FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

January 18, 2022

MEMORANDUM TO: The Board of Directors

FROM: Bret Edwards
Deputy to the Chairman and Chief Financial Officer

Art Murton
Deputy to the Chairman for Financial Stability

SUBJECT: Final Rule on Deposit Insurance Simplification

RECOMMENDATION

Staff is presenting to the Board of Directors the attached final rule for approval and publication in the *Federal Register*. The final rule amends the FDIC's deposit insurance regulations by: (1) simplifying the coverage rules for deposits held in connection with revocable and irrevocable trusts; and (2) providing consistent deposit insurance treatment for all mortgage servicing account deposit balances held to satisfy principal and interest obligations to a lender. Staff also recommends that notice to Part 370 covered institutions regarding the effect of the final rule be published in the *Federal Register*.

DISCUSSION

I. Simplification of Deposit Insurance Coverage Rules for Trusts

<u>Background</u>

The Federal Deposit Insurance Act (FDI Act) establishes the key parameters of deposit insurance coverage, including the standard maximum deposit insurance amount (SMDIA), currently $250,000. In addition to providing deposit insurance coverage up to the $250,000 limit at each insured depository institution (IDI) where a depositor maintains deposits, the FDI Act also provides separate insurance coverage for deposits that a depositor maintains in different rights and capacities (also known as insurance categories) at the same IDI. Some of the deposit insurance categories are defined by statute, while others are defined through regulations issued by the FDIC. The FDIC currently recognizes three different insurance categories for deposits held in connection with trusts: (1) revocable trusts; (2) irrevocable trusts; and (3) irrevocable trusts with an IDI as trustee.

Revocable Trust Deposits

The revocable trust category applies to deposits for which the depositor has evidenced an intention that the deposit will belong to one or more beneficiaries upon his or her death. This category includes deposits held in connection with formal revocable trusts – that is, revocable

Concur:

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trusts established through a written trust agreement. It also includes deposits that are not subject to a formal trust agreement, where the IDI makes payment to the beneficiaries identified in the IDI's records upon the depositor's death based on account titling and applicable state law. The FDIC refers to these types of deposits, including payable-on-death accounts and similar accounts, as "informal revocable trusts." Deposits associated with formal and informal revocable trusts are aggregated for purposes of the deposit insurance rules.

The calculation of deposit insurance coverage for revocable trust deposits depends upon the number of unique beneficiaries named by a depositor. If five or fewer beneficiaries have been named, the depositor is insured in an amount up to the total number of named beneficiaries multiplied by $250,000, and the specific allocation of interests among the beneficiaries is not considered.[1] If more than five beneficiaries have been named, the depositor is insured up to the greater of: (1) $1,250,000; or (2) the total of the interests of each beneficiary, with each such interest limited to $250,000.[2]

Irrevocable Trust Deposits

Deposits held by an irrevocable trust that has been established either by written agreement or by statute are insured under the irrevocable trust deposit insurance category. Calculating coverage for deposits insured in this category requires a determination of whether beneficiaries' interests in the trust are contingent or non-contingent. Funds held for non-contingent trust interests are insured up to $250,000 for each beneficiary, while funds held for contingent trust interests are aggregated and insured up to $250,000 in total.[3]

Deposits Held by an IDI as Trustee of an Irrevocable Trust

The FDI Act establishes separate insurance coverage for deposits held by an IDI in its capacity as trustee of an irrevocable trust. The FDIC's regulations relating to such trusts are found at 12 C.F.R. 330.12. Given the statutory basis for coverage, the FDIC is not changing these rules.

<u>Need for Rulemaking</u>

The trust rules often require detailed, time-consuming, and resource-intensive review of trust documentation to obtain the information necessary to calculate deposit insurance coverage. This information is often not found in an IDI's records and must be obtained from depositors after an IDI's failure. For example, insurance determinations for depositors of IndyMac Bank, F.S.B. (IndyMac) following its failure in 2008 were challenging in part because IndyMac had a large number of trust accounts. FDIC claims personnel contacted thousands of IndyMac depositors to obtain the trust documentation necessary to complete deposit insurance determinations for their revocable trust and irrevocable trust deposits. In some cases, this process took several months.

