Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Corporate Decision #99-36
November 1999

October 29, 1999

E. Jay Finkel, Esquire
Porter, Wright, Morris & Arthur
1667 K St, NW Suite 1100
Washington, DC 20006-1605

Re: Application by Huntington National Bank, Columbus, Ohio to establish an operating subsidiary to reinsure mortgage insurance.
Application Control Number: 1999-CE-08-0021

Dear Mr. Finkel:

This responds to the application filed by Huntington National Bank, Columbus, Ohio (the "Bank"), to establish an operating subsidiary, HMC Reinsurance Company (the"Subsidiary") to reinsure a portion of the mortgage insurance on loans serviced, originated, or purchased by the Bank or the Bank's mortgage lending subsidiary, The Huntington Mortgage Company (the "mortgage lending subsidiary"). Based upon the representations and commitments made by the Bank, we have approved the Bank's application to establish the Subsidiary to engage in the proposed activities.[1]

[1] As discussed in the "Analysis" section of this letter, reinsuring a portion of the mortgage insurance on loans originated or purchased by the parent bank of an operating subsidiary, or by affiliates of that bank, is generally permissible under the National Bank Act as part of, or incidental to, the business of banking. *See* Corporate Decisions No. 99-05 (December 28, 1998), No. 99-04 ((December 23, 1998), No. 99-02 (December 11, 1998)(collectively, the "Mortgage Reinsurance Approval Letters"); Interpretive Letter No. 743, *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-108 (October 17, 1996) ("IL 743"). In Corporate Decisions No. 99-05 (December 28, 1998), No. 99-02 (December 11, 1998); No. 98-40 (August 18, 1998), the OCC concluded that reinsuring a portion of the mortgage insurance on loans serviced by the parent bank of an operating subsidiary, or by affiliates of that bank, is also permissible under the National Bank Act as part of, or incidental to, the business of banking.

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.[2]

Mortgage insurance has played a vital role in helping low and moderate-income families become 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.[3]

B. The Proposed Reinsurance Activities

1. The Reinsurance Relationship Generally

Under the Bank's proposal, the Subsidiary will enter into reinsurance agreements[4] with a number of unaffiliated insurance carriers that issue mortgage insurance on mortgage loans originated, purchased or serviced[5] by the Bank or its mortgage lending subsidiary. Under the

---

[2] For purposes of this letter, "low down payment loans" are those loans with down payments of less than 20 percent of the property's value, or loans with loan-to-value ratios in excess of 80 percent.

[3] *See* Mortgage Insurance Companies of America 1995-1996 Fact Book.

[4] 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).

[5] When the Bank or its mortgage lending subsidiary services loans, it collects payments of principal and interest, as well as tax, insurance and other escrow payments and forward them to the investors, insurers, and taxing authorities. The Bank and its mortgage lending subsidiary are paid a fee for this service. Typically, the Bank and its mortgage lending

Bank's proposal, therefore, the Subsidiary will agree to accept from a mortgage insurer a portion of the risk of default associated with certain mortgage loans serviced, made, or purchased by the Bank or its mortgage lending subsidiary. In return for accepting risk of default, the Subsidiary will receive a share of premiums paid under reinsurance agreements between the Subsidiary and one or more primary mortgage insurers (each an "Insurer").[6]

2. Terms of the Reinsurance Agreements

Under the reinsurance agreements, the Subsidiary will become liable[7] to the extent provided in the reinsurance agreement to the Insurer when a loan that is originated, purchased, or serviced by the Bank or its subsidiary, and that is insured by an Insurer, goes into default (i.e., the borrower does not make a scheduled payment of principal and/or interest by the stated due date

---

subsidiary are required to remit payments to the owners of the loans they service (such owners are usually referred to as "investors"), even if loan payments are not received by the Bank or its mortgage lending subsidiary. This requirement to remit payments to investors regardless of the actual payment practices of the individual borrowers normally terminates upon commencement of foreclosure.

When a foreclosure commences, the investor reimburses the Bank for the amount of funds advanced by the Bank for delinquent payments. However, the Bank still incurs additional costs when a borrower defaults because it must advance payments without collecting from the borrower for a period of time, and must attempt to collect the delinquent loan and write-off the servicing asset. These costs arise from a borrower's default on a loan and thus involve credit-related risk.

