Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

May 10, 1995

[redacted]

Re: Foreign Mortgage Lending and Mortgage Consulting Services

Dear [redacted]

This responds to your inquiry submitted on behalf of [redacted] (the "Association"), concerning whether it may: (1) make residential construction loans and engage in residential mortgage warehouse lending in [redacted] and (2) provide management and consulting services to financial institutions in [redacted] regarding the internal procedures required to originate pools of loans supporting residential mortgage-backed securities ("MBSs").

For reasons explained fully below, we conclude that federal savings associations have legal authority to make loans on the security of foreign residential real estate pursuant to § 5(c)(1)(B) of the Home Owners' Loan Act ("HOLA").[1] However, because foreign lending presents risks not typically encountered in domestic lending, no savings association may commence foreign lending operations until it has demonstrated to the satisfaction of the appropriate OTS regional office that it is in a position to conduct such lending safely and soundly. The types of safety and soundness issues that must be addressed in submissions to OTS regional offices are specified in Appendix A to this letter.

We also conclude that federal savings associations have authority to provide MBS management and consulting services to foreign lenders pursuant to the incidental powers doctrine. Because this activity does not involve lending risk, it may be commenced without further consultation.

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1 12 U.S.C. § 1464(c)(1)(B).

I. Background

The Association, either directly or indirectly through an operating subsidiary, intends to provide dollar-denominated residential construction lines of credit to builders and developers chartered and doing business in [redacted]. These lines of credit will be secured by cash flows from the companies and by liens on the [redacted] real estate being developed. The Association will also provide, either directly or through an operating subsidiary, dollar-denominated lines of credit to [redacted] lenders to warehouse permanent mortgage loans. These lines of credit will be secured primarily by cash flows from the lenders and by mortgage notes that are secured by the underlying residential real estate located in [redacted].

In addition, the Association proposes to provide MBS management and consulting services to [redacted] financial institutions. Currently, there is no secondary market for mortgage loans in [redacted]. The [redacted] however, is in the process of developing a secondary mortgage market modeled on the United States secondary market. The Association has expertise in buying, managing, securitizing and selling mortgages and mortgage securities in wholesale and secondary markets in the United States and would like to assist in the development of the market in [redacted].

In return for a fee, the Association proposes to provide management consulting services to financial institutions in [redacted]. To facilitate the creation of pools of residential real estate mortgages with uniform characteristics, the Association would assist financial institutions in the development of comprehensive internal policies and procedures addressing the loan origination process, including loan application, underwriting, appraisal and closing procedures. Additionally, the Association would advise financial institutions regarding the securitization and sale of MBSs and the subsequent administration and servicing of the mortgages in the securitized pools.

II. Discussion

A. Foreign Residential Real Estate Lending

HOLA § 5(c)(1)(B) authorizes federal savings associations to invest in, sell or otherwise deal in loans on the security of liens on residential real property, without limitation based upon percentage of assets. Secured residential real estate construction

loans and residential mortgage warehouse lines of credit both fall within the scope of this statutory provision.[2]

Section 5(c)(1)(B) does not specifically permit or prohibit loans secured by residential real property located outside of the United States. Historically, however, federal savings associations evolved as local home-financing institutions, and limitations reflecting this evolution were initially incorporated in the governing statutes. For example, at one point in time, HOLA § 5(a) referred to "local" home-financing institutions,[3] and HOLA § 5(c) generally limited real estate lending by federal savings and loan associations to property that was either located in the state in which their home office was located or within one-hundred miles of their home office.[4] Similar geographic lending restrictions applied to federal mutual savings banks.[5] Further, § 403(b) of the National Housing Act ("NHA") required each applicant for deposit insurance from the Federal Savings and Loan Insurance Corporation ("FSLIC") to agree that "it will not make any loans beyond one hundred miles from its principal office . . . except loans which are made pursuant to regulations of the [FSLIC]."[6]

While these limitations were in place, the OTS's predecessor, the Federal Home Loan Bank Board ("FHLBB"), consistently held that the federal thrifts were prohibited from making loans on the security of foreign real estate.[7]

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[2] 12 U.S.C. § 1464(c)(6)(A) (the statutory definition of residential real estate specifically includes real estate to be improved by the construction of residences); and OTS Op. Acting Chief Counsel, dated Oct. 29, 1993 (concluding that warehouse lines of credit may properly be classified as residential real estate loans provided certain conditions are met).

