market still lacking even modest regulatory comparability across state jurisdictions, there is continued anecdotal evidence that the industry's reputation with the public is still poor. If those same conditions that first prompted the NAIC to act in 1995 still largely persist today, and are now arguably even more acute, then it might be time for interested parties to revisit the current state of the regulation of the service contract industry.

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14. 93% of all VSCs are negotiated and sold at the time of the purchase of a new or used automobile, as opposed to being sold as an aftermarket purchase through other channels.

15. Spahn (1996) addresses Florida's regulation of service contracts at length.

Regulation of the Service Contracts Market Going Forward

Regulation is not necessarily a panacea for all marketplace dysfunction. While the intent of regulation is to correct/avert marketplace dysfunction, it may also invite additional costs. Consider the following:

Benefits of Regulation

- It endeavors to provide for the safety of consumers.
- It seeks to protect the safety and health of the public, as well as the environment.
- It promotes the stability of the broader economy.

Costs of Regulation

- The creation of a government bureaucracy that may inhibit growth.
- The facilitation of the creation of monopolies that result in increased prices to consumers.
- The inhibition of innovation due to over-regulation.

Thus, the regulatory path of a given market is seldom couched in absolute terms, but rather it is typically a question as to the "proper degree" and character of marketplace regulation, if any at all. Regulation as a solution should not be a foregone conclusion but rather a measured decision based on the market's specific character of operational inefficiency. To the extent that insurance and service contracts are, at the very least, commonly perceived to be sibling commodities, we look to the insurance regulatory framework to assess what, if any, regulation of the service contract industry might be appropriate.

Under the U.S. federalist model of shared regulatory authority by both the state and federal governments, insurance regulation consists mostly of state laws and other regulations regarding the solvency and markets of insurance companies. Rejda and McNamara (2016) note some of the relative advantages specifically associated with federal versus state level regulation:

Advantages of Federal Regulation

- Uniform state laws and regulation.
- More effective negotiations of international agreements.
- More effective treatment of systemic risk.
- Greater efficiency of insurers.

Advantages of State/Local Regulation

- Quicker response to local insurance problems.
- Promotion of uniform laws by the NAIC.
- Greater opportunities for innovation.
- Unknown consequence of federal regulation.

Certainly, all goals noted above possess value, but some qualities are likely more attainable through regulation at one level versus the other; given the general abdication of federal-level guidance to the service contract industry, efforts to regulate the service contract industry have been largely relegated to state-level efforts, such as Model

#685. Traditional public interest theories of regulation—i.e., normative theories as to how the system *should* operate—suggest that insurance regulation exists to serve the public interest and often identify the following as key goals:

- Maintain insurer solvency.
- Protect consumers.
- Make insurance available to people who, because they are poor risks, might otherwise be unable to get it.
- Regulate premium rates.

What Regulation Does the Service Contracts Industry Need?

Two basic categories of market regulation include oversight of insurer solvency and market regulation. *Solvency regulations* seek to ensure that the financial strength of insurers is maintained and remedy the effects of an insolvency when it occurs. *Market regulation* seeks to ensure the fair treatment of policyholders; prevent discrimination and dubious claim practices; and regulate advertising and other marketing, underwriting, claims payment, rates charged, and insurance policies. State insurance regulatory agencies also prohibit unfair or deceptive procedures when selling policies, settling claims, and other procedures with an overarching goal of protecting the consumer. Despite the limited scope of Model #685, it should be noted that it does specifically address the normative issues of service contract administrator solvency (Section 4) and market regulation in the form of consumer protection (Sections 5 and 9) (see footnote 13 above for a summary of Model #685 content). However, noticeably lacking from Model #685 is any specific discussion of price regulation, which is arguably the core consumer complaint with respect to service contracts.

In their assessment of the regulation of the U.S. service contract market, Pope et al. (2014) proposed three tractable suggestions to improve the operations of the system:

- Eliminating the situational monopoly.[16]
- Simplifying contractual language.
- Seeking consistency in regulation.

Taken together, these three suggestions would be expected to introduce price competition by dismantling the situational monopoly; enhance consumer understanding, requiring specific, simpler contract language; and introduce a mandated degree of product consistency across the U.S. market. While feasible in concept, implementation within the fragmented U.S. regulatory marketplace is another matter. Arguably, the most daunting task would be to impose regulatory consistency across the many NAIC jurisdictions, a matter that, given the advisory nature of the organization, would seem difficult without federal government involvement that could impose some degree of mandated consistency across jurisdictions.