[6]Specifically, under the Bank's reinsurance proposal, the Subsidiary's reinsurance obligations will take the form of an "excess loss" arrangement. Under an "excess loss" arrangement, the primary insurer pays, and is solely responsible for, claims arising out of a given book of business up to a predetermined percentage, after which the reinsurer is obligated to reimburse the primary insurer's claims up to another predetermined percentage. Thereafter, the primary insurer is solely responsible for claims in excess of the reinsurer's tier of losses on a given book. In the event the Subsidiary desires to enter into a "quota share" arrangement the Bank will provide prior notice to the OCC. If the Bank proposes to enter into such arrangements involving a risk portion of greater than 50%, the Bank will request the prior approval of the OCC.

[7] Neither the Bank nor any of its subsidiaries or affiliates will guarantee the activities or obligations of the Subsidiary or provide the Subsidiary with any other credit enhancement. The Bank's total exposure to the mortgage reinsurance activities will be limited, therefore, to the amount of its capital investment. The Bank will insure that the mortgage insurance companies with which the Bank or the Subsidiary may negotiate are advised that none of these credit enhancements will be provided.

or within the stated grace period).[8] The Bank represents that, under the terms of the reinsurance agreements between the Subsidiary and the Insurers, the Subsidiary's maximum contractual exposure will be limited to an exact percentage of the mortgage insurance risk on each loan or on a pool of loans. Additionally, the Bank represents that its potential liability for the Subsidiary's reinsurance obligation will not exceed the Bank's investment in the Subsidiary.

The Subsidiary will not reinsure mortgage insurance on mortgage loans that have not been originated, purchased or serviced by the Bank or the Bank's mortgage lending subsidiary, and will not underwrite such insurance as a primary insurer.[9]

3. Capitalization and Reserve Requirements

The capitalization of the Subsidiary will be subject to both initial and ongoing requirements, which may vary depending on its size and expected book of business, and other factors. The Subsidiary will maintain a statutory contingency reserve as required by state insurance authorities. This reserve is essentially a "reservation of capital" that restricts dividend payments. The Bank represents that in most states, the contingency reserve is accumulated by retaining 50 percent of earned premiums each year. In most states, the Subsidiary may make

---

[8] The primary insurer's agreement to reinsure will not be conditioned on the Bank's or an affiliated lender's agreement to refer any of its mortgage insurance business to the primary insurer, nor will the terms of the agreement (such as the percentage of the premium per loan reinsured that is paid to the Subsidiary) fluctuate depending on the volume of the primary insurance business referred by the lenders to the primary insurer.

[9] Subsidiary represents that it may avail itself of the arrangements, subject to the same representations, described in Interpretive Letter No. 862, reprinted in [Current Transfer Binder] Fed. Banking L. Rep. ¶ 81-356 (June 7, 1999)("IL 862"). In IL 862, a domestic insurer provided mortgage insurance on a portfolio of loans originated or purchased by the subsidiary's parent bank or its affiliates. An offshore reinsurer affiliated with the insurer reinsured part of that portfolio. The subsidiary proposed to enter into a reinsurance agreement with the offshore reinsurer under which the offshore reinsurer retrocedes to the subsidiary the risk assumed (and substantially all the premiums paid to the offshore reinsurer) on the portfolio of loans originated or purchased by the subsidiary's parent bank or one of its affiliates. The OCC found that the existence of the offshore reinsurer between the primary insurer and the subsidiary does not alter the nature of the activities conducted by the subsidiary. In both IL 862 and the Mortgage Reinsurance Letters, a subsidiary accepts the risk of default associated with certain mortgage loans made or purchased by the subsidiary's parent bank or bank's affiliates and receives compensation for its share of premiums paid under reinsurance contracts. Accordingly, the Subsidiary may enter into the arrangements described in IL 862, subject to the same terms and representations as described in IL 862.

withdrawals from the contingency reserves to the extent that losses exceed 35 percent of earned premiums in any year.

