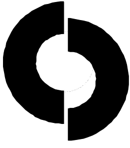

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

April 6, 1998

Interpretive Letter #828
May 1998
12 U.S.C. 24(7)
12 C.F.R. 5.34

Re: Proposed Mortgage Reinsurance Activities Through Reciprocal Insurer

Dear [ ]:

We are responding to your letter asking whether national banks may participate in a proposed reciprocal mortgage reinsurance exchange (the "Exchange"). The Exchange will provide for the reinsurance of private mortgage insurance on loans originated or purchased by participating lenders. Based on representations contained in your letter and made in conversations with OCC staff, as described herein, we conclude that national banks' participation in the Exchange is permissible under 12 U.S.C. § 24(Seventh).

You have also inquired about what OCC approvals are required for national banks to participate in the Exchange. A national bank may participate directly in the Exchange without prior OCC approval but we urge national banks to notify their Examiners in Charge (the "EICs") in conjunction with commencing the activity. A national bank that participates through an operating subsidiary must obtain the OCC's prior approval under 12 C.F.R. § 5.34.

I. BACKGROUND

A. Mortgage Insurance Generally

Mortgage insurance protects an investor holding a mortgage loan against default by the mortgagor. Banks and mortgage lenders generally require that borrowers obtain mortgage insurance from third-party mortgage insurers on low down payment loans.[1] Mortgage insurance has played a vital role in helping low and moderate-income families become

[1] For purposes of this letter, a low down payment loan is a loan with a down payment of less than 20 percent of the property's value, or a loan with a loan-to-value ratio in excess of 80 percent.

homeowners by allowing families to buy homes with less cash. Mortgage insurance also has expanded the secondary market for low down payment mortgages and the funding available for these loans. Government sponsored enterprises such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, and most other purchasers in the secondary market, typically will not consider purchasing low down payment conventional loans unless the loans have mortgage insurance. Secondary market purchases of low down payment loans with mortgage insurance helped fuel the expansion in home construction and sales during the 1970s and 1980s, aiding many first-time and other home buyers. See Mortgage Insurance Companies of America 1995-1996 Fact Book.

B. Parties

Under your proposal, the [ ] (the "Exchange") will be formed under Vermont insurance law as an association captive reciprocal insurer.[2] The authorized activities of the Exchange will consist solely of writing private mortgage reinsurance[3] coverage for loans originated or purchased by the participating lenders. The Exchange will not be a separate legal entity, but rather, will exist as a relationship among the participating lenders that is established through agreements.[4] All lenders who will participate in the Exchange are members of the [ ] (" "). [ ] is a pooled arrangement among over seventy bank and non-bank mortgage lenders in [*States*] and [*State*] for the purchase of mortgage credit life insurance at advantageous rates. While all lenders who will be participating in the Exchange are members of [ ], not all members of [ ] will participate in the Exchange. [ ] Insurance Company ("*Co. 1*"), which serves as the insurer for [ ], will provide initial financial assistance to the Exchange, so that the Exchange can meet certain

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[2] Captive insurers insure or reinsure only risks related to the business of their owner(s) and are subject to special insurance regulations. Vermont law (8 V.S.A. Chapter 141) has authorized the formation of captive insurers and reinsurers since 1981. 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.

[3] Reinsurance is a process whereby an original insurer reduces its underwriting risk by passing all or part of this risk on to another insurance company. The first underwriter may retain only a portion of the risk and reinsure the balance with a second company that then owns the cash flow and assumes that portion of the risk. See 13A John Alan Appleman & Jean Appleman, Insurance Law and Practice § 7681 (1976).

[4] Each participating lender will sign a (1) subscriber agreement which includes a prorata reinsurance risk assumption, and a (2) power of attorney. A participating lender may voluntarily withdraw from the Exchange at any time, and shall be entitled to receive the amount in the lender's subscriber savings account less any amounts owed by the subscriber to the Exchange, subject to any restrictions or limitations on distributions to members of the Exchange.

surplus requirements.[5] The [ ] Insurance Company ("*Co. 2*"), a [*State*] monoline insurance company licensed to write mortgage insurance in the states of [*State, State*], and [*State*], will write the mortgage insurance coverage that will be reinsured by the Exchange. [*Co. 2*]'s business is restricted to providing mortgage insurance.

