P-98-11

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

October 2, 1998

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Re: Issuance of Mortgage Loan Performance Guaranties by a Federal Savings Association

Dear [ ]:

This responds to your inquiry to the Office of Thrift Supervision ("OTS") on behalf of [ ], a federal savings association (the "Association"), concerning whether the Association may offer performance guaranties on low down payment mortgage loans it originates or purchases and insures with [ ], a private mortgage insurer (the "Company"). Through the performance guaranties, the Association would assume a portion of the default risk on mortgage loans insured by the Company and covered by the guaranties.

In brief, we conclude that the proposed activity is authorized because it is subsumed within the mortgage lending authority of federal savings associations in section 5(c)(1)(B) of the Home Owners' Loan Act ("HOLA")[1] and is a power incident to this authority. However, as discussed in Part III below, OTS is imposing several conditions for approval. Further, we have consulted informally with the Department of Housing and Urban Development ("HUD") about whether the activity would comply with section 8 of the Real Estate Settlement Procedures Act ("RESPA").[2] There may be a potential RESPA issue with your manner of conducting the activity and we urge you to consult with HUD before you commence the activity to ensure that it does not violate RESPA.

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

[2] 12 U.S.C.A. § 2607 (West 1989 & Supp. 1998).

I. Background

According to your letter and supplementary information you and the Association provided to OTS in subsequent discussions with OTS staff, the Association would like to make effective a loan performance guaranty agreement (the "Agreement") it has entered into with the Company.[3] Under the Agreement, the Association would issue performance guaranties to the Company by which the Association would assume a portion of the risk of default on low down payment[4] one- to four-family residential first lien mortgage loans the Association originates or acquires and insures with the Company. In return for the guaranties, the Company would pay the Association a guaranty fee equal to a percentage of the mortgage insurance premiums the Company receives on loans outstanding, as specified in the Agreement.[5]

The guaranties would cover $[ ] million of the Association's existing mortgage loans, representing approximately 46 percent of its current mortgage loan portfolio with private mortgage insurance but less than one percent of its existing residential mortgage loan portfolio. The guaranties would also cover a substantial portion of the mortgages the Association expects to originate in 1998 and thereafter.[6] The guaranties would only cover loans that are subject to the Association's underwriting standards because the Association would have either originated or acquired each of the loans. The Association would disclose to borrowers the existence of the Agreement and provide them with the opportunity of having their mortgage loans excluded from the Agreement. The Association would issue the guaranties directly, rather than through an operating subsidiary or service corporation.

You represent that the Association's risk would be limited as follows: The Association would bear no liability on a "book of covered loans,"[7] unless the

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[3] The Company is a private mortgage insurer approved by the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac").

[4] For purposes of this letter, "low down payment" mortgage loans have down payments of less than 20 percent of the property's value or loan-to-value ("LTV") ratios over 80 percent. The maximum LTV ratio of loans covered by performance guaranties would be 95 percent.

[5] The guaranty fee would range from 1.80 to 15.60 basis points depending on the loan term, loan type (fixed or adjustable rate), LTV, and amount of mortgage insurance coverage.

[6] The Association does not intend to purchase loans specifically for the purpose of issuing performance guaranties as a way to increase earnings.

[7] A "book of covered loans" are the set of loans guarantied in the same year.

"cumulative loss ratio" exceeded 65 percent.[8] If losses exceeded that level, the Association would be obligated to reimburse the Company up to a maximum of one percent of the original "aggregate risk" on each book of loans.[9] The Company would remain directly liable as the primary insurer to the holders of the insured loans for the full amount of the mortgage insurance coverage.