[3] 12 U.S.C. § 1464(a) (1982).

[4] 12 U.S.C. § 1464(c) (1976).

[5] 12 U.S.C. § 1464(a) (1982). At the time, the lending authority of federal savings and loan associations and federal mutual savings banks was governed by different provisions of the HOLA.

[6] 12 U.S.C. § 1726(b) (1988).

[7] See FHLBB Op. by Goldberg, dated Mar. 30, 1976 ("the thrust of [the NHA and the HOLA] is addressed to sound and economical home financing of domestic rather than foreign real estate"); FHLBB Op. dated Mar. 26, 1973 ("[t]he Board's Insurance Regulations (and the statutory authority which those regulations implement) contemplate only loans on the security of domestic real estate").

In the 1980's, Congress began to remove the geographic restrictions on the lending authority of federal thrifts. First, Title IV of the Depository Institutions Deregulation and Monetary Control Act of 1980 (the "DIDMCA")[8] deleted the geographic restrictions on lending authority in HOLA § 5(c). Later, § 311 of the Garn-St Germain Depository Institutions Act of 1982 (the "DIA")[9] amended HOLA § 5(a) to delete the restrictions on mutual savings banks. In 1989, § 407 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA")[10] repealed the 100-mile lending restriction contained in NHA § 403(b).[11] Thus, current law contains no geographic lending restrictions applicable to federal savings associations.

It is a well settled principle of statutory construction that those who are charged with interpreting statutes should not presume to graft new requirements or restrictions on to the plain language of those statutes in the absence of compelling evidence that this is what Congress intended.[12] It is clear from the legislative history of the foregoing statutory amendments that Congress intended to foster national lending by federal savings associations.[13] However, the legislative history is silent as to foreign lending. In the absence of evidence of an intent to prohibit foreign lending, we believe it would be inappropriate to graft such a restriction on to the plain language of the statute.[14]

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8 Pub. L. No. 96-221, 94 Stat. 132.

9 Pub. L. No. 97-320, 96 Stat. 1469.

10 Pub. L. No. 101-73, 103 Stat. 363.

11 Section 407 of FIRREA, however, had little impact because the FHLBB had promulgated regulations in 1983 lifting the 100-mile lending restriction contained in Section 403(b) of NHA. See 12 C.F.R. § 563.9 (1984-89); 48 Fed. Reg. 23032, 23052-53 (May 23, 1983).

12 1A and 2A Sutherland, Statutory Construction, §§ 31.06 and 47.37 (5th Ed.).

13 See Joint Explanatory Statement of DIA at 128 Cong. Rec. H8120 (Sept 30, 1982) (the purpose of DIA was to permit thrifts to maintain their place "as the nation's primary home lender").

14 We are aware that this position differs from opinions issued after DIDMCA and DIA in which the FHLBB refused to permit federal savings associations to make loans secured by property located outside the United States under the residential real estate lending authority. See FHLBB Op. by Raiden, dated Jan. 10, 1985; and FHLBB Op. by Doyle, dated Aug. 10, 1983. At least one FHLBB

Several considerations reinforce this conclusion. First, one of the key policies supporting the removal of the geographic restrictions in DIDMCA was competitive parity between federal thrifts and national banks. In DIDMCA, Congress deleted the geographic restrictions in order to permit federal savings associations "to make residential real estate loans to the same extent as national banking associations" and, thus, to ensure competitive parity between these institutions.[15] Representative St Germain explained:

> The bill's expansion of Federal association lending authority was designed to correct the anomalous situation that Federals, which are overwhelmingly home mortgage lenders, currently operate under certain geographic. . . restrictions on their residential lending authority that do not apply to national or commercial banks. The conference language just points out that Federal S&Ls will no longer be at a statutory disadvantage with regard to national banks -- also chartered by the U.S. Government -- on residential real estate loans.[16]

The DIA served a similar function by removing language limiting the lending of federal mutual savings associations in order to provide "parity of entitlements" between all federal associations.[17]

National banks are authorized under 12 U.S.C. § 24 Seventh and 12 U.S.C. § 371 to make loans or extensions of credit secured by interests in real estate.[18] Like HOLA § 5(c)(1)(B), this

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legal opinion, however, suggests that this earlier conclusion was driven by supervisory, rather than legal, considerations. See FHLBB Op. by Quillian, dated June 11, 1986.

