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The End of Unlimited FDIC Insurance: How Banks Can Retain—and Depositors Can Protect—Their Uninsured Deposits

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In an attempt to limit the flight of deposits from insured depository institutions resulting from the 2008 fiscal crisis, Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act provided temporary, unlimited deposit insurance coverage for non-interest bearing transaction accounts ("Transaction Accounts") at all depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) for a period of two years starting December 31, 2010 (the "Dodd-Frank Deposit Insurance Program").[1] Effective January 1, 2013, the Dodd-Frank Deposit Insurance Program expired and, as a result, deposits in excess of $250,000 in Transaction Accounts maintained by banking customers at FDIC-insured depository institutions will no longer be insured by the FDIC in the event that the insured institution fails.

Following the termination of the FDIC's unlimited deposit insurance program, certain insured depository institutions (smaller or lower-rated institutions, for example) may be concerned that non-interest bearing demand deposit account customers will seek shelter by withdrawing their deposits and transferring them to an institution perceived to be "safer."[2] Insured depository institutions ("Insured Institutions") can limit deposit flight by offering a product that provides a practical solution to the loss of unlimited FDIC insurance: an internal repo sweep account in which the swept funds are invested in US government securities. An internal repo sweep arrangement that is "properly executed" will ensure that the dollar amount of the customer's swept funds is fully protected (up to the value of the repo securities) in the event that the Insured Institution fails, and should encourage Transaction Account customers to maintain their deposits with the Insured Institution.

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1 In the immediate wake of the 2008 fiscal crisis, the Transaction Account Guarantee Program, adopted in October 2008 as part of the FDIC's Temporary Liquidity Program, provided unlimited insurance for deposits held in certain accounts at FDIC-insured depository institutions that elected to participate in the program and pay to the FDIC the requisite assessment (or insurance) fee. The Dodd-Frank Deposit Insurance Program, which superseded the Transaction Account Guarantee Program, was extended to all FDIC-insured depository institutions (regardless of whether they elected to participate in the program) and eliminated any requirement on the part of the insured institution to pay an assessment fee to the FDIC for the unlimited insurance coverage.

2 See "Money Funds Brace for Flood," *The Wall Street Journal* (December 19, 2012) ("Businesses and municipalities that use the [non-interest bearing deposit] accounts largely for payroll needs are expected to move cash to money-market funds or large banks."); "Senate Lets Special Deposit Insurance Plan Expire," *The Wall Street Journal* (December 14, 2012) (in expressing concern about the unwillingness of Congress to approve an extension of the unlimited FDIC insurance program, John McWeeney, President of the New Jersey Bankers Association, was quoted as saying: "The vote is a worrisome development for community bankers because hefty deposits they received from businesses, municipalities, hospitals and other non-profit organizations are likely [to] flee to mutual fund providers and the big banks, which still seem safer to many depositors who believe the government will again bail out the larger institutions if necessary."); and "End of Unlimited DDA Coverage to Drive Deposit Shifts," Fitch Wire (December 19, 2012) ("The expected expiration of unlimited FDIC protection for non-interest bearing demand deposit accounts....will likely lead to some deposit flight from smaller and lower-rated U.S. banks in 2013, according to Fitch Ratings. Beneficiaries of the insurance program's expiration may be the major U.S. banks, still viewed by many to be too big to fail, as well as highly rated regional banks.").

To understand why swept funds in an internal repo sweep arrangement will be fully protected (up to the value of the repo securities) in the event an Insured Institution fails, one needs to understand how the FDIC, upon institution failure, (i) treats internal repo sweep arrangements compared to external repo sweep arrangements, (ii) establishes a failed institution's end-of-day ledger balance, and (iii) processes claims made against the receiver.

