Federal Deposit Insurance Corporation
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TO: The Board of Directors

FROM: Harrel M. Pettway
General Counsel

DATE: July 30, 2024

SUBJECT: Interim Final Rule - Clarification of Deposit Insurance Coverage for Legacy Branches of U.S. Banks in the Federated States of Micronesia, the Marshall Islands, and Palau

RECOMMENDATION

Staff recommends that the FDIC's Board of Directors (Board) approve the attached notice of an interim final rule for publication in the *Federal Register* with a 60-day comment period.

The interim final rule would amend the FDIC's deposit insurance regulations to clarify that the FDIC insures the deposits of legacy branches of U.S. insured depository institutions (IDIs) in the Federated States of Micronesia (FSM), the Republic of the Marshall Islands (Marshall Islands), and the Republic of Palau (Palau), collectively known as the Freely Associated States.

POLICY OBJECTIVES

The FDIC has a long history of providing deposit insurance coverage in the Freely Associated States. At one time, the FDIC provided deposit insurance coverage pursuant to the Federal Deposit Insurance Act (FDI Act), as these islands were territories of the United States. The FSM, the Marshall Islands, and Palau later became independent nations, and entered into Compacts of Free Association (Compacts) with the United States that provided, among other economic benefits, the availability of the FDIC's deposit insurance. The unique and somewhat complex legal framework comprised of the Compacts, their relevant subsidiary agreements, and the FDI Act is what has allowed the FDIC to insure deposits in the Freely Associated States.

The United States recently negotiated, and Congress approved, new agreements related to the Compacts with each of the Freely Associated States. Some of these new agreements include provisions relating to the services and programs of the FDIC in the Freely Associated States. In light of this, staff believes it would be beneficial to clarify the application of the FDI Act and the deposit insurance regulations to legacy branches of U.S. IDIs operating in the Freely Associated States. The interim final rule would clarify that the FDIC insures the deposits of legacy branches of U.S. IDIs operating in the FSM, the Marshall Islands, and Palau.

HISTORICAL BACKGROUND

The interim final rule would implement the FDI Act, rather than the Compacts. However, a brief historical discussion and overview of the Compacts provides helpful context for understanding the interim final rule, which is based upon the special and historic relationship between the United States and the Freely Associated States.

The FSM, the Marshall Islands, and Palau were once part of the Trust Territory of the Pacific Islands, established by the United Nations following World War II and administered by the United States pursuant to a trusteeship agreement.[1] In 1981, Congress added the Trust Territory of the Pacific Islands to the FDI Act's definition of "State," with the result that deposits in banks located in the Trust Territory were eligible to be insured by the FDIC.

The FSM, the Marshall Islands, and Palau each adopted a Compact of Free Association with the United States that was subsequently approved by the U.S. Congress in 1986. Each of these nations then exited the Trust Territory of the Pacific Islands by becoming an independent nation. The Compacts contained provisions requiring certain agencies of the U.S. government, including the FDIC, to provide their programs and services to each nation.[2]

The United States, the FSM, and the Marshall Islands eventually renewed negotiations concerning their Compact, resulting in separate agreements between the United States and each nation that took effect in 2003. The amended Compacts included changes to the provision of deposit insurance coverage. Specifically, section 221(a)(5) of the amended U.S.-FSM Compact stated that the FDIC would provide deposit insurance "for the benefit only of the Bank of the Federated States of Micronesia," in accordance with a Federal Programs and Services Agreement executed by the two nations.[3] By contrast, the corresponding provision of the amended Compact with the Marshall Islands, section 221(a), included no reference to deposit insurance.[4]

The U.S.-Palau Compact does not include a termination date, but requires formal review of its terms by the 15-year, 30-year, and 40-year anniversaries of its effective date. The direct economic assistance provisions of the Compact expired in 2009, and, following the required 15-year review, were renegotiated and signed on September 3, 2010. Congress approved a Compact Review Agreement with respect to the U.S.-Palau Compact in December 2017.[5]

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[1] In addition to the FSM, the Marshall Islands, and Palau, the Trust Territory of the Pacific Islands also included the Northern Mariana Islands. The Northern Mariana Islands became a self-governing commonwealth of the United States in 1986, and has since been added to the FDI Act's definition of "State." *See* 12 U.S.C. 1813(a)(3).

[2] The Compacts provided continuing authority for the FDIC to insure banks chartered by the FSM, the Marshall Islands, and Palau, which, due to their exit from the Trust Territory of the Pacific Islands, no longer fell within the FDI Act's definition of "State."

[3] Pub. L. 108-188, § 201(a) (Dec. 17, 2003).

[4] Pub. L. 108-188, § 201(b).

[5] Pub. L. No. 115-91, § 1259C (2017).

During 2023, the United States and each of the Freely Associated States concluded new agreements relating to their respective Compacts. Congress approved all three Compacts in March 2024.[6] Some of the new agreements include the provision of deposit insurance by the FDIC.

STATUTORY FRAMEWORK

The FDI Act governs deposit insurance coverage for U.S. banks and savings associations. The statute includes two provisions on foreign deposits that are particularly relevant to the interim final rule.

