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Innovating for future growth
Automotive assurance products' strategy

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Background

The rise of the internet in the late 1990s marked the beginning of a significant shift in the traditional auto dealer, Original Equipment Manufacturer ("OEM"), and captive finance lender profit models. As consumers shifted their research online and new car pricing became far more transparent, new car margins have continued to be under attack, falling 25% over the last decade[1]. This has created a strong impetus to search for alternative ways to maintain profitability and has led to finance and insurance products ("F&I") being viewed as a more key building block in total profit. Assurance products, or the 'I' side of F&I, make up a significant chunk of that total profit, and are expected to grow in importance as recent regulatory actions by the CFPB seem to be leading to an elimination of finance rate markup, putting even more pressure on the "I" side. For purposes of this paper, the department or unit responsible for assurance products will be referred to as the "**assurance unit.**"

The assurance unit could be part of the OEM's parts and accessories division; it could reside within a captive finance company, or within the sales and marketing department. Wherever they reside, these units are generally responsible for products including vehicle service contracts, GAP insurance, roadside assistance, tire & wheel protection, as well as appearance protection type products and other ancillary products. Vehicle service contracts (VSCs) remain the quintessential assurance product, with new car service contract penetration (the ratio of VSCs sold on new cars to new cars sold) climbing from 27% in 2001 to 38% in 2011[2].

As focus has shifted to F&I profitability to offset falling gross margins, F&I's portion of car sales profit has risen steadily from approximately 23% in 2001 to over 30% in 2011[3]. As dealers continue to successfully implement new F&I strategies and ideas are socialized via 20 Groups and other dealer meeting venues, the collective pressure to maximize contribution from assurance products continues to increase. As a result, dealers have become more sophisticated in the assurance product space than ever before. They have grown their understanding of assurance product profit and its components, and are seeking an ever expanding piece of the pie.

The competition between the assurance units and third-party providers of assurance products to capture market share of vehicles sold as well as presence in dealerships has grown to be fiercely competitive. The assurance units traditionally held large market share because of existing relationships with dealers and brand recognition associated with their products. With innovations in products, dealer incentive programs, and their investment in

[1] NADA (http://www.nada.org/NR/rdonlyres/C1C58F5A-BE0E-4E1A-9B56-1C3025B5B452/0/NADADATA2012Final.pdf)

[2] NADA (http://www.nada.org/NR/rdonlyres/C1C58F5A-BE0E-4E1A-9B56-1C3025B5B452/0/NADADATA2012Final.pdf)

[3] NADA (http://www.nada.org/NR/rdonlyres/C1C58F5A-BE0E-4E1A-9B56-1C3025B5B452/0/NADADATA2012Final.pdf)

sales teams, third-party providers have strengthened their business model and have successfully taken significant market share.

In order to remain competitive and maintain growth into the future, assurance units should reconsider their strategic approach to the areas described below.

OEM benefits: more than just profit

OEMs are uniquely positioned to take advantage of the benefits that the assurance product space has to offer. These are categorized in four main goals and benefits:

- **Owner loyalty and retention**
  Assurance products are a great way for OEMs to deepen the relationship with the customer. These products keep the customer coming back to the dealership and create a positive experience that the customer associates with the vehicle, the dealership, and ultimately the OEM. This also results in the customer returning to the dealer for all future services, often generating opportunities for future sales.
- **Parts and accessories sales**
  OEMs can stipulate that only their OEM parts and accessories be used on an extended service contract repair. This can be used as a selling feature to the customer as well as drive an increase in parts and accessories revenue.
- **Dealer satisfaction**
  The F&I office is a significant revenue and profit generator for dealers. OEMs can help improve their relationships with the dealer by providing relevant products at competitive rates, that the dealer can sell successfully by leveraging the factory name.
- **OEM profitability and cash flow**
  Selling additional assurance products assurance unit provides the OEM with incremental profitability. The assurance product space also allows for increased liquidity as most assurance contracts are paid for up front by the customer.

