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UK FSA and US FDIC Concerned Over Effects of National Depositor Preference Regimes

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UK and US bank supervisors have recently issued proposals to address the impact of US and other national depositor preference regimes on local depositors. This memorandum summarises these proposals and in particular discusses the impact on US (and other similarly placed) banks operating by way of branches in the UK.

National depositor preference regimes typically operate to prefer claims of depositors in the home country of a bank to claims of depositors of branches of the bank outside the home country. Such regimes present obstacles to the orderly and fair resolution of global financial institutions and the Financial Stability Board has called for them to be removed. Despite that, long standing national depositor preference regimes in some countries, for example, the United States, Australia, Singapore and Turkey, remain and are likely to continue. In September 2012 the UK FSA published proposals which would require banks to take steps to eliminate any subordination of UK branch depositors to home country depositors in the event of the bank's insolvency. In the US, the Federal Deposit Insurance Corporation ("FDIC"), which is responsible for liquidating insolvent insured banks, is concerned that US banks, in response to the FSA proposals, will be compelled to cause UK branch deposits to be payable also by US offices, making them "deposits" for FDIC purposes. The result would be that UK branch deposits would be treated as preferred deposits in the US and insured by the FDIC. The FDIC has issued a proposal that would prevent such UK branch deposits from being treated as "insured deposits" whilst permitting such deposits to have preferred status.

The FDIC proposal appears to provide US banks with a solution that would satisfy the FSA's proposed requirements. However, a US bank would still need to amend its terms and conditions with customers and may still be subject to notification and disclosure requirements under FSA rules. Otherwise, a bank will need either to subsidiarise its UK deposit-taking operations or ring-fence the UK branch assets effectively to eliminate the effects of any national depositor preference scheme of its home state on its UK branch depositors.

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Background

When a bank outside the EEA uses a branch to accept deposits in the UK, those deposits are effectively placed with the "parent" legal entity in the home country as the branch has no legal personality separate to that of its "parent". Currently, in the insolvency and liquidation of a US bank, US depositors would be paid in priority and preference to depositors in non-US branches. The FSA is concerned that UK branch depositors may incorrectly consider that they will have equal rights in the distribution of an insolvent bank's assets. However, they are likely only to participate in any distribution once home country depositors, insolvency administrators and secured creditors have been paid. The FSA considers the situation to be unacceptable and has proposed new rules to counter the effects of national depositor preference schemes.[1]

In the US, it has been clear for many years that deposits payable only at a non-US branch of an insured bank are not "deposits" for purposes of depositor preference in the event of a bank's liquidation. The FDIC is concerned that rules such as those proposed by the UK FSA may lead to US banks being compelled to cause their UK branch deposits to be payable by a UK and a US office (dual-office deposits), resulting in such deposits being "insured deposits" for FDIC purposes, as well as placing them on an even footing with US depositors in terms of the national depositor preference scheme. The other option is for the bank to convert its UK branch to a subsidiary. The FDIC has therefore proposed a new regulation under which a deposit at a non-US branch would be a deposit for depositor preference but not an "insured deposit" for the purposes of insurance coverage.

The FSA Proposals

Eliminating the Effects of National Depositor Preference Regimes

UK branches of non-EEA banks that are subject to national depositor preference regimes will be required to take measures to eliminate the subordination of UK branch depositors in the event the bank becomes insolvent. The principal means by which the FSA expects banks to achieve this involves subsidiarisation, which is to establish a UK incorporated subsidiary for accepting deposits from UK customers. On the insolvency of a UK incorporated subsidiary, all depositors would be subject to UK insolvency law and treated equally as unsecured creditors (unless the eligible depositor preference scheme proposed by the UK Government comes into effect, in which case the depositors would have preferred claims - see below under Effect on the UK Financial Services Compensation Scheme).

The FSA is open to banks adopting alternative measures, including employing options that are available under their home country legislative framework that would restore UK branch depositors to the same rank as home country depositors. Any bank adopting an alternative approach would need to provide a legal opinion to the FSA on how the measure would eliminate the subordination of UK branch depositors.

If no such option is available, the FSA suggests that, as an alternative to subsidiarisation, some banks might be able to ring-fence the assets of the UK branch to meet the deposit liabilities of that branch. Banks electing to take this approach would need to:

[1] The FSA proposal is available at http://www.fsa.gov.uk/library/policy/cp/2012/12-23.shtml.

- provide a legal opinion that explains how the ring-fencing eliminates the subordination of UK branch depositors and confirms that any legal challenge would not undermine the ring-fencing of assets and their intended use. Specifically, banks would need to ensure that the ring fenced assets could not be diverted for other uses or repatriated to the home country and would remain outside the bank's estate in liquidation; and
- explain the arrangement to the FSA, including which assets would be ring-fenced, the amounts involved and the strategy employed to monitor the arrangement. Banks will need to demonstrate that the ring-fenced assets are sufficiently liquid and readily capable of being used to repay the UK branch depositors.