Sweep Accounts

A "sweep account" is an account held by a bank account customer (under a contract between the customer and the Insured Institution) that involves the "pre-arranged, automated" transfer of funds from a deposit account to either (i) another account or investment vehicle located within the depository institution (an "internal sweep account") or (ii) an investment vehicle located outside the depository institution (an "external sweep account"). Although institutions may offer a variety of sweep products, the analysis for determining whether swept funds are "deposits" and, if not, whether the banking customer would, with respect to such swept funds, be considered a secured creditor in the event the institution fails can be complex and depends on a variety of factors, including the type and design of the sweep product, whether the sweep is an internal or external sweep, and the time at which the funds are swept from the deposit account.

Repo Sweeps

One of the most common types of sweep arrangements is a "repo sweep," which involves a transaction in which typically one party (the Insured Institution) sells securities (usually consisting of US government securities) to its deposit customer using the funds swept from the depositor's account.[3] The transaction is coupled with a simultaneous agreement made by the Insured Institution to repurchase from the depositor the subject securities at a specified time (typically the next business day) and for a specified price (which includes an interest component), at which time the sales price is returned to the deposit customer's account. This sale and repurchase cycle often repeats itself on a daily basis. As noted above, sweep arrangements can consist of either an internal sweep arrangement or an external sweep arrangement. Whether a repo sweep is an internal or external sweep, or was effected pursuant to a "properly executed" repurchase agreement, can have outcome-determinative implications and will affect whether the swept funds will be returned to the depositor upon the failure of an Insured Institution.

FDIC Rule on Processing of Deposit Accounts in the Event of Failure

In 2009, the FDIC issued a final rule describing the treatment of deposit accounts in the event of an insured depository institution failure[4] (the "FDIC Rule"). The FDIC Rule sets out the FDIC's practices for determining the value and nature of claims against a failed Insured Institution, and requires all insured depository institutions to disclose annually (and at certain other times) to all sweep account customers the nature of their swept funds (i.e., whether they constitute deposits) and, if such swept funds are not deposits, what type of creditor status such funds would have if the institution were to fail. The FDIC Rule, along with the explanatory guidance set out in the preamble thereof and informal guidance published by FDIC staff, provides useful (and cautionary) direction to both insured depository institutions and their Transaction Account customers on the most favorable ways to structure sweep accounts and, in particular, repo sweep account arrangements, when taking into consideration the risk of the institution's failure.

Establishing the Insured Institution's End-of-Day Ledger Balance

One factor that will impact whether swept funds are returned to a depositor after an Insured Institution fails is whether the sweep occurs before or after the applicable cutoff time for the specific transaction.

Normal Posting Procedures Generally Apply

When the FDIC, as receiver, takes control of a failed Insured Institution, it must construct an ending balance sheet for the institution and determine the value and nature of the claims to be made against the failed institution by a variety of creditors, including, among others, depositors, general creditors, subordinated creditors and shareholders. In making determinations regarding deposit insurance and the value and nature of claims against the failed institution on the date of failure, the FDIC will (as insurer and receiver) treat deposits and other liabilities of the failed institution based on the end-of-day ledger balances for each deposit or other liability using the institution's normal posting procedures (unless the FDIC applies its own FDIC Cutoff Point, as described below).

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3 Sweep arrangements typically involve a pre-established threshold set by the customer in which only funds in excess of the threshold are swept into the repo investment. In many cases, the threshold is $250,000; in other cases, the threshold will vary according to the needs and risk tolerance of the customer.

4 12 C.F.R. Part 360.8.

FDIC Cutoff Point

In general, the FDIC will use the cutoff rules previously applied by the failed institution in establishing the end-of-day ledger balance for deposit insurance determination purposes. However, the FDIC may establish, pursuant to the FDIC Rule, a different cutoff point, which is referred to in the FDIC Rule as the "FDIC Cutoff Point." The FDIC Cutoff Point is the point in time that the "FDIC establishes after it has been appointed receiver of a failed insured depository institution and takes control of the failed institution." Once the FDIC takes control of the failed institution (i.e., as of the FDIC Cutoff Point), the FDIC "will use its best efforts to take all steps necessary to stop the generation, via transactions or transfers coming from or going outside the institution, of new liabilities or extinguishing existing liabilities for the depository institution."