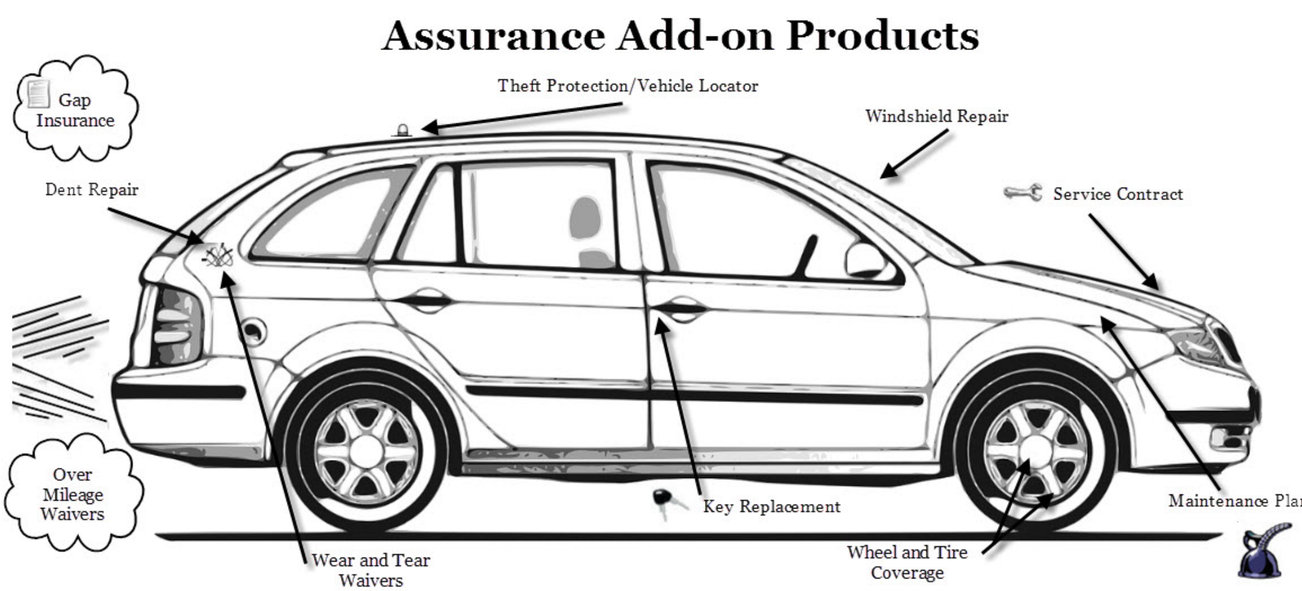
All of the above are important factors and benefits that can be realized by the OEM; however it is important that the organization rank, weigh, and quantify each of the above as part of its assurance product strategy as there are elements of product and program design that favor one goal over another.

The rest of this paper examines the ways in which the OEMs can change their strategy in order to help capture market share of assurance products sold as well as presence in dealerships. The conclusions reached in this paper are based on PwC's industry experience working with various OEMs, captive lenders, third-party providers, and dealers.

Evolving with the market

Understanding changes in the competitive landscape is an important component of developing a forward-looking strategy. Unlike traditional financing, assurance products are unlikely to drive upfront car sales, but similarly, assurance units compete more with third-parties than other OEMs. Re-assessing and adapting to the market and the competition is a must to be successful going forward.

Where third-party providers have most distinguished themselves is with the innovation of niche products. As menu selling becomes more widespread, dealers are looking for a wider product offering for their customers. Newer products like Tire & Wheel insurance, Prepaid Maintenance and Powertrain-Only Vehicle Service Contracts often entice dealers targeting more F&I profits. While these products often only appeal to a small portion of dealership customers, they have significant curb appeal for many dealers who are looking for new approaches to increase assurance product sales. They also often create a dealer perception that OEM assurance units are lagging behind on innovation, and open the door for third-parties to garner additional business, such as core VSC or Guaranteed Automobile Protection ("GAP") sales[4].



[4] Based on PwC dealer interviews

In the long-run, it is likely that not all of the new innovations have staying power. The past has shown that assurance products can fall out of favor, such as credit and life and disability insurance which have been in decline for years. But there is a clear perception from dealers that the third-party providers they do business with have a more extensive offering of products that dealers can leverage to fill out their F&I menus. Dealers also expect their providers to keep abreast of the market and either act as an innovator or at least a fast follower with new products.

This makes it important for assurance units to monitor the market closely for changes and to offer products beyond the traditional VSC and GAP products. While product offerings need to be evaluated against organizational objectives, consideration should also be given to the totality of profits across the assurance product line-up. Since assurance relationships tend to be long-term, adding a marginally profitable product to round out the line-up and cement dealer loyalty may well make sense.

The assurance unit product offering needs to be up to date and relevant to today's markets. While dealers are focusing on assurance profits by utilizing an evolving menu of products, assurance units have to look beyond traditional VSC and GAP offerings and provide a robust menu of products to keep third-parties at bay. This does not need to be limited to copying existing products in the market; opportunities also exist for the assurance unit to act as an innovator. This could include new products, or new approaches to existing products, such as selling maintenance plans during service visits.

