

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis *Diane Ellis*
Director
Division of Insurance and Research

Richard J. Osterman, Jr. *RJO*
Acting General Counsel

DATE: September 5, 2013

SUBJECT: Final Rule on Definition of Insured Deposit

RECOMMENDATION:

Staff recommends that the FDIC Board of Directors (“Board”) approve and authorize publication of the attached Final Rule on the Definition of Insured Deposit (“Final Rule”). The Final Rule would amend the Deposit Insurance Regulations, 12 C.F.R. Part 330.

Specifically, the Final Rule would:

- Specify that deposits carried on the books and records of a foreign branch of a United States bank are not insured deposits even if they are also payable at an office of the bank within the United States (“dual payability”); and
- Clarify through a rule of construction that Overseas Military Banking Facilities operated under Department of Defense regulations are not considered to be offices located outside the United States.

Staff believes that the 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 U.S. 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 maintaining stability and public confidence in the nation’s financial system. The Final Rule would make final a Notice of Proposed Rulemaking on the Definition of Insured Deposit (“Proposed Rule”) that was adopted by the Board on February 12, 2013, and published in the Federal Register on February 19, 2013.

BACKGROUND:

The Federal Deposit Insurance Act (“FDI Act”) 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.¹ 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 maintains stability and public confidence in the nation's financial system. 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.

A pending proposal by the United Kingdom's Prudential Regulation Authority ("U.K. PRA"), has made it more likely that large U.S. banks will employ dual payability.² This action would have the potential to expose the DIF to expanded deposit insurance liability and create operational complexities if such deposits were treated as insured. The Final Rule would clarify that deposits in foreign branches of U.S. banks are not FDIC-insured deposits.

Definition of "Deposit"

The term "deposit" is defined in FDI Act section 3(l), 12 U.S.C. 1813(l). Since the establishment of the FDIC in 1933, Congress has made distinctions between domestic and foreign deposits. The current statutory definition of "deposit" under section 3(l) makes clear that foreign branch deposits are not "deposits" for any purpose under the FDI Act, except under certain prescribed circumstances. In particular, deposit obligations carried on the books and records of a foreign branch of a U.S. bank that would otherwise fall within one of the categories of deposits created by section 3(l) are *not* deposits for any purpose 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 in the United States.³

The vast majority of deposit agreements governing relationships between U.S. banks and their foreign branch depositors have to date not expressly provided for payment of foreign branch deposits at an office in the United States. Accordingly, these foreign branch deposits would not qualify as "deposits" for any purpose under the FDI Act, including deposit insurance and the priority regime for distribution of failed bank's receivership assets, known as "depositor preference," as further discussed below. While "deposit" has a defined legal meaning under the FDI Act, for ease of reference, these obligations in foreign branches will generally be called "foreign branch deposits" in this memorandum.

National Depositor Preference

When a U.S. bank fails, uninsured depositors share in the proceeds from the liquidation of the failed bank's assets. In 1993, Congress amended the FDI Act to establish a system of depositor preference in failed-bank resolutions.⁴ In general, "depositor preference" refers to a

¹ 12 U.S.C. 1811, *et seq.*; *see* FDI Act section 11(f)(1), 12 U.S.C. 1821(f)(1).

² The U.K. PRA was formerly known as the U.K. Financial Services Authority.

³ FDI Act section 3(l)(5), 12 U.S.C. 1813(l)(5). The FDI Act provides that the FDIC Board may prescribe a deposit by regulation.

⁴ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312.

resolution distribution regime in which the claims of depositors have priority over (that is, are satisfied before) the claims of general unsecured creditors.

Under this regime, set forth in section 11(d)(11) of the FDI Act, the receiver of a failed bank distributes amounts realized from its liquidation to pay claims in the following order of priority.⁵ Administrative expenses of the receiver are reimbursed first.⁶ Any “deposit liability” is reimbursed next, followed in order by general or senior liabilities, subordinated liabilities, and obligations to shareholders. The term “deposit liability” in section 11(d)(11) is not defined.

