

**DATE:** February 2, 2018

**MEMORANDUM TO:** Board of Directors

**FROM:** Doreen R. Eberley, Director  
Division of Risk Management Supervision

**SUBJECT:** **Final Rule: Alternatives to References to Credit Ratings With Respect to Permissible Activities for Foreign Branches of Insured State Nonmember Banks and Pledge of Assets by Insured Domestic Branches of Foreign Banks**

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**Recommendation:** Staff recommends that the FDIC Board of Directors (“Board”) approve publication of the attached final rule entitled “Alternatives to References to Credit Ratings With Respect to Permissible Activities for Foreign Branches of Insured State Nonmember Banks and Pledge of Assets by Insured Domestic Branches of Foreign Banks” (“final rule”). The final rule would amend subparts A and B of the FDIC's international banking regulations in 12 CFR Part 347 ("Part 347"). The final rule would conform Part 347 with the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("section 939A"), and would make other modifications to Part 347 pursuant to the FDIC's authority under section 5 of the Federal Deposit Insurance Act ("FDI Act"). Section 939A directs each federal agency to review and modify regulations that reference credit ratings. The final rule would amend the FDIC's requirements for insured state nonmember banks that operate foreign branches by deleting references to nationally recognized statistical rating organization ("NRSRO") credit ratings in the definition of "investment grade," and replacing the references with alternative standards for determining the creditworthiness of securities and other financial instruments. The final rule would also: apply this revised investment grade standard to each type of asset that foreign banks operating FDIC-insured branches may pledge to the FDIC; establish a liquidity standard for such assets; and subject each category of pledgeable assets to a fair value discount. The final rule would also add two asset categories to the list of assets that foreign banks may use for pledging.

**Concurrence:**

Charles Yi  
General Counsel

## Background

Section 939A<sup>1</sup> requires each federal agency to review its regulations that require the use of an assessment of creditworthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings. Each agency must modify its regulations identified in the review by removing references to, or requirements of reliance on credit ratings, and substituting appropriate standards of creditworthiness.

Subpart A of Part 347<sup>2</sup> addresses the international banking and investment activities of insured state nonmember banks that operate foreign branches. There are currently seven state nonmember banks operating 13 foreign branches in six countries. In general, Part 347 implements the FDIC's statutory authority under section 18(d)(2) of the FDI Act<sup>3</sup> regarding branches of insured state nonmember banks in foreign countries, and section 18(l) of the FDI Act<sup>4</sup> regarding insured state nonmember bank investments in foreign entities.<sup>5</sup> Under subpart A, a foreign branch of a state nonmember bank may invest in, underwrite, distribute and deal, or trade foreign government obligations that have an investment grade rating, up to an aggregate limit of ten percent of the bank's Tier 1 capital.<sup>6</sup> Investment grade is currently defined in subpart A as a security that is rated in one of the four highest categories by two or more NRSROs, or one NRSRO if the security is rated by only one NRSRO.<sup>7</sup>

Subpart B of Part 347 implements provisions of the FDI Act and the International Banking Act ("IBA")<sup>8</sup> concerning insured and noninsured U.S. branches of foreign banks. There

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<sup>1</sup> Pub. L. 111-203, 124 Stat. 1376, 1887 (July 21, 2010).

<sup>2</sup> 12 CFR § 347.101, et seq.

<sup>3</sup> 12 U.S.C. § 1828(d)(2).

<sup>4</sup> 12 U.S.C. § 1828(l).

<sup>5</sup> The limitations on international investments and the definition of permissible activities found in the FDIC's regulations in Part 347 are similar but not identical to those found in Regulation K of the Board of Governors of the Federal Reserve System.

<sup>6</sup> 12 CFR § 347.115(b).

<sup>7</sup> 12 CFR § 347.102(o).

<sup>8</sup> 12 U.S.C. § 3101 et seq.

are currently only ten insured U.S. branches of foreign banks in operation (four federal branches licensed by the Office of the Comptroller of the Currency (“OCC”), and six state branches, licensed by state banking authorities).<sup>9</sup> Under section 5(c) of the FDI Act, the foreign banks that own and operate these ten “grandfathered” branches must pledge assets for the benefit of the FDIC.<sup>10</sup> If the FDIC is obligated to pay the insured deposits of an insured branch, the assets pledged become the property of the FDIC and will be used to protect the Deposit Insurance Fund (“DIF”). Section 5(c) of the FDI Act also authorizes the FDIC to prescribe regulations related to the amounts and types of assets that may be used to satisfy the asset pledge requirement in that section.

