Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

January 10, 1995

[redacted]

Re: Authority of Federal Savings Associations to Underwrite and Reinsure Credit Insurance Through Operating Subsidiaries

Dear [redacted]

This responds to your inquiry submitted on behalf of [redacted] ("Association"), concerning whether an operating subsidiary of the Association may underwrite and reinsure credit insurance on loans originated by the Association and its subsidiaries.

For reasons explained fully below, we conclude that operating subsidiaries of federal savings associations may underwrite or reinsure credit insurance, provided such insurance is issued only in connection with loans made by the association or subsidiaries of the association. When engaging in these activities, however, operating subsidiaries must comply with any applicable state insurance laws and certain supplemental policies and conditions imposed by the Office of Thrift Supervision ("OTS"), as more fully described below.

I. Background

You have indicated that the Association wants to redesignate its second-tier service corporation, [redacted] ("Insurance Company"), as an operating subsidiary of the Association. The Association has filed an application with the OTS West Region for Insurance Company to become an operating subsidiary. Although the OTS and its predecessor, the Federal Home Loan Bank Board, have long permitted federal savings associations on a case-by-case basis to underwrite and reinsure credit insurance indirectly through service corporation subsidiaries, your request to conduct the activity through an operating subsidiary raises a significant issue of law and policy. Hence, the Association's application is being held in abeyance pending this response.

Insurance Company is incorporated in Arizona and is licensed to do business in California. Currently, Insurance Company's

business is limited to reinsuring credit insurance[1] issued by a third party underwriter on loans originated by the Association and the Association's consumer finance subsidiary.[2] The Association's exposure is limited to not more than $25,000 as to any single borrower by a "stop-loss" provision in the agreement it has with the insurer. The Association seeks confirmation that these reinsurance activities may be performed in an operating subsidiary of a federal savings association. The Association also inquires whether Insurance Company, as an operating subsidiary, could directly underwrite credit insurance on loans originated by the Association and its consumer finance subsidiary.

You have informed us that the Association's initial investment in Insurance Company as an operating subsidiary will be the same as its current capital investment in Insurance Company as a service corporation, which as of June 30, 1994, was 0.11 percent of the assets of the Association. Over the next several years, you anticipate that additional investments in Insurance Company may be necessary for expansion purposes as the business of the Association and its consumer finance subsidiary grow. You do not expect Association's future investment in Insurance Company to exceed $10 million in the aggregate (0.47 percent of the Association's June 30, 1994, assets).

You have also represented that Insurance Company at all times maintains capital and surplus and reserves equal to or in excess of that required by its state insurance regulators. As of September 30, 1994, Insurance Company had total assets of $6.0 million, reserves of $2.7 million, and capital and surplus of $3.0 million (or approximately 50 percent of assets).

Insurance Company is managed by its president, who has 35 years experience in the business of credit insurance. Insurance

---

1. Credit insurance policies pay off the outstanding indebtedness of the loans to which they relate if the borrower dies or is disabled while the loan is outstanding. See, e.g., 2 OTS Regulatory Handbook of Thrift Activities § 630 at 630.13 (Jan., 1994) ("Handbook"); OCC Interpretive Letter No. 283 (Mar. 16, 1984), reprinted in [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,090).

2. The underwriter is the party who is legally obligated to make payment on an insurance policy upon the occurrence of the contingencies covered by the policy. See Handbook § 630, at 630.8. A reinsurer is a party who agrees to reimburse the underwriter for all or a portion of any payment the underwriter must make. Thus, reinsurance is essentially underwriting insurance for insurers. See Handbook § 630, at 630.9. Since reinsurance is a form of underwriting, underwriting and reinsurance activities will be collectively referred to herein as "underwriting."

Company has not, at any time, been subject to sanctions by its state insurance regulators.

II. Discussion

A. Legal Authority

Section 5(c)(1)(B) of the Home Owners' Loan Act ("HOLA") expressly authorizes federal savings associations to "invest in, sell or otherwise deal in . . . loans on the security of liens upon residential real property."[3] Section 5(c)(2)(D) of the HOLA expressly authorizes federal savings associations to "make loans for personal, family, or household purposes," i.e., consumer loans.[4]

In 1993, the OTS issued an opinion concluding that this express statutory authority for federal savings associations to originate loans includes the power to issue debt cancellation contracts.[5] In that opinion, the OTS noted that the authority to lend necessarily includes within it the power to specify the terms and conditions under which a loan will be compromised or forgiven. The reasoning of the 1993 Opinion is directly relevant to the question currently before us, and, we therefore quote from it at length:

> Section 5(c)(2)(D) of the Home Owners' Loan Act,[6] expressly authorizes federal savings associations to "make loans for personal, family, or household purposes," i.e., consumer loans. This express authorization to "make" consumer loans necessarily includes within it the authority to negotiate and fix the terms of each loan, including the terms for repayment and the circumstances under which a repayment obligation can be modified, compromised, or forgiven. We believe that debt cancellation contracts properly fall within the scope of this authority. The absence of a specific statutory statement to this effect is no more significant than the absence of a specific statutory statement that a savings association may include a maturity date, a due-on-sale clause, or a prepayment penalty in its loan contracts.

