

MEMORANDUM TO: The Board of Directors

FROM: Mitchell L. Glassman, Director
Division of Resolutions and Receiverships

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SUBJECT: Claims and Large-Bank Modernization NPR

Recommendation: We recommend that the Board of Directors approve the attached notice of proposed rulemaking (“NPR”) and authorize its publication in the *Federal Register*. Public comment is sought for a period of ninety days.

Executive Summary

The NPR contains two parts. Part 1 proposes a rule governing how and at what point in time deposit account balances would be determined in the event of an insured depository institution failure. This part would apply to all insured depository institutions. Part 2 proposes requirements to facilitate the process for determining the insurance status of depositors of large insured depository institutions in the event of failure. As contemplated, the Part 2 requirements currently would apply only to the 159 insured depository institutions with at least \$2 billion in domestic deposits and either: (1) more than 250,000 deposit accounts or (2) total assets over \$20 billion, regardless of the number of deposit accounts.

Part 1 – Processing of Deposit Accounts

Background

Upon the failure of an FDIC-insured depository institution, the FDIC must determine the total insured amount for each depositor. To make this determination, the FDIC must ascertain the balances of all deposit accounts owned by the same depositor in the same ownership capacity at a failed institution as of the day of failure.

The second part of this proposed rule, among other things, would require certain large depository institutions to place holds on liability accounts, including deposits, in the event of failure. The amount held would vary depending on the account balance, the nature of the liability (whether it is a deposit or non-deposit for insurance purposes) and the expected losses resulting from the failure. In order to calculate these hold amounts,

the rules used by the FDIC to determine account balances as of the day of failure must be clearly established.

Many deposit account transactions affecting balances typically occur on any given day. A customer, a third party or the depository institution can initiate a deposit account transaction. These transactions can occur at any point during the day. All depository institutions process and post these deposit account transactions according to a predetermined set of rules to determine whether to include a transaction either in that day's close-of-business balances or in the next day's close-of-business balances. Further, institutions automatically execute prearranged "sweep" instructions affecting deposit balances at various points throughout the day. The cutoff rules for posting deposit account transactions and the prearranged automated sweep instructions define the close-of-business balance for each deposit account on any given business day.

In the past, the FDIC usually took over an institution as receiver after it had closed on a Friday. For institutions with a few branches in one state, deposit transactions for the day were completed and determining account balances on that day was relatively straightforward. The growth of interstate banking and branching over the past two decades and the increasing complexity of bank products and practices (such as sweep accounts) has made the determination of account balances on the day of closing much more complicated. Financial institutions are much larger and the industry is more concentrated than in the past, factors further complicating the determination.

The Proposed Rule

The proposed rule would define what is meant by a deposit account balance on the day an insured depository institution fails and, thus, would define the deposit account balances on which the FDIC would make insurance determinations. A deposit account balance on the day of failure would be defined as the end-of-day *ledger* balance of the deposit on the day of failure. Whether a deposit account transaction would be included in the end-of-day ledger balance on the day of failure would depend generally upon how it normally would be treated using the institution's ordinary cutoff time on that day. Many institutions have different cutoff times for different kinds of transactions, such as check clearing, Fed wire, ATM and teller transactions. Under the proposed rule, the FDIC would establish the FDIC Cutoff Point, defined as a point in time after it takes control of the failed institution as receiver. If the institution's ordinary cutoff time on the day of failure *for any particular kind of transaction* preceded the FDIC Cutoff Point, the institution's ordinary cutoff time would be used. Otherwise, the institution's ordinary cutoff time for an individual kind of transaction would be replaced by the FDIC Cutoff Point.

As contemplated under the proposed rule, upon taking control of a failed institution as receiver, the FDIC would take steps necessary to limit additional transactions to ensure, to the extent practicable, that funds would not be received by or removed from the failed institution. These steps might include the suspension of wire activities and new deposit

account transactions. For example, wire transactions not yet executed by the FDIC Cutoff Point would not be allowed to occur.

Treatment of uncollected deposited checks. Under the proposed rule, in determining deposit account balances at a failed insured depository institution, the FDIC would deem all checks deposited into and posted to a deposit account by the applicable cutoff time as part of the deposit account balance for insurance purposes. This approach means that the FDIC would use the “ledger balance” of the account for purposes of its deposit insurance determination, in contrast to using either “available funds” or “collected funds” account balances. The proposed rule differs from the FDIC’s past and current practice. In the past, for a check that was posted to an account but not yet collected at the time of failure—including a check already forwarded by the failed institution for collection but not yet collected—the FDIC acted as agent or trustee for the depositor and remitted or credited payments received on these checks to the depositor in full. These checks were not included in deposits on the day of failure and were not subject to deposit insurance limits. Under the proposed rule, when a check is posted to an account at the failed institution by the applicable cutoff time, the check would be included in the end-of-day balance and would be subject to deposit insurance limits, even if uncollected.

Some depositors may receive less favorable treatment under the proposed rule than if the FDIC were to continue to use its current approach to handling uncollected deposited checks. The increasing speed with which checks are processed as a result of electronic check processing, the use of checking account debit cards and other developments, however, should limit the effect of the proposed rule in this regard. Moreover, the current approach would not be feasible in a larger bank failure, and the FDIC must plan for all contingencies.

