Date: March 11, 1999.

Summary Conclusion: A federal savings association may participate in the New England Mortgage Insurance Exchange ("Exchange"), a reciprocal mortgage guaranty reinsurer established under Vermont law. Participating lenders in the Exchange originate or purchase low down payment residential mortgages that are insured by a private mortgage insurance company. The Exchange then writes reinsurance coverage on those mortgages, allowing lenders to contribute risk from their loans into a pool and then take back a share of the risk from the pool.

Subject: Home Owners' Loan Act/Savings Association Powers.

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

P-99-4

Chief Counsel

March 11, 1999

[

]

Re: Proposed Mortgage Guaranty Reinsurance Activities through Reciprocal Insurer

Dear [ ]:

This responds to your inquiry to the Office of Thrift Supervision ("OTS") regarding whether [ ], a federal savings association (the "Association"), may participate in the New England Mortgage Insurance Exchange (the "Exchange"), a reciprocal mortgage guaranty reinsurer. The Exchange provides private mortgage guaranty reinsurance coverage for loans originated or purchased by participating lenders and insured with a private mortgage insurance company.

In brief, we conclude that the activity is authorized because it is a power incident to the residential real property lending authority of federal savings associations in section 5(c)(1)(B) of the Home Owners' Loan Act ("HOLA").[1]

I. Background

The Association would like to participate in the Exchange, an association captive reciprocal mortgage guaranty reinsurer established under Vermont insurance law.[2] The authorized activities of the Exchange consist solely of writing private mortgage

[1] 12 U.S.C.A. § 1464(c)(1)(B) (West Supp. 1998).

[2] Captive insurers insure or reinsure only risks related to the business of their owner(s). "Association captives" are a type of captive insurer, all of whose participants or owners are also members of a sponsoring industry association or similar group, and which insures or reinsures only risks relating to its members. As a licensed reinsurer in the state of Vermont, the Exchange will be subject to ongoing supervision and regulation of the Vermont Commissioner of Banking, Insurance, Securities and Health Care Administration.

guaranty reinsurance coverage for loans originated or purchased by the participating lenders. As detailed in a supporting letter from the Exchange's legal counsel ("Counsel"),[3] the Exchange is not a separate legal entity, but is a web of contractual agreements among its members ("Participating Lenders"). Counsel represents that the current members of the Exchange consist of several national banks[4] and a large number of state-chartered commercial and savings banks. Counsel also represents that several federal savings associations, including the Association, have indicated that they wish to participate in the Exchange. Membership in the Exchange is limited to banks and other mortgage lenders that also participate in the Northern New England Insurance Trust ("NNEIT").[5] The Association is a member of NNEIT.

We are advised that, at inception, the Exchange funded three obligations. Under Vermont law, an association captive formed as a reciprocal must have free surplus of at least $1 million.[6] This level of surplus allows the Exchange to issue reinsurance obligations on a nonassessable basis, meaning there is no available recourse against the Participating Lenders for the Exchange's liabilities.[7] To satisfy this surplus requirement, Counsel represents that the Exchange has furnished a $1 million letter of credit in favor of the Vermont Commissioner of Banking, Insurance, Securities and Health Care Administration (the "Commissioner"), issued by a bank that is not participating in the Exchange.[8] The letter of credit was fully collateralized with cash, cash equivalents or other liquid assets acceptable to the Commissioner.

The Exchange also funded start-up expenses of $[ ] and a reinsurance trust with an initial deposit of $[ ]. The reinsurance trust was established to secure performance of the Exchange's reinsurance obligations to the private mortgage

---

[3] Denise Deschenes, Law Offices of Primmer and Piper, PC, St. Johnsbury, Vermont, authored the supporting letter.

[4] The Office of the Comptroller of the Currency ("OCC") concluded last year that national banks may participate in the Exchange either directly or, with the OCC's approval, through their operating subsidiaries. See OCC Interpretive Letter No. 828 (Apr. 6, 1998).

[5] NNEIT is a pooled arrangement among bank and non-bank mortgage lenders in several states for the purchase of credit insurance at advantageous rates. Not all of the lenders participating in NNEIT will also participate in the Exchange.

[6] Vt. Stat. Ann. Tit. 8, § 6005(b) (1998). Free surplus is not defined within this section. However, the general Vermont insurance statute notes that such free surplus "shall be in the form of cash or marketable securities." Vt. Stat. Ann. Tit. 8, § 3304 (1998).