The term of the Association's guaranty on each book would run from the time the book first became subject to a performance guaranty to the earliest of (1) 84 months following the end of the calendar year in which the book first became subject to a performance guaranty, (2) the date the Association's exposure on the book equals zero, or (3) a date mutually agreed to by the Association and the Company. The guaranty would be secured by a document (a letter of credit or financial guaranty instrument) in an amount at least equal to the Association's risk exposure on the guaranty.[10] This security document would be irrevocable, but could be terminated if the total cumulative loss ratio were less than 65 percent at the end of the period the guaranty was in effect.

II. Discussion

Two legal bases support the authority of a federal savings association to issue performance guaranties as described in Part I above. First, the activity is subsumed within the express authority to "invest in, sell, or otherwise deal in" loans on the security of liens upon residential real estate contained in HOLA section 5(c)(1)(B). Second, the activity is a power incident to this authority.

A. Authority Subsumed within Mortgage Lending Authority

Authority to issue performance guaranties is subsumed within a federal savings association's mortgage lending authority under HOLA section 5(c)(1)(B). The credit judgments and risks involved in issuing performance guaranties are similar to those in

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[8] The "cumulative loss ratio" would be calculated by adding the book's losses since inception plus various expenses (e.g., cost of investigating, negotiating, settling, or defending claims paid) and dividing this sum by the book's premiums since inception.

[9] The "aggregate risk" would be calculated by multiplying the original principal balance of each book by the mortgage insurance coverage provided by the Company (expressed as a percentage). The mortgage insurance coverage would range from 6 to 35 percent, depending on the amount of coverage selected by the Association.

[10] While the Association plans to provide the document itself, the Agreement would permit the Association to substitute a letter of credit from a third party acceptable to the Company with a credit rating of "AA" or better from Standard & Poor's and at least one of the other major rating agencies.

mortgage lending, particularly making loans with LTV ratios between 80 and 95 percent without mortgage insurance but with a higher interest rate to cover the risk of non-payment.[11] In issuing performance guaranties, as in loan underwriting or purchasing mortgage loans, there is a credit risk that the borrower will default. Lenders traditionally have dealt with this credit risk by absorbing the losses as they occur (and with increasing frequency, attempting to price loans to reflect risk) or requiring the risk to be underwritten by a third party mortgage insurer. Performance guaranties would provide an additional way for the Association to deal with credit risk, by allowing the Association to bear a portion of the credit risk in exchange for compensation. Just as a federal savings association may use mortgage insurance to allocate the risk between itself and a mortgage insurer, so too may an association reallocate a portion of that risk through performance guaranties.

In a previous opinion, OTS concluded that the authority of a federal savings association and its operating subsidiary to underwrite and reinsure credit insurance on loans made by the association or its subsidiaries is subsumed within the express mortgage lending and consumer lending powers in HOLA sections 5(c)(1)(B) and 5(c)(2)(D),[12] respectively.[13] OTS reasoned that underwriting credit insurance is simply one way for the lender to deal with the risk that the borrower will become unable to meet his or her repayment obligation on the loan and observed that no evidence suggests that Congress intended to prohibit associations from exercising this option.[14] The opinion concluded that "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 risk of default in a way that fits with its own

[11] The Interagency Guidelines for Real Estate Lending Policies ("Guidelines") do not establish a loan-to-value limit for permanent mortgage or home equity loans on owner-occupied, 1- to 4-family residential property. However, the Guidelines indicate that "for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral." 12 C.F.R. § 560.101 (1998).

We note that OTS has recently issued Thrift Bulletin ("TB") 72, which makes clear special risks associated with high LTV loans and provides guidance. OTS TB-72 (Aug. 27, 1998).

[12] 12 U.S.C.A. §§ 1464(b)(2) and (c)(2)(D) (West Supp. 1998).

[13] OTS Op. Chief Counsel (Jan. 10, 1995) at 3, 6. For safety and soundness and other reasons, OTS required that the activity be performed in a operating subsidiary and not as a direct association activity. Id. at 7. OTS's predecessor, the Federal Home Loan Bank Board ("FHLBB"), has also authorized federal savings association service corporations to underwrite and reinsure credit insurance. See, e.g., FHLBB No. 84-234 (May 14, 1984).

