February 11, 2013

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton
Director
Division of Insurance and Research

Richard J. Osterman, Jr.
Acting General Counsel

SUBJECT: Notice of Proposed Rulemaking on Definition of Insured Deposit

RECOMMENDATION:

Staff recommends that the FDIC Board of Directors ("Board") authorize publication of the attached Notice of Proposed Rulemaking on Definition of Insured Deposit ("NPR" or "proposed rule") with a 60 day comment period. The NPR would amend the Deposit Insurance Regulations, 12 CFR Part 330.

Specifically, the proposed rule would amend paragraph 3(e) to:

- Specify that deposits carried on the books and records of a foreign branch of a United States bank are not insured deposits whether or not they are made payable both at that branch and at an office of the bank in any State of the United States ("dually payable"); and

- Provide an exception for Overseas Military Banking Facilities operated under Department of Defense regulations, or similar facilities authorized under Federal statute.

Staff believes that the proposed amendments would provide important guidance on the scope of deposit insurance, as it relates to deposits carried on the books and records of foreign branches of United States banks. This is particularly important at a time when changes in global banking could expose the Deposit Insurance Fund ("DIF") to risks that are inconsistent with its role of promoting depositor confidence and providing stability to the United States economy.

INTRODUCTION

Congress created the FDIC in 1933 to end the banking crisis experienced during the Great Depression, to restore public confidence in the banking system, and to safeguard bank deposits through deposit insurance. Deposit insurance promotes sound, effective, and uninterrupted operation of the banking system by protecting the safety and liquidity of covered bank deposits. The FDIC pays out deposit insurance from the DIF, which is funded by assessments on insured depository institutions. In addition, the FDIC can access a line of credit from the United States Treasury if necessary for deposit insurance purposes. In the most recent financial crisis, the FDIC's deposit insurance guarantee, with its backing by the full faith and credit of the United States Government, contributed significantly to financial stability in an otherwise unstable financial environment. In the FDIC's history, no depositor has ever lost a penny of an insured deposit.

The Federal Deposit Insurance Act ("FDI Act"), 12 U.S.C. § 1811, *et seq.*, mandates the payment of deposit insurance "as soon as possible" to reduce the economic disruptions caused by bank failures and to preserve stability in the financial markets of the United States. *See* FDI Act section 11(f), 12 U.S.C. § 1821(f). The FDIC generally pays out deposit insurance on the next business day after a bank failure, and insured depositors often have uninterrupted access to their insured deposits through ATMs and other means. The prompt payment of deposit insurance preserves confidence in the deposit insurance system and promotes financial stability. Prompt payment depends on a number of key factors, including the FDIC's having immediate access to the deposit records of the failed bank and clarity about the application of laws and practices that could affect deposits in a particular location.

To the extent a failed bank's depositors are uninsured, these depositors share in the proceeds from the liquidation of the assets of the failed bank, as conducted by the FDIC as receiver. The FDI Act contains a priority framework, known as "national depositor preference," which governs the distribution of bank receivership proceeds to claimants, other than secured creditors whose claims are satisfied to the extent of their security. Under this regime, administrative expenses of the receiver are reimbursed first. Deposit liabilities (which include both home-country (uninsured) deposits and the claim of the FDIC standing in the shoes of insured depositors as subrogee) are reimbursed next, followed in order by general or senior liabilities; subordinated liabilities; and obligations to shareholders. FDI Act section 11(d)(11), 12 U.S.C. § 1821(d)(11).