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[1] 12 CFR § 330.10(a).

[2] 12 CFR § 330.10(e).

[3] 12 CFR § 330.13(b).

Several factors contribute to the challenges of making insurance determinations for trust deposits. First, there are three different sets of rules governing deposit insurance coverage for trust deposits. Understanding the coverage for a particular deposit requires a threshold inquiry to determine which set of rules to apply – the revocable trust rules, the irrevocable trust rules, or the rules for deposits held by an IDI as trustee of an irrevocable trust. This may require review of the trust agreement to determine the type of trust (revocable or irrevocable). Second, even after determining which set of rules applies to a particular deposit, it may be challenging to apply the rules. For example, the irrevocable trust rules may require detailed review of trust agreements to determine whether beneficiaries' interests are contingent, and may also require actuarial or present value calculations. Third, the complexity and variety of depositors' trust arrangements adds to the difficulty of determining deposit insurance coverage. Trust interests are sometimes defined through numerous conditions and formulas, and a careful analysis of these provisions may be necessary in order to calculate deposit insurance coverage under the current rules. Arrangements involving multiple trusts where the same beneficiaries are named by the same grantor(s) in different trusts add to the difficulty of applying the trust rules.

Proposed Rule

In July 2021, the FDIC proposed to amend the rules that apply to trust deposits. The FDIC proposed to merge the revocable and irrevocable trust categories into a new "trust accounts" category. This category would include: (1) informal revocable trust deposits, such as payable-on-death accounts; (2) formal revocable trust deposits; and (3) irrevocable trust deposits. The deposit insurance coverage provided in the "trust accounts" category would continue to remain separate from the coverage provided for other deposits held in a different right and capacity at the same IDI.

Under the proposed rule, the calculation of insurance coverage for trust accounts would be similar to the rule currently used for revocable trusts with five or fewer beneficiaries, which has been the most straightforward for bankers and the public to understand. A depositor's trust accounts would be insured in an amount up to $250,000 multiplied by the number of trust beneficiaries, not to exceed five, regardless of whether the trust is revocable or irrevocable, and regardless of contingencies or the allocation of funds among the beneficiaries. This would, in effect, limit coverage for each grantor's trust deposits at each IDI to a total of $1,250,000. The proposed rule's $1,250,000 per-grantor limit balances the objectives of simplifying the trust rules, promoting timely payment of deposit insurance, facilitating resolutions, ensuring consistency with the FDI Act, and limiting risk to the Deposit Insurance Fund (DIF).

Summary of Comments

The comment period for the proposed rule ended on October 4, 2021. The FDIC received seven comment letters, including one joint letter from three national trade associations and individual letters from another national trade association, a State bankers' association, a deposit solutions provider, and three individuals. While commenters generally supported the FDIC's effort to simplify the trust rules, two individual commenters questioned the final rule's $1,250,000 per-grantor coverage limit.

Three trade associations raised a concern about the coverage that would apply to certain institutional trusts under the proposed rule, including common trust funds, collective investment funds, indenture bonds, and securitization trusts._The commenters asserted that deposits of such trusts would experience a reduction in coverage because per-beneficiary coverage would be provided only for up to five eligible beneficiaries. To neutralize any reduction in coverage resulting from this final rule, they urged the FDIC to amend the pass-through deposit insurance rules to explicitly provide pass-through coverage for beneficiaries of these trusts. Staff notes that pass-through insurance coverage currently applies to deposits of specific types of institutional trusts, such as employee benefit plan deposits and pass-through coverage would not be affected by this rule. Pass-through insurance coverage rules do not apply to other types of investment trusts, such as mutual funds or other investment company structures. While some institutional trusts (similarly to some individual trusts) may experience a reduction in coverage under this final rule, the FDIC believes that a simplified insurance calculation for trust deposits has substantial benefits for depositors and IDIs, as discussed in the preamble.