15 H. Rep No. 842, 96th Cong., 2d Sess. 76 (1980); S. Rep. No 640, 96th Cong. 2d Session 76 (1980).

16 See 126 Cong. Rec. H2289 (Mar. 27, 1980) (statement by Rep. St Germain). See also S. Rep. 368, 96th Cong., 1st. Sess. 17 (1979) (Federal savings associations may "invest in or sell or otherwise deal in loans or investments secured by liens on residential real estate to the same extent and in the same manner and amounts without limitation as national banks [under] section 24 of the Federal Reserve Act (12 U.S.C. § 371)."

17 S. Rep. No. 536, 97th Cong., 2d Sess. 52 (1982).

18 Section 24 of the Federal Reserve Act (the "FRA") states "[a]ny national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in

authority does not include any express geographic restraints on real estate lending. The Office of the Comptroller of the Currency (the "OCC") has interpreted this authority to permit loans secured by foreign real property. In addition to this real estate lending authority, national banks have long been permitted to engage in other foreign operations, including full service foreign branches, subject to Federal Reserve Board approval.[19] Thus, to ensure residential real estate lending parity between federal savings associations and national banking associations, as intended by DIDMCA, it is appropriate to construe HOLA § 5(c)(1)(B) to permit foreign lending.[20]

Second, the FHLBB and OTS have previously interpreted similarly unconditioned lending authority to include foreign lending. Immediately following the removal of the geographic limitations in the DIDMCA and DIA, the FHLBB observed that "[n]either the statute nor the Board's regulation imposes any limitations on the exercise of the commercial lending authority that would require that commercial loans be made only to U.S. citizens or domiciliaries, or that they be secured by property in the United States."[21] Accordingly, the FHLBB and OTS have permitted federal savings associations to invest in various foreign enterprises under the commercial loan authority at HOLA §

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real estate, subject to section 1828(o) of this title and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order." 12 U.S.C. § 371. Section 24 includes the authority to make construction loans, except certain construction loans with maturities of 60 months or less. This construction lending, however, is permitted under the national banks' incidental powers at 12 U.S.C. § 24 Seventh. See 12 C.F.R. §§ 34.1 and 34.3.

19 See Section 25 of the FRA, 12 U.S.C. § 601; and 12 C.F.R. § 211.5(b)(2)(iii).

20 We note that 12 U.S.C. § 1466 states that "the provisions [of the HOLA] shall apply to the United States and to Puerto Rico, Guam, and the Virgin Islands." This section was intended to extend the privileges and benefits of the HOLA to the citizens of United States territories, rather than to impose limitations on the investment authority of thrifts. See 69 Cong. Rec. H2578 (statements of Reps. Dimond and Lanzetta)(1933). National banks are subject to a similar provision at 12 U.S.C. §§ 40-42.

21 FHLBB Op. by Long, dated July 2, 1984. See also FHLBB Op. by Doyle, dated Aug. 10, 1983; and 48 Fed. Reg. at 23052 ("[Congress] intended [in DIDMCA and DIA] that Federal associations be able to make commercial-purpose loans without limitations based on the domicile of the borrower or the location of security property.")

5(c)(2)(A).[22] The FHLBB reached the same conclusion regarding the corporate debt security and commercial paper investment authority under HOLA § 5(c)(2)(D) and removed regulatory prohibitions against investment in issuances of foreign entities shortly after the enactment of DIDMCA and DIA.[23] Similarly, federal savings associations have long been permitted to invest in second-tier off-shore subsidiaries under the service corporation investment authority.[24] More recently, federal savings associations have been permitted to establish limited overseas agency offices and foreign operating subsidiaries.[25]

In light of the plain language of HOLA § 5(c)(1)(B), the parity considerations that undergird the DIDMCA and DIA amendments to the lending authority of federal savings associations, and the OTS's traditional reluctance to impose geographic restrictions where none is required by law, we conclude that federal savings associations have authority to make loans secured by foreign real estate under HOLA § 5(c)(1)(B).