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16. A situational monopoly exists when a seller is the only supplier of a certain product or service to customers in a combination of markets, needs, times, and positions. While service contracts may be sold in a variety of settings, the situational monopolistic setting is by far the most common. Elimination of the situational monopoly in this setting would presumably provide the consumer with alternative choices, resulting in a more competitive price environment; i.e., reduce the product price. For more on the topic of situational monopolies, please see Trebilcock (1993).

Thus, the matter of regulation of the service contract industry is complex for multiple reasons. The first is the lack of a formal governmental entity at any level that might assume broad regulatory responsibilities. A second issue is the "proper" role, if any, of insurance regulatory authorities. The last issue is at which level, local or federal, such regulation might manifest itself. The next section of this paper endeavors to identify the feasible sources from which service contract regulation might emanate and, in turn, discusses the feasibility of each possibility and associated implications.

Potential Sources of Service Contract Market Regulation

As noted above, the NAIC operates as a unique regulatory hybrid model, where it operates as a non-governmental association whose membership possess state-level governmental authority over their respective jurisdictional insurance markets, typically on a state-by-state basis. To the extent allowed by each respective state's legislature, the NAIC can influence the regulation of the state's service contract industry, which is largely defined by the parameters outlined in Model #685. Thus, the regulatory authority of the service contract markets in the U.S. defies easy categorization as a regulatory body. Putting aside any current role the NAIC might have in the future regulation of the service contract markets, this paper now turns its attention to the identification and discussion of potential sources of regulation of that market, including federal, state, and even non-governmental sources

Federal Oversight

While regulatory oversight of the service contract industry has traditionally been administered at the local/state level, it need not be the only regulatory model worthy of consideration. Indeed, given the current highly fragmented service contract regulatory framework across state jurisdictions, a powerful argument can be made for a more centralized model emanating from the federal/national level. Two commonly cited advantages associated with national-level regulation are uniformity and efficiency across jurisdictions, something the service contract industry currently lacks. In this context, a handful of federal agencies represent potential state insurance regulators, and a few stand out as relatively more feasible alternatives. For example, consider the roles that might be played by the Federal Trade Commission (FTC), the Consumer Financial Protection Bureau (CFPB), and the Federal Insurance Office (FIO).

Well before the emergence of Model #685, legal scholars noted and promoted federal-level regulation of the service contract marketplace through the FTC (Myerscough, 1979). The FTC's stated purpose is to protect consumers and competition by preventing anticompetitive, deceptive, and unfair business practices through law enforcement, advocacy, and education. Proponents argued that by utilizing a more uniform, less costly, and less restrictive control of service contract sales than that imposed by multiple state regulations, the FTC could help the consumer and the service contract industry to interact more efficiently. While the FTC has demonstrated a modest level of interest in such regulation with its creation of a service contract reporting hotline at its Consumer Information web page, *ftc.gov/about-ftc*, these efforts represent a *post*-incident solution on a case-by-case basis as opposed to a proactive regulatory endeavor proscribing appropriate behaviors.

More recently, the CFPB has been identified as a possible source for federal regulation of the service contract industry.[17] Created as part of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the CFPB's stated goal is to "empower consumers with information they need to make financial decisions in their own best interests," and it has the authority to supervise and regulate entities that offer or provide consumer financial products or services. Additionally, the CFPB has the power to stop practices that are "unfair, deceptive, or abusive." While the powers afforded the CFPB a hint at its authority to regulate service contract-type agreements, such authority would likely only be granted when those contracts are part of a financing arrangement, likely associated with the purchase of the underlying asset to which the service contract applies (Casey, 2013). However, as of this writing, the CFPB has yet to indicate an interest in asserting/testing such authority. It should also be noted that the FTC shares authority with the CFPB to enforce the consumer protection laws with respect to non-bank financial institutions.

The FIO exists as the central regulatory agency for the insurance industry in the U.S. While the matter of differentiation between service and insurance contracts is currently a largely settled matter, it is possible that, paralleling the regulatory experience at the state level, the FIO might interject itself into the service contract market environment in a manner similar to the NAIC's participation in the regulation of the service contract market. That said, there has been no overt indication of an interest in the regulation of the service contract market by the FIO.

