Illinois Department of Financial and Professional Regulation

Division of Banking

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Interpretive Letter 2020-01 (February 11, 2020)
[Securities investment (SBA 6001 and 6003(18)); lending authority (SBA 6001 and 6002)]
[Illinois savings bank – authority to treat debt securities secured by real estate as loans]

February 11, 2020

VIA EMAIL: []

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Re: Treating debt securities secured by real estate loans as loans

[]:

This responds to your [], 2019 email to me as supplemented by your [], 2019 emails. On behalf of your client, [] (the "Savings Bank"), an Illinois savings bank, you ask whether the Savings Bank may rely on its lending authority to purchase debt securities backed by residential mortgage loans, even though they are not marketable investment grade securities. That is, if the Savings Bank treats the investment as a loan, especially with respect to underwriting, may it invest in the debt securities.

The debt securities, as your emails describe, would be issued by a commercial entity (the "Commercial Entity") that originates consumer home improvement loans ("loans"). Specifically, the Commercial Entity would establish LLCs or series-LLCs to which the Commercial Entity would transfer pools of loans. Each LLC or each series of a series-LLC would issue debt securities backed by a designated pool of loans. Each LLC or series LLC would be a non-operating company. Payment on the debt securities would rely solely on the income stream of the underlying pool of loans. Neither the Commercial Entity nor the LLCs would guarantee the debt. There would be no recourse to the Commercial Entity or the LLCs for payment. The securities would not be marketable investment grade securities under Section 6003(18) of the Savings Bank Act (the "SBA"). 205 ILCS 205/6003(18).

It appears that the Department of Financial and Professional Regulation, Division of Banking (the "Department"), whether regarding Illinois savings banks or banks, has not previously addressed this question. However, based on federal agency interpretive letters you reference, the U.S. Office of the Comptroller of the Currency (the "OCC") (including the former Office of Thrift Supervision (the "OTS")), has resolved this issue in the affirmative regarding national banks and federal savings associations, subject to certain conditions.

Related OCC Guidance

In Interpretive Letters No. 579 (Mar. 24, 1992) and No. 834 (July 8, 1998), the OCC determined that a national bank may purchase a debt security, even if it is not an investment security, but only if the national bank treats the security as a loan. Further, if there is no recourse to the seller of the security, and if the bank underwrites each of the loans underlying the security, the OCC indicated that the legal lending limit of 15% of unimpaired capital and unimpaired surplus would apply to the underlying loans individually. Nevertheless, according to Letter No. 579, the OCC also held that a national bank still places significant reliance on the seller of the security. Therefore, the OCC limited concentration of investment in the securities of one issuer. This "prudential lending limit" is based on safety and soundness principles and limits investment in a single source of securities to no more than 15% of the bank's unimpaired capital and unimpaired surplus.

Similarly, in a March 28, 1996 letter regarding federal savings associations, then-OTS Chief Counsel explained, among other things, that Section 5 of the Home Owners' Loan Act (HOLA) defines "loans" to include both whole loans and "interests in loans" and that the OTS "has typically used a pass-through analysis when assessing the authority of federal savings associations to invest in securities representing an interest in or backed by loans." The OTS letter also provides that, in the case of "loans on security of liens upon residential real estate," HOLA imposes "no percentage-of-assets limitations." Continuing, the OTS letter notes that HOLA applies the national bank legal lending limit to federal savings associations (15% of unimpaired capital and unimpaired surplus). A savings association, according to the letter, is permitted to apply this legal lending limit directly to the loans underlying the securities if the association "reviews each of the loans underlying the securities pursuant to the association's customary underwriting standards for loan originations and documents that the underlying loans meet those standards without reference to any recourse commitment issued by the seller[.]" The OTS letter ultimately declines to follow the OCC in applying a prudential lending limit to the issuer of the securities. However, the Department notes that the OCC, as the successor agency to the OTS, has not yet issued guidance either adopting its own precedent and applying the same prudential lending limit to federal savings associations or following the OTS's precedent and continuing the disparate treatment of national banks and federal savings associations on this matter.

