Home Owners' Loan Act/Savings Association Powers

Calculation of HOLA Consumer Loan Limits

Summary Conclusion: Under the circumstances presented, when calculating its consumer loan limit under the HOLA, a federal savings association need not include certain secured automobile loans.

Date: May 18, 2006

Subjects: Home Owners' Loan Act/Savings Association Powers

P-2006-4

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, DC 20552 • (202) 906-6372

John E. Bowman
Chief Counsel

P-2006-4

May 18, 2006

Re: Calculation of Consumer Loan Limits for Auto Lending

Dear

This responds to your letter submitted on behalf of (Association), a federal savings association. You have asked the Office of Thrift Supervision (OTS) to confirm that, under the circumstances you have presented, if the Association has secured indirect automobile loans in excess of thirty percent (30%) of the Association's total assets, the Association will not be in violation of the consumer loan limitations imposed by § 5(c)(2)(D) of the Home Owners' Loan Act (HOLA)[1] and § 560.30 of OTS regulations.[2] For the reasons set forth below, we conclude that, under the circumstances you have described, the Association need not count or include certain of its secured automobile loans when calculating its consumer loan limit under § 5(c)(2)(D) of the HOLA.

I. Background

A. General

You have provided the following information. The Association is a volume originator of indirect secured auto loans. Since 2001, the Association has sold in excess of $ million in auto loans, and the Association currently services a gross portfolio of in excess of $ million of auto loans. You state that this secondary market auto loan program has become the contributor to the Association's profits. The majority of the auto loans the Association

[1] 12 U.S.C.A. § 1464(c)(2)(D) (West 2001).

[2] 12 C.F.R. § 560.30 (2006).

originates are prime loans that are secured by the underlying automobiles.[3] The Association sells pools of auto loans each month to third parties and the loans generally are sold within 30-days of origination.

You indicate that the consumer loan limits established by § 5(c)(2)(D) of the HOLA substantially restrict the Association's ability to hold auto loans in an "available for sale" portfolio during the period between origination and sale. You note that in some instances, it may be more economically beneficial for the Association to retain portions of an available for sale portfolio for longer periods or until market interest in the portfolio increases. In your view, the HOLA consumer loan limits place a "severe strain" on the Association's capital and funding resources, and to mitigate that strain the Association "must adhere to a relatively strict monthly sale program." Moreover, you state that to ensure ongoing compliance with HOLA limits and to maintain sufficient balance sheet assets to support its auto loan operations, the Association must acquire mortgage assets, primarily mortgage backed securities. The Association therefore "incurs relatively more interest rate risk in the MBS portfolio at wholesale spreads that are not favorable from an investor perspective, and suffers incremental pressure on its funding resources and capital base."

It is your assertion that because of the HOLA consumer lending limits, the Association has been forced to substantially restrict its auto lending operations, sell its auto loan portfolios more rapidly than market conditions dictate, artificially grow the asset side of its balance sheet, or engage in some combination of the foregoing to comply with the HOLA consumer lending limits. You note that potentially riskier, unsecured, credit card loans are not subject to lending limits under the HOLA.[4] You also note that major thrift competitors in the auto loan arena -- for example, captive finance arms of the "Big Three" automakers -- do not face similar limits on consumer lending limits. Finally, you contend that the Association faces several other problems because its profitable, secured auto lending activities are constrained by the HOLA consumer lending limits.

B. The Association's "Commitment for Sale" Option

You have provided the following information, description, and details regarding the Association's proposal, which you describe as the "Commitment for Sale Option." The Association sells a majority of its automobile loans to, and has had a four-year relationship with, (Purchaser), an operating subsidiary of . The Association and Purchaser are parties to an "Agreement for Purchase, Sale and Servicing of Auto Loans" dated January 31, 2005 (Purchase Agreement). The Purchase Agreement contains, among other things, certain representations and warranties by Purchaser for the benefit of the Association, including a representation and warranty that Purchaser's financial condition is adequate to meet its obligations to purchase auto

[3] Although you originally indicated that all of the auto loans the Association originates are prime loans, you subsequently clarified that the Association also originates a small amount of subprime loans.