Also, the OCC requires that national banks hold capital commensurate with the level and nature of all the risks of their business, including the operation of operating subsidiaries. If the OCC determines that the Bank's capital levels do not adequately protect the Bank from any risks of the reinsurance business of its Subsidiary, the OCC may use its authority under 12 C.F.R. Part 3 to require the Bank to maintain additional capital.[10] The Bank commits that it will evaluate the risks presented by the Subsidiary's reinsurance activities and to maintain appropriate levels of capital for the Bank and the Subsidiary.[11] The Bank represents that it will have in place management information systems that will enable the Bank, and the OCC as part of its supervision of the Bank, to monitor, on a quarterly basis, the amount of the Bank's risk-based capital and the amount of reinsurance risk in force at the Subsidiary to verify that the level of Bank capital is sufficient to support the risk. Moreover, the Bank represents that the Subsidiary has made a commitment to establish and maintain adequate contingency and specific case basis reserves as required under the reinsurance agreements.

The Bank also represents that under standard insurance accounting practices and the applicable reinsurance agreements, the reinsurer or the primary insurer is required to establish the following types of reserves for reinsurance risks: an unearned premium ("UEP") reserve, a loss reserve, and an incurred but not reported ("IBNR") loss reserve. The UEP reserve represents the unearned portion of premiums assumed. The loss reserve represents estimated future loss payments for loans that are delinquent but for which an insurance claim has not yet been perfected and paid. The IBNR loss reserve is a liability for future estimated losses and loss adjustment expenses for loans which are delinquent, but not yet reported as such to the primary mortgage insurer.

---

[10] Section 3.10 specifically authorizes the OCC to require higher capital ratios for an individual bank in view of its circumstances. For example, higher capital ratios may be required for "a bank with significant exposure due to the risks from concentrations of credit, certain risks arising from nontraditional activities, or management's overall inability to monitor and control financial and operating risks presented by concentrations of credit and nontraditional activities." 12 C.F.R. 3.10(d).

[11] The OCC will treat the Subsidiary's reinsurance obligation as recourse with respect to loans that the Bank originates or acquires, and subsequently sells, and will apply a capital requirement for the obligation equivalent to the Bank's maximum contractual obligation, which, in this case will be limited to its investment in the Subsidiary, plus any retained earnings generated by the Subsidiary. To the extent that the Bank believes and can demonstrate to the satisfaction of the OCC that its actual risk is less than this amount, the OCC will consider whether a different approach to determining the Bank's capital requirement would be more appropriate.

4. Consumer Provisions

The Bank has relationships with various mortgage insurance companies and purchases mortgage insurance directly from an insurer in connection with mortgage loans that the Bank and its mortgage lending subsidiary originate or purchase. The borrower is charged for the cost of such insurance. Charges for mortgage insurance are included in the monthly payments and annual percentage rates disclosed by banks to customers who are shopping for a low down payment mortgage. Mortgage insurance fees thus are a component of the costs customers consider when comparing competing loan products. The Bank represents that, in the highly competitive market for residential mortgage loans, the Bank and its mortgage lending subsidiary have an overriding incentive to arrange for reasonably priced mortgage insurance fees in order to offer competitively priced loans. The Bank also represents that mortgage insurers are regulated under state laws that include requirements for rate filings and approval.

The Bank represents that the Bank and its mortgage lending subsidiary and affiliates will disclose to obligors on residential mortgage loans that are originated, serviced, or purchased by the Bank or its mortgage lending subsidiary or affiliates, that the Subsidiary will reinsure a portion of the mortgage insurance issued in connection with the loan and, in return for assuming such risk, the Subsidiary may receive a portion of the insurance premium.[12] The disclosures also will explain that the reinsurance arrangement does not affect the costs of such insurance to the borrower. With respect to originated or purchased loans, the Bank further represents that, for those borrowers whose loans have mortgage insurance coverage, the Bank or its mortgage lending subsidiary or affiliates will allow those borrowers the choice to prohibit the Subsidiary from entering into a reinsurance arrangement with the Insurer on their loans.[13]

---

[12] The Bank also represents that the Subsidiary does not pay any commission, fee, remuneration, or other compensation to an insured lender in connection with the placement of mortgage insurance.

