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Iowa Consumer Credit Code Informal Advisory # 92
***GAP Products: 06-24-03*:**

Financing GAP products in the sale of motor vehicles:
Iowa Code § 322. 19, as amended by SF 97, § 22 (2003 General Assembly),
and the Iowa Consumer Credit Code § § 537.2510, 537.4104

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On July 1, 2003, SF 97, § 22 (2003) will become effective, which provides that GAP products sold in connection with motor vehicles may be excluded from the calculation of the finance charge. The law amended Chapter 322, "Motor Vehicle Manufacturers, Distributors and Dealers." It did not amend the Iowa Consumer Credit Code. Questions have arisen with respect to how the new provisions of Iowa Code § 322.19 interact with the Iowa Consumer Credit Code. This Informal Advisory provides guidance with respect to the interaction of the new law with certain provisions of the Iowa Consumer Credit Code.

I. THE 2003 AMENDMENT TO CHAPTER 322, THE MOTOR VEHICLE CODE:

Iowa Code § 322.19 prescribes the maximum finance charge permitted in a motor vehicle retail installment transaction.[1] (The 2003 amendment is underlined.)

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[1] A "retail installment transaction" is defined as "any sale evidenced by a retail installment contract between a retail buyer and a retail seller wherein the retail buyer buys a motor vehicle from a retail seller at a time price payable in one or more installments. Iowa Code § 322.2(17). See also:
- Iowa Code § 322.2(15) ("retail buyer" means a person who buys a motor vehicle from a retail seller.)
- Iowa Code § 322.2(16) ("retail installment contract" means an agreement, entered into in this state, pursuant to which the title to, the property in or a lien upon the motor vehicle, which is the subject

322.19 Finance charges -- amount.

Notwithstanding the provisions of any other existing law, a retail installment transaction may include a finance charge not in excess of the following rates:

Class 1. Any new motor vehicle designated by the manufacturer by a year model not earlier than the year in which the sale is made, an amount equivalent to one and three-fourths percent per month simple interest on the declining balance of the amount financed.

Class 2. Any new motor vehicle not in Class 1 and any used motor vehicle designated by the manufacturer by a year model of the same or not more than two years prior to the year in which the sale is made, an amount equivalent to two percent per month simple interest on the declining balance of the amount financed.

Class 3. Any used motor vehicle not in Class 2 and designated by the manufacturer by a year model more than two years prior to the year in which the sale is made, an amount equivalent to two and one-fourth percent per month simple interest on the declining balance of the amount financed

Amount financed shall be as defined in section 537.1301. However, notwithstanding section 322.33, subsection 3, the amount financed may also include additional charges for the following, which shall not be included in the finance charge:

1. A motor vehicle service contract as defined in section 516E.1.

2. Voluntary debt cancellation coverage, whether insurance or debt waiver, which may be excluded from the finance charge

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matter of a retail installment transaction, is retained or taken by a retail seller from a retail buyer as security, in whole or in part, for the buyer's obligation. The term includes a chattel mortgage, a conditional sales contract and a contract for the bailment or leasing of a motor vehicle by which the bailee or lessee contracts to pay as compensation for its use a sum substantially equivalent to or in excess of its value and by which it is agreed that the bailee or lessee is bound to become, or has the option of becoming, the owner of the motor vehicle upon full compliance with the provisions of the contract.)

- Iowa Code § 322.2(18) ("retail seller" mans a person who sells a motor vehicle to a retail buyer.)
- Iowa Code § 322.2(20) ("selling" includes bartering, exchanging, delivering, or otherwise dealing in.) See also Iowa Consumer Credit Code § 537.1301(36) (definition of "sale of goods.")

under the federal Truth in Lending Act as defined in section 537.1302.

Iowa Code Section 322.33, subsection 3, referred to in the new amendment, provides:

322.33 Applicability of the Iowa consumer credit code.

1. The provisions of the Iowa consumer credit code shall apply to a consumer credit sale in which a licensed motor vehicle dealer participates or engages, and any violation of that code shall be a violation of this chapter.

2. Article 2, parts 5 and 6, and article 3, sections 537.3203, 537.3206, 537.3209, 537.3304,537.3305, and 537.3306 shall apply to any credit transaction as defined in section 537.1301, that is a retail installment transaction. For the purpose of applying provisions of the consumer credit code in those transactions, "consumer credit sale" shall include a sale for a business purpose.