FDIC Will Block Transactions and Transfers Not Completed by the Applicable Cutoff Time

For any given transaction, if the failed Insured Institution's normal cutoff time on the date of failure is prior to the FDIC Cutoff Point, the FDIC will apply the Insured Institution's normal cutoff time to such transaction. However, if the Insured Institution's normal cutoff time for such transaction is later than the FDIC Cutoff Point, then the FDIC Cutoff Point (i.e., the time at which the FDIC takes control of the failed institution) will apply to such transaction. For any specific type of deposit account transaction, the FDIC refers to the earlier of the failed Insured Institution's normal cutoff time and the FDIC Cutoff Point as the "Applicable Cutoff Time." Thus, if the Insured Institution's normal cutoff time is 4:30 p.m. Eastern, but the FDIC, as receiver, takes control of such institution at 3:00 p.m. Eastern, then 3:00 p.m. Eastern will be the Applicable Cutoff Time.

External Versus Internal Repo Sweeps

The Risks Associated With External Repo Sweeps

In the case of an external repo sweep, the deposit account customer's funds are swept to an investment vehicle located outside the depository institution. The FDIC will, as of the Applicable Cutoff Time (i.e., the earlier of the normal cutoff time and the FDIC Cutoff Point), use its best efforts to block funds from moving out of or into the institution in order to ensure the proper distribution of the failed institution's assets. The time at which the swept funds are processed will depend on the depository institution's particular sweep mechanism. As specified by the FDIC Rule with respect to external sweep accounts, the FDIC will treat swept funds consistent with their status in the end-of-day ledger balances of the failed depository institution and the external entity, ***provided that the transfer of funds is completed prior to the Applicable Cutoff Time***. Thus, if the swept funds have not left the failed institution prior to the Applicable Cutoff Time, the FDIC will block the funds from being transferred to the external entity, in which case the swept funds will be treated as having never left the original deposit account. As a result, all funds in the deposit account (including the funds that were intended to be swept to the external investment vehicle) in excess of $250,000 on the date the institution fails will not be insured by the FDIC.

The Comparative Safety of Internal Repo Sweeps

In the case of an internal repo sweep, the FDIC will determine the ownership of the funds and the nature of the receivership claim based on the depository institution's records for the specific account or investment vehicle as of the closing day end-of-ledger balance using the institution's normal posting procedures. As noted in the preamble to the FDIC Rule, any "transaction – including sweep arrangements – would be completed for the [day on which the institution fails] according to normal procedures if it involves only the movement of funds between accounts within the confines of the depository institution." Accordingly, since an internal repo sweep results in the swept funds residing within the depository institution on the day the repo transaction is effected, the FDIC will treat the swept funds as having left the deposit account, ***but only*** if the repo sweep transaction qualifies as a "properly executed" repo sweep arrangement. ***In such case, the FDIC will fully recognize the depositor's ownership or security interest in the securities that are the subject of the repo transaction,[5] and if the value of the subject securities at least equals the dollar amount of the swept funds, the customer's swept funds will be returned to the depositor***.[6]

If, however, the repo sweep fails to qualify as a properly executed repo sweep arrangement, the FDIC will treat the swept funds as having never left the deposit account from which the funds originated. In such case, all funds in such deposit account (including the funds that were intended to be swept into the repo) in excess of $250,000 (the FDIC insurance limit as of January 1, 2013) on the date the institution fails will not be insured by the FDIC.

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[5] As noted in the preamble to the FDIC Rule within the context of a "properly executed" repo sweep arrangement, "[i]f the value of the securities at least equals the dollar amount of the funds swept from the customer's account, the customer's swept funds will be fully protected in the event of failure [of the depository institution]."

[6] The return of the swept funds to the depositor will be accomplished either by way of a check or other payment from the FDIC if no acquiring institution assumes the deposit account in a purchase and assumption transaction, or by a return of the funds to the depositor's account at the acquiring institution where the acquiring institution assumed the repo customer's deposit account.