Part 347 identifies the types of assets that a foreign bank may pledge for the benefit of the FDIC. These assets currently include:

- Negotiable certificates of deposit;
- Obligations of the United States or any agency or instrumentality thereof;
- Commercial paper (if rated P-1 or P-2 by an NRSRO)<sup>11</sup>;
- Bankers acceptances;
- State and municipal obligations (if rated within the top two rating bands of an NRSRO);
- Obligations of certain international development banks; and
- Notes issued by bank and thrift holding companies, banks, or savings associations (if rated within the top two rating bands of an NRSRO).

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<sup>9</sup> The FDIC no longer insures the deposits accepted by non-grandfathered branches of foreign banks. Since the enactment of the Foreign Bank Supervision Enhancement Act of 1991 (“FBSEA”), a foreign bank seeking to accept retail deposits (initial deposits under \$250,000) in the United States may do so only by establishing a U.S. subsidiary bank (or savings association) whose deposits are insured by the FDIC. Before FBSEA, a small number of foreign bank branches had obtained FDIC insurance under the provisions of the IBA and thus were permitted to accept retail deposits. These branches (insured branches) are “grandfathered,” i.e., they may continue to receive insured retail deposits pursuant to section 12 U.S.C. § 3104(d)(2).

<sup>10</sup> 12 U.S.C. § 1815(c).

<sup>11</sup> P-1 and P-2 are Moody’s top two ratings bands for short-term obligations.

## 2016 Notice of Proposed Rulemaking

On June 28, 2016, the FDIC published a notice of proposed rulemaking (“NPR”) in the Federal Register and sought comments on all aspects of the proposal.<sup>12</sup>

### Subpart A Revisions

The NPR proposed amending the definition of "investment grade" in subpart A of Part 347 in order to remove the definition's references to credit ratings and NRSROs. The NPR proposed redefining "investment grade" as a security issued by an entity that has adequate capacity to meet financial commitments under the security for the projected life of the exposure. An issuer of such an instrument would meet this standard if the obligor presents low default risk and is expected to make timely payments of principal and interest. The revisions to the regulatory definition of investment grade would remove references to credit ratings consistent with section 939A of the Dodd-Frank Act, and would not otherwise materially change the scope of permissible investments held by foreign branches of state nonmember banks.

The NPR's revised definition of investment grade in subpart A of Part 347 would be consistent with the definition of investment grade that was adopted by the FDIC, OCC, and the Board of Governors of the Federal Reserve System ("Federal Reserve") in the promulgation of regulatory capital rules that implement the Basel III framework ("Basel III capital rules").<sup>13</sup> Moreover, this definition is also consistent with the non-ratings based creditworthiness standard applicable to permissible corporate debt securities investments of savings associations adopted by the FDIC in 12 CFR Part 362<sup>14</sup> and the credit quality standards regarding permissible investments for national banks adopted by the OCC under 12 CFR Parts 1, 16, and 160.<sup>15</sup> In

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<sup>12</sup> 81 FR 41877 (June 28, 2016).

<sup>13</sup> See 78 FR 62018 (Oct. 11, 2013) (Federal Reserve and OCC final rule); 78 FR 55340 (Sept. 10, 2013) (FDIC interim final rule), 79 FR 20754 (April 14, 2014) (FDIC final rule).

<sup>14</sup> See 77 FR 43151 (July 24, 2012).

<sup>15</sup> See 77 FR 35253 (June 13, 2012).

addition, it is consistent with the rules adopted by the OCC that remove references to credit ratings from its regulations pertaining to foreign bank capital equivalency deposits for Federal branches under 12 CFR § 28.15.<sup>16</sup>

#### Subpart B Revisions

The NPR proposed adding eligibility criteria to the list of asset types that may be pledged by FDIC-insured branches of foreign banks to satisfy the asset pledge requirements of subpart B. Specifically, consistent with section 939A, the NPR proposed replacing the references to credit ratings issued by NRSROs with the same alternative investment grade standard as subpart A. This standard would apply to all of the asset types enumerated in subpart B's asset pledge provisions. In addition, the NPR proposed requiring that all pledgeable assets be "highly liquid" and subject to fair value haircuts.

Staff notes that the three instances in subpart B that are required to be revised by section 939A contain references not to investment grade ratings, but to the highest subset of rating bands within the investment grade categories established by the ratings agencies. In other words, subpart B imposes a standard on pledged assets that goes beyond a simple investment grade standard. Staff believes that adopting the investment grade and highly liquid criteria, as well as the fair value haircut, would ensure that pledged assets continue to provide a high degree of protection to the DIF.