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

business strategy."[15] The opinion's reasoning also applies to the issuance of performance guaranties, since performance guaranties also help federal savings associations manage default risk.[16]

Accordingly, we conclude that the authority to issue performance guaranties is subsumed within the express mortgage lending authority of federal savings associations.[17] Since this conclusion is based upon our interpretation of this explicit authority, we need not rely upon the incidental powers doctrine. Nevertheless, this doctrine would provide an alternative basis for our conclusion and that analysis is set forth below.

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[15] Id. In previous opinions, OTS also concluded that a federal savings association may enter into a debt cancellation contract in connection with a consumer loan it originates. OTS Op. Chief Counsel (September 15, 1993) at 2; OTS Op. Chief Counsel (December 18, 1995) at 2. Through these contracts, an association takes on the risk that a borrower will die or become unable to repay a loan due to a defined event such as medical disability or loss of employment, in exchange for a fee or a higher interest rate. OTS Op. Chief Counsel (September 15, 1993) at 1; OTS Op. Chief Counsel (December 18, 1995) at 1. OTS concluded that the authority to enter into such contracts is subsumed within the consumer lending authority in HOLA section 5(c)(2)(D) because such contracts specify the details of the rights and responsibilities of the borrower and lender in circumstances of default by the borrower. OTS Op. Chief Counsel (September 15, 1993) at 2.

[16] The Association's performance guaranties would differ in certain respects from the credit insurance and reinsurance activities previously approved by OTS. For example, the performance guaranties would be issued directly, rather than through an operating subsidiary or service corporation. Also, the performance guaranties would cover loans the Association originates or purchases, rather than being limited to loans it originates.

OTS, however, finds no need to limit the issuance of performance guaranties to an operating subsidiary or service corporation, so long as the Association holds adequate reserves and capital, and meets other conditions set forth in Part III of this opinion. Nor is it necessary to limit the performance guaranties to loans originated by the Association, so long as all the loans covered meet the Association's underwriting standards (having been originated or purchased by the Association). Application of these underwriting standards will ensure a level of consistency and uniformity in the loans, as will the acceptance of the loans by the Company for mortgage insurance coverage. Further, you and the Association have represented that the Company has analyzed the loans the Association added to its portfolio through acquisition and determined that these loans meet the same underwriting requirements and pose the same level of risk as loans originated by the Association.

[17] An alternative basis for the authority to issue performance guaranties may be the express surety authority of federal savings associations under HOLA section 5(b)(2), 12 U.S.C.A. § 1464(b)(2) (West Supp. 1998). This opinion, however, does not reach that issue, in part, because OTS is currently reviewing its regulations in this area as part of the regulatory reinvention process. See 63 Fed. Reg. 49,874 (Sept. 1, 1998) (Notice of Proposed Rulemaking on Letters of Credit, Suretyship and Guaranty).

B. Incidental Authority

OTS opinions have articulated a four-factor test for incidental powers of federal savings associations under the HOLA.[18] OTS precedents establish that the relative weight given to each factor may vary depending upon the type of activity in question and it is not critical that each factor be satisfied in order to conclude that an activity is permissible.[19] Each factor is identified below, along with an explanation of how each factor and the overall test apply to issuing performance guaranties.

1. The activity is consistent with the purpose and function Congress envisioned for federal savings associations. Lending lies at the heart of the statutory mission Congress established for federal savings associations, i.e., to extend credit for homes and other goods and services.[20] Mortgage insurance is integral to low down payment mortgage lending for two reasons. First, the borrower purchases mortgage insurance at the same time he or she obtains a low down payment mortgage loan and does so where the lender requires the insurance as a condition of granting the loan. Second, mortgage insurance enables lenders to offer low down payment mortgages to customers, while limiting risks. As a result, mortgage insurance plays a vital role in helping low and moderate-income people become homeowners by allowing them to buy homes with less cash.[21]

Performance guaranties affect the allocation of risk between the lender and the mortgage insurer and may facilitate the availability of mortgage insurance by providing a competitive alternative to reinsurance as a method of reducing the primary mortgage insurer's risk.[22] Thus, performance guaranties are closely connected to mortgage insurance. Because of the interrelationship between performance guaranties, mortgage

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

[19] See, e.g., OTS Mem. Dep. Chief Counsel (Mar. 25, 1994) at 8.

