



Office of Thrift Supervision
Department of the Treasury

Chief Counsel

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

November 2, 1998

[

]

Re: Reinsurance of Private Mortgage Insurance
for Loans Originated by Affiliates

Dear []:

This is in response to your letter dated July 8, 1998, on behalf of [] (the "Association"). You asked that we issue a legal opinion in support of an application requesting that a service corporation of the Association be permitted to reinsure private mortgage insurance issued by third parties for loans originated or purchased by the Association, its mortgage lending subsidiaries, or its mortgage lending affiliates.

The OTS [] Regional Office ("Regional Office") approved the Association's service corporation application, in part, on July 28, 1998. The Regional Office deferred action on that portion of the application pertaining to loans originated or purchased by affiliates of the Association, pending the issuance of an opinion by this Office. This letter represents our interpretive opinion on that narrow issue.

For the reasons set forth below, we conclude that reinsuring private mortgage insurance for loans originated or purchased by the Association's affiliate, a sister savings association,¹ is reasonably related to the activities of financial institutions, and, as such, may be approved by the OTS as a service corporation activity under 12 C.F.R. Part 559.

I. Background

Private mortgage insurance ("PMI") protects mortgage lenders against default by the borrower. Mortgage lenders generally require that borrowers obtain mortgage insurance from third party mortgage insurers on low down payment loans. Purchasers in

¹ []].

the secondary market typically will not consider purchasing low down payment mortgage loans unless the loans are insured.

Reinsurance is a process by which an original insurer reduces its underwriting risk by passing part of this risk on to another insurance company. PMI reinsurers provide an excess layer of PMI insurance in return for a specified percentage of the PMI premiums. Generally, the PMI reinsurer is obligated to pay a capped percentage of losses above a "first percentage" of losses that is borne by the PMI insurer.

The obligations of PMI reinsurers are usually secured and collateralized under separate trust agreements that require the PMI reinsurer to establish trust accounts with an independent trustee for the benefit of each primary PMI insurer. Virtually all amounts paid by the insurers to the PMI reinsurer must be deposited in the trust accounts as a source of funds to satisfy the PMI reinsurer's obligations to each insurer.

On October 10, 1997, the OTS, for the first time, approved an application for a service corporation to provide reinsurance of private mortgage insurance issued by third parties for loans originated by a savings association or the savings association's mortgage lending subsidiaries (the "1997 Approval".)² On the basis of this action, the Regional Office approved on July 28, 1998, the portion of the Association's application dealing with PMI reinsurance of loans originated or purchased by the Association or its mortgage lending subsidiaries. The issue of first impression before us is whether a service corporation may provide PMI reinsurance for loans originated or purchased by affiliates of a savings association.

The OCC has issued a number of interpretive letters stating that it is permissible under the National Bank Act for a bank to establish an operating subsidiary to reinsure a portion of the mortgage insurance on loans originated or purchased by the parent bank or one of its affiliates. The OCC's approach has been predicated on two representations from a bank. First, the bank's affiliate whose loan will receive the benefit of reinsurance from the operating subsidiary will use underwriting standards comparable to the bank's standards for mortgage lending. Second, the reinsurance subsidiary will accept only home mortgage credit risks consistent with the bank's underwriting standards.³

II. Discussion

We discuss below the permissibility of PMI reinsurance by a service corporation on loans purchased or originated by the savings association's affiliates, as well as certain supervisory restrictions on such activity.

² See OTS Op. Business Transactions Division (Oct. 10, 1997) and OTS Order No. 97-107 (Oct. 10, 1997.)

³ Id.

A. Permissibility

Service corporation subsidiaries of Federal associations may engage in the preapproved activities listed under 12 C.F.R. § 559.4,⁴ or Federal associations may request approval for service corporations to engage in any activity "reasonably related to the activities of financial institutions."⁵ Engaging in the business of PMI reinsurance (of any kind) is not on the list of preapproved activities. Accordingly, service corporations may engage in such activity only after receiving OTS approval.