[7] Vt. Stat. Ann. Tit. 8, § 4853(a) (1998).

[8] The letter of credit was provided with the assistance of an insurance company.

insurance company (discussed below).[9] The start-up expenses and the initial contribution of $[ ] to the reinsurance trust were met with a loan from NNEIT. Because these funding requirements were met with the proceeds of this loan, no initial cash outlay or investment of funds is required to become a Participating Lender. The loan was funded by an insurance company and is evidenced by a [ ] surplus note.[10] The Exchange must make quarterly contributions into the trust of [ ] percent of new covered risk.[11] The Exchange is also required to contribute a specified percentage of its ceded premium[12] to the reinsurance trust beginning in the [ ] year of the program's operation, with the percentage contribution increasing over time to a rate of [ ]% of ceded premium in the [ ] years of operation. Once the trust achieves a level of funding equal to [ ]% of the aggregate risk in force, contributions of ceded premium to the trust in excess of that amount will be released to the Exchange and will be available for distribution to Participating Lenders. The initial $[ ] deposit to the trust was credited toward future required deposits.

The Participating Lenders in the Exchange originate or purchase low down payment residential mortgages[13] that are insured by [ ], a [ ] monoline private mortgage insurer (the "Company"). In turn, the Exchange writes private mortgage guaranty reinsurance coverage on those residential mortgages. Each Participating Lender must execute a Subscriber Agreement pursuant to which it agrees to remit mortgage insurance policy premiums to the Company and assume a pro rata share of the risk reinsured by the Exchange.[14] This arrangement allows Participating Lenders to contribute risk from the loans they have underwritten to a pool and then take back a share of the risk from that pool. If an institution does not contribute risk from its mortgages to the pool during a particular

---

[9] In the event the Exchange's obligations under the Reinsurance Agreement are triggered, the Company has agreed to limit its claims against the Exchange to assets held in the reinsurance trust, plus offsets against future ceded premiums.

[10] A surplus note is a promissory note that may be repaid only out of the insurer's earned surplus and with the approval of the Vermont Commissioner.

[11] New covered risk is the added risk taken on by the Exchange during a quarter.

[12] The ceded premium is the premium income that the private mortgage insurance company cedes to the Exchange as compensation for taking on risk.

[13] For purposes of this letter, "low down payment mortgages" means those that have down payments of less than 20 percent of the property's value, or loan-to-value ("LTV") ratios of over 80 percent.

[14] Each Participating Lender must also appoint a common attorney-in-fact and agree to be bound by the Exchange's rules and regulations.

period, then it does not share in the premiums for that period.[15] New members to the Exchange contribute risk to the pool, take on their pro rata share of the risk of the Exchange, and are obligated to direct premium income toward the expenses of the Exchange to the same degree as other Participating Lenders. Like the original participants in the program, no initial cash outlay or investment of funds is required to become a Participating Lender.

Under an Excess Layer Primary Mortgage Guaranty Reinsurance Agreement ("Reinsurance Agreement") between the Exchange and the Company, the Company is responsible for the first layer of risk on the insured mortgages, up to a specified percentage ranging from [ ] percent to [ ] percent of an annual book.[16] Under the Reinsurance Agreement, the Exchange contractually assumes from the Company, and is obligated to the Company for, a second loss layer on each annual book. The Exchange's obligation on the second loss layer on an annual book is capped at [ ] percent of the total of the Company's first layer of risk on all product books included in the annual book.[17] The Exchange's reinsurance liability for an annual book terminates on December 31, [ ] years after the end of the calendar year of origination. In return for taking on this risk, the Exchange is compensated by payment of a fixed rate of [ ] percent of the mortgage insurance premiums paid to the Company by the Participating Lenders.[18] The Company continues to be directly liable, as the primary insurer, to the holders of the insured loans to pay the full amount of the mortgage insurance coverage.

Participating Lenders in the Exchange do not delegate credit underwriting analysis and decision making on any loan to the Company or any other party. The

---

[15] For example, if an institution contributes risk from mortgages to the Exchange for two years, and then does not contribute risk during the third year, it will share in the premium allocation with respect to loans contributed to the pool during the first two years (for the ten year life of each of the annual books for such years), but not the premium allocation with respect to loans contributed to the pool during the third year.

