Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

June 7, 1999

Interpretive Letter #862
June 1999
12 USC 24(7)

Dear [ ]:

This responds to your request that the Office of the Comptroller of the Currency ("OCC") confirm that it would be permissible for a national bank's captive mortgage reinsurance subsidiary ("Captive Reinsurer") to enter a mortgage reinsurance agreement with a segregated portfolio company[1] domiciled in the Cayman Islands, to reinsure private mortgage insurance on loans originated or purchased by the bank or one of its affiliates. Your request is on behalf of [ ] ("*Co.*"), [*State*] domestic monoline mortgage guaranty insurer that is a wholly-owned subsidiary of [*Inc.*] Based on the information and representations provided, and for the reasons discussed below, we agree with your conclusion that the proposed structure would be permissible under the National Bank Act.

BACKGROUND

A. The Proposed Reinsurance Activities

Pursuant to a Facultative Excess Layer Primary Mortgage Guaranty Reinsurance Agreement ("Reinsurance Agreement")[2] which has been approved by the [*State*] Department of

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[1] A segregated portfolio insurance company insures or reinsures separately the risks related to the business of each portfolio company and is subject to a special insurance statute that protects the assets of each portfolio company from creditor claims against the insurer based on liabilities related to the activities of other portfolio companies. *See* Sections 229 - 237 of The Companies (Amendment) (Segregated Portfolios Companies) Law (1998) (Cayman Islands).

[2] 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).

Insurance, [*Co.*] will write mortgage insurance coverage, for loans originated or purchased by a national bank or its affiliates, that will be reinsured by [ ] ( ) ("Cayman Segregated Portfolio Reinsurer"). The Cayman Segregated Portfolio Reinsurer is a segregated portfolio company domiciled in the Cayman Islands that is wholly-owned by [*Inc.*], and that is authorized to write mortgage reinsurance coverage for loans originated or purchased by a national bank, or an affiliate of a national bank.[3] Under the proposed arrangement, [*Co.*] will agree to cede mortgage insurance risk on an excess of loss or quota share basis, on specified books of business and risk layers and premiums to be determined and set forth in separate Certificates of Facultative Reinsurance (each a "Certificate").

[*Co.*] will negotiate the terms of a reinsurance transaction with a particular bank's Captive Reinsurer. The bank must obtain approval from the OCC to establish such a subsidiary, and the bank and the subsidiary will be subject to any conditions imposed by the OCC in its decision approving the subsidiary.[4] The Captive Reinsurer will also be subject to regulation by state insurance authorities and state law requirements including licensing, capital, and reserve requirements.[5]

In connection with a particular bank's or its affiliate's book of business, [*Co.*] would obtain a Certificate from the Cayman Segregated Portfolio Reinsurer accepting the reinsurance of that bank's or affiliate's loans. The Cayman Segregated Portfolio Reinsurer would in turn enter into a Mortgage Guaranty Insurance Retrocession Agreement ("Retrocession Agreement") with the bank's Captive Reinsurer. Under the Retrocession Agreement, the Cayman Segregated Portfolio Reinsurer would retrocede to the Captive Reinsurer all the risk ceded pursuant to the Certificate and substantially all the premium ceded pursuant to the Certificate (the difference to be sufficient to cover the Cayman Segregated Portfolio Reinsurer's expenses of operation).[6]

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[3] As a licensed reinsurer in the Cayman Islands, the Cayman Segregated Portfolio Reinsurer will be subject to ongoing supervision and regulation by the Cayman Islands Inspector of Financial Services. Any material change in the Cayman Segregated Portfolio Reinsurer's plan of operation would require the prior approval of the Cayman Islands Inspector of Financial Services.

[4] *See, e.g.*, Corporate Decisions No. 99-04 (December 23, 1998) (Hibernia); No. 98-43 (September 11, 1998) (M&I); and No. 98-22 (April 22, 1998) (Fifth Third) and the decisions cited therein (collectively, the "Mortgage Reinsurance Approval Letters").

[5] *See id*.

[6] Copies of the Reinsurance Agreement and Certificate would be appended to the Retrocession Agreement.

Under the proposed arrangement, therefore, the Captive Reinsurer would agree to accept from the Cayman Segregated Portfolio Reinsurer a portion of the risk of default associated with certain mortgage loans made or purchased by the Captive Reinsurer's parent bank or the bank's affiliates. In return for accepting risk of loss from default, the Captive Reinsurer will receive substantially all the premiums paid under the Reinsurance Agreement and Certificate between the Cayman Segregated Portfolio Reinsurer and [*Co.*]. [*Co.*] represents that its proposal will enable [*Co.*] to remain flexible and achieve efficiencies in doing business with lenders that have captive mortgage reinsurance subsidiaries through the use of the Cayman Segregated Portfolio Reinsurer, which is, in effect, a vehicle to consolidate relationships between [*Co.*] and Captive Reinsurers.