However, because foreign lending presents risks not typically encountered in domestic lending, no savings association may commence foreign lending operations until it has first demonstrated to the satisfaction of the appropriate OTS regional office that it is in a position to conduct foreign lending safely and soundly. The types of safety and soundness issues that must be addressed in submissions to OTS regional offices are specified in Appendix A to this letter. The Association should submit this information to the OTS [redacted] Regional Director. If the Association decides to conduct these activities through a foreign agency office or foreign operating subsidiary, the requested information may be included

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22 See FHLBB Op. by Doyle, dated July 12, 1983 (accounts at foreign banks); FHLBB Op. by Barnett, dated July 15, 1983 (foreign government securities and certificates of deposit in foreign banks); FHLBB Op. by Long, dated July 2, 1984 (foreign loans guaranteed by the Export-Import Bank of the United States); FHLBB Op. by Quillian, dated June 12, 1987 (foreign corporation debt securities denominated in foreign currency); OTS Op. Acting Chief Counsel, dated June 18, 1993 (debt instruments of foreign governments).

23 48 Fed. Reg. at 23047. See also FHLBB Op. by Barnett, dated July 15, 1983.

24 FHLBB Op. by Long, dated May 31, 1984.

25 OTS Op. Acting Chief Counsel, dated June 13, 1994; and OTS Op. Acting Chief Counsel, dated July 6, 1994.

with the Association's application for approval of the agency office or operating subsidiary.[26]

B. MBS Consulting and Advisory Services

Federal savings associations are not expressly authorized by statute to engage in consulting and advisory services for other financial institutions. Nonetheless, such authority falls within the "incidental powers" of federal savings associations.

Long before the OTS announced its four-part test for assessing whether proposed activities fall within the incidental powers of federal saving associations,[27] the FHLBB and the OTS had already recognized that the incidental powers of federal savings associations include the provision of "correspondent services" to other financial institutions.[28] Pursuant to this line of authority, federal savings associations have been permitted to offer the same services to other financial institutions that associations are authorized to generate in-house for themselves in the course of their regular business.[29]

No exclusive list of correspondent services can be created because the activities and needs of financial institutions constantly change in response to the demands of the market. Nonetheless, the Supreme Court has summarized correspondent banking as follows:

> Among the services typically provided within a conventional correspondent arrangement are check clearing, help with bill collections, participation in large loans, legal advice, help in building securities portfolios, counseling as to personnel policies, staff

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[26] The OTS has previously indicated that applications are always required prior to establishment of foreign agency offices, OTS Op. Acting Chief Counsel, dated June 13, 1994, n. 12, or foreign operating subsidiaries. OTS Op. Acting Chief Counsel, dated July 6, 1994, n. 11.

[27] OTS Op. Acting Chief Counsel, dated Mar. 25, 1994.

[28] 48 Fed. Reg. at 23035; 47 Fed. Reg. 17468, 17469 (Apr. 23, 1982); FHLBB Op. by Long, dated Jan. 13, 1984; FHLBB Op. by Barnett, dated Nov. 10, 1982.

[29] 47 Fed. Reg. at 17469.

training, help in site selection, auditing, and the provision of electronic data processing.[30]

The consulting activities proposed by the Association fall within the scope of services that the Association could -- and indeed does -- provide for itself in the course of its regular business. While the proposed activities were not expressly listed as correspondent services in the above-quoted Supreme Court opinion, the activities are of the type that might be embraced by "participation in large loans, legal advice [and] help in building securities portfolios." We also note that the OCC has authorized national banks to provide similar types of services to other financial institution under the rubric of incidental correspondent services.[31] Accordingly, we conclude that the Association's proposed services fall within the purview of correspondent activities that may be offered pursuant to the incidental powers doctrine.

Even in the absence of the above-cited precedent on correspondent services, we would reach the same conclusion regarding the permissibility of the proposed services on the basis of the four-part incidental powers test currently employed by the OTS.[32] First, the proposed services will advance one of the primary objectives of federal savings associations -- the promotion of residential real estate lending. Although the proposed services will advance residential lending abroad rather than in the United

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30 United States v. Citizens & Southern National Bank, 422 U.S. 86, 115 (1975).

31 The OCC emphasizes that such services must "reflect and incorporate the unique nature of the banking business," rather than the nature of business in general. Interpretive Letter No. 137, dated Dec. 27, 1979, reprinted in [1981-82 Transfer Binder] Fed. Banking L. Rep. (CCH) at Para. 85,218. It has permitted national banks to offer the following correspondent services: described management consulting services (Id.); various research and consulting services (OCC Op. by Selby, dated Oct. 2, 1975); auditing services (OCC Op. by Murphy, dated Sept 24, 1975); loan application or disclosure statement design (Interpretive Letter 137, supra.; and Interpretive Letter No. 513 dated June 18, 1990 reprinted in [1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) at Para. 83,215); real estate appraisal services (Interpretive Letter No 467 dated January 24, 1989, reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) Para. 85,691); and personnel training and consulting services (OCC Op. by DeShazo, dated Aug. 22, 1975).

