Articles + Publications | April 5, 2023

Locke Lord QuickStudy: Protecting High Value Bank Accounts – ?Options to Increase FDIC Insurance Limits and Trust ?Solutions

Locke Lord LLP

WRITTEN BY

Jonathan W. Young | Adrienne K. Walker | William L. Barnard | Ryan Last

The recent collapses of Silicon Valley Bank ("SVB") and Signature Bank—followed by the bailout of Credit Suisse—have led depositors to look for ways to protect their deposits in excess of the Federal Deposit Insurance Corporation ("FDIC") insurance limits. In this latest bank scare, the FDIC used its discretion to insure the full value of the deposits at SVB and Signature Bank so that no depositor lost any deposits; this sort of a rescue (or bail-out) is not guaranteed in the future. As a result, many depositors are exploring steps they can take to protect bank deposits above the FDIC limits in the unlikely event that their bank fails. In a worst case scenario, a depositor could become a general creditor of a defunct bank with respect to uninsured amounts held in a deposit, savings, money market or certificate of deposit account.

While the economic and regulatory situation continues to evolve, there are several potential ways for depositors to increase the security of high value deposit accounts, and potentially improve the treatment of these deposits in a subsequent financial institution insolvency and/or receivership.

<u>FDIC Deposit Networks</u>. Many FDIC insured banks participate in "deposit networks." A deposit network allows a bank (the "relationship bank") to sweep a depositor's account balance in excess of the $250,000 FDIC insurance coverage to other FDIC insured network banks ("depository banks"), such that the amount on deposit at each network institution stays within FDIC insurance limits. By spreading a large deposit across the network, the depositor assures the full measure of FDIC insurance protection from all the banks that receive a portion of the account without having to "diversify" deposits at multiple banks to gain additional FDIC insurance protection. As a result, depositors face less operational and administrative burdens while keeping their funds both liquid and secure.

For instance, if a bank participates in a network of 10 FDIC insured banks, one relationship bank can offer depositors up to $2,500,000 of FDIC insurance coverage. When a depositor places funds into a deposit account and opts into a deposit network, account amounts that exceed FDIC insurance limits are automatically swept to the other depository banks in the network. In practice, the relationship bank transfers an amount slightly less than $250,000 to each network depository bank to allow capacity in the depository bank account for the accrual of interest while remaining under the $250,000 insurance threshold. Many U.S. banks participate in small or larger deposit networks, some of which have the ability to provide coverage of up to $750 million of FDIC insurance per depositor account. A depositor may also open multiple accounts at a relationship bank (assuming compliance with disaggregation rules), so that the accounts are not deemed to belong to the same depositor. In that scenario, the available FDIC insurance would be multiplied by the number of accounts held. We note that there is usually a fee, in the form of a reduced interest rate, charged to the depositor to participate in a deposit network. Depositors that participate in a deposit network program are asked to “block” relationship banks to which the depositor does not want its funds to be swept. The blocking is generally used to keep funds from going to a depository bank where the depositor has a pre-existing relationship that could be aggregated with the swept funds for FDIC insurance purposes, or potentially subjected to offset rights exercised by this other institution.

From the bank’s perspective, there are generally three options to participate in a deposit network: (i) as a relationship bank that sends excess deposits into the network (thereby reducing its deposit base), (ii) as a depository bank that receives excess deposits from the network (thereby increasing its deposit base), and/or (iii) as a reciprocal bank that sends and receives deposits from the deposit network in equal amounts (thereby having a neutral effect on its deposit base). While beyond the scope of this QuickStudy, depository banks and reciprocal banks should also consider the impact of “brokered deposits” when monitoring deposit network participation capacity.

Trust Accounts. When the deposit network at a bank is not sufficient to insure all of a customer’s deposits, where a different type of security is desired, or where the circumstances of the underlying commercial relationship so warrant, a depositor may want to consider opening a trust account with a trust company (usually a separate entity affiliated with the relationship bank). Where the Trustee or other financial institution accepts the funds in trust, and where the form of the trust complies with applicable state law, the deposited funds should retain their trust character in a subsequent insolvency or receivership of the financial institution. That is to say, the deposited funds would not become general assets of the receivership, would not be available for distribution to general creditors, and would continue to be held for the benefit of the applicable trust beneficiaries. Trust account assets, unlike bank accounts (including demand deposit accounts, money market deposit accounts, savings accounts and certificates of deposit), are not comingled with bank assets. Instead, with a trust account, the bank contracts to return to the depositor the same asset that it entrusted to the bank (although, we note that there are certain nuances regarding cash under the Uniform Commercial Code that must be navigated). Since a trust account depositor never becomes a creditor of the bank, the depositor can expect the entire value of the trust account to be afforded protected status, even if the trust company should fail. Depositors should be aware, however, that trust accounts usually incur set up and maintenance fees greater than those associated with bank accounts. To offset trust fees, “settlors” often diversify some trust assets into highly stable investment products such as U.S. treasury bonds. Bear in mind that, to the extent the bank or trust company invests trust assets into general deposit accounts maintained by the same institution in its commercial bank (and not in its trust company), those assets would be subject to commingling and reinvestment, and would once again become vulnerable to the extent greater than the applicable FDIC insurance limits. That is to say, trust assets may cease to become trust assets when transferred into and commingled with the general deposit accounts held by the commercial bank.

Bank Failures. As noted above, depositors of SVB or Signature Bank did not lose any of their deposits despite the fact that many held sums far in excess of FDIC insurance limits. The depositors did, however, lose access to their deposits for several days and had serious concerns while the regulators closed down these institutions and arranged for the ultimate disposition of their assets. For a short period of time, many customers were blocked from accessing their credit lines. Debt instruments, including lines of credit, are not protected by FDIC insurance. Moreover, in some cases, the FDIC canceled the failed banks’ customer credit lines, and offset deposit accounts by amounts due under debt instruments. Therefore, it may be prudent for bank customers who rely on lines of credit to diversify their sources of credit to avoid a cash crunch if in the unlikely event their bank were to fail.

Locke Lord attorneys have significant experience advising banks, financial institutions, investors, portfolio companies, and other corporate clients as to how to navigate these issues. We will continue to monitor these developments and expect to provide future client updates when useful. ???In the interim, please ?reach out to the authors with any questions. ?

This paper is intended as a guide only and is not a substitute for specific legal or ?tax ?advice.

RELATED INDUSTRIES + PRACTICES

- Corporate