A. Treatment of Deposits in Foreign Branches of United States Banks

Funds deposited into foreign branches of United States banks are not "deposits," as defined under the FDI Act, unless those banks make the deposits payable at an office of the bank in the United States using express contractual terms to that effect. FDI Act section 3(*l*)(5)(A), 12 U.S.C. § 1813(*l*)(5)(A). United States banks currently operate through branches in dozens of countries. Foreign branch deposits have doubled since 2001 to total approximately $1 trillion today. A significant percentage of these branch deposits are located in the United Kingdom. United States banks often operate foreign branches to provide banking, foreign currency, and payment services to multinational corporations. In many cases these branches do not engage in retail deposit or other retail banking services; their typical depositors are large businesses that choose to bank in a foreign branch of a United States bank to benefit from the advantages of a large bank's multi-country branch network, which allows the transfer of funds to and from branch offices located in different countries and in different time zones pursuant to deposit agreements governed by non-United States law.

Currently, the overwhelming majority of the deposits in these foreign branches of United States banks are payable only outside the United States. This may in part be because, in the past, making deposits in foreign branches dually payable has been costly for two reasons. First, it increased a bank's deposit insurance assessment base (which, in the past, excluded deposits solely payable outside the United States) and, thus, its deposit insurance assessment. Second, the deposits became subject to the Federal Reserve's Regulation D, 12 CFR Part 204. Recent events have reduced or eliminated the cost of making these deposits dually payable, however. First, in section 331(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress changed the deposit insurance assessment base so that it now includes all liabilities; converting a deposit in a foreign branch to dual payability no longer increases a bank's assessment base or deposit insurance assessment. Second, the Federal Reserve now pays interest on reserves and allows more flexibility with respect to the reserves it requires. We also understand that United States banks may have refrained from making deposits in foreign branches dually payable out of concern that doing so could cause them to lose the protection from sovereign risk accorded them under section 25(c) of the Federal Reserve Act, 12 U.S.C. § 633.[1] Nothing in this proposed rule is intended to preclude a United States bank from protecting itself against sovereign risk by excluding from its deposit agreements with foreign branch depositors liability for sovereign risk.

Because these deposits have not been deposits for purposes of the FDI Act, depositors in foreign branches of United States banks have not received FDIC insurance. They are also not considered depositors for purposes of the national depositor preference provisions of the FDI Act and thus, if the bank were to fail, would share in the distribution of their bank's liquidated assets only as general creditors after the claims of United States (uninsured) depositors and the FDIC as subrogee of insured depositors had been satisfied. As discussed further below, this treatment of

[1] This section provides that a member bank is not required to repay a deposit in a foreign branch if it cannot do so because of "war, insurrection, or civil strife" or actions taken by the foreign government, unless the member bank has explicitly agreed in writing to repay foreign branch deposits in such circumstances.

deposits payable only in overseas branches under the FDI Act's priority regime reflects important policy considerations.

B. <u>The Consultation Paper of the United Kingdom's Financial Services Authority</u>

In September 2012, the United Kingdom's Financial Services Authority ("U.K. FSA") published a Consultation Paper addressing the implications of national depositor preference regimes in countries outside the European Economic Area ("EEA"). The Consultation Paper proposes to prohibit banks from non-EEA countries, including United States banks, from operating deposit-taking branches in the United Kingdom unless United Kingdom depositors in such branches would be on an equal footing in the national depositor preference regime with home-country (uninsured) depositors in a resolution of the bank if it were to fail. One of the U.K. FSA's proposed remedies would require United States banks to change their United Kingdom deposit agreements so that the deposits are payable both in the United Kingdom and in the United States.

As outlined above, the effective result of such a change proposed by the U.K. FSA to the existing deposit agreements would be that the bank's deposits in the United Kingdom branch would be treated on a par with deposits in a branch in the United States and thus would be given *depositor preference priority* in a distribution of assets. However, the FDI Act and FDIC regulations do not specifically deal with the availability of *deposit insurance* for deposits in foreign branches that have been made dually payable, leaving unaddressed the question whether United Kingdom branch deposits would be eligible for FDIC deposit insurance as well.

Any potential for a significant expansion of FDIC deposit insurance coverage outside the United States, with the concomitant potential impact on United States taxpayers, must be addressed expeditiously. Absent decisive action, the FDIC could find itself subject to liability to depositors throughout the world.

