ARTICLES

THE STATUS OF FOREIGN DEPOSITS UNDER THE FEDERAL DEPOSITOR-PREFERENCE LAW

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1. INTRODUCTION

The liquidation regime applicable to failed American banks was fundamentally altered in 1993 when Congress amended the Federal Deposit Insurance Act ("FDI Act") to provide that depositors' claims be paid before those of general creditors.1 Because of the definitional structure of the FDI Act, federal regulators interpret the preference as not being available to holders of foreign deposits—deposits that are payable only abroad.2 Consequently, unless the government were to intervene to bail them

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out, recoveries of foreign-deposit holders in liquidation of a multi-

tinational bank would be drastically reduced or eliminated.\(^3\) The

result would likely be consternation in the international banking

community, disruption of the current system for dealing with

troubled multinational banks, and a serious competitive setback

for U.S. banks operating abroad.\(^4\) This Article argues that Con-
gress did not intend those results and that the statute should be

interpreted to rank foreign deposits on a parity with domestic de-

posits in liquidation priority.

2. THE STATUTORY PROVISIONS

The depositor-preference provision of the FDI Act, appropriately

headed “depositor preference,” provides that amounts real-

ized upon liquidation or another disposition (in regulatory par-

lance, a “resolution”) of an insured depository institution, after

satisfaction of secured claims, be distributed to satisfy claims in

the following order of priority: first, administrative claims of the

receiver; second, “[a]ny deposit liability of the institution”; third,

general creditors; fourth, subordinated liabilities; and last, claims

of equity holders.\(^5\) The term “deposit” is elsewhere defined in the

Act as a list of broadly described categories of obligations; in addi-
tion, the definition grants to the FDIC the authority to promul-
gate regulations identifying other obligations as deposits “by gen-

eral usage,” except that any foreign deposit “shall not be a deposit

for any of the purposes of [the FDI Act].”\(^6\) When Congress en-
acted the depositor-preference provision in 1993, a foreign deposit

was defined as any obligation “payable only at an office... lo-

cated outside of” the United States.\(^7\) That definition was

amended in 1994 to cover any obligation carried on the books

and records of a foreign branch, unless the deposit contract ex-

pressly provided for payment at an office in the United States.\(^8\)

\(^3\) See Appendix A.

\(^4\) See FDIC Depositor Preference Provisions May Have Impact on Foreign

Creditors, BANKING DAILY (BNA), Sept. 10, 1993; Depositor Preference Provi-

sion May Pose Some Greater Risks, Banking Experts Warn, BANKING REP.

(BNA), Sept. 27, 1993; Reality of Depositor Preference Appalling to Bank Regu-


\(^6\) Id. § 1813(l)(5).

\(^7\) Id. § 1813(l)(5)(A).

\(^8\) See id.
Under either variation, foreign deposits—deposits normally raised abroad, and payable only abroad—are not "deposits" within the plain meaning of the Act. That exclusion expressly applies "for any of the purposes of" the Act, the plain meaning of which would extend to the depositor-preference provision.

Is a "deposit liability"—the term used in the depositor-preference provision—different from a "deposit" as defined in the definitional section and therefore not, literally speaking, restricted by that definition? That is not a plausible evasion. In common usage, a "deposit liability" is a liability for a "deposit," and that common usage recurs throughout the Act. For example, the very definitional paragraph containing the exclusion of foreign deposits gives the FDIC authority to expand the definition of "deposits" by identifying obligations that are "deposit liabilities by general usage." Likewise, the FDIC’s controversial cross-guarantee right is subordinate to "[a]ny deposit liability" of the assessed institution. Moreover, the provision of the FDI Act governing the termination of separate insurance of deposits assumed by acquiring institutions is activated when "liabilities . . . for deposits" of one insured institution are assumed by another. On a literal level, therefore, the exclusion of foreign deposits from liquidation status as deposits is hard to escape.

On a superficial level, that literal approach gains support in at least some of the purposes underlying the Act. The principal purpose of the depositor-preference provision was budgetary, to save money for the federal government. Because the FDIC in-

9 Id. § 1813(f)(5) (emphasis added).
10 Id. § 1815(e)(2)(C)(ii)(I). The FDIC’s cross-guarantee claim is also subordinate to third-party general-creditor claims, a class that would include foreign deposits. See id. § 1815(e)(2)(C)(ii)(III). The constitutionality of the cross-guarantee power was upheld in Branch v. United States, 69 F.3d 1571 (Fed. Cir. 1995), and Meriden Trust & Safe Deposit Co. v. FDIC, 62 F.3d 449 (2d Cir. 1995). See also Christopher T. Curtis, The Takings Clause and Regulatory Takeovers of Banks and Thrifts, 27 HARV. J. ON LEGIS. 367, 385-89 (1990).
12 See H.R. REP. No. 103-111, at 96 (1993) (reciting a Congressional Budget Office estimate that depositor preference would save the FDIC $490 million and the RTC $260 million over the period from 1994 to 1998). The budgetary purpose— as opposed to a regulatory or safety-and-soundness purpose—of the depositor-preference regime was widely reported in the trade press while the bill was moving through Congress. Depositor preference was preferred by the banking industry to the alternative proposed money-raising device, additional examination fees. See infra note 56.
sures only “deposits” as defined in the statute, and not other obligations such as general creditor claims, requiring a failed institution’s assets to be dedicated first to deposit liabilities would minimize the loss to the FDIC resulting from its insurance obligation; and because the FDIC’s outlays are scored on the federal budget (although it is not an appropriated agency and derives its revenues from insurance premiums), a reduction in the FDIC’s resolutions costs will marginally reduce the federal deficit—assuming that the FDIC’s premium income is not correspondingly reduced as it subsequently has been. Because foreign deposits are uninsured, classifying them with general creditor obligations rather than with domestic deposits would transfer the share of assets that would have been theirs under a pro rata regime to domestic deposit claims, including the claim of the FDIC as subrogee of the insured depositors, and hence would reduce the FDIC’s outlay in the liquidation of an insolvent institution holding any such foreign deposits. To that extent, subordinating foreign deposits to domestic deposits would serve the principal purpose of the depositor-preference law.

Other provisions of the FDI Act demonstrate a specific Congressional antipathy toward foreign deposits as well as a desire to disfavor them in bank failures. When the FDIC received its statutory least-cost-resolution mandate in 1991, it was specifically instructed to expend its insurance funds only to cover insured deposits. That mandate, of course, excludes foreign deposits, which were always understood to be uninsured. In addition, Congress simultaneously added a new section 41 to the FDI Act, “Payments on foreign deposits prohibited,” forbidding the FDIC

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13 H.R. REP. NO. 103-111, at 87. See also the Conference Report on the depositor-preference law, which stated: “Depositor preference will increase the amount of the distribution to depositors of failed institutions. Because the FDIC is subrogated to the claims of insured depositors, it will increase its recovery and therefore realize a savings under a depositor preference scheme.” H.R. REP. NO. 103-213, at 436 (1993).

14 See 12 U.S.C. § 1821(d)(11)(A)(g) (noting that the FDIC is subrogated to claims of insured depositors whom it has paid).

15 See id. § 1823(c)(4).

16 See id. § 1823(c)(4)(E). The FDIC may cover uninsured deposits where they pay for themselves through a sufficiently increased premium paid by the failed bank’s acquirer. See id. § 1823(c)(4)(E)(iii). So qualified, the prohibition on covering uninsured deposits is actually no more than a corollary of the more general least-cost mandate, making the specific statutory paragraph redundant. See 12 C.F.R. § 360 (1993).
and any other federal agency to make payments on behalf of, or provide assistance for the benefit of, foreign deposits, except that the FDIC may take such action if it determines that the action is not inconsistent with its least-cost-resolution mandate. Since the least-cost mandate generally forbids such payments except in a systemic risk resolution—to which section 41 by its terms would itself be no bar—section 41 added little of substance to the Act, save perhaps the suggestion that Congress disliked foreign deposits. If that is indeed the legislative state of mind embodied in the FDI Act as currently in force, subordinating foreign deposits to domestic deposits in liquidation is certainly consistent with it.