[13] A meaningful choice would provide the consumer an easy, non-burdensome opportunity to opt out by, for example, indicating a preference one way or the other on a form, or calling a specified 800-number. With respect to serviced loans, however, if neither the Bank nor its affiliates are involved in the selection of the Insurer used by the loan originator and a borrower obtains his/her mortgage insurance prior to the sale of servicing to the Bank or its affiliates, then it is not necessary for the Bank to allow borrowers the choice to prohibit the Subsidiary from entering into a reinsurance arrangement with the Insurer on their loans.

5. Safety and Soundness Considerations

The Bank's proposal includes safeguards to limit its mortgage reinsurance risk. The Subsidiary will be a state-chartered, state-regulated[14] monoline company (that is, its business will be restricted to the reinsurance of mortgage insurance)[15] and will reinsure mortgage insurance only on loans serviced, originated, or purchased by the Bank or its mortgage lending subsidiary or affiliates. The Subsidiary will not reinsure other mortgage loans.

The Subsidiary also will not underwrite mortgage insurance as a primary insurer. Specifically, the Bank notes that: (1) a primary insurer operating under applicable state laws will underwrite the mortgage insurance that will be reinsured by the Subsidiary; (2) the primary insurer will set premium rates and will administer the claim settlement process; (3) the lender's insurance contract will be solely with the primary insurer, not the Subsidiary; (4) the primary insurer will be solely responsible for all loss, except a predetermined range of loss; and (5) the primary insurer must pay the entire portion of claims and then seek reimbursement from the Subsidiary for the reinsured portion.

The Subsidiary will be a bona fide subsidiary. Officers and directors of the Subsidiary may also be officers and directors of the Bank or its subsidiaries. When acting in their official capacities for the Subsidiary, however, these employees, officers and directors will act solely on behalf of the Subsidiary and will be subject to all applicable fiduciary duties owed to the Subsidiary corporation.[16] In addition, the services of a third party administrator ("TPA") will be utilized. Pursuant to a management agreement,[17] the TPA will provide assistance and services to the Subsidiary, including collection and recording of premiums, preparation of

---

[14] The Subsidiary will be chartered and regulated by the State of Vermont.

[15] All investments made by the Subsidiary will be limited to those investments which are permissible for national banks.

[16] The Subsidiary will maintain separate books and records and hold itself out to the public as a separate corporate entity, and will be regulated under state insurance laws as a separate corporation.

[17] Under the terms of the management agreement, the TPA will indemnify and hold the Subsidiary harmless from and against any and all losses, costs, damages and expenses which the Subsidiary may incur as a result of the negligence or willful misconduct of the TPA, its employees, agents and contractors or the breach of any term, warranty or covenant of the management agreement.

budgets and forecasts, maintenance of premium and policy records, processing claim payments, and tracking and monitoring claims and claim activity.[18]

The Bank's own credit standards and credit underwriting experience will also be used to manage reinsurance risk since the Subsidiary will only be accepting home mortgage loan credit risks consistent with the Bank's underwriting standards. With respect to mortgage loans originated by the Bank and its mortgage lending subsidiary, the Bank and its subsidiary purchase mortgage insurance from several different underwriters. These mortgage insurance underwriters have accepted the mortgage lending standards of the Bank and the Bank's mortgage lending subsidiary[19] as a sufficient basis for determining if they will issue mortgage insurance coverage. Under this process, commonly referred to as "delegated underwriting," the mortgage insurance companies rely on the same underwriting standards and the same personnel used by the Bank and the Bank's mortgage lending subsidiary in determining whether to approve a particular mortgage loan in the first instance. Thus, the approval of mortgage loans by the Bank and the Bank's mortgage lending subsidiary is accepted by the primary mortgage insurance companies as the basis upon which to issue mortgage insurance coverage.