[20] OTS Op. Chief Counsel (Jan. 10, 1995) at 5. See also 12 U.S.C.A. § 1464(a) (West Supp. 1998); S. Rep. 96-368, at 12 (1979), reprinted in 1980 U.S.C.C.A.N. 236, 248; S. Rep. 97-536, at 15 (1982), reprinted in 1982 U.S.C.C.A.N. 3054, 3069.

[21] See Office of the Comptroller of the Currency ("OCC") Corporate Decision No. 98-22 (May 1, 1998) at 2-3 (explaining, in greater detail, how the availability of mortgage insurance facilitates mortgage lending).

[22] Performance guaranties may also benefit customers by indirectly promoting the availability of mortgage insurance at competitive rates by providing this competitive alternative to reinsurance.

insurance, and mortgage lending, performance guaranties are consistent with the central mortgage lending function Congress intends federal savings associations to fill.

2. The activity is similar to, or facilitates the conduct of, expressly authorized activities for federal savings associations. Issuing performance guaranties is similar to and facilitates three authorized activities. First, it is similar to extending residential real property loans.[23] As discussed in Part II.A. above, the credit judgments and risks are similar to extending mortgage loans with LTV ratios between 80 and 95 percent without mortgage insurance but with higher interest rates to cover the risk of non-payment. As noted in Part II.B.1. above, the activity may also facilitate mortgage lending by enabling lenders to make low down payment loans. The activity would also facilitate the Association's mortgage lending in other ways. It would: (1) enable the Association to use existing credit staff and expertise to generate additional credit-related revenue; (2) provide flexibility for the Association in acquiring and allocating credit risk; and (3) serve as an integral part of the Association's policies for dealing with mortgage loan defaults.[24]

Second, the activity is similar to an association repurchasing a portion of loans that it has sold, a traditional banking activity.[25] Both activities involve the assumption of risk that would otherwise rest with another entity. When an association sells loans, the purchaser takes on risk associated with the loans. If the association later repurchases a portion of the loans it previously sold, the association takes back risk that it had transferred to the purchaser. Similarly, by issuing performance guaranties, the Association would bear a portion of the risk that otherwise would rest with the Company through mortgage insurance.

Third, the activity is similar to serving as a surety, an expressly authorized activity under HOLA section 5(b)(2), but with less risk to the Association.[26] Through

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[23] This activity is authorized by HOLA section 5(c)(1)(B).

[24] See 12 C.F.R. § 560.101, Appendix, at 150 (savings associations should establish loan administration policies on collections and foreclosure, including delinquency follow-up procedures, foreclosure timing, extensions and other forms of forbearance).

[25] See footnote 23 above.

[26] OTS and the FHLBB have long recognized that the authority of a federal savings association to act as guarantor is subsumed within surety authority. See, e.g., 12 C.F.R. § 545.16(a)(3) (1998) ("Surety means surety under real and/or personal suretyship, and includes guarantor"); 48 Fed. Reg. 23,032, 23,043 (May 23, 1983) (stating that HOLA section 5(b)(2) empowers the FHLBB to authorize by regulation the issuance of suretyship devices by federal savings associations for the purposes of guaranteeing the obligations of others); FHLBB Mem. Assoc. Gen. Counsel (July 5, 1983) (permitting an association to act as surety or guarantor under HOLA section 5(b)(2)).

the performance guaranties, the Association would be obligated to reimburse the Company for a specified percentage of losses resulting from the failure of the borrowers to repay loans originated or purchased by the Association, in exchange for a fee. The Association's performance guaranties would pose only a very limited risk to the Association. The Association's obligation to pay would only arise where borrowers with covered loans defaulted and losses exceeded the threshold established in the Agreement. Also, the Association's obligations would be limited to a fixed dollar amount based on the principal balance of each book of loans and the mortgage insurance coverage and would be limited in duration.

