

FDIC Proposal on Insured Deposits: Depositor Preference, Foreign Deposits and Concerns Over Becoming “Insurer to the World”

On February 12, 2013, the Federal Deposit Insurance Corporation (the “FDIC”) approved a Notice of Proposed Rulemaking (the “Proposed Rule”)¹ that would revise its deposit insurance regulations to provide that deposits held on the books and records of a foreign branch of a U.S. insured depository institution (“IDI”) and that are payable both in the United States and abroad are not insured deposits. Previously, the consensus view had been that such “dually payable” deposits would be insured. Although not addressed in the proposed regulatory text, the FDIC’s preamble to the Proposed Rule makes clear that such “dually payable” deposits would be afforded the benefit of “depositor preference” as a “deposit liability” in the liquidation of an IDI.

While the Proposed Rule addresses only the definition of “insured deposit” under the Federal Deposit Insurance Act (“FDIA”), it is a direct response to a recent Consultation Paper by the U.K. Financial Services Authority (the “FSA”)² which focuses exclusively on depositor preference. The Proposed Rule, in effect, responds to two separate but related issues.

The FSA Consultation Paper, released in September 2012, proposes to require non-U.K. banks with branches in the U.K. to accept deposits using a U.K.-incorporated subsidiary or implement an alternative arrangement that eliminates any subordination of U.K. depositors in liquidation of the bank. This has long been an issue of contention under the U.S. depositor preference framework in bank receiverships because a 1994 FDIC Advisory Opinion had opined that deposits payable in a foreign branch of a U.S. bank were subordinated to U.S. domestic deposits. One alternative arrangement to eliminate this potential subordination is to make the foreign branch deposits payable in the U.S. as well as in the U.K. This prospect, however, has created concern at the FDIC.

¹ 78 Fed. Reg. 11604 (Feb. 19, 2013). Other documents related to the Proposed Rule can be found at www.fdic.gov/news/news/press/2013/pr13009.html.

² U.K. FSA Consultation Paper, Addressing the implications of non-EEA national depositor preference regimes (September 2012) available at <http://www.fsa.gov.uk/static/pubs/cp/cp12-23.pdf>.

The second issue is that under current U.S. law and related FDIC interpretations, such dually payable deposits would not only have priority over general creditors in the liquidation of an IDI, but also become FDIC-insured. The Proposed Rule is therefore an attempt by the FDIC to avoid the perceived strain on the Deposit Insurance Fund (the “DIF”) that could accompany the expansion of deposit insurance to these accounts in the United Kingdom – and potentially to deposits in other jurisdictions.

Below we address the Proposed Rule’s limitation on the scope of deposit insurance for foreign deposits, the factors driving the FDIC’s decision to release this proposal, and potential alternatives to the FDIC’s current approach.

The Proposed Rule

Pursuant to Section 3(l)(5)(A) of the FDIA,³ deposits at foreign branches of U.S. banks are excluded from the definition of “deposit”, unless they are also payable at a branch in the United States. Because such obligations are not considered “deposits”, they are also not “insured deposits” under Section 3(m) of the FDIA⁴ and are not eligible for FDIC deposit insurance.

Section 11(d)(11) of the FDIA⁵ sets forth the national depositor preference framework for priority of creditors in the liquidation of a failed IDI. Pursuant to that section, general unsecured creditor claims are subordinated to any “deposit liability” of the IDI. The 1994 Advisory Opinion by then-Acting FDIC General Counsel Douglas Jones⁶ declared the meaning of the term “deposit liability” to be coterminous with the definition of “deposit” in Section 3(l) of the FDIA. Pursuant to this Advisory Opinion, obligations payable solely at a foreign branch of a U.S. bank are deemed to be excluded from the term “deposit liability” for purposes of national depositor preference and instead rank *pari passu* with general creditors in the liquidation of an IDI.

However, if deposits at foreign branches of U.S. banks are made dually payable at an office of a bank in the United States, “by express terms [in the deposit contract], and not by implication,” they would fall within the definition of “deposit” under Section 3(l)(5)(A). IDIs with foreign branches are permitted to enter into such dually payable contracts without requiring approval of the FDIC. Based on the consensus reading of the FDIA, such deposits would therefore be “insured deposits” under Section 3(m)(1) of the FDIA, which extends

³ 12 U.S.C. § 1813(l)(5)(A).

⁴ 12 U.S.C. § 1813(m).

⁵ 12 U.S.C. § 1821(d)(11).

⁶ FDIC Advisory Opinion, “Deposit Liability” for Purposes of National Depositor Preference Includes Only Deposits Payable in U.S., FDIC 94-1 (February 28, 1994).