The 1994 Advisory Opinion

Shortly after Congress added the national depositor preference provisions, the FDIC’s Acting General Counsel was asked whether the term “deposit liability” would include deposit obligations payable *solely* at a foreign branch of a U.S. bank.⁷ As described in the Acting General Counsel’s 1994 Advisory Opinion (“General Counsel Advisory Opinion 94-1”), national depositor preference makes general unsecured creditor claims subordinate to any “deposit liability” of the institution. General Counsel Advisory Opinion 94-1 concluded that the term “deposit liability” should be defined with reference to “deposit” under section 3(l) of the FDI Act, which excluded, for any purpose, any obligation of a bank payable only at an office of that bank located outside the United States.⁸

Under the interpretation set forth in General Counsel Advisory Opinion 94-1, “deposit liability” for purposes of national depositor preference includes only deposits payable in the United States and excludes obligations payable solely at a foreign branch of a U.S. bank. Accordingly, an obligation in a foreign branch of a U.S. bank has not been considered a “deposit liability” for purposes of the national depositor preference provisions of section 11(d)(11) of the FDI Act. Thus, if a U.S. bank were to fail, its foreign branch depositors would share in the distribution of the bank’s liquidated assets as general creditors after the claims of uninsured domestic depositors and the FDIC as subrogee of insured depositors have been satisfied.⁹ If a foreign branch deposit of a U.S. bank were expressly payable at an office of the bank in the United States, however, that deposit would be treated equally with uninsured domestic deposits in the depositor preference regime.

Foreign Branch Deposits of U.S. Banks

Many U.S. banks currently operate through branches in foreign countries, often to provide banking, foreign currency and payment services to multinational corporations. Foreign

⁵ 12 U.S.C. 1821(d)(11).

⁶ Secured creditors’ claims are satisfied to the extent of their security.

⁷ See FDIC Advisory Opinion 94-1, Letter of Acting General Counsel Douglas H. Jones (Feb. 28, 1994).

⁸ Section 3(l) was later amended to specify that an obligation carried on the books and records of a foreign office of a U.S. bank would not be a “deposit” for any purpose unless it were payable at an office located in the United States and the contract evidencing the obligation expressly provided for such payment and met other criteria. Riegle Community Development and Regulatory Improvement Act, Pub. L. No. 103-325 (1994), section 326(b)(2).

⁹ While section 41 of the FDI Act, 12 U.S.C. 1831r, generally prohibits the FDIC in its corporate capacity and other agencies from making any payment that would satisfy any claim against a bank for foreign branch deposits, the FDIC as *receiver* of a failed bank may make payments from the receivership estate to satisfy such claims.

branch deposits have doubled since 2001 and total approximately \$1 trillion today. In many cases, these branches do not engage in retail deposit taking or other retail banking services. Often, their typical depositors are large businesses that choose to bank in a foreign branch of a U.S. bank under deposit agreements governed by non-U.S. law to take advantage 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.

Currently, the overwhelming majority of the foreign branch deposits of U.S. banks are payable only outside the United States. In the past, making deposits in foreign branches dually payable would have been costly to U.S. banks for several reasons. Recent events, however, have reduced the cost of making foreign deposits dually payable. For example, a U.S. bank's use of dual payability would no longer increase a bank's assessment base or deposit insurance assessment. In addition, the Federal Reserve now pays interest on reserves and allows more flexibility with respect to the reserves it requires.

The U.K. FSA Consultation Paper

In September 2012, the U.K. PRA 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 U.S. banks, from operating deposit-taking branches in the United Kingdom unless U.K. depositors in those branches would be on an equal footing in the national depositor preference regime with domestic (uninsured) depositors in a failure resolution of the bank. A significant percentage of foreign branch deposits of U.S. banks are located in the United Kingdom and would be subject to this requirement.