A closer examination of the legislative history, however, reveals that Congress was actually far more sensitive to the needs of U.S. banks doing business abroad than a recitation of the statutory language and purposes in broad brush strokes would suggest.

3. THE LEGISLATIVE HISTORY

Before reviewing the evidence of what Congress was actually thinking about foreign deposits in the early 1990s, it is necessary to emphasize the propriety of doing so. Even when statutory language appears to be clear, the touchstone of statutory interpretation remains Congressional intent. Clear language is the best evidence of intent, but it is not the only evidence: it is equally necessary to examine the structure and purposes of the statute as well as the legislative history. Specifically with respect to an ostensibly clear definitional provision, such as the one at issue here, no less an authority than the Supreme Court has ruled that such a provision may be disregarded if giving effect to it would violate an important purpose of the statute.

Even without delving into the legislative history, a number of factors combine to suggest that rigorous literalism is not the appropriate approach to understanding Congress' use of the term "deposit" in the depositor-preference law.

First, the ordinary meaning of the term "deposit" is not limited by the country in which the deposit is taken or payable.

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18 See id. § 1823(c)(4)(G).
Rather, it refers to a particular kind of bank obligation, regardless of the country in which it is taken or payable. For example, in the very 1994 law in which Congress amended the FDI Act’s definition of “deposit” to reemphasize that a deposit had to be payable in the United States to qualify for FDIC insurance, Congress also amended the Federal Reserve Act to limit American banks’ liability for deposits taken and payable abroad that could not be paid abroad by reason of various force majeure circumstances. In that provision, Congress referred to that particular class of deposits as “any deposit made at a foreign branch of the bank.” 20 The Federal Reserve Board, in its regulations under the International Banking Act, defines a “foreign bank” as an entity organized under the laws of a foreign country that, inter alia, “receives deposits to a substantial extent in the regular course of its business” and “has the power to accept demand deposits.” 21 These examples show that Congress and the regulators share the same general understanding of what a deposit is, and they use the term in its ordinary sense outside the FDI Act when describing deposits that are foreign deposits and hence not “deposits” for purposes of the FDI Act. 22 Caution is required, therefore, in assuming that Congress could not have had that ordinary meaning in mind when enacting the depositor-preference law in 1993.

Second, the fact that the depositor-preference provision and the amendments to the FDI Act’s definition of “deposit” were adopted at different times suggests that Congress did not focus on the definition when the depositor-preference provision was enacted. It is more likely that Congress and its drafters had in mind the common understanding of the term “deposit”—which would have included foreign deposits.

Finally, the purpose of the depositor-preference provision—to govern distribution of a bank’s assets upon liquidation—is different from the general purpose of the FDI Act, which is primarily to govern deposit-insurance rights and obligations. Statutory

22 An expansive view of the term “deposit” in the depositor-preference provision is further supported by the proposition that statutory exceptions to broader concepts—as the foreign-deposit definition is an exception to the broader concept of “deposit”—are to be narrowly construed. See Piedmont & Northern Ry. Co. v. ICC, 286 U.S. 299, 311-12 (1932); Israel-British Bank (London) Ltd. v. FDIC, 536 F.2d 509, 513 (2d Cir.), cert. denied, 429 U.S. 978 (1976).
terminology, when used for different purposes in separate provisions, can reasonably have distinct meanings in the respective provisions. There may be logic to limiting deposit insurance to domestic deposits: the purpose of deposit insurance is to protect the domestic financial system and domestic depositors from financial panics, using insurance paid for by domestic financial institutions, underwritten by the federal government, and ultimately supported by taxpayer money. If foreign governments are similarly motivated to protect deposits in branches within their territories, they can establish similar insurance systems at their own risk and expense—just as the United States insures deposits in U.S. branches of foreign banks.\(^{23}\) The liquidation priority regime, on the other hand, governs the distribution of private assets to private claimants. There is much less reason to discriminate against foreign claimants, especially since many of the assets, like many of the deposits, may be foreign.

A large body of analogous state statutes indicates the approach taken by state legislatures to the problem of what to do with foreign deposits in a depositor-preference regime. Twenty-nine states had depositor-preference laws in 1993. Not one of them specifically excluded foreign deposits from the benefit of the preference. Most of them referred to deposits, or to obligations or claims of depositors, without providing any relevant restrictive definition\(^{24}\) (possibly in part because of the difficulty in defining

\(^{23}\) See International Banking Act, 12 U.S.C. § 3104(b). Federal insurance of deposits in branches of foreign banks is of less significance now, because post-BCCI U.S. law requires foreign banks to establish U.S. subsidiaries if they wish to conduct a retail deposit business in the United States. Insured branches in operation at the time that that requirement was enacted were permitted to continue operating. See id. § 3104(d).

\(^{24}\) The following states' depositor-preference statutes used the term "deposit" without relevant definition: ALASKA STAT. § 06.05.470(l)(4) (Michie 1999); CONN. STAT. ANN. § 36(a)(237) (West 1996); ME. REV. STAT. ANN. tit. 9-B § 365(10)(B) (West 1997); N.M. STAT. ANN. § 58-1-75(H)(4) (Michie 1978).

A number of states' depositor-preference laws used the term "claims of depositors" or an equivalent formulation referencing depositors rather than deposits, without relevant definition: ARIZ. REV. STAT. ANN. § 6-395.11.A.5 (West 1999); COLO. REV. STAT. § 11-5-104(9)(a)(II) (1987); GA. CODE ANN. § 7-1-202(a)(2) (Michie 1997); HAW. REV. STAT. § 412:2-400; IDAHO CODE § 26-1019(3) (Michie 1947); IOWA CODE ANN. § 524.1312(3) (West 1946); KANSAS STAT. ANN. § 9-1906(b)(3) (1964); MINN. STAT. ANN. § 49.24 subd. 9 (West Supp. 2000); MO. ANN. STAT. § 361.190(2) (West 1968 & Supp. 2000); MONT. CODE ANN. § 32-1-534(1)(d) (1999); N.D. CENT. CODE § 6-07-52(3) (Supp. 1999); OKLA. STAT. ANN. tit. 6 § 1204(K)(1)(6) (West 1965); OR. REV. STAT. § 711.520(3) (1953 & Supp. 1998); TEX. CODE ANN. § 342-804a(2) (West 1964 &
the concept of "deposit" analytically\textsuperscript{25}). Those statutes would include foreign deposits within the preference. Only four states had adopted depositor-preference laws that incorporated by reference the FDI Act's definition of "deposit;\textsuperscript{26} and only one of those

\textsuperscript{25}The broad definitions of "deposit" in the FDI Act and in the Federal Reserve Board's regulations under the Federal Reserve Act, Regulation D, 12 C.F.R. § 204.2(a), are workable because they apply only to obligations of insured depository institutions. The definitions include many items, such as credit balances, that are also held by non-depository institutions such as retailers and other merchants, and which if regarded as deposits might well cause those enterprises to violate state statutes precluding the taking of deposits without a financial institution charter, as well as the Bank Holding Company Act's provisions governing companies that own deposit-taking enterprises. However, in those statutes, the term "deposit" is generally not defined and therefore can be applied according to its common usage.

