



**Office of Thrift Supervision**

Department of the Treasury

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

Chief Counsel

July 18, 1997

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**Re: Performance Notes Transaction**

Dear [ ]:

This responds to your inquiry to the Office of Thrift Supervision ("OTS") regarding the permissibility of a proposed transaction involving [ ], a unitary savings and loan holding company ("Holding Company"); its wholly owned subsidiary, [ ] ("Association"); [ ] ("Mortgage Insurer"); and its parent corporation, [ ] ("Issuer"). The proposed transaction ("Transaction") would involve Holding Company's purchase of "Performance Notes" from Issuer, the interest on which would be based on the performance of the mortgage loans originated by Association and insured by Mortgage Insurer. In brief, we conclude that we would not object to Holding Company's purchase of Performance Notes from Issuer, subject to the conditions and limitations described herein.

**I. Background**

You represent that Mortgage Insurer, with which Association does business, has established a program intended to induce mortgage originators to improve the general quality of the loans insured by Mortgage Insurer. Mortgage Insurer's parent company, Issuer, is offering "Performance Notes" for sale on a quarterly basis to lenders that insure their low down payment residential loans, i.e., loans having a loan-to-value ratio greater than 80%, with Mortgage Insurer's private mortgage insurance. The amount of principal of each Performance Note will be selected by the lender at the end of each

calendar quarter based on a schedule related to the aggregate principal balance of residential mortgage loans that the lender originated or acquired during the previous calendar quarter and on which Mortgage Insurer has issued insurance ("Covered Loans"). It is contemplated that the principal amount of each Performance Note will not exceed .32% of the quarterly aggregate principal balance of all the Covered Loans insured by Mortgage Insurer in the previous quarter. There is no requirement that the lender purchase a Performance Note each quarter.

Each Performance Note is an unsecured, subordinated promissory note with a term of 8 years. Interest on each Performance Note is payable annually and, for the first three years, will be set at a fixed rate to be established when the Note is purchased.<sup>1</sup> The interest rate for the remaining five years of the Performance Note's term will be determined each year based on the performance of the Covered Loans that were insured during a specified "origination period." That period will consist of at least four calendar quarters to be determined jointly by the parties to the Transaction.<sup>2</sup> You represent that the interest rate on the note can vary from zero to above market depending on the quality of the Covered Loans, but that in no case will the interest rate be negative. The principal on each Performance Note is due at maturity, but is subordinated to claims of Issuer's senior creditors, which includes all obligations that do not contain subordination provisions.<sup>3</sup> You indicate that the Performance Notes are not rated.

In the scenario you present to us, you represent that Holding Company, a unitary savings and loan holding company, will select the amount of each Performance Note and will purchase each Performance Note with its available funds from Issuer.<sup>4</sup>

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<sup>1</sup> You indicate that it is currently contemplated that the fixed rate will be 12% but make no commitment that this will in fact be the rate.

<sup>2</sup> The performance of the Covered Loans will be measured by the "Claims Ratio" which is equal to the amount of cumulative claim payments made by Mortgage Insurer on the Covered Loans since the beginning of the Origination Period divided by the cumulative premiums written by Mortgage Insurer over the same period on the Covered Loans. The Claims Ratio is influenced by a number of factors including the incidence of default of Covered Loans, and the frequency and severity of claims filed and paid with respect to Covered Loans. If the Claims Ratio exceeds 65% during a particular period, the return on the Performance Note would be zero for that period.

<sup>3</sup> You also represent that the Performance Notes contain certain redemption and prepayment provisions as protections for Holding Company purchaser. The Performance Notes are not transferable without the prior written consent of Issuer.

<sup>4</sup> Based on information you have provided, it appears that in situations not involving a federal thrift, Issuer would sell the notes directly to the lender originating the loan without the holding company's involvement.

Holding Company will downstream any interest it receives from Issuer in excess of a "cost of capital" charge to Association, Holding Company's wholly owned subsidiary.<sup>5</sup> You also represent that Association does not assume any risk of loss of principal or any credit risk whatsoever.<sup>6</sup> You further represent that Association's role in the Transaction is limited to (i) originating mortgage loans that may be insured by Mortgage Insurer and (ii) receiving from Holding Company downstreamed interest that is generated by the Performance Notes Transaction.