C. The Proposed Reinsurance Activities

The Exchange is authorized under Vermont law to write only private mortgage reinsurance coverage for loans originated or purchased by participating lenders.[6] Under a reinsurance agreement (the "Reinsurance Agreement"), the Exchange will assume (*i.e.*, reinsure) a portion of [*Co. 2*]'s risk on [*Co. 2*]'s mortgage insurance coverage. Each lender participating in the Exchange, would contractually agree with each of the other members of the Exchange to assume its pro rata share of the Exchange's total reinsurance risk. For purposes of the Agreement, loans will be divided into various product categories ("Product Books") based on loan to value ratios and whether the loans are fixed rate or adjustable rate. The sum of these Product Books originated during a calendar year will be treated as separate books of business ("Annual Books") for purposes of applying the overall loss layer provisions. The participant's pro rata share of the reinsurance risk applicable to an Annual Book is determined by dividing the aggregate amount of the ceded premium attributable to reinsured loans originated or purchased by that lender during the calendar year that are included in each Annual Book, by the aggregate principal amount of ceded premiums attributable to reinsured loans originated or purchased by all participating lenders during such calendar year that are included in that Annual Book. The Exchange's reinsurance liability for an Annual Book terminates on December 31, ten years after the end of the calendar year of origination.

The reinsured portion will be limited to a second layer above a layer of risk assumed by [*Co. 2*]; the "excess loss" or "excess layer" of the portfolio. Under the Reinsurance Agreement, [*Co. 2*] would be responsible as to each Annual Book for the first layer of risk on the insured mortgages, up to specified percentages (between [ ]% and [ ]%) of the various Product Books included in the Annual Book. The Exchange, in turn, would contractually assume from [*Co. 2*], and be obligated to [*Co. 2*] for, a second loss layer, which would be limited to an aggregate dollar amount equal to one-half of the sum of [*Co. 2*]'s maximum first loss layer on all Product Books included in the Annual Book. Notwithstanding the Exchange's reinsurance obligations to [*Co. 2*], [*Co. 2*], as the primary

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[5] [*Co. 1*] is assisting in formation of the Exchange as an accommodation to the [ ].

[6] You have confirmed that the Vermont Commissioner of Banking, Insurance, Securities and Health Care Administration (the "Vermont Commissioner") has granted the application to form the Exchange and has issued to the Exchange a Certificate of General Good and a Certificate of Authority. However, no business operations as yet have been conducted.

insurer, will be directly liable to the insured (the holder of the mortgage) to pay the full amount of insured losses.

In return for assuming that second layer of risk, the Exchange would receive [ ]% of the mortgage insurance premium, subject to subsequent increase or decrease based on the loss experience of the insured mortgages over time (the "ceded premium"). In accordance with the Reinsurance Agreement, a specified percentage of the premium ceded to the Exchange would be paid to the Exchange and the remainder would be placed in trust as a reserve for the payment of reinsurance claims. An additional $[ ][7] will be placed in the trust as an initial reserve fund at the time of the program's start-up. In addition, the Reinsurance Agreement requires that the Exchange make quarterly deposits to the Trust equal to a specified percentage of the risk insured on loans added to an Annual Book during that quarter. The default experience reflected in the Annual Books will determine subsequent adjustments to the allocation of ceded premiums to reflect the loss experience of the portfolio.

D. Reserve Requirements and Capitalization

Vermont law requires an association captive formed as a reciprocal, like the Exchange, to have free surplus[8] of at least $1 million. This amount is also sufficient to allow the Exchange to issue its insurance obligations on a nonassessable basis, that is without recourse to the participants in the Exchange.[9] To satisfy the free surplus requirement, the Exchange will obtain a $[ ] letter of credit, in favor of the Vermont Commissioner, from a bank not participating in the Exchange, fully collateralized by cash or cash equivalents or other liquid assets acceptable to the Vermont Commissioner. The collateral for the letter of credit will be pledged by [*Co. 1*] as an accommodation to [ ] and its members. The collateral will consist of liquid assets held by [*Co. 1*] as reserves built up over the years in connection with the [ ] mortgage credit life program and which exceed the statutory reserves required to be maintained by [*Co. 1*] for operation of the program.[10] The Vermont Commissioner will require the Exchange to maintain a contingency reserve equal to 50% of earned premiums each year. Amounts held as contingency reserves are not available for distribution to subscribers in the Exchange.