3. The activity is necessary to enable federal savings associations to remain competitive and relevant in the modern economy. The OCC recently issued an opinion permitting national banks to participate, either directly or through their operating subsidiaries, in a reciprocal mortgage reinsurance exchange that reinsures private mortgage insurance on loans originated or purchased by the participating lenders.[27] Since 1996, the OCC has also permitted national banks to establish operating subsidiaries to underwrite captive mortgage reinsurance, i.e., reinsurance of mortgage loans originated or purchased by the parent bank or one of its affiliates.[28] In addition, although the OCC has not opined on this type of performance guaranty, the OCC regulations permit national banks to serve as surety or guarantor in a variety of circumstances.[29]

Like the activities OCC has authorized, issuing performance guaranties would also involve the assumption of risk by a lender that would otherwise rest with the mortgage insurer. To date, OTS has only approved captive mortgage reinsurance as a

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While there are differences between a suretyship and a guaranty, the differences between these two forms of credit enhancement generally make issuing a guaranty less risky for the issuer. For example, a surety is bound with its principal to pay or perform an obligation to a third party whereas a guarantor agrees to satisfy the obligation of the principal to another only if the principal fails to pay or perform. See Blacks Law Dictionary 705, 1441-42 (6th ed. 1990).

[27] OCC Interpretive Letter (Apr. 6, 1998).

[28] See OCC Interpretive Letter No. 743 (Oct. 17, 1996) and OCC Corporate Decisions Nos. 98-22 (May 1, 1998), 98-15 (Feb. 19, 1998), 98-10 (Jan. 28, 1998), 97-97 (Nov. 10, 1997), 97-93 (Oct. 20, 1997), 97-89 (Sept. 26, 1997), 97-27 (May 2, 1997), 97-15 (Mar. 17, 1997), and 97-06 (Jan. 22, 1997). OTS has not addressed whether a federal savings association may provide captive mortgage reinsurance directly or through an operating subsidiary.

[29] See 12 C.F.R. § 7.1017 (1998).

service corporation activity on a case-by-case basis.[30] This opinion makes no change in that regard. Thus, the ability of federal savings associations to issue performance guaranties would be particularly useful to federal savings associations in their efforts to remain competitive with national banks.

4. The activity relates to the financial intermediary role that all federal savings association were intended to play. Issuing performance guaranties supports the provision of financial intermediary services by savings associations by facilitating mortgage lending, as discussed in Parts II.B.1 and II.B.2. above. The activity does not, however, in and of itself, constitute funds intermediation, i.e., channeling available funds from points of surplus to points of demand. As noted above, however, an activity need not necessarily meet each of the four factors in order to be authorized. Rather, a cumulative assessment must be made after applying each factor in the test.

As the foregoing analysis indicates, three of the four factors in the incidental powers test are clearly satisfied. In our view, the cumulative force of these three factors justifies the conclusion that the incidental powers doctrine provides an alternative basis for our conclusion that federal savings associations may issue performance guaranties.

III. Conditions for Approval

The Association must provide the performance guaranties in a safe and sound manner and in compliance with applicable consumer protections. To these ends, as a result of the Chief Counsel's Office's consultations with Supervision Policy and Compliance Policy, we are imposing several conditions on the approval of the activity:

1. Reserves. The Association must establish adequate reserves for the additional loss it estimates it would likely incur as a result of taking on additional credit risk, consistent with conventional credit analysis. The reserve levels maintained must meet or exceed any that may be required under applicable law or imposed by the OTS [ ] Regional Office. The Association must also make an allocation to the allowance for loan and lease losses for loans held on its books.