[16] The range will vary depending upon the underlying loan type (fixed rate or variable rate) and LTV ratio (80 percent to 97 percent). Variable rate loans will have a higher first layer percentage than fixed rate loans and higher LTV loans will have a higher first layer percentage than lower LTV loans. The annual book is the total of all product books for a year. A product book is a grouping of loans originated or purchased during a year with similar characteristics for purposes of applying the applicable first layer percentage.

[17] For example, if $[ ] million of originations is insured for [ ]% of the principal balance, or $[ ] million, and the applicable percentage for the first layer of coverage is [ ]%, then the first loss layer maximum exposure for the Company is $[ ] and the second loss layer maximum exposure for the Exchange is $[ ].

[18] The borrower pays the mortgage insurance premium to the Participating Lender. In turn, the Participating Lender forwards the premium to the Company which pays the Exchange its [ ] percent share. The Exchange, after making appropriate deductions, including expenses, then returns the pro rata share of premiums back to the Participating Lender.

Company performs its own independent insurance underwriting evaluation of each loan, but it has approved delegated underwriting authority for certain of the lenders participating in the Exchange.[19]

Each Participating Lender in the Exchange provides the borrowers on loans it originates with a notice disclosing the reinsurance arrangement. This notice states that the lender will derive a financial benefit from the arrangement and that the borrower may choose to be excluded from the arrangement if desired.[20]

A Participating Lender may voluntarily withdraw from the Exchange at any time upon notice to a Subscribers' Advisory Committee ("Committee"). If a participant terminates membership at a time other than the end of a calendar year, that participant will share in the net income or loss of the Exchange for that partial year only at the discretion of the Committee. A participant terminating membership has no claim to the assets held in the reinsurance trust. The entire Exchange program may be terminated by a vote of three-fourths of the participants, subject to any limitations in the Reinsurance Agreement.

II. Discussion

The HOLA does not expressly authorize federal savings associations to participate in reciprocal mortgage guaranty reinsurance activities. However, OTS has long recognized that federal savings associations possess "incidental powers," i.e., powers that are incident to the express powers of federal savings associations, as set forth in the HOLA. OTS employs a four-factor analysis to determine the incidental powers of federal savings associations under the HOLA.[21] We will analyze the Association's proposed participation in the Exchange, a reciprocal mortgage guaranty reinsurance exchange, under each of these factors.

1. The Activity is Consistent with the Purpose and Function Congress Envisioned for Federal Savings Associations. In section 5(c)(1)(B) of the HOLA,

---

[19] In other words, an institution with delegated underwriting authority from the Company has the ability to bind mortgage insurance coverage for a loan that it approves utilizing Company-approved underwriting criteria.

[20] Counsel's supporting letter recognizes the applicability of the Real Estate Settlement Procedures Act ("RESPA"). The Department of Housing and Urban Development ("HUD") issued an August 6, 1997 letter on captive mortgage reinsurance arrangements that will assist you in meeting your responsibility to comply with RESPA. You should contact HUD if you require further clarification.

[21] See, e.g., OTS Op. Chief Counsel (Jan. 10, 1995); OTS Op. Acting Chief Counsel (Oct. 17, 1994); OTS Op. Acting Chief Counsel (Mar. 25, 1994).

Congress granted explicit authority to savings associations to "invest in, sell or otherwise deal in ... [l]oans on the security of liens upon residential real property."[22] Participation in a reciprocal mortgage guaranty reinsurance program advances residential real property lending by enhancing the attractiveness of low down payment mortgages to lenders, investors and borrowers. Furthermore, the "statutory lending mission of federal savings associations is best served by giving each association the flexibility to structure debt repayment terms and to manage the risks of default in a way that fits with its own business strategy."[23] Thus, participation in the Exchange is consistent with the purpose and function Congress envisioned for federal savings associations.

2. The Activity is Similar to, or Facilitates the Conduct of, Expressly Authorized Activities for Federal Savings Associations. Participating in a reciprocal mortgage guaranty reinsurance program is similar to several activities that are expressly authorized for federal savings associations. Participation in a reciprocal mortgage guaranty program is similar to pricing and allocating risk on residential real property loans directly or through loan participations.[24] It is also a variation on a simple mortgage reinsurance program or mortgage loan performance guaranties.

First, participation in the Exchange will allow the Association and other members to partially take back risk on their own mortgage loans. The credit judgments and risks involved in taking back this risk are similar to those involved in residential real property lending. In both instances, an assessment must be made of the likelihood of default and the probability of loss upon liquidation of the pledged collateral based upon the credit history of the borrower, the size of the down payment made by the borrower and the value of the collateral. Thus, with respect to reinsuring the risks associated with loans they have already originated, Participating Lenders engage in credit underwriting analysis no different from that undertaken in conventional residential real property lending.

