FDIC Proposal on Foreign Branch Deposits: Dual Payability, Depositor Preference and Deposit Insurance

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The FDIC has proposed a new regulation that would construe the statutory term "insured deposit" to exclude ***all*** deposits maintained by a foreign branch of a U.S. bank, even if they are expressly payable at both the foreign branch and one of the bank's U.S. offices ("**dually payable deposits**").[1] At the same time, in its release accompanying the proposed rule, the FDIC cited an uncodified 1994 advisory opinion by the then Acting General Counsel of the FDIC (the "**1994 Advisory Opinion**") for the proposition that the term "deposit liability," as used in the depositor preference regime in Section 11(d)(11) of the Federal Deposit Insurance Act ("**FDI Act**"), only includes a foreign branch deposit if it is a dually payable deposit.[2]

The FDIC described its proposed interpretation as one of several alternative ways of ensuring that the FDIC would not become insurer to the world, while leaving U.S. banks to address concerns expressed by the UK Financial Services Authority ("**UK FSA**") about the U.S. depositor preference regime.[3] At the same time, if the FDIC's reference to the 1994 Advisory Opinion means that the FDIC is now adopting the view expressed in that previously uncodified advisory opinion, the FDIC's approach would mean that in a U.S. bank resolution proceeding a foreign branch deposit that is payable solely at a foreign branch would be subordinate to:

- a domestic branch deposit that is payable at the domestic branch;
- the FDIC's claim as subrogee on any insured deposits; and
- a foreign branch deposit that is a dually payable deposit.

Implications for U.S. Banks: The approach chosen by the FDIC could force U.S. banks to make their foreign branch deposits dually payable in order to avoid the subordination of such deposits to domestic branch deposits in a resolution proceeding and thereby address concerns of foreign regulators such as the UK FSA. Making foreign branch deposits dually payable would expose U.S. banks to greater U.S. reserve requirements, foreign sovereign risk, foreign customer confusion, documentation costs and potentially new foreign regulatory requirements.

To the extent the FDIC's chosen approach would adopt the 1994 Advisory Opinion and place pressure on U.S. banks to amend their foreign branch deposits in a way that exposes them to these additional risks and costs, it would appear to conflict with two public policy choices made by other organs of the U.S. government. First, it would appear to undermine the very deliberate public policy choice made by Congress to protect the U.S. banking system against foreign sovereign risk when it enacted Section 25C

[1] FDIC, *Notice of Proposed Rulemaking on Definition of Insured Deposit* (Feb. 2013), available **here**. *See also* FDIC Staff Memorandum to FDIC Board of Directors (Feb. 2013), available **here**.

[2] FDIC, *Notice of Proposed Rulemaking on Definition of Insured Deposit*, 10-11 (discussing FDIC Advisory Opinion 94-1, Letter of Acting General Counsel Douglas H. Jones (Feb. 28, 1994), available **here**).

[3] UK FSA, *Addressing the Implications of Non-EEA National Depositor Preference Regimes* (Sep. 2012), available **here**.

of the Federal Reserve Act.[4] Second, it seems to be inconsistent with one of the international standards established by the Financial Stability Board ("**FSB**") in its October 2011 document, *Key Attributes of Effective Resolution Regimes ("**Key Attributes**")*,[5] which the U.S. Secretary of the Treasury appears to have endorsed on behalf of the United States by joining a declaration made by the Group of 20 ("**G20**").[6]

Alternative Approach that the FDIC Should Adopt: We believe that there is an alternative approach that the FDIC should take that will: (1) adequately address the risk of the FDIC becoming the insurer of the world; (2) avoid the above-mentioned adverse consequences for U.S. banks; and (3) help U.S. banks address concerns about the U.S. depositor preference regime expressed by the FSB and the UK FSA.

This alternative approach would be for the FDIC to confirm that the term "deposit liability," as used in Section 11(d)(11), includes both domestic and foreign branch deposits, whether or not they are dually payable deposits. Davis Polk and two other law firms have submitted a joint memorandum to the FDIC explaining why this interpretation is consistent with, if not compelled by, the plain language and legislative history of Section 11(d)(11) and the rest of the FDI Act, and why the 1994 Advisory Opinion is not consistent with either the statutory text or legislative history.[7] The joint memorandum is available **here**.

Comments on the FDIC's proposal are due 60 days after publication in the Federal Register, which is expected shortly.