---

3. 12 U.S.C.A. § 1464(c)(1)(B) (West Supp. 1994).

4. 12 U.S.C.A. § 1464(c)(2)(D) (West Supp. 1994).

5. OTS Op. Chief Counsel (Sept. 15, 1994) ("1993 Opinion"). The 1993 Opinion dealt only with the statutory authority to issue debt cancellation contracts on consumer loans, due to the particular facts presented by the inquiry. However, the rationale from that opinion clearly applies with equal force to debt cancellation contracts on residential real estate loans.

6. 12 U.S.C.A. § 1464(c)(2)(D) (West Supp. 1993).

The statutory authorization to "make" loans reasonably includes within it the authority to specify the details of the rights and responsibilities of the borrower and lender.

Of course, this does not give savings associations license to include provisions in a loan contract that are clearly unrelated to the extension of credit. Here, however, we are dealing with the terms and circumstances under with a debt must be repaid, which is the heart of a loan contract. Given the obvious risk that a borrower may die or become disabled during the term of a loan and given the costs and complexities associated with repossessing and reselling property or pursuing a deficiency claim against a borrower's estate, it is reasonable for a loan contract to contain terms specifying alternative rights and responsibilities of the parties in the event of such an occurrence.

Indeed, the authority to compromise or forgive a loan is so fundamental to the lending business of a federal savings association that the model bylaws prescribed by the OTS and its predecessor for federal mutual savings associations have long contained a provision expressly acknowledging that savings associations may "extend leniency and indulgence to borrowing members who are in distress and generally . . . compromise and settle any debts and claims."[7] Although the model bylaws for federal stock savings associations employ a briefer format and, therefore, do not enumerate specific powers, federal stock savings associations also have always been deemed to possess authority to compromise and cancel their loans. If a savings association has legal authority to compromise or cancel a loan once a borrower encounters distressing circumstances, it follows that the association also has authority to specify in its loan contracts the terms under which the association will compromise or cancel its debts and to receive compensation for making this commitment.

Accordingly, we conclude that authority to offer debt cancellation contracts is subsumed within the authority of federal savings associations to "make" loans.[8]

The only distinction between underwriting credit insurance and debt cancellation contracts is that credit insurance is documented in the form of an insurance contract, rather than as a

---

7. Bylaws § 11(d), 12 C.F.R. Part 544, Appendix, § 11(d).

8. 1993 Opinion at 2-3.

debt cancellation contract. This is a purely formal distinction. The economic substance of the two forms of transaction is identical. It has long been the OTS's position that the form of a transaction should not be exalted over its economic substance.[9]

With respect to both credit insurance and debt cancellation contracts, borrowers pay a fee to the issuer in exchange for the issuer's agreement to forgive the debt upon their death or upon the occurrence of certain defined events that would affect their ability to repay their loan, such as medical disability or loss of a job. In both instances, the costs to the borrower are comparable. The exposure of the institution to loss is also the same regardless whether the transaction is documented as insurance or a debt cancellation contract. Based on conventional actuarial analysis, the issuer will, in both instances, reserve a portion of the fee paid by the borrower to cover the risk of death or disability. The amount reserved will be the same regardless which form the transaction takes.

As was pointed out in our 1993 Opinion, lending lies at the heart of the statutory mission of federal savings associations,[10] and negotiating the terms of the repayment of a loan lies at the heart of lending. When evaluating whether to originate a loan, a lender must consider the repayment terms and the risks that the borrower may die or become disabled and thus unable to meet the repayment obligation on the loan. A lender has three options for dealing with these lending risks: (a) absorb the losses as they occur from death or disability; (b) underwrite the risk in exchange for compensation (via credit insurance or a debt cancellation contract); or (c) require the risk to be underwritten by a third party insurer.[11] No evidence suggests that Congress intended to prohibit thrifts from exercising any of these options. 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.

---

9. See OTS Op. Chief Counsel (Aug. 22, 1994); OTS Op. Chief Counsel (Oct. 15, 1990) and the cases cited therein.

10. See e.g. 12 U.S.C.A. § 1464(a) (West Supp. 1994); and S. Rep. No. 368, 96th Cong., 1st Sess. 12 (1979), reprinted in 1980 U.S. Code Cong. & Admin. News 236, 248.