The U.K. FSA currently has proposed that the rules governing deposit-taking by foreign banks in the United Kingdom will become final in early 2013, with implementation to take place two years later. Shortly after the rule's becoming final, however, United States banks with branches in the United Kingdom will be required to disclose to their United Kingdom depositors information regarding how the FDI Act's national depositor preference regime operates. Specifically, the required disclosure must indicate that, upon failure of the bank, claims for recovery of the bank's United Kingdom deposits would be subordinated to claims for recovery of the bank's United States deposits and, among other disclosures, that United Kingdom depositors would suffer losses before home-country depositors suffer any losses. The Consultation Paper makes clear that a disclosure that merely indicates that United Kingdom depositors would be in a weaker position vis-à-vis home-country (uninsured) depositors in the event of insolvency would not constitute sufficient disclosure.

The Consultation Paper also specifies the required methodology of disclosure, including disclosure in deposit contracts with new customers and required revisions to deposit contracts with existing customers; among other things, the revisions to existing deposit contracts must explain to customers the specific purpose of the revisions. The firms are directed to make no distinction between retail and corporate customers. Furthermore, the disclosures are to be made on any website that offers deposit-taking services.

United States banks have advised the FDIC staff that they are likely to begin the process of sending out these disclosures shortly and, further, that they would likely make their deposits payable both in the United Kingdom and the United States at the same time or shortly thereafter to minimize the likelihood of depositor run-off and mitigate any potential damage to their customer relationships. Such changes are of particular concern to the FDIC. Absent timely direction from the FDIC, there could be significant impact on the FDIC's deposit insurance program.

"Dual payability" should not be confused with mere access to funds in a country other than one's home country. Thus, for example, a United States-based traveler may have access to funds in a United States bank account via an ATM transaction overseas without making that account dually payable, and the reverse is true for travelers with deposits in foreign branches accessing their funds at an ATM in the United States. In each case such access is a mere service the bank provides to its customer as distinguished from a right to payment in a liquidation.

In light of these recent international developments, staff recommends issuing this notice of proposed rulemaking, with request for comments, to address the applicability of deposit insurance to deposits in foreign branches of United States banks.

BACKGROUND

A. U.K. FSA Consultation Paper

As noted above, in September 2012, the U.K. FSA issued a Consultation Paper addressing the implications of national depositor preference regimes of countries outside the EEA. The U.K. FSA has proposed to prohibit a non-EEA bank from operating a deposit-taking branch in the United Kingdom unless United Kingdom depositors are on an equal footing in the national depositor preference regime with home-country (uninsured) depositors in a resolution scenario. The U.K. FSA has directed that banks from non-EEA countries that operate national depositor preference regimes take steps to ensure such equal treatment, and has identified three potential solutions (while not precluding the possibility that there could be other solutions that would satisfy the U.K. FSA's concerns):

a. The first alternative offered by the U.K. FSA is subsidiarization. Under this alternative, non-EEA banks whose home countries operate national depositor preference regimes would accept deposits in the United Kingdom using a United Kingdom-incorporated subsidiary rather than a branch. If firms from a non-EEA country that operates a national depositor preference regime place their United Kingdom deposits in a United Kingdom-incorporated subsidiary, the United Kingdom depositors would not be subordinated to home-country depositors in the event the firms fails. When a United Kingdom-incorporated subsidiary fails, all of its depositors, including United Kingdom depositors are subject to United Kingdom resolution and/or insolvency laws.

b. The second alternative offered by the U.K. FSA is to give banks the option of segregating, or ring-fencing, assets in the United Kingdom through a trust arrangement. The trust arrangement would specify that United Kingdom branch depositors are the beneficiaries of the trust, and the banks would have to provide a legal opinion explaining how the measure eliminates the subordination of United Kingdom branch depositors, and that any legal challenge would not divert the ring-fenced assets from their intended use.

c. A third option for those countries like the United States whose statutes permit, would be "dual payability" – making deposits payable in both the home country and the United Kingdom. Under United States law, dual payability would result in those deposits occupying the same distribution priority level as home-country (uninsured) deposits under the national depositor preference regime.