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states, California, acknowledged the unusual status of foreign deposits in the definition, specifically including foreign deposits within the preference. Hence, the statutes that are the best evidence of what a legislature would think about the appropriateness of including foreign deposits in depositor preference— and the examples that were before Congress in 1993 to the extent that Congress might have considered that issue— are statutes that broadly applied the common understanding of the term "deposit" to include foreign deposits.

Fortified by the foregoing considerations, we turn to the relevant legislative history of the FDI Act. That legislative history confirms that the exclusion of foreign deposits from the definition of "deposits" had nothing to do with the fair distribution of assets upon liquidation, and everything to do with the desired allocation of the burden of insurance premiums. The modern definition of "deposit" in the FDI Act originated in the Banking Act of 1935. A review of the Act's legislative history makes clear that foreign deposits were excluded from the definition of "deposit" because it was feared that imposing deposit insurance premiums on them would place U.S. banks operating abroad at a cost disadvantage in raising funds overseas. As one Congressman noted, the exclusion of foreign deposits "is there because, if they had the cost of the insurance to add to their operating cost, they would be in a bad competitive situation in a foreign country." Concern for the competitive position of U.S. banks overseas has continued unabated for most of the Twentieth century. During the deliberations on the FDIC Improvement Act in 1991 ("Improvement Act"), Senator Garn recited that concern as one of the "very good reasons why such [insurance] assessments [on foreign deposits] have been considered and rejected at least nine times since the 1930s."

The legislative history of the 1991 Improvement Act is especially pertinent because that Act represented the high-water mark

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27 The California preference extends to "deposits," as defined in 12 U.S.C. § 1813(I), but includes obligations of the type described in 12 U.S.C. §§ 1813(I)(5)(A) and (B) (that is, foreign deposits). See CAL. FIN CODE § 3119.5(a)(3) (West 1999).
29 Hearings before the House Committee on Banking and Currency, 74th Cong., 71-72 (1935) (colloquy between Congressman Hollister and General Counsel Birdzell of the FDIC, which had been created two years earlier).
30 137 CONG. REC. S16904 (Nov. 18, 1991).
(so far) of anti-foreign-deposit sentiment in Congress. The Improvement Act added the new section 41, described above, forbidding federal provision of assistance for the benefit of foreign deposits. Section 41 was motivated by Congress’ anger over a perceived pattern of the FDIC’s bailing out large banks and making their depositors whole—including holders of foreign deposits, although no insurance premiums had been paid on those deposits—while smaller banks were closed and liquidated and their uninsured depositors were made to bear a pro-rata share of the institution’s loss. Many of the bank-resolution transactions recited by opponents of the FDIC’s practice—First Pennsylvania, Continental Illinois, First Republic, Bank of New England—were

32 The Congressional attitude was ably summarized by Senator Sasser:

There has never been a bank failure where foreign deposits have not been made whole. In one way or another, the Federal Government has stood behind an estimated $22 billion... in foreign deposits over the last decade. In 1980, for example, First Pennsylvania failed with over $2 billion in foreign deposits on its books, and they were covered. Four years later, Continental Illinois went under with a whopping $18.5 billion of overseas deposits. Nearly $900 million was insured at the First Republic; $138 billion [sic] at First City [in the 1988 open-assistance transaction]. In August 1990, $85 million of deposits at the Bahamas branch of National Bank of Washington... were bailed out. In January, depositors at the Bank of New England’s Cayman Islands branch got help from the FDIC to the tune of $100 million. The problem... is these banks did not pay 1 cent of premiums to ensure these foreign deposits. Yet, they were fully insured by the Federal Government.... The coverage of foreign deposits is particularly unfair when it is considered that community banks pay premiums on all their domestic deposits, but typically the FDIC only covers those up to $100,000 in a small bank failure. The failure of Freedom National Bank in Harlem last year was a good example of this phenomenon; many charities were left holding the bag because of the FDIC policy. However, at just the same time the FDIC arranged a transaction that resulted in full coverage for the depositors at the Bahamas branch of the National Bank of Washington, even though NBW never paid premiums on those deposits.

33 This does not include National Bank of Washington, a resolution that was the source of some of the greatest distress by reason of its temporal coincidence with the failure of Freedom National Bank, a small black-owned-and-operated bank in Harlem, N.Y. The FDIC resolved the Freedom failure in compliance with its statutory requirement not to spend more on an assisted acquisition than it would spend in a liquidation; no bidders for the failed bank had appeared who were willing to make up the cost of protecting the uninsured depositors. See S. REP. NO. 102-167, at 3-4, 44 (1991). At the time of
transactions in which the FDIC made uninsured depositors whole in order to prevent disruption and loss of confidence in the nation’s banking system, even though that required spending more than would have been necessary to effect a resolution in which depositors were protected only up to the insurance limit (which in the case of foreign deposits, of course, is zero). To take such action, the FDIC relied on what it characterized as the “essentiality” exception—commonly called the “too big to fail” doctrine—to the pre-Improvement Act requirement that an FDIC-funded acquisition of a failed or failing bank be no more expensive than a liquidation. The FDIC’s ability to effect such transactions survived in the Improvement Act under the heading “systemic risk.” As noted above, a “systemic risk” resolution, which requires among other things a finding that the transaction is necessary to avert “serious adverse effects on economic conditions or financial stability,” is an exception to the current least-cost requirement, and hence an exception to section 41’s prohibition on assistance to foreign deposits.

That statutory structure suggests a tension between Congress’ desire to suppress transactions protecting foreign deposits and its recognition of the importance of foreign deposits to the U.S. banking system. The legislative history of the systemic risk exception—specifically the provisions concerning how systemic

that resolution, the FDIC’s politically astute chairman, L. William Seidman, was in the hospital after falling off a horse. He later suggested that the resolution would have been handled differently had he been actively at the agency’s helm.

“...No assistance shall be provided under this subsection in an amount in excess of that amount which the [FDIC] determines to be reasonably necessary to save the cost of liquidating, including paying the insured accounts of, such insured depository institution, except that such restriction shall not apply in any case in which the [FDIC] determines that the continued operation of such insured depository institution is essential to provide adequate depository services in its community.” 12 U.S.C. § 1823(c)(4)(A).


37 As one of the Congressional opponents to the FDIC’s practice with respect to foreign deposits remarked, “[i]t is my hope that the reformed too-big-to-fail policy will prevent the FDIC from bailing out foreign deposits. But past history and the realities of the structure of our financial system suggest that, despite the reforms in this legislation, the FDIC may at some point have to cover foreign deposits at large banks in order to avert the collapse of our financial system.” 137 CONG. REC. S16906 (Nov. 18, 1991) (statement of Sen. Conrad).
risk resolutions are to be paid for—throws that tension into startlingly clear focus. The statement by Senator Garn reproduced above was made in the course of a colloquy on that subject.\(^{38}\) The Senate was considering an amendment to its version of the Improvement Act to provide that, in the case of a systemic risk resolution in which holders of foreign deposits received more than they would have received in a least-cost resolution, the FDIC must recover the incremental cost of such protection by means of special assessments on insured institutions allocated proportionally to the amount of foreign deposits held by those institutions.\(^{39}\) That amendment was proposed as an alternative to including foreign deposits in the deposit-insurance assessment base, an action that Senator Garn staunchly opposed, claiming it would render U.S. banks uncompetitive in raising deposits overseas. “Most foreign deposits are raised and used overseas,” he said. “A 25-30 basis point assessment [which was the deposit-insurance rate range in the early 1990s] could cause U.S. banks to either lose customers or lose money, putting them out of this business.”\(^{40}\) He also argued that the withdrawal of U.S. banks from their overseas funding sources would reduce the available funding for U.S. exports.\(^{41}\) Other senators would have liked to include foreign deposits in the insurance assessment base, but did not advocate such a proposal because they assumed it would be unacceptable to the House and hence would not survive the joint conference on the Improvement Act.\(^{42}\)

Those senators were right to be concerned. Even their “compromise” amendment did not survive the conference.\(^{43}\) At a public session on the evening of November 25, 1991, the conference had before it three proposals for funding systemic risk resolutions involving foreign deposits.\(^{44}\) A House proposal would have recovered the cost of systemic risk resolutions by means of special

\(^{38}\) See text accompanying supra note 30.