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[7] The initial trust deposit may exceed $[ ] to the extent the size of the first Annual Book exceeds the pro forma projections. In such event, the amount of the Exchange's initial borrowings will be increased accordingly.

[8] Free surplus is a statutory term for capital.

[9] Should free surplus fall below $1 million for any reason, the Exchange will suspend its assumption of reinsurance obligations on any new loans until the free surplus is restored to at least the $1 million level.

[10] The sponsors expect this collateral arrangement for the letter of credit will be phased-out over approximately seven years as sufficient free surplus is built up by the Exchange through operation of the mortgage reinsurance program.

[*Co. 1*] and [ ] will also assist the Exchange in financing its start up expenses (estimated at approximately $[ ]) and an initial contribution of approximately $[ ] by the Exchange to a reinsurance loss reserve fund to be held by a third party trustee under the terms of the Exchange's Reinsurance Agreement. [*Co. 1*] is expected to lend the required funds (estimated at approximately $[ ]) to [ ] out of its excess loss reserves on the credit life program in exchange for a three year promissory note, and [ ] in turn, will lend these funds to the Exchange, receiving a surplus note as the form of repayment.[11]

Any income accruals a participating bank makes for its pro-rata share of Exchange income, will be based on the current year's income. No bank will accrue as income long-term estimates of expected income from the Exchange. Participating national banks' investment in the Exchange, and any potential reinsurance liability from Exchange activities will be paid only from earned ceded premiums or offsets against future ceded premiums.

E. **Limitations on the Liability of Each Participant**

No exchange participant will be liable for any of the activities of the Exchange. The Exchange's reinsurance obligations to [*Co. 2*] will be made on a nonassessable basis, that is, without recourse to the participants in the Exchange. This means the participating banks will be liable for reinsurance losses only to the extent of their prorata share of losses, up to the available funds in the reinsurance trust, plus offsets against future ceded premiums.[12] Each participants' liability under the subscriber agreement and Vermont insurance laws for future offsets of ceded premiums will be pro rata, not joint and several.

Because not all of the lenders participating in [ ] will also participate in the Exchange, the Exchange's subscriber's agreement provides that if operation of the Exchange results in any expense or liability to [ ], the subscriber will hold harmless those participants in [ ] who are not members of the Exchange for the member's pro rata share of the liability. However, the source of payment to [ ] will be limited to offsets against future administrative fees or other revenues under the [ ] credit life program.

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[11] A surplus note is a promissory note subject to two contingencies on repayment. It may be repaid only out of the insurer's earned surplus and only with the approval of the Vermont Commissioner. As a result, it is not treated as a fixed liability by the issuer, since the contingencies applicable to its repayment make it more in the nature of capital.

[12] The Exchange's reinsurance loss reserves are expected to be built up to adequate levels over a three-year period following commencement of operations. No distributions will be made from the trust other than for payment of reinsurance losses until the amount of the reserve held in trust equals a specified percentage of the total amount of the Exchange's estimated remaining risk. Amounts in excess of this required reserve will be released to the Exchange and available for distribution to participating lenders, subject to compliance with applicable requirements of Vermont insurance law.

As described earlier, [*Co. 1*] will pledge collateral to allow [ ] to secure a $[ ] letter of credit on behalf of the Exchange. [*Co. 1*] will also finance the Exchange's start up expenses including the initial trust deposit, estimated to be approximately $[ ], by lending money to [ ]. In the event the letter of credit is drawn upon and [*Co. 1*]'s collateral is utilized to satisfy the obligation to the issuing bank, or in the event of a default on the $[ ] [ ] note to [*Co. 1*], [*Co. 1*] has agreed to limit its source of repayment to offsets against future administrative fees or other revenues under the [ ] credit life program. These events will not give [*Co. 1*] any direct claim against the capital or assets of any of the members of the Exchange.

F. <u>Consumer Provisions</u>

The participating banks currently have relationships with various mortgage insurance companies and purchase mortgage insurance directly from insurers. The borrowers are charged for the cost of this insurance. Charges for mortgage insurance are included in the monthly payments and annual percentage rates disclosed by the participating banks to customers who are shopping for low down payment mortgages. Mortgage insurance fees thus are a component of the costs customers consider when comparing competitive loan products.