B. Limitations on the Liability of the Bank and the Captive Reinsurer

Each Captive Reinsurer's performance under its individual Retrocession Agreement with the Cayman Segregated Portfolio Reinsurer will be secured by assets in a Trust Account to be established with a United States bank acceptable to both [*Co.*] and the Captive Reinsurer. The Captive Reinsurer would be required to deposit funds equal to a specified percent of the risk being retroceded into the Trust Account and all retroceded premium would initially be deposited into the Trust Account, subject to release to the Captive Reinsurer as long as a specified minimum funds requirement is maintained. Under this structure, there would be a separate Trust Account for each book of business retroceded by the Cayman Segregated Portfolio Reinsurer and assumed by the Captive Reinsurer.

The Captive Reinsurer would become liable to the extent provided in the Retrocession Agreement to the Cayman Segregated Portfolio Reinsurer when a bank's or its affiliate's loan insured by [*Co.*] goes into default (i.e., the borrower does not make a scheduled payment of principal and/or interest by the stated due date or within the stated grace period). The potential exposure to loss of a Captive Reinsurer's parent bank for the Captive Reinsurer's reinsurance obligation will not exceed the bank's investment in the Captive Reinsurer.

No Captive Reinsurer will be liable for any of the activities of the Cayman Segregated Portfolio Reinsurer or other Captive Reinsurers. The Cayman Segregated Portfolio Reinsurer's reinsurance obligation will be made without recourse to the Captive Reinsurer.[7]

[*Co.*] represents that its Reinsurance Agreement with the Cayman Segregated Portfolio Reinsurer meets the requirements of, and has been approved by, the [*State*] Department of Insurance. The form of the Retrocession Agreement that the Cayman Segregated Portfolio

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[7] The Cayman Segregated Portfolio Reinsurer will have no less than $1 million of policyholders surplus as required under [*State*] law. This surplus will be provided by The [*Inc.*]

Reinsurer will use with each Captive Reinsurer has been approved by the [*State*] Department of Insurance.

DISCUSSION

The OCC has previously determined that a Captive Reinsurer may reinsure a portion of the mortgage insurance on loans originated or purchased by the Captive Reinsurer's parent bank, or by the parent bank's lending affiliates.[8] The OCC concluded that this reinsurance activity is part of the business of banking because the activity (1) is functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) responds to customer needs or otherwise benefits the bank or its customers; and (3) involves risks similar in nature to those already assumed by banks. The OCC also concluded that, even if the activity were not part of the business of banking, it was permissible as an activity incidental to a national bank's express power to make loans, because it optimized the use of the bank's credit underwriting capacities.[9]

The primary difference between the proposed arrangement and the activities that the OCC has previously approved for Captive Reinsurers is the introduction of the Cayman Segregated Portfolio Reinsurer as an intervening reinsurer between the primary insurer and the Captive Reinsurer. The existence of the Cayman Segregated Portfolio Reinsurer, however, will not alter the nature of the activities conducted by the Captive Reinsurer, which are the same types of mortgage reinsurance activities that have been approved by the OCC. Similar to the mortgage reinsurance activities previously approved by the OCC in the Mortgage Reinsurance Approval Letters, it is envisioned that the Captive Reinsurer in this arrangement will reinsure mortgages held by its parent bank or the parent bank's affiliates, and will receive compensation for the risk of default through its share of premiums paid under the reinsurance contracts. Thus, this arrangement will also involve credit judgments and the assumption of credit risks, and resemble the repurchase of bank loans or the extension of low down payment loans without mortgage insurance. The proposed arrangement also will provide exactly the same kinds of benefits to customers and to the bank as the mortgage reinsurance activities already approved by the OCC. In addition, the risks involved in the proposed arrangement will be comparable both to the risks involved in mortgage lending and the risks of the previously approved reinsurance activities. As in the other cases considered by the OCC, the proposed reinsurance arrangement additionally will 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.

CONCLUSION

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[8] *See* the Mortgage Reinsurance Approval Letters.

[9] *See id*.

Based upon the foregoing facts and analysis, we agree with your conclusion that under the National Bank Act, a national bank's Captive Reinsurer may enter into a mortgage reinsurance agreement with a segregated portfolio company to reinsure private mortgage insurance on loans originated or purchased by the bank or its affiliates, in the manner described herein.[10]

Sincerely,

/s/

Julie L. Williams
Chief Counsel

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[10] A specific proposal by a national bank's Captive Reinsurer to enter a mortgage reinsurance agreement with the Cayman Segregated Portfolio Reinsurer to reinsure mortgage insurance on loans originated or purchased by the bank or one of its affiliates would be subject to the OCC's review under 12 C.F.R. § 5.34. The OCC's review would include an assessment of whether any supervisory concerns or legal issues in addition to those discussed herein are presented in each case. Also, of course, activities of individual banks and their subsidiaries are subject to other applicable laws and regulations.