11. A lender may require a borrower to obtain credit insurance from a company or person approved by the lender as a condition for granting a loan. See 12 C.F.R. § 563.35(b) and (c) (1994). However, the lender may not require that the borrower purchase such insurance from the lender or an affiliate. 12 U.S.C.A. § 1464(q) (West Supp. 1994); 12 C.F.R. § 563.35. Nor may the lender refuse to extend credit because the credit insurance is not available on the basis of the applicant's age. 12 C.F.R. § 202.7(c)(1994).

Thus, we conclude that authority to underwrite credit insurance is subsumed within the authority of federal savings associations to lend. Since this conclusion is based upon our interpretation of the scope of the meaning of the statutory language authorizing federal savings associations to originate loans, we need not rely on an application of the incidental powers doctrine.

We nevertheless note that the incidental powers doctrine would provide an alternative basis for our conclusion, since the activity in question meets each of the four tests commonly used by the OTS to identify incidental powers.[12] First, as explained above, underwriting credit insurance furthers the statutory mission Congress has assigned to federal savings associations to extend credit. Credit insurance provides a means for protecting both the borrower and lender in the case of death or disability of the borrower.[13] Second, underwriting credit insurance is substantially identical to issuing debt cancellation contracts which is an activity subsumed within the statutorily authorized lending function. Third, underwriting credit insurance constitutes funds intermediation, i.e., channeling available funds from points of surplus to points of demand, by means of receiving funds from one source and investing them in another.[14] Fourth, authorizing federal saving associations to underwrite credit insurance will help them remain competitive with national banks, which already underwrite credit insurance.[15]

Accordingly, we conclude that even if underwriting credit insurance were not encompassed within the express authority of federal savings associations to originate loans, such activities would nevertheless be permissible as a proper incident to that

---

12. See OTS Op. Chief Counsel (Mar. 25, 1994) (concluding that federal savings associations can offer postal services from their retail offices).

13. See E.W. Armstrong, Jr., The Insurance Guide for Savings Associations at 118 (1988).

14. See OTS Op. Chief Counsel (Oct. 17, 1994) at 8-9.

15. OCC Interpretive Letter No. 277 (December 21, 1983), reprinted in [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,441 (concluding that national banks have the authority to underwrite credit insurance). In addition, bank holding companies and their subsidiaries are expressly authorized to underwrite credit insurance because this activity is "so closely related to banking . . . as to be a proper incident thereto." 12 U.S.C. § 1843(c)(8) (1988). See also 12 C.F.R. § 225.25(b)(8) (1994).

express power.[16] Thus, we conclude that federal savings associations, and their operating subsidiaries,[17] have legal authority under the HOLA to underwrite credit insurance, provided the insurance is issued in connection with loans made by the association or subsidiaries of the association.

It is important to emphasize however, that the question of legal authority does not end our analysis. In prior opinions, we have stressed that activities that fall within the scope of what is permissible under the HOLA may nevertheless be restricted or prohibited by the OTS on grounds of safety and soundness.[18] OTS supervisory staff have concluded that it is advisable for federal savings associations to conduct credit insurance underwriting activities exclusively through subsidiaries, for reasons of safety and soundness. Use of a subsidiary will enable federal savings associations to isolate and contain the liabilities associated with underwriting. Use of a subsidiary will also eliminate the need on the part of state insurance regulators to examine the books and records of federal savings associations. (See discussion of state insurance laws, infra.)

Thus, federal savings associations that wish to underwrite credit insurance should do so through subsidiaries.[19]

---

16. Our opinion that concluded that federal savings associations may directly sell credit life insurance and fixed annuities on an agency basis followed an incidental powers analysis similar to that described above. OTS Op. Chief Counsel (Oct. 17, 1994). We note, however, that credit insurance agency activities are merely a subset of the credit insurance underwriting activities discussed here. Thus, the statutory argument presented above in this opinion (i.e., that credit insurance underwriting is subsumed within the express statutory authorization to originate loans) applies with equal force to credit insurance agency activities and provides an alternative basis for our prior conclusion that credit insurance agency activities are permissible.

17. OTS regulations provide that operating subsidiaries may engage in any activities that a federal savings association has legal authority to conduct directly. 12 C.F.R. § 545.81(b)(1) (1994).

18. See, e.g., OTS Op. Chief Counsel (Oct. 17, 1994) at 5, n. 8.

19. For reasons of safety and soundness, the OTS has concluded that this same requirement should be imposed on debt cancellation contracts. Since this is a new requirement for debt cancellation contracts, OTS examiners and regional supervisors should work with institutions already issuing debt cancellation contracts to establish a reasonable transition period for moving this activity into an operating subsidiary.