## II. Discussion

Section 28(d)(1) of the Federal Deposit Insurance Act ("FDIA") prohibits a savings association from acquiring or retaining any corporate debt security not of investment grade.<sup>7</sup> OTS regulations similarly limit a federal savings association's authority to invest in corporate debt securities that are not rated in one of the four highest rating categories.<sup>8</sup> Unitary savings and loan holding companies, however, have wide latitude with respect to activities in which they may engage, provided their subsidiary savings associations have met certain conditions.<sup>9</sup> Moreover, the prohibition on acquiring corporate debt securities not of investment grade in Section 28 of the FDIA does not apply to a savings association's qualified affiliate, which is defined so as to include unitary holding companies.<sup>10</sup>

<sup>5</sup> You indicate that the cost of capital charge will be equal to the prime rate set forth in the Wall Street Journal as averaged for the period for which the interest payment applies.

<sup>6</sup> You indicate that Association's low down payment borrowers are not required to obtain mortgage insurance from Mortgage Insurer. You also represent that a borrower's premiums for mortgage insurance will not be affected by the Performance Notes program. Finally, you state that as a matter of prudent business practice, the Performance Notes program and Holding Company's participation will be disclosed to borrowers on the mortgage insurance disclosure form and borrowers will be given the option to exclude their loans from the program.

<sup>7</sup> 12 U.S.C.A. § 1831e(d)(1) (West 1989). Exceptions exist for, *inter alia*, securities issued or guaranteed by certain government-sponsored corporations. 12 U.S.C.A. § 1831e(d)(4)(C) (West Supp. 1997). See also OTS Op. Chief Counsel (November 23, 1992) (Section 28 does not permit holding company's substitution of credit-enhancing guarantees for investment grade ratings).

<sup>8</sup> 12 C.F.R. § 560.40(a)(2) (1997).

<sup>9</sup> 12 U.S.C.A. § 1467a(c)(3) (West Supp. 1997); 12 C.F.R. § 584.2a(a)(1)(i) (1997); OTS Op. Chief Counsel (March 28, 1995).

<sup>10</sup> 12 U.S.C.A. § 1831e(d)(2), (4) (West 1989). "Qualified affiliate" means, in the case of a stock savings association, an affiliate other than a subsidiary or an insured depository institution. "Affiliate" is defined to include any company that controls another company. 12 U.S.C.A. § 1841(k) (West 1989).

You concede that because the proposed Performance Notes are not rated, § 28 of the FDIA prohibits Association from acquiring the Performance Notes. For that reason, it is proposed that Holding Company (rather than the lending Association) purchase the Performance Notes in this case and downstream a percentage of interest earned on the Performance Notes to Association. As discussed above, unitary holding companies such as Holding Company are not *per se* prohibited from acquiring corporate debt securities not of investment grade. However, § 10(c)(1)(A) of the Home Owners' Loan Act ("HOLA")<sup>11</sup> generally prevents the use of a holding company structure to circumvent rules applicable to a savings association. The proposed Transaction thus raises a question as to whether Holding Company is purchasing Performance Notes on behalf of Association for the purpose of evading § 28's prohibition on acquiring debt securities not of investment grade.

OTS has previously opined that where a holding company possesses sufficient assets independent of its investment in its savings association subsidiary to fulfill its obligations with respect to a particular transaction, HOLA § 10(c)(1)(A) may be inapplicable.<sup>12</sup> You represent that Holding Company will use its own available funds to purchase Performance Notes, that Association will not employ any of its funds for the purchase of Performance Notes, and that Association will maintain no investment risk. Based on the information available to us, it appears that, currently, Holding Company would be able to purchase some limited amount of Performance Notes without giving rise to the concerns discussed above. Accordingly, provided that Holding Company has sufficient assets to purchase the amount of performance notes in question and subject to the limitations set forth herein, we do not presently raise any HOLA § 10(c) objection to the Transaction.

Moreover, there exists a potential for supervisory concerns regarding the Transaction's compliance with safety and soundness standards. For example, it is possible that Holding Company's purchase of Performance Notes might place undue pressure on Association to pay excessive dividends to Holding Company in a manner inconsistent with OTS's capital distributions regulation, 12 C.F.R. § 563.134, or to otherwise change Association's management or dividend policies in a manner inconsistent with safety and soundness.<sup>13</sup> Similarly, in the event that the interest rate on

<sup>11</sup> 12 U.S.C.A. § 1467a(c)(1)(A) (West Supp. 1997).

