

## **Operating Subsidiaries and Most Favored Lender Doctrine**

**Summary Conclusion:** Federal preemption of state licensing, registration, and lending laws would be available to a federal savings association's second-tier operating subsidiary to the same extent preemption is available to the association. A second-tier operating subsidiary may rely on the most favored lender provision to use interest rates permitted by the state where the association's home office is located.

**Date:** July 20, 2006

**Subjects:** Home Owners' Loan Act/Savings Association Powers

P-2006-6



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**Office of Thrift Supervision**  
Department of the Treasury

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6372

John E. Bowman  
Chief Counsel

July 20, 2006

Re: Operating Subsidiaries and Most Favored Lender Doctrine

Dear :

This is in response to your inquiry submitted to the Office of Thrift Supervision (OTS) on behalf of (Association). You seek confirmation that under a proposed restructuring of the Association's holding company and certain of its subsidiaries, (i) federal preemption of state licensing, registration, and lending laws would be available to the Association's new, second-tier mortgage origination operating subsidiary to the same extent federal preemption is available to the Association, and (ii) the second-tier operating subsidiary would be able to utilize and export interest rates under the applicable federal "most favored lender" provision based on the interest rates permitted to state-licensed lenders in the state where the Association's home office is located.

In brief, we confirm that upon consummation of the proposed restructuring, federal preemption would be available to the Association's second-tier operating subsidiary to the same extent federal preemption is available to the Association. We also confirm that when making loans nationwide, the Association's second-tier operating subsidiary will be able to utilize and export the most favored lender interest rates permitted by the state where the Association's home office is located, even though the operating subsidiary is located in another state.

**I. Background**

You have provided the following information. (Holding Company) and its wholly-owned subsidiary, (Subsidiary) propose to reorganize their existing banking subsidiaries. Holding Company owns, directly or indirectly, three FDIC-insured institutions, including the Association.<sup>1</sup> The Association currently is a limited purpose federal savings bank that engages solely in the trust business. Holding Company and Subsidiary, by virtue of their ownership of the Association, are savings and loan holding companies regulated by OTS.

<sup>1</sup> The other two FDIC-insured institutions owned by Holding Company are (Institution A) and (Institution B).

As part of the proposed reorganization, the Association would expand its business plan to become a full service federal savings bank, and Institution B would be merged with and into the Association.<sup>2</sup> A joint venture would be created between the Association and Institution A, and those entities would form and capitalize (NewCo), as a Delaware corporation that would be designated a direct operating subsidiary of the Association. The Association would own approximately 85% of the common stock of NewCo, Institution A would own approximately 15% of the common stock of NewCo, and the Association would have the right to appoint four out of five members of the board directors of NewCo, thereby making NewCo subject to the direction and control of the Association.<sup>3</sup> In addition, Institution A would contribute and transfer all of the issued and outstanding shares of its mortgage banking subsidiary (MortgageCo) to NewCo, such that MortgageCo would become a subsidiary of NewCo.<sup>4</sup> Upon completion of the reorganization, MortgageCo would be a direct subsidiary of NewCo and a second-tier subsidiary of the Association. It is expected that the Association's home office will be located in the state of New York.

MortgageCo is a residential mortgage lender with its principal office in Florida and offers its loan products nationwide.<sup>5</sup> Mortgage loans made by MortgageCo are secured by first and junior liens on primary and secondary residences, including one- to four-family residences, condominiums, and cooperatives, most of which are owner-occupied. At present, MortgageCo maintains various state licenses as a real estate or mortgage broker, mortgage banker, and/or first or second mortgage lender. The majority of mortgage loans originated by MortgageCo are referred to it by financial advisors (Advisors) of

(Broker-Dealer), a regulated securities broker-dealer. The Advisors have relationships with brokerage customers of Broker-Dealer, and seek to refer them to MortgageCo when a customer needs a mortgage loan. The activities of the Advisors include distributing marketing materials prepared by MortgageCo or Broker-Dealer; conducting seminars; advertising mortgage products; soliciting applications for mortgage loans; and discussing features, pricing, and terms of MortgageCo's products with customers. The Advisors do not accept mortgage loan applications or preclosing fees, and do not conduct loan closings. The Advisors receive compensation from Broker-Dealer.<sup>6</sup>

<sup>2</sup> Only those components of the proposed reorganization directly relevant to your inquiry are described herein.

