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

July 12, 1996

Dear Mr. :

This is in response to your letter dated April 10, 1996, in which you have asked for our views regarding the authority of:

(i) a Federal savings association to insure a portion of mortgage loans that it originates with a private mortgage insurance company that has entered into a reinsurance agreement with the association's service corporation under which the service corporation would receive premium payments from the insurance company based on the default risk of the original loans; and

(ii) a Federal association to pay all or a portion of the private mortgage insurance premiums related to mortgage loans that it originates.

In addition, you requested our position regarding the effect on the calculation of the loan-to-value ratio of a mortgage loan, for purposes of 12 C.F.R. Section 567.6, if a savings association pays a portion of the private mortgage insurance for such loan.

In brief, we conclude that the activity posed by the first question listed above is prohibited by 12 C.F.R. § 563.44. As to the second question, a savings association may pay all or a portion of the insurance premiums related to mortgage loans that it originates. Where the association receives payments from the borrower for the insurance premiums, the loan-to-value ratio of the loan would not be affected.

Background

("Savings Bank") proposes to establish a mortgage guaranty reinsurance company as a wholly owned service corporation ("Service Corporation"). The Service Corporation would enter into an arms-length reinsurance agreement with a mortgage

guaranty company. The insurer would pay premiums to the Service Corporation based on the default risk presented by the loans originated by the Savings Bank.

In connection with the Savings Bank's mortgage lending activities, the Savings Bank requires borrowers to obtain private mortgage insurance when the ratio of the amount loaned to the value of the property exceeds 80 percent. The private mortgage insurance is for the amount of the loan that exceeds 80 percent of the loan-to-value ratio. In the event of a default on a loan that is subject to private mortgage insurance, the Savings Bank is paid the difference between the loan balance and the level to which coverage is provided (generally 80 percent), plus out-of-pocket expenses.

The Savings Bank contemplates that private mortgage insurers that are reinsured by the Service Corporation would be among the private mortgage insurers that would insure loans made by the Savings Bank. The Savings Bank has represented that it would disclose the existence of reinsurance agreements, and would offer a choice from a list of several private mortgage insurers to its customers.

Separately, the Savings Bank proposes to offer mortgage borrowers obtaining loans that need private mortgage insurance the options of (i) obtaining private mortgage insurance themselves (i.e., paying the premium along with the principal and interest on the mortgage loan, as is customarily the case), or (ii) having the Savings Bank itself obtain the private mortgage insurance and pay the premiums, with the borrower paying the Savings Bank a higher interest rate on the loan than would otherwise be the case. The Savings Bank represents that, under the second option, the amount of interest paid by the borrower, including the amount attributable to private mortgage insurance obtained by the Savings Bank, would be tax deductible.[1] Under the latter arrangement, customers would continue to have the option of choosing the private mortgage insurer from a list of several insurers acceptable to the Savings Bank.

Discussion

Proposed Service Corporation Activities

Section 563.44 includes four prohibitions relating to private mortgage insurance, only one of which is relevant to your inquiry. Section 563.44(b)(1) provides that no savings association or service corporation affiliate may insure any loan with a mortgage insurance company if, either directly or indirectly, any commission, fee, or other compensation is to be paid to or received by such association,

1. We express no views as to whether the increased interest payment would be tax deductible.

any service corporation affiliate, or any director, officer, or employee of the association or service corporation in connection with the issuance or renewal of mortgage insurance by the company.[2]

Section 563.44 originally was adopted by the Federal Home Loan Bank Board ("FHLBB"), in order to "limit the potential for abuse and risk as a result of self-dealing business practices."[3] In addition, the FHLBB, in a later rulemaking procedure, stated that there "is substantial benefit in the 'discipline' of arm's length evaluation and bargaining which presently occurs between savings and loans and [mortgage insurance companies]."[4]

In our opinion, Section 563.44(b)(1) prohibits the Savings Bank from insuring any mortgage loan with a private mortgage insurance company that has entered a risk-sharing agreement with the Service Corporation. Under the risk-sharing arrangement, the Service Corporation, which would be a service corporation affiliate of the Savings Bank, would be paid premiums by the insurance company based on the default risk presented by the loans insured with the insurance company. Therefore, the compensation would be paid in connection with the issuance of mortgage insurance by the mortgage insurance company.

The fact that payments to the Service Corporation would not be directly related to any single loan is immaterial. The prohibition applies whenever compensation is paid to the enumerated entities "in connection with the issuance or renewal of mortgage insurance by such company." Furthermore, the potential for conflicts of interest that are addressed by the regulation exist under the circumstances presented in your letter, in that the presence of the reinsurance agreement could affect the Savings Bank's choice of a private mortgage insurer (or the Savings Bank's presentation of mortgage insurance options to customers).

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2. 12 C.F.R. § 563.44(b)(1) (1996). The remaining prohibitions prohibit a savings association or service corporation affiliate from insuring a loan with a mortgage insurance company if: (i) the company maintains any type of deposit account at the association (12 C.F.R. § 563.44(b)(2)); (ii) any officer or employee of such company, or a parent company thereof, is a director, officer or controlling person of the association or the service corporation affiliate (12 C.F.R. § 563.44(b)(3)); or (iii) the amount of investment in such mortgage insurance company, or any parent company thereof by association, its service corporation affiliates and the directors, officers, and controlling persons of such association or such affiliates is sufficient to give rise to a conflict of interest in the placement or renewal of mortgage insurance (12 C.F.R. § 563.44(b)(4)) (Section 563.44(b)(4) sets forth situations under which the OTS will generally presume a conflict of interest to exist).