Your letter represents that, in the highly competitive market for mortgage loans, the participating banks have an overriding incentive to arrange for reasonably priced mortgage insurance fees in order to offer competitively priced loans. Mortgage insurers are regulated under state laws that include requirements for rate filings and approval.

Once the Exchange becomes operational, the participating banks will disclose to each borrower, prior to closing of loans they originate, that the Exchange may reinsure a portion of the mortgage insurance issued in connection with the loan and, in return for assuming this risk, the Exchange may receive a portion of the insurance premium. If a borrower objects, [*Co. 2*] will nevertheless furnish mortgage insurance for the loan (assuming the loan meets [*Co. 2*]'s underwriting criteria), but no part of the risk attributable to that loan will be reinsured by the Exchange. The Reinsurance Agreement does not prohibit the Exchange from establishing a reinsurance arrangement with any other mortgage insurer, nor does it require any of the participating lenders to place their mortgage insurance with [*Co. 2*]. Banks on an individual basis may obtain mortgage insurance from insurance companies other than [*Co. 2*], but these loans will not be placed in the Exchange.

G. <u>Safety and Soundness Considerations</u>

As noted above, the liability of participating lenders from Exchange operations will be limited to future ceded premiums and administrative fees. The authorized activities of the Exchange will consist solely of writing private mortgage reinsurance coverage for loans originated or purchased by the participating lenders. The Exchange will not reinsure other mortgage loans.

All reinsured mortgages will have to meet [*Co. 2*]'s insurance criteria, which will provide minimal, uniform requirements.[13] In addition, the reinsurance agreement provides a financial incentive for participating lenders to contribute high quality mortgage loans. [*Co. 2*] will pay to the Exchange, 36 months following the close of an Annual Book, an additional percentage of the gross premium based on the extent to which the cumulative loss ratio for that Annual Book is below a specified percentage. As a licensed reinsurer in the state of Vermont, the Exchange will be subject to ongoing supervision and regulation by the Vermont Commissioner, and its operations will be limited to those specified in its Certificate of Authority from the Vermont Commissioner (mortgage reinsurance). Any material change in the Exchange's plan of operation (including the writing of any direct insurance, or any other kind of reinsurance) would require the prior approval of the Vermont Commissioner. In return for accepting the limited credit risk associated with the proposed reinsurance arrangement, the Exchange will receive reinsurance premiums, as well as investment income from its cash flow, providing a potentially important source of revenue for participating banks.

The Exchange will allocate on at least an annual basis, each participating lender's pro rata percentage of the Exchange's net income or loss. The percentage allocations will be based on the lender's portion of the ceded premium earned during that year on all Annual Books then in force.[14]

II. ANALYSIS

A. "Business of Banking" Analysis

The OCC previously has determined that reinsuring a portion of the mortgage insurance on loans originated or purchased by the parent bank of an operating subsidiary, or by the parent bank's lending affiliates, is generally permissible under the National Bank Act, because this activity is part of, or incidental to, the business of banking. Corporate Decisions No. 97-97 (November 10, 1997) (First Tennessee); No. 97-93 (October 20, 1997) (SunTrust); No. 97-89 (September 26, 1997) (Norwest); No. 97-27 (May 2, 1997) (Bank One); No. 97-15 (March 17, 1997) (PNC); and No. 97-06 (January 22, 1997) (Chase) (collectively, the "Mortgage Reinsurance Approval Letters"); and in Interpretive Letter No. 743, reprinted in [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶81-108 (October 17, 1996) ("IL 743"). The OCC concluded that, in general, this reinsurance activity is part of the business of banking because it is comparable to an extension of low down payment mortgage loans without reinsurance, but with a higher interest rate to cover the risk of repayment. The reinsurance activities also were found to be functionally equivalent to a partial repurchase of a national

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[13] Some of the participating lenders may have delegated underwriting authority to approve loans for mortgage insurance coverage utilizing [*Co. 2*]-approved underwriting criteria.

