



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

Washington, DC 20219

**Interpretive Letter #833
August 1998
12 U.S.C. 24(7)**

July 8, 1998

Re: []
Variable Rate Subordinated Notes

Dear []:

This is in response to your request for confirmation that national banks may purchase Variable Rate Subordinated Notes (Notes) issued by [*Company 1*], the parent company and sole shareholder of [*Company 2*].¹ For the reasons described below, based on the facts and representations provided, we conclude that national banks have the authority to purchase the Notes as loans under 12 U.S.C. § 24(Seventh).² However, national banks have a responsibility to ensure that the purchase of Notes complies with the Real Estate Settlement Procedures Act (RESPA) and the standards and conditions set forth in a February 17, 1998, letter from Nicholas P. Retsinas, Assistant Secretary, Department of Housing and Urban Development (HUD) to W. Roger Naughton, President/Chief Executive Officer, PMI Mortgage Insurance Company (PMI).

Background

[*Company 1*] (Borrower) proposes to issue and to sell Notes to lender banks (including national banks) that obtain mortgage insurance policies (Policies) from [*Company 2*] (Insurer) covering individual mortgage loans made by the bank. The Notes are structured to provide market-based incentives to those banks that obtain Policies from Insurer in order to encourage those banks to provide better performing mortgage

¹ Borrower's common stock is listed on the New York Stock Exchange.

² The OCC does not endorse particular lending or investment products, and this letter is neither an endorsement nor a criticism of the Notes as investments for national banks.

loans to Insurer. Under the terms of the Notes, on a periodic basis, a bank will have an opportunity to purchase a Note in a principal amount based upon either: (1) an estimate of the dollar volume of insured mortgages originated by the lender bank and insured by Insurer during an agreed upon initial measuring period, such as twelve consecutive months following the date of issuance of the Note; or (2) the actual dollar amount of mortgages insured by Insurer originated by the lender during the preceding calendar quarter. The term of the Notes is ten years. However, in order to preserve the percentage relationship between the outstanding principal balance of the Notes and the aggregate face amount of the Policies, Borrower anticipates making partial prepayments on the Notes at periodic intervals. Borrower also has an annual opportunity to prepay the Notes in full at par plus accrued interest to the date of the prepayment.

The Notes would be unsecured subordinated loans that would have fixed maturities and would bear interest linked to two factors: (1) an agreed upon fixed percentage rate that would constitute a floor interest rate; and (2) a variable interest component that would be linked to the performance of the mortgage loans originated by the lender and insured by Insurer.³ The variable rate paid on the Notes would be calculated under a formula that measures the fluctuating rate of return to Insurer produced by the Policies that is inversely proportional to the amount of claims paid by Insurer on those Policies. The Borrower does not intend to register the Notes under the Securities Act of 1933 or obtain ratings for the Notes 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.⁴ 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

³ Under the terms of the Notes, Borrower would have the option to make interest payments on the Notes to lenders in the form of shares of the Parent’s common stock or in cash. However, the Notes expressly provide that if a lender, such as a national bank, notified Borrower that its receipt of interest payments in the form of stock would be incompatible with any regulatory restrictions, the Borrower’s interest payments to that lender would instead be made exclusively in cash.

⁴ *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 (March 24, 1992); Interpretive Letter No. 182, *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. ¶ 85,263 (March 10, 1981).

purchases should be based on a complete review of relevant credit information and be subject to appropriate loan administration practices.⁵ In addition, purchases should meet bank loan underwriting standards.

Lenders may purchase and hold the Notes as loans.⁶ *See* Interpretive Letters No. 600, 579, and 182, *supra*. The Notes 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) and 12 C.F.R. § 32.2(j). The Note, rather than a loan agreement, would evidence the contractual commitments made by the lender and the Borrower. National bank lenders that purchase the Notes as loans must conduct appropriate credit reviews and determine that the Notes meet the bank’s underwriting standards, and must obtain from the Borrower, prior to purchasing the Notes, 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 Notes 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 Note 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.⁷

⁵ *See* Banking Circular No. 181 (August 2, 1984); *see also* Banking Bulletin No. 97-21 (April 10, 1997) (purchase of loans and loan participations).

⁶ Even though the Notes will be unrated, they potentially could qualify as investment securities if they were the credit equivalent of investment grade securities. *See* 12 C.F.R. § 1.2(e). The Borrower, however, does not represent that the Notes will be marketable and it does not appear that national banks could purchase the Notes as investment securities.

⁷ No Objection Letter No. 90-1, *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. ¶ 83,095 (February 16, 1990).

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 the Notes to affect other lending decisions in an inappropriate manner. National banks must comply with all applicable federal and state 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 Notes for compliance with RESPA. OCC examination staff may review purchases of the Notes by national banks for compliance with RESPA and the conditions and standards described by HUD. National banks must ensure that purchases of the Notes comply with section eight of RESPA and the standards and conditions established by HUD, which has primary authority for interpreting RESPA.⁸ The HUD Letter outlines the standards under which the offer of interest bearing notes by a private mortgage insurance company (similar to the instant Notes) for purchase by mortgage lenders which refer mortgage insurance business to that private mortgage insurance company comply with sections of RESPA.

If you have any questions regarding this matter, please contact me at (202) 874-5210.

Sincerely,

/s/

Joel Miller
Senior Attorney
Securities and Corporate Practices Division

⁸ See 12 U.S.C. §§ 2607(d) and 2617(a), and Letter from Nicolas P. Retsinas, Assistant Secretary, HUD to W. Roger Naughton, PMI (February 17, 1998).