

## **FDIC Clarifies Sweep Disclosure Rule, Repo Requirements**

During a May 21, 2009 ABA telephone briefing on the new sweeps disclosure rule issued on February 2, 2009, staff from the Federal Deposit Insurance Corporation clarified the types of accounts intended to be covered by the rule's disclosure requirement as well as the agency's views of the perfection requirement with respect to sweep accounts involving repurchase agreements.

The final rule describes the principles FDIC will use when processing deposit accounts when a bank fails. While most of the rule reiterates longstanding FDIC policy, the new disclosures for sweep accounts beginning on July 1, 2009, require banks to notify sweep customers of their status with respect to swept funds as insured depositors, uninsured depositors, secured creditors or general creditors.

### **Scope of the Rule**

A "sweep account" is defined in the rule as a pre-arranged transfer of funds from a deposit account to an (1) investment vehicle outside the institution, or (2) another account or investment vehicle inside the institution. The definition *does not* include:

Transactions initiated by the customer;

- Deposit-to-deposit sweeps (regardless of whether the customer is aware of the existence of sub-accounts) including:
  - Zero-balance accounts;
  - Reserve sweeps;
  - Sweeps to MMDAs;
  - Sweeps to pay down (amortize) loan accounts where there is no return sweep to the originating deposit account;
  - Sweeps that periodically transfer funds from one account to another (regardless of the ownership of the accounts);
- Bill-paying arrangements; and
- Accounts held on the institution's trust accounting system, even if the Trust Department uses an omnibus deposit account to collect idle cash and then sweep it from the omnibus account to an investment vehicle. FDIC views the omnibus account as an intermediary account used simply for administrative purposes to hold the idle cash before sweeping it to the investment vehicle.

### **Disclosure Requirements**

The new disclosures must prominently disclose whether the funds swept out of the deposit account will be treated as deposits. If the swept funds are not deposits, the disclosures must include the status of the funds if the institution failed, i.e., general creditor or secured creditor status. *This distinction will be extremely important for customers because general creditors usually receive nothing when a bank fails.*

When an insured institution fails, FDIC operates under depositor preference rules, meaning that both insured and uninsured depositors must be paid in full before any general creditors are paid. The order of FDIC claims priorities is:

- Secured claims;
- Insured deposits;
- Uninsured deposits;
- General creditors;
- Subordinated debt;
- Shareholder interests.

The disclosures may be made through various means, including client letters, transaction confirmation statements, or account statements.

### **Internal vs. External Sweeps**

FDIC determines the treatment of funds swept out of a deposit account based on where the funds reside on the institution's end-of-day ledger. If the sweep is to an account within the institution, it will be treated as an internal sweep. *Importantly, internal sweeps will be completed in accordance with the institution's normal processing procedures, even if that processing occurs after the bank is closed.*

Funds that reside outside the institution on its end-of-day ledger will be treated as external sweeps. *Once FDIC takes control of a failed bank, it will try to stop external sweeps, which may or may not be possible.*

### **Examples of internal sweeps:**

- Sweeps from a deposit account into a Eurodollar or IBF account in the failed bank. Funds that have been swept into a Eurodollar and IBF account are not deposits and will be treated as general creditor claims against a receivership.
- Sweeps from a deposit account to a Fed Funds account. Funds that have been swept into a Fed Funds account are not deposits and will be treated as general creditor claims against a receivership.
- Sweeps from a deposit account to pay an existing loan where the funds are swept back into the originating deposit account. Funds that have been swept out of the deposit account will be used to reduce the loan balance; funds remaining in the deposit account are insured deposits.
- Depositor-owned funds in a general ledger account will be treated as if they had never left the originating deposit account and therefore will have the status of an insured deposit.
- The full amount of swept funds attributable to an individual customer residing in an omnibus account will be deemed to be the customer's regardless of any netting practices used.

### Examples of external sweeps:

- Sweep to a money market mutual fund (MMMF) that is stopped; funds will be treated as if they never left the originating deposit account. The key question is whether the account is over the deposit insurance limit.
- Sweep completed to a MMMF; funds reside outside the bank. The customer is a secured creditor and will receive payment for the value of the assets in the MMMF.
- Sweep completed to a MMMF into an account maintained by the MMMF at the failed bank. Customer may get pass-through deposit insurance depending on how the account is titled. If the depository institution's records establish the MMMF as owner of the swept funds, the sweep would be completed, and the maximum insurance amount would be \$250,000. However, if the depository institution's records state that the MMMF account was established for the benefit of the sweep customers, then the swept funds are treated as though they never left the originating deposit account, and the sweep customers would be eligible for pass-through insurance.

### Repo Sweeps: A Special Case

In the final rule the FDIC stated for the first time that it will distinguish between sweeps involving repurchase contracts that in its view are "properly executed" and those that are not. The difference is that in a properly executed sweep, at the end of the day the customer either holds legal title to the assets or has a perfected security interest in the assets. In FDIC's view, whether such a perfected security interest exists is based on:

- Who "controls" the security;
- Whether the daily confirm identifies a particular security; and
- Whether the bank has the right to substitute securities.

Properly executed sweeps generally involve a third-party custodian for the assets who takes direction to effect the transfer of funds or securities only from the repo customer. By contrast, "improperly executed" sweeps typically involve repos for which the bank retains control over the security or a pool of securities and simultaneously serves as the repo buyer's custodial agent. This type of repo is often called a hold-in-custody, or HIC repo. Even though the assets are segregated in accordance with the Treasury Department's rules under the Government Securities Act and the assets may be held at a correspondent bank or other third party, FDIC's position is that a HIC repo gives the bank too much control over the securities for the customer to have a perfected security interest.

The consequence of having an improperly executed sweep repo is that FDIC will treat funds swept from such a sweep account as though they never left the deposit account. Therefore, under the final rule, a bank would have to disclose to its customer that in the event of failure, funds in excess of FDIC insurance limits will be treated as uninsured deposits. ***Just as critically, the final rule states that funds swept from an improperly executed sweep account must be reported on a Call or Thrift Financial Report as deposits for purposes of reserves and assessments as well as for Regulation Q, which prohibits the payment of interest on demand deposits.***

### Resolution of the Perfection Issue

Concerned about the timing and impact of this change on the large number of banks that operate HIC repos, ABA urged the FDIC to clarify what it will accept as a "properly executed"

repo. During the ABA telephone briefing, FDIC staff said the agency will consider a sweep repo to be properly executed if it satisfies each of the following conditions:

- Specific securities subject to the transaction are identified by written daily confirmations (as required by the Government Securities Act);
- There is language in the agreement expressly stating that the bank is acting as the agent of the repo customer and in the event of default (i.e., bank failure), the repo customer will have the right to direct the bank to sell the securities and apply the proceeds in satisfaction of any repo seller liability; and
- The agreement does not include a right of substitution of securities.

**ABA is aware that many sweep repo agreements include a provision in which the bank retains the right to substitute securities. *Importantly, as a temporary measure solely to assist insured institutions with meeting the impending disclosure effective dates, even if a repo contract includes a right of substitution, FDIC stated that if a bank expressly states in its sweep repo disclosure or on its daily confirmation that it will not exercise its right of substitution, FDIC will recognize the repo as properly executed. However, the agency expects insured institutions to take the steps necessary to amend their repo contracts to provide the necessary customer protection.***

#### **Timing of Disclosures**

The rule has a rolling effective date over a two-month period.

- **July 1, 2009:** Disclosures must be provided for new sweep accounts and for renewals of existing sweep accounts; and
- **August 29, 2009:** Disclosures must be provided for all other existing sweep accounts.
- **Annually thereafter.**