Creating the optimal sales force

Sales and training are areas where third-party providers have developed an edge on OEM assurance units. Dealers are no longer satisfied with the traditional approach of having assurance products be an "also-ran" for one-size-fits-all representatives; the increasing dealer focus on assurance products requires additional focus and specialization. Assurance units often rely on a relationship-based sales force with one OEM sales representative covering the full suite of products, including financing and sometimes even wholesale. These representatives have varying degrees of knowledge regarding assurance products, but even the best are rarely as effective as a dedicated assurance product representative. Dealers strongly prefer a dedicated sales representative who is not only familiar with the products, but also has the time and focus to commit. Third-party providers have consistently been recognized as best-in- class by dealers because they offer dedicated sales staff to the assurance product space. These sales representatives perform frequent "informal" training as well by coaching the dealership F&I staff during visits, which dealers find quite valuable.

While assurance units often have constraints and objectives that prevent a dedicated assurance sales force, serious consideration should be given to reevaluating sales force responsibilities and compensation plans. As product and incentive offerings increase and sales become more complex, it will be even more valuable to have a knowledgeable sales resource interacting with dealers. Driving sales and increasing profits requires a significant rethinking of the dealer sales model.

Dealer training: cost center or profit driver?

Training is one area in particular where third-parties have established themselves as market leaders and left most assurance units to play catch-up. Much of this advantage comes from recruiting practices which target experienced assurance professionals; a specialized training force with relevant assurance product experience is better able to speak the dealer's language. It also enables more focus on training by using a consultative selling approach, which dealers tend to find more effective.

Formal training, while having a place and a value, is a less critical component of the overall selling process, especially given the high turnover prevalent in dealer F&I offices. Dealers often find little value in formal off-site training from the OEM assurance unit and are reluctant to commit F&I personnel for extended absences, though third-party training sessions consistently receive higher marks than the assurance unit's offerings. In-dealership training is consistently preferred.

Assurance units should consider training and on-going dealer education as an integral part of the sales representative position and should make this an important consideration when redefining expectation and compensation for the position. In our experience, this training also pays off financially as dealers with a dedicated and qualified assurance product staff tend to sell more products.

Dealer compensation plans

Another important component of the product line-up is the dealer compensation structure offered by the assurance unit. While dealer compensation has always been a key driving factor in selecting a provider, dealer expectation of payouts has evolved. There are two primary trends here: dealers are becoming more sophisticated in their capital and tax strategies and are looking for alternative ways to receive funds. As the landscape changes from primarily VSC to a full menu, dealers are also looking to their provider for a holistic compensation strategy. In exchange for selling multiple product lines for a provider rather than just a VSC, dealers expect to be compensated with some of the incremental profit.

This trend presents an opportunity for the assurance units to cement relationships with loyal dealers and to rekindle relationships with those who defected to third-parties. In order to execute, assurance units will have to structure dealer compensation to be competitive but also matched to dealer loyalty and sales execution. Compensation levels should be closely tied to sales across the full product line-up. When executed successfully to drive profits, compensation should drive increases in dealer sales volume by sharing the marginal profitability between the assurance unit and the dealer. Assurance units should also encourage dealers to consider adjusting compensation plans for their F&I sales team to account for the full product suite as well.

Aging infrastructure: a barrier to the future

Systems and processes that have served assurance units well for decades are now showing their age and acting as a barrier to rapid evolution to today's realities. Adaption for new products, compensation structures, and improved claims processing will often require updated technology and processes. The technology space is an area where the assurance units often lag behind the third party providers as this is what the third parties are here to sell, so this space will be their chief priority. With limited budgets, assurance units need to be strategic and prioritize investments in order to be competitive in the future.

Newer, best-in-class systems, whether homegrown or purchased, have emerged that provide significant benefits over the older systems. Product design and configuration is business user driven, allowing for rapid development and deployment of new products in a much shorter time at a much lower cost. Claims administration is more configurable and can be designed to be more efficient and at the same time lower fraud rates. Data warehousing has become more sophisticated, allowing for superior analysis and thus process and product improvement opportunities. Improved data and analytics provide a better understanding of the trends in the products sold, and understanding claims trending can provide early warning signals that can be addressed before it is too late.

Older systems also frequently do not support modern customer interaction such as integrated e-mail, chat functionality, ability to capture pictures and attach to claims records, and more, which is becoming more widely expected by customers in the marketplace. Customer relationships often cannot be tracked in a sophisticated manner, preventing a holistic approach to customer and brand loyalty.