FDIC insurance to “deposits” in an IDI. Based on the FDIC’s 1994 Advisory Opinion, such dually payable deposits would also simultaneously be granted the higher priority accorded to deposits in the U.S. national depositor preference regime.

In the Proposed Rule, the FDIC recognized that, in addition to the definition of “insured deposits”, Section 11(a)(1)(A) of the FDIA requires the FDIC to “insure the deposits” of all IDIs. However, the FDIC declared that Section 11(a)(1)(A) “does not expressly address foreign deposits.” Invoking its authority to promulgate regulations under the FDIA,⁷ the FDIC would clarify that dually payable foreign deposits would continue to benefit from depositor preference, but would not be insured by the FDIC. Specifically, the FDIC would amend Sections 330.1(i) and 330.3(e) of its regulations⁸ to state that any “obligation of an [IDI] which is carried on the books and records of an office of such institution located outside the States of the United States . . . shall not be an insured deposit . . . , notwithstanding that it may also be payable at an office of such institution located within a State”⁹

Rationale

Although the potential for banks to offer dual payability (and, therefore, depositor preference and deposit insurance) to foreign branch depositors has existed since at least 1994, the FDIC has acted now in response to a perceived “threat” to the DIF that has been “aggravated” by several developments since 1994.

The primary driver of the FDIC’s Proposed Rule was the U.K. FSA Consultation paper. The FDIC’s alarm over a potential increase in dually payable deposits was heightened by its observation that dual payability has become less costly to banks over time. For example, due to changes to the calculation of the insurance assessment base pursuant to Section 331(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, dual payability would no longer increase a bank’s deposit insurance assessment. Furthermore,

⁷ Specifically, the FDIC cites FDIA Section 11(d)(4)(B)(iv), 12 U.S.C. § 1821(d)(4)(B)(iv), which authorizes the FDIC to promulgate “such regulations as may be necessary to assure that the requirements of this section [FDI Act section 11, 12 U.S.C. § 1821, which addresses, in section 11(f), 12 U.S.C. § 1821(f), the payment of deposit insurance] can be implemented with respect to each insured depository institution in the event of its insolvency”, as well as FDIA Section 9(a)(Tenth), 12 U.S.C. § 1819(a)(Tenth) (authorizing the FDIC Board to prescribe “such rules and regulations *as it may deem necessary* to carry out the provisions of this chapter”) and FDIA Section 10(g), 12 U.S.C. § 1820(g) (authority to “prescribe regulations” and “*to define terms* as necessary to carry out” the FDIA) (emphasis added).

⁸ 12 C.F.R. §§ 330.1(i) and 330.3(e).

⁹ The FDIC explains that the Proposed Rule is not intended to 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. Such facilities are established to benefit specific American customers, including U.S. military personnel, Department of Defense United States civilian employees, and American employees of other U.S. government departments stationed abroad.

although dually payable deposits are subject to reserve requirements under Regulation D promulgated by the Board of Governors of the Federal Reserve System (the “Federal Reserve”),¹⁰ the Federal Reserve now pays interest on reserves and the requirement is therefore less burdensome than it may have been in the past. Furthermore, the FDIC noted that U.S. deposit insurance may be attractive to foreign depositors because of higher deposit insurance limits offered by the DIF in contrast to those offered by foreign deposit insurance schemes.

Based on these observations, the FDIC concluded that the DIF faced the “threat” of “potential liability that could be global in scope, a risk that could extend to the United States which backs the DIF with full faith and credit.” Determined to act “expeditiously” and “decisive[ly]”, the FDIC released the Proposed Rule to prevent the operational complications¹¹ and DIF exposure that would accompany the potential extension of insurance to foreign deposits. In the FDIC Board meeting approving the Proposed Rule, staff members indicated that they had discussed the Proposed Rule with the U.K. FSA and expressed confidence that banks that create dually payable deposits would satisfy the U.K. FSA Consultation Paper requirement that depositors in the U.K. be treated *pari passu* with depositors in U.S. branches in a liquidation of an IDI, while not subjecting the FDIC to “liability to depositors throughout the world.”

Though the FDIC’s desire to avoid being the insurer to the world is understandable, the FDIC may have overestimated the desirability and advantages of dual payability for U.S. banks. While the FDIC perceives banks to be moving quickly toward dual payability, banks have indicated in talks with regulators and in a comment letter to the FSA that they would only institute dual payability if another solution was not available.¹² There is little question that banks would have supported an alternative interpretation that would have obviated the need to adopt dual payability in order to provide foreign deposits with depositor preference¹³

¹⁰ 12 C.F.R. Part 204.