With respect to loans acquired or serviced by the Bank, before the Bank or its subsidiary agrees to acquire the individual loan or portfolio or act as servicer, these individual loans or portfolios are reviewed to determine whether: (1) the credit quality meets the Bank's credit standards; or (2) they were underwritten by the seller in accordance with the Bank's credit underwriting standards. The Bank represents that when the Bank or its mortgage lending subsidiary acquires loan servicing rights, the Bank or its subsidiary attempts to measure credit risk by applying to a portion of the portfolio of the loans being serviced underwriting procedures that are consistent with those that the Bank uses when it underwrites a loan portfolio or purchases a participation interest in a portfolio of third party loans.[20] This process, which is sometimes referred to as "re-underwriting," includes review procedures to determine if the loans or portfolios meet the Bank's credit quality standards or were originally underwritten by the seller in a manner consistent with Bank underwriting standards, and is intended to assess the

---

[18]The Bank Service Company Act ("BSCA") provides that the appropriate federal banking agency may regulate and examine the performance of any service, authorized by the BSCA, for a bank or its subsidiary or affiliate. 12 U.S.C. §1867(c). The services authorized under the BSCA pursuant to 12 U.S.C. §§1863 and 1864 include the services performed by the TPA for the Subsidiary. Therefore, the performance of services for the Subsidiary by the TPA is subject to OCC regulation and examination pursuant to 12 U.S.C. §1867(c).

[19] The Bank represents that its mortgage lending subsidiary uses underwriting standards comparable to the Bank's for its mortgage loans.

[20] The Bank represents that, typically, at least a statistically valid sample of the loans in a portfolio will be reviewed during the due diligence phase prior to the decision to acquire the servicing rights.

default risk of the serviced loan. Consequently, before acquiring the rights to service a loan portfolio, the Bank engages in a credit review, using its lending expertise, similar to credit reviews involved in other lending activities.

The Subsidiary will also be subject to regulation and oversight by regulatory authorities. As a state-chartered reinsurer, the Subsidiary will be subject to regulation by the state insurance authorities and state law requirements including licensing, capital, and reserve requirements. The Bank represents that the Subsidiary will be chartered in Vermont. The Bank also represents that under the reinsurance agreements between the Subsidiary and the mortgage insurers, the Subsidiary will agree to comply with the reinsurance regulatory requirements of the mortgage insurer's state of domicile.[21]

In return for accepting the limited credit risk associated with the proposed reinsurance arrangement, the Subsidiary will receive insurance premiums, as well as investment income from its cash flow, providing a potentially important source of revenue for the Bank and the Subsidiary.

ANALYSIS

A. Statutory Framework

The National Bank Act provides that national banks shall have the power:

> [t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes . . . .

12 U.S.C. § 24(Seventh).

The Supreme Court has held that this powers clause is a broad grant of the power to engage in the business of banking, including the five specifically recited powers and the business of banking as a whole.[22] Many activities that are not included in the enumerated powers are also

---

[21] The Bank is also aware of the applicability of certain provisions under the Real Estate Settlement Procedures Act ("RESPA"), 12 U.S.C. §§ 2601-2617 (1997), and represents that the Subsidiary's activities will be conducted in compliance with applicable provisions of RESPA.

[22] *See NationsBank of North Carolina, N.A. v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("*VALIC*").

part of the business of banking. Judicial cases reflect three general principles used to determine whether an activity is within the scope of the "business of banking:" (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks.[23] Further, as the Supreme Court established in the *VALIC* decision, national banks are also authorized to engage in an activity if that activity is incidental to the performance of the five specified powers in 12 U.S.C. § 24(Seventh) <u>or</u> incidental to the performance of an activity that is part of the business of banking.

B. "Business of Banking" Analysis

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

The OCC previously has determined that reinsuring a portion of the mortgage insurance on loans originated, purchased, or serviced 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.[24] With respect to originated or purchased loans, the OCC concluded that this reinsurance activity is part of the business of banking because it is comparable to an extension of low down payment mortgage loans without mortgage insurance, 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 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

---

[23] *See, e.g.*, *Merchants' Bank v. State Bank*, 77 U.S. 604 (1871); *M & M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978); *American Insurance Association v. Clarke*, 865 F.2d 278, 282 (2d Cir. 1988).