Section 3

The FDI Act defines the "deposits" insured by the FDIC, and makes clear that foreign branch deposits of IDIs are not "deposits" for the purposes of the FDI Act except under prescribed circumstances. In particular, section 3(*l*)(5)(A) excludes the following from the definition of "deposit":

> 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.[7]

Accordingly, deposit obligations of a foreign branch of an IDI that would otherwise fall within the definition of "deposit" under section 3(*l*) are deemed not to be deposits unless they (1) would be deposits if carried on the books and records of the IDI in the United States; and (2) are expressly payable at an office of the IDI located in the United States. The FDIC has generally referred to this second prong of subparagraph (A) as requiring "dual payability" of a deposit.

Section 41

Section 41 of the FDI Act generally prohibits the payment of deposit insurance with respect to certain deposits carried on the books and records of foreign branches of U.S. IDIs. Section 41(a) provides, in relevant part:

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[6] Pub. L. 118-42, div. G, tit. II.

[7] 12 U.S.C. 1813(*l*)(5)(A).

> Notwithstanding any other provision of law, the Corporation … may not, directly or indirectly, make any payment or provide any assistance, guarantee, or transfer under this Act or any other provision of law in connection with any insured depository institution which would have the direct or indirect effect of satisfying, in whole or in part, any claim against the institution for obligations of the institution which would constitute deposits as defined in section 3(*l*) but for subparagraphs (A) and (B) of section 3(*l*)(5).[8]

This provision of the statute generally prohibits payment of obligations that would have the direct or indirect effect of satisfying any claim against an IDI which would constitute deposits "but for subparagraphs (A) and (B) of section 3(*l*)(5)."

As described above, subparagraph (A) of section 3(*l*)(5) excludes an obligation from being considered a "deposit" unless (1) the obligation would constitute a "deposit" if carried on the IDI's books and records in a State; and (2) the contract expressly provides dual payability. An obligation that constitutes a deposit "but for" subparagraph (A) is one that is excluded from the "deposit" definition only because it does not satisfy the two-part test in subparagraph (A). Put differently, obligations which constitute deposits "but for" subparagraph (A) include those that would constitute a "deposit" if carried on the IDI's books and records in a State, yet are not expressly payable at a location of the IDI within a State. Section 41 therefore prohibits the FDIC from paying deposit insurance on obligations of IDIs' foreign branches that are not dually payable. Dual payability is, in effect, a statutory prerequisite for deposit insurance with respect to U.S. IDIs' foreign branch deposits.

2013 RULEMAKING ON THE DEFINITION OF "INSURED DEPOSIT"

While dual payability is a statutory prerequisite for deposit insurance, the FDIC has also used its authority to limit the availability of deposit insurance for IDIs' foreign branch deposits. In 2013, the FDIC amended its deposit insurance rules to clarify the status of deposits maintained in foreign branches of U.S. banks.[9] The 2013 rule made clear that if a bank's deposits carried on the books of its foreign branches were made dually payable under section 3(*l*)(5)(A), this could make them "deposits" for purposes of depositor preference in resolution proceedings, but would not make them insured deposits.

Specifically, the 2013 rule amended § 330.3(e) of the FDIC's deposit insurance regulations to provide that obligations of IDIs payable solely at an office of the IDI located outside any State (as defined in section 3(a)(3) of the FDI Act) are not "deposits" for purposes of Part 330. Thus, obligations that are not dually payable may not be considered "deposits." The 2013 rule further provided that even if such obligations are made dually payable at an office of the IDI located within a State, they are not "insured deposits" for purposes of Part 330. The 2013 rule also

[8] 12 U.S.C. 1831r(a).

[9] *See* 78 FR 56583 (Sept. 13, 2013).

included a rule of construction for overseas military banking facilities operated under U.S. Department of Defense regulations, stating that such offices would not be considered to be located outside any State.

While the focus of the 2013 rule was clarifying the effect of dual payability, the FDIC also discussed the rule's effect on deposits in the Freely Associated States. Specifically, the FDIC stated that the 2013 rule was not intended to "affect the status of insured deposits, if any, located in the former Trust Territories."[10]

INTERIM FINAL RULE

In light of the FDIC's role in the Freely Associated States under the new Compact-related agreements, staff believes it would be beneficial to clarify the application of the FDI Act and the deposit insurance regulations to branches of U.S. IDIs operating in the Freely Associated States. The interim final rule would clarify that the FDIC, pursuant to the FDI Act, insures the deposits of legacy branches of U.S. IDIs operating in the FSM, the Marshall Islands, and Palau, aligning the regulation with the historical coverage provided for these deposits.