¹¹ The FDIC seemed to place excessive weight on a procedural requirement to pay out deposit insurance “as soon as possible” under Section 11(f)(1) of the FDIA. The FDIC was concerned that difficulties in accessing information about foreign deposits and differences in jurisdictional law and practice would “threaten[] the ability to make timely payment.” The FDIC did not explore alternatives to address these procedural issues, nor did the Proposed Rule analyze the meaning of “as soon as possible” in the context of foreign deposits. Instead, the FDIC concluded that any potential delay “would undermine . . . confidence” in the deposit insurance system.

¹² See Joe Adler, “FDIC Looks to Head Off Costly U.S.-U.K. Tension Over Deposits,” *American Banker*, Feb. 8, 2013 (“Am. Bkr. Feb. 8 Article”) (quoting senior counsel at the American Bankers Association as saying that “Dual pay is ‘the best worst option.’ . . . Both subsidiarization or dual pay would place all of the burden and cost of fixing this international regulatory issue on the industry.”).

¹³ Indeed, the FDIC even acknowledged that, notwithstanding the ability of banks to make foreign deposits dually payable since at least 1994, “[c]urrently the overwhelming majority of the deposits in these foreign branches of United States banks are payable only outside the United States” and “[h]istorically, the great majority of deposit agreements governing relationships between United States banks and their foreign branch depositors have not expressly provided for payment

– such as an interpretation (described further below) that would include a “foreign deposit” as a “deposit liability” under the depositor preference statute while not requiring that it be an “insured deposit”. In addition, the FDIC recognized that banks expressed concern about the possibility of having to take on sovereign risk (such as through nationalization, exchange controls, etc.) by allowing depositors to claim at an office in the United States.¹⁴ The FDIC believed, however, that such risks could be allocated to customers via contract. All of the banks concerns about operational complications, customer disruption and sovereign risk could be exacerbated if nations beyond the U.K. seek similar remedies for their home country depositors.

Potential Alternatives

The Proposed Rule stated that the FDIC explored alternatives for addressing the issues triggered by the U.K. FSA Consultation Paper. In particular, the FDIC noted that it contemplated reconsideration of the 1994 Advisory Opinion that equated “deposit liability” under national depositor preference with the definition of “deposit” used elsewhere in the FDIA, although the Proposed Rule does not expand upon this statement.

Cleary Gottlieb participated with two other law firms in advocating an interpretation of the term “deposit liability” in the depositor preference statute to include foreign deposits payable solely outside the United States. Such an interpretation would offer foreign deposits priority under national depositor preference on par with U.S. domestic deposits, while not including such “deposit liabilities” in the term “deposit” and therefore not extending FDIC insurance to such foreign deposits. Such an interpretation would also not require banks to change their customer relationships to create dual payability.¹⁵ Curing the depositor preference issue would remove the chief incentive for banks to create dually payable deposits and should allay FDIC fears of strain on the DIF, as banks will be far less likely to incur the operational and logistical costs of a transition to dual payability. This interpretation of “deposit liability” should therefore simultaneously address the concerns of the FDIC and the FSA and avoid the disadvantages of dual payability for banks. In sum, this approach should be a better alternative, and we would hope that the FDIC continues to consider the benefits and directness of such approach.

of foreign branch deposits at an office in the United States,” thus evidencing a lack of incentives for banks to choose dual payability for their customers.

¹⁴ See Section 25(c) of the Federal Reserve Act, 12 U.S.C. § 633 (providing that a bank is not required to repay a foreign branch deposit if unable to do so due to “war, insurrection, or civil strife” or foreign government actions, unless the bank has explicitly agreed in writing to repay deposits in the foreign branch in such circumstances).

¹⁵ See Am. Bkr. Feb. 8 Article; Joe Adler, “FDIC Floats Compromise Over U.K. Depositor Treatment,” American Banker, Feb. 13, 2013 (describing this alternative interpretation and the memorandum by the three firms). Cleary Gottlieb joined Sullivan & Cromwell LLP and Davis Polk & Wardwell LLP in the submission of such memorandum.

The FDIC did suggest certain alternatives for deposit insurance, unrelated to the depositor preference issue. Predicting that some foreign depositors may still desire access to the U.S. deposit insurance system, the FDIC also welcomed suggestions for proposals that would maintain insurance for dually payable deposits if certain conditions were met. Such conditions might include, for example, collateral pledges or the transmission of assets in favor of the FDIC to cover the amount of insurance required on an insured foreign branch deposit and to eliminate the possibility of DIF losses.

Comments on the Proposed Rule should be received by the FDIC on or prior to April 22, 2013. Large international banks are expected to comment on alternatives to, and the effectiveness of, the Proposed Rule by this deadline.

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If you have any questions about the Proposed Rule, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under “Banking and Financial Institutions” under the “Practices” section of our website at <http://www.clearygottlieb.com>.

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