Office of Thrift Supervision
Department of the Treasury

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94-CC-10

June 14, 1994

MEMORANDUM FOR: SUSAN ANDREWS
SOUTHEAST POLICY MANAGER

FROM: CAROLYN B. LIEBERMAN
ACTING CHIEF COUNSEL

SUBJECT: Definition of "readily marketable collateral" under real estate lending standards; applicability of sections 23A and 23B of the Federal Reserve Act to certain collateral on loans made to third-party purchasers

At your request we have reviewed a request from [redacted] (the "Savings Bank"). The Savings Bank seeks OTS's views as to whether mutual fund shares and the cash value of life insurance policies would be considered "readily marketable collateral" and thus permissible credit enhancements under the real estate lending rules[1] for residential loans with loan-to-value ("LTV") ratios that exceed 90%. Also, the Savings Bank requests OTS's views as to whether acceptance from a borrower as down payment on a home loan of a pledge of either a) mutual fund shares issued by mutual funds for which an affiliate of the Savings Bank acts as an investment advisor, or 2) the cash value of life insurance policies issued by the Savings Bank's holding company, [redacted] (the "Holding Company") would be considered a "covered transaction" under section 23A of the Federal Reserve Act ("FRA")[2] and OTS transactions with affiliate regulations.[3]

Based on the facts presented, we conclude that both mutual fund shares and the cash value of life insurance policies would be considered "readily marketable collateral" and thus permissible credit enhancements under the real estate lending rules for permanent mortgage or home equity loans on owner-occupied one-to-four family residential property with LTV ratios that exceed 90%. We also conclude that 1) the pledge of mutual fund shares issued by an affiliate as collateral for a loan would give rise to a covered transaction, and 2) if any

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1. 12 C.F.R. §§ 563.100, 563.101.

2. 12 U.S.C. § 371c.

3. 12 C.F.R. § 563.41.

affiliate of the Savings Bank is an investment advisor to any mutual fund, the fund itself also is an affiliate for purposes of sections 23A and 23B of the FRA.[4] Thus, loans by the Savings Bank to third-party purchasers of real estate that are collateralized by securities of a mutual fund affiliate would be covered transactions under sections 23A and 23B. While on the basis of the limited facts presented we are unable to opine that the life insurance policies are securities for purposes of constituting covered transactions under section 23A, the use of the cash value of life insurance policies as collateral under the facts presented raises safety and soundness concerns which warrants the imposition of certain restrictions, discussed below.

I. Background

The Savings Bank is a thrift subsidiary of the Holding Company. As noted above, the Holding Company is a life insurance company that issues life insurance polices. The Savings Bank's sister companies include [redacted] and [redacted] owns 100% of five subsidiaries, including [redacted] acts in various servicing roles for mutual funds. The [redacted], however, issues no mutual fund shares - mutual fund shares are issued by the mutual fund itself and owned by the shareholders of the mutual fund. [redacted] owns three subsidiaries, namely [redacted], [redacted] and [redacted] acts as investment advisor to eight mutual funds and as investment manager to one mutual fund. Additionally, a subsidiary of [redacted] acts as broker/dealer distributor, i.e., an intermediary between the mutual funds which issue the securities and the public.

The Savings Bank is requesting OTS approval to offer a new mortgage product, which would allow borrowers to borrow up to 100% of the purchase price or appraised value of the borrower's new home. In addition to a mortgage or deed of trust on the borrower's home, the borrower will pledge to the Savings Bank the cash value of a life insurance policy, publicly traded equity securities or mutual fund shares. Included among this collateral could be the cash value of life insurance policies issued by the Holding Company, or mutual fund shares where an affiliate of the Savings Bank is an investment advisor to the mutual fund.

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4. 12 U.S.C. §§ 371c, 371c-1.

As a result of the foregoing, the Savings Bank has asked us if these forms of collateral are permissible under the real estate lending rules, and to what extent acceptance of such collateral would constitute a covered transaction under section 23A of the FRA and the OTS transactions with affiliate regulations.