\(^{39}\) See 137 CONG. REC. at S16902 (discussing Amendment No. 1350(6)(B) (ii)).

\(^{40}\) Id. at S16904 (statement of Sen. Garn).

\(^{41}\) See id.

\(^{42}\) See id. at S16904 (statement of Sen. Kohl); id. at S16906 (statement of Sen. Conrad).

\(^{43}\) See Transcript of House-Senate Joint Conference on H.R. 3768 and S. 543 (Nov. 25, 1991) [hereinafter Conference Transcript].

\(^{44}\) See id.
assessments on the traditional assessment base, comprising domestic deposits. The Senate bill (unamended) called for the special assessments to be based on total assets minus capital, a base that, though expressed in terms of assets and capital, clearly would have included foreign deposits. That proposal was ultimately enacted, in preference to both the House proposal and a third proposal, the Senate’s “compromise” amendment to its own bill, which would have specifically assessed insurance fund members on the basis of the foreign deposits they held to recoup the incremental costs of covering foreign deposits in a systemic risk resolution.

While the House proposal was unacceptable to the Senate, the Senate’s proposed special assessment on foreign deposits was unacceptable to the House. Representative Schumer succinctly stated the competing goals: “One is to make sure that foreign deposits don’t get a free ride . . . The other is to make sure we don’t chase foreign deposits in our own institutions to foreign institutions.” The House members rejected the Senate’s proposed amendment, because they believed that foreign deposits should never be assessed for insurance costs. Representative Schumer argued that: “If you start assessing foreign deposits, given the close margins with which this business is competitively run, you are going to chase billions and billions and billions of dollars out of our banks and into other banks.” Although the House members were told that the Senate’s proposal was only for a special assessment to recover the cost of a systemic risk transaction, and was therefore “not an ongoing cost,” the House members were not satisfied; their concern was that “[a]s soon as one large bank fails, the assessment occurs and the foreign deposits flee.”

45 See id.
46 See id. at 118-19, 127.
47 The statute prescribes that the assessment base shall be “the amount of each [deposit insurance fund] member’s average total assets . . . minus the sum of the amount of the member’s average total tangible equity and the amount of the member’s average total subordinated debt.” FDI Act, 12 U.S.C. 1823 (c)(4)(a)(ii)(I) (1999).
49 Id. at 110.
50 Id. at 111.
51 Id. at 120 (statement of Sen. Gramm).
52 Id. at 120 (statement of Rep. Schumer). “The risk is even greater because you put every single institution with foreign deposits at tremendous risk.
The deadlock among legislators was eventually broken when the conferees requested the opinion of the Treasury Department and the Federal Reserve Board. The representatives of those agencies noted that: (1) the systemic risk exception to the least-cost requirement was necessary; (2) the scope of possible coverage had to extend to foreign deposits; and (3) a post hoc special assessment on a base that was broader than domestic deposits and included foreign deposits was acceptable. As a result, the Senate bill's approach, but not that of the Senate amendment, was adopted. From the legislators' point of view, it had two merits. First, it did not explicitly assess foreign deposits or any other liabilities—a semantic point, but apparently an important one since it received a great deal of discussion. Second, the special assessments to cover the costs of systemic risk resolutions, including those with a substantial foreign-deposit element, would be spread over a wider base than foreign deposits.

As a result, the cost of protecting foreign deposits in a systemic risk resolution that will be borne by other foreign-deposit-holding institutions is less than it would have been if the Senate amendment, with its assessment specifically on foreign deposits, had been adopted, and also less than it would have been if foreign deposits were included in the overall deposit-insurance assessment base and no special assessment were provided for. Under the Senate proposal, excess costs of covering foreign deposits would have been borne solely by the other foreign deposits in the banking system and not shared with domestic deposits. In addition, under the alternative of including foreign deposits in the deposit base, while domestic deposits would have shared the cost of covering foreign deposits, so would foreign deposits have shared the cost of covering domestic deposits. As Appendix B shows, the cost advantage to foreign deposits of the alternative that Congress adopted in the Improvement Act is dramatic.

The lesson of the foregoing legislative history is that Congress, in 1991, was extremely sensitive to the risk of creating a competitive disadvantage to U.S. banks raising foreign deposits, even in the event of a major bank failure in the course of which

You could wipe out 60, 70 percent of their equity.” Id. (statement of Sen. LaFalce).

See id. at 129-30.

See id. at 116-20.

See id. at 133-34.
foreign deposits would arguably be asked to pay no more than their own freight. A liquidation regime subordinating foreign deposits to domestic deposits, in a period such as the early 1990s in which bank failures were common events, would place U.S. banks at an even greater competitive disadvantage in raising funds overseas. When the depositor-preference provision was enacted, Congress expected that general creditor recoveries under it would ordinarily be zero. It is not plausible that Congress would have consciously legislated such a fate for foreign deposits while simultaneously displaying such solicitude over the competitive status of U.S. banks' foreign deposit raising activities.

There is no evidence that Congress' attitude changed in the less than two years between the Improvement Act and enactment of the depositor preference law. As noted above, the depositor-preference regime was not enacted for reasons having to do with safe and sound bank regulation or with orderly liquidation, but rather, as indicated by its inclusion in the Omnibus Budget Reconciliation Act of 1993, entirely for budgetary reasons—it was a means for the federal government to spend less money. The House report on the Budget Act forthrightly enumerated depositor preference as one of five measures adopted "[t]o comply with the instructions of the conference agreement on the budget resolution to reduce the deficit by $3.758 billion for fiscal years 1994 through 1998." The contribution of depositor preference to

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56 "As a result of this depositor preference, creditors who are not depositors are unlikely to recover any of their claims on failed institutions." H.R. REP. NO. 103-111, at 95 (1993). Actual recoveries of foreign depositors would depend on the loss ratio of the failed institution as well as the ratio of priority to non-priority obligations. Zero recovery is certainly a plausible outcome. In the hypothetical institution described in Appendix A with its 80% ratio of asset recoveries to liabilities, distribution on foreign-deposit claims falls to zero as the ratio of domestic deposits rises to 89% of total liabilities. Bank troubles were not limited to small domestic institutions: The financial difficulties of America's largest multinational bank, Citibank, were well known. See Brett D. Fromson & Jerry Knight, The Saving of Citibank: Partnership of Regulators, CEO Brings Firm through Crisis, WASH. POST, May 16, 1993, at A1. Citibank was placed on the government's 'watch list' of problem banks in December 1991. The list is not made public, but every quarter the government reports how many banks are on it and totals their assets. The year-end report showed little change in the number of banks but a huge jump in the assets. Everyone in banking knew that Citibank had gone on the list.

