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ICCC Informal Advisory # 86
Vendor's Single Interest Insurance (VSI)

Our office has had several inquiries recently regarding Vendor's Single Interest Insurance, and how it is to be treated under the Iowa Consumer Credit Code, (ICCC), Iowa Code Chapter 537..

This informal advisory is being issued to clarify what appears to be some confusion about the issue.

A. SUMMARY

There are two different kinds of "VSI" insurance. As is described in more detail below, one insures the tangible property (the collateral) itself – though only the lienholder's interest in the collateral. The second more broadly insures the lienholder's risk of default or credit loss.

It is absolutely critical for the lender and dealer to properly characterize which type of VSI insurance is involved, for the first one (insuring the tangible property itself) may be treated as an approved "additional charge" under Iowa Code § 537.2501, and may be part of the "amount financed" for Truth in Lending[1] purposes, as well.

Default or credit loss "VSI" insurance, however, is a finance charge under the ICCC in all circumstances. Default or credit loss insurance cannot be treated as part of the amount financed under any circumstance. Failure to properly account for credit loss VSI will create a contract which is not in compliance with the ICCC, and will in all probability also not comply with Truth in Lending; the amount financed, the finance charge, and the APR all will be incorrect if a default/credit loss VSI charge is included in the amount financed.

B. NATURE OF THE TWO DIFFERENT KINDS OF "VSI" INSURANCE

1. *Insuring tangible property*: Insurance which insures the property itself -- the collateral -- against normal property damage risks -- may be "dual coverage" or "vendors' single interest."

[1] "Truth in Lending," as referred to herein, means the federal Truth in Lending Act, 15 USC § 1601 at seq.

For example, a car valued at $5000, with an outstanding loan balance of $3000, may be totalled in an accident, or stolen. VSI insurance of this sort would pay only the lien-holder's $3000 interest in the vehicle, and the buyer-owner would receive nothing from the insurance for his lost $2000 equity in the vehicle.

2. *Default or credit loss VSI*: Other types of VSI relate to risks of default or credit loss. A credit insurance text describes one VSI policy of this sort, purchased as blanket coverage,[2] as follows:

> Under [this type of blanket single interest insurance] policy, a lender purchases coverage for all loans secured by property as collateral. A premium is paid monthly by the lender to the insurer. Rates are a flat premium per loan or a monthly outstanding balance premium per $1,000 of loan balances. Premiums are usually absorbed by the lender, although a charge may be passed on to the borrower in some states.
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> Coverage protects only the lender. For benefits to be payable, the loan must be in default and the property repossessed. The insurance covers only the difference between the value of the property at repossession and the loan balance at the time of repossession. A benefit is paid only if the loss is caused by damage to the property. Perils covered are similar to standard collision and comprehensive coverage. The lender must require the borrower to carry insurance.[3]

This describes a default/credit loss VSI. Other forms of VSI may not track precisely this description, but still fall on the default/credit loss side of the dividing line.

C. ICCC RULES FOR VSI

VSI insurance will fall under one of two provisions.

1. *Insuring tangible property*: The first type described above would be governed by Iowa Code

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[2] It is not the fact that it is a blanket policy, as opposed to a specific, transactional policy, which makes this a finance charge. It is the nature of the risks insured which is determinative. Cf. Reg. Z, Official Staff Commentary § 225.4(d)-9 (TIL).

[3] Gary Fagg, *Credit Life and Disability Insurance* 523 (1986). Another kind of default/credit loss VSI insurance was described in Cordova v. Simonpietri Insurance Agency v. Chase Manhattan Bank, 649 F.2d 36 (1st Cir. 1981), though the legal issues in that case were unrelated to these issues. See generally National Consumer Law Center, *Truth in Lending* §3.9.4.7 (3d Ed. 1995 and Supp.) and National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* § 8.3.5.2 (1995 & Supp.)

§ 537.2501(2)(a):[4]

> An additional charge may be made for insurance written in connection with the transaction...
> (a) with respect to insurance against loss of or damage to property, or against liability arising out of the ownership or use of property, if the creditor furnishes a clear, conspicuous and specific statement in writing to the consumer setting forth the cost of the insurance if obtained from or through the creditor and stating that the consumer may choose the person through whom the insurance is to be obtained.

