



Office of Thrift Supervision  
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

94/00-15

July 6, 1994

[REDACTED]

Re: Foreign Operating Subsidiaries

Dear Mr. [REDACTED]:

This responds to your letter of September 22, 1993, as supplemented by your letters of December 30, 1993, and June 10, 1994, requesting confirmation that your client, [REDACTED] ("the Association"), a federally chartered savings association, may establish an operating subsidiary in Bermuda to manage a substantial portion of the Association's investment portfolio.

For the reasons set forth below, we conclude that the Association may establish and maintain an operating subsidiary in Bermuda, subject to the conditions discussed below.

Background

The Association has requested permission to establish an operating subsidiary in Bermuda to manage a large part of the Association's securities investments. The Association estimates that it will transfer between \$150 million and \$200 million of its investment portfolio to the subsidiary.

The Association's proposal was initially submitted to the Central Region of the Office of Thrift Supervision ("OTS") in the form of an operating subsidiary notice. The notice was filed under the expedited procedures contained in the OTS operating subsidiary regulation and became effective after expiration of the 30 day waiting period.<sup>1</sup> Shortly thereafter, however, the Central Region advised the Association that it should defer establishment of a Bermuda operating subsidiary until confirmation could be obtained from the OTS Chief Counsel's office in Washington that federal savings associations have legal authority to establish foreign operating subsidiaries. This prompted your correspondence with us.

The purpose for establishing the Bermuda operating subsidiary is to reduce the Association's Indiana income tax liability. Based

<sup>1</sup> 12 C.F.R. § 545.81(c)(1)(i).

on information submitted by the Association's outside auditors, it appears that the State of Indiana has deliberately structured its tax code to permit companies located in Indiana to reduce their state income tax by transferring investment activity offshore. Such transactions do not affect federal tax liability.<sup>2</sup>

The activities of the Association's operating subsidiary will be limited to: (1) holding legal title to securities physically located inside the United States at the Federal Home Loan Bank of Indianapolis ("FHLBI"), and (2) managing the Association's investment portfolio.

The operating subsidiary will be incorporated in Bermuda, will be wholly-owned by the Association, and will consist of a single office located in Bermuda. The operating subsidiary's Board of Directors will be composed of three officers of the Association (all U.S. residents) and the President of the operating subsidiary and a local attorney (both Bermuda residents). The operating subsidiary's President will be its sole officer and employee. The Association has represented that this person was selected for the position based upon his extensive accounting and investment experience.

The Board of Directors of the operating subsidiary will meet at least once per year in Bermuda. At such meeting, the Board will: review the operating subsidiary's Investment Policy; review consummated transactions and evaluate overall performance of the portfolio; monitor the operating subsidiary's net capital gain/loss position; and determine whether to declare dividends. The initial Investment Policy of the subsidiary will be reviewed and approved by the Board of Directors of the Association. Any changes in the Investment Policy will also require explicit approval by the Board of the Association.

The Association will transfer legal title to a segment of its assets to the Bermuda subsidiary in exchange for the subsidiary's stock. The actual assets, however, will remain physically in the custody of the FHLBI, and the FHLBI will collect and hold all principal and interest arising from these securities. The securities in the portfolio will be limited by the Investment Policy to: U.S. Treasury obligations, short term commercial paper, mortgage-backed securities and collateralized mortgage obligations.

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<sup>2</sup> The Association has represented that three banks in Indiana (the assets of one of which exceeds \$3 billion) have formed Bermuda operating subsidiaries for the same purposes as the Association now proposes. We have confirmed that at least one bank has done so with the approval of the Federal Reserve Board.

The Association has represented that the assets that will be transferred to the operating subsidiary are not necessary for the Association's operational or liquidity needs. If necessary, however, the assets could be transferred back to the Association within the same business day. Since custody of all the securities will be maintained in the FHLBI, a transfer could be accomplished by book entry.

The operating subsidiary's President will manage the day-to-day operations of the subsidiary. He will be responsible for executing the Investment Policy (including appointing and directing the custody agent to execute trades in the portfolio through U.S. broker-dealers), investing excess funds in earning assets, accounting for the portfolio and maintaining appropriate records. Cash transfers from the custodial account maintained at the FHLBI must be countersigned by a majority of the Board of the operating subsidiary.

The Association has represented that a duplicate set of the operating subsidiary's books will be maintained at the Association's home office in Indiana. Specifically, the operating subsidiary will send the Association monthly statements of cash flow and income received, a statement of transactions, and a portfolio summary and valuation. The operating subsidiary will also provide the Association with a listing of transactions to the general ledger, month-end trial balances, and monthly (and year-to-date) balance sheet and income statements. In addition, the operating subsidiary will monitor its net capital/gain loss position and inform the Association whenever the operating subsidiary is in an excess net capital loss position.

The Association has further represented that the operating subsidiary will limit its operations to the investment activities described above and will not issue stock other than its initial issuance. As a back-up control to the operating subsidiary's investment authority, the FHLBI will be directed not to allow the movement of funds to and from the operating subsidiary's account except pursuant to the subsidiary's Investment Policy.