Under the NPR, all pledgeable assets would have to be "investment grade." The NPR proposed adding to subpart B of Part 347 a definition of "investment grade" that is identical to the definition of "investment grade" in subpart A. The NPR also proposed requiring all pledgeable assets to be "highly liquid," which is a standard that would be satisfied with respect to securities if such securities: (a) exhibit low credit and market risk; (b) are traded in an active

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<sup>16</sup> *Id.*

secondary market; and (c) are the types of assets that investors have historically purchased in periods of financial markets distress.<sup>17</sup> A fair value haircut would also apply to assets pledged under subpart B through the introduction of a haircut table that takes into account an asset's risk weight under the Basel III capital rules and the remaining maturity of the instrument.<sup>18</sup>

The NPR proposed requiring that all assets pledged under subpart B be investment grade, highly liquid, and subject to a fair value haircut. However, the NPR also recognized that certain types of assets, such as U.S. government obligations, would be necessarily deemed investment grade and highly liquid, and therefore would require no additional analysis on the part of pledging banks with respect to such assets. Furthermore, any asset that has a zero risk weighting under the capital rules would not be subject to a haircut. In addition to adopting these eligibility criteria, the NPR proposed introducing cash as a new asset type that foreign banks may pledge under subpart B and creating a separate asset category expressly for debt securities issued by government sponsored enterprises.<sup>19</sup>

The NPR also proposed adding to subpart B a definition of "agency" consistent with the IBA and making other modifications concerning certain pledged assets issued by a branch or agency of a foreign bank. The NPR's revisions would make clear that when a foreign bank with an insured branch pledges CDs, banker's acceptances, or notes issued by a branch or agency of another foreign bank, the issuing branch or agency must be located in the United States and belong to a foreign bank that is headquartered in a country other than the pledging bank's home country.

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<sup>17</sup> The definition of a highly liquid asset is consistent with the definition established in the Federal Reserve's regulations at 12 CFR Part 252 subpart O, Enhanced Prudential Standards for Foreign Banking Organizations.

<sup>18</sup> This method for discounting fair values is consistent with haircuts applied to financial collateral pledged to certain transactions under the Basel III capital rules as adopted by the FDIC.

<sup>19</sup> Cash and securities issued by government sponsored enterprises are included in the definition of highly liquid assets in the Federal Reserve's regulations at 12 CFR Part 252, subpart O, Enhanced Prudential Standards for Foreign Banking Organizations.

Lastly, the NPR proposed updating the list of eligible collateral to eliminate the exception for non-negotiable certificates of deposit ("CDs") that were "pledged as collateral to the FDIC on March 18, 2005, until maturity according to the original terms of the existing deposit agreement."<sup>20</sup> The maturity date for any non-negotiable CD that was grandfathered under this provision had passed. Consequently, the provision by its terms no longer serves a useful purpose and is obsolete. Accordingly, the NPR proposed removing this provision.

### Comments Received

Two comment letters were received—one from a foreign banking organization and one from a private individual. Both commenters expressed concern that the proposed new standards for determining the creditworthiness of securities in the definitions of “investment grade” and “highly liquid” are general and may require subjective determinations. In reference to the proposed liquidity standards for pledged assets under subpart B, one commenter expressed the opinion that the “highly liquid” standard is not required under Section 939A and that the introduction of this new standard is burdensome and not necessary to protect the DIF. The commenter also expressed concerns about the burden of implementing the quarterly valuation calculation associated with the fair value discount of pledged assets and the cost of the additional assets that would have to be pledged as a result of the discount.

With respect to the “investment grade” standard, FDIC staff believes that the revised definition provides a flexible, straightforward measure of creditworthiness that is consistent with existing policy. Achieving consistency with other creditworthiness standards adopted by the federal banking agencies advances section 939A’s directive that agencies establish, to the extent feasible, uniform standards of creditworthiness. Based on these considerations, FDIC staff

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<sup>20</sup> 12 CFR § 347.209(d)(1)(ii).

recommends adopting as final the revisions in the proposed rule to the regulatory definition of “investment grade.”

With respect to the proposed revisions to subpart B, FDIC staff believes that, although requiring foreign banks to verify that pledged assets satisfy the proposed standards may require some initial adjustment of existing processes, such requirements would impose minimal additional burden because these standards of investment grade and highly liquid assets are already in use in other banking regulations. In addition, insured U.S. branches of foreign banks are currently expected to conduct due diligence to meet applicable standards of safety and soundness in connection with their investment activities without reliance on NRSRO ratings as a measure of creditworthiness. Furthermore, market data should already be accessible through an insured branch’s normal data source channels, and should be used in pre-purchase and ongoing investment due diligence. Therefore, FDIC staff does not believe that the proposed changes will significantly increase the operational burden on insured branches of foreign banks.

### **Overview of the Final Rule**

After considering the comments, and for the reasons described above, FDIC staff recommends adopting as final the revisions proposed in the NPR.

### **Conclusion:**

Staff recommends that the Board approve publication of the attached Final Rulemaking in the *Federal Register*.

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