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Preferring Foreign Depositors – The Final Rule

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The Federal Deposit Insurance Corporation has issued a final rule adopting with virtually no change its proposed approach to depositor preference for deposits payable at foreign offices of US banks. While the rule will provide guidance for US banks responding to international efforts to require equal treatment of local branch deposits with home-country deposits in insolvency, it does not address several outstanding issues. US banks will have to tread carefully.

The proposed rule from last April was intended to deal with international efforts, and primarily one led by the United Kingdom, to protect depositors of local branches of US banks. Those branches are not covered by the US deposit insurance scheme.[1] The FDIC was concerned that an insured bank with a London branch would cause the branch's deposits to be equally payable at either the London branch or the US head office; these would effectively be "dual-office" deposits. The advantage of making them payable at the head office is that the deposits thereby become insured deposits under Federal law and FDIC regulations, and a US bank would not have to take costly steps such as converting its London branch into a subsidiary bank.

[1] For the background of this issue, you may wish to view our client memorandum, "Preferring Foreign Depositors" (April 10, 2013), available at http://www.shearman.com/files/Publication/5465fe3b-4c56-4ee7-b759-0dcf19c90adf/Presentation/PublicationAttachment/22e20fa4-16f8-4038-8734-cfb35f6bc012/Preferring-Foreign-Depositors-FIA-041013.pdf. The FDIC's final rule is at 78 Fed.Reg. 56583 (Sept. 13, 2013).

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The FDIC's concern was that it is responsible for paying insured deposits as soon as possible after insolvency of a bank, and doing so in foreign jurisdictions would pose a host of legal and operational issues. In order to avoid this result, the FDIC proposed to adopt a regulation stating that any dual-office deposits not be considered to be "insured deposits" for insurance purposes. Then the FDIC would not be responsible for covering them in the event of insolvency. However, a dual-office deposit could still be a "deposit" for purposes of depositor preference. This would mean that dual-office deposits would be treated the same as US office deposits in insolvency, and deposits would be paid ahead of non-deposit unsecured liabilities under the depositor preference requirement of Federal law. In this way, the FDIC believes that the requirements of the United Kingdom, and presumably of other countries that adopt the same requirement, would be satisfied, and US banks would not be required to take other action to protect foreign branch depositors.[2]

There are several points that are not addressed in the FDIC regulation and that need to be considered by US banks that decide to adopt the dual-office arrangement:

- In the event that local conditions in a country make it impossible to repay deposits there, will dual-office deposits continue to have the protection of Section 25C of the Federal Reserve Act? That statute effectively absolves a bank from being obligated to repay foreign-branch deposits due to acts of war or other events in the country where the branch is located.[3] By its terms the statute applies only if the bank has not "expressly agreed in writing to repay the deposit under those circumstances." The FDIC notice simply says that "nothing in this Final Rule is intended to preclude a US bank from protecting itself against sovereign risk." Stated more succinctly: "Not our problem." Banks might be able to thread the needle by including explicit reference to acts of war and other events listed in Section 25C in their deposit agreements as excusing repayment at either the branch or at the US head office. There is no court decision on the effectiveness of Section 25C.
- Will dual-office deposits be subject to attachment and execution by claimants against the depositor? Under New York law, deposits payable at non-US branches of US banks

[2] The UK regulator consulted on proposed measures to protect depositors of local branches of US banks in September 2012. No further steps have since been taken by the regulator on this issue; however, a policy statement on the issue still features in the regulator's list of forthcoming publications. For information on the UK proposals, you may wish to view our client memorandum, "UK FSA and US FDIC Concerned Over Effects of National Depositor Preference Regimes" (Feb. 28, 2013), available at http://www.shearman.com/files/Publication/06a46737-db9c-426d-b75e-a6999379ce07/Presentation/PublicationAttachment/4be4e14d-ac15-4020-a42d-d4e3b6fc8a41/UK-FSA-and-US-FDIC-Concerned-Over-Effects-of-National-Depositor-Preference-Regimes-FIA-022.pdf.

[3] 12 U.S.C. § 633.

are generally not subject to attachment or execution in US courts; any attempt to seize such a deposit would have to be done in the country of the branch. A dual-office deposit would be payable at the US office as well. It is not clear whether the parties to a dual-office deposit could effectively agree to adopt any contractual or other limitation to avoid the jurisdiction of a US court in a legal action brought in the United States. Non-US depositors might hesitate to deposit significant sums under a dual-office deposit if they believe attachment or seizure is possible.

- How will a US bank deal with any differences between US and local law limitations on the terms of deposits? One would expect the contractual terms of the deposit contract to be the same whether payable in either location. Whether local law would allow all dual-office deposit terms to be effective would have to be reviewed.
- Dual-office deposits will be subject to reporting to the Federal Reserve for purposes of reserve calculation under Regulation D, and all deposits treated as transaction accounts under that regulation will be subject to reserve requirements.[4] US banks need to assure themselves that their systems will include such balances in their reports. Such inclusion will also have to be made in bank call reports. Query whether the Federal Reserve will make any changes to reserve requirements or reporting procedures in light of the FDIC action.
- Many deposits at non-US branches are likely to be payable in the home country's currency and not in US dollars. Banks will have to decide whether to treat the deposit as payable in that currency on the books of the US office. Among other things, US banks generally do not provide non-US currency at all their branches and ATMs. Perhaps the deposit contract can provide that any demand for payment at the US office is payable in US dollars and a demand at the branch is payable in local currency. Valuation changes would be necessary, and disclosure to depositors might be appropriate. Depositors might be interested in hedging the valuation differences in such cases. Also, banks would have to determine, among other things, whether their systems provide the capacity to coordinate instantly the available balances in the two accounts. Whether checks may be drawn against both accounts, or only one, and how to handle wire transfer instructions would also have to be reviewed. Perhaps a simple way to deal with such difficulties is to refuse to allow any actions, such as deposits or withdrawals, to be taken through the US account, forcing all transactions into the non-US branch account.

Whether the UK regulator takes any action as a result of the FDIC action remains to be seen. The regulator may await action by other jurisdictions before issuing any final proposals.

The FDIC regulation is effective on October 15, 2013.

[4] Regulation D is at 12 C.F.R. Part 204 (2012). Transaction account reserves are generally 10 percent.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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