

Participation in Group Mortgage Guaranty Reinsurance Program

Summary Conclusion: A federal savings association may participate in a mortgage guaranty reinsurance program either directly or indirectly through an operating subsidiary or service corporation. Indirect participation is subject to the notice requirements of 12 CFR 559.11.

Date: May 13, 2004

Subjects: Home Owners' Loan Act/Savings Association Powers

P-2004-2



Office of Thrift Supervision
Department of the Treasury

Chief Counsel

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

May 13, 2004

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Re: Participation in Group Mortgage Guaranty Reinsurance Program

Dear []:

This responds to your inquiry whether [] (“Association”), a federal savings association, may participate in the Michigan Bankers Reinsurance Company (“Reinsurer”), an association captive insurance company. Reinsurer proposes to provide reinsurance of private mortgage guaranty insurance on residential mortgage loans originated or purchased by participating lenders and their mortgage banking subsidiaries and affiliates. We also have been asked whether indirect participation by a federal savings association through an operating subsidiary or service corporation would qualify for the notice process under OTS regulations.

We conclude that the Association may participate in Reinsurer’s mortgage guaranty reinsurance program either directly, or indirectly through an operating subsidiary or service corporation. We also conclude that indirect participation would qualify for the notice process under OTS regulation 12 C.F.R. § 559.11.¹

BACKGROUND

In a series of written and oral communications with Office of Thrift Supervision (“OTS”) staff, the legal counsel (“Counsel”) for Reinsurer has made representations and provided factual information and documentation concerning Reinsurer and its proposed mortgage guaranty reinsurance program (the “Program”).² The Association is interested in participating in Reinsurer’s Program.

¹ 12 C.F.R. § 559.11 (2003).

² Denise J. Deschenes, Law Office of Primmer and Piper, St. Johnsbury, Vermont, is Counsel for Reinsurer. Counsel has described the Reinsurer, Reinsurance Arrangements, Shareholder Accounts, Limitation of Liability, Customer Disclosure, and various other features of the Program. Counsel also has described some of the differences between Reinsurer’s Program and the program considered in a March 11, 1999 OTS Chief Counsel opinion involving federal savings association participation in the New England Mortgage Insurance Exchange.

The Association and Counsel seek confirmation that the Association may directly participate in the Reinsurer through ownership of a non-controlling interest in Reinsurer's common stock. Counsel also seeks confirmation that a federal savings association may indirectly participate in the Reinsurer through ownership by an operating subsidiary or service corporation of Reinsurer's common stock and that such indirect participation would qualify for the expedited notice process under OTS regulation 12 C.F.R. § 559.11.

Reinsurer and the Program

Counsel represents that Reinsurer was organized under the sponsorship of the Michigan Bankers Association ("MBA"), a trade association of Michigan financial institutions, as an association captive insurance company under Vermont's captive insurance law.³ Reinsurer is organized as a Vermont corporation. The Vermont Commissioner of Banking, Insurance, Securities, and Health Care Administration ("Vermont Commissioner") issued a Certificate of Authority to conduct business to Reinsurer on September 21, 2003. Reinsurer's Business Plan, filed with the Vermont Commissioner, limits ownership of Reinsurer's common stock to member financial institutions of the MBA, their mortgage banking subsidiaries, and their affiliates. Reinsurer's authorized activities consist solely of providing reinsurance of private mortgage guaranty insurance coverage⁴ issued by non-affiliated third party mortgage insurers for loans originated or purchased by the participating financial institutions and their subsidiaries and affiliates.⁵ A material change in Reinsurer's Business Plan would require approval of the Vermont Commissioner.⁶ Reinsurer's bylaws prohibit Reinsurer from engaging in any activity that is not permissible for a national bank and a federal savings association.

³ Title 8, Vermont Statutes Annotated, Chapter 141. Captive insurers insure or reinsure risks related to the business of their owner or owners and are subject to special insurance regulations. Association captives are a type of captive insurer, all of whose participants or owners are also members of a sponsoring industry association or similar group, and which insures or reinsures only risks relating to its members.