The interim final rule amends § 330.3(e) of the FDIC's deposit insurance regulations, which governs deposits of IDIs that are payable outside of the United States and certain other locations. Currently under the regulation, an obligation of an IDI that is payable solely at an office of the IDI located outside any State is not considered a "deposit" for purposes of the deposit insurance regulations.[11] Where an obligation of an IDI is carried on the books and records of an office of the IDI located outside any State, the regulations provide that it shall not be considered an insured deposit, even if it is also made payable at an office of the IDI located within any State.[12] Essentially, where obligations booked outside the U.S. are made dually payable, they may be entitled to depositor preference (payment ahead of the institution's other creditors), but are not generally eligible for deposit insurance coverage. Section 330.3(e)(3) includes a rule of construction providing a limited exception to these general rules for overseas military banking facilities operated under U.S. Department of Defense regulations. Military banking facilities are not considered to be offices located outside any State under the regulation, meaning that military banking facility deposits are eligible to be insured.

The interim final rule would amend the rule of construction in § 330.3(e) to apply expressly to deposits of legacy branches of U.S. IDIs operating in the FSM, the Marshall Islands, and Palau. Such branches would not be considered to be offices located outside any State for purposes of

[10] 78 FR 56583, 56587 (Sept. 13, 2013). As explained above, eligibility of a U.S. IDI's foreign branch obligations for deposit insurance coverage under the FDI Act would depend upon whether the deposits were expressly payable at an office of the IDI located in a State.

[11] 12 C.F.R. 330.3(e)(1).

[12] 12 C.F.R. 330.3(e)(2).

the deposit insurance rules, meaning that their deposits, if dually payable, would be eligible to be insured by the FDIC pursuant to Part 330.

The coverage for U.S. IDIs' legacy branches provided by the rule is intended to function as a limited-scope exception to the general rule that excludes IDIs' foreign branch deposits from deposit insurance coverage. This limited exception aligns the regulation with the historical coverage that has been provided for banks operating in the Freely Associated States through the special and historical relationship the United States has maintained with each of the Freely Associated States. Accordingly, the exception provided by the interim final rule is limited to the legacy branches of U.S. IDIs, meaning the number of branches in operation as of the interim final rule's effective date. Any changes to branch locations remain subject to existing applicable requirements depending on the circumstances.[13] Staff believes that limiting coverage to legacy branches of U.S. IDIs serves the FDIC's policy objectives while promoting consistency, to the extent possible, with the rules that generally apply to foreign deposits.

As explained above, dual payability is a statutory prerequisite for deposit insurance with respect to U.S. IDIs' foreign branch deposits. Therefore, deposits of U.S. IDIs' legacy branches in the Freely Associated States would only be eligible for deposit insurance if they have been made dually payable. This means that, under the contract, they are expressly payable at an office of the IDI located in a State (as defined in 12 U.S.C. 1813(a)(3)).

Importantly, all dually payable deposits of the legacy branches of U.S. IDIs would be eligible for deposit insurance coverage under the interim final rule.[14] Coverage would not be limited to deposit balances maintained by the depositor as of the rule's effective date, or limited to deposit accounts opened prior to the rule's effective date. This aspect of the interim final rule would ensure that coverage is easily understood by consumers and bankers. It also would reduce operational complexity for the FDIC in the event of a bank failure that would require a deposit insurance determination. Under the interim final rule, calculation of deposit insurance coverage would be determined by application of the deposit insurance regulations that generally apply to all IDIs, found in 12 C.F.R. Part 330.

It is important to note that the interim final rule would not affect the provision of deposit insurance to banks chartered by any of the Freely Associated States or branches of such banks. This is because the rule is intended to clarify the application of the FDI Act to branches of U.S.-chartered IDIs. Deposit insurance coverage is provided to certain banks chartered by the Freely Associated States pursuant to separate authority provided by legislation concerning the Compact-related agreements, as discussed above.

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[13] *See* 12 C.F.R. Part 303, subparts C, D, and J.

[14] Deposit insurance coverage only applies to "deposits" as that term is defined in the FDI Act. Other types of products, such as stocks, bonds, money market mutual funds, securities, commodities, and crypto assets are not insured under the interim final rule.

EFFECTIVE DATE AND COMMENT PERIOD

The Administrative Procedure Act typically requires notice and opportunity for public comment prior to agencies' rules taking effect. However, prior notice and comment are not required with respect to a rulemaking when an agency for good cause finds that notice and comment are impracticable, unnecessary, or contrary to the public interest.[15]

Staff believes that the public interest is best served if the interim final rule is effective as soon as possible. The interim final rule aligns the FDIC's regulation with the deposit insurance coverage historically provided for deposits in the Freely Associated States, clarifying the application of section 330.3(e) of the FDIC's regulations in this context. Moreover, a delayed effective date could lead depositors of IDIs in the Freely Associated States to question whether their deposits are insured during the comment period. The interim final rule includes a statement that the FDIC has determined that prior notice and comment would be contrary to the public interest in this instance, and therefore, that good cause exists to waive the customary 30-day delayed effective date for rules.

The interim final rule would solicit comment during a 60-day comment period, after which the FDIC would adopt a permanent final rule. The interim final rule could be revised at that time in light of any comments received.

CONCLUSION

Staff recommends that the Board approve the interim final rule for publication in the *Federal Register*.

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[15] 5 U.S.C. § 553(b)(B).