Impetus for the FDIC Proposal: The FSB's Key Attributes Document and the UK FSA's Consultation Paper on Depositor Preference

The FDIC's proposal is a direct response to the UK FSA's September 2012 consultation paper, which expressed concerns about the claims of UK depositors being subordinated to those of home country depositors under certain depositor preference regimes outside the European Economic Area ("**EEA**"). The consultation paper proposes to prohibit non-EEA banks, including U.S. banks, from accepting deposits in their UK branches *unless* the claims of UK depositors rank *pari passu* with the claims of home country depositors in a resolution proceeding of the bank.

According to the consultation paper, U.S. banks can address the UK FSA's concerns about depositor preference by, among other things: (1) making UK branch deposits dually payable; (2) ring-fencing certain UK assets through a trust arrangement for the benefit of UK depositors; or (3) accepting deposits through a UK-incorporated subsidiary rather than a UK branch.

The FDIC's proposal is also an indirect response to Paragraph 7.4 of the FSB's *Key Attributes*. Paragraph 7.4 of the *Key Attributes* provides that "[n]ational laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim, ***or the jurisdiction where it is payable***."[8] The G20 endorsed the FSB's *Key Attributes* without any reservation for Paragraph 7.4.[9]

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[4] Section 25C provides that a U.S. bank is not required to repay a foreign branch deposit if the "[foreign] branch cannot repay the deposit due to – (1) an act of war, insurrection, or civil strife; or (2) an act by a foreign government or instrumentality (whether de jure or de facto) in the country in which the [foreign] branch is located, unless the [U.S.] bank has expressly agreed in writing to repay the deposit under those circumstances." 12 U.S.C. 633. *See also* 12 U.S.C. 1828(q) ("Section 25C of the Federal Reserve Act shall apply to every nonmember insured bank in the same manner and to the same extent as if the nonmember insured bank were a member bank.").

[5] FSB, *Key Attributes of Effective Resolution Regimes* (Oct. 2011), available **here**.

[6] G20, *Cannes Summit Final Declaration* (Nov. 4, 2011) ¶ 28 ("we endorse the FSB comprehensive policy framework, comprising a new international standard for resolution regimes. . . ."), available **here**.

[7] Cleary Gottlieb Steen & Hamilton LLP, Davis Polk & Wardwell LLP and Sullivan & Cromwell LLP, *Memorandum on the Status of Foreign Branch Deposits Under the Depositor Preference Rule* (Jan. 2, 2013), available **here**.

[8] FSB, *Key Attributes of Effective Resolution Regimes* (Oct. 2011) ¶ 7.4 (emphasis added).

Since the U.S. Secretary of the Treasury joined the G20's declaration on behalf of the United States, the U.S. government has effectively endorsed Paragraph 7.4 of the *Key Attributes*.

If the FDIC proposal's reference to the 1994 Advisory Opinion means that the FDIC is now adopting the view expressed therein that foreign branch deposits payable solely at a foreign office are subordinated to domestic branch deposits in a U.S. bank resolution proceeding, then the FDIC's proposal is inconsistent with the policy choice made by the U.S. Secretary of the Treasury when joining the G20 statement endorsing the *Key Attributes*, including Paragraph 7.4.

Dually Payable Deposits and Deposit Insurance

The FDIC's proposal aims to limit the U.S. Deposit Insurance Fund's exposures if U.S. banks choose to make their foreign branch deposits dually payable to comply with the requirements in the UK FSA's consultation paper. Specifically, the proposal would amend the FDIC's regulations on deposit insurance coverage to provide that deposits maintained on the books and records of foreign branches of U.S. banks, including dually payable deposits, are ***not*** insured by the FDIC.[10] The FDIC believes such an amendment is necessary because the FDI Act and existing FDIC regulations only exclude foreign branch deposits that are payable *solely* outside the U.S. from the general definition of the term "deposit,"[11] but do not expressly address whether dually payable foreign branch deposits are "insured deposits."[12]

Dually Payable Deposits and Depositor Preference

In the United States, the depositor preference provisions in Section 11(d)(11) of the FDI Act provide that "any deposit liability of the institution" has priority over "any other general or senior liability of the institution" in a U.S. bank resolution proceeding.[13]

"Deposit liability" is not defined in the FDI Act. However, the 1994 Advisory Opinion asserted that the term "deposit liability," like the term "deposit," should exclude a foreign branch deposit that is payable *solely* outside the U.S.[14] Referring to the 1994 Advisory Opinion, the preamble to the FDIC's proposal – but not the proposed rule text – noted that a *dually* payable deposit is a "deposit liability" for purposes of the FDI Act's depositor preference provisions and therefore ranks *pari passu* with domestic deposits, but that a foreign branch deposit payable solely outside the U.S. would be subordinated to domestic branch

(*cont.*)

[9] *See* G20, *Cannes Summit Final Declaration* (Nov. 4, 2011) ¶ 28.

