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FDIC Closed-Bank Rules Yield Surprises for Sweep Accounts

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In July 2008, the FDIC published an interim rule that generally was effective upon publication. This rule primarily addressed the treatment of sweep accounts in connection with bank failures.

Just a few short months ago it seemed that the FDIC was confident that it could address the number of problem banks without any rash of bank failures. Instead, economic conditions deteriorated. As a result, the U.S. Department of the Treasury promulgated the capital purchase program under the Troubled Assets Relief Program and the FDIC Temporary Liquidity Guarantee Program. What has seemed to escape notice by many bankers is the interrelationship between the FDIC's process for closure of a failed bank and the Liquidity Guarantee Program.

Liquidity Guarantee Program

On October 14, 2008, the FDIC announced that it would provide an unlimited guarantee on deposits held in noninterest-bearing transaction accounts at U.S. banks. Initially, the guarantee would apply to all domestic banks for 30 days, at which time each bank would have to opt out of the program or pay a fee for the guarantee to continue through December 31, 2009. The 30-day "free period" has been extended to December 5, 2008. Most financial institutions seem to be committed to paying the increased assessment in order to provide their demand deposit account customers with unlimited protection.

The Liquidity Guarantee Program was aimed at businesses for which it is impractical to split certain accounts, such as a payroll account, among several banks in order to stay below the current $250,000 deposit insurance limit. The FDIC's treatment of sweep accounts, however, has a potential to frustrate the objective of protecting business account holders in the event of a bank failure.

Sweep Accounts

Sweep accounts were designed as a "win-win" for business account holders. In the typical arrangement, the business receives a much higher effective yield on an account that otherwise would not pay interest, and the bank reduces its assessable deposit base. The impact of the FDIC Liquidity Guarantee Program and the treatment of sweep accounts in connection with a bank failure, however, may change the risk reward paradigm for corporate treasurers.

Under FDIC rules, in the event of a financial institution insolvency, the FDIC would give effect to automatic transfers provided they occur before the earlier of either the failed bank's normal cut-off time for that specific type of transaction or the time established as a cut-off point by the FDIC after it has been appointed receiver.

The FDIC's rule on sweep accounts distinguishes between internal and external sweep accounts. Pursuant to internal sweep arrangements, funds are transferred within the financial institution itself such as by account posting or book entry. In contrast, external sweep arrangements involve the transfer of funds outside the institution, such as to a money market mutual fund. Under the FDIC's rules, any automated internal sweep transaction from one account to another account at the failed institution would be deemed completed on the day of the failure. In other words, the FDIC would recognize the transfer pursuant to the account agreement in determining the end of day balance for deposit insurance and depositor preference purposes. The FDIC, however, would not complete an external sweep unless the funds have left the institution prior to the cut-off point. This is the case even if the external sweep would transfer the funds to an account or product of an affiliate of the bank and even if such transfer were by book entry means.

Effect of Bank Failure

The FDIC's failed-bank process has obvious implications because of the different limit of deposit insurance for noninterest-bearing transaction accounts under the Liquidity Guarantee Program as compared to other bank deposit products. Under the Liquidity Guarantee Program, noninterest-bearing transaction accounts at participating banks generally would have unlimited insurance coverage. However, funds that are held for most of the day in a noninterest-bearing transaction account, if subject to a sweep arrangement, would not be covered under the Liquidity Guarantee Program (unless the funds are swept into a noninterest-bearing savings account at the bank). Instead, if the bank failed, these funds would be deemed by the FDIC as receiver to be transferred to the account into which the funds are to be swept at the end of the day, either a money market account protected only by $250,000 of deposit insurance or a nondeposit product for which there is no insurance.

These rules also have significance if the funds are swept into a nondeposit product. For instance, under a Eurodollar sweep, funds are transferred into a Eurodollar account typically in a foreign branch of the financial institution. Thus, each night the customer's end-of-day ledger balance is reported as a Eurodollar account. At the start of the next business day, the financial institution reports the balance as in the domestic deposit account. If a financial institution were to fail in the interim, the customer's funds very likely would be deemed to be held in the Eurodollar account. By definition, Eurodollar accounts are not deposits. As a result, the customer would be deemed to be a general creditor of the receivership and not a depositor at all.

The FDIC regulations provide a preference for uninsured depositors. Typically, the uninsured depositors receive some percentage of their uninsured deposits at bank closing based on the FDIC's assessment of what it will recover from liquidation of the failed bank's assets. In contrast, general creditors of the failed institution are usually wiped out. Thus, if a sweep arrangement provides for funds in an account to be transferred at the end of the day to a nondeposit product, but the account is still on the failed bank's general ledger when the bank is closed by the FDIC, then the business will likely lose its entire funds.

The FDIC recognized that the impact of these rules could have dramatic and unexpected results for businesses. So, earlier in the year, it asked for comments on whether it should insure sweep accounts and subject those accounts to FDIC assessments. The FDIC decided not to do so because of negative comments from financial institutions concerned about the added cost.

The FDIC met with a number of corporate treasurers to assess their knowledge of its rules for processing a bank failure. It was clear to the FDIC that these rules are not well understood. The FDIC noted that many institutions provide some disclosure to sweep customers, but the significance of what happens to depositors as a consequence of some sweep transactions when a bank fails requires consistent disclosures. The FDIC requested comment on what shape these disclosure rules should take. As a result, the FDIC delayed until July 1, 2009 a new rule that would require financial institutions to prominently disclose whether swept funds are deposits and the implications if they are not. Notwithstanding this delay, under the Liquidity Guarantee Program, banks will be required to disclose to their customers which accounts are covered under the program and which are not. This disclosure presumably would apply to accounts subject to a sweep arrangement.

What to do now?

Financial institutions should understand the implications of the rules regarding bank closures and sweep accounts. In the current environment, some corporate treasurers may be willing to forgo the increased yield associated with a sweep arrangement in order to have the certainty of FDIC insurance of the demand deposit account. Certainly, the combined effect of the FDIC's rules regarding sweep accounts and bank closures and the FDIC Liquidity Guarantee Program can provide a financial institution with ammunition to suggest to a customer who otherwise desires to institute a sweep arrangement that it may wish to forestall that decision until the economic climate improves.

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