3. A provision of the Iowa consumer credit code shall supersede a conflicting provision of this chapter.

II. QUESTIONS PRESENTED REGARDING SF 97 § 22 AND THE ICCC

In anticipation of the effective date of the new legislation, our office received an inquiry presenting four questions from an indirect auto lender.

1. Is it the position of the [Administrator][2] that GAP may be financed in an installment sales contract pertaining to the installment sale of a motor vehicle? If so, does the [Administrator] make any distinctions between GAP products sold as insurance policies and those that take the form of non-insurance debt waiver agreements?

2. Assuming that GAP may be financed in an installment sale contract after July 1, 2003, is it a requirement that before any Iowa dealer adds the charge for a GAP product to the amount financed under an installment sale transaction and excludes such charge from the finance charge amount, the [Administrator] must adopt a rule pursuant to Iowa Code Section 537.2501(1)(h) before such charges are added to the contract? Does the form of the GAP product (i.e., insurance product or debt waiver agreement) cause the need for any distinction in the answer to this question?

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[2] The inquiry came to the Division of Banking, and refers to the Division throughout the letter. The Banking Division referred the inquiry to the Office of the Attorney General, which is responsible for the interpretation of the Iowa Consumer Credit Code. Iowa Code §§ 537.1301(2); 537.6103; Iowa Administrative Code 61-10.1

3. What are the rules to be applied to refunds of unearned GAP premiums or charges? Which party (dealer, assignee-holder, or GAP provider) must make any required refund? Because Section 537.2510 does not appear to be applicable to GAP charges that are excluded from the finance charge amount, are the issuers of GAP insurance policies free to develop their own refund rules or to prohibit refunds of any GAP insurance premium? Additionally, are charges for non-insurance GAP (debt waiver agreements) subject to any refund rules?

4. Again assuming that GAP may be financed in an installment sale contract after July 1, 2003, may a GAP debt waiver agreement, recognizing that this type of product is normally prepared as a contract addendum and not issued as a policy or certificate of insurance, be contained in a writing that is separate and outside of the retail installment sale contract?

II. ANALYSIS

A. Background: GAP products

"Guaranteed Automobile Protection" or "Guaranteed Asset Protection" (GAP) is a product sold in credit sales transactions, often as an add-on, where the collateral may depreciate faster than the loan balance will decline, most commonly car leases and sales. In theory, it is a dual benefit coverage, which should protect both a secured-party creditor or assignee and a borrower against the risk that the amount paid out by property insurance on collateral in the event that a covered loss befalls the collateral is less than the amount of the outstanding loan balance. In essence, it is intended to cover the deficiency "gap" created when the loan balance is greater than the insurance value of destroyed or damaged collateral. It thus is not technically a type of property insurance, but rather it is intended to protect against a specific type of risk of credit loss – the risk of an under-collaterized loan when the collateral is lost or damaged.

The product initially was developed for the auto lease market. Originally, the cost typically was absorbed in the overall pricing of the transaction, rather than sold as a separate add-on.[3] As the product has migrated to the sales market, and as it has become more common to sell it for an extra charge to consumers, the cost appears to have increased. When a three-party product is sold, the dealer may mark-up the actual cost of a third-party provider's product, retaining the mark-up for extra revenue. (One GAP provider reported having seen as much as a 100+ % mark-up for dealer profit.) The coverage may also come in the form of a two-party product, where the seller/creditor agrees by contract to waive the buyer/debtor's liability for the deficiency gap, increasingly commonly for a separate charge.

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[3] The Uniform Consumer Lease Act, approved and recommended for adoption by the National Conference of Commissioners on Uniform State Laws, would effectively prohibit a separate charge for GAP coverage. See Section 401, Official Comments 1, 2.

As a type of credit loss coverage, absent explicit legislative or regulatory exclusion, the premium or charge for such coverage should be a finance charge under Truth in Lending, Reg. Z, § 226.4(b)(5), (10). In 1996, the FRB promulgated that explicit regulatory exclusion. See Reg. Z, 226.4(d)(3)(ii); Official Staff Commentary, § 226.4(d)(3)-1. In promulgating that rule, the Federal Reserve Board noted the distinction between credit property insurance, which insures the collateral itself, and GAP insurance, which insures the debt in a specific set of circumstances. "Even though GAP coverage is triggered by the loss of or damage to property, GAP agreements do not insure against such loss or damage. Instead, GAP agreements typically cover the remaining balance due on the obligation *after* traditional property insurance benefits are exhausted." (Emphasis in original) Supplementary Information, 61 Fed. Reg. 49237, 49241 (Sept. 19, 1996).[4] (The true nature of GAP as a form of credit insurance, rather than property insurance, is relevant to the analysis for Question # 3, below.)