A trade association also suggested that the FDIC provide template language for bankers to explain trust coverage changes to depositors and publish and regularly update guidance and frequently asked questions on its website to address specific scenarios. The FDIC provides many resources for bankers and the public that explain deposit insurance coverage, including resources focused on trust deposits. If the final rule is adopted, staff will update these materials to reflect the changes in the deposit insurance coverage.

A few commenters also addressed aspects of the proposed rule that have implications for IDIs covered by 12 C.F.R. Part 370 (covered institutions under Part 370). Part 370 was adopted in 2016 to promote the timely payment of deposit insurance in the event of the failure of a large IDI. It generally requires covered institutions (IDIs with two million or more deposit accounts) to maintain complete and accurate depositor information and to configure their information technology systems, unless otherwise provided, so as to permit the FDIC to calculate deposit insurance coverage promptly in the event of the IDI's failure. If the final rule is adopted, covered institutions will need to update their information technology systems that calculate deposit insurance coverage in order to reflect the new rules as of the effective date. The comments also addressed particular aspects of covered institutions' compliance with part 370 that are discussed in further detail in the attached final rule for publication in the *Federal Register*.

Final Rule

If the Board approves the attached notice, it would finalize the rule generally as proposed with only technical, non-substantive edits. The final rule would take effect April 1, 2024, providing banks (including Part 370 covered institutions), depositors, and the FDIC slightly more than two years to prepare for the changes in deposit insurance coverage.

II. Amendments to the Mortgage Servicing Account Rule

Background

The FDIC's deposit insurance rules also define a separate insurance category for mortgage servicing accounts (MSAs) that are comprised of principal and interest funds. The FDIC's rules governing coverage for MSAs were adopted in 1990 following the transfer of responsibility for insuring deposits of savings associations from the FSLIC to the FDIC. Under the rules adopted in 1990, funds representing payments of principal and interest were insured on a pass-through basis to mortgagees, investors, or security holders. In adopting this rule, the FDIC focused on the fact that principal and interest funds were generally owned by investors, on whose behalf the servicer, as agent, accepted principal and interest payments. Payments of taxes and insurance were insured to the mortgagors or borrowers on a pass-through basis.

In 2008, after identifying that securitization methods and vehicles for mortgages had become more complex, the FDIC amended its rules to provide coverage to lenders based on each mortgagor's payments of principal and interest into the MSA, up to the SMDIA per mortgagor. The FDIC did not amend the rule for coverage of tax and insurance payments, which continued to be insured to each mortgagor on a pass-through basis and aggregated with any other deposits maintained by each mortgagor at the same IDI in the same right and capacity.

Need for Rulemaking

The current rules do not specifically address a common servicing arrangement utilized in the industry. Specifically, some servicing arrangements may permit or require servicers to advance their own funds to the lenders when mortgagors are delinquent in making principal and interest payments, and servicers might commingle such advances in the MSA with principal and interest payments collected directly from mortgagors. The 2008 amendments to the rules for MSAs did not provide for the fact that servicers may be required to advance their own funds to make payments of principal and interest on behalf of delinquent borrowers to the lenders.

The current rule provides coverage for principal and interest funds only to the extent "paid into the account by the mortgagors"; it does not provide coverage for funds paid into the account from other sources, such as the servicer's own operating funds, even if those funds satisfy mortgagors' principal and interest payments. As a result, such advances are not provided the same level of coverage as other deposits in an MSA comprised of principal and interest payments directly from the borrower, which are insured up to the SMDIA for each borrower. Instead, the advances are aggregated and insured to the servicer as corporate funds for a total of $250,000. Additionally, the current rule does not address whether foreclosure collections represent payments of principal and interest by a mortgagor. This inconsistent treatment of principal and interest amounts could contribute to financial instability during times of stress and could further complicate the insurance determination process.