II. Discussion

A. Real Estate Lending Standards

The OTS real estate lending rule[5] prescribes standards that require each insured depository institution to adopt and maintain comprehensive written real estate lending policies that are consistent with safe and sound banking practices. In order to supplement and clarify the standards stated in the final rule, the banking agencies adopted Interagency Guidelines for Real Estate Lending Policies (the "Guidelines"). Generally, the Guidelines do not specify a loan-to-value limit for permanent mortgages on owner-occupied one-to-four family residential property[6] and for home equity loans. The Guidelines do specify, however, that a permanent residential mortgage or home equity loan originated with a loan-to-value ratio that equals or exceeds 90 percent should have appropriate credit enhancement in the form of mortgage insurance or readily marketable collateral.

"Readily marketable collateral" is defined as insured deposits, financial instruments, and bullion in which the lender has a perfected interest.[7] Financial instruments and bullion must be saleable under ordinary circumstances with reasonable promptness at a fair market value determined by quotations based on actual transactions, on an auction or similarly available daily bid and ask price market.[8] Readily marketable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral.[9]

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5. 12 C.F.R. §§ 563.100, 563.101. See also Appendix A to Subpart D of Part 563.

6. For the purposes of the Guidelines, owner-occupied, when used in conjunction with the term 1- to 4-family residential property means that the owner of the underlying real property occupies at least one unit of the real property as a principal residence of the owner.

7. See Appendix A to Subpart D to Part 563 - Interagency Guidelines for Real Estate Lending. 57 Fed. Reg. 62896 (December 31, 1992).

8. Id.

9. See supra note 7.

In our view, mutual fund shares clearly fall within the scope of "readily marketable collateral" under the Guidelines. The Appendix does not include a definition of "financial instruments." The definition of financial instruments, however, is included in the OTS's lending limitations regulation at 12 C.F.R. 563.93 (b)(7).[10] We are not aware of any other definition of "financial instruments" in OTS regulations, and believe it sensible to rely on the definition cited. The term "financial instruments" as defined in the lending limitations regulation includes "stocks, bonds and debentures traded on a national securities exchange, OTC margin stocks (as defined in Regulation U of the Federal Reserve Board), commercial paper, negotiable certificates of deposit, banker's acceptances and shares in money market and mutual funds of the type that issues shares in which banks may perfect a security interest." In our view, it is reasonable to conclude that mutual fund shares are financial instruments within the meaning of "readily marketable collateral." Thus, provided such shares satisfy the requirements of the Guidelines, the shares will be deemed "readily marketable collateral" under the Guidelines.

As to the Savings Bank's proposal to use the cash value of life insurance policies as credit enhancements, OTS has not to date issued any guidance on this issue. However, the OTS Thrift Activities Handbook guidance on real estate mortgage lending, to be issued in the near future, sets forth the OTS's policies in this area. It provides that "readily marketable collateral" can include the cash value of life insurance policies if the following conditions are met: 1) the Savings Bank holds the insurance policy and a legally binding hypothecation agreement with the policy owners; 2) the Savings Bank has a written statement from the insurance company that it will honor the hypothecation agreement; and 3) the Savings Bank only uses as collateral the "net realizable value" of the policy (i.e., cash value, less any required IRS or local tax withholdings).[11] In addition, it would be prudent, as a matter of safety and soundness, for the Savings Bank to determine that the life insurance company is viable and is likely to remain viable throughout the term of the loan.

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10. The OTS lending limitation regulation incorporates the Office of the Comptroller of the Currency ("OCC") definition of "readily marketable collateral," which includes the OCC's definition of "financial instruments." See 12 C.F.R. § 32.4(c).

11. See January 1994 Thrift Activities Handbook, Section 212, Appendix A: Real Estate Mortgage Lending, Question 11 (scheduled to be distributed later this month).

Thus, provided these proposed standards are met, we believe it is appropriate to permit the cash value of a life insurance policy to be used as a credit enhancement in these circumstances. Prior to instituting this program, the Savings Bank should consult with the Southeast Regional Office to assure that the insurance policies to be used as credit enhancements meet these standards.