Treatment of sweep accounts. The proposed rule is prompted, in part, by a recent court decision involving the treatment of sweep accounts. In *Adagio Investment Holding Ltd. v. FDIC*, the FDIC was appointed as the receiver of the failed Connecticut Bank of Commerce. In accordance with its customary practice, the FDIC “completed the day’s business,” which involved processing pending transactions from a demand deposit account in the bank to a non-insured non-deposit account in the bank’s international banking facility. The court concluded that the sweep should not have been performed given the lack of “any provision in either the statute or regulations that would permit the sweep that occurred” In light of the *Adagio* decision, staff believes it is important to specify through notice-and-comment rulemaking how the FDIC proposes to determine deposit account balances when an institution fails.

Insured depository institutions maintain two types of sweep accounts. Internal sweep arrangements—such as those involved in the Connecticut Bank of Commerce case—sweep funds only within the institution itself by accounting or bookkeeping entries. External sweep arrangements—such as those connected to investments in money market mutual funds—move funds (usually by wire transfer) outside the institution and, hence, off its books altogether. The proposed rule would treat these two types of sweep arrangements differently.

Under the proposed rule, the FDIC would complete a prearranged internal sweep transaction on the day of the institution's failure if the applicable sweep account agreement provides for the automated sweep after transactions are posted for the day, but before the final deposit account balance is established. The completion of prearranged internal sweep transactions results in the calculation of end-of-day deposit balances for insurance purposes consistent with how such funds currently are treated for Call Report and assessment purposes.

The proposed rule would apply differently to sweep accounts involving the external transfer of funds outside the depository institution. In those situations, the status of the funds as of the institution's day of failure would depend on whether the funds left the institution (via wire transfer or otherwise) by the FDIC Cutoff Point. External sweep arrangements typically provide that invested funds remain outside the institution on a day-to-day basis. In this regard, at the point of failure the preponderance of a customer's funds would reside in the external sweep investment vehicle and not be considered a deposit for Call Report, assessment or insurance purposes. Such external funds typically would not be subject to loss in the event of failure. The proposed rule would affect only those balances leaving the institution on the day of failure. Thus, the proposed treatment of external sweep arrangements is consistent with the FDIC's practice, upon taking control of a failed institution as receiver, to limit the removal of funds from the failed institution.

Completing automated sweep arrangements on the day of failure, even after an institution is closed, would in many cases convert deposit claims into uninsured general claims against the receivership that may not be paid at all.

Requests for specific comments. In Part 1 of the NPR specific comments are requested on several matters:

- Whether the FDIC should impose requirements on depository institutions to have in place mechanisms capable of applying the applicable cutoff time to determine deposit account balances upon an institution's day of failure.
- Whether there are alternative approaches for determining deposit account balances at a failed institution, including whether the FDIC should have the discretion to establish a universal cut-off time for such determinations at the time it takes control of a failed institution.
- Among several questions related to repurchase-agreement sweep arrangements, whether some or all repurchase arrangements, as actually executed, pass title to the customer in a transaction that is enforceable against the FDIC or create perfected security interests that are enforceable against the FDIC.

- Whether, if internally swept funds were to be assessed insurance premiums, they also should be eligible to be treated as deposits for purposes of FDIC deposit insurance and depositor preference.

Part 2 – Large-Bank Modernization

Background

This part of the proposed rule applies to large FDIC-insured institutions with complex deposit systems, defined in the proposed rule as “Covered Institutions.” The definition would encompass insured depository institutions having at least \$2 billion in domestic deposits and either: (1) more than 250,000 deposit accounts; or (2) total assets over \$20 billion, regardless of the number of deposit accounts. Based on June 30, 2007 Call Report data, the combined total number of “Covered Institutions” would be 159. In summary, Covered Institutions would be required to adopt mechanisms that would, in the event of the institution’s failure:

- Allow automatic posting of provisional holds on large deposit accounts in any percentage specified by the FDIC on the day of failure.
- Provide the FDIC with deposit account data in a standard format.
- Allow automatic removal of the provisional holds and posting of the results of insurance determinations as specified by the FDIC.

Need For a Rule

When handling a depository institution failure the FDIC is required to structure the least costly of all possible resolution transactions, except in the event of systemic risk. In addition, the FDIC is required to pay insured deposits “as soon as possible” after an institution fails. The FDIC places a high priority on providing access to insured deposits promptly and, in the past, has usually been able to allow most depositors access to their deposits on the business day following closing. Doing so enables the FDIC to: (1) maintain public confidence in the banking industry and the FDIC; (2) provide the best possible service to insured depositors by minimizing uncertainty about their status and avoiding costly disruptions that may limit their ability to meet financial obligations; (3) mitigate the spillover effects of a failure, such as risks to the payments system, problems stemming from depositor illiquidity and a substantial reduction in credit availability; and (4) retain, where feasible, the franchise value of the failed institution (and thus minimize the FDIC’s resolution costs).