### Discussion

Section § 5(a) of the Home Owners' Loan Act (the "HOLA") authorizes the Director of the OTS to provide for "the organization, incorporation, examination, operation, and regulation of . . . federal savings associations." The courts have recognized that this is an exceptionally broad delegation of power that gives the OTS wide regulatory discretion.<sup>3</sup>

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<sup>3</sup> See, e.g., Fidelity Federal Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 160-167 (1982).

Pursuant to this broad grant of authority, the OTS promulgated 12 C.F.R. § 545.81. This regulation provides for the establishment and maintenance of operating subsidiaries. The regulation defines operating subsidiaries as corporations that are majority-owned and controlled by a single federal savings association and engage exclusively in activities that federal savings associations may undertake directly.<sup>4</sup> The regulation imposes no geographic limits on operating subsidiaries.

It is a well settled principle of interpretation that those who are charged with interpreting a statute or regulation should not graft new restrictions on to the statute or regulation unless there is compelling evidence that this is what the promulgating authority intended.<sup>5</sup> In this case, the preamble issued by the OTS at the time it promulgated § 545.81 tells us exactly what the OTS intended.

The preamble states expressly that "[t]he OTS is not placing any particular geographic restrictions on operating subsidiaries of federal savings associations. This will provide the parent savings association with maximum operational flexibility regarding the location of operating subsidiaries."<sup>6</sup> It is thus clear that the OTS specifically considered whether geographic restrictions should be imposed on operating subsidiaries and consciously choose not to impose such restrictions, so as to preserve "maximum operational flexibility." Hence, the preamble expressly affirms that "[a]n operating subsidiary may be established in any geographic location."<sup>7</sup>

This conclusion is consistent with one of the key policy objectives that prompted the OTS to promulgate § 545.81, *i.e.*, to move federal savings associations toward greater parity with national banks. National banks have long been permitted to establish foreign operating subsidiaries, and even full service foreign branches, subject to Federal Reserve Board ("FRB") approval.<sup>8</sup> If we were to interpret § 545.81 in a manner that

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<sup>4</sup> 12 C.F.R. § 545.81(b)(1).

<sup>5</sup> 1A and 2A Sutherland, Statutory Construction, §§ 31.06 and 47.37 (5th Ed.).

<sup>6</sup> 57 Fed. Reg. 12226, 12228 (April 9, 1992).

<sup>7</sup> See 57 Fed. Reg. at 12226 (emphasis added).

<sup>8</sup> See § 25 of the Federal Reserve Act, 12 U.S.C.A § 601 (West 1989 and Supp.); 12 C.F.R. § 211.5(b)(2)(iii). As a matter of practice, the FRB requires banks to establish a branch in a foreign jurisdiction before an operating subsidiary may be established in that jurisdiction. To date, however, the OTS has not authorized

imposes geographic restrictions on the operating subsidiaries of federal savings associations, we would not only depart from the express language of the regulation and the preamble, but also undercut the parity principle that underlies § 545.81.

For these reasons, we conclude that federal savings associations have legal authority under § 545.81 to establish operating subsidiaries in any foreign or domestic jurisdiction so long as the activities of the subsidiary are limited to activities permissible for the parent savings association,<sup>9</sup> the technical and procedural requirements of § 545.81 are met, and the proposed subsidiary does not present safety and soundness or supervisory concerns.<sup>10</sup>

In this regard, we note that § 545.81 specifically provides that the OTS will review operating subsidiary applications "to determine if the proposed activities are consistent with applicable law, with safe and sound operating principles, and with OTS policies."<sup>11</sup> When reviewing applications to establish foreign

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federal thrifts to establish foreign branches. Thus, it is not feasible to require federal thrifts to follow precisely the same procedures as national banks when establishing foreign operating subsidiaries.

<sup>9</sup> We are aware that a prior document issued by the OTS entitled "Operating Subsidiaries Questions and Answers" (March, 1993) ("Q&A") indicated that operating subsidiaries may not be located overseas "at this time." The Q&A raised, without resolving, the question whether the provision in the regulation restricting operating subsidiaries to activities permissible for a federal savings association should be read as implicitly prohibiting foreign operations by operating subsidiaries. Based on our review of the regulatory history of the operating subsidiary regulation described above, however, we conclude that this clearly was not the intent of the drafters of the regulation. Thus, Answer No. I(E)(2) in the Q&A is superseded by this opinion.

<sup>10</sup> See 12 C.F.R. § 545.81(h).