[30] See OTS Op. Business Transactions Division (Oct. 10, 1997) and OTS Order No. 97-107 (Oct. 10, 1997); Subsidiaries and Equity Investments, 61 Fed. Reg. 66,561, 66,565-66,566 (Dec. 18, 1996). As indicated in footnote 28 above, OTS has not addressed whether a federal savings association may provide captive mortgage reinsurance directly or through an operating subsidiary.

The Association must also establish a liability account for loans the Association covers by a performance guaranty and subsequently sells. OTS will treat the Association's obligation as recourse and will apply a capital requirement for the obligation equivalent to the Association's maximum contractual obligation.

2. Risk-based capital. For each "qualifying mortgage loan"[31] covered by a performance guaranty, the applicable risk weight is 50 percent. In calculating whether a loan is insured to at least an 80 percent LTV ratio by private mortgage insurance for purposes of determining whether it is a qualifying mortgage loan, the Association's total exposure must be considered, including the Association's maximum potential liability under the performance guaranties.[32] In addition, the Association must observe the guidance discussed in TB-72 in providing performance guaranties, to the extent applicable.[33]

3. Management expertise and controls. The Association must have adequate management expertise and controls to support the scope of the activity conducted.

4. RESPA. As stated at the beginning of this opinion, we reach no conclusion on whether the activity would comply with any other potentially applicable standards, including the anti-kickback provisions of section 8 of RESPA. However, we have consulted informally with HUD and there may be a potential RESPA issue with how you propose to conduct the activity.

HUD is statutorily authorized to prescribe regulations and issue interpretations implementing RESPA.[34] HUD has issued regulations implementing RESPA and has specified procedures for requesting interpretations of RESPA.[35] Accordingly, we urge you to consult with HUD before you commence the activity to ensure that it does not

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[31] See 12 C.F.R. §§ 567.1 (definition of "qualifying mortgage loan") and 567.6(a)(1)(iii)(B) (1998).

[32] The information provided indicates that the Association's total exposure would be below 80 percent on loans covered by the performance guaranties. We note, however, that if the Association's total exposure on any covered loan were to exceed 80 percent, a 100 risk weight would apply to that entire loan since such loans would not be qualifying mortgage loans. See 12 C.F.R. § 567.1(a)(1)(iv)(D) (1998).

[33] For example, for loans where the private mortgage insurance ("PMI") does not cover the portion of the loan that exceeds the supervisory LTV limits, that portion not covered by PMI (or a government guarantee) counts toward the percentage of capital investment limit. TB-72 at 4.

[34] 12 U.S.C.A. § 2617 (West 1989 & Supp. 1998).

[35] 12 C.F.R. §§ 3500.3 and 3500.4 (1998).

violate RESPA. You should contact the Assistant General Counsel, GSE/RESPA Division, HUD, 451 7th Street, S.W., Washington, D.C. 20410. You should also refer to HUD's August 6, 1997 letter on captive mortgage reinsurance arrangements and section 8's standards, including the discussion of prohibited kickbacks and providing a meaningful disclosure and a meaningful choice.

5. Requirements set by Regional Office. The Association must consult with the OTS [ ] Regional Office and comply with any additional restrictions that office may impose.

In reaching the foregoing conclusions, we have relied on the factual representations made in the materials you submitted to us and in our subsequent staff discussions. Any material change in facts or circumstances, including the level and priority of the risk shared and its relation to the premiums received, from those described herein could result in a different conclusion.

If you have any questions regarding this matter, please feel free to contact Richard Bennett, Counsel (Banking and Finance), at (202) 906-7409.

Very truly yours,

Carolyn J. Buck
Chief Counsel

cc: Regional Directors
Regional Counsel