Thus this type of insurance is an "authorized additional charge," and therefore may be considered as part of the amount financed.

2. *Default/Credit loss VSI*: The second type described above is governed by Iowa Code § 537.1301(19)(a)(3): A finance charge includes a

> ...(3) Premium or other charge for any guarantee or insurance protecting the creditor against the consumer's default or other credit loss.

Since a credit loss VSI charge is a finance charge, if it is passed on to the borrower/purchaser, the cost:

* <u>must</u> be calculated as part of the finance charge;

* <u>must</u> be taken into account as a finance charge in calculating the APR;

* <u>must</u> be treated as part of the finance charge subject to rebate under Iowa Code § 537.2510 in the event of prepayment, refinance, acceleration, or early pay-off;

* must <u>not</u> be treated as part of the amount financed, irrespective of what disclosures are made.[5]

D. TIL RULES FOR VSI

The above ICCC rules closely track the Truth in Lending rules, which determine how the

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[4] The ICCC makes no distinction between dual interest and VSI property insurance which insures this type of risk.

[5] Since this type of VSI insurance is governed by Iowa Code § 537.1301(19)(a)(3), instead of § 537.2501(2), the disclosures mandated by the latter are irrelevant.

finance charge, amount financed, and APR is calculated for purposes of disclosure to consumers.[6]

As with the ICCC, TIL rules permit property insurance against loss of or damage to the property, or against liability arising out of ownership or use of property to be excluded from the finance charge if certain specified conditions are met. Reg. Z, § 226.4(d)(2). This includes VSI property insurance, if all rights of subrogation against the consumer have been waived, Reg. Z, § 226.4(d)(2) n. 5, and includes both blanket and specific coverage. OSC § 226.4(d)-9.

While the Reg. Z Commentary permits VSI insurance protecting tangible property against normal property damage to include some additional types of risks to the property which would ordinarily be default- or credit loss-related (concealment, confiscation, conversion, embezzlement, and skip), other credit-loss coverages (repossession and holder-in-due course) which are part of a package cannot qualify for the exclusion.[7] The cost of that coverage, instead, is a finance charge under Reg. Z § 226.4(b)(5).[8]

If a VSI policy includes both qualifying and non-qualifying coverages, the premium must be broken down. The portion attributable to the non-qualifying coverage must be included in the finance charge.[9]

Two caveats must be noted about the default-related additional coverages which may qualify for an exclusion under the Commentary.

* First: While the presence of some coverage such as skip or concealment may not disqualify a premium for a VSI insurance policy which insures the tangible property, there is no indication in the Commentary that such coverages independently qualify for the exclusion. In other words, while the presence of such coverages to go "along for the ride" in an otherwise qualifying policy will not taint that premium charge, when such coverage is sold independently to protect the creditor against that type of loss, the charge would appear to be purely one for insurance against "the consumer's default or other credit loss," and therefore be a finance charge under Reg. Z, § 226.4(b)(5).

* Second: The labels given do not determine the substantive character of insurance coverage. For example, applying the label of "concealment, conversion, embezzlement and skip" to a product to

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[6] See National Consumer Law Center, *Truth in Lending* § 3.9.4.7 (3d. Ed. 1995 & Supp.) Truth in Lending governs the manner in which disclosures are given to consumers; the ICCC governs the substantive terms of a consumer credit contract, and defines the character of various charges for purposes of measuring the cost of credit against applicable state usury ceilings. See id., § 3.2.3 for a discussion of the distinction.

[7] See Reg. Z, OSC § 226.4(d)-10.

[8] Premiums or other charges for any guarantee or insurance protecting the creditor against the consumer's default or other credit loss are a finance charge.

[9] Id.

attempt to bring it within the scope of the Commentary will not protect a creditor from liability if that is not in fact what the policy covers or how it functions in practice. See *Edwards v. Your Credit*, ____ WL ______ (5th Cir. 1998)(nominally "non-filing insurance" which is really a general default insurance in practice would not qualify for the finance charge exclusion for "non-filing insurance" under Reg. Z § 226.4(e)(2)).