Given the ICCC's similar definition of "finance charge," a charge for GAP coverage remains a finance charge under Iowa Code § 537.1301(19)(a)(3), except where explicit legislation or regulation authorizes the exclusion. Prior to the 2003 amendment to Iowa Code § 322.19, no such legislation or regulation existed. *See* ICCC Informal Advisories # 70 (Doland, October 14, 1994); # 83 (Keest, April 25, 1997).

It should be noted that by virtue of enacting the explicit exclusion in Chapter 322, the legislature has authorized the exclusion of a GAP charge from the finance charge *only* in connection with motor vehicle financing. A charge for GAP coverage sold in a consumer credit transaction secured by other types of collateral must still be treated as a finance charge under the ICCC. For example, a purchase money security interest in furniture purchased in a consumer credit sale, or, where otherwise permitted by law, a non-purchase money security interest in household goods in connection with a consumer loan, would not be subject to the GAP exclusion permitted under S.F. 97, § 22.

In evaluating the questions presented, we also note that the Iowa Consumer Credit Code continues to apply to the transaction, Iowa Code § 322.33(1), (2). The exception carved out by S.F. 97 § 22 is limited to sanctioning the exclusion of the fee from an ICCC calculation of the finance charge, so long as the requirements for excluding it from the TIL finance charge are met. Those conditions are:

1. The coverage is not required, and the consumer is so informed in writing.
2. The cost for the initial term of coverage is disclosed. If that is less than the term of the loan, the covered term shall also be disclosed, and
3. The consumers signs or initials an affirmative written request for coverage after

[4] In its 1996 amendment, the FRB unequivocally rejected the reasoning of decisions which had previously said that GAP charges were not a finance charge, e.g. *McGee v. Kerr-Hickman*, 93 F.3d 380 (7th Cir. 1996). The *McGee* court had held that it was not a finance charge because it was voluntary, a ruling the FRB noted was not the proper test. *See* 61 Fed. Reg. 49237, 49239 (Sept. 19, 1996).

receiving the disclosures required above.

Reg. Z, § 226.4(d)(3). Traditional principles of statutory construction require that statutes should be read together and harmonized, unless there is a direct, irreconcilable conflict. *In re Estate of Kirk*, 591 N.W.2d 630, 633 (Iowa 1999); *Kelly v. State*, 525 N.W.2d 409, 411 (Iowa 1994). Amendments by implication are not favored. *Caterpillar Davenport Employees Credit Union v. Huston*, 292 NW 2d 393, 396 (Iowa Code 1980).

B. Question 1: Is it the position of the [Administrator] that GAP may be financed in an installment sales contract pertaining to the installment sale of a motor vehicle? If so, does the [Administrator] make any distinctions between GAP products sold as insurance policies and those that take the form of non-insurance debt waiver agreements?

In connection with the retail sale of a motor vehicle, a charge for GAP may be financed as part of a retail installment sales transaction.

It has been the Administrator's position, and remains so, that the question of whether a GAP product is insurance is a determination to be made by the Iowa Division of Insurance. As a question of ICCC interpretation, there should be no distinction made as to whether the GAP product is an insurance product or not, with one exception.

If the Iowa Division of Insurance determines that a GAP product is insurance, the product must be sold in compliance with Insurance Division regulations governing the product. Should the charge for an insurance-regulated product exceed any rate limitations which may pertain to the product or otherwise not comply with applicable law, it would constitute an excess charge under the ICCC. Iowa Code § 537.4101.[5]

C. Question 2: Assuming that GAP may be financed in an installment sale contract after July 1, 2003, is it a requirement that before any Iowa dealer adds the charge for a GAP product to the amount financed under an installment sale transaction and excludes such charge from the finance charge amount, the [Administrator] must adopt a rule pursuant to Iowa Code Section 537.2501(1)(h) before such charges are added to the contract? Does the form of the GAP product (i.e., insurance product or debt waiver agreement) cause the need for any distinction in the answer to this question?