The Consultation Paper proposes several options to ensure that depositors in U.K. branches would be treated equally in the event of a multinational bank's resolution. U.S. banks with branches in the United Kingdom could comply in one of these ways. First, the U.S. bank could accept deposits in the United Kingdom using a U.K.-incorporated subsidiary. Second, U.S. banks could create a trust arrangement to segregate assets of the U.K. branch to meet its deposit liabilities, under which the trust would specify the U.K. branch depositors as beneficiaries of the trust. Third, U.S. banks could take other actions to comply, such as making their U.K. deposits payable both in the United States and in the United Kingdom. The Consultation Paper indicates that dual payability should allow U.K. depositors to participate in the preference given to home country (that is, United States) depositors in the resolution of a U.S. bank. The U.K. PRA is still considering comments on the Consultation Paper and has not provided a date by which the requirements proposed in the Consultation Paper will be implemented.

Notice of Proposed Rulemaking

In light of the U.K. PRA's proposal and subsequent action required of U.S. banks with branches in the United Kingdom, the FDIC proposed to amend its deposit insurance regulations with respect to deposits payable in branches of U.S. banks located outside the United States. On February 12, 2013, the Board adopted the Proposed Rule. On February 19, 2013, the FDIC

published in the Federal Register and solicited public comment on the Proposed Rule.¹⁰ The Proposed Rule proposed to amend the FDIC's deposit insurance regulations to clarify that deposits in foreign branches of U.S. banks are not FDIC-insured deposits.

SUMMARY OF COMMENTS IN RESPONSE TO PROPOSED RULE:

The comment period for the Proposed Rule ended on April 22, 2013. The FDIC received comments from three industry groups and two individuals in response to the Proposed Rule.

Overall, commenters were not opposed to the concept that foreign branch deposits are not insured, as clarified in the Proposed Rule. Commenters did not object to the Proposed Rule itself, but instead raised several issues related to costs and risks they assert would result if U.S. banks employed dual payability to satisfy the U.K. PRA requirement to treat uninsured domestic deposits and foreign branch deposits equally. These commenters advocated an alternative approach, which they believe would better address their concerns. Ultimately, staff believes that the commenters' proposed alternative approach is inconsistent with the FDI Act, as explained in section III of the preamble to the Final Rule.

The FDIC specifically sought comment on whether it should consider another option that would not preclude deposit insurance for dually payable deposits, if enumerated conditions designed to protect the DIF and facilitate deposit insurance determinations were satisfied. The FDIC did not receive any comments addressing this alternative.

The FDIC also requested comment on the Proposed Rule's effect on deposits at Overseas Military Banking Facilities located on Department of Defense installations or similar facilities or programs authorized under Federal statute. The FDIC did not receive any comments in response to this request.

The FDIC received an inquiry on the potential impact of the Proposed Rule on a former member of the Trust Territory of the Pacific Islands, which is addressed in the preamble to the Final Rule.

SUMMARY OF FINAL RULE:

The Final Rule would clarify that foreign branch deposits are not insured deposits for purposes of the FDI Act, regardless of the location at which the deposit is payable. The Final Rule largely adopts the text of the Proposed Rule, with minor technical changes.

The Final Rule would amend the deposit insurance regulations, 12 C.F.R. Part 330, section 330.3(e), as they relate to deposits payable outside of the United States. The Final Rule would state explicitly that an obligation of an IDI that is carried on the books and records of a foreign branch of a U.S. bank shall not be an insured deposit for the purposes of the deposit insurance regulations, even if the obligation is also payable at an office within the United States.

¹⁰ 78 Fed. Reg. 11,604 (February 19, 2013).

The Final Rule would not affect the ability of a U.S. bank to make a foreign deposit dually payable. 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 uninsured deposits.

The Final Rule would clarify that it does not 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. Deposits placed at these facilities overseas would not be affected by the Final Rule and would continue to receive FDIC deposit insurance, as is currently the case, if they meet the definition of "deposit" under section 3(*l*) of the FDI Act.¹¹

CONCLUSION:

For the reasons discussed above, staff recommends that the Board approve and authorize publication in the Federal Register of the attached Final Rule.

Staff Contacts: Roberta K. McInerney, Legal, 8-3830
 Ruth R. Amberg, Legal, 8-3736
 F. Angus Tarpley III, Legal, 8-6646
 Matthew Green, DIR, 8-3670

¹¹ 12 U.S.C. 1813(*l*). See FDIC Advisory Opinion 96-6, Letter of Assistant General Counsel Alan J. Kaplan (Mar. 5, 1996).