<sup>3</sup> With respect to Institution A's ownership of a minority interest in NewCo, you represent that under a shareholders agreement between the Association and Institution A, Institution A will have only "traditional and limited rights to protect its minority investment," and NewCo "shall not" (i) amend its certificate of incorporation in a manner that would affect Institution A in a way materially different from the effect on other shareholders; (ii) materially alter its business or enter into any line of business not authorized for a national bank; or (iii) create any new class or series of security having preference over Institution A's shares.

<sup>4</sup> NewCo also would have two other subsidiaries after the reorganization, and

<sup>5</sup> The Association currently does not have, nor will it have after the reorganization, any branches in Florida.

<sup>6</sup> We do not address whether such compensation comports with the Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 *et seq.*, as the United States Department of Housing and Urban Development interprets that statute.

You indicate that MortgageCo has entered into an outsourcing arrangement with \_\_\_\_\_ under which the latter conducts certain loan origination and processing activities on behalf of MortgageCo on a “private-label” basis. You further indicate that all MortgageCo loans are underwritten pursuant to MortgageCo’s underwriting guidelines, except in limited circumstances; closed in MortgageCo’s name; and funded by MortgageCo.

You seek confirmation that after consummation of the proposed reorganization, MortgageCo will be viewed as an operating subsidiary of the Association and federal preemption of state licensing, registration, and lending laws would apply to MortgageCo to the same extent federal preemption applies to the Association. Further, you seek confirmation that MortgageCo will be able to utilize and export interest rates under the federal most favored lender provision applicable to federal savings associations based on the rates permitted to state-licensed lenders in New York, the state in which you expect the Association’s home office to be located.

## **II. Discussion**

### **A. Operating Subsidiaries and Applicability of Federal Preemption**

OTS’s subordinate organizations regulations provide that a federal savings association may designate as an operating subsidiary any subsidiary as to which (i) the association owns, directly or indirectly, more than 50% of the voting shares and (ii) no other person may exercise effective operating control.<sup>7</sup> The regulations also limit the activities of an operating subsidiary to only activities that are permissible for a federal savings association to conduct directly.<sup>8</sup> Approval by OTS of the proposed restructuring and establishment of NewCo and MortgageCo as operating subsidiaries will necessarily involve a determination by OTS that the requirements for operating subsidiary status have been met. We also note that OTS regulations authorize an operating subsidiary of a federal savings association to hold a lower tier subsidiary as an operating subsidiary, and state that the provisions of OTS’s subordinate organization regulations also apply to such an entity.<sup>9</sup> Accordingly, assuming OTS approves the proposed reorganization, NewCo would be a direct, or first-tier, operating subsidiary of the Association, and MortgageCo would be a direct subsidiary of NewCo and a second-tier operating subsidiary of the Association.

Regarding the availability of federal preemption to MortgageCo, OTS regulations provide that (i) an operating subsidiary and its parent federal savings association generally are consolidated and treated as a unit for statutory and regulatory purposes, and (ii) federal statutes and regulations generally apply to operating subsidiaries in the same manner as they apply to federal savings associations, unless otherwise specifically provided by statute, regulation, or OTS

<sup>7</sup> 12 C.F.R. §§ 559.2 and 559.3(c)(1) (2006).

<sup>8</sup> 12 C.F.R. §§ 559.2 and 559.3(e)(1) (2006).

<sup>9</sup> 12 C.F.R. §559.3(f)(1)(i) (2006) provides “[a]n operating subsidiary may itself hold an operating subsidiary. Part 559 applies equally to a lower-tier operating subsidiary.” An operating subsidiary may also invest in other types of lower-tier entities. 12 C.F.R. § 559.3(f)(1)(ii) 2006.

policy.<sup>10</sup> Similarly, the regulations specifically provide that state law applies to an operating subsidiary only to the extent state law applies to the parent federal savings association.<sup>11</sup> OTS has affirmed this principle on several occasions.<sup>12</sup> Accordingly, after consummation of the proposed reorganization and the Association's designation of MortgageCo as an operating subsidiary, federal preemption would be available to MortgageCo to the same extent federal preemption is available to the Association. In particular, OTS regulations specifically provide that state laws purporting to impose requirements regarding licensing, registration, and lending do not apply to federal savings associations.<sup>13</sup> Such state laws therefore would not apply to MortgageCo.