[4] Section 5(c)(1)(T) of the HOLA, 12 U.S.C.A. § 1464(c)(1)(T) (West 2001), provides that loans made by a federal savings association through credit cards or credit card accounts are not subject to a percentage of assets limitation.

loans from the Association. You indicate that the Association, by means of performing sufficient due diligence on Purchaser and obtaining sufficient representations and warranties in the Purchase Agreement, has confirmed Purchaser's ability to fulfill its obligations under the Purchase Agreement and Purchaser's ongoing financial condition. Neither party can terminate the Purchase Agreement without 90-days written notice, which time period may be shortened if the reason for the termination is the Association's failure to service loans in accordance with the terms of the Purchase Agreement.

The Association and Purchaser have amended the Purchase Agreement with an "Amendment No. 1" dated August 26, 2005 (Amendment No. 1). Pursuant to Amendment No. 1, Purchaser has committed to purchase auto loans originated by the Association during specified 30-day periods, provided the loans meet underwriting standards that the Association and Purchaser have established. Amendment No. 1 contains as "Exhibit A," a form of "Forward Commitment Agreement" that Purchaser will use to accept a request by the Association to purchase loans, in a specified aggregate amount, that the Association will originate within a specified 30-day time period. Amendment No. 1 provides, among other things, that Purchaser shall not have the right, granted in Section 2.2 of the Purchase Agreement, to decline to purchase a loan pool provided the loans are in conformity with the Forward Commitment Agreement and the Purchase Agreement. With respect to a loan pool purchased under a Forward Commitment Agreement, Amendment No. 1 limits Purchaser's ability to demand that the Association repurchase more than 5% of the loan pool for any reason specified in section 4.1(a) of the Purchase Agreement,[5] except to the extent any loan fails to conform to underwriting standards that the Association and Purchaser have agreed to. The 5% repurchase demand limitation only applies to loans purchased by Purchaser pursuant to a Forward Commitment Agreement and Amendment No. 1, and Amendment No. 1 specifically provides that the 5% limitation does not apply to any other type of repurchase demand authorized under the Purchase Agreement.[6]

Under the terms of Amendment No. 1, Purchaser can demand that the Association repurchase only up to 5% of the loans sold by the Association to Purchaser under Amendment No. 1 and a Forward Commitment Agreement, therefore, the Association proposes to exclude 95% of such loans from the Association's consumer loan calculations. The remaining 5% of the loans sold under Amendment No. 1 and a Forward Commitment Agreement, as to which Purchaser may demand repurchase by the Association, would be included in the Association's consumer loan calculations.

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[5] Section 4.1(a) of the Purchase Agreement provides that within 30 days following a specified "Transfer Date" Purchaser shall have the right to demand that the Association repurchase any loan: (i) if the borrower's credit history fails to meet the Purchaser's minimum standards, or (ii) if the borrower's perceived ability to remit and maintain timely payments on the loan is otherwise not approved by the Purchaser.

[6] For example, under § 4.1(b) of the Purchase Agreement, Purchaser has the right to demand repurchase of any loan that is secured by an "Ineligible Vehicle," as defined in the Purchase Agreement. In addition, under § 5.1 of the Purchase Agreement, Purchaser has the right to demand repurchase of a loan for a variety of reasons, including (i) if the auto dealer breaches certain representations and warranties; (ii) the Association breaches any of its representations, warranties, or covenants in the Purchase Agreement; or (iii) the loan is not properly closed, documented and executed, assigned, and in compliance with applicable laws.

Finally, you contend that 95% of the loans made and sold by the Association to Purchaser pursuant to Amendment No. 1 and a Forward Commitment Agreement should be excluded from the Association's consumer loan limit because such loans would be:

> (i) subject to a binding commitment for sale to a third party pursuant to a forward sale agreement (sic) and not eligible for a demand of repurchase by the purchaser; (ii) underwritten to terms that are agreed to in advance by the seller and purchaser; and (iii) sold to a third party purchaser within 30 days of origination. This alternative also presumes that (a) neither party may cancel or terminate the sale agreement and thereby be relieved of its obligations to purchase auto loans originated under the sale agreement prior to such party's notice of termination or cancellation; and (b) the savings association has confirmed the purchaser's ability to fulfill its obligations by means of sufficient due diligence on the purchaser and sufficient representations and warranties incorporated into the sale agreement regarding the purchaser's ongoing financial condition. (footnote omitted)