As explained above, funds intended to be swept into a sweep arrangement in either an internal repo sweep that is not properly executed or pursuant to an external repo sweep that is not completed prior to the Applicable Cutoff Time will be treated by the FDIC as having never left the original deposit account.[7] Insured Institutions that are trying to encourage their Transaction Account customers to maintain their deposits with them in the wake of the elimination of the unlimited FDIC insurance program should consider offering those customers a "properly executed" internal repo sweep arrangement, which involves the customer obtaining either an ownership interest or a perfected security interest in the repo securities (as discussed below).

Properly Executed Internal Repo Sweep Arrangement

For repurchase agreement sweep accounts where, as a result of the sweep transaction, the customer becomes either the legal owner of the identified assets subject to repurchase or obtains a perfected security interest in those assets, the FDIC will, for receivership purposes, recognize the customer's ownership interest or security interest in the assets.[8] The preamble to the FDIC Rule, along with informal guidance published on July 6, 2009, by the staff of the FDIC (the "Staff FAQs"),[9] provides guidance on how to structure a "properly executed" repurchase transaction.

In adopting the FDIC Rule, the FDIC specifically drew attention to the fact that it had become aware that some depository institutions' repo arrangements are not "properly executed."[10] As explained, where the Transaction Account customer becomes either the legal owner of the securities subject to the repurchase transaction, or obtains a perfected security interest in the subject securities, the repo sweep arrangement will be considered by the FDIC to be a properly executed repo arrangement, and upon the failure of the depository institution the customer's swept funds will be fully protected to the extent of the value of the subject securities. However, where the customer receives neither an ownership interest nor a perfected security interest in the repo securities, the repurchase transaction will constitute an improperly executed repo arrangement and, as a result, the FDIC will treat the swept funds as if they had never left the Transaction Account (in which case all funds in such account in excess of the then-applicable FDIC insurance limit—or $250,000 as of January 1, 2013—will be uninsured).

The Three Elements for Determining a Perfected Security Interest in a Repo Transaction

Pursuant to guidance provided in the Staff FAQs, the FDIC generally considers three elements in determining whether the Transaction Account customer (i.e., the purchaser of the repo security) has a perfected security interest in the securities subject to the repo sweep arrangement:

i. the particular security in which the customer has an interest has been identified, and this identity is indicated in a daily confirmation;
ii. the customer has "control" of the particular security; and
iii. there is no substitution of the security during the term of the repurchase agreement even if the agreement allows for substitution with the customer/buyer's consent.

Identifying the Particular Security

To satisfy the requirement to identify the particular security subject to the repurchase transaction, the Staff FAQs indicate that the buyer's (i.e., the Transaction Account customer's) interest must be indicated by a confirmation (which must be sent out each day on which funds are swept) that identifies the security (by CUSIP or mortgage-backed security pool number). The daily confirmation must also specify the issuer, maturity date, coupon rate, par amount and market value of the repo securities. Furthermore, if the buyer is acquiring a fractional interest in the repo securities, such fractional interest must also be indicated. Importantly, the staff of the FDIC cautions that a buyer will not receive an identified interest in specifically identified securities in arrangements that involve bulk segregation or pooling of repurchase collateral without identification of specific securities. Thus, in designing or reviewing a repo sweep arrangement that is properly executed, Insured Institutions and their customers must ensure that the confirmation statements contain all the requisite information and are timely delivered.

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7 Coincidentally, ***prior to*** the expiration of the FDIC's unlimited insurance program, it was of little to no consequence whether swept funds would be returned to the deposit account in the case of either an external repo sweep not completed prior to the Applicable Cutoff Time or an improperly executed internal repo sweep arrangement. This was because all funds in the Transaction Account—including funds returned to the account—then enjoyed unlimited FDIC insurance. With the expiration of the FDIC's unlimited insurance program, the consequences of having swept funds returned to the Transaction Account may now, as explained, have a significant impact on the customer if the Insured Institution fails.

8 12 C.F.R. Part 360.8(d)(3)(iii).

9 Financial Institution Letter, "Sweep Account Disclosure Requirements Frequently Asked Questions" (July 6, 2009, FIL-39-2009).