[14] Actual distributions by the Exchange of available funds will be made only upon a vote of an advisory committee and receipt of prior approval from the Vermont Commissioner.

bank's own loans, a traditional banking activity. The OCC concluded that the reinsurance activities benefited national banks by providing flexibility in acquiring credit risks and obtaining new sources of credit related income. Banks involvement in reinsurance may also benefit customers by increasing competition and promoting the availability of mortgage insurance at competitive rates. Finally, the OCC concluded that reinsurance involves credit judgments and the assumption of credit risks comparable to other lending activities. The OCC thus concluded that the reinsurance activities are part of the business of banking. Alternatively, the OCC concluded that mortgage reinsurance would be permissible as an activity incidental to banking, particularly to a national bank's express power to make loans, because it optimized the use of the bank's credit underwriting capacities. Id. To determine the permissibility of a national bank's participating in the Exchange, we will discuss each of the "business of banking" factors analyzed in the Mortgage Reinsurance Approval Letters and IL 743, and apply them to the specific facts of the Exchange proposal.

1. Functionally Equivalent to or a Logical Outgrowth of Recognized Banking Functions

Each national bank will contribute to the Exchange, mortgage loans the bank has originated or purchased. As noted above, each bank will assume its pro rata share of the reinsurance risk and receive its pro rata share of the reinsurance premium based on its participation in the Annual Books of the Exchange. Thus national bank participants in the Exchange are using this arrangement as a means to reinsure their own mortgages, an activity the OCC has found permissible for national banks.

The proposed arrangement differs somewhat from reinsurance activities previously approved by the OCC because the bank assumes risks arising from an Annual Book of mortgages that includes loans originated or held by the bank and other lenders. However, each Annual Book will be comprised of loans of the same product category, (based on loan-to-value ratios and fixed or adjustable rate), and all the loans reinsured by the Exchange must meet [*Co. 2*]'s underwriting criteria to be accepted for mortgage coverage. Thus, in addition to the product category composition of each Annual Book, [*Co. 2*]'s underwriting criteria will assure a level of consistency and uniformity analogous to the standardized credit underwriting criteria utilized by members of a bank holding company system. Those underwriting criteria will assure that participating national banks assume a pro rata share of reinsurance liability on an essentially homogenous mortgage pool issued under the same general credit guidelines.

These arrangements could be viewed as involving purchases and sales of mortgage interests among the participants, so that each owns a pro rata interest in each mortgage loan in the pool, an activity that is permissible for national banks. It is well established that banks may originate, purchase and sell mortgage and other loans. See 12 U.S.C. § 371(a); OCC Letter No. 418, reprinted in Fed. Banking L. Rep. (CCH) [1988-89 Transfer Binder] ¶ 85,642, at 78,011 (Feb. 17, 1988) (referring to origination, making, purchase and sale of real estate loans as "centrally traditional banking activities"); OCC, Mortgage Banking: Comptroller's

Handbook 1-3, 9-10 (March 1996). National banks are also permitted to purchase interests in pools of loans under some circumstances, without undertaking an independent credit analyses of each individual loan held in the pool. Rather, it is sufficient that a bank satisfy itself that the overall credit underwriting standards utilized in connection with the origination of the loans in the pool and the credit profiles and performance of the pool satisfies the bank's criteria. *See*, Interpretive Letter No. 779 (April 3, 1997) (investment in privately offered investment fund that would invest in loans) and Interpretive Letter No. 663 (June 8, 1995) (investment in Farmer Mac subordinated securities.) A mortgage reinsurance obligation is the functional equivalent of an assumption of a portion of the credit risk on a pool of loans in which the bank has effectively purchased an interest, which is a permissible activity for national banks.

The process of reinsuring mortgage insurance in the manner proposed is essentially a new way of conducting an aspect of the very old business of banking. See M&M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377, 1382 - 1383 (9th Cir. 1977). In the M&M Leasing Corp. decision, the court affirmed the opinion of the Comptroller, holding that personal property leasing was a permissible activity for national banks. The court concluded that leasing, when the transaction constitutes a loan secured by leased property, is essentially the lending of money on personal security, an express power under the National Bank Act. Id. at 1382. In its analysis, the court discussed how financial leasing is similar to lending on personal security, serves the same purpose as lending, and is "functionally interchangeable" with lending. The court stressed that this "functional interchangeability" was the touchstone of its decision. Id. at 1383. Similarly, in American Insurance Association v. Clarke, 865 F.2d 278 (D.C. Cir. 1988), the court also considered whether a new activity was "functionally equivalent" to a recognized banking power. There, the court affirmed the Comptroller's opinion that the use of standby credits to insure municipal bonds was functionally equivalent to the issuance of a standby letter of credit, a device long recognized as within the business of banking. The proposal to allow national banks to reinsure loans through their participation in the Exchange is clearly consistent with this line of analysis and represents an alternative way for national banks to extend mortgage loans.