### **B. Availability of Most Favored Lender Provision to Operating Subsidiary**

As indicated above, unless otherwise specifically provided, federal statutes and regulations that apply to federal savings associations also apply to their operating subsidiaries. Among the federal statutes and regulations that would apply to MortgageCo in the same manner they apply to the Association are § 4(g) of the Home Owners' Loan Act (HOLA),<sup>14</sup> commonly referred to as the "most favored lender" provision, and OTS's implementing regulations.<sup>15</sup> Section 4(g) of the HOLA authorizes a savings association to charge interest on any extension of credit "at the rate allowed by the laws of the State in which such savings association is located," notwithstanding any contrary state law.<sup>16</sup> This statutory provision expressly preempts state laws that purport to regulate interest rates on loans and extensions of credit by savings associations.<sup>17</sup> OTS lending regulation § 560.2(b)(12) provides that usury and interest rate ceilings are preempted to the extent provided in § 4(g) of HOLA, and OTS regulation § 560.110 provides that a savings

<sup>10</sup> 12 C.F.R. § 559.3(h)(1) (2006).

<sup>11</sup> 12 C.F.R. § 559.3(n)(1) (2006).

<sup>12</sup> See e.g., OTS Op. Chief Counsel (July 26, 1999); OTS Op. Chief Counsel (August 19, 1997); and OTS Op. Chief Counsel (January 10, 2002). See also *WFS Financial, Inc. v. Dean*, 79 F. Supp.2d (1024) (W.D. Wisc. 1999). Cf. *State Farm Bank v Burke*, No. 3:05cv808(JBA), 2006 U.S. Dist. LEXIS 41467, \*32 (D. Conn. June 21, 2006)

<sup>13</sup> See e.g. 12 C.F.R. § 560.2(b) (2006).

<sup>14</sup> 12 U.S.C.A. § 1463(g) (West 2001).

<sup>15</sup> 12 C.F.R. §§ 560.2(b)(12) and 560.110 (Most favored lender usury preemption)(2006).

<sup>16</sup> 12 U.S.C.A. § 1463(g)(1) (West 2001). Section 4(g) of the HOLA alternatively permits an association to charge interest in connection with an extension of credit at a rate of not more than 1% above the rate on 90-day commercial paper in effect at the Federal Reserve Bank in the Federal Reserve district where the association is located.

<sup>17</sup> We note that § 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 Pub. L. 96-221, 12 U.S.C.A. § 1735f-7a (West 2001) (DIDMCA), expressly preempts state interest rate ceilings on "Federally-related residential mortgage loans" secured by first liens on residential real property, unless a state opted out of such federal preemption. OTS regulations implementing § 501 of DIDMCA are at 12 C.F.R. Part 590 (2006). To the extent mortgage loans made by MortgageCo meet the definitions and requirements of DIDMCA § 501 and Part 590 regulations, then those statutory and regulatory provisions may provide an alternate basis of federal preemption of state interest rate ceilings. See 12 U.S.C.A. § 1735f-7a note (Choice of Highest Applicable Interest Rate.)

association located in a state may charge interest at the maximum rate permitted to any state-chartered or licensed lending institution by the law of that state.<sup>18</sup> Under this regulation, a federal savings association may make loans at the interest rate permitted by the state in which it is located when making loans in other states.<sup>19</sup> This is known as “exporting” the interest rate permitted by the state in which the association is located.