Id.

ward that goal, according to the House report, was $750 million.\textsuperscript{58} The administration’s original proposal for raising that revenue—imposition of federal examination fees on state-chartered banks—was rejected and replaced by the depositor preference regime proposed by the Conference of State Banking Supervisors, which did not want state-chartered banks to bear the entire burden of that budgetary element.\textsuperscript{59} The administration’s preferred version of depositor-preference would have increased its budgetary impact by extending liquidation preference only to the insured deposits, so that the only beneficiary of the preference would have been the FDIC rather than private depositors. Congress rejected that version at the insistence of the lobby of the smaller banks, which feared that they would be competitively disadvantaged.\textsuperscript{60}

No inference regarding Congress’ view of the correct liquidation status of foreign deposits can be drawn from its amendment to the foreign deposit definition in 1994. As noted above, the amendment clarified that a deposit carried on the books of a foreign branch is a foreign deposit, and hence not a “deposit” for purposes of the FDI Act, unless the deposit agreement explicitly permits payment in the United States.\textsuperscript{61} That amendment was originally drafted in 1991\textsuperscript{62} before the depositor-preference regime was proposed, and for reasons unrelated to it. The amendment accompanied a parallel amendment to the Federal Reserve Act providing that member banks would not be liable to repay deposits made at a foreign branch if the foreign branch could not repay the deposit due to specified circumstances of force majeure or act

\textsuperscript{58} See id. at 96. That estimate was based on Congressional Budget Office projections of prospective bank and thrift failures, which were probably overstated.


\textsuperscript{60} Smaller banks objected to limiting the preference to insured deposits on the ground that they would not be able to attract deposits in excess of the insurance limit. Those excess deposits would migrate to large banks. The small banks argued that excess depositors would assume that the regulators would treat the large banks as “too big to fail” and would therefore cover all deposits in full in case of trouble. See Arthur D. Postal, Budget Bill Rolls Back Restrictions in FDICIA, AM. BANKER, June 14, 1993, at 1; Robert M. Garsson, Clinton’s Proposal for Bigger Haircuts Seem Destined for Defeat in Senate Panel, AM. BANKER, June 7, 1993, at 18.


The amendments were designed to reverse a line of court decisions allowing depositors in foreign branches to recover their deposits from the bank's home office in such circumstances. In the case of Vietnamese depositors, for example, permitting recovery of their deposits after the conquest of South Vietnam by the North prevented depositors from accessing their deposits. The amendments were proposed with the support of the Federal Reserve Board in 1991 as part of the FDIC Improvement Act, but were among the many provisions removed from the bill in the final weeks and days before its passage in order to reduce controversy and accelerate enactment in response to the FDIC's then-perceived imminent need for more funds. The interested parties returned to the legislative well in 1994 and obtained the language that they had earlier proposed, unchanged.

As the foregoing recitation shows, there is compelling evidence of Congress' sensitivity to the perceived need not to disadvantage foreign deposits held by U.S. banks. Furthermore, there is no contrary evidence that anything Congress did to the relevant statutory provisions was motivated by a desire to radically disadvantage foreign deposits in the event of bank failure.

4. INTERNATIONAL LAW

If foreign deposits were subordinated to domestic deposits, the liquidation regime applicable to U.S. banks with foreign branches would be inconsistent with international law. A familiar postulate of U.S. law, however, is that international law is a part of U.S. law and that, if possible, domestic legislation is to be interpreted consistently with international law. A conflict between the depositor-preference regime and international law, therefore, is an additional reason for concluding that Congress did not intend to subordinate foreign deposits.

64 See Wells Fargo Asia Ltd. v. Citibank, 936 F.2d 723 (2d Cir. 1991); Trinh v. Citibank, 850 F.2d 1164 (6th Cir. 1988).
U.S. law is already inconsistent in its approach to the liquidation of multinational banks. In general, a U.S. bank and its foreign branches are part of the same legal entity, so that the assets and liabilities of any part are the assets and liabilities of the whole.\textsuperscript{68} That is the distinction between branches and subsidiaries. The foreign \textit{force majeure} cases noted above\textsuperscript{69} were premised on that underlying reality, which is also reflected in the federal liquidation regime: the FDIC as receiver of a failed bank collects and realizes upon all assets, and responds to all claims, of the institution regardless of their situs.\textsuperscript{70} That is the unitary or “single entity” approach to bank liquidation.

Liquidation of U.S. branches of a foreign bank is subject to a dramatically different regime. Upon the insolvency of a foreign bank or the inability of its U.S. branch to meet claims against it, the receiver takes possession of all assets of the bank in the United States and uses their proceeds to pay claimants who did business with the bank in the United States.\textsuperscript{71} Proceeds are turned over to the foreign bank’s home-country liquidator for distribution to other claimants against the bank only if there is value left over after claimants in the United States are made whole. This manner of segregating local assets to pay local claims is known as the “separate entity” approach to multinational bank liquidation.\textsuperscript{72}

“Balkanization” might be a more appropriate term. The adverse effects of the separate entity approach are well documented, and were dramatically illustrated in the BCCI collapse. Creditors in some jurisdictions are short-changed, while those in other jurisdictions get a windfall, especially if their jurisdiction applies a U.S. style regime, in which the liquidator takes over all of the assets of the bank in that jurisdiction, and not just the assets of the branch. There may be friction among liquidators competing for


\textsuperscript{69}See Citibank, N.A., 936 F.2d at 723; Trinh v. Citibank, N.A., 850 F.2d at 1164.

\textsuperscript{70}See FDI Act, 12 U.S.C. § 1821; FDIC Opinion, supra note 2.


\textsuperscript{72}The U.S. approach actually goes beyond segregation of the assets of the branch: the receiver is to take possession of all assets of the foreign bank in the United States for the benefit of claimants who did business with the bank in the United States, regardless of whether those assets were booked at, or related to the operations of, the bank’s branches or agencies in the United States. See \textit{id}. 
assets whose location is legally ambiguous. For example, securities may be issued by an issuer residing in one jurisdiction, carried on the books of a branch in a second, and held by a custodian in a third. To combat such risks to creditors in their jurisdictions, host country supervisors may seek to limit inter-branch exposures within the group, argue with one another over the proper allocation of assets and capital, and require the allocation of separate capital in their jurisdictions to a greater extent than would be indicated by efficient global corporate finance. Counterparties, for their part, may shun branches in single-entity jurisdictions for those in separate-entity jurisdictions, seek to do business with the strongest branch, and prefer to do business only with a branch in their own country, if they feel they would thereby get a liquidation preference either de jure or through effective influence in the host country’s liquidation system. Derivatives markets may be impaired by the uncertain validity of multi-branch netting arrangements. In sum, the separate-entity approach could substantially impair the efficiency of global financial markets.

While there may be a trend in transnational bankruptcy law favoring a single-entity approach in cross-border insolvency proceedings,\(^\text{73}\) it is no violation of international law to segregate local assets for the benefit of local creditors. Local segregation has been a traditional approach, not yet successfully displaced by treaties or uniform state practice.\(^\text{74}\) In the United States, the constitutionality of such segregation was established in *United States v. Pink*, which upheld the legality of the Litvinov Assignment.\(^\text{75}\)

The specific legal objection to the depositor-preference regime, if it is interpreted as subordinating foreign deposits, is not simply that it prefers domestic creditors to non-domestic creditors, but that it establishes that preference in the context of a single-entity liquidation regime that has the effect of extending the


\(^{75}\) See 315 U.S. 203, 228 (1942).
domestic preference to non-domestic assets. All assets, including foreign assets, are brought into the receivership estate, but not for the purpose of equal distribution. Instead, a class of domestic claimants is given priority. Claimants of the same class, distinguishable only by the foreign situs of their claims, must stand in line behind U.S. claimants for their share of the assets of the branches with which they did business (who did not do business with those branches). That regime surely is not a legitimate exercise of the United States' prescriptive jurisdiction.