B. **Compliance With State Laws Regulating Insurance Activities**

State insurance laws regulate all aspects of insurance activities, including: who may engage in the insurance business, registration and examination requirements for agents and companies, and consumer protection. Recently, there has been significant litigation between national banks and various states and the insurance industry regarding the extent, if any, to which these state laws apply to national banks. These cases are likely to produce additional interpretive guidance regarding the proper reach of the McCarran-Ferguson Act, which defines the scope of state regulatory authority over insurance activities.[20]

In an OTS opinion dated October 17, 1994 (regarding certain insurance agency activities of federal savings associations), we indicated that OTS will defer any ultimate determination regarding the extent to which state insurance laws apply to the insurance activities of federal savings associations and their operating subsidiaries pending further developments in the relevant case law. In the interim, federal savings associations and their operating subsidiaries should comply with all state insurance laws, including any state laws prohibiting depository institutions from directly or indirectly engaging in the insurance business ("anti-affiliation laws"), unless specifically advised otherwise by the OTS. As a practical matter, this will mean that the operating subsidiaries of federal savings associations in some states may be barred from underwriting and reinsuring credit insurance. It is our understanding, however, that most state anti-affiliation statutes are inapplicable to credit insurance.

Operating subsidiaries engaging in credit insurance underwriting will, until further notice, be subject to examination by state insurance regulators. However, the states should have no need to examine the books and records of the parent savings association.

C. Compliance With OTS Policies And Conditions

In addition to complying with applicable state insurance laws, there are several OTS policies that operating subsidiaries of federal savings associations must follow when underwriting or reinsuring credit insurance.

First, section 630 of the OTS Regulatory Handbook of Thrift Activities is devoted to evaluating the risks associated with insurance activities conducted by savings association service corporations. This section provides guidance on potential areas of risk that should be examined by savings associations and OTS examiners, including: unfair trade and claim practices; pricing

---

20. See OTS Op. Chief Counsel (Oct. 17, 1994) at 11-13 for a fuller discussion of these issues.

and policy premiums; financial condition; and accounting issues. The OTS will instruct its examiners to use the principles in section 630 to evaluate the risks of underwriting and reinsuring credit insurance by federal savings association operating subsidiaries. Operating subsidiaries should use this section as guidance in structuring their sales policies and procedures.

Second, both the HOLA and OTS regulations expressly prohibit "tying" arrangements, which are deemed to occur when, inter alia, a savings association conditions an extension of credit on the borrower purchasing other services from the association or an affiliate.[21] Federal savings associations and their operating subsidiaries must enforce sales policies and train product salespersons to ensure that these anti-tying prescriptions are carefully followed. To ensure compliance with these provisions, the OTS will require operating subsidiaries of federal savings associations that offer credit insurance to inform borrowers in writing of their right to freely select the organization selling or underwriting credit insurance.[22]

Third, operating subsidiaries may only underwrite or reinsure credit insurance issued in connection with loans originated by itself, its parent savings association and subsidiaries of the parent.

Fourth, operating subsidiaries must provide written disclosure to their customers that their underwriting and reinsurance activities are not FDIC-insured.

Fifth, the reserve levels and capital and surplus maintained by operating subsidiaries must meet or exceed what is required under applicable state law. Reserve levels must be consistent with conventional actuarial analysis. Operating subsidiaries of federal savings associations must maintain appropriate documentation to confirm compliance with these requirements.

Finally, a federal savings association that proposes to establish an operating subsidiary to engage in credit insurance underwriting or to commence underwriting through an existing operating subsidiary must give notice to or file an application with the appropriate OTS regional office in accordance with the technical and procedural requirements set forth in 12 C.F.R.

---

21. 12 U.S.C.A. § 1464(q) (West Supp. 1994) and 12 C.F.R. § 563.35 (1994).

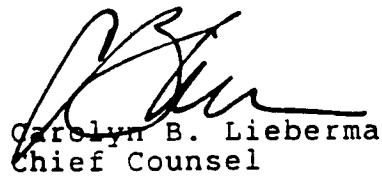
22. See also 12 C.F.R. § 563.35(b) (requirement to notify customers in writing of credit insurance options relating to residential home loans).

section 545.81 (1994).[23] The issues to be considered by the OTS in reviewing operating subsidiary proposals to engage in credit insurance underwriting will include the expertise of the individuals managing the underwriting activities and the financial standing of the operating subsidiary and its parent association.

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

If you have further questions regarding this matter, please feel free to contact Dorene Rosenthal, Senior Attorney, at (202) 906-7268.

Very truly yours,



Carolyn B. Lieberman
Chief Counsel

cc: John Downey
All Regional Directors

---

23. We are aware that service corporation applications to engage in credit insurance underwriting must be approved by the OTS in Washington, D.C. See 12 C.F.R. § 545.74(b) (1994). The OTS is in the process of transferring approval authority for credit insurance underwriting by a service corporation to the regions.