B. National Depositor Preference

In 1993, Congress amended the FDI Act to include a depositor preference provision in the federal failed-bank resolution framework. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66. As noted above, in general, "depositor preference" refers to a distribution model in which the claims of depositors have priority over (*i.e.*, are satisfied before) the claims of general unsecured creditors.

Shortly after Congress added the national depositor preference provisions, FDIC legal staff was asked to address the impact of these new preference provisions on deposit obligations payable solely at a foreign branch or branches of a United States bank. *See* FDIC Advisory Opinion 94-1, Letter of Acting General Counsel Douglas H. Jones (Feb. 28, 1994). As described in this Advisory Opinion, national depositor preference made general unsecured creditor claims subordinate to any "deposit liability" of the institution. Since all deposit liabilities would be preferred over the claims of other creditors, FDIC staff was expressly asked whether the term "deposit liability" would include, or exclude, those obligations payable solely at a foreign branch of a United States bank.

The Advisory Opinion explored the meaning of the term "deposit liability" used in other provisions of United States law. The Advisory Opinion specifically noted that the FDI Act definition of the term "deposit" expressly excludes any obligation of a bank that is payable only at an office of such bank located outside of the United States. *See* FDI Act section 3(*l*), 12 U.S.C. § 1813(*l*), and discussion below. The Advisory Opinion concluded that, to qualify as a deposit liability under the national depositor preference amendments to the FDI Act, the controlling deposit agreement would have to specify in express terms that the obligation is payable in the United States. Only by way of these express contractual terms would certain obligations of a foreign branch be considered deposits under the new depositor preference regime and be preferred over the claim of any general, unsecured creditor in a liquidation of a multinational bank. Obligations payable solely at a foreign branch of a United States chartered bank were deemed to be excluded from the term "deposit liability" for purposes of national depositor preference.

STATUTORY FRAMEWORK

A. Definition of "Deposit"

The term "deposit" is defined in FDI Act section 3(*l*), 12 U.S.C. § 1813(*l*). As early as the Banking Act of 1933, Congress made a distinction between domestic and foreign deposits, and the current statutory definition of "deposit" makes clear that foreign branch deposits are not deposits for the purposes of the FDI Act except under certain prescribed circumstances:

> *[T]he following shall not be a deposit for any of the purposes of this chapter or be included as part of the total deposits or of an insured deposit:*
>
> *(A) any obligation of a depository institution which is carried on the books and records of an office of such bank or savings association located outside of any State, unless—*
>
> *(i) such obligation would be a deposit if it were carried on the books and records of the depository institution, and would be payable at, an office located in any State; and*
>
> *(ii) the contract evidencing the obligation provides by express terms, and not by implication, for payment at*

> *an office of the depository institution located in any State . . . .*

FDI Act section 3(*l*)(5), 12 U.S.C. § 1813(*l*)(5).

Therefore, deposit obligations of a foreign branch of a United States bank that would otherwise fall within one of the categories of deposits created by section 3(*l*), or which the FDIC Board would otherwise prescribe as a deposit by regulation, are deemed not to be deposits unless they (1) would be deposits if carried on the books and records of the insured depository institution in the United States and (2) are expressly payable in the United States.

Historically, the great majority of deposit agreements governing relationships between United States banks and their foreign branch depositors have not expressly provided for payment of foreign branch deposits at an office in the United States. Thus, these foreign branch deposits have not been considered "deposits" for any purpose under the FDI Act, including depositor preference and deposit insurance.

B. *<u>Definition of "Insured Deposit"</u>*

The definition of "Insured Deposit" provides, in relevant part –

> *(1) IN GENERAL.-- . . . .*[T]*he term "insured deposit" means the net amount due to any depositor for deposits in an insured depository institution* ***as determined under sectio[n] ... 11(a).***

FDI Act section 3(m)(1), 12 U.S.C. § 1813(m)(1) (emphasis added).