<sup>12</sup> OTS Op. Chief Counsel (February 26, 1991) at 2 n. 2; OTS Op. Chief Counsel (June 16, 1992) at 2 n. 4.

<sup>13</sup> See, e.g., OTS Op. Chief Counsel (February 26, 1991). See also OTS's capital distributions regulation, 12 C.F.R. § 563.134 (1997), which limits the amount of dividends an association is authorized to make during a calendar year.

the Performance Notes fell below the prime rate, Holding Company might attempt to hold Association liable for some cost of capital charge.<sup>14</sup> We are not presently raising any safety and soundness objection to the Transaction, subject to the limitations set forth herein. Should the financial situation of Holding Company or Association change, or should the financial arrangements involving the Performance Notes or the Transaction vary, however, we may raise supervisory concerns with respect to the Transaction at that time. Similarly, should we determine that Association is being put at risk in the manner described above or otherwise, we will reevaluate our no objection position.

With respect to the applicability of § 23B of the Federal Reserve Act ("FRA") and its implementing regulations<sup>15</sup> to the Transaction, you represent that Holding Company would downstream to Association as capital contributions the interest payments received on the Performance Notes, net of the cost of capital charge. We believe that this arrangement moots the issue as to whether the Transaction meets the standards of FRA § 23B and OTS's implementing regulation. 12 C.F.R. § 563.42. Where, as here, there is no comparable transaction, § 23B requires that a transaction be on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, a nonaffiliated company.<sup>16</sup> Holding Company's agreement to downstream interest to Association represents a term or circumstance that is at least as favorable to Association as might be offered or applicable to a nonaffiliated company. In our view, the standards of § 23B would be met in this case. Accordingly, we find it unnecessary to address the issue of whether the Transaction is a covered transaction under FRA § 23B.

We also believe that the Performance Notes Transaction may raise significant issues with respect to the Real Estate Settlement Procedures Act ("RESPA").<sup>17</sup> The Department of Housing and Urban Development ("HUD") is statutorily authorized to prescribe regulations and issue interpretations implementing RESPA.<sup>18</sup> HUD has

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<sup>14</sup> Based on your representations, it is our understanding that in the event that the interest rate on the Performance Notes falls to 0% or below the cost of capital, Holding Company would not hold Association responsible for any cost of capital charge.

<sup>15</sup> 12 U.S.C.A. § 371c-1 (West 1989) and 12 C.F.R. § 563.42 (1997).

<sup>16</sup> 12 U.S.C.A. § 371c-1(a)(1)(B) (West 1989).

<sup>17</sup> 12 U.S.C.A. §§ 2601 *et seq.* (West 1989 and West Supp. 1997); 24 C.F.R. Part 3500 (1997).

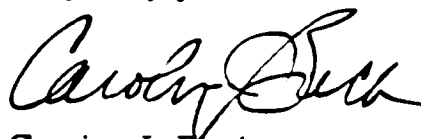
<sup>18</sup> 12 U.S.C.A. § 2617 (West 1989 and West Supp. 1997).

issued regulations implementing RESPA and has specified procedures for requesting interpretations of RESPA.<sup>19</sup> Accordingly, you should consult with the Assistant General Counsel, GSE/RESPA Division, HUD, 451 7<sup>th</sup> Street, S.W., Washington, D.C. 20410-8000, to ensure that the Transaction does not violate RESPA.

In reaching the foregoing conclusions, we have relied upon the representations made in the materials you submitted and in conversations with staff. Our conclusions depend upon the accuracy and completeness of those representations. Any material difference in facts or circumstances from those described herein could result in different conclusions. In particular, any direct or indirect involvement of Association in the Transaction other than as described herein will require further consultation with OTS.

If you have any questions regarding this matter, please feel free to contact Catherine Shepard, Senior Attorney, at (202) 906-7275, or Ellen Sazzman, Counsel (Banking and Finance), at (202) 906-7133.

Very truly yours,



Carolyn J. Buck  
Chief Counsel

cc: All Regional Directors  
All Regional Counsel

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<sup>19</sup> 12 C.F.R. § 3500.4 (1997).