It is the position of the administrator that S.F. 97 Section 22 authorizes otherwise legal

[5] "A charge for insurance in excess of the rates promulgated by the commissioner of insurance, or otherwise made in violation of the law, including this chapter, or the rules promulgated by the commissioner of insurance, is an excess charge for purposes of determining rights of parties under section 537.5201, and authority of the administrator to bring civil action under section 537.6113." Iowa Code § 537.4101(2).

charges for GAP coverage to be excluded from the finance charge without the necessity for an administrative rule. However, should a need for additional guidance or clarification arise with respect to this or other products, the Administrator does have the authority, within the parameters of applicable statutes, to promulgate rules. Iowa Code § 537.6104(3).

As explained above, Iowa Code § 537.4101 does require that any insurance products sold in connection with a consumer credit transaction comply with insurance regulations. Therefore, we suggest that you contact the Iowa Insurance Division to see what, if any, insurance department regulations may be applicable to your product.

D. Question 3: What are the rules to be applied to refunds of unearned GAP premiums or charges? Which party (dealer, assignee-holder, or GAP provider) must make any required refund? Because Section 537.2510 does not appear to be applicable to GAP charges that are excluded from the finance charge amount, are the issuers of GAP insurance policies free to develop their own refund rules or to prohibit refunds of any GAP insurance premium? Additionally, are charges for non-insurance GAP (debt waiver agreements) subject to any refund rules?

Because ultimately the risk protected by a GAP product is a portion of the debt – specifically the deficiency balance which equals any gap between the value of the lost or damaged collateral and the outstanding loan balance -- an early termination of the debt also terminates the exposure to the covered risk. Neither the creditor nor the borrower has any remaining interest at risk when the credit transaction terminates early. This is true irrespective of whether any given GAP product is deemed insurance or a debt cancellation/waiver product.

In the circumstances in which there is a time component to a cost passed on to the consumer – e.g., interest, credit insurance premiums – the UCCC explicitly requires that rebates be given upon prepayment. Iowa Code §§ 537.2510, 537.4101, 191 Iowa Administrative Code § 28.3(9), (10). The rebate requirement is not, however, limited to those two types of charges. Indeed, the statement in your above-quoted question that "Iowa Code § 537.2510 does not appear to be applicable to GAP charges that are excluded from the finance charge amount" is inaccurate. The rebate requirement is not limited to finance charges. To the contrary, Iowa Code § 537.2510(1) states in relevant part that the creditor shall rebate any unearned finance charge, "*and rebate any other unearned charges, including charges for insurance.*" (Emphasis added.) The use of the word "including" clearly denotes that charges which function in a manner similar to insurance, such as GAP waiver, also would be encompassed. *See generally*, Singer, 2A Statutes and Statutory Construction § 47.07 (6th Ed.).

Because the rebate requirement is not determined by whether a particular charge is a finance charge or not, S.F.97 Section 22 does not affect the application of § 537.2510 to this type of unearned charge. There is not a conflict, as a charge can be a part of the amount financed, and nevertheless be subject to rebate, just as is the case with credit life, disability, property, or unemployment insurance under Iowa Code § 537.2501(2).[6]

Given the nature of the risk covered by GAP, early termination of the credit transaction means that some portion of the GAP charge will not have been earned. It is the intrinsic character of the product that the risk exposure disappears when the debt does. Therefore, the explicit language of Iowa Code § 537.2510(1) requires that the "unearned charge" be rebated, irrespective of whether it is deemed insurance or a debt cancellation product by the Insurance Division. Consequently, there must be a refund, and GAP issuers are clearly not free "to prohibit refunds of any GAP insurance premium," nor are creditors in a two-party GAP/ debt waiver agreement free to do so. *See also* Iowa Code § 537.1107(1) ("Except in settlement of a bona fide dispute, a consumer may not waive or agree to forego rights or benefits under this Act.")

You are correct, however, that the actuarial method as spelled out in § 537.2510(2) for calculating the unearned finance charge does not specifically mention the method to be used in calculating a refund for "other unearned charges," such as GAP, when they are not included in the finance charge. (It should be remembered that if it is sold in conjunction with a non-motor vehicle transaction, any GAP charge still will be a finance charge.) If the Insurance Division determines a specific GAP product is insurance, the specific method by which the rebate is to be calculated may be determined by Insurance Division rules. Our office will evaluate whether there is a need for a specific rule to adopt a uniform refund formula. We note, for example, that the Colorado Administrator's 1998 rules on GAP required that refunds on contractual GAP charges were to be made on a pro-rata basis, while GAP recognized as insurance were to be refunded in accordance with Colorado Insurance Division rules. 4 Co. Adm. Code 902-1, Rule 8(h).