32 A complete explanation of the incidental powers analysis is contained in OTS Op. Acting Chief Counsel, dated Mar. 25, 1994; and OTS Op. Acting Chief Counsel, dated Oct. 17, 1994.

States, such a result is not inconsistent with the functions of federal savings associations as envisioned by Congress. Second, the proposed activities are similar to activities already conducted by federal savings associations. Indeed, the proposed activities would be virtually identical to the services that the institution already provides to itself internally in its own United States secondary mortgage operations. Third, the proposed services are closely related to the financial intermediary role that federal savings associations are intended to play. The practical effect of the services will be to enhance the flow of money and credit in [redacted]. Finally, as noted above, the types of services being proposed can already be provided by commercial banks and other competitors of federal savings associations. Thus, authorization of the activity will help federal savings associations remain competitive and relevant in the changing global economy. Accordingly, we conclude that the Association may offer the proposed consulting services pursuant to the incidental powers doctrine.

In reaching the foregoing conclusions, we have relied on the factual representations made in the materials you submitted to us and in subsequent discussions, as summarized herein. Our conclusions depend on the accuracy and completeness of the those representations. Any material change in facts or circumstances from those described herein could result in different conclusions.

If you have any questions regarding this matter, please feel free to contact Karen Osterloh, Counsel (Banking and Finance), at (202) 906-6639.

Very truly yours,

Carolyn J. Buck
Chief Counsel

cc: All Regional Directors
All Regional Counsel

SAFETY AND SOUNDNESS SAFEGUARDS

No savings association should commence any foreign residential lending activity without first providing the following information to the appropriate OTS regional office and obtaining clearance to proceed.

1. A detailed description of why the association is interested in engaging in the proposed activities. What is the expected rate of return on the loans? How is this rate of return affected when adjusted for risk?

2. An analysis of the country-risk that specifically evaluates the economic trends, political developments and cultural considerations. The association should also address, within its policies and procedures, the methods it will use to evaluate country-risk on an ongoing basis. Additionally, the policies and procedures should define the internal reporting and monitoring systems that will be put in place to control country exposure.

3. An analysis of the legal system in the foreign country that specifically evaluates how the association's interest in property located in that country will be protected (e.g., title and recording procedures to establish a security interest, covenants in loan agreements, and foreclosure rights). Also, a discussion of other lending requirements imposed by foreign law should be provided.

4. An analysis of the transfer risk associated with dollar-denominated transactions in the country. Specifically, what types of reserves will be set aside, additional collateral required or other precautions taken to mitigate the risk of foreign currency devaluation? How will such risk be factored in determining the ability of the borrower to repay a loan?

5. A detailed discussion of how the lending program will be administered. Specifically, the association should address how standard underwriting criteria will be reviewed. For instance, in determining the capacity of a borrower to repay the loan, what types of financial statements will be required? How will the credit history of a borrower be evaluated? How will collateral be appraised or otherwise valued? What procedures will be in place to oversee and monitor the collateral?

6. An analysis of the accounting and tax treatment of income or losses on the foreign activities. How will loan loss reserves be determined? Also, the association should provide an analysis of the capital treatment of the proposed loans. Will the loans satisfy the criteria of qualifying residential

construction loans for purposes of determining risk-based capital? Will the warehouse lines of credit contain unconditionally cancelable clauses that allow the association to reduce the line of credit, prohibit additional extensions of credit or terminate the commitment?

7. What types of expertise will be required from sources outside the association? Will the association have local legal counsel, accountants, linguists or underwriters?

In addition to the risk factors noted above, the policies and procedures of the association must address all of the traditional areas required for domestic real estate construction and warehouse lending such as loan portfolio diversification standards, prudent underwriting standards (including loan-to-value ratio limits that are clear and measurable), loan administration procedures, loan disbursement controls, documentation and reporting requirements to monitor compliance, limits on aggregate outstanding loan balances, maturities, loan approval authority, and interest rate structures.

The foreign activities will likely require greater oversight by management and the board of directors. The policies and procedures should not merely restate domestic criteria, but focus on the additional risk present as a result of foreign operations.