FDI Act section 11(a), 12 U.S.C. § 1821(a), cross-referenced in the definition of "Insured Deposit," directs the FDIC to "insure the deposits of all insured depository institutions as provided in this Act." Section 11(a) provides only limited direction affecting certain categories of deposits. It does not expressly address foreign deposits.

The FDIC issues rules and regulations necessary to carry out the statutory mandates of the FDI Act and other laws that the FDIC is charged with administering or enforcing. In instances such as this one where a statute is silent or general on issues critical to the FDIC's fundamental responsibilities, the FDIC has used its rulemaking authority to effectuate its statutory responsibilities.

Providing deposit insurance to insured depository institutions and maintaining public confidence in the banking system through that deposit insurance in the event of a bank's insolvency are two central functions of the FDIC. In order to permit the FDIC to carry out these functions successfully, Congress has authorized the FDIC to undertake rulemaking to implement the FDI Act effectively, particularly with respect to its deposit insurance functions. The FDI Act gives the FDIC explicit rulemaking and definitional authorities to ensure that it can adapt to changed circumstances as necessary to carry out its important deposit insurance responsibilities.

The FDI Act contains several provisions granting the FDIC broad authority to issue regulations to carry out its core functions and responsibilities, including the duty "to insure the deposits of all insured depository institutions." Notably, FDI Act section 11(d)(4)(B)(iv), 12 U.S.C. § 1821(d)(4)(B)(iv), authorizes the FDIC (in its corporate capacity) to promulgate "such regulations as may be necessary to assure that the requirements of this section [FDI Act section 11, 12 U.S.C. § 1821, which addresses, in FDI Act section 11(f), 12 U.S.C. § 1821(f), the payment of deposit insurance] can be implemented with respect to each insured depository institution in the event of its insolvency."

Other grants of FDIC rulemaking authority can be found in FDI Act section 9(a)(Tenth), 12 U.S.C. § 1819(a)(Tenth) (authorizing the FDIC Board to prescribe "such rules and regulations *as it may deem necessary* to carry out the provisions of this chapter . . . "), and FDI Act section 10(g), 12 U.S.C. § 1820(g) (authority to "prescribe regulations" and "*to define terms* as necessary to carry out" the FDI Act) (emphasis added).

THE PROPOSED RULE

A. The Proposed Rule

The proposed rule would address several key concerns: (1) maintaining public confidence in federal deposit insurance; (2) protecting the DIF; (3) ensuring that, in the event of an insolvency, the FDIC is in a position to administer the resulting receivership effectively and fairly; and (4) enhancing international cooperation.

Staff recommends that the Board authorize publication of the attached proposed rule, which would amend the FDIC's deposit insurance regulations, 12 CFR Part 330, section 330.3(e), relating to deposits payable outside of the United States. The proposed rule would explicitly state that an obligation of an insured depository institution that is carried on the books and records of a foreign branch shall not be an insured deposit for the purpose of the deposit insurance regulations, even if the obligation is payable both at an office within the United States and outside the United States. This would ensure that the FDIC will be able to carry out its critical mission in the United States, and the DIF will be protected from potential global liability.

The proposed rule would not affect the ability of a bank to make a foreign deposit "dually payable" in the United States and abroad. Should a bank do so, its foreign branch deposits would be treated as deposit liabilities under the FDI Act's depositor preference regime in the same way as, and on an equal footing with, domestic deposits.