10 It is important for an Insured Institution to properly determine and disclose, based on the specific construction of its repo sweep arrangement, whether the swept funds are deposits and, if not, the status of such funds upon failure. The disclosures must be consistent with the manner in which the institution reports such funds on its quarterly "call" reports. 12 C.F.R. Part 360.8(e).

Establishing Control of the Particular Security

To meet the requirement that the buyer possess "control" of the repo securities, the FDIC requires the Transaction Account customer (i.e., the buyer) to have the ability to direct the disposition of the repo securities in the event of default (i.e., upon failure of the institution). The FDIC staff identified the two most common arrangements used by an Insured Institution (i.e., the seller of the repo security) to hold securities used in repurchase agreements: (i) the hold-in-custody arrangement (a "HIC repo") and (ii) the tri-party arrangement.

In a HIC repo arrangement, either the Insured Institution maintains physical possession of the repo securities, or (and more likely) a third party maintains physical possession of the repo securities but the third party accepts direction regarding the securities solely from the depository institution. The staff of the FDIC states that a HIC repo arrangement may result in a transfer of control of the repo securities to the customer/buyer thereof if, pursuant to the repurchase agreement, the depository institution, acting as agent for the customer, is allowed to effect the customer's orders regarding the repo securities, such as transferring the securities to the customer in the event of failure. Thus, Insured Institutions and their customers must ensure that the proper language is included in the repurchase agreement, pursuant to which the customer appoints the Insured Institution its agent and the Insured Institution agrees to effect the customer's order.[11]

In a tri-party repo arrangement, the buyer/customer, the depository institution and an independent third party (the custodian) execute a tri-party agreement under which such third party has possession of and acts as custodian with respect to the repo securities. The custodian performs certain functions, including effecting the buyer's (i.e., the Transaction Account customer's) orders regarding the repo securities. The FDIC staff cautions that it is essential that the customer/buyer of the repo security possess the ability to direct the custodian to dispose of the repo securities in the event of a default by the depository institution. Simply transferring the repo securities to the custodian will not be sufficient to satisfy the element of "control." If the seller (i.e., the depository institution) is the sole party who can direct the custodian to act with respect to the repo securities, the element of control will not be satisfied. Again, the proper language must be included in the repurchase agreement transaction documents to ensure that the parties have agreed to the rights retained by the customer/buyer in order to satisfy this element of control.

Eliminating Substitution of the Particular Security

To satisfy the third element for a perfected interest in the repo securities, the repurchase agreement should eliminate any right of the seller (i.e., the Insured Institution) to substitute securities during the term of the repurchase transaction.[12] The FDIC specifically raised concerns about the ability to perfect a security interest in the repo securities when there is a substitution clause in a repurchase agreement, since substitution will result in the repo securities specifically identified in the confirmation to be inaccurate. Recognizing that repo transactions are typically overnight investments where the customer owns or has an interest in the repo securities for just a few hours (i.e., late evening to early morning), it is likely impractical to substitute securities during such time and, as a practical matter, substitution generally is not exercised.

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[11] For hold-in-custody repurchase agreements involving US government securities, the Insured Institution must comply with certain other federal regulations applicable to its holding of government securities for the customer's account. See, e.g., 12 C.F.R. Part 450.4 (requiring the depository institution to, among other things, segregate the securities from the assets of the institution, keep the securities free of liens, and maintain records of the customer's securities holdings separate from other records of the depository institution), and 12 C.F.R. Part 403.5 (requiring repurchase agreements to be in writing and setting out certain requirements applicable to the confirmation statement relating to the repo transaction).

[12] At the time that the FDIC Rule was adopted in 2009, the FDIC (in the Staff FAQs) recognized that outstanding repurchase agreements may contain a right of substitution, and the FDIC allowed institutions to eliminate the right of substitution by merely stating in the sweep disclosure delivered to customers that the institution agrees not to exercise any right of substitution even if the repurchase agreement granted such right to the institution. That temporary measure must now be replaced in all newly issued or amended repurchase agreements (including contract renewals) with an express provision to the effect that the institution will not substitute securities during the term of the repurchase transaction.