While federal regulation may indeed offer economies of scale, as well as a potential for more competent state insurance regulators, arguments against federal-level regulation suggest that such regulation would be weaker in terms of innovative advancements and state-specific needs due to a diverse geographical and socio-cultural landscape.[18] Despite that potential, federal agencies have thus far displayed scant interest in the regulation of the service contract industry.

Self-Regulation

Another source of potential national-level oversight might come in the form of self-regulation. Self-regulation, in all its permutations, is a vital part of many industries. The private sector relies on self-regulation to address a range of issues, from establishing industry standards, to developing and applying codes of professional ethics, to ensuring consumer confidence. Despite its widespread use, some policymakers are skeptical of the efficacy of self-regulation when it comes to truly protecting the consumer. While self-regulation can sometimes be more efficient for a given industry when compared to government regulation, self-regulation commonly lacks any coercive authority and instead relies on the voluntary compliance of its membership. Additionally, self-regulation may suffer from inherent conflicts of interest resulting in less-than-ideal outcomes.

17. The federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is available online at *congress.gov/bill/111th-congress/house-bill/4173/text*.

18. For more on the respective benefits and drawbacks of state and federal-level regulation please see Randall (1999).

While no jurisdiction expressly regulates its service contract industries solely via self-regulation, jurisdictions that largely eschew available formal regulatory models, such as Model #685, are possibly more likely to, but not expressly, rely on the service contracts market's efforts at self-regulation. That said, it should not be assumed that these markets operate in a formal regulatory void or are operating solely under a self-regulatory model, but rather their respective regulatory models are more likely to reflect a co-regulatory environment, discussed below, with perhaps relatively more oversight emanating from an industry association or consortium.

The service contract industry has a significant history of self-regulation efforts, even preceding the NAIC's initial adoption of Model #685. For example, the Service Contract Industry Council, first formed in 1988, maintains a strong presence at the industry association level. More recently, some segment-specific associations have surfaced, focusing specifically on the VSC marketplace, such as the Motor Vehicle Protection Products Association (MVPPA). Others, such as the Voluntary Protection Products Coalition, exist to help coordinate the broader efforts of these various associations themselves. Still others have come and gone in the last quarter century (e.g., the Vehicle Protection Association [VPA]). While the presence of self-regulators in the service contract marketplace is without question, their effectiveness in achieving professed altruistic goals (e.g., the protection of consumer interests) is difficult to clearly assess.

Non-Model #685 State/Local Regulation

As noted earlier, jurisdictional adoption of elements of Model #685 has been inconsistent and difficult to accurately assess. Indeed, according to Schmitz's (2012) assessment, eight states have eschewed the adoption of any Model #685-specific guidelines and instead endeavor to regulate their state's service contract industry without explicit Model #685 guidance.[19] Instead, such states might typically rely on non-insurance regulatory authorities for marketplace oversight, including state attorney generals who, much like the FTC's involvement at the federal level, are charged with leading consumer protection efforts on a *post*-incident basis within their respective states. Less authoritative entities may also serve a role in mitigating undesired behavior in the service contracts market, such as local better business bureaus, etc.

While state-level service contract regulation has been delivered via the NAIC's involvement through Model #685, it should be noted that formal state legislative bodies can also impose regulation wholly separate from any similar regulation emanating from the states' insurance regulatory offices. For example, a given state's legislative body could conceivably create a separate service contracts regulatory office, if it were so inclined. One potential benefit of more localized oversight is that such regulation is typically perceived to be more responsive to apparent problems/issues, as well as providing more opportunities for innovation.