The proposed rule is not intended to affect the operation of Overseas Military Banking Facilities operated under Department of Defense regulations, 32 C.F.R. Parts 230 and 231, or similar facilities authorized under Federal statute. Such facilities are established under statutory authority, separate from State or Federal laws that govern the broader banking industry, for the benefit of specific United States customers. These customers include active duty and reserve United States military personnel, Department of Defense United States civilian employees, and United States employees of other United States government departments stationed abroad. Consistent with this approach, a United States military banking facility located in a foreign country has been treated as a "domestic" office for purposes of the Report on Condition and Income. Accordingly, deposits placed at such facilities overseas have and would continue to receive FDIC deposit insurance if they meet the requirements of FDI Act section 3(*l*)(5)(A), 12 U.S.C. § 1813(*l*)(5)(A).[2]

B. Objective of the Proposed Rule

The goal of the proposed rule is to ensure that the FDIC can carry out its mandate to provide deposit insurance by protecting the DIF. Absent this rulemaking, the DIF faces potential liability that could be global in scope, a risk that could extend to the United States which backs the DIF with full faith and credit. This threat is aggravated by the higher deposit insurance limits afforded by the DIF as contrasted with the deposit insurance systems of many other countries.

Timely payment of deposit insurance in the event of a bank failure is critical to promoting depositor confidence in the United States deposit insurance system. That system is designed to function in the context of the domestic legal system and functions very effectively in that context. Insuring deposits in foreign jurisdictions raises a series of challenges that threatens the ability to make timely payment. These challenges include access to books and records and foreign law and practice. Any resulting delay would undermine this confidence.

With respect to the FDIC's insurance determination and prompt payment of deposit insurance, there can be no assurance that the FDIC will have access to either the failed branch's premises or its deposit records. Rather, such access could be subject to the local law of the foreign jurisdiction and, possibly, to the discretion of the foreign jurisdiction's regulatory authorities. For example, in an extreme case, FDIC representatives may be unable to obtain visas or other travel permits even to enter the foreign jurisdiction. Even if full access to the foreign branch's premises and deposit records were provided to the FDIC, such access may be

[2] *See* FDIC Advisory Opinion 96-6, Letter of Assistant General Counsel Alan J. Kaplan (Mar. 5, 1996).

delayed for an indeterminate period of time, and any significant delay would be antithetical to one of the primary objectives of providing deposit insurance to depositors: the FDIC's payment of deposit insurance "as soon as possible" in accordance with FDI Act section 11(f)(1), 12 U.S.C. § 1821(f)(1). Consequently, significant operational issues due to external factors may impede the FDIC's prompt payment of deposit insurance (usually the next business day) to depositors of foreign branches of failed United States insured depository institutions. Indeed, in the context of a significant financial crisis in a number of countries, the problems presented could be particularly acute.

C. *Other Options*

Staff has explored alternative options for addressing the issues the U.K. FSA Consultation Paper has triggered. As noted above, the FDIC published an advisory opinion in 1994 that found that foreign deposits payable solely abroad were not deposits under the FDI Act for purposes of national depositor preference. Staff has considered whether to revisit the conclusions reached in this advisory opinion. Staff has also reviewed the status of deposits in foreign branches in light of the history of the FDI Act. In addition, staff has received input from a number of United States banks affected by the U.K. FSA's actions, as well as the U.K. FSA itself. The proposed rule seeks comment from all interested parties on all aspects of the proposed rule, including whether other alternatives are available that would accomplish the goals of the rule (protecting the DIF from exposure to expanded international deposit insurance liability arising from dually payable deposits and associated operational complexities) in a more effective manner.

In particular, the proposed rule seeks comment on whether the FDIC should consider an alternative approach to the proposed rule that would not entirely preclude deposit insurance for dually payable deposits, but only if enumerated conditions designed to protect the DIF and facilitate deposit insurance determinations were satisfied. The proposed rule invites comments on any aspect of this alternative proposal and welcomes comment on other alternative enumerated conditions that would allow the FDIC to continue providing deposit insurance to dually payable deposits while ensuring no possibility of loss to the DIF.

CONCLUSION:

For the reasons discussed above, staff recommends that the Board authorize publication in the Federal Register of the attached notice of proposed rulemaking.

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