⁴ Mortgage insurance protects an investor holding a mortgage loan against the risk of default by the mortgagor. Lenders generally require borrowers to obtain mortgage insurance on low down payment loans, generally loans with a down payment of less than 20% or a loan-to-value ratio in excess of 80%.

⁵ Counsel's initial letter indicated that loans serviced, but not originated or purchased, by participants would be included in the Program. However, in a subsequent letter, Counsel indicated that Reinsurer has decided to limit the program to first lien residential mortgage loans originated or purchased by participating institutions and their subsidiaries and affiliates. Therefore, loans that are merely serviced by a participant, but that were not also originated or purchased by it, will not be eligible for reinsurance under the Reinsurer's Program.

⁶ Counsel represents that a material change would include the writing of any direct insurance or any other kind of reinsurance by Reinsurer.

Reinsurer's Articles of Incorporation authorize the issuance of one share each of classes 1 through 200, no par value stock.⁷ All classes of shares are equal and have identical rights, except as to possible dividends, and distributions on liquidation, which will be based on the performance of each participant's contributed loans. Each share is entitled to one vote and has unlimited voting rights, with the shares of all classes voting together as a group on matters requiring shareholder action, except as otherwise required by Vermont corporate laws. Each participant in the Program will purchase one share of stock (consisting of its own class) for a purchase price of \$4,000. The Articles of Incorporation provide for mandatory redemption of a shareholder's stock upon cancellation or termination of the shareholder's active participation in Reinsurer's Program for any reason. A participant may voluntarily withdraw from the Program at any time.⁸

Counsel further represents that (i) Reinsurer will be subject to ongoing supervision and regulation by the Vermont Commissioner, (ii) initial capital funds of \$750,000, the statutory minimum capital for association captives, are being provided by the MBA through a letter of credit issued by a commercial bank in favor of the Vermont Commissioner; (iii) additional capital funds will be obtained through the stock subscriptions of participating financial institutions, (iv) Reinsurer will maintain the statutory minimum capital at all times, as well as statutorily required contingency reserves, and (v) in the initial years of the Program, participants will have to furnish additional capital funds in proportion to their insured loans to cover Reinsurer's administrative expenses, tax liabilities, and deposits to a reinsurance trust.

The Reinsurance Arrangements

Counsel represents that Reinsurer has entered into a Reinsurance Agreement with [Company], a [] monoline mortgage guaranty insurance company. Under the Reinsurance Agreement, Reinsurer will reinsure a portion of [Company]'s risk on mortgage guaranty insurance [Company] provides on residential mortgage loans originated or purchased by participants in the Reinsurer or their mortgage banking subsidiaries and affiliates. In exchange for a specified percentage of the written

⁷ Counsel advises that dividends paid on a particular class of stock must be the same for each share of that class under Vermont law. The purpose of the separate classes of Reinsurer's stock, therefore, is to facilitate dividend distributions to participants based on the economic performance in the Program of their own mortgage loans, without regard to the economic performance of other participants' loans.

⁸ There are no express provisions for involuntary termination of a participant, but Counsel advises that a participant is not entitled contractually to have its loans reinsured through the Program, and that if the MBA's quarterly monitoring of the Program and the individual participants reveals persistent underwriting risk with a participant, the Reinsurer would cease to accept any new loans from that participant into the Program. In such event, the participant's loans previously reinsured would remain insured in accordance with the terms of the Program.

premiums on the underlying insurance policies, Reinsurer will reinsure a five percent (5%) excess-of-loss layer with respect to insured loans above an initial five percent (5%) layer retained and insured by [Company]. [Company] will be responsible for the payment of all losses above Reinsurer's layer.⁹ Reinsured loans are segregated into annual "books," each having a ten-year term and consisting of first lien residential mortgage loans.