[10] The FDIC states that its proposal is not intended to affect deposits in overseas military banking facilities governed by regulations of the Department of Defense. According to the FDIC, "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)."

[11] Section 3(*l*)(5) of the FDI Act, 12 U.S.C. § 1813(*l*)(5) ("The term 'deposit' means . . . . (5) such other obligations of a bank or savings association as the Board of Directors, after consultation with the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System, shall find and prescribe by regulation to be deposit liabilities by general usage, except that the following shall not be a deposit for any of the purposes of this Act 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--
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> > (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 . . . .").

[12] Section 3(m) of the FDI Act, 12 U.S.C. § 1813(m).

[13] 12 U.S.C. § 1821(d)(11).

[14] *See* FDIC Advisory Opinion 94-1, Letter of Acting General Counsel Douglas H. Jones (Feb. 28, 1994), available **here**.

deposits, the FDIC's claim as subrogee on insured deposits and foreign branch deposits that are dually payable deposits.

Implications of Making Foreign Branch Deposits Dually Payable

Currently, the overwhelming majority of deposits in foreign branches of U.S. banks are payable solely outside the U.S. As the FDIC itself acknowledges, making foreign branch deposits dually payable has significant implications for U.S. banks, some of which are outlined below. While the UK is the first major jurisdiction to require U.S. banks to take steps to address depositor preference issues, other jurisdictions may follow suit.

- **Reserve Requirements:** The exemption from U.S. reserve requirements for "deposits payable *only* outside the States of the United States and the District of Columbia"[15] is *not* available for dually payable deposits. Currently, the reserve requirement for a U.S. bank's net transaction accounts[16] in excess of the low-reserve tranche is 10 percent.[17] The low-reserve tranche is currently set at $79.5 million and is adjusted every year.
- **Foreign Sovereign Risk:** Making deposits dually payable could cause U.S. banks to lose the protection from foreign sovereign risk provided by Section 25C of the Federal Reserve Act. Section 25C provides that a U.S. bank shall not be required to repay any deposit made at a foreign branch of the bank if the branch cannot repay the deposit due to an act of war, insurrection, civil strife or an action by a foreign government in the country in which the branch is located "*unless* the [U.S.] bank has expressly agreed in writing to repay the deposit under those circumstances."[18]
- **Amending Deposit Agreements:** For U.S. banks that have a significant number of foreign branch deposit accounts, the process of negotiating amendments to deposit agreements with customers and persuading foreign regulators that it has been done properly can be very time consuming and burdensome.

A Preferable Alternative: Confirming that the Term "Deposit Liability" Includes Foreign Branch Deposits

The FDIC seeks comments on all aspects of its proposal, including whether other alternatives would accomplish the goals of the proposal in a more effective manner.

In January 2013, Davis Polk and two other law firms submitted a joint memorandum to the FDIC regarding the status of foreign branch deposits under the U.S. depositor preference regime. The joint memorandum, available **here**, concludes that the term "deposit liability" in the FDI Act's depositor preference provisions includes all domestic deposits as well as *all* foreign branch deposits, including those that are payable solely outside the U.S. Under this approach, foreign branch deposits that are payable solely outside the U.S. would remain uninsured for purposes of FDIC deposit insurance. The joint memorandum sets forth in detail the legal and policy reasons for its conclusion.

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[15] Section 19(b)(6) of the Federal Reserve Act, 12 U.S.C. § 461(b)(6) (emphasis added). *See also* 12 C.F.R. § 204.1(c)(5).

[16] Since December 27, 1990, nonpersonal time deposits and eurocurrency liabilities have been assigned a 0 percent reserve requirement.

[17] 12 C.F.R. § 204.4.

[18] 12 U.S.C. 633 (emphasis added). *See also* 12 U.S.C. 1828(q). The preamble to the FDIC's proposal notes that "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."

By adopting the interpretation recommended in the joint memorandum, the FDIC would address foreign regulators' concerns about the subordination of foreign branch deposits to domestic deposits without increasing the financial exposure of the Deposit Insurance Fund – because U.S. banks would have no incentive, and many disincentives, to make their foreign branch deposits dually payable.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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