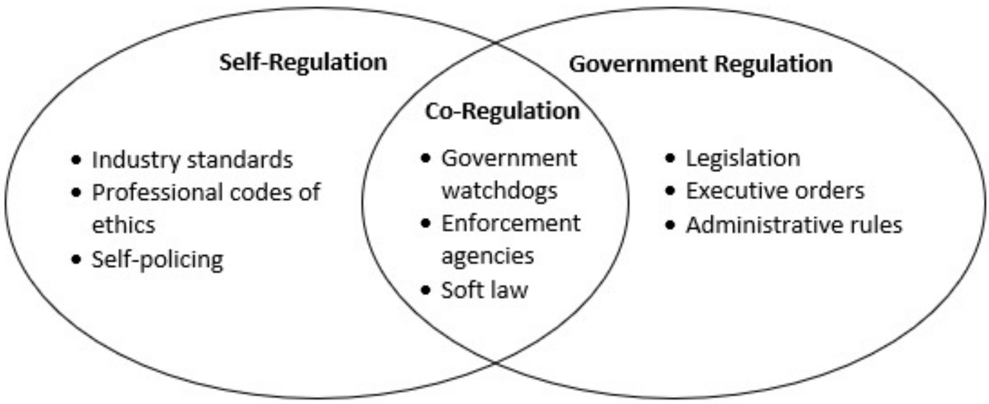
A Regulatory Spectrum

Thus, the potential regulatory spectrum of the service contract markets includes potential regulation at both the local/state level, as well as from the national/federal

19. This includes Delaware, District of Columbia, Indiana, Michigan, New Jersey, Pennsylvania, South Dakota, and Tennessee.

level. Graphic 2 describes the poles of the spectrum that are anchored by self-regulation and government regulation, respectively.[20] In reality, few actual examples exist at the extremes, but rather most current examples represent more amorphous forms of regulation that occupy positions more toward the central portion of the graphic, generically defined by the co-regulation cohort.

Graphic 2: Regulatory Spectrum



Source: Adapted from Castro (2011).

Reconceptualizing Service Contract Regulation

Aside from the various levels of potential regulation addressed in the preceding section, the service contract industry is imbued with its formal regulation in most jurisdictions by the insurance industry. Thus, the regulatory framework of the service contract industry is not only described by potentially differing sources of regulation (e.g., local versus national) but also to the degree to which the local insurance regulatory system affects its operations. This next section presents a conceptualization of the regulatory framework facing the service contract industry incorporating both dimensions, the loci of regulation (e.g., local or national), and the degree of insurance regulatory involvement.

Regulation may come in a variety of forms and from several sources. Governmental regulation is commonly differentiated based on its origin (e.g., either emanating from either the federal or state level).[21] Similarly, *non-governmental* oversight might emanate from relatively more local sources or possibly even from national entities, as might be the case with a national trade association. The nexus of these two dimensions, the level

20. The now defunct VPA is an example of the VSC industry's efforts at self-regulation. First organized in the early years of the 2000s, it was disbanded by 2015. For more details, see Warranty Week (2010).

21. For a discussion as it pertains to U.S. insurance regulation, see the NAIC's publication, Federalism and Insurance Regulation, available online at naic.soutronglobal.net/Portal/Public/en-GB/DownloadImageFile.ashx?objectId=4455&ownerType=0&ownerId=2557. For the purposes of this paper, we ignore the implications of international insurance regulation, as it has no implications for the regulation of the U.S. service contract market. However, for those interested in the topic, see the NAIC's publication, *International Insurance Supervision/IAIS,* which is available online at content.NAIC.org/cipr_topics/topic_international_insurance_supervisioniais.htm.

of the regulatory source, and the involvement of the insurance regulatory framework are presented in Graphic 3. Four pairs of regulatory descriptions, enumerated as Quadrants I, II, III, and IV, are identified and discussed in terms of their feasibility/likelihood as sources of potential service contract market regulation moving forward. Notable within this framework, Quadrant I most closely describes the NAIC's involvement in state service contracts markets, and according to Schmitz's (2012) assessment, it would aptly describe the majority of the NAIC membership. A lesser number are associated with Quadrant III. Quadrants II and IV require national-level regulation oversite, of which none now currently exists. Thus, within the context of this framework, those two quadrants are not associated with current service contract regulation.

Graphic 3: Regulatory Authority Conceptualization

		Regulatory Level: Local	Regulatory Level: National
Insurance Regulatory Umbrella	Yes	State/local oversight under the insurance regulatory umbrella (I)	(II) Federal/national oversight under the insurance regulatory umbrella
	No	(III) State/local oversight *without* insurance regulatory influence	(IV) Federal/national oversight *without* insurance regulatory influence