The U.S. liquidation regime is extraterritorial in that it purports to prescribe the status of assets and claims in other countries. While that feature does not make the regime illegal—the United States has a basis for exercising its jurisdiction by reason of the subject institution's U.S. nationality— the exercise of such jurisdiction is legitimate only if it is reasonable. A cross-border liquidation regime may be reasonable only if it attempts to fairly allocate assets and claims without discriminating on the basis of nationality. The depositor-preference regime, though, discriminates on precisely that basis. The current Restatement of the Foreign Relations Law of the United States identifies, among the factors relevant to assessing the reasonableness of an exercise of jurisdiction, "the extent to which another state may have an interest in regulating the activity" and "the likelihood of conflict with regulation by another state." The state in which the foreign deposit is located has at least as much interest in regulating its disposition as does the United States, because the claim and probably the assets of the relevant branch as well as possibly the claimant reside in that state and not in the United States, while the likelihood of conflict with that state's regulation can fairly be estimated at one-hundred percent.

The depositor-preference provision should be interpreted to avoid effecting an extraterritorial exercise of jurisdiction that is unreasonable and hence in violation of international law. There are two interpretations that would achieve that result: (1) foreign deposits are deposits that benefit from the preference; and (2) liq-

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77 See id. § 403.
78 Id. § 403(2)(g).
79 Id. § 403(2)(h).
80 See id. § 403 cmt. g.
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of a multinational U.S. bank is to proceed on the separate-entity basis. The second alternative, though it may appear shocking, is by no means impossible. Indeed, the single-entity approach to liquidation is nowhere explicitly stated in U.S. law, whereas there is an explicit statutory provision mandating separate-entity liquidation of U.S. branches of foreign banks. Such an interpretation, however, is senseless, for it would deprive the supposed subordination of foreign deposits of effect. Foreign deposits would have priority over domestic deposits with respect to the assets of their branch. In the event that those assets were not sufficient to pay local claims in full and the foreign-deposit deficiency claims were asserted in the U.S. liquidation, they would be subordinate to the domestic-deposit claims; but in a separate-entity regime, they would be subordinate regardless of their definitional exclusion from the preferred class. Clearly, a subordination of foreign deposits can be meaningful only in the context of a single-entity liquidation—yet it is precisely in that context that the concept is legally obnoxious.

Insisting on the subordinate status of foreign deposits, while attempting to implement a single-entity liquidation of a U.S. multinational bank, would not be effective, as it is impossible to imagine that foreign regulators would allow it. The effect of such an attempt would simply be to force foreign governments to segregate the assets of branches in their countries for the benefit of claimants against those branches—that is, to implement a separate-entity liquidation regime. Consequently, U.S. depositors and the FDIC would obtain no benefit from the preference regime as applied to foreign deposits backed by foreign assets. The preference would be effective only with respect to those foreign branches at which there were not sufficient matching assets—branches whose principal purpose is foreign-deposit raising. Offshore Caribbean branches might fall into that category. The immediate practical effect of implementing the depositor-preference regime, as interpreted by the regulators, could be to put such

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81 Of the statutory provisions cited in the FDIC Opinion, the only one that specifically establishes a single-entity liquidation regime does not apply to banks, but only to Edge Act corporations. See FDIC Opinion, supra note 2. That single-entity liquidation regime is subject to the proviso that "the assets of the corporation subject to the laws of other countries or jurisdictions shall be dealt with in accordance with the terms of such laws." Federal Reserve Act § 25A ¶ 19, 12 U.S.C. § 624 (1994).

branches out of business or at least to provoke the host regulators to require that assets be dedicated to those branches in excess of what prudent corporate finance would require.

5. SYSTEMIC RISK RESOLUTIONS

The regulators’ current interpretation of the depositor-preference provision increases the likelihood that a bank failure involving foreign deposits will be treated as a case of “systemic risk.” As noted above, the “systemic risk” provision of the FDI Act authorizes the FDIC to effect a non-least-cost resolution—a transaction in which the FDIC covers some liabilities that are not insured, at a cost greater than required to meet its insurance obligation—if the transaction is required to avoid “serious adverse effects on economic conditions or financial stability.”

Banks holding foreign deposits include the largest banks in the country. The failure of such a bank would already be a likely candidate for a systemic risk resolution. The largest failed bank that the FDIC ever resolved on a least-cost basis, so that uninsured depositors were not made whole in the resolution transaction, was the First City bank group in 1992, which held approximately $9 billion in assets. America’s largest banks today, after eight years of rapid industry consolidation, dwarf First City. They are ten, twenty, and thirty times its size. It would be surprising if the FDIC, especially with its now shrunken staff, were equipped to handle a liquidation or any other least-cost resolution of such magnitude and complexity. Today’s banks also dwarf the largest banks that the FDIC had earlier resolved even on a non-least-cost basis: Bank of New England, First Republic, the MBanks, and Continental Illinois. In effecting these resolutions,


* The First City group comprised 20 closely affiliated banks. The uninsured deposits of only some of them were left behind in their receiverships. The other banks were rendered insolvent by exercise of the FDIC’s “cross guarantee” power. See id. Because the FDIC’s cross-guarantee claim is subordinate to claims of uninsured depositors, they were made whole. The First City banks whose depositors were not made whole totaled approximately $6 billion in assets. See FDIC News Release PR-7-93 (Jan. 27, 1993). The “bridge banks” created when the First City banks were closed, see 12 U.S.C. § 1831r, attracted such large premiums from interested acquirers that uninsured depositors in all the First City banks were ultimately made whole, and there was substantial value left over for the bank’s holding company, which consequently was able to emerge successfully from bankruptcy reorganization. See FDIC News Release PR-7-93 (Jan. 27, 1993).
the FDIC relied on the statutory predecessor of the "systemic risk" authority. The regulators might well conclude that the prospective failure of such huge banks posed a systemic risk, either through the ripple effects of disrupted payment transactions, through secondary failures of banks with federal-funds advances to, or correspondent deposits at, the failing bank, or through "contagion," a spreading loss of faith in the banking system as a whole or some significant part of it, causing massive withdrawals from other institutions.

Systemic risk could be aggravated if foreign deposits, a significant class of an institution's funding base, found themselves subordinated and out of the money in a least-cost resolution. Regulators might fear that foreign deposits in other large institutions, especially if those banks were also troubled as part of a generally adverse economic or financial conditions for banks, might be hurriedly withdrawn. Hence, the regulators might fear the weakening or failure of other banks and might consider it necessary to protect the foreign deposits in the initially failing bank. Therefore, treating foreign deposits as subordinate to domestic deposits in liquidation could automatically cause any bank resolution involving foreign deposits to be a systemic risk resolution, resulting in foreign deposits being de facto insured for their full amount.

Congress clearly recognized the possibility that a bank failure involving foreign deposits could pose a systemic risk, and it did not want to preclude the regulators from covering foreign deposits in such a case. The ban on providing assistance to foreign deposits in section 41 of the FDI Act is subject to an exception for transactions meeting the requirements of section 13(c), which includes the systemic risk authority. In the debates over that statute, at least one Senator noted regretfully that "past history and the realities of the structure of our financial system suggest

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85 See supra note 34.

