June 21, 2016

MEMORANDUM TO: Board of Directors

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

SUBJECT: **Notice of Proposed Rulemaking: 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**

Recommendation: Staff recommends that the FDIC Board of Directors ("Board") authorize for publication in the *Federal Register* the attached Notice of Proposed Rulemaking titled: *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* ("NPR" or "proposed rule") for a 60-day comment period. The proposed rule would amend subparts A and B of the FDIC's international banking regulations in 12 CFR part 347 ("Part 347"). The proposed 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 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 proposed 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

Concurrence:

Charles Yi
General Counsel

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 proposed rule would also apply this revised investment grade standard to each type of pledgeable asset held by a foreign bank that operates an FDIC-insured branch, establish a liquidity standard for such assets, and subject each category of pledgeable asset to a fair value discount. The proposed rule would also add two asset categories to the list of assets that foreign banks may use for pledging.

Background

Section 939A[1] requires each relevant 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 as identified by this review to remove references to or requirements of reliance on credit ratings, and to substitute appropriate standards of creditworthiness.

Subpart A of Part 347[2] addresses the international banking and investment activities of insured state nonmember banks that operate foreign branches. There are currently nine state nonmember banks operating 16 foreign branches in seven countries. In general, Part 347 implements the FDIC's statutory authority under section 18(d)(2) of the FDI Act[3] regarding branches of insured state nonmember banks in foreign countries, and section 18(*l*) of the FDI Act[4] regarding insured state nonmember bank investments in foreign entities.[5] Under subpart A,

---

[1] Pub. L. 111-203, 124 Stat. 1376, 1887 (July 21, 2010).

[2] 12 CFR § 347.101, *et seq.*

[3] 12 U.S.C. § 1828(d)(2).

[4] 12 U.S.C. § 1828(*l*).

a foreign branch of a state nonmember bank may invest in, underwrite, distribute and deal, or trade certain foreign government obligations that are rated as "investment grade," up to an aggregate limit of ten percent of the bank's Tier 1 capital.[6] Investment grade is 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.[7]

Subpart B of Part 347 implements provisions of the FDI Act and the International Banking Act ("IBA")[8] concerning insured and noninsured U.S. branches of foreign banks. There 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).[9] 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.[10] 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

---

[5] 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.

[6] 12 CFR § 347.115(b).

[7] 12 CFR § 347.102(o).

[8] 12 U.S.C. § 3101 *et seq.*

[9] 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).

[10] 12 U.S.C. § 1815(c).

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 currently pledge for the benefit of the FDIC. These assets 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)[11];
- 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).

Overview of Proposed Rule

Subpart A Revisions

The proposed rule would amend the definition of "investment grade" in subpart A of Part 347 by deleting the existing definition in subpart A that references credit ratings and NRSROs. The proposed rule would redefine "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 state nonmember bank operating a foreign branch determines that the obligor presents low default risk and is expected to make timely payments of principal and interest. The revisions to the regulatory definition of

[11] P-1 and P-2 are Moody's top two ratings bands for short-term obligations.

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 proposed definition of investment grade in subpart A of Part 347 is 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").[12] 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[13] and the credit quality standards regarding permissible investments for national banks adopted by the OCC under 12 CFR Parts 1, 16, and 160.[14] In addition, it is also 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.[15]

Subpart B Revisions

The proposed rule would add 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 proposed rule would replace the references to credit ratings issued by NRSROs with the same alternative investment grade

---

[12] *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).

[13] *See* 77 FR 43151 (July 24, 2012).

[14] *See* 77 FR 35253 (June 13, 2012).

[15] *Id.*

standard that is proposed for subpart A. This standard would apply to all of the asset types enumerated in subpart B's asset pledge provisions. In addition, the proposed rule would require 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 embodies a standard for protection of the DIF from the pledged assets that goes beyond that of simply being investment grade. 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 proposed rule, all pledgeable assets would have to be "investment grade." The proposed rule would add to subpart B of Part 347 a definition of "investment grade" that is identical to the definition of "investment grade" proposed for subpart A. The proposed rule would also require all pledgeable assets to be "highly liquid," which would be defined as securities that: (a) exhibit low credit and market risk; (b) are traded in an active secondary market; and (c) are the types of assets that investors have historically purchased in periods of financial markets distress.[16] 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.[17]

---

[16] The definition of a highly liquid asset is consistent with the definition established in 12 CFR Part 252 subpart O, Enhanced Prudential Standards for Foreign Banking Organizations.

[17] This proposed method for discounting fair values is consistent with the haircuts applied to financial collateral pledged to certain transactions under the Basel III capital rules as adopted by the FDIC.

The proposed rule would require that all assets pledged under subpart B be investment grade, highly liquid, and subject to a fair value haircut. However, the proposed rule recognizes that certain types of assets, such as U.S. government obligations, are categorically investment grade and highly liquid, and therefore 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 proposed rule would introduce cash as a new asset type that foreign banks may pledge under subpart B and create a separate asset category expressly for debt securities issued by government sponsored enterprises.[18]

The proposed rule would also add to subpart B a definition of "agency" consistent with the IBA and make other modifications concerning certain pledged assets issued by a branch or agency of a foreign bank. The revisions would make clear that when an insured branch of a foreign bank pledges CDs, banker's acceptances, or notes issued by a branch or agency of a 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.

Lastly, the proposed rule would further update 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."[19] The maturity date for any non-negotiable CD that was grandfathered

---

[18] 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.

[19] 12 CFR § 347.209(d)(1)(ii).

under this provision has passed. Consequently, the provision by its terms no longer serves a useful purpose and is obsolete.

Conclusion:

Staff recommends that the Board approve publication of the attached NPR in the *Federal Register* for a 60-day comment period.

Staff Contacts:

Bobby Bean, ext. 86705
Eric Reither, ext. 83707
Lanu Duffy, ext. 86625
Catherine Topping, ext. 83975
Benjamin Klein, ext. 87027