Reinsurer also has entered into a Trust Agreement under which Reinsurer will establish a master reinsurance trust account. [Company] will deposit premiums ceded to the Reinsurer into the trust account. The Reinsurance Agreement requires quarterly deposits to the trust of an amount equal to at least 10% of the risk exposure ceded to Reinsurer on new loans acquired during the quarter. Each participant will be required to contribute funds sufficient to make deposits to the trust to maintain funding at the 10% level with respect to that participant's reinsured loans. The purpose of the trust is to secure Reinsurer's reinsurance obligations to [Company]. The Reinsurance Agreement prohibits distribution of funds from the trust, other than for payment of taxes and administrative expenses, prior to a specified period of time after the effective date of the Reinsurance Agreement. Thereafter, funds may be distributed from the trust only under certain conditions.

Counsel states that each participant in the Program will enter into a Subscription and Shareholders Agreement with Reinsurer. The Shareholders Agreement requires a separate bookkeeping account to be maintained for each participant to track the economic performance of its participation in the Program.¹⁰ The participants and Reinsurer have agreed that dividends or distributions (if any) to a participant will be based on the performance of the loans that participant contributed to the Program, subject to prior approval of the Vermont Commissioner, applicable law, and the provisions of the Reinsurance Agreement and Trust Agreement. The performance of a participant's loans will be reflected in the participant's bookkeeping account maintained by Reinsurer. In the event Reinsurer is required to pay reinsurance losses to [Company] with respect to an annual book, the bookkeeping accounts of participants whose loans contributed to the loss would be reduced pro rata, thereby negatively impacting each such participant's entitlement to any distributions.

⁹ Counsel represents that [Company] has agreed to look only to the reinsurance trust in satisfaction of Reinsurer's obligations, and that any losses above the amount of available trust funds would be absorbed by [Company], not Reinsurer or the individual participants.

¹⁰ Items that will be tracked include capital contributions, trust deposits to support reinsured risk, returns from operations, dividends and distributions to the participant, and losses and expenses in relation to the participant's insured loans.

The default experience on all reinsured loans in a particular annual book will be aggregated for purposes of determining whether the Reinsurer's contractual loss layer has been reached. If the loss layer is reached, all funds deposited in the reinsurance trust would be available to [Company] to pay reinsurance losses under the Reinsurance Agreement, without regard to the relative contributions to that trust attributable to individual participants or the performance of the loans they have contributed. The participants and Reinsurer have agreed among themselves, however, that funds in the reinsurance trust and allocated to a participant's shareholder account will be used to pay reinsured losses incurred with respect to that participant's insured loans. Thus, if Reinsurer were required to pay reinsurance losses to [Company] with respect to an annual book, the accounts of all participants whose loans contributed to the loss would be reduced pro rata. If funds allocated to a participant's account to pay such losses are insufficient, then losses may be paid from other available funds in the reinsurance trust attributable to other participants or from the Reinsurer's statutory and capital surplus.

Counsel represents that [Company] has agreed to look only to the reinsurance trust in satisfaction of Reinsurer's obligations and that participants in Reinsurer will not be personally liable for Reinsurer's reinsurance obligations or other debts and liabilities.¹¹ Counsel further represents that (i) as a corporate shareholder, a participant's exposure to Reinsurer's losses is limited to the funds the participant invested in Reinsurer, (ii) reinsurance losses can only be paid out of the assets held in the reinsurance trust, and (iii) in the event the assets in the trust are insufficient to pay such losses, the Program will be discontinued, with no further liability to the Reinsurer or any participant.

Other Program Features

Participating financial institutions and other lenders in the Program will conduct their own credit underwriting analysis and decisionmaking in connection with insured mortgage loans and will not delegate those functions to [Company] or any other party. [Company] will perform its own independent insurance underwriting evaluation of loans submitted for coverage.¹² [Company] will accept for mortgage guaranty insurance only those loans that meet [Company]'s underwriting criteria.

Each participating lender will be required to furnish to borrowers on loans it originates with mortgage insurance a written notice disclosing the reinsurance arrangement and stating that the lender, or subsequent holder of the loan, may have an

¹¹ Counsel cites 11A Vermont Statutes Annotated § 6.22, which provides that the shareholders of a corporation are not personally liable for the acts and debts of the corporation.