Until and unless the Administrator adopts a rule specifying a single method of refund calculation, use of either the pro rata method or the actuarial method would be acceptable to the Administrator for enforcement purposes under Article 6. (The actuarial method is the rule specified by the ICCC for calculating the rebate in the finance charge context. Iowa Code § 537.5210(2).) Use of the Rule of 78 would not be acceptable to the Administrator for enforcement purposes.

As to which party must make the refund, Section 537.2510 specifies that "the creditor" shall make the refund. The "creditor" includes assignee-holders. Iowa Code § 537.1301(17). Assignees are liable for all obligations imposed on creditors with respect to those which occur after the assignment. Comment UCCC (1974) § 1.301(18) (definition of "creditor," parallel to Iowa Code § 537.1301(17).) Thus if the early termination occurs after assignment, it is the obligation of the assignee/holder. (This office has addressed this issue in the context of refunds of credit insurance. An edited version of that memorandum is attached as Appendix A.)

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[6] Credit life, health, property and unemployment insurance premiums may be excluded from the finance charge when certain conditions are met, just as is the case with GAP charges under the new legislation.

E. ***Question 4: Again assuming that GAP may be financed in an installment sale contract after July 1, 2003, may a GAP debt waiver agreement, recognizing that this type of product is normally prepared as a contract addendum and not issued as a policy or certificate of insurance, be contained in a writing that is separate and outside of the retail installment sale contract?***

Iowa Code § 322.3(6) requires that a retail installment contract "shall be in writing, shall be signed by both the buyer and the seller, and shall be completed as to all essential provisions prior to the signing of the contract by the buyer...." Iowa Code § 537.3203 requires that the creditor give to the consumer "any writing" evidencing a consumer credit transaction...if the writing requires or provides for the signature of the consumer. We do not believe that either of these provisions would preclude providing the agreement itself on a separate document, providing that these requirements are met, and that the disclosures comply with the requirements of Reg. Z, § 226.4(d)(3).

F. ***Other Considerations***

In selling GAP coverage, creditors should be aware, too, that Iowa Code § 537.5108 or Iowa's Unfair and Deceptive Acts and Practices Act (Iowa Code § 714.16) or both also apply to the sale of this product. Its sale may be unfair and deceptive or unconscionable in certain circumstances, such as where there is little or no likelihood of benefit to the consumer. For example, GAP products may limit the payout to a percentage of the collateral's value, e.g. 120% of market value or similar external value index. In the event the price of the vehicle was over fair market value, such as where negative equity was buried in the cash price, or the vehicle was simply significantly overpriced, the product would in fact be of no benefit to the consumer. In that case, it would be difficult to sell the product to the consumer "voluntarily" without making deceptive representations, or omitting the material fact that the "protection" purchased was in fact illusory. The Colorado Administrator has explicitly addressed this issue in its GAP rules, see 4 Co. Adm. Code 902-1, Rule 8(g). Such conduct may well fall within the scope of Iowa's existing statutory provisions, such as Iowa Code § § 537.5108(4)(b), (c), (d) (factors to consider in determining unconscionability are inability of the consumer to receive substantial benefits from goods or services sold, gross disparity between price and value, or improper sale of insurance)

III. SUMMARY AND CONCLUSIONS

In sum:

* GAP charges may be financed in a motor vehicle transaction (but only in motor vehicle transactions), and excluded from the finance charge provided the disclosures required by Reg. Z, 226.4(d)(3) are complied with.

* The provisions of S.F. 97, Section 22 will go into effect July 1, 2003, and do not require the adoption of a rule by the ICCC Administrator.

* A GAP charge is subject to rebate upon early termination. If the Insurance Division determines a GAP product to be insurance, the formula for calculating the rebate will be that authorized by the Insurance Division. If it is a non-insurance product, for purposes of the Administrator's enforcement of Iowa Code § 537.2510, the rebate may be calculated by either the actuarial method or the pro rata method.

* The creditor, or, if the paper was assigned, the assignee/holder, is the entity responsible for making the GAP refund.

* Provided all other delivery, signature, and disclosure requirements are complied with, a waiver agreement may be contained in a document separate from the retail installment contract.

If you have additional questions, please feel free to contact me.

Sincerely,

Kathleen E. Keest

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Iowa Consumer Credit Code

Appendix A follows: (Party responsible for making rebates)