As newer technologies such as tablets and mobile technology enter the marketplace, it also presents opportunities for an assurance unit to act in a first-mover role in the assurance space. For example, mobile maintenance reminders for prepaid maintenance contract customers may increase customer satisfaction and lower repair expense.

Fixing it better: using claims as a sales tool

Traditionally, claims processing for products, especially VSC and maintenance plans, have been viewed as a cost of doing business. While it's true that claims payments are an expense, many assurance units are missing opportunities to use claims to cement loyalty.

Claims processing should not be overlooked as a driver of dealer and customer loyalty. Efficient claims processing, coupled with an effective fraud control, can contain costs, increase loyalty, and cement long-term partnerships with the dealer. This is especially important for products where dealers own the risk, such as in reinsurance programs.

Dealers indicate widespread frustration with the claims process. Common complaints include a lack of enabling technology, which requires the dealer to navigate a manual, paperwork based bureaucracy. The perception of a bureaucratic process is often reinforced by claims staffs, which do not always have car repair experience and may not have a good technical understanding of the problem. Dealers are also frustrated with the approval process, as fraud controls often delay repairs. While dealers understand the need for controls, the speed of response is not always sufficient to ensure end-customer satisfaction, which can be additionally problematic on the luxury side where customer expectations are higher. But even for mainstream brands, the effect of slow claims processing on end-customer loyalty should not be overlooked.

By making targeted investments into claims systems and processes, assurance units can use the claims process to help build a foundation of loyalty with dealers and end-customers. Technology can be a key enabler here, with things like online self-authorization very popular, but more low-tech items such as extended hours or having knowledgeable representatives can also lead to increased satisfaction and retention. Studies have shown that customers who are satisfied with their service contracts tend to be more brand-loyal[5].

[5] Assurant whitepaper

Capturing the customer downstream

Assurance products have traditionally been sold almost exclusively at point of sale. Some dealerships will make follow-up calls soon after a sale, or may even attempt to sell products in their service drives, but these efforts are largely afterthoughts. An opportunity exists to help the dealer sell products after the point of sale.

There can be many reasons why an interested customer would pass on purchasing assurance products during the sale; sticker shock with a large purchase, distrust of the dealer, lack of time, etc. The two viable approaches to capturing some of this potential incremental business would be either to encourage further dealer follow-up or for the assurance unit to follow-up on behalf of the dealer.

Assurance units should consider branded, downstream marketing efforts. In order to maintain dealer relationships, and comply with the various state dealer franchise laws, this would have to be done in cooperation with the dealer. Dealers would have to set the price and be the ultimate seller, while the assurance unit would handle the outreach and facilitate the paperwork. This set-up would be a potential win/win for both sides. The dealer would retain control over the point-of-sale process and the assurance unit would leverage its brand reputation to generate incremental sales that benefit both parties.

The assurance unit could also leverage its relationship with the OEM's captive lender here as well. As the lender is already in the business of collecting payments every month and interacting with the customer, that presents a perfect opportunity for assurance units to create a post-point of sale product available at a low monthly payment. If priced properly, it could even be sold to customers' in the dealer's service drives at "time of need." For instance, a customer coming in for a routine service could be given the option of purchasing a maintenance plan to pay for the service over time rather than immediately, and to protect themselves from future unforeseen expense. By offering such as product, the assurance unit could distinguish itself from third-parties which would not have the lender relationship to leverage.

Understanding the world of reinsurance

The traditional model of the assurance unit retaining underwriting risk has been replaced with a litany of changing models. Reinsurance in particular has experienced great growth in dealer acceptance and penetration. Much of this change has been led by third-party providers, who have often been first movers and have used it to their advantage to gain a foothold in dealerships. Reinsurance programs provide the dealer with the ability to participate in underwriting income as well as estate and tax planning strategies. Third-party's representatives are able to dissect each dollar of the existing program in which the dealer is enrolled, segregating and contrasting administrative fees, underwriting profits, and exposing any other fees to which the dealer may be subjected. Then they model a very compelling case for dealers that are willing to take on the risk.

In order to stop the leakage and exodus of dealers, assurance units should respond by offering their own reinsurance programs and train their sales staff on the pros and cons of such reinsurance programs contrasted with more conventional programs. Reinsurance programs through which the dealers will benefit from the premium income and tax and estate planning advantages with the assurance product unit providing the services. The assurance product unit will continue to service the contract with the dealer reinsurance program accountable for making claims payments.

Assurance units should consider four major concepts to adapt their business model for dealer reinsurance:

- **Protect the dealer**
  Dealers enrolled in reinsurance programs are taking on underwriting risk that they do not control. Assurance units must protect the dealer's interest by controlling claims costs, reducing fraud, and handling customer complaints as if the risk was their own.