II. Discussion

A. Calculation of HOLA Lending and Investment Limits

Section 5(c) of the HOLA authorizes federal savings associations to make and invest in a variety of loans and assets. Federal savings associations may invest in some categories of loans and assets without statutory limits on the aggregate amount of such loans and investments, while other investments and loans are subject to statutory limits in the HOLA.[7] Such limits are often expressed as a percentage of the association's assets or capital. Section 5(c)(2)(D) of the HOLA provides that consumer loans, *i.e.*, loans made for "personal, family, or household purposes, including loans reasonably incident to such credit," and investments in certain securities, made by a federal savings association may not exceed 35 percent of the assets of the association, and that amounts in excess of 30 percent of assets only may be invested in loans made by the association directly to the obligor.[8] The question thus is whether the Association must include or count secured auto loans that are made pursuant to the Purchase Agreement, as amended by Amendment No. 1, and a Forward Commitment Agreement, when calculating whether the Association has reached its consumer lending limit, or may the Association exclude such loans from the consumer loans category?

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[7] Categories of loans and investments that are unlimited include, for example, residential real property loans, home improvement loans, government securities, certain mortgage-backed securities, credit card loans, and educational loans. *See* § 5(c)(1) of the HOLA, 12 U.S.C.A. § 1464(c)(1) (West 2001 & Supp. 2006). Loan and investment categories that are subject to limits include commercial loans, nonresidential real property loans, consumer loans, personal property investments, community development investments, unsecured construction loans, service corporation investments, and investments in business development credit corporations, among others. *See* § 5(c)(2), (3), and (4) of the HOLA, 12 U.S.C.A. § 1464(c)(2), (3), and (4) (West 2001 & Supp. 2005).

[8] 12 U.S.C.A. § 5(c)(2)(D) (West 2001). *See also*, 12 C.F.R. §§ 560.3 and 560.30 (2006) (chart and endnotes 2 and 5). A federal savings association's investments in commercial paper and corporate debt securities are subject, along with its consumer loans, to the percentage of assets limits.

The HOLA does not expressly state a method by which to calculate compliance with consumer lending and investment limits. We therefore look to OTS regulations for guidance. In the lending context, an OTS regulation provides that a loan commitment shall be counted as an investment and included in the total assets of a federal savings association for purposes of calculating compliance with HOLA § 5(c) investment limits "only to the extent that funds have been advanced and not repaid pursuant to the commitment."[9] The regulation goes on to state that "loans or portions of loans sold to a third party shall be included in the calculation of a percentage-of-assets or percentage-of-capital investment limitation *only to the extent they are sold with recourse.*"[10] The issue, therefore, is whether auto loans that the Association makes and sells to Purchaser within 30 days pursuant to (i) the Purchase Agreement, (ii) Amendment No. 1, and (iii) a binding Forward Commitment Agreement, may be considered loans sold to a third party without recourse.

OTS regulations do not elaborate on what constitutes "loans sold to a third party." However, in our view, based on the facts and circumstances presented including the Purchase Agreement, Amendment No. 1, and the Forward Purchase Agreement, provide a reasonable basis upon which to conclude that the transactions between the Association and Purchaser would constitute loans sold to a third party.

OTS regulations do define the term "with recourse." OTS's definitions for regulations affecting all savings association provide, at § 561.55, that in connection with the sale of a loan the term "with recourse" means, in pertinent part,

> an agreement or arrangement under which the purchaser is to be entitled to receive from the seller a sum of money or thing of value, whether tangible or intangible (including any substitution) upon default in payment of any loan involved or any part thereof or to withhold or to have withheld from the seller a sum of money or anything of value by way of security against default.[11]

The recourse liability from a sale with recourse generally is the total book value of the loan sold with recourse minus certain items.[12] Moreover, the term "with recourse" does not include loans or interests therein where the agreement of sale provides for the savings association (i) to retain a subordinate interest in a specified percentage of the loans or (ii) to guarantee against loss a specified percentage of the loans, not exceeding 10% of the outstanding balance of the loans at

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[9] 12 C.F.R. § 560.31(a) (2006).

