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

December 18, 1995

[redacted]

Re: Debt Cancellation Contracts

Dear [redacted]

This responds to your inquiry regarding whether [redacted] (the "Association"), may include a debt cancellation provision in its consumer installment loan contracts, without utilizing an operating subsidiary for this purpose, as was required by a prior opinion.

We have reexamined this issue and, for the reasons stated below, conclude that federal savings associations may include debt cancellation clauses in their loan contracts without utilizing an operating subsidiary, subject to the conditions set forth below.

I. Background

The Association wishes to provide, as a term of its consumer installment loan agreements, that the obligation to repay the loan will be cancelled upon the borrower's death. This provision will be included in all the Association's consumer installment loan agreements. The Association will not charge its customers a separate fee for this feature, but will cover its costs from the interest rates charged on its loans.

Rather than reserving a portion of the interest received on each loan to cover the cost of its debt cancellation obligations, the Association plans to purchase a contractual liability insurance policy that will insure the amount of each loan cancelled, up to a maximum amount of $[redacted] per loan (which includes the vast majority of the Association's consumer installment loans), subject only to exceptions for amounts in arrears, unpaid late charges, loans in default and deaths due to suicide. The Association will obtain this insurance from an affiliated underwriter that is in compliance with all regulatory requirements and has all licenses required to issue this insurance in the relevant jurisdictions.

II. Discussion

In an opinion issued September 15, 1993 ("1993 Opinion"), the Office of Thrift Supervision ("OTS") concluded that federal savings associations may enter into debt cancellation contracts in connection with the consumer loans they originate.[1] As is discussed in the 1993 Opinion, this authority is subsumed within the express power of a savings association to "make" consumer loans under Section 5(c)(2)(D) of the Home Owners' Loan Act ("HOLA")[2] and, alternatively, could also be based upon the "incidental powers" doctrine.

In an opinion issued January 10, 1995, the OTS further concluded that federal savings associations may underwrite and reinsure credit insurance issued in connection with loans that either they or their subsidiaries originate.[3] That opinion noted the similarities between debt cancellation and credit life insurance, and drew upon the reasoning used in the 1993 Opinion. However, the 1995 Opinion also concluded that, for reasons of safety and soundness, a savings association wishing to engage in credit insurance underwriting activities will be required to do so through an operating subsidiary, for two reasons: (a) to isolate and contain the liabilities associated with the underwriting; and (b) to eliminate any need for state insurance regulators to examine the association's books and records.[4] A footnote in the 1995 Opinion extended the operating subsidiary requirement to debt cancellation contracts as well.[5]

The Association has requested reconsideration of the requirement that debt cancellation contracts be issued only through operating subsidiaries, especially where, as here, an institution's risk of loss from debt cancellation is covered almost entirely by insurance.

As a result of the Association's request, the OTS has again reviewed the safety and soundness implications of debt cancellation contracts and concluded that such

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[1] OTS Op. Chief Counsel (Sept. 15, 1993).

[2] 12 U.S.C.A. § 1464(c)(2)(D) (West Supp. 1995)

[3] OTS Op. Chief Counsel (January 10, 1995).

[4] Id. at 7.

[5] Id. at 7, n. 19

contracts generally need not be offered through subsidiaries, even when the risk of loss is not covered by insurance. For these purposes, an important distinction can be drawn between credit insurance and debt cancellation contracts. Credit insurance is structured and sold as a separate product from the underlying loans. This raises the possibility that a savings association could sell a substantial volume of loans covered by credit insurance while retaining the credit insurance risk. Under these circumstances, a savings association could accumulate insurance liabilities that are quite substantial compared to its asset size and capital level. Any extraordinary insurance losses that outstrip insurance reserves could threaten the stability of the institution. For this reason. we believe it is generally prudent to confine credit insurance liabilities to an operating subsidiary. By contrast, debt cancellation by its nature is a basic term of the underlying loan rather than a separable obligation. Thus, any transfer of a loan that is subject to debt cancellation should remove the associated cancellation risk from the lender. Removal of this risk mitigates our safety and soundness concerns.

In addition, there are differences between debt cancellation and credit insurance that minimize the likelihood that a state insurance regulator would have a basis to examine the books and records of a savings association offering debt cancellation. As discussed above, debt cancellation simply requires the extinguishment of the debt upon the borrower's death or disability; it does not require payment of a death benefit or disability payments by an insurer, whose solvency is the primary concern of state insurance regulation.[6]

We therefore conclude that federal savings associations may directly offer debt cancellation contracts on loans they originate without utilizing an operating subsidiary, so long as the association retains no risk related to debt cancellation upon any sale of the loans. However, an association offering debt cancellation must either obtain insurance to cover its risk of loss or establish reasonable actuarial reserves (or some combination of reserves and insurance). In the present instance, the Association has indicated that the insurance it obtains will not cover losses on loan balances in excess of [redacted] or losses under certain other defined circumstances. Reasonable actuarial reserves should be established for these uninsured risks.

Finally, we also note that the Association intends to obtain its insurance from an affiliate of the Association. This transaction will be subject to Section 23B of the

[6] See First National Bank of East Arkansas v. Taylor, 907 F.2d 775, 780 (8th Cir. 1990), cert. denied, 498 U.S. 972 (1990).

Federal Reserve Act ("FRA")[7] and to the implementing regulations of the OTS at 12 C.F.R. § 563.42, which require that the terms of the transaction must be at least as favorable to the Association as those prevailing at the time for comparable transactions with nonaffiliates.[8]

In reaching the foregoing conclusions, we have relied upon the representations made in the materials you submitted and in subsequent discussions, as summarized herein. Our conclusions depend upon the accuracy and completeness of those representations. Any material difference in facts or circumstances from those described herein could result in different conclusions.

If you have any questions regarding this matter, please feel free to contact Gary Sutton, Counsel (Banking and Finance), at (202) 906-5761.

Very truly yours,

Carolyn Buck

Carolyn J. Buck
Chief Counsel

cc: All Regional Directors
All Regional Counsel

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[7] Section 11(a) of the HOLA applies Section 23B of the FRA to savings associations "in the same manner and to the same extent as if the savings association were a member bank of the Federal Reserve System." 12 U.S.C.A. § 1468(a) (West Supp. 1995)

[8] We have considered whether the Association's proposal to offer debt cancellation as a standard term of its consumer loan contracts (rather than offering it as an option) would run afoul of the restrictions on tying arrangements which, in relevant part, prohibit a savings association from extending (or varying the consideration for) credit, on the condition that the customer obtain some additional credit, property or service from the association or any affiliate. 12 U.S.C.A. § 1464(q) (West Supp. 1995). In this instance, it is the Association that will obtain insurance from its affiliate; the customer will have no relationship of any kind with the affiliate. Moreover, an illegal tying arrangement requires two distinct products: a tying product and a tied product. See McGee v. First Fed. Sav. & Loan Ass'n., 761 F.2d 647 (11th Cir. 1985), cert. denied, 474 U.S. 905 (1985). Under the Association's proposal, the debt cancellation provision is an integral part of the loan and has no existence as a separate product.