Proposed Rule

In July 2021, the FDIC proposed to amend the rules that apply to mortgage servicing account deposits. Under the proposed rule, accounts maintained by a mortgage servicer in an agency, custodial, or fiduciary capacity, which are comprised of payments of principal and interest, would be insured for the cumulative balance paid into the account to satisfy principal and interest obligations to the lender, whether paid directly by the borrower or by another party, up to the SMDIA per mortgagor. Mortgage servicers' advances of principal and interest funds on behalf of delinquent borrowers would therefore be insured up to the SMDIA per mortgagor, consistent with the coverage rules for payments of principal and interest collected directly from borrowers.

The composition of an MSA attributable to principal and interest payments would also include collections by a servicer, such as foreclosure proceeds, that are used to satisfy a borrower's principal and interest obligation to the lender. Thus, under the proposed rule foreclosure proceeds used to satisfy a borrower's principal and interest obligation would be insured up to the SMDIA per mortgagor.

The proposed rule would make no change to the deposit insurance coverage provided for MSAs comprised of payments from mortgagors of taxes and insurance premiums. Such deposits would continue to be insured based on the ownership interest of each mortgagor in the account and aggregated with other deposits maintained by the mortgagor at the same IDI in the same capacity and right.

Summary of Comments

As noted above, the comment period for the FDIC's proposed rule ended on October 4, 2021. Of the seven comment letters submitted, only one joint letter from three trade associations specifically addressed the proposed changes to mortgage servicing account coverage. These associations requested additional clarity on the coverage that would be provided for three specific types of funds placed into mortgage servicing accounts by servicers – interest shortfall payments, funds from distressed homeowner programs, and funds used to satisfy buyout or repurchase obligations. Staff expects that interest shortfall payments and funds from programs designed to help homeowners generally would be covered by the proposed rule, as these funds are used to satisfy borrowers' principal and interest obligations. By contrast, funds used to satisfy buyout or repurchase obligations generally do not satisfy a borrower's principal and interest obligation, and would therefore fall outside the scope of the rule.

The associations further suggested that the FDIC eliminate the borrower-level allocation of funds that is required by the mortgage servicing account rule, noting that many servicers account for custodial deposits at a portfolio level rather than at a loan-specific level. This would mean that funds held to satisfy each borrower's principal and interest obligation would not be individually limited to the SMDIA. Staff believes that this would significantly expand deposit insurance coverage in some circumstances, such as large commercial mortgage payments.

Final Rule

If the Board approves the attached notice, it would finalize the rule as proposed. Consistent with the trust rule changes, the amendments to the mortgage servicing account rule would take effect April 1, 2024.

Notice to Insured Depository Institutions Subject to 12 C.F.R. Part 370

Staff has also prepared a related notice to Part 370 covered institutions, attached hereto. The FDIC previously committed to publish notice in the *Federal Register* after a change in law that alters the availability or calculation of deposit insurance to specify the period of time following the effective date of the change in law during which covered institutions will not be considered to be in violation of Part 370 as a result of the change in law.[4] Because the final rule would have a delayed effective date of at least 24 months following adoption by the Board, staff believes covered institutions will have sufficient lead time to be able to implement changes necessary to ensure compliance with Part 370 as of the effective date of the final rule. Staff recommends that the Board approve publication of the attached notice in the *Federal Register* stating that covered institutions must prepare updates or changes to their part 370 capabilities as a result of the amendments, and such changes must be implemented and operational on April 1, 2024, the effective date of the amendments.

CONCLUSION

The final rule would simplify deposit insurance coverage for revocable and irrevocable trust accounts and provide consistent deposit insurance treatment for all MSA deposit balances held to satisfy principal and interest obligations to a lender. Staff recommends that the Board approve both the final rule and the attached Notice to insured depository institutions subject to Part 370 for publication in the *Federal Register*.

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Attachments

[4] 12 C.F.R. § 370.10(d). See also 84 Fed. Reg. 37023.