3. 41 Fed. Reg. 7494, 7498 (Feb. 19, 1976).

4. See 43 Fed. Reg. 60571, at 60572 (Dec. 28, 1978).

Since receiving your letter, the OTS has proposed rescinding Section 563.44.[5] The OTS explained that Section 563.44 may be unnecessary in light of the disclosure requirements of the Real Estate Settlement Procedures Act, applicable transactions with affiliates statutes and the terms of a proposed new rule addressing conflicts of interest.[6] In addition, we note that one of the bases for removing section 563.44 -- the revised conflicts of interest rule -- remains in proposed rather than final form. The proposed removal of Section 563.44 has not become final, and thus it is still in effect.[7]

Proposed Option Regarding Payment of Private Mortgage Insurance by the Savings Bank

It also is our opinion that the Savings Bank may offer mortgage borrowers the option of having the Savings Bank obtain and pay for private mortgage insurance in return for an increase in the interest rate paid on the loan. Section 5(c)(1)(B) of the Home Owners' Loan Act expressly authorizes Federal savings associations to make loans based upon the security of liens upon residential real property.[8] This express authority necessarily includes within it the authority to negotiate and fix the terms of each loan, including the terms for repayment.[9] 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[10] and, therefore, the proposed arrangement properly falls within the scope of this authority.

Federal associations, of course, cannot claim authority to engage in a particular practice simply by providing for the practice within the terms of a loan contract. The provision at issue, however, addresses the terms and circumstances under which the debt will be repaid, which is the heart of a loan contract.[11] Given the risk that

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5. See 61 Fed. Reg. 30190, 30192 (Jun. 14, 1996).

6. Id.

7. You may apply to the OTS for a waiver of section 563.44, pursuant to 12 C.F.R. § 500.30(a), prior to the issuance of final regulation. Such a waiver request would need to be accompanied by the applicable filing fee. We do not address herein whether the OTS would grant such a waiver if requested.

8. 12 U.S.C. § 1464(c)(1)(B).

9. Cf. Op. C.C. (Sept. 15, 1993) (authority of Federal savings associations to enter into debt cancellation contracts).

10. Id.

11. See, 1993 Opinion, at 2.

the loan may not be repaid, it is reasonable for a savings association to address issues related to non-repayment, including private mortgage insurance, in the loan contract.

Moreover, under closer examination the proposed arrangement, as we understand it, is not greatly different from the customary arrangement regarding private mortgage insurance; in each case, the lender essentially acts as a conduit for the private mortgage insurance payment. Typically, the borrower pays a specified amount related to private mortgage insurance into an escrow fund along with each mortgage payment. The lender uses such payments to pay the private mortgage insurance when due. If the borrower fails to make payments on the loan, the lender generally does not receive the private mortgage insurance payments either.

Under the proposed arrangement, the lender would increase the interest rate on the loan and would use the additional interest received to make payments to the private mortgage insurer. If the borrower fails to make payments on the loan, the lender would not receive the amount needed to make the private mortgage insurance payment. Also, you have represented that under this arrangement the borrower would have the ability to select the private mortgage insurer from a list of several insurers acceptable to the lender.

Accordingly, we conclude that the authority to offer the proposed option relating to private mortgage insurance payments is subsumed within the authority of Federal associations to make mortgage loans.

Effect of Payment of Private Mortgage Insurance Premiums by a Federal Association on Loan-To-Value Ratio

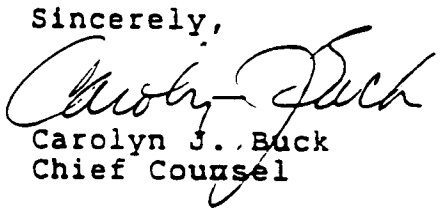
The loan-to-value ratio is calculated at the time of origination, by dividing the amount of the loan by the value of the property. Your question, in essence, is whether the OTS would consider the amount of the loan to be increased by the amount covered by the private mortgage insurance where the Savings Bank has contracted to pay the private mortgage insurance.

The proposed arrangement, under which the Savings Bank would receive additional interest payments from the borrower sufficient to pay the private mortgage insurance premiums, would not cause us to consider the amount of the loan to increase by the amount covered by private mortgage insurance. Private mortgage insurance would be provided by an independent insurer, in accordance with applicable conflicts of interest rules. The borrower would have the ability to choose the private mortgage insurer. While the Savings Bank, rather than the borrower, would have the obligation to make the payment to the private mortgage insurer, the funds used to pay for the private mortgage insurance would be received from the borrower. Therefore, because the mortgage insurance is funded by the borrower, it is equivalent in substance to the traditional escrow arrangement for payment of mortgage insurance.

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

If you have any questions regarding this letter, please call Dean Shahinian, Senior Counsel for Corporate Activities, at (202) 906-7289.

Sincerely,



Carolyn J. Buck
Chief Counsel

cc: Regional Directors
Regional Counsels