B. Sections 23A and 23B of the FRA

The Savings Bank contends that its loans to third parties that are collateralized by a pledge to the Savings Bank of eligible securities -- specifically, mutual fund shares from affiliates of the Savings Bank and the cash value of a life insurance policy issued by the Holding Company[12] -- are not subject to sections 23A and 23B of the FRA. Specifically, the Savings Bank argues that 1) the mutual fund shares are not issued by an affiliate pursuant to 23A(b)(7)(D),[13] and 2) the life insurance policy is not a security as defined in 23A(b)(9).[14]

Under section 11 of the HOLA, sections 23A and 23B of the FRA are applicable to thrifts or their subsidiaries generally "in the same manner and to the same extent as if the savings association [or its subsidiary] were a member bank" of the Federal Reserve System.[15] Section 23A generally limits the amount of an institution's transactions with affiliates to 10% of capital stock and surplus with any one affiliate, and 20% with all affiliates; requires that transactions with affiliates be on terms and conditions that are consistent with safe and sound banking practices; and requires that loans be collateralized in accordance with section 23A(c). Section 23B imposes an arms-length standard on transactions with affiliates, including those not covered by section 23A.

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12. In a telephone conversation with the Savings Bank's associate counsel on or about October 13, 1993, the OTS was advised that the Savings Bank intends to use whole life and universal life insurance policies as part of the new mortgage product, but not term life (where there is not cash build-up) or annuities (which prohibit assignment of cash).

13. 12 U.S.C. § 371c(b)(7)(D).

14. 12 U.S.C. § 371c(b)(9).

15. 12 U.S.C. § 1468(a)(1).

In 1991, the OTS adopted regulations implementing the mandate of HOLA section 11 which made FRA sections 23A and 23B applicable to thrifts.[16] Under 12 C.F.R. § 563.41(b)(7)(iii), the acceptance by a savings association of securities issued by an affiliate as collateral for a loan or extension of credit by a savings association to any person or company is a "covered transaction."[17] Pursuant to 12 C.F.R. § 563.41(b)(9), the term "securities" is broadly defined to include stocks, bonds, debentures, notes, and other similar obligations. In our view, there can be no question that mutual fund shares fall within the definition of securities for purposes of section 563.41(b)(9).

The Savings Bank believes that although the mutual fund shares that would be involved in the proposed transactions are securities, they are not securities issued by an affiliate of the Savings Bank and thus, their pledge as collateral does not give rise to a "covered transaction."[18] We do not agree.

The Holding Company, sister companies and their subsidiaries are clearly "affiliates" for purposes of sections 23A and 23B. The term "affiliate" with respect to a savings association means "any company that controls the savings association and any other company that is controlled by the company that controls the savings association."[19] The Holding Company is an affiliate because it controls the Savings Bank and the sister companies and their affiliates are affiliates because they are controlled by the Holding Company.[20]

Mutual fund shares issued by any affiliate of the Savings Bank would be considered securities, and the pledge of such securities as collateral constitutes a "covered transaction."[21]

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16. 36 Fed. Reg. 34005 (July 25, 1991), codified at 12 C.F.R. § 563.41-42.

17. The acceptance by a savings association of the securities of an affiliate as collateral for a loan by the savings bank to that affiliate or any other affiliate is impermissible under 12 C.F.R. § 563.41(c)(4).

18. In response to discussions with OTS/Washington staff, the Savings Bank, by letter dated May 20, 1993, conceded that mutual fund shares are securities.

19. 12 C.F.R. § 563.41(b)(1)(i).

20. See March 24, 1993 letter from Savings Bank to Southeast Region.

21. 12 U.S.C. § 371c(b)(7)(D); 12 C.F.R. § 563.41(b)(7)(iii).