The proposal is also consistent with our precedents that hold that national banks may pool their resources to engage in banking activities collectively. See, Letter from James M. Kane, District Counsel dated June 8, 1988 (unpublished) (national banks permitted to purchase preferred stock in captive insurance company where stock purchase was a prerequisite to obtaining directors' and officers' ("D&O") liability insurance); Interpretive Letter No. 554 [1991-1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶83,301 (captive insurer similar to Kane situation); Interpretive Letter No. 427 [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,651 (May 9, 1988) (bank purchases of stock in the Federal Agricultural Mortgage Corporation ("Farmer Mac") where stock purchases were necessary for participation in the agricultural mortgage secondary market promoted by Farmer Mac; Letter of James J. Saxon, Comptroller of the currency (October 12, 1966) (banks may purchase minority interests in a corporation that operated a credit card clearinghouse for the benefit of the owner banks);

and Letter of Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (equity investment to join an ATM network).

As with other collective ventures permitted by the OCC, the Exchange offers the opportunity to engage in banking services more efficiently and effectively. Participating banks can realize an overall cost savings through economies of scale offered by the Exchange that will reduce transaction costs. Participating banks also can achieve greater diversification through reinsuring in a larger, more diverse, portfolio of loans. This will be particularly helpful to community and mid-size banks, which, individually, may lack the resources and loan volume to achieve the level of diversification or economies of scale, offered by the Exchange.

2. Respond to Customer Needs or Otherwise Benefit the Bank or Its Customers

The Exchange would offer benefits for participating banks and their customers. The participating banks and mortgage companies usually require down payments on residential loans of at least 20 percent of appraised values. However, the participating lenders will accept smaller down payments if repayment of a mortgage is backed by mortgage insurance. Moreover, purchasers in the secondary market, including the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) will ordinarily not purchase low down payment loans unless they are covered by mortgage insurance. Thus, customers benefit from mortgage insurance because it enables them to make small down payments on the purchases of their homes. They have the option of paying the higher monthly costs associated with low down payments, or making a larger down payment. The participating banks' involvement in mortgage reinsurance should not diminish customers' abilities to obtain optional mortgage insurance.

The Exchange also would benefit the participating banks by providing the banks flexibility in structuring their activities to obtain new sources of credit-related income. [*Co. 2*] will assume some of the credit risks on low down payment loans that might otherwise be borne by the participating banks. Through the proposed reinsurance activities, the participating banks may acquire additional mortgage credit business that can be managed as part of their overall mortgage credit risk management programs. This additional business will provide the participating banks with an alternative vehicle for achieving risk objectives.

As described above, the Exchange also offers participants a potentially more cost-effective and attractive vehicle for reinsurance of their own mortgages. Through economies of scale the Exchange may enhance the profitability of reinsurance activities, particularly for community and mid-size banks. The expanded diversification offered to participants in the Exchange also may reduce credit risks they assume through reinsurance.

3. Risks Similar in Nature to Those Already Assumed by National Banks

As discussed, the risks a national bank assumes in reinsuring mortgage insurance through the Exchange are essentially the same risks associated with the permissible activities of underwriting mortgage loans. Through the proposed reinsurance activities, the participating banks will assume credit risks transferred to [*Co. 2*] and then back to the Exchange. Consistent with the assumption of credit risks, there is a potential loss of future premiums to the Exchange. However, these risks are similar to risks that would be incurred by the participating banks on loans with high loan-to-value ratios not covered by mortgage insurance or through purchases of participations in the mortgage loans.

As noted above, all loans reinsured by the Exchange must meet [*Co. 2*]'s insurance underwriting criteria in order to be accepted for mortgage coverage. Thus, [*Co. 2*]'s underwriting criteria will serve as a "screen" for all loans reinsured by the Exchange, and will provide the consistency and uniformity analogous to the standardized credit underwriting criteria utilized by members of a bank holding company system.[15] [*Co. 2*]'s underwriting criteria will help to ensure that participating national banks assume a pro rata share of reinsurance liability on a quality loan pool with relatively homogenous risk.