For purposes of HOLA § 4(g), a savings association is “located” in the state where its home office is located, as well as in any state where it maintains a branch.<sup>20</sup> OTS has concluded that a federal savings association may always use and export the most favored lender interest rate of the state where its home office is located.<sup>21</sup> If an association has a branch office in a state other than its home office state, the association also has the option of using and exporting the most favored lender interest rates of the branch office state when making loans that are booked out of the branch state.<sup>22</sup> Therefore, when making loans under the most favored lender provision, an association has a choice; it may utilize and export the most favored lender interest rates of its home office state, and at its option, it may utilize and export the most favored lender interest rates of a branch office state with respect to loans the association books in such branch office.<sup>23</sup> Thus, under HOLA § 4(g) and OTS regulation § 560.110, a federal savings association may always use and export the most favored lender interest rate permitted by its home office state. This is so regardless of where the loan is made or booked, where the borrower resides, or where the security property is situated.

Your inquiry raises an issue we have not previously addressed, namely, whether a federal savings association’s operating subsidiary located in, and making loans from, a state where the parent savings association does not have a home office or a branch office, may utilize and export the most favored lender interest rate of the parent association’s home office state. In the context of your inquiry the question is whether after consummation of the proposed reorganization, MortgageCo, which has its principal office in, and makes loans nationwide from, Florida may use and export the most favored lender interest rates permitted by New York, the state where the Association’s home office will be located?

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<sup>18</sup> 12 C.F.R. § 560.110(b) (2006). If state law permits different interest charges on specified classes of loans, a federal savings association making such loans is subject only to the provisions of state law relating to that class of loans that are material to the determination of the permitted interest. *Id.*

<sup>19</sup> See OTS Op. Chief Counsel (December 24, 1992) and authorities cited therein.

<sup>20</sup> *Id.* See also OTS Op. Chief Counsel (April 2, 1992) at 4-5.

<sup>21</sup> OTS Op. Chief Counsel (December 24, 1992).

<sup>22</sup> *Id.* A loan is considered “booked” out of a branch office when the loan is underwritten, approved, processed, and disbursed from that office. *Id.* at note 19.

<sup>23</sup> *Id.* OTS also has concluded that even when a federal savings association’s officers and employees perform certain non-ministerial functions with respect to loans, but not loan approvals, in a state where the association has branch offices, the association may still use and export the most favored lender interest rates of its home office state. OTS Op. Chief Counsel (September 17, 2004).

OTS concludes that since the Association may use and export the most favored lender interest rate permitted under New York law if the Association's home office is located in that state, MortgageCo may also use and export New York's most favored lender interest rate. This conclusion is based on OTS regulation § 559.3(h)(1), which states "[u]nless otherwise specifically provided by statute, regulation, or OTS policy, all federal statutes and regulations apply to operating subsidiaries *in the same manner* as they apply to [the parent federal savings association]." (Emphasis added.) As noted above, under the authority of HOLA § 4(g) and regulation § 560.110, a federal savings association may always use and export the most favored lender interest rate permitted by its home office state – regardless of where the loan is booked, the borrower resides, or the property is situated. Thus, if the Association directly made a loan to a Florida buyer for the purchase of a home situated in Florida, the Association could properly use and export the most favored lender interest rate permitted by the home office state, New York. Applying these provisions to MortgageCo *in the same manner* as they apply to the Association, if MortgageCo similarly made a loan to a Florida home buyer, MortgageCo could properly use and export the most favored lender interest rate permitted by the Association's home office state, New York.<sup>24</sup> In short, under regulation § 559.3(h)(1), the same rules for determining interest rate ceilings and exporting those interest rates apply regardless of whether a federal savings association chooses to make the loan directly, or indirectly through its operating subsidiary.

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

We trust this is responsive to your inquiry. If you have questions, please contact Vicki Hawkins-Jones, Special Counsel, at (202) 906-7034.

Sincerely

/s/

John E. Bowman  
Chief Counsel

cc: Regional Directors  
Regional Counsel

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<sup>24</sup> We note that the Office of the Comptroller of the Currency (OCC) similarly has concluded that under a substantially identical most favored lender statutory provision applicable to national banks, 12 U.S.C. § 85, an operating subsidiary of a national bank may impose and export interest rates permitted by the bank's home office state under the same terms and conditions applicable to the bank. *See e.g.*, OCC Interpretive Letter No. 974 (July 21, 2003); OCC Interpretive Letter No. 968 (February 12, 2003); and OCC Interpretive Letter No. 954 (December 16, 2002).