[10] 12 C.F.R. § 560.31(b) (2006) (emphasis added).

[11] 12 C.F.R. § 561.55(a) (2006).

[12] *Id.* The items specified in the regulation are: the amount of any insurance or guarantee against loss in the event of default provided by a third party, the amount of any loss to be borne by the purchaser in the event of default, and the amount of any loss resulting from a recourse obligation entered on the books and records of the savings association.

the time of sale, provided the savings association designates adequate reserves for the subordinate interest or guarantee.[13]

In our view, the auto loans originated and sold to Purchaser under the Purchase Agreement, as amended by Amendment No. 1, and a binding Forward Commitment Agreement, and not subject to a demand for repurchase, qualify as loans sold to a third party without recourse. The facts and circumstances surrounding the proposed transactions do not meet the definition of "with recourse" in § 561.55 of OTS's regulations.[14] Accordingly, such loans need not be included in the calculation of percentage of total assets limitation in HOLA § 5(c)(2)(D).

An analogy to this situation can be drawn from the supervisory loan-to-value limits context. OTS real estate lending standards recognize that it may be appropriate, in individual cases, to permit an institution to exceed loan-to-value limits under certain conditions, and that in determining the aggregate amount of such loans, an association should include the recourse obligation of any such loan sold with recourse. In other words, if a loan is sold without recourse, then the loan need not be included in determining the aggregate amount of loans in excess of the supervisory loan to value limits.[15] If a loan is sold with recourse, only the recourse obligation of such loan need be included in the supervisory loan-to-value limits.

Importantly, OTS has expressly recognized that there are several lending situations in which other factors significantly outweigh the need to apply supervisory loan-to-value limits, including "[l]oans that are to be sold promptly after origination, without recourse, to a financially responsible third party."[16] Such transactions are excluded from the supervisory loan-to-value limits. Here, the Association generally will sell the loans to Purchaser within 30 days after origination. In our view, a sale 30 days from origination to sale meets the criteria of "promptly."

Based on all of the facts and circumstances you have described, we conclude that loans sold by the Association to Purchaser pursuant to the Purchase Agreement, as amended by Amendment No. 1, and a Forward Commitment Agreement, may be considered sold *without recourse*. Accordingly, the Association need not count such loans when calculating whether it has reached or exceeded its consumer loan limit.

B. Supervisory Conditions

Under the facts and circumstances you have described and provided, we conclude that secured auto loans originated under the Purchase Agreement, as amended by Amendment No. 1,

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[13] 12 C.F.R. §561.55(b) (2006).

[14] This opinion does not address questions of recourse treatment under the OTS capital regulations. *See e.g.*, 12 C.F.R.§ 567.1 (2006) (definition of recourse).

[15] *See* Appendix to 12 C.F.R. § 560.101 (2005) – Interagency Guidelines for Real Estate Lending Policies: *Loans in Excess of the Supervisory Loan-to-Value Limits.*

[16] *Id., Excluded Transactions.*

and a binding Forward Commitment Agreement *and not subject to repurchase*, may be excluded from the Association's consumer lending limitation for purposes of HOLA § 5(c)(2)(D). The terms of the various agreements and all aspects of the Association's proposed transactions with Purchaser are subject to review, evaluation, and supervisory oversight by the OTS Northeast Regional Office (Regional Office) for, among other things, safety and soundness, concentration concerns, prudent underwriting, and the like.

Any loans originated under the Purchase Agreement, as amended by Amendment No. 1, and a binding Forward Commitment Agreement that are subject to a repurchase demand are sold with recourse and, therefore, must be included in the calculation of the Association's consumer lending limitation under the HOLA. Moreover, this opinion is not intended to affect the way the Association must report assets on its balance sheet for purposes of GAAP. Accordingly, the Association must report, in accordance with the requirements of GAAP, all loans originated under a binding Forward Commitment Agreement, whether subject to a repurchase demand or not, *i.e.*, with or without recourse. In other words, all of the auto loans made by the Association are on the books, or on the balance sheet, as appropriate under GAAP.