- **Protect the brand and the customer**
  Assurance units may take on a role similar to a third-party administrator, but the relationship with the customer and the perception of the brand is unique. Assurance units must balance the pressures of its dealers to minimize claims costs with managing its own reputation.

- **Adverse selection**
  The growth of dealer reinsurance can result in low-loss dealers moving to reinsurance programs leaving high-loss dealers on traditional walk-away programs. This will result in adverse selection for the assurance unit programs and highlights the need to reexamine existing programs and better analyze claims on those programs.

- **Act like a third-party administrator (TPA)**

With dealer reinsurance programs, assurance units no longer have underwriting profits to fall back on. In order to stay maintain profitability on administrative fees, they must look at current operations, processes, and technology for opportunities to increase efficiency and decrease costs, much like a traditional TPA would. They can also consider using the reinsurance program as a hook to become the provider for other assurance products, which can potentially offset the lost underwriting income.

Getting along with the parents

Relationships between the assurance unit and OEM parents have always been complex. With the traditional focus being on VSC, the OEM has most often focused on driving OEM parts sales, though contribution to profit has also been an important secondary consideration. Creating an updated strategic framework to ensure consistency of approach between the OEM, the assurance unit, and the dealers is key to executing on future plans and reviving growth.

With the evolution and elaboration of assurance products, the corporate structure should also be re-evaluated by determining and defining current objectives and creating a strategic framework. While parts sales and profits should still be large components of the overall strategy, newer products may offer different considerations. Each product needs to be evaluated against the strategic framework. While some products (such as maintenance plans) may closely follow the traditional parts sales and profitability model, others may offer new considerations; for instance, theft deterrent devices may be used to locate skip vehicles and decrease credit losses.

The strategic framework should also take into account the impact of the rise of third-party providers, many of whom were mere niche players when OEMs established their current strategic framework. The increasing prevalence of third-parties partnering with dealers has implications beyond the loss of profitability and the loss of parts sales. Customer satisfaction may be impacted by providers having an unduly restrictive claims policy. Customers may also be sold products that may not hold much value (such as short-term power train only warranties) but may expose the captive finance lender to regulatory scrutiny for providing financing.

With assurance products becoming an increasing component of dealer profitability, changes also need to be evaluated more closely for impact to dealers. Dealer buy-in is key for successful updates to assurance products and should be part of the planning phase via dealer councils, etc. The dealer feedback can also help to reinforce the need for cutting edge incentive programs to the OEM.

While there is no leading class structure evident, the most successful providers have a clearly articulated strategy, and the vision is clearly shared and understood by the OEM, assurance unit, and the dealers. The strategic framework should be carefully constructed to serve as the foundation of this tripartite alignment of goals.

PwC has a broad experience assisting assurance units to strengthen their business model

- **Business strategy, market entry, program design**
  PwC professionals can assist in developing the strategic vision and goals for assurance programs and then design a program to accomplish those goals.
- **VSC technology strategy and implementation**
  PwC can work with you to define the goals and develop a multi-year strategic roadmap based on data and analytics to implement a modern technology solution to enhance business capabilities. PwC has developed an approach to launching and managing enterprise-wide integrations. Our solutions include a proven integration methodology and an extensive set of processes, tools, templates, and guides to support the overall integration.
- **Product innovation and rationalization**
  PwC can help you understand the current inventory and acceptance levels of products in the market, and which could be a good fit for your organization. We can also support creation of innovative product features, such as mobile apps.
- **CFPB**
  As the CFPB begins to target the automotive industry, PwC professionals can help construct compliance frameworks to strengthen the assurance unit's and the captive lenders' operations from a regulatory perspective.
- **F&I benchmarking**
  PwC has extensive experience benchmarking the assurance product industry as well as the competition. We also provide a gap analysis comparing our client's offering against key competitors and leading practices including long-term strategic recommendations as well as near-term opportunities to address the gaps.
- **Dealer voice of customer (VOC)**
  PwC has found in working with our clients in the past that they struggle to get an accurate representation of their dealer VOC. Dealers are hesitant to offer fully candid responses directly to our clients regarding the quality of their sales staff, training, operations, technology, etc. PwC has also found that as a neutral third-party we are able to get candid and constructive feedback from dealers and are able to use those responses to make recommendations to improve our clients' program.
- **Tax planning**
  PwC tax professionals assist our clients to structure their assurance products programs in a manner that can result in reductions in tax liabilities of the OEMs / finance captives, and the dealers.

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