Unlike direct conventional residential mortgage lending, however, members of the Exchange take on risk that derives from loans underwritten by other Participating Lenders in the Exchange. Thus, institutions participating in the Exchange diversify risk by indirectly participating in lending activities in other geographic areas, including other states in the region. This is similar to a thrift diversifying its loan portfolio by

---

[22] 12 U.S.C.A. § 1464(c)(1)(B) (West Supp. 1998).

[23] OTS Op. Chief Counsel (Jan. 10, 1995) at 6.

[24] This activity is authorized by HOLA section 5(c)(1)(B), 12 U.S.C.A. § 1464(c)(1)(B) (West Supp. 1998).

participating in one or more loan participations. Usually, a credit review of real estate loans is undertaken by the federal savings association extending the credit.[25] However, the loans pooled in the Exchange are reviewed by the originating Participating Lender, and as an additional review of the risk, the Company generally performs its own independent insurance underwriting evaluation. So long as Participating Lenders in the Exchange review the underwriting standards of the Company, and determine that these criteria are not less stringent than their own lending standards, it is not necessary for each participant to undertake a review of each loan reinsured by the Exchange.

Second, the activity is also similar to reinsurance and related activities that are authorized for federal savings associations. For example, in 1995, OTS concluded that the residential real property lending authority expressly granted to federal savings associations by HOLA section 5(c)(1)(B) includes the power to underwrite and reinsure credit insurance for loans made by the Association or its subsidiaries.[26] OTS noted that underwriting and reinsuring credit insurance is one way for a lender to set the terms of each loan, including the terms for repayment, and that no evidence suggests that Congress intended to prohibit associations from setting these terms.[27] The opinion concluded that flexibility in structuring debt repayment terms and managing the risks of default serves the statutory lending mission of federal savings associations."[28] This reasoning also fully applies to membership in the Exchange, which will assist the Association in managing the risk of default in two ways: by obtaining insurance for loans contributed to the pool and by diversifying its overall risk geographically by accepting risk from other Participating Lenders.

Participation in the Exchange is also similar to a federal savings association's issuance of mortgage loan performance guaranties on loans it originates, which is permissible under the authority of HOLA section 5(c)(1)(B).[29] Under the performance

---

[25] Real estate lending standards are contained in 12 C.F.R. § 560.101 (1998).

[26] OTS Op. Chief Counsel (Jan. 10, 1995). The 1995 opinion also relied on the consumer lending authority set forth in HOLA section 5(c)(2)(D), 12 U.S.C.A. § 1464(c)(2)(D) (West Supp. 1998). For safety and soundness reasons, OTS indicated that the activity should be conducted in the association's operating subsidiary. OTS has also authorized federal savings association service corporations to underwrite and reinsure credit insurance. See, e.g., FHLBB No. 84-234 (May 14, 1984).

[27] OTS Op. Chief Counsel (Jan. 10, 1995) at 5.

[28] Id. See also OTS Op. Chief Counsel (Dec. 18, 1995) (a federal savings association may include a debt cancellation provision in a consumer loan contract) and OTS Op. Acting Chief Counsel (Sept. 15, 1993) (authority of federal savings associations to enter into debt cancellation contracts).

[29] OTS Op. Chief Counsel (Oct. 2, 1998).

guaranties, an association assumes a portion of the risk of default on low down payment mortgages it originates.[30]

Participating in a reciprocal mortgage guaranty reinsurance program also facilitates the conduct of residential real property lending, an expressly authorized activity. Mortgage insurance increases the attractiveness to lenders and secondary market participants of low down payment mortgages by carving out a first loss position in the lending transaction. This structure offers the option of reallocating risk between the lender and the insurer beyond what is available in a standard mortgage insurance contract without reinsurance.[31]

3. The Activity is Necessary To Enable Federal Savings Associations To Remain Competitive and Relevant in the Modern Economy. The ability of federal thrifts to participate in the Exchange is necessary to enable them to remain competitive and relevant. As noted above, the OCC has determined that national banks and their operating subsidiaries may participate in the Exchange.[32] The OCC concluded that the activities of the Exchange are part of the business of banking, and are, alternatively, an activity incidental to banking. Similarly, numerous state-chartered commercial banks and savings banks currently participate in the Exchange.