The largest insured institutions are growing increasingly complex. The proposed rule would help facilitate an insurance determination and dramatically improve upon access to depositor funds if one of these institutions were to fail. The proposed rule is intended to

allow the deposit operations of a failed institution to be continued on the day following failure. It is also intended to permit the FDIC to meet its legal mandates regarding the resolution of failed insured institutions, provide liquidity to depositors promptly, enhance market discipline, ensure equitable treatment of depositors at different institutions and help preserve the franchise value of a failed institution (thus reducing the FDIC's costs).

Limitations of Current Processes

Making deposit insurance determinations is inherently complex because a single depositor may have more than one account and may hold accounts in different ownership capacities, each of which may be separately insured. To make insurance determinations, the FDIC must aggregate all accounts owned by a depositor in a single ownership capacity. This process often requires reviewing detailed account agreements and other documents.

The larger the *number* of deposit accounts at an institution, the more complex and difficult the insurance determination becomes. Complexity also depends upon the *volume* of transactions, the amount of uninsured funds, the number of separate computer systems or "platforms" on which deposit accounts are maintained and the speed at which the institution's deposit operations must be resumed following failure. These factors all present significant challenges in a large-bank failure.

All of the insured institution failures using the FDIC's current processes and procedures have been of modest size, the largest being NetBank (2007) with total deposits at the time of closure of \$1.9 billion and roughly 175,000 deposit accounts. With this proposed rule, the FDIC's processes and procedures for determining deposit insurance coverage would be improved to avoid delays.

ANPRs

In 2005, the FDIC published an advance notice of proposed rulemaking (the 2005 ANPR),¹ which requested comment on three options for enhancing the speed at which depositors at larger, more complex insured institutions would receive access to their funds in the event of failure. All of the options would have required that *Covered Institutions* modify their deposit account systems.

- Option 1 would have imposed requirements very similar to those in this proposed rule, except that, in addition, institutions would have been required to maintain a unique identifier for each depositor and for the insurance ownership category of each account.
- Option 2 was similar to Option 1 except that the standard data set would have included only information that institutions currently possessed. The option

¹ 70 FR 73652 (Dec. 13, 2005).

would not have required institutions to create a unique identifier for each depositor or to classify each account by ownership category, similar to the requirements in this proposed rule.

- Option 3 was to require the largest ten or twenty insured institutions (in terms of the number of deposit accounts) to know the insurance status of their depositors and to be able to deduct expected losses to uninsured depositors in the event of failure.

Sixty-four percent of the 28 comment letters on the 2005 ANPR opposed the proposal, citing high costs and regulatory burden. In response, the FDIC published a second advance notice of proposed rulemaking (the 2006 ANPR)² that offered less costly and burdensome alternatives. The 2006 ANPR proposed dividing *Covered Institutions* into two tiers. Tier 1 institutions would comprise the largest, most complex *Covered Institutions*. The Tier 1 proposed requirements were the same as the Option 1 requirements under the 2005 ANPR, except that the deposit insurance category would not be required for each deposit account. Tier 2 institutions—the remainder of *Covered Institutions*—would have the same requirements as Tier 1, except that there would not be a unique depositor ID requirement.

The comment letters from the trade associations nevertheless still cited high costs and regulatory burden and argued that the benefits to the FDIC would be low and might never materialize. These letters suggested that the FDIC needed to conduct more research on the costs of the options and the potential benefits. It was recommended that the FDIC focus on troubled institutions or abandon the initiative altogether.³

In response, the FDIC has further reduced the potential costs and burdens in this NPR by dropping the requirement that the largest, most complex *Covered Institutions* provide a unique identifier for each depositor. The FDIC has strived to limit costs and burdens as much as possible while still resolving failed institutions at the least cost and providing depositors prompt access to funds. The FDIC still is interested in whether a unique identifier requirement would be desirable if applied to new deposit accounts.

In each ANPR the FDIC requested comment on other alternatives allowing it to meet its objectives in a less costly or burdensome manner. No alternative strategies have been proposed. Some trade organizations proposed delaying implementation of these requirements until a Covered Institution becomes troubled. Given the technological complexity of making funds available quickly and the risk that a Covered Institution could fail with limited warning, this proposal is not compatible with the FDIC's obligation to be prepared for a large-bank failure.

² 71 FR 74857 (Dec. 13, 2006).

³ In total, the FDIC received 13 comments on the 2006 ANPR. The 2006 comment letters are available at: <http://www.fdic.gov/regulations/laws/federal/2006/06comAC98.html>. Appendix B provides a more complete discussion of comments.

In response to the 2006 ANPR, the Board of Governors of the Federal Reserve System noted that the options reduced the likelihood of a too-big-to-fail resolution structure, promoted market discipline, lowered resolution costs and should be in place and tested before a large institution becomes troubled. The Federal Reserve Bank of Minneapolis also argued that the FDIC must revamp its systems for determining insurance at large institutions, should work with the industry to minimize the costs of the proposed options (but still ensure they meet the FDIC's objectives) and should not wait to implement the options until a bank becomes troubled. We agree.

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Attachments