86 Foreign-deposit holders are already aware of the risk of subordination. For example, the Federal Reserve Board has instructed member banks to inform at least their U.S. depositors who make deposits in their foreign branches that the deposits have a lower liquidation priority than domestic deposits, see Federal Reserve Board Supervisory Letter SR 94-49(IB), Sept. 2, 1994, Fed. Banking L. Rep. (CCH) ¶61-145 (1994), and that the member banks may have adjusted their positions accordingly. Although they may consider the risk remote while the banking industry is healthy, in troubled conditions, the lower liquidation status could lead to accelerating instability. They may also believe that, whatever the law says, the regulators will be sure to make them whole in a failure— a belief that, as discussed in the text, could be warranted.
that... the FDIC may at some point have to cover foreign deposits at large banks in order to avert the collapse of our financial system.\textsuperscript{87} Also, the conference debate over the systemic risk exception, described above, focused on how such resolutions involving foreign deposits should be paid for.\textsuperscript{88} In that debate, representatives of the Treasury Department and the Federal Reserve Board urged that the ability of regulators to cover uninsured liabilities in a systemic risk resolution should extend to foreign deposits, a position that the legislators adopted.\textsuperscript{89}

However, Congress clearly did not want foreign deposits to be automatically protected. Indeed, when enacting the Improvement Act in 1991, Congress acted against a perceived regulatory practice of doing just that. In response, Congress reinforced the uninsured status of foreign deposits by enacting section 41 of the FDI Act, with its prohibition on providing special protection for foreign deposits. Three years later, in 1994, Congress reinforced the exclusion of foreign deposits from the definition of "deposits" that receive insurance coverage.\textsuperscript{90} Furthermore, in 1991, the legislators were generally opposed to the "too big to fail" policies of the FDIC, and were particularly opposed to the protection of foreign deposits as part of those policies. Accordingly, they acted to restrict those practices. Congress may have been concerned that regulators were too eager to effect a non-least-cost resolution because of the characteristic bureaucratic risk-avoiding mentality: government officials would rather spend money than risk a conspicuous and market-disruptive event for which they might be blamed. Congress had several reasons for objecting to such practices. On a theoretical level, too liberal protection of participants in the financial sector damages market discipline, leads to inefficient market behavior and allocation of resources, and may contribute to the fragility of the banking industry.\textsuperscript{91} On a practical

\textsuperscript{87} 137 CONG. REC. S16906 (Nov. 18, 1991) (statement of Sen. Conrad).

\textsuperscript{88} See supra notes 42-52 and accompanying text.

\textsuperscript{89} "[The systemic risk exception] needs to extend to the protection of foreign deposits as well. So what that means is that the flat ban on foreign deposits on protecting them under any circumstances doesn't work from the standpoint of a systemic risk exception. The systemic risk exception has to apply as well to foreign deposits in our view." Conference Transcript, supra note 43, at 129-30 (remarks of Assistant Secretary of the Treasury Jay Powell).

\textsuperscript{90} See supra notes 6, 58.

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and political level, Congress was concerned that the FDIC was spending too much money, contributing to the then-perceived insolvency of the bank insurance fund and the possibility of a taxpayer bail-out. Congress also objected to the inequity of little banks and their uninsured depositors not being covered while big banks were protected, an inequity exacerbated by the sense that big banks paid less for deposit insurance because their foreign deposits were not assessed and possibly by the perception that holders of foreign deposits were likely to be foreigners.

Congress implemented its goal to cut back on “too big to fail” transactions in two ways. First, it raised and multiplied the procedural hurdles necessary to effect a systemic risk resolution. Whereas prior to the Improvement Act, the FDIC could effect such a transaction on its own initiative with a majority vote of its board of directors, now the decision must be made by the Secretary of the Treasury, upon recommendation of both the FDIC and the Federal Reserve each acting by a supermajority vote of its board, and after consultation with the President. Second, Congress enacted what it thought was a higher substantive standard for justifying such a transaction. While the earlier “essentiality” exception could be applied to a smaller institution whose continued operation was deemed essential to provide services in its community, the current systemic risk exception implicitly applies only to institutions whose failure could have a serious adverse affect on the stability of the financial system as a whole. In the words of the Senate Banking Committee Report, the exception is intended to be used only in “those rare instances in which the failure of an institution could threaten the entire financial system.”

Congress’ obvious desire to limit the number of “too big to fail” transactions is a further reason why the depositor-preference provision should not be interpreted as creating a structure that might artificially drive the regulators toward systemic risk resolutions.

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93 See 137 CONG. REC. S16903-04.
95 S. REP. NO. 102-167, at 45.
6. CONCLUSION

During the unusually prosperous period for the American banking industry since the enactment of the federal depositor-preference regime, no American bank holding foreign deposits has failed. If such a failure should occur, however, and if the law should be allowed to have its effect as presently interpreted, the consequences could be severe. The FDIC should exercise its substantial ability to interpret its own statute\(^{96}\) to change its present interpretation of the depositor-preference provision, and should instead adopt the interpretation that is much more likely to reflect the intent of Congress. In order to promote market certainty, the FDIC should take that action now, at a time when the industry's prosperity offers the regulators the luxury of engaging in reasoned deliberation and the opportunity to establish a legal structure that will work smoothly when the industry encounters its next time of troubles.

If foreign deposits are classified with general-creditor claims rather than with domestic deposits, the effect on them of a depositor-preference regime in the liquidation of an insolvent bank can be severe. How severe depends on the proportion of domestic to foreign deposits, as shown below.

In the absence of depositor preference, the liquidation recovery ratio on foreign-deposit claims \( R_{fd} \) is the same as the liquidation recovery ratio for other deposit claims and for general-creditor claims: assuming no secured or otherwise preferred liabilities, the ratio is the assets \( A \) of the failed institution divided by its liabilities \( L \).

\[
R_{fd} = \frac{A}{L}
\]

But if the insolvent institution's domestic deposits \( D_d \) rank ahead of foreign deposits and other general-creditor liabilities, then they must be subtracted from both assets and liabilities, and the remaining assets, if any, must be divided among the remaining liabilities.

\[
R_{fd} = \frac{A - D_d}{L - D_d}
\]

If we assume a hypothetical failed bank holding assets with a net liquidation value of $80 million and with liabilities of $100 million, of which $90 million are deposit liabilities, we can graph the recovery ratio on foreign-deposit claims as a function of the ratio of domestic deposits to foreign deposits as follows:
In this hypothetical example, the recovery rate on foreign deposits drops to zero when the ratio of domestic deposits to all deposits rises to 89%.
APPENDIX B

IMPACT OF ALTERNATIVE METHODS OF ASSESSING THE COST OF A SYSTEMIC RISK RESOLUTION OF A BANK HOLDING FOREIGN DEPOSITS

In 1991, Congress considered (though perhaps not with equal seriousness) at least three different regimes for paying the cost of systemic risk resolutions in which the foreign deposits of the failed or failing bank were made whole.

Alternative A:

Foreign deposits are insured as are domestic deposits. Costs of all resolutions are borne (either with or without a special assessment) by the deposit base, including foreign deposits.

Alternative B:

As proposed by the Senate, the incremental cost of covering the foreign deposits is recovered by a special assessment on banks holding foreign deposits in proportion to the amount of foreign deposits that they hold.

Alternative C:

The incremental cost of a systemic risk transaction is recovered by a special assessment on banks proportional to their liability bases (defined as total liabilities, not including capital or subordinated debt). As this was the alternative that was enacted in the FDIC Improvement Act, 12 U.S.C. § 1823(c)(4)(G)(ii), it may be called the FDICIA Alternative.

Let us assume that there is a single bank failure in the relevant accounting period, and that it is addressed as a systemic risk resolution. Under those assumptions, the cost $C_{of}$ of that resolution borne by each unit of foreign deposits held elsewhere in the U.S. banking system is as follows:

Alternative A:

The incremental cost $X$ of covering foreign deposits in the systemic risk transaction is distributed over all deposits $D$ in the
banking system, including both foreign and domestic deposits. So the incremental cost per unit of foreign deposits $X_{uf}$ is given by:

$$X_{uf} = \frac{X}{D}$$

However, the foreign deposits are also paying a share of all other costs of the resolution. Consequently, the per unit share of foreign deposits $C_{uf}$ in the total cost $C$ of the resolution is given by:

$$C_{uf} = \frac{C}{D}$$

**Alternative B:**

In the special assessment, the incremental cost $X$ of covering foreign deposits is borne entirely by the total foreign deposits $D_f$, therefore:

$$X_{uf} = \frac{X}{D_f}$$

Since, under this alternative, foreign deposits have no share in other portions of total cost $C$, their per unit share in $C$ is the same as their per unit share in the incremental cost $X$:

$$C_{uf} = \frac{X}{D_f}$$

**FDICIA Alternative:**

The incremental cost of the systemic risk resolution is assessed on total liabilities.