Disclosure of the Effects of National Depositor Preference Regimes

Prior to implementation of the measures to eliminate the effects of national depositor preference regimes, the FSA proposes that a bank should be required to disclose information about the national depositor preference scheme under which it operates to all its UK depositors.

The disclosure must:

- highlight the fact that the claims of UK branch depositors will be subordinated to the claims of depositors in the home country if the bank becomes insolvent;
- refer to the risk of loss being greater for UK branch depositors compared to the depositors of the home country; and
- explain that UK branch depositors will suffer losses before home country depositors suffer any loss at all.

The FSA expects banks to discuss the proposed text with the FSA before sending the information to customers.

The disclosure would need to be included in all current and new agreements with depositor customers. Banks will need to amend existing terms and conditions. Banks taking deposits from different legal entities within a group must include the information in all agreements with each of the legal entities.

The disclosure would also need to be displayed on a bank's website, in particular on the web pages where deposit-taking services are offered by the UK branch.

Any bank which is, or has a reasonable prospect of becoming, subject to a national depositor preference regime would also have to notify the FSA that it operates under that regime. A description of the regime must be included as well as an explanation of how UK branch depositors would be treated in the event that the bank became insolvent.

Timing

The FSA proposes providing banks with a two-year transitional period to implement the necessary changes required to ensure that UK branch depositors are treated equally to home country depositors. Banks would have three months from publication of the new rules to comply with the disclosure requirements. The FSA had intended to publish final rules in January 2013 and so envisaged banks complying with the disclosure requirements by April 2013 and for the effects of national depositor preference schemes on UK branch depositors to be removed by January 2015. However, the FSA rules have yet to be finalised. It is likely that the FSA will still provide banks with some period to implement the requirements but the actual timetable remains to be seen.

From April 2013, the proposed requirements will fall under the remit of the new Prudential Regulation Authority ("PRA"), which will be the prudential supervisor of non-EEA deposit-taking banks operating in the UK.

FDIC Proposal to Create Depositor Preference without Deposit Insurance

The problem presented by the FSA proposal is the subject of an FDIC proposal issued on 19 February 2013.[2] It addresses the FDIC's concern that US banks will cause their UK branch deposits to be issued by a US office of the bank in order to obtain coverage by the depositor preference provisions of US law and to comply with the proposed FSA restrictions. The FDIC would issue a regulation that a deposit at a non-US branch may not be given insured-deposit status by making the deposit a "dual-office" deposit. Rather, a dual-office deposit would be a "deposit" for purposes of depositor preference but not an "insured deposit" for purposes of FDIC insurance coverage.

Under FDIC statutes and regulations, deposits payable solely at a non-US branch of a US insured bank are not "deposits" and therefore are not "insured deposits" under the relevant definitions. The rule follows long practice by the Federal Reserve in the coverage of deposits subject to its reserve requirements; as long ago as 1918 it ruled that deposits at non-US branches of member banks were not subject to reserve requirements. However, such deposits would be subject to reserves if payment were guaranteed by a US office. Such guarantees have been rare over the years primarily due to the cost of maintaining reserves. For FDIC purposes, until recent years an insured bank was liable for deposit insurance premium assessments based on the amount of the bank's deposits; excluding deposits at non-US branches had the effect of reducing the amounts of insured banks' premiums.

The FDIC proposal indicates its concern that major US banks will be compelled, at least in the short term, to take steps to cause their UK branch deposits to be payable also by US offices, causing them to be "deposits" for FDIC purposes. This would be the only clear way to cause UK deposits to be "deposits" for purposes of depositor preference rules because the FDIC statutory definitions use the fundamental term "deposit" for both insured-deposit status and other provisions, including depositor preference.[3] The FDIC believes that it might have a great deal of difficulty in obtaining deposit records at a non-US branch of a bank in liquidation so that it could repay depositors. The proposal does not say so, but it also appears concerned that it might not be able to obtain the assets associated with such a branch, which it would want to use in order to obtain funds to carry out the liquidation. Otherwise it would have to rely on US assets to repay both US and UK depositors. The FDIC also fears that the cost of maintaining reserves with the Federal Reserve on such deposits is much lower than in previous years, and that the reduced cost would make it more likely that banks would take this step.

Commentary

The FDIC's proposed solution is clever. It would use its general authority to establish rules in order to define a dual-office deposit to be a "deposit", but not an "insured deposit". In that way, the non-US depositor would obtain the benefit of depositor preference but would not have a claim against the FDIC for an insured deposit. In addition, the FDIC would explicitly disallow an insured bank from causing its non-US branch deposits to be FDIC-insured through the dual-office route; in other words, the option that has long been available of issuing dual-office deposits would be revoked. The FDIC asks for comment on whether it should take steps to allow banks to issue insured dual-office deposits and how the FDIC might protect itself if it did so; one example it cites is to require the bank to hold cash or other collateral in the United States to cover the full amount of such dual-office deposits.

The FDIC's statutory authority to take such a step is unclear. Arguably its proposal would effectively amend the statutory definitions. That is, the FDIC by regulation would amend the statutory definition of "deposit" by removing the exclusion for non-US branch deposits and transferring it to the definition of "insured deposit". The FDIC proposal suggests that it is filling a hole in the definition of "insured deposit" because that definition does not make clear what deposits must be FDIC insured;

[2] The proposal may be found at 78 Fed. Reg. 11604 (Feb. 19, 2013).