In addition, OTS deems it appropriate to make the approval of the Association's proposal subject to certain supervisory conditions. Within 90 days of the date of this letter, the Association shall provide to the Regional Office an updated three-year business plan, which shall include *pro forma* projections of the Association's proposed lending activities and, thereafter, any other items the Regional Office requests or deems appropriate. Any proposed deviation from the Association's updated business plan will be subject to review and approval by the Regional Office. In particular, you have indicated that substantially all of the auto loans in the proposed transactions will be prime loans. Accordingly, if the Association intends to begin originating or purchasing more than a *de minimis* amount of subprime loans, the Association must first notify the Regional Office that the Association is changing its business plan to include subprime loans. Such proposed change shall be subject to the Regional Office's review for safety and soundness concerns and other concerns.

Moreover, notwithstanding the consumer lending and investment limits established by the HOLA, the Regional Office may impose additional requirements on the lending and investment activities of the Association when there is a safety and soundness concern based on, among other things, the aggregate level of loans or investments in a particular category, weak performance levels, or high-risk lending.[17] Such requirements may include imposing limits on concentration of certain activities. In addition to the foregoing, our conclusions herein are subject to, and OTS hereby imposes, the following supervisory conditions:

1. Future growth in the Association's consumer/auto lending shall be moderate and remain within the Association's pro forma budget as submitted to and approved by the Regional Office.

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[17] OTS regulations reserve the authority to impose additional restrictions on federal savings association investment activities for safety and soundness reasons. *See e.g.*, 12 C.F.R. §§ 559.1(a), 559.5, and 560.30 (introductory language).

2. Not more than a *de minimis* amount of the loans made by the Association pursuant to the Purchase Agreement, as amended by Amendment No. 1, and a binding Forward Commitment Agreement, may be subprime loans.

3. The Association's auto lending program shall be subject to periodic review by the Regional Office for the purpose of determining underwriting standards, lending policies, credit risk, concentrations, and overall safety and soundness of the program. The Regional Office may impose any limits it deems appropriate.

4. If the Association intends to deviate significantly from its business plan, the Association must provide the Regional Office with at least thirty (30) days' advance notice.

5. All sale and purchase transactions between the Association and Purchaser shall be at arm's length.

6. In the event Purchaser fails to purchase loans for which Purchaser has issued a Forward Commitment Agreement, then such loans must be included in the Association's HOLA consumer loan limit calculation until the Association disposes of such loans.

7. The Association shall submit to the Regional Office a quarterly reconciliation of the Association's compliance with the HOLA consumer loan limit and the effect of netting out loans sold to Purchaser pursuant to a Forward Commitment Agreement.

8. Our conclusions herein relate solely to the particular arrangement, including the specific agreements, that the Association has with Purchaser. If the Association intends to enter into a similar arrangement with an entity other than Purchaser and does not intend to include loans sold to such other entity in the Association's consumer loan limit calculation, the Association must obtain the prior approval of the Regional Office.[18]

Any substantive changes in the terms of the Purchase Agreement, Amendment No. 1 thereto, or the form of Forward Commitment Agreement, may render our conclusions herein invalid. Finally, our conclusions assume that the Association will not retain any liability or responsibility for losses associated with the loans it will service for Purchaser after Purchaser buys the loans.

In reaching the foregoing conclusions, we have relied on the factual representations contained in the written materials you submitted and in subsequent conversations with OTS staff. Our conclusions necessarily depend upon the accuracy and completeness of those representations. Any material difference in facts or circumstances could result in different

[18] Similarly, other federal savings associations that may wish to enter into similar arrangements for the purpose of excluding certain loans from the consumer loan limit calculation must also obtain the approval of the appropriate OTS Regional Office.

conclusions. We trust this is responsive to your inquiry. If you have any questions, please contact Vicki Hawkins-Jones, Special Counsel, at (202) 906-7034, or William Magrini, Senior Project Manager, at (202) 906-5744.

Sincerely,

/s/

John E. Bowman
Chief Counsel

cc: Regional Directors
Regional Counsel