Illinois Savings Bank Act

The Department finds that the SBA provides equivalent bases for a savings bank to rely on its lending authority to purchase debt securities that are not marketable investment securities. Section 6002(a) of the SBA permits a savings bank to loan funds on the security of real estate ("real estate loans"). 205 ILCS 205/6002(a). Further, Section 1075.515 of administrative rules established under the SBA (the "Rules") specifies that a savings bank may invest in an "interest" in a real estate loan. 38 IAC 1075.515(a). Even if these two provisions insufficiently stated the express authority of the Savings Bank, treating securities as loans as discussed in this letter lies within a savings bank's implied authority under SBA Section 1006(e). Therefore, the Department need not opine on the Savings Bank's parity powers under the SBA.[1]

Legal Lending Limit and Underwriting Standards

[1] Accordingly, the Department does not now request your detailed views on whether SBA Sections 1006(a), 1008(a)(26) and 6002(a)(11) apply in this matter.

The authority to treat debt securities that are not marketable investment securities as loans is not unconditional. Section 6013 of the SBA imposes legal lending limits on loans to an individual borrower. The general legal lending limit under this section is 25% of total capital plus general loan loss reserves (the "LLL"). The key task in applying the LLL is identifying the identity of borrower and the expected source of repayment. In this case, whether the LLL applies to the LLCs in the aggregate; to the particular LLC that sells a given debt security to the Savings Bank; or to the respective borrower for each of the underlying loans, depends on the underwriting the Savings Bank performs.

If the Savings Bank seeks to apply the LLL to the individual borrowers of the loans underlying the debt securities, the underwriting must look through to each of those borrowers. The underwriting requirement stated in the OTS letter applies equally well to Section 6013 of the SBA. That is, the Savings Bank must:

> Review [] each of the loans underlying the securities pursuant to the [savings bank's] customary underwriting standards for loan originations and document[] that the underlying loan meet those standards without reference to any recourse commitment [if any] issued by the seller [of the debt securities].

This standard, as the Department applies it, also requires the Savings Bank to clearly show that the "customary underwriting standard" is in fact consistent with safe and sound lending, and that it is properly applied and revised as needed.

With respect to the proposed purchase of the debt securities, your [] email summarizes the Savings Bank's proposed underwriting process:

> All loans will be originated in accordance with underwriting guidelines reviewed and approved by the bank in advance, and any changes to the underwriting criteria of pooled loans will require prior consent and approval of the bank. Prior to an investment, the bank will receive detailed loan-level information and will conduct appropriate due diligence on all loan to ensure that they conform with the approved underwriting requirements. This will include statistically significant sampling of loan files.

The Saving Bank's proposed underwriting process does not meet the above-stated standard applied by the Department. The Savings Bank would not apply the same underwriting standard it would customarily apply to an individual who seeks a home improvement loan directly from the Savings Bank. To meet this standard, the Savings Bank must assess each underlying borrower's creditworthiness and all other risks associated with lending in a manner that assures and demonstrates that the Savings Bank undertakes no more risk than it would if the underlying borrower were its own customer.

If the Department, upon examination or other visitation of the Savings Bank, determines that the underwriting of the individual underlying loans did not occur, apparent violations of the SBA may result. In addition, if the underwriting does not clearly show the Savings Bank is relying on the income stream from individual underlying borrowers, the underlying loans may be subject to aggregation under Section 6013(e) or any other applicable grounds. Whether the loans are aggregated to individual issuers of securities, overarching series-LLCs or to the Commercial Entity itself will depend on the circumstances. These include, but are not limited to, the extent and quality of the underwriting overall,

whether the LLCs merely passively accept loans for pooling from the Commercial Entity, who in reality the Savings Bank depends on for repayment, and the actual repayment and performance of the debt securities. To the extent aggregated loan dollar amounts exceed the Savings Bank's lending limit, the Savings Bank may be subject to apparent violations of Section 6013 of the Act. Moreover, if circumstances indicate that the Savings Bank could not have reasonably and safely treated the debt securities as loans, the Savings Bank may be subject to apparent violations of Section 6003(18), and its directors and officers may be subject to apparent violations of Section 6011 of the SBA for unauthorized investments.