That incremental cost is not necessarily limited to the cost of covering foreign deposits, but would also include the cost of covering other liabilities that the government decided needed to be covered. Those liabilities plausibly could include domestic deposits in excess of the insurance limit, as well as non-deposit liabilities.
like bank notes and federal funds purchased. In an open-bank assistance transaction such as the resolution of Continental Illinois, all liabilities would ordinarily be protected by the nature of the transaction; in other transaction forms involving the closure of the bank and the creation of a receivership estate, they need not be. The language of the statute, which authorizes the FDIC to take such action "as necessary to avoid or mitigate such adverse [economic or financial] effects," is reinforced by the legislative history indicating Congress's desire to cut back on such transactions and compels the conclusion that the government must not protect liabilities beyond those necessary to avert the systemic risk it has identified, if the institution's liabilities can be feasibly split apart. Assuming in our hypothetical case that the government decides to protect foreign deposits and excess domestic deposits but not non-deposit liabilities, then foreign deposits' per unit share in the non-least-cost portion of the transaction is:

\[(X + Y)_{\text{off}} = \frac{X + Y}{L}\]

where \(Y\) is the cost of covering the excess domestic deposits. Because foreign deposits do not share in the least-cost portion of the resolution, their per-unit share in the total cost \(C\) of the resolution is likewise:

\[C_{\text{off}} = \frac{X + Y}{L}\]

The FDICIA Alternative is clearly the least costly for foreign deposits. Assuming a hypothetical scenario in which total deposits in the banking system \(D\) are $10 trillion, of which foreign deposits \(D_f\) are $1 trillion, total liabilities \(L\) in the banking system are $10.75 trillion, and the total cost of the systemic risk resolution \(C\) is $2 billion of which the incremental cost \(X\) of covering the failed bank's foreign deposits is $200 million and the incremental cost \(Y\) of covering excess domestic deposits is also $200 million, while non-deposit liabilities are not covered, then the

cost of that resolution borne by each million dollars of foreign deposits elsewhere in the banking system under each payment alternative is as follows:

Table I

<table>
<thead>
<tr>
<th>Alternative</th>
<th>Cost per million dollars of foreign deposits</th>
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<tbody>
<tr>
<td>Alternative A</td>
<td>$200</td>
</tr>
<tr>
<td>Alternative B</td>
<td>$200</td>
</tr>
<tr>
<td>FDICIA Alternative</td>
<td>$37.20</td>
</tr>
</tbody>
</table>

The U.S. deposit-insurance regime is no stranger to disparities in treatment: insurance premiums are assessed on the full amount of domestic deposits, but only amounts up to $100,000 are protected. Nevertheless, the huge disparity in the contributions made by foreign deposits to resolution costs under the different alternatives described above suggests that the statute is not being correctly interpreted. Perhaps the special assessment called for by FDIC Act § 13(c)(4)(G)(ii) is intended to recoup the total cost of the systemic risk resolution rather than simply the cost in excess of that entailed by a least-cost resolution.

The language of the statute, which refers to "the loss to the appropriate insurance fund resulting from any action taken or assistance provided ... under clause (i)"98 (which authorizes the FDIC to take action to avert adverse systemic effects) suggests the concept of incremental cost, but could be interpreted the other way. Similarly, if the cost of a least-cost transaction is adequately covered by the standard assessment on insured deposits, one could plausibly assume that a special assessment triggered by a systemic risk resolution would recover only the incremental cost of that transaction, that being the portion of the cost that is not already adequately provided for. That assumption, however, may not be warranted if the mechanism of the special assessment results in the cost of protecting certain classes of liabilities being paid primarily by other classes of liabilities that arguably received no benefit from the extra coverage and are already paying separately for the protection they receive.

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Assuming the statute calls for the special assessment to recover the total cost of the systemic risk resolution, and not the incremental cost, then the cost per unit of foreign deposits is given by:

\[ C_{uf} = \frac{C}{L} \]

Applying that formula to the hypothetical scenario described above yields the following results:

**Table II**

<table>
<thead>
<tr>
<th></th>
<th>Cost per million dollars of foreign deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative A</td>
<td>$200</td>
</tr>
<tr>
<td>Alternative B</td>
<td>$200</td>
</tr>
<tr>
<td>FDICIA Alternative</td>
<td>$186</td>
</tr>
</tbody>
</table>

The FDICIA Alternative is now only slightly cheaper for foreign deposits than are Alternatives A and B. The slight cost advantage results from some of the cost of the resolution being borne by non-deposit liabilities even though, on our assumptions, they contributed nothing to that cost. If we modify those assumptions and assume a transaction in which non-deposit liabilities are covered, at an additional cost of, say, $150 million, then the results are as follows:

**Table III**

<table>
<thead>
<tr>
<th></th>
<th>Cost per million dollars of foreign deposits</th>
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</thead>
<tbody>
<tr>
<td>Alternative A</td>
<td>$215</td>
</tr>
<tr>
<td>Alternative B</td>
<td>$200</td>
</tr>
<tr>
<td>FDICIA Alternative</td>
<td>$200</td>
</tr>
</tbody>
</table>

In this scenario the costs to foreign deposits of the FDICIA Alternative and Alternative B are exactly the same. Alternative A is slightly more expensive to foreign deposits, because that alternative, while the non-deposit liabilities are contributing to the cost of the resolution, they are not assessed for any part of that cost; instead, the incremental cost attributable to them is borne entirely by deposits, including foreign deposits.
The hypothetical scenario represented in Table III merits attention because there are at least two reasons why non-deposit liabilities might be covered. First, the government might conclude that those liabilities in themselves would pose a systemic risk if not made whole. Second, in order not to make them whole with the deposit liabilities—and to leave general creditors with their pro rata share of the insolvent bank’s assets—it would be necessary to close the bank and create a receivership estate against which the non-deposit creditors would claim. In the case of a huge contemporary bank, the FDIC might conclude that the process of closing the bank and attempting to disentangle the protected from the unprotected interests would be too disruptive even to the interests that the FDIC was trying to protect, and that the only feasible resolution would be one in which, as with Continental Illinois, the bank is left open and continues to operate with FDIC assistance. Such a resolution would necessarily protect the non-deposit liabilities. In the conference debate that resulted in adoption of the systemic risk provision as enacted in the Improvement Act, one Congressman proposed that open-assistance transactions not be permitted. That proposal was rejected, with one Senator going so far as to suggest that the principal purpose of the systemic risk exception was to permit such open assistance in cases of systemic risk: “I think the general view [in the Senate] is that the intervention is to try to prevent a failure.”

The problem with the whole-cost interpretation of the FDICIA Alternative, as shown in Table II and even more clearly in Table III, is that it does not provide a significant cost advantage (or in the case of Table III, any cost advantage) to foreign deposits over the Senate-devised special assessment (Alternative B) that was the FDICIA Alternative’s principal competitor for the conference’s approval. Yet, the FDICIA Alternative was adopted precisely because it was thought to be better for foreign deposits:

Mr. Schumer... Will this type of ex post facto assessment,... why don’t you think it will drive money out of, out of U.S. banks and into others?...
Mr. Powell [Treasury Department]. It ought not to, because the assessment will be spread over the entire funding base of the banking system and not focused simply on foreign deposits.\footnote{id}

The necessary conclusion is that Congress intended the special assessment, as suggested by the statute’s language, to recover only incremental costs, with the effects shown in Table I.

\footnote{id}{Id.}