If federal savings associations are not allowed to pool their risks through a reciprocal mortgage guaranty reinsurance exchange, they may be placed at a

---

[30] OTS has also approved reinsurance of private mortgage insurance by a saving association's service corporation. Under this reinsurance program, loans originated or purchased by the federal savings association, its mortgage lending subsidiaries, or its mortgage lending affiliates, are insured by a private mortgage insurer and then reinsured by the service corporation. In contrast, the Exchange involves a number of institutions pooling reinsurance risk from their mortgages and then taking back risk from loans underwritten by other lenders and from their own loans. OTS Op. Chief Counsel (Nov. 2, 1998). See also OTS Op. Business Transactions Division (Oct. 10, 1997) (service corporation providing reinsurance on private mortgage insurance for loans originated by a federal savings association or its mortgage lending subsidiaries).

[31] As noted previously, the OTS has permitted service corporations of federal savings associations to engage in reinsurance activities. The OTS also allows federal savings associations to engage in joint ventures. The vehicle for participating in the Exchange is similar to entering into a joint venture or joint user corporation to engage in permitted activities. Although the structure is not expressly authorized, these arrangements allow federal savings associations to join together with others to pool their resources to form a viable and potentially profitable entity and to do jointly what any one would be unable to do individually. See e.g., OTS Op. Chief Counsel (Dec. 22, 1995); OTS Op. Chief Counsel (Sept. 15, 1995). For example, it might be difficult for a small institution, like many of the Participating Lenders in the Exchange, to achieve individually the requisite economies of scale, and thus establish a viable mortgage guaranty reinsurance program by engaging in significant amounts of reinsurance activity.

[32] OCC Interpretive Letter No. 828 (Apr. 6, 1998).

competitive disadvantage in comparison to institutions that are able to take back, in return for compensation, some portion of the risk on their own loans. Through arrangements like the Exchange, institutions can achieve economies of scale and efficiencies that may not be possible individually. For example, smaller institutions may only find it feasible to participate in reinsurance activities if they can share risk on a pooled basis, as in the case of the Exchange.

4. <u>The Activity Relates to the Financial Intermediary Role that All Federal Savings Associations Were Intended To Play.</u> Federal savings associations play a role as financial intermediaries by facilitating transfers of funds. They do so by first receiving funds from depositors, investors and other creditors and then directing those funds to borrowers in need of credit. Participation in the Exchange relates to the financial intermediary role of federal savings associations. As discussed previously, it does so by facilitating the conduct of residential real estate lending by pooling and reallocating the risk from loans originated by Participating Lenders. By increasing the options available to participants in the real estate lending process, the Exchange may lead to expanded lending over the level achievable in an environment lacking the availability of reinsurance.

III. Conclusion

All four factors in the incidental powers analysis provide a basis for our conclusion that federal savings associations are authorized to participate in the Exchange. For the foregoing reasons, we conclude that the Association may participate in the Exchange as proposed. In participating in the Exchange, the Association should observe the guidance discussed in OTS Thrift Bulletin 72 pertaining to high loan-to-value home mortgage lending.[33] Finally, the Association's conduct of the proposed activity is subject to any safety and soundness or other conditions OTS's Northeast Region may deem appropriate.

In reaching the foregoing conclusions, we have relied on the factual information and representations contained in the materials submitted to us by you and by Counsel for the Exchange and made in subsequent telephone conversations with OTS staff. Any material change in facts or circumstances from those described herein could result in a

[33] OTS Thrift Bulletin 72, "High Loan-to-Value Home Mortgage Lending" (August 27, 1998) ("TB-72"). For example, for loans where the private mortgage insurance does not cover the portion of the loan that exceeds the supervisory LTV limits or where the risk is assumed through reinsurance, that portion not covered by private mortgage insurance (or a government guarantee) counts toward the percentage of capital investment limit. TB-72 at 4.

different conclusion. Furthermore, we wish to emphasize that these conclusions only apply to participation in the Exchange, and do not apply to, or authorize, participation in any other reinsurance program or arrangement. This office will review other proposed reinsurance programs or arrangements on a case-by-case basis.

If you have any questions regarding this matter, please feel free to contact Vern McKinley, Senior Attorney, at (202) 906-6241.

Very truly yours,

Carolyn J. Buck
Chief Counsel

cc: Regional Directors
Regional Counsel
Denise J. Deschenes, Esq.,
Counsel for the Exchange