Moreover, any mutual fund that has an investment advisor that is an affiliate of the Savings Bank is also itself an affiliate of the Savings Bank because it is an investment company with respect to which an affiliate serves as investment advisor.[22] Thus, the eight mutual funds listed in the Savings Bank's May 20, 1993 letter, and any other similar funds, are "affiliates" of the Savings Bank because they are investment companies with respect to which an affiliate, [redacted] serves as the mutual funds' investment advisor.[23]

Accordingly, mutual fund shares that would be pledged as collateral for the proposed transactions would be subject to the limitations and restrictions of sections 23A and 23B.[24] For purposes of complying with the quantitative limitations of section 23A, the entire amount of funds loaned by the Savings Bank under this program would be the proper measure of the value of a covered transaction.[25]

It is less clear, however, whether use of the cash value of life insurance policies issued by an affiliate as collateral is subject to section 23A. Based upon the limited facts presented, among other things, we are unable to conclude at this time whether the life insurance policies issued by the Holding Company are "securities."[26] However, even if the subject life insurance policies would not be deemed securities under the OTS affiliated transaction regulations, it is our opinion that the use of the cash value of life insurance policies as collateral under these circumstances raises safety and soundness concerns.

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22. 12 U.S.C. § 371c(b)(1)(D); 12 C.F.R. § 563.41(b)(1)(iv).

23. 12 C.F.R. § 563.41(b)(1)(iv)(B); See also Op. Ch. Couns., June 30, 1993.

24. Pursuant to 12 C.F.R. § 563.41(c), such a transaction is not subject to the collateral requirements of the statute. See also Op. Bd. of Gov. of Fed. Res., March 22, 1984.

25. See Op. Bd. of Gov. of Fed. Res., May 23, 1990; See also Op. Bd. of Gov. of Fed. Res., March 19, 1984. The 1984 opinion does offer the option that an institution could divide the loan amount into two separate loans, one of which would be secured by the mutual fund shares. Only this loan then would be subject to the quantitative limitations of section 23A.

26. We note, however, that the cash value of a life insurance policy is similar in economic substance to a debt security insofar as it represents an obligation of the Holding Company to pay money. See 12 U.S.C. § 371c(d)(9).

To a large extent, the value of collateral which is a product of an affiliate depends on the health of that affiliate. Congress recognized this issue in amending section 23A of the FRA in 1982 to prohibit the acceptance of securities from an affiliate as collateral for a loan to an affiliate.[27] The legislative history of this amendment indicates that Congress intended to prevent potential danger in the event the borrowing affiliate defaulted on the loan -- in turn devaluing the collateral securing the loan.

A similar concern is presented here. The OTS recognizes that, unlike the situation expressly contemplated by section 23A(c)(4), the Savings Bank has recourse against an independent borrower as well as the collateral, and thus, the Savings Bank's exposure is mitigated. Nonetheless, if the health of the insurance company deteriorates, so may the cash value of its policies which serve as collateral for the Savings Bank's loans. Thus, an affiliated thrift would be exposed to the deterioration of an affiliate not only indirectly by virtue of its interrelationship under the holding company structure, but also directly through the impairment of collateral securing third party loans.

The OTS has the authority to impose additional restrictions on any transactions involving affiliates as it determines to be necessary to protect the safety and soundness of the Savings Bank, as well as its general authority to preserve the safety and soundness of an institution.[28] Given the increased risk exposure in the event of default, the OTS believes that the imposition of such restrictions under the limited facts presented is appropriate.

Because the safety and soundness issue results from a concentration of risk, it is appropriate to use the restrictions set forth in the OTS lending limitations rule, which is primarily concerned with limiting risk concentration in loans.[29] Thus, per the limits of the lending limits regulation, the amount of loans secured by life insurance policies issued by the Holding Company should be limited to 15% of unimpaired capital and unimpaired surplus of the Savings Bank.

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27. 12 U.S.C. § 371c(c)(4).

28. 12 U.S.C. § 1468(a)(4); 12 U.S.C. § 1463(a)(1).

29. 12 C.F.R. § 563.93.

In reaching the foregoing conclusions, we have relied on the factual representations contained in the materials submitted by the Savings Bank to the Regional Office and Washington staff, and our conclusions depend upon the accuracy and completeness of those representations. Should the Regional Office become aware of any material change in circumstances from those set forth in the submissions, our conclusions could change.

If you have any further questions on this matter, please contact Teri M. Valocchi, Counsel (Banking and Finance), at (202) 906-7299 or V. Gerard Comizio, Deputy Chief Counsel, at (202) 906-6411.

cc: Regional Director
Regional Counsel
Southeast Regional Office