To the extent that the Exchange will include residential mortgage loans originated in a tri-state area (*States, and State*) or originated in other states and purchased by participating lenders, participation in the pool is analogous to the purchase of participations to achieve geographic diversification and manage mortgage credit risk.

B. Incidental To the Business of Banking Analysis

The OCC also determined in the Mortgage Reinsurance Approval Letters and IL 743 that even if mortgage reinsurance activities were not viewed as a part of the business of banking, those activities would be generally permissible as incidental to a national bank's express power to make loans. Similarly, national bank participation in the proposed Exchange is incidental to the business of banking.

In VALIC, the Supreme Court expressly held that the "business of banking" is not limited to the enumerated powers in 12 U.S.C. § 24(Seventh), but encompasses more broadly activities that are part of the business of banking. VALIC at 814, n.2. The VALIC decision further established that banks may engage in activities that are incidental to the enumerated powers as well as the broader "business of banking."

Prior to VALIC, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972) ("Arnold Tours"). The Arnold Tours standard defined an incidental power as one that is "convenient or useful in connection with

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[15] *See* Corporate Decision No. 97-15 (March 1997), p.5, fn 9.

the performance of one of the bank's established activities pursuant to its ***express*** powers under the National Bank Act." Arnold Tours at 432 (emphasis added). Even prior to VALIC, the Arnold Tours formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act. Interpretive Letter 494 (December 20, 1989). The VALIC decision, however, has established that the Arnold Tours formula provides that an incidental power includes one that is convenient and useful to the "business of banking," as well as a power incidental to the express powers specifically enumerated in 12 U.S.C. § 24(Seventh).

Participation in the Exchange is incidental to the business of banking under the Arnold Tours standard. Reinsuring mortgage insurance in the manner proposed through membership in the Exchange is incidental to a national bank's express power to make loans. The proposed activity is "convenient" and "useful" to the power of participating banks to make loans because membership in the Exchange will enable participating banks to structure mortgage loans in a more flexible way. Arnold Tours.[16]

Specifically, the proposed activity will provide the participating banks an alternative structure for making loans that could otherwise be made with a higher rate of interest to cover the increased risk of nonpayment associated with a low down payment. The proposed activities also provide the participating banks an alternative to participating in loans to expand their credit activities. This flexibility is convenient and useful to the participating banks in determining how to structure their mortgage lending activities in the most efficient and profitable manner and in offering a competitive array of mortgage lending products to their customers. The proposed activities also are incidental to lending activities because they enable the participating banks to optimize the use of their existing credit staff and credit expertise to generate additional revenues through activities that support and enhance their lending businesses and enable them to better manage their credit risk.

III. CONCLUSION

Based upon the foregoing facts and analysis, and the representations in your request for interpretive advice, we have concluded that national banks' participation in the Exchange is permissible under 12 U.S.C. § 24(Seventh). A national bank must obtain prior approval of the OCC under 12 C.F.R. § 5.34, before an operating subsidiary (whether through a new

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[16] See also, Franklin National Bank of Franklin Square v. New York, 347 U.S. 373 (1954) (power to advertise bank services); and Auten v. United States Nat'l Bank, 174 U.S. 125 (1899) (power to borrow money). In these cases the courts' holdings relied on whether the activity was "useful."

subsidiary or through expansion of the activities of an existing subsidiary) may participate in the Exchange. A national bank that wants to participate in the Exchange directly, should notify its EIC in conjunction with commencing the activity.[17]

Sincerely,

/s/

Julie L. Williams
Chief Counsel
Attachment

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[17] We express no opinion on whether the proposal complies with any other potentially applicable standards, including the anti-kickback provisions of § 8 of the Real Estate Settlement Procedures Act, Pub. L. No. 93-533, 88 Stat. 1724; 12 U.S.C. §§ 2601-2617 ("RESPA"). Attached for your reference is an August 6, 1997 letter from Department of Housing and Urban Development ("HUD") Assistant Director Nicolas Retsinas, which discusses captive mortgage reinsurance arrangements and the standards of § 8 of RESPA. You should consult with HUD to the extent further clarification is needed to assure that the Exchange arrangement is consistent with RESPA.