Quadrant I

Quadrant I includes state/local oversight with insurance industry regulatory influence. This quadrant connotes the current character of service market regulation in most states where the dominant oversight comes from each jurisdiction's respective insurance regulatory office, but the nature of this regulation is not necessarily comprehensive for the service contract industry. As noted above, the NAIC is only advisory in its authority, and states have inconsistently adopted various elements of Model #685. The merits and deficiencies of the system have been discussed at length earlier in this paper, and Schmitz (2012) suggests that 42 states already generally reflect this profile.[22]

Quadrant II

Quadrant II connotes federal/national-level oversight under the auspices of the insurance regulatory system. At the federal level, the insurance regulatory authority is vested in the FIO, and to date, it has not yet demonstrated any overt interest in the regulation of the service contract industry. This seeming indifference is likely prompted

22. This includes Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

by a handful of issues, including the comparatively small market the service contract industry represents relative to the U.S. insurance industry. Additionally, the character of the services provided by service contract industry do not represent a systemic risk to the broader U.S. economy; thus, they do not typically warrant significant attention at the federal level The federal government has largely deferred any involvement in the regulation of the service contract marketplace.

Quadrant III

Quadrant III describes the efforts of a state/local jurisdiction to regulate its own service contract marketplace *without* the overt influence of the state's insurance regulatory system (e.g., without the specific adoption of Model #685 elements). Failing the involvement of state insurance regulators, state legislatures and non-insurance regulators are left to cobble together their own system of oversight for the service contract markets, etc. Such regulation may take the form of attorney general oversight, state-level legislation aimed specifically at service contract industry, the promotion of informal oversight by local better business bureaus, etc. Per Schmitz's (2012) assessment, only the eight states identified in footnote 21 above share this regulatory profile.

Quadrant IV

Quadrant IV includes federal/national level oversight *without* the involvement of the insurance regulatory system. As noted in the discussion of Quadrant II, the lack of a broad systemic threat to the U.S. economy likely plays a significant role in the lack of regulatory interest at the federal level. While the relatively recent creation of the CFPB may hold some, albeit limited, implications for potential service contract regulation, the Bureau has yet to actively test the extent of its authority in that arena.

Industry self-regulation also presents itself as a potential option falling within Quadrant IV (see the above discussion associated with footnote 21 for more commentary). Most likely, industry associations will continue to coordinate some industry standards on a voluntary basis, but they will not play a significant role in the industry's regulation in the near future simply because they lack any coercive authority. Rather, industry association efforts will more likely take the form of preemptive efforts to stave off further regulatory attention from governmental authorities.

Potential Regulatory Roadmap - Where to Go from Here

A little more than a quarter century has now passed since the adoption of Model #685, and the conditions that first prompted the NAIC to act remain and can be argued to have become even more acute. While consumer protection groups continue to warn consumers to beware when considering service contracts, the industry continues to grow at a vigorous pace, which is driven largely by the VSC market. At the same time, the insurance industry still struggles to improve its image with the public, and consumers still commonly view service and insurance contracts as essentially the same product fostering the negative contagion effect that initially attracted the insurance industry's concern.

With seemingly little motivation for intervention at the federal level, any and all efforts intended to mitigate the negative contagion effects of the service contract industry's reputation would seem, by default, to fall to state and local-level efforts.

While not an exhaustive list as to what could be considered, four of the more feasible regulatory options are presented below for consideration:

- Allow the current equilibrium to continue.
- Create a regulatory system for the service contract industry that parallels that of the NAIC in the insurance industry.
- Promote federal-level regulatory intervention to introduce more consistency.
- Introduce a second round of Model #685-like regulation.

Allow the Current Equilibrium to Continue

Leaving the current system as it exists would be a default solution. While the existence of an enhanced service contract regulatory environment cannot be denied, the framework employed today, even with its many inconsistencies and idiosyncrasies, is still more rigorous than the pre-Model #685 regulatory environment. While it may allow for the continued functioning of the service contract industry, it does little to facilitate the improvement of the insurance industry's public image, which was a key impetus for the NAIC's original foray into the regulation of the service contract industry.

Introduce an NAIC-Like Regulatory Framework

While a service contract regulatory system paralleling the NAIC model might seem ideal in this context, two major barriers are likely to preempt this from occurring. First, unlike the insurance industry, the service contract industry does not represent a systemic risk to the U.S. economy; thus, the issue does not warrant similar levels of regulatory attention and funding. The current level of development of the insurance industry's regulatory system is the product of more than 150 years of intense legal and legislative scrutiny; efforts to clone a comparable system for the regulation of the service contract market is not a feasible near, or medium-term, solution.