[3] The definitions and depositor preference provision can be found at 12 U.S.C. §§ 1815(l)(5)(A), 1815(m)(1), 1821(a) and 1821(d)(11)(A), which are provisions of the Federal Deposit Insurance Act.

however, that same definition has a carve-out from insured-deposit coverage for a specified type of employee benefit plan investment contract, and such exclusions usually support the position that additional exclusions are not to be implied.

On the other hand, the FDIC has generally broad authority to issue regulations governing deposit insurance. In addition, the only aggrieved parties would likely be non-deposit creditors in a US bank liquidation that receive a smaller amount of returns than would be the case if non-US branch depositors did not have the benefit of depositor preference, and the likelihood of such a situation arising in the near future might be remote. Note that if the FSA requires US banks relying on a final regulation adopted by the FDIC to obtain a legal opinion on the regulation's effectiveness, the issuer of the opinion would have to be comfortable doing so.

Timing

The FDIC proposal is subject to a 60-day comment period ending 22 April 2013.

Effect on UK Financial Services Compensation Scheme

The Financial Service Compensation Scheme (the "FSCS") is the UK's compensation fund for customers of authorised banks. It is an independent body which is overseen by the FSA. From 1 April 2013, the PRA and the Financial Conduct Authority ("FCA") will jointly assume responsibility for the FSCS. In the event of an insolvency of a bank, the FSCS will pay the customer the value of its deposit up to a certain limit (currently £85,000). The FSCS covers deposits in UK banks, including deposits held at UK branches or subsidiaries of foreign banks. The FSCS does not cover deposits held in overseas branches of UK banks. The FSCS is funded by contributions by banks which are covered by the fund.

The UK Government is seeking to introduce an eligible depositor preference scheme under the Financial Services (Banking Reform) Bill (the "Banking Reform Bill")[4] which was presented to Parliament on 4 February 2013. Deposits eligible for compensation under the FSCS will become preferred debts in UK insolvency proceedings. This means that, for example, where a US bank fails and its UK branch becomes subject to UK insolvency proceedings (which is not possible currently given the absence of a branch insolvency regime in the UK), the UK branch depositors would rank above unsecured creditors. The Banking Reform Bill provisions do not, however, address the issue of subordination of UK branch depositors in US insolvency proceedings. The UK Government has committed to finalising the Banking Reform Bill by May 2015. Banks would be expected to comply with its provisions by 2019.

UK branch deposits of a US bank adopting the dual-deposits model proposed by the FDIC would still be covered by the FSCS. Otherwise there would be a lacuna because such deposits would not be insured in either the US or the UK.

Impact on Non-EEA Banks

It appears that the FDIC proposal offers US banks the potential to satisfy the FSA's proposed requirements for UK branch depositors to be placed on an even footing with US depositors in the event of insolvency. However, a US bank that opts to amend its deposit-taking operations so that UK branch deposits are issued by its US bank will need to amend its terms and conditions with UK branch depositors. A US bank may still need to notify the FSA that it operates under a national depositor preference scheme as well as disclose the effects to its customers.

A bank which does not have a similar option available to it will need to consider subsidiarisation or ring-fencing measures to eradicate the effects of national depositor preference schemes on UK branch depositors. Such measures will impact banks' business models and legal structures. Many banks will have to incorporate new UK subsidiaries to carry out deposit-taking activities or move business activities from UK branches to already existing UK subsidiaries. Banks which are able to use their home country legislative framework, such as that proposed in the US notion of dual-office deposits, should be able avoid such drastic measures.

[4] The Financial Services (Banking Reform) Bill is available here.

Any planning undertaken by a bank as a result of the FSA proposals should simultaneously consider other proposals that may impact legal structuring, such as:

- the UK, European and US recovery and resolution plan (RRP) regimes under which regulators may require banks to restructure their businesses if they consider that a bank would not be able to be resolved in an orderly manner in the event of its failure;
- the EU Liikanen Report which recommends that trading activities should be carried out from separate subsidiaries;
- the Alternative Investments in Fund Managers Directive which requires AIFMs to be legally separate from other MiFID business activities;[5] and
- the proposed new EU and US regulatory capital requirements.[6]

In addition, banks should consider any current or proposed requirements in their own jurisdiction that may also influence structural choices. Challenges could arise because of the plethora of forthcoming regulatory-driven changes required, in particular due to the different timeframes for implementation of these changes. Any restructuring is likely to be a complex and expensive process and banks should keep one eye on future, as well as on their current requirements.

[5] You may wish to see our prior client publication, "AIFMD "Level 2" Published – Time to Get Moving!" dated 13 January 2013 and "European Regulation of Fund Managers: AIFM Directive Agreed and Adopted" dated 12 November 2010.

[6] You may wish to see our prior client publication, "Implementation of the Basel III Framework: Comparison of US and EU Proposals" dated 18 October 2012.

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