¹² [Company] may approve delegated underwriting authority for certain lenders, and such lenders will have the ability to bind mortgage insurance coverage for a loan that it approves using [Company]-approved underwriting criteria.

ownership interest in Reinsurer and may receive a portion of the mortgage insurance premium for reinsured risk on the borrower's loan. Borrowers will have the opportunity to require that their loans be excluded from the reinsurance arrangement.¹³

Counsel also represents that the Program will meet the Financial Requirements for Captive Reinsurance under Freddie Mac's Private Mortgage Insurer Eligibility Requirements (March 2002), because many of the insured loans are sold into the secondary market.¹⁴

DISCUSSION

Direct Participation

OTS has previously concluded that federal savings associations possess incidental authority to participate in an association captive reciprocal mortgage guaranty insurer organized under Vermont law, the New England Mortgage Insurance Exchange ("Exchange").¹⁵ In approving such participation, we noted that federal savings associations possess authority to reinsure portions of their own loans, price and allocate risk on residential real property loans directly or through loan participations, reinsure credit risk, and issue mortgage loan performance guarantees.¹⁶ We will examine the differences between the Exchange and its program on the one hand, and Reinsurer and its Program on the other hand, to ascertain whether any variations might affect federal savings associations' incidental authority to participate in Reinsurer and its Program.

Based on the information provided by Counsel, the differences between the previously approved Exchange and its program and Reinsurer and its Program appear to be as follows. First, Reinsurer is organized as a Vermont corporation and institutions wishing to participate in Reinsurer and its program must become stockholders of Reinsurer. The Exchange was not a separate corporate entity, but rather, a web of contractual relationships among the member participants.

¹³ In such event, the loan will still be insured by [Company], but no portion of the risk attributable to that loan will be reinsured by Reinsurer and no premium will be ceded to Reinsurer in connection with such loan.

¹⁴ Counsel advises that Freddie Mac (i) limits the amount of gross risk assumed by and premium ceded to the captive, (ii) requires establishment of a trust in favor of the ceding insurer that meets specified funding requirements, and (iii) requires that ceded premiums be proportionate to the risk assumed and paid only as received by the insurer.

¹⁵ OTS Op. Chief Counsel (March 11, 1999). The opinion found that such authority was incident to the residential real property lending authority of federal associations in section 5(c)(1)(B) of the Home Owners' Loan Act ("HOLA"), 12 U.S.C.A. § 1464(c)(1)(B) (West 2001).

¹⁶ See OTS Op. Chief Counsel (March 11, 1999) and authorities cited therein at 6 – 8.

Second, the loans being reinsured in the Exchange program were loans originated or purchased by participating banks, savings banks, savings associations and a specified group of other mortgage lenders. The current request involves loans originated or purchased by participating financial institutions, as well as loans originated or purchased by their mortgage banking subsidiaries and affiliates. Thus, the universe of potential loans that may be submitted to the Program is somewhat different, and potentially larger, than that previously considered. In addition, there is the possibility that the underwriting standards of affiliates and subsidiaries may be different than the underwriting standards of their related participating financial institutions, although all loans in the Program would have to meet [Company]'s underwriting standards.

Third, there are differences in the allocation of reinsurance losses and payment of net income. In the Exchange program, each participant agreed to assume a pro rata share of the entity's obligations and to receive a pro rata share of its net income. In Reinsurer's Program, the financial performance of each participant will be based primarily on the performance of the loans it contributes to the program, rather than on the performance of the loans of all participants. As explained above, although the losses on loans of all participants are aggregated for purposes of determining whether Reinsurer's contractual second layer of loss is reached, once the loss layer is reached, the participants whose loans contributed to the reinsured loss would share pro rata in such losses.