Promote Federal Oversight

The presence of federal-level regulatory oversight would hold the promise of a more cohesive and consistent regulatory structure for the service contract industry, which might ameliorate many of its current issues. Potential roadblocks to this possible path include the fact that unlike the insurance industry, the service contract market does not represent a systemic risk to the economy. Additionally, while growing, the size of the service contract market does not yet warrant significant federal-level attention from the FIO.

While still relatively quiet on its intentions, the CFPB might offer the most likely source of federal-level intervention. While the CFPB could rationally claim some level of regulatory responsibility for the service contract market, it would be limited to contracts that are part of a financing arrangement (e.g., as part of a financed vehicle purchase). If the service contract were not part of the broader financing of the asset purchase, it would not be subject to the protection of CFPB regulatory oversight. Consumer confusion on the nuanced differences would likely follow. Thus, while having some potential as a limited solution, without some level of modification to the CFPB's mandate, it is not likely to become deeply involved in the service contract market.

Model #685 2.0

An attempt to revisit and modify the original Model #685 framework with another round of proposed regulation may hold some merit. The NAIC's 26 years of experience and insight with the service contracts industry may have significant value in this context. That said, the NAIC is not imbued with any formal regulatory authority to regulate the service contracts industry; thus, it relies on its respective member states to adopt and implement elements of a proposed model act. Suffice to say, cooperation at each successive level is a tenuous matter and should not be assumed. A given state's insurance industry may now have other pressing priorities (e.g., the industry's acute human capital drain due to retirement, etc.). Additionally, the importance of any negative association with the operations of the service contract industry may have waned in recent years, or the significant growth of the service contracts industry over the past 25 years has emboldened it to resist external interference in its operations by state-level entities, such as the insurance regulatory framework.

Given the significant and consistent growth of the service contracts market over the past quarter century, as well as the public's seeming acceptance of the service contract status quo in the marketplace, a revisitation of Model #685 with some refinements borne of experience over the last quarter century might prove to be the most rational and measured course of action. Certainly, the impact of a "Model #685 2.0" would be enhanced with something as simple as a more consistent pattern of adoption of the provisions in Model #685. That said, as it currently stands, the NAIC lacks the coercive authority to impose such adoption. While not likely in the foreseeable future, enhanced regulatory authority for the NAIC would facilitate broader consistent adoption of model act content.

Conclusion

Since its emergence in the U.S. marketplace almost 80 years ago, the service contract industry operated largely without a cohesive and coordinated regulatory framework. What regulation that existed was largely a matter of local and/or state jurisdiction. That lack of cohesive regulatory oversight likely contributed to market behavior that invited negative attention from consumer protection groups, the broader media, and regulatory authorities. At the same time, the shared similarities of service and insurance contracts created confusion among the consuming public and led to a presumption that the behavior of the service contract industry was synonymous with that of the insurance industry. Believing its public image to be damaged from such association, the insurance industry, through the NAIC, promoted Model #685 as a recommended standard for service contract regulation; in doing so, it asked that the state-level insurance regulatory system employed in the U.S. to impose its oversight authority on the service contract industry.

Over the ensuing 26 years, parties to the service contract industry and its state insurance regulators have seemingly remained largely copacetic with these dynamics, which would lead one to believe that the matter is in a satisfactory equilibrium. That said, the original motivations for the insurance industry's foray into the regulation of the service contract industry persist. The service contract industry still finds itself in the news for the wrong reasons—i.e., consumers continue to view service contracts as if they were insurance—and the insurance industry still feels the pangs of the negative association. So, what has really changed over the past quarter century? If the original issues still largely remain, is it worth the insurance industry's time and effort to revisit the situation, and if not the insurance industry as a regulator, then who?

While an obvious regulatory savior for the service contracts market does not appear to exist, short of federal level intervention, the NAIC may choose to offer regulatory guidance to the service contracts industry. As was the case 26 years ago, the NAIC cannot simply demand that its membership adopt and implement model act proposals. That said, it offers its experience, market familiarity, and own vested interest in a better-behaved service contract industry. While a deeper involvement in the operations of a separate, sovereign industry would not be palatable, a second wave of regulatory influence from the NAIC—i.e., a "Model #685 2.0"—might be the most feasible option at this time.

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