Prudential Lending Limit

Besides the LLL, the SBA imposes prudential limits on investments, including loans. Pursuant to Section 1002, SBA provisions on safety and soundness, investments and management shall be strictly construed, and each savings bank shall apply the prudent person rule. Invoking safety and soundness, Section 6001, regarding a savings bank's exercise of its lending authority, mandates:

> No savings bank shall make any loan or investment authorized by this Article unless the savings bank first has determined that the type, amount, purpose, and repayment provisions of the loan or investment in relation to the borrower's or issuer's resources and credit standing support the reasonable belief that the loan or investment will be financially sound and will be repaid according to its terms and that the loan or investment is not otherwise unlawful[;]

and

> [e]ach loan or investment that a savings bank makes or purchases, whether wholly or in part, must be adequately underwritten, reviewed periodically, and reserved against as necessary in accordance with its payment performance, all in accordance with the regulations and directives of the Commissioner. 205 ILCS 205/6001.

The Rules established under the SBA further caution savings banks:

> When making an authorized investment [including loans[2]] of savings bank funds, the board of directors, all officers, employees, and agents of any kind must exercise the judgment and care under circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital. 38 IAC 1075.500(a).

Whether an action is prudent depends on the circumstances. Your emails, as the Department understands them, indicate that, on the one hand, the Savings Bank necessarily will rely to a significant extent on information provided by interested third parties (the Commercial Entity and its affiliated LLCs). This point is especially important because that information is critical to underwriting the individual loans underlying the securities. Furthermore, the Savings Bank appears unable to assess these

[2] 205 ILCS 205/1007.80.

parties' track record because, as we understand from our communications with you, this arrangement with the Commercial Entity would be new and exclusive to the Savings Bank. On the other hand, the Savings Bank maintains that this arrangement is substantially the same as a purchase of a bulk loan portfolio. Because agreements for such purchases would have varied terms, conditions, and representations and warranties, the Department declines to comment on whether this is an apt comparison. In any event, if the Savings Bank were authorized to make the bulk purchase, the individuals' loans would have to be ones that the Savings Bank could make itself.

Ultimately, Sections 1002 and 6001 of the SBA and Section 1075.500 of the Rules require the Savings Bank to determine what prudential limits to apply to its purchases and to in fact act prudently. However, the Savings Bank's practices under this arrangement are subject to the Department's examination and supervisory review. Imprudent investments may be considered apparent unsafe and unsound banking practices.

In the Department's view, even if the Savings Bank meets the underwriting standard discussed above, the Savings Bank will be investing in debt securities that are not marketable investment grade securities. Further, the Savings Bank likely will rely on information from, and the competence and good faith of, interested third parties. As such, significant extant risks associated with securities investment remains. Therefore, concentration in the proposed debt securities is a key prudential consideration.

The Department will consider the limits imposed by Section 6003(18) of the SBA: investment in one maker or obligor may not exceed 15% of a savings bank's total capital and aggregate investment in all securities of this type generally may not exceed 15% of total assets. In applying these limits, the Department will consider the Commercial Entity to be maker or obligor of the securities. In addition, the Department views the above-discussed OCC prudential lending limit of 15% to be a pertinent standard. Moreover, this limit — and any other restriction applicable to a national bank — may be applicable to the Savings Bank under Section 24 of the Federal Deposit Insurance Act. The Department may also look to other measures of prudence.

The views expressed in this letter are based on the information you have provided in your emails or as described above. If the information changes or proves inaccurate or incomplete, the Department may change its views. Furthermore, this letter should not be construed as approving any particular underwriting process or condoning any lending or investment activity as prudent or consistent with safe and sound banking practices. Throughout the Department's supervision of its activities, the Savings Bank must continue to show that its policies and actions are prudent and safe and sound under the circumstances.

If I may be of further assistance, please contact me at (312) 793-1454 or robert.stearn@illinois.gov.

Sincerely,

Robert Stearn
Associate General Counsel