[24] *See, e.g.*, the Mortgage Reinsurance Approval Letters. We note, moreover, that national banks have long been recognized to have broad authority to reinsure credit-related insurance products. *See* Corporate Decision No. 97-92 (November 1997) (authorizing reinsurance of credit-related disability and involuntary unemployment insurance); Interpretive Letter No. 277, *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,441 (December 13, 1983) (authorizing reinsurance of credit-related life insurance); Letter dated March 31, 1995 (unpublished) (authorizing reinsurance of credit-related involuntary unemployment, life, and disability insurance).

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.[25]

With respect to the reinsurance of mortgage insurance on loans serviced by a national bank or its affiliates, the OCC also concluded that this reinsurance activity also is part of the business of banking, because reinsuring mortgage insurance on loans serviced by a national bank or its affiliates is functionally equivalent to, or a logical outgrowth of, a bank's mortgage banking business.[26] As a loan servicer, the Bank conducts a credit review of the insured mortgage loan portfolio that is similar to the credit review employed when purchasing participation interests in a portfolio of mortgage loans. Using its lending expertise, the Bank evaluates the credit risks involved in the portfolio in determining appropriate charges for its servicing activities. When the Bank agrees to become a servicer, it assumes credit risks that a borrower will default and must manage those risks when foreclosures occur. Thus, the proposed reinsurance of serviced loans is functionally equivalent to purchases of a loan participation in the serviced loans. These reinsurance activities permit the Bank to acquire credit risks and new sources of credit-related income. Reinsuring mortgage insurance on loans that the Bank and its mortgage lending subsidiary service involves credit judgments and the assumption of credit risks similar to reinsuring loans the Bank and its subsidiary originates or purchases.

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

The Bank's proposal potentially benefits the Bank and its customers. The Bank and its mortgage lending subsidiary usually require a down payment of at least 20 percent of the appraised value of a home. However, the Bank and its mortgage lending subsidiary will accept smaller down payments if repayment of a mortgage is backed 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 paying a larger down payment. The Bank's involvement in mortgage reinsurance should not diminish customers' ability to obtain optional mortgage insurance, and may even increase competition and promote the availability of mortgage insurance at competitive rates.

The Bank's proposal also benefits the Bank because it provides the Bank flexibility in structuring its activities to obtain new sources of credit-related business and income. Not only will the Bank be able to engage in credit activity by originating or acquiring loans and loan participations, but it will also be able to reinsure loans it originated, acquired, or services for

---

[25] *See* the Mortgage Reinsurance Approval Letters and IL 743.

[26] *See* Corporate Decision No. 98-40 (August 18, 1998).

others. This will provide the Bank an alternative vehicle for managing its mortgage-related risk exposure and achieving risk objectives. In addition, as described below, the Bank's proposal will enable the Bank to use its existing credit staff and credit expertise to generate additional revenues.

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

National banks are already authorized to reinsure credit-related insurance, including mortgage insurance.[27] The risks a national bank assumes in reinsuring mortgage insurance in the manner proposed by the Bank are essentially the same type as the risks associated with the permissible activities of underwriting, servicing, participating in and reinsuring mortgage loans. Through the proposed reinsurance activities, the Subsidiary will assume credit risks in mortgage loans. With respect to the reinsurance of mortgage insurance on loans made or purchased by the Bank or its mortgage lending subsidiary, the Subsidiary's risks are similar to risks that would be incurred by the Bank or its mortgage lending subsidiary on a loan with a high loan-to-value ratio not covered by mortgage insurance or through purchases of participations in the Bank's loans. With respect to the reinsurance of mortgage insurance on loans serviced by the Bank or its mortgage lending subsidiary, the Subsidiary's risks are similar to risks that would be incurred by the Bank in the purchase of a participation interest in mortgage loans made by a third party, or incurred by the Bank in the acquisition of servicing rights to a portfolio of mortgage loans. These risks also are similar to risks assumed when reinsuring the Bank's and its subsidiary's mortgage loans.