A fourth difference is the method of capitalization. Initial capital funds for the Exchange and Reinsurer are provided via commercial letters of credit in favor of the Vermont Commissioner. However, each participant in Reinsurer and the Program also will be required to make an initial cash outlay of \$4,000.00 to purchase its single share of Reinsurer's capital stock, will contribute amounts to the reinsurance trust to cover at least 10% of the risk on the loans it has in the Program, and may be required to furnish additional funds for Reinsurer's administrative expenses and tax liabilities. No initial cash outlay or investment of funds was required to participate in the Exchange.

Finally, the annual books of loans in Reinsurer's Program are not subdivided by loan type and all loans made in a particular year are part of a single annual book. In the Exchange program, the annual books were divided by loan type and the reinsured loss layer varied depending on the type of loan. Counsel for Reinsurer represents that the structure of Reinsurer's Program has come to be the industry norm in the years since the Exchange program was established, due in part to the standardizing effect of the Freddie Mac financial eligibility guidelines for captive reinsurance.

In our view, none of the differences identified above is so significant as to adversely affect the authority of the Association to Participate in Reinsurer's Program pursuant to an incidental powers analysis. The proposed investment still meets the four

factors of the incidental powers analysis in that the investment: is consistent with the purpose and function Congress envisioned for federal savings associations; is similar to and facilitates the conduct of expressly authorized activities; relates to the role of federal savings associations as financial intermediaries; and is necessary to enable federal savings associations to remain competitive and relevant in the modern economy. Indeed, with respect to the fourth factor, we note that national banks may participate in reinsurance programs.¹⁷ Therefore, to remain competitive, federal savings associations should be able to participate in the Program.

Nevertheless, we believe that one difference warrants imposing a condition that we did not impose in connection with the Exchange program. To the extent that a federal savings association submits to the Program loans originated or purchased by the association's mortgage banking subsidiaries or affiliates, the association should ensure that the subsidiaries and affiliates use the same underwriting standards for their loans that the association uses for its own loans. Finally, as we noted in the Exchange opinion, federal savings associations participating in the Program should observe the guidance in OTS's Thrift Bulletin 72a pertaining to high loan-to-value real estate lending.¹⁸

Moreover, there is another source of authority for the Association to participate in Reinsurer and the Program. OTS has long recognized that under certain circumstances federal savings associations have incidental power to invest in corporations that engage exclusively in activities that associations may conduct directly, without having to comply with service corporation and operating subsidiary requirements. For example, OTS has approved federal savings association participation in joint user corporations when the predominant purpose of the investment facilitated an activity for which the joint participation of several users is required.¹⁹

OTS has codified the authority to invest in joint user corporations. OTS regulation § 560.32 authorizes making pass-through investments in an entity that engages only in activities that an association may conduct directly and that meets certain regulatory

¹⁷ See Office of the Comptroller of the Currency Interpretive Letter No. 985 (January 14, 2004).

¹⁸ OTS Thrift Bulletin 72a, "Interagency Guidance on High Loan-to-Value Residential Real Estate Lending (October 8, 1999).

¹⁹ See e.g., Op. OTS Chief Counsel September 15, 1995) (federal savings association may acquire stock of a corporation operating an electronic funds transfer system where all stockholders would consist exclusively of insured depository institutions using the system) and Op. OTS Chief Counsel (December 13, 1993) at 4 (federal savings associations may jointly invest in the stock of a corporation that provides data-processing services).

requirements.²⁰ Permissible pass-through investments include stock investments made primarily to use a corporation's services (*e.g.*, data processing) under § 560.32(b)(5)(v).²¹ Pass-through investments that do not meet all of the regulatory criteria require prior notice to OTS, and if the proposed investment presents supervisory, legal, or safety and soundness concerns, prior approval by OTS.²² To the extent the Association's proposed investment and participation in Reinsurer's Program may not meet all of the regulatory criteria for preapproved investments and, therefore, require prior notice, we deem the Association's inquiry to constitute notice in accordance with the regulation. We note that Association's proposed ownership of one share of Reinsurer's stock does not appear to be for speculative purposes, but rather, would facilitate participation in the Program.²³

To summarize, the Association's direct participation in Reinsurer and the Program is permissible as an incidental power, and pursuant to the authority to make pass-through investments under OTS regulation § 560.32. Other federal savings associations wishing to directly participate in Reinsurer and the Program will be subject to any supervisory, safety and soundness, or other conditions that their OTS regional office may deem appropriate. Federal savings associations that participate in the Program and that include loans of their affiliates or subsidiaries should insure that the underwriting standards used by those entities are consistent with the underwriting standards of the association itself.

