SHEARMAN & STERLING LLP

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY

CLIENT ALERT

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Preferring Foreign Depositors

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The Federal Deposit Insurance Corporation has issued a proposed regulation intended to address an emerging issue in international banking: how to grant non-US branch deposits equal treatment with US deposits in the event of the bank's insolvency. Below are both big-picture and technical issues that need to be addressed in order to make the proposal effective.

The proposed regulation would effectively grant deposit status at non-US branches of US insured banks to deposits booked there for purposes of the depositor preference provisions of Federal law.[1] Its purpose is to provide the benefits of depositor preference status to deposits in branches in other countries. Depositor preference simply means that, in the liquidation of the bank, deposits will be paid ahead of non-deposit unsecured creditors, thereby increasing significantly the likelihood of full or almost-full repayment. This issue has been spotlighted by the United Kingdom, which has proposed to require that UK branches of foreign banks be entitled to depositor preference under their home country insolvency rules or provide clear disclosure of its absence to their depositors. This requirement, if implemented, might create an incentive for US banks to take such steps as making their US offices liable for repayment of such deposits; these would be so-called "dual-office" deposits, in which both a US and a non-US office would be liable for repayment.

1 The proposed regulation of the Federal Deposit Insurance Corporation ("FDIC") is at 78 Fed. Reg. 11604 (Feb. 19, 2013). The depositor-preference provision of Federal law is Section 11(d)(11)(A) of the Federal Deposit Insurance Act ("FDIA"), at 12 U.S.C. § 1821(d)(11)(A). If you are interested in further discussion of the FDIC proposal and its background in relation to proposed actions in the United Kingdom, you might review our client memorandum dated 28 February 2013, "UK FSA and US FDIC Concerned Over Effects of National Depositor Preference Regimes."

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However, the FDIC does not want to be liable as the insurer of deposits for deposits payable only outside the United States. Its proposed solution to avoid such a result is to grant deposit status for depositor preference provisions of US law, but not insured-deposit status, to a "dual-office" deposit. If adopted, a new FDIC regulation would state that a dual-office deposit would be a "deposit" for other purposes, such as depositor preference, but would not be an "insured deposit," and therefore not benefit from FDIC insurance.

The comment period ends April 22. Following are several issues that should be addressed by the FDIC in any final adoption of the proposed regulation:

- May the "dual-office" aspect be obtained if a US branch guarantees payment of the non-US branch deposit? Such a guarantee has caused offshore deposits to be considered US deposits by the Federal Reserve for purposes of its reserve requirements, implemented by its Regulation D.[2] A guarantee of payment by a US office would seem to give the non-US branch depositor the benefit of US coverage for FDIA purposes. Issuing a guarantee would likely simplify the operation of such deposits by the banks since there would be no need to give access to the deposit inside the United States on a regular basis; coordinating the balances of such deposits in both a US and a non-US branch could require daunting system changes and unforeseen complications. In addition, since deposits at non-US branches are much more likely to be in currencies other than the US dollar, there would likely be serious issues with making those currencies available in the US. On the other hand, a guarantee would become effective only upon non-payment at the non-US branch, which would occur upon insolvency. There might be a question whether a US-office guarantee is sufficient to bring the non-US deposit within the ambit of "deposit" under the FDIA, but a FDIC regulation to that effect would seem to make it likely to be upheld.
- How should banks deal with terms of non-US deposits that might be typical in the foreign country but not viewed under FDIC precedent as qualifying for treatment as a "deposit"? This issue has come up in the past with indexed deposit instruments in which the return is based on some measure other than a stated interest rate, such as increases or decreases in equity-market indices. The FDIC staff has indicated that such an instrument must be principal-protected – that is, the depositor must have the right to obtain at least 100% of principal upon maturity – in order to qualify as a "deposit" for insurance purposes. If a bank's non-US branch offers indexed deposits on which some portion of principal might be lost, in conformity with local law or practice, may that instrument be dual-officed and be recognized as a deposit under

[2] The Federal Reserve stated in a 1970 interpretation, "[A] deposit in a foreign branch of a depository institution that is guaranteed by a domestic office is subject to the reserve requirements of Regulation D the same as if the deposit had been made in the domestic office." 12 C.F.R. § 204.128.

FDIC rules? If the FDIC does not wish to export US concepts to non-US markets, then it should indicate flexibility on such points. Otherwise US banks might be at a competitive disadvantage against non-US banks in those markets.

- As noted above, many non-US deposits are likely to be denominated in currencies other than US dollars. The FDIC clearly treats US deposits as insured even if denominated in other currencies.[3] There seems to be no reason not to allow dual-office deposits the same status for depositor preference purposes. A final rule should make this explicit. Among other things, US banks may be required to provide opinions of counsel to a non-US supervisor concerning the effectiveness of depositor preference for such deposits, and questions may arise concerning the treatment of such deposits by the FDIC as liquidator. Disclosure to branch depositors of the FDIC's foreign exchange valuation rules might be required.