<sup>11</sup> 12 C.F.R. § 545.81(c)(2)(iii). Although the regulation contains an expedited notice procedure for institutions that meet the criteria of 12 C.F.R. § 516.3 (i.e., healthy, well-managed institutions), the regulation also specifies that the OTS may deny expedited treatment whenever an operating subsidiary proposal is deemed to raise significant supervisory or safety and soundness issues. 12 C.F.R. § 545.81(c)(1)(i). For the reasons set forth below, all proposals to establish foreign operating subsidiaries will require careful supervisory and safety and soundness review. Thus, expedited treatment is not available for any foreign operating subsidiary proposal. All such proposals must follow the

operating subsidiaries, the OTS will consider whether certain unique risks that can be presented by foreign operations have been adequately addressed in the institution's application. The types of risks that the OTS will consider include:

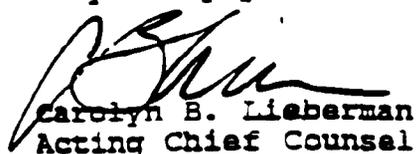
- The risk of instability in the economy, currency, or political system of the proposed host country.
- The risk that the institution in question will not be sufficiently familiar with the markets, laws, culture, and political system of the host country to operate effectively and avoid problems.
- The risk that the remoteness of the location will result in insufficient oversight and monitoring by management of the institution.
- The risk that OTS will not have full access to the operating subsidiary and full enforcement jurisdiction.

In the present instance, we are satisfied that the materials that the Association has submitted have adequately addressed the foregoing concerns, provided the conditions set forth in Appendix A are satisfied.<sup>12</sup>

In reaching the conclusions set forth in this letter, we have relied upon the representations contained in the Association's notice and subsequent correspondence, as summarized herein. Our conclusions depend upon the accuracy and completeness of those representations. Any material change in circumstances from those described herein might require different conclusions.

If you have further questions regarding this matter, please feel free to contact Laurie Nicoli, Counsel (Banking and Finance), at (202) 906-7452.

Very truly yours,



Carolyn B. Lieberman  
Acting Chief Counsel

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application procedures set forth in 12 C.F.R. § 545.81(c)(2).

<sup>12</sup> It is our understanding that the Association submitted notice of the proposed Bermuda subsidiary to the Federal Deposit Insurance Corporation ("FDIC") in accordance with 12 U.S.C.A. § 1828(m) (West 1989) at the time the Association filed its initial notice with the OTS, and that the FDIC raised no objection.

CONDITIONS OF APPROVAL

OTS authorization for the Association to establish a Bermuda operating subsidiary is subject to the following conditions:

1) The activities of the operating subsidiary shall be conducted in accordance with the representations made in the Association's notice, as supplemented by letters to the OTS dated September 22, 1993, December 30, 1993, and June 10, 1994. In particular and without limitation, the location and incorporation of the operating subsidiary shall be limited to Bermuda and, absent written authorization from the OTS Central Regional Director ("Regional Director"), the total amount of assets transferred to the operating subsidiary shall not exceed \$200 million.

2) The Association must establish and document internal controls that demonstrate adequate oversight of the operating subsidiary, and provide materials documenting the institution of such internal controls to the Regional Director.

3) The operating subsidiary shall make available to the OTS such information as the OTS deems necessary from time to time to monitor the operating subsidiary's activities and the effect of those activities on the safe and sound operation of the Association. The operating subsidiary shall maintain a duplicate set of records in the U.S. at the Association's home office.

4) The operating subsidiary and each institution-affiliated party associated with the operating subsidiary shall consent in writing to the jurisdiction of the U.S. over, and the applicability of U.S. law to, the operating subsidiary and its institution-affiliated parties for purposes of all claims made by, proceedings initiated by, or obligations to, the U.S., the OTS and any U.S. governmental agency, department or division, and shall consent in writing to the jurisdiction of the OTS over the operating subsidiary and its institution-affiliated parties for purposes of examination, supervision and enforcement. The operating subsidiary and its institution-affiliated parties shall further agree in writing not to challenge the authority of any conservator/receiver appointed for the Association to control the Association and the Association's shares of the operating subsidiary.

5) The operating subsidiary shall submit a reasoned opinion of counsel in a form acceptable to the OTS indicating that there are no Bermuda laws that would restrict OTS access to, or enforcement authority over, the operating subsidiary or its institution-affiliated parties.

6) The operating subsidiary shall maintain a registered agent in the Association's home office to receive service of process on its behalf.

7) The operating subsidiary shall consent in writing to the disclosure by Bermuda governmental authorities to the OTS of such information on its operations and its affiliates that the OTS deems necessary from time to time to determine and enforce compliance with applicable U.S. law.

8) The operating subsidiary shall provide all financial statements in U.S. dollars in accordance with generally accepted accounting principles, including financial information required to be submitted quarterly in the Thrift Financial Report.

9) The Regional Director must be promptly informed, in writing, of all changes in the directors, officers, and employees or managers of the operating subsidiary.

10) The operating subsidiary and the Association shall agree in writing to terminate operations of the operating subsidiary as soon as possible (but no later than 30 days) after being advised in writing that the OTS, in its sole discretion, has determined that such operations present undue risk.

The documents required by conditions 2, 4, 5, 7 and 10 shall be submitted to the Regional Director. Once these documents are submitted and the Central Region indicates in writing that the documents are in acceptable form, the Association may transfer securities to the Bermuda operating subsidiary and commence operations, subject to the foregoing conditions. The OTS intends to closely monitor the operations of the operating subsidiary on an ongoing basis and to conduct a focused review of its operations one year after it commences operations.