Typically, the OTS has approved an activity on "reasonably related" grounds because it is linked to an established banking activity or a preapproved activity. Recent opinions have focused on the nature and purpose of the activity and the kind of risk it presents.⁶

The legal opinion accompanying the OTS's 1997 Approval order (the "1997 Opinion") applied these standards to PMI reinsurance for loans originated by a savings association and found the activity so closely linked to mortgage lending, and the associated risks so similar to those that savings associations take in originating low down payment loans, as to establish that the activity was "reasonably related to the activities of financial institutions." The nature of the link between PMI reinsurance and the activities of a financial institution, in this case a savings association specifically, can be explored in terms both of the economic function the PMI reinsurance serves and of the risk it would present to the service corporation.

With respect to economic function, the financial institution activity to which PMI reinsurance is linked is mortgage lending. PMI is only issued in connection with mortgage loans. PMI enhances the lender's ability to recover on low down-payment loans in the event of a borrower's default, and it permits the originator to sell such loans in the secondary market. PMI reinsurance also acts to distribute the insurance risk of PMI. In this way PMI reinsurance, like PMI, is directly linked to and complements mortgage lending.

As to risk, the kind of risk PMI reinsurance presents is similar to the credit risk a savings association takes in originating low down-payment loans. In both cases, the risk presented is that the borrower will default. The core activity is assessment of the creditworthiness of the borrower. Indeed, PMI reinsurance is simply an extension of the

⁴ The preamble to the OTS Subordinate Organization regulations discusses the possibility of recognizing captive mortgage reinsurance as a preapproved service corporation activity, but concludes that such activity should be considered on a case-by-case basis to allow OTS to gain additional supervisory experience with the business over time.

⁵ 12 C.F.R. § 559.4 (1998).

⁶ See OTS Op. Chief Counsel (July 16, 1997) at 4; Legal Opinion (Business Transactions Division, May 7, 1997).

credit risk. The lender lays off a portion of the credit risk by requiring the borrower to obtain PMI; the PMI insurer in turn can pass off a portion of its credit risk through a reinsurance program. Moreover, both the lender and the reinsurer share risk with the PMI insurer. The lender mitigates its credit risk by requiring private mortgage insurance. The reinsurer reduces its risk through the primary insurer's "first percentage" and remainder loss obligations.

The remaining issue is whether the fact that a service corporation is underwriting PMI reinsurance for an affiliate that is not directly controlled by the savings association should lead to a different result. Strictly as a legal matter, we think not. The economic function that PMI reinsurance serves and the credit risk analysis that the reinsurance subsidiary must undertake remain essentially the same, regardless of whether a thrift, a thrift subsidiary, or an affiliate originate or purchase the reinsured loans. Even so, the regulatory status of an affiliate may give rise to supervisory concerns that should be considered in connection with each service corporation application. The supervisory issues that arise in the context of your request are discussed below. We render no opinion on whether a service corporation may underwrite PMI reinsurance on loans originated by an unaffiliated third party; such a practice would raise supervisory issues that are beyond the scope of this opinion.

Accordingly, in our view, PMI reinsurance on loans originated or purchased by affiliates of a savings association is linked to certain activities in which Federal associations engage, and there is an adequate legal basis for the OTS to conclude that engaging in such PMI reinsurance is reasonably related to the activities of financial institutions.

B. Investment Limits and Supervisory Concerns

The OTS may, at any time, limit a savings association's investment in service corporations, or may limit or refuse to permit any activities of such entities for supervisory, legal, or safety and soundness reasons.⁷

Neither the 1997 Approval, nor the Regional Office's partial approval of the Association's service corporation application raised significant supervisory concerns relating to the reinsurance of PMI for loans originated by a savings association or its subsidiaries. In each case, the OTS determined that the service corporations engaging in such activity did not pose a threat to parent savings associations because they would maintain corporate separateness, be adequately capitalized, maintain trust accounts that function as loss reserves, and because the primary PMI insurers would remain fully liable to holders of insured loans for payments of all claims beyond the scope of the reinsurance agreements.

