**Comptroller of the Currency**
**Administrator of National Banks**

Washington, DC 20219

July 8, 1998

# Interpretive Letter #834
# August 1998
# 12 U.S.C. 24(7)
# 12 U.S.C. 2601

Re: [ ] ("Insurer") -- Performance Note Loans

Dear [ ]:

This is in response to your request for confirmation that national banks may purchase Performance Note Loans ("PNLs") issued by the parent company ("Borrower") of [ ] ("Insurer"). For the reasons described below, based on the facts and representations provided, we conclude that national banks have the authority to purchase PNLs as loans under 12 U.S.C. § 24(Seventh).[1] However, national banks have a responsibility to ensure the purchase of PNLs complies with the Real Estate Settlement Procedures Act ("RESPA") and the standards and conditions set forth in a February 17, 1998, letter from Nicolas P. Retsinas, Assistant Secretary, Department of Housing and Urban Development ("HUD"), to W. Roger Naughton, President/CEO, PMI Mortgage Insurance Company.

Background

The Borrower proposes to issue and sell PNLs to lenders (including national banks) that refer mortgage customers to the Insurer, a private mortgage insurer, for mortgage insurance. PNLs are structured to provide market-based incentives to those banks that refer mortgages to Insurer in order to encourage those banks to provide better performing mortgage loans to Insurer. Each quarter, a lender would have an opportunity to purchase a PNL in a principal amount based on the principal amount of mortgage loans resulting from the lender's referrals to the Insurer. The lender may choose to purchase a PNL up to a maximum amount established by the Borrower. The lender would transmit the funds to the Borrower, and in return, would

[1]The OCC does not endorse particular lending or investment products, and this letter is neither an endorsement nor a criticism of PNLs as investments for national banks.

receive a PNL. If a lender chooses not to purchase a PNL in a quarter, the lender may not purchase any PNL for the remainder of the year.

PNLs would be unsecured subordinated loans that would have fixed maturities and initially bear interest at fixed rates. PNLs subsequently would bear interest at variable rates linked to the performance of the mortgage loans that the lenders originated, and the Insurer insured. The variable rates would be inversely proportional to the amount of claims the Insurer paid on the underlying loans.

PNLs would be transferrable only with the Borrower's written consent, which it would not unreasonably withhold if the transfer complies with applicable federal and state securities laws. The Borrower will not register PNLs under the Securities Act of 1933 or obtain ratings for the PNLs from any rating organization.

Discussion

A national bank may purchase and hold a debt security that is not marketable if the bank treats the instrument as a loan.[2] The term "loan" includes "any direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person." 12 U.S.C. § 84(b)(1); *see also* 12 C.F.R. § 32.2(j). The OCC by regulation defines the term broadly to include contractual commitments to advance funds, obligations arising from a bank's discount of commercial paper, and overdrafts. 12 C.F.R. § 32.2(j)(1)(i), (ii), and (v).

A bank may purchase non-marketable instruments under its general lending powers, subject to safety and soundness restrictions. *See* Interpretive Letter No. 579, *supra*. The OCC expects a bank to make an informed credit judgment in a manner consistent with its credit policy. Such purchases should be based on a complete review of relevant credit information and be subject to appropriate loan administration practices.[3] In addition, purchases should meet bank loan underwriting standards.

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[2]*See* Interpretive Letter No. 600, *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. ¶ 83,427 (July 31, 1992); Interpretive Letter No. 579, *reprinted in* [1991-1992 Transfer Binder] Fed. Banking L. Rep. ¶ 83,349 (Mar. 24, 1992); Interpretive Letter No. 182, *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. ¶ 85,263 (Mar. 10, 1981).

[3]*See* Banking Circular No. 181 (Aug. 2, 1984); *see also* Banking Bulletin No. 97-21 (April 10, 1997) (purchase of loans and loan participations).

Lenders may purchase and hold PNLs as loans.[4] *See* Interpretive Letter Nos. 600, 579, and 184, *all supra*. PNLs satisfy the definition of a "loan." The lenders would advance funds to the Borrower, and the Borrower would be obligated to repay the funds. 12 U.S.C. § 84(b)(1); 12 C.F.R. § 32.2(j). The PNL, rather than a loan agreement, would evidence the contractual commitments made by the lender and the Borrower. National bank lenders that purchase PNLs as loans must conduct appropriate credit reviews and determine that the PNLs meet the bank's underwriting standards, and must obtain from the Borrower prior to purchasing PNLs assurances of continuing access over the life of the instruments to appropriate credit data. National bank purchasers should maintain analyses conducted at the time of purchase as part of fully documented loan files. *See* Interpretive Letter No. 600, *supra*.

The Borrower may also pay a variable rate of interest on PNLs issued to national banks. National banks may make loans with variable rates, such as adjustable rate mortgages. *See* 12 C.F.R. § 34.21(a). Banks have authority to purchase a PNL with an interest rate linked inversely to the amount of claims that the Insurer pays.

> When taking deposits and making loans, national banks are permitted to enter into contracts which provide for interest payments which have fixed or variable rates. As the OCC explained in the Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A., to Offer the Chase Market Index Investment Deposit Account, national banks have the authority to establish the amount of the payments to be made and received under their deposit and loan contracts based on market conditions and the needs of their customers. Accordingly, a bank may determine the amount of those payments by reference to any index or standard as long as the bank complies with safe and sound banking principles and, in the case of loans, with state usury laws.[5]

A national bank may take as consideration for a loan a share in the profit, income, or earnings from a business enterprise, so long as the borrower remains obligated to repay the principal of the loan. 12 C.F.R. § 7.1006.

National banks should not allow their investments in PNLs to affect other lending decisions in an inappropriate manner. National banks must comply with all applicable federal and state

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[4]Even though PNLs will be unrated, unrated debt obligations may qualify as investment securities if they are the credit equivalent of investment grade securities. *See* 12 C.F.R. § 1.2(e). The Borrower expects, however, that PNLs may not be marketable and, thus, national banks could not purchase PNLs as investment securities.

[5]No Objection Letter No. 90-1, *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. ¶ 83,095 (Feb. 16, 1990).

laws, including consumer protection statutes such as the Fair Debt Collection Practices Act and the Equal Credit Opportunity Act, and operate in a safe and sound manner.

The OCC has not reviewed the PNL program for compliance with RESPA. OCC examination staff may review purchases of PNLs by national banks for compliance with RESPA and the conditions and standards described by HUD. National banks must ensure that purchases of PNLs comply with section 8 of RESPA and the standards and conditions established by HUD, which has primary authority for interpreting RESPA.[6] The HUD Letter to the Insurer outlines the standards under which the offer of PNLs for purchase by mortgage lenders that refer mortgage insurance business to the Insurer comply with sections of RESPA.

If you have any questions, please feel free to contact me at 202-874-5210.

Sincerely yours,

/s/

Frederick G. Petrick, Jr.
Senior Attorney
Securities and Corporate Practices Division

[6]*See* 12 U.S.C. §§ 2607(d) and 2617(a), and Letter from Nicolas P. Retsinas, Assistant Secretary, HUD, to W. Roger Naughton (Feb. 17, 1998).