- The effect of dual-office status on country risk should be dealt with explicitly. The proposal notes that it "is not 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."[4] The language of Section 25C of the Federal Reserve Act seems to support this view.[5] It would be helpful if the FDIC clearly so stated in the final regulation.

- The proposal does not address deposits booked at an international banking facility ("IBF"). IBFs are effectively a separate set of books at a US office that are treated as though they were offshore for purposes of Federal Reserve reserve requirements and therefore not subject to reserves.[6] IBFs are within the United States for purposes of sovereign risk, and exist solely for the purpose of avoiding reserve requirements (and certain New York City taxes if located there). The FDIA explicitly excludes them from the definition of "deposit" and accordingly they are not "deposits" for insurance purposes.[7] Adoption of the final regulation might not allow for IBF deposits to be dual-officed since this would defeat the purpose of having an IBF deposit to avoid the cost of reserves. This could result in the anomalous position that a US bank's offshore branch deposits are treated as deposits for purposes of depositor preference while its IBF deposits are not.

- The proposal offers for comment the possibility that a US bank desiring to create dual-office deposits that are covered by FDIC insurance could maintain collateral in the United States in the amount of the dual-office deposits. In this way, the FDIC would be protected against loss in the event that it had to liquidate such a bank and pay insured offshore deposits. However, such an arrangement needs to avoid the issue whether US banks may provide collateral for deposits. The Supreme Court in 1934 ruled that national banks do not have the corporate power to do so.[8] However,

[3] 12 C.F.R. § 330.3(c).

[4] 78 Fed. Reg. 11604 at 11605.

[5] Section 25C (12 U.S.C. § 633(a)) states that a member bank will not be required to repay any deposit at a foreign branch if the branch cannot repay due to an act of war and the like unless the bank expressly agrees in writing to do so "under those circumstances." It seems that the deposit agreement could be drafted to exclude repayment due to war or similar events even though the deposit is also payable in the United States. Any ambiguity on this point could be cleared up if the Federal Reserve and the Office of the Comptroller of the Currency prescribe regulations under Section 25C, as they are authorized to do.

[6] Pursuant to the Federal Reserve's Regulation D at 12 C.F.R. § 204.8.

[7] For a decision discussing these points, see *Adagio Investment Holding Ltd. v. FDIC*, 338 F. Supp. 2d 71 (D.D.C. 2004).

[8] *Texas & Pac. Ry. Co. v. Pottorff*, 291 US 245 (1934), amended on other grounds, 291 US 649 (1934).

subsequently the Court ruled that national banks may provide collateral to the Federal Government and its "agencies."[9] So long as any such collateral were designed to secure the FDIC, even though the FDIC or any other Federal Government office or agency did not own the funds, this might be within the power of a national bank. If the FDIC were to adopt this alternative, it should clearly state the basis for finding that this would be permissible for insured banks.[10]

- The proposal describes, but does not address, an alternative suggested by the UK Financial Services Authority ("FSA").[11] The FSA might allow a UK branch to segregate, or "ring-fence," assets in the UK through a trust arrangement for the benefit of UK branch depositors. It appears that the powers question on collateralizing deposits discussed above would pose a problem here. The depositors, and not a US government agency, would be the secured party. The FDIC may not have discussed the FSA's idea because of this difficulty. However, it may also have ignored the idea because it would not want to allow non-US supervisors to obtain first call on local assets for purposes of repaying depositors and other creditors. The FDIA contemplates a global resolution for insured banks with global operations. However, if the FDIC were willing to allow this alternative, the question about authority to collateralize deposits might be overcome through the Federal Reserve's use of its authority to grant additional powers to non-US branches of national and State member banks.[12]

It would be highly advisable for the FDIC to address these points in any final adoption of the proposal.

9 *Inland Waterways Corp. v. Young*, 309 US 517 (1940). While there was no statutory authority to do so, the Court found, 4-3, that collateral for the Federal Government was a longstanding practice predating the National Bank Act that was intended to be authorized for national banks.

10 FDIC-insured State banks are subject to the same limitations on "activities" as those applicable to national banks, and the FDIC in 1997 indicated that collateralization of deposits would constitute an "activity" for this purpose. The FDIC is authorized to approve such activities. FDIC advisory opinion 97-1 (Jan. 6, 1997), at footnote 2.

11 The UK FSA, which published its proposals on depositor preference in September 2012, is no longer in existence, and new regulators have taken over its functions. The Prudential Regulatory Authority is now the relevant regulator responsible for the supervision of accepting deposits. You may wish to refer to our client note dated 4 April 2013, "New UK Financial Services Regulators Established and New Rulebooks Come into Effect".

12 This authority is in Section 25, Paragraph 10, of the Federal Reserve Act (12 U.S.C. § 604a) and has been exercised by the Federal Reserve to authorize guarantees by non-US branches, dealing in local government securities and the like. The Federal Reserve must find that any such additional powers are "usual in connection with the transaction of the business of banking" in the location. See the Federal Reserve's Regulation K, 12 C.F.R. § 211.4.

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