Indirect Participation

Counsel also seeks confirmation that federal savings associations may participate indirectly in Reinsurer's Program through service corporation or operating subsidiary ownership of Reinsurer's stock. OTS regulation § 559.3(e) provides authority for an

²⁰ 12 C.F.R. § 560.32 (2003). Those requirements, set forth in § 560.32(b)(1) – (5), are: the investment must not exceed 15% of the association's total capital; the book value of the association's aggregate pass-through investments does not exceed 50% of total capital after making the investment; the investment would not give the association direct or indirect control of the company; the association's liability is limited to the amount of the investment; and the company is a limited partnership, an open-end mutual fund, a closed-end investment trust, a limited liability company, or an entity in which the association is investing primarily to use the company's services.

²¹ 12 C.F.R. § 560.32(b)(5)(v) (2003). *See* preamble to OTS regulation § 560.32 at 61 Fed. Reg. 66561, 66568 (December 18, 1996) ("pass-through investments (except for investments made primarily to use a corporation's services under 560.32(b)(5)(v)) may take the form of stock investments only with special approval from OTS and may only be made in entities that engage in activities that a federal savings association could conduct directly").

²² 12 C.F.R. § 560.32(c)(2003). OTS supervisory staff have not raised any supervisory or safety and soundness concerns.

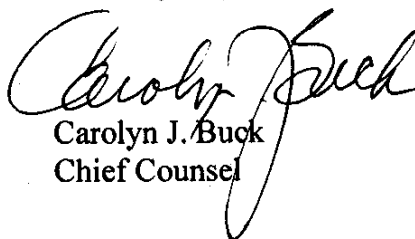
²³ Federal savings associations generally may invest in stock or equity securities only in specified circumstances, such as certain highly rated corporate debt securities, stock or securities of the Federal Home Loan Banks, Fannie Mae, Freddie Mac, Sallie Mae, or Ginnie Mae, certain investment companies, community development equity investments, new markets venture capital companies, and small business investment companies and securities, among others. *See* HOLA § 5(c), 12 U.S.C.A. § 1464(c) and 12 C.F.R. §§ 560.30 and 560.40 (2003).

operating subsidiary of a federal savings association to conduct any activity that federal savings associations may conduct directly, subject to giving notice to OTS in accordance with OTS regulation § 559.11. Similarly, OTS regulation § 559.4(a) provides that a service corporation may conduct as a preapproved activity, any activity that federal savings associations may conduct directly (except taking deposits), subject to a notice or application requirement. We have concluded that federal savings associations may directly participate in Reinsurer and its Program, therefore, indirect participation through an operating subsidiary or a service corporation is likewise permissible.²⁴ Finally, because we have considered and reviewed information and representations provided by Counsel regarding Reinsurer and the Program, federal savings associations wishing to participate through service corporations should file a notice in accordance with § 559.11. Under § 559.11, if OTS notifies the association within 30 days that the notice presents supervisory concerns, or raises significant issues of law or policy, then the association will be required to file an application under part 516 of OTS's regulations.

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

We trust that this is responsive to your inquiry. If you have further questions, please contact Vicki Hawkins-Jones, Special Counsel, at (202) 906-7034.

Sincerely,



Carolyn J. Buck
Chief Counsel

cc: Regional Directors
Regional Counsel
Denise J. Deschenes, Esquire, Primmer & Piper

²⁴ We note that OTS previously has permitted service corporations to engage in reinsurance activities with respect to private mortgage insurance for loans originated by a federal savings association, and its mortgage lending subsidiaries and affiliates. See OTS Op. Chief Counsel (November 2, 1998) and OTS Op. Business Transactions Division (October 10, 1997).