While these elements are also present with regard to the Association's request that

⁷ 12 C.F.R. § 559.5(b)(2) (1998).

its service corporation be permitted to reinsure PMI for loans originated or purchased by affiliates, this additional activity raises additional safety and soundness concerns.

Implicit in the prior approvals was an element of control the OTS possessed because of the captive nature of the mortgage loans that were the object of the PMI reinsurance. The OTS has primary regulatory authority over the entities making the loans, and therefore has oversight of the loan underwriting process and standards employed by these entities. OTS monitors these matters in order to ensure that savings associations understand and implement the agency's lending rules and guidelines.

While the OTS also examines savings and loan holding companies,⁸ including the operations of their affiliates, such oversight will not necessarily focus on the underwriting standards of mortgage lending affiliates of the holding company. Accordingly, where a service corporation wishes to act as PMI reinsurer for an affiliate, the OTS may require representations or conditions to ensure that the quality of underwriting by the affiliate will not result in a high rate of borrower defaults and correspondingly high reinsurer pay-outs.

The OCC has addressed this risk by obtaining representations and commitments from banks that the underwriting standards of the affiliate are comparable to those of the bank, and that the reinsurance subsidiary will only accept home mortgage credit risks consistent with the bank's underwriting standards. The OTS may similarly choose to require these types of representations and commitments. The fact that in this case the Association's mortgage lending affiliate is a sister thrift regulated by OTS,⁹ coupled with certain representations made in the application,¹⁰ may alleviate concerns about underwriting standards in the present case.

We defer to the Regional Office to determine, in the course of its evaluation of that portion of the Association's application not yet acted upon, whether the application raises particular supervisory concerns, and, if so, how such concerns should be addressed.¹¹

⁸ 12 U.S.C. § 1467a(b).

⁹ Since the Association's mortgage lending affiliate is a savings association, it would not be deemed an affiliate for purposes of applying the restrictions contained in section 23B of the Federal Reserve Act. See 12 C.F.R. § 563.42(d)(1).

¹⁰ In addition to making certain representations regarding underwriting standards, the Association has committed to give proper disclosure to mortgage loan borrowers about possible reinsurance arrangements.

¹¹ The Association's application refers to loans originated or purchased by the Association, its mortgage lending subsidiaries, or its mortgage lending affiliates. The Interagency Guidelines for Real Estate Lending Policies, found as an Appendix to 12 C.F.R. § 560.101, defines "extensions of credit or loans" to include loans acquired by a lender by purchase, assignment, or otherwise. This means that loans purchased by Federally regulated institutions must meet the same standards as loans originated by these institutions. This may not be true for loans purchased by certain affiliates of depository institutions. Accordingly, any applicant representation or condition imposed by OTS concerning the underwriting standards of an affiliate, made in the context of an application to engage in reinsurance, should be written so as to make clear that it applies to loans both originated and purchased by the affiliate.

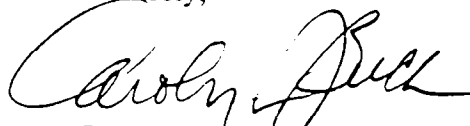
III. Conclusion

In our view, there is an adequate legal basis to conclude that reinsuring private mortgage insurance for loans originated or purchased by the Association's affiliate, a sister savings association, is reasonably related to the activities of financial institutions, and, as such, may be approved by the OTS as a service corporation activity under 12 C.F.R. Part 559.

In reaching the foregoing conclusion, we have relied on the factual representations contained in the materials presented to us. Our conclusion depends upon the accuracy and completeness of those representations. Any material change in the facts or circumstances from those set forth in your submission could result in a different conclusion.

We trust that the foregoing has been responsive to your request. Any questions regarding this matter should be directed to Eric E. Berg, Counsel (Banking & Finance), Business Transactions Division, at (202)906-6464.

Sincerely,



Carolyn J. Buck
Chief Counsel

cc: [] Regional Director
 [] Regional Counsel