C. Incidental To the Business of Banking Analysis

The OCC also previously determined that, even if reinsuring a portion of the mortgage insurance on loans originated, purchased, or serviced by the parent bank of an operating subsidiary, or originated or purchased by the parent bank's lending affiliates were not viewed as part of the business of banking, this reinsurance activity is generally permissible because it is incidental to the business of banking, since it is incidental to a national bank's express power to make loans.[28]

Based on the particular facts of the Bank's case, the Bank's proposal clearly is incidental to the business of banking. In *NationsBank of North Carolina, N.A. v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("*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

---

[27] *See* the Mortgage Reinsurance Approval Letters, IL 743, and Corporate Decision 98-40 (August 18, 1998).

[28] *See* footnote 25, *supra*.

encompasses more broadly activities that are part of the business of banking.[29] 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 the performance of one of the bank's established activities pursuant to its ***express*** powers under the National Bank Act."[30] Even prior to *VALIC*, the *Arnold Tours* formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act.[31] 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).

The activity the Bank proposes is incidental to the business of banking under the *Arnold Tours* standard. Reinsuring mortgage insurance in the manner proposed by the Bank is incidental to its express power to make loans. The proposed activity is "convenient" and "useful" to the Bank's power to make loans because it will enable the Bank to structure mortgage loans in a more flexible way.[32] Specifically, with respect to loans originated or purchased by the Bank or its mortgage lending subsidiary, the proposed activity will provide the Bank 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 Bank an alternative to participating in loans to expand its credit activities. With respect to loans serviced by the Bank or its mortgage lending subsidiary, reinsuring the mortgage insurance on serviced loans is another mechanism for engaging in the business of assuming mortgage credit risk. The proposed activities will provide the Bank with flexibility by enabling the Bank to further diversify its mortgage banking activities by adding a new activity to the origination and acquisition of mortgage loans as a source of revenue. This flexibility is convenient and useful to the Bank in determining how to structure its mortgage banking business in the most efficient and profitable manner.

---

[29] *VALIC* at 258, n.2.

[30] *Arnold Tours* at 432 (emphasis added).

[31] Interpretive Letter No. 494, *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083 (December 20, 1989).

[32] *Arnold Tours*. *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."

The proposed activities also are incidental to lending activities because they enable the Bank to optimize the use of its existing credit staff and credit expertise to generate additional revenues through activities that support and enhance the Bank's lending business. The activities also enable the Bank to better manage its credit portfolio.

In connection with reviewing the scope of national banks' incidental powers authority, the courts have also determined that, within reasonable limits, certain activities can be incidental to banking when those activities enable a bank to realize gain or avoid loss from activities that are part of or necessary to its banking business.[33] The general conclusion reached by the courts, *i.e.*, that activities that enable a bank to realize gain or avoid loss from activities that are part of or necessary to its banking business are incidental activities to banking, is directly applicable to the Bank's proposal to reinsure mortgage insurance on loans originated, purchased or serviced by the Bank or its mortgage lending subsidiary. Here, the Bank will realize additional gain for its lending and servicing activities. The Bank already conducts credit reviews in connection with extending, purchasing, and servicing mortgage loans. Through the proposed reinsurance activities, the Bank may generate additional income from those credit activities, thereby realizing a gain or revenue. In leveraging its existing expertise, the Bank would be using its existing mortgage servicing and mortgage loan underwriting and risk management capabilities in a cost effective manner.

CONCLUSION

Based upon the foregoing facts and analysis, and the representations and commitments made by the Bank in connection with its request, we have approved the Bank's application to establish a subsidiary that will reinsure mortgage insurance for loans made, purchased, or serviced by the Bank or the Bank's mortgage lending subsidiary, in the manner described in this letter.

Sincerely,

/s/

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

---

[33] *See generally*, *Morris v. Third Nat'l Bank*, 142 F. 25 (8th Cir. 1905), *cert. denied*, 201 U.S. 649 (1906); *Birdsell Mfg. Co. v. Anderson*, 104 F.2d 340 (6th Cir. 1939); *Bailey v. Babcock*, 241 F. 501 (W.D. Pa. 1915); *Cooper v. Hill*, 94 F. 582 (8th Cir. 1899); *Cockrill v. Abeles*, 86 F. 505 (8th Cir. 1898); *National Bank v. Case*, 99 U.S. 628 (1879); *First Nat'l Bank v. National Exchange Bank*, 92 U.S. 122 (1875).