



Office of Thrift Supervision
Department of the Treasury

Chief Counsel

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

March 2, 1998

MEMORANDUM

FOR: Regional Directors
Regional Counsel

FROM: Carolyn J. Buck
Chief Counsel

SUBJECT: Permissibility of Sweep Arrangements

I. Introduction and Summary of Conclusions

The Regions have reported receiving many questions about the extent to which federal savings associations may, on a daily basis, “sweep” excess funds out of non-interest bearing commercial checking accounts into interest-earning accounts or investments overnight, then return the funds to the checking accounts the following morning so the funds will be available to the depositors. Interest in such sweep arrangements arises out of a statutory ban on the payment of interest on demand deposits.¹

This memorandum examines relevant statutory and regulatory provisions and concludes that sweep arrangements are currently permissible in two circumstances. As I more fully explain below, federal savings associations may establish sweep arrangements using government securities repurchases. Federal savings associations also may, subject to the conditions described below, sweep funds out of the depository institution to a third party, which would then invest the funds in mutual funds overnight. Institutions contemplating other types of sweep arrangements are encouraged to submit detailed factual information and legal analyses in support of their proposals.

¹ Commercial checking accounts are non-interest bearing demand deposits owned by commercial entities, and against which checks may be written. Individuals may hold interest-bearing negotiable order of withdrawal (“NOW”) accounts, which function as checking accounts. Commercial entities may not hold NOW accounts or interest-bearing checking accounts, as described below. This prohibition on interest-bearing commercial checking accounts gave rise to sweep arrangements.

Three bills are pending in Congress that would permit the payment of interest on commercial demand deposits and obviate the need for sweeps. They are: H.R. 2323, the Small Business Banking Act of 1997, introduced by Representative Metcalf on July 31, 1997; S. 1249, the Small Business Banking Act of 1997, introduced by Senators Hagel and Reed on October 3, 1997; and S. 1405, the Financial Regulatory Relief and Economic Efficiency Act of 1997, introduced by Senators Shelby and Mack on November 7, 1997. We understand that Representative Leach is preparing legislation that would permit corporate depositors to cover checks by making daily withdrawals from money market deposit accounts. This would permit the use of simple, linked account sweeps, as discussed below.

II. Background

Many federal savings associations have expressed a desire to compete with banks that are currently offering sweep arrangements. Federal savings associations are particularly interested in specific arrangements in which they would sweep excess funds from commercial checking accounts at the end of each day. Federal savings associations have proposed transferring swept funds into savings accounts or into mutual funds outside the association, with the association receiving a fee for processing transfers to and from the mutual funds. The next morning, or as needed, the transfers would be reversed and the funds would be returned to the checking accounts where they would be available to cover checks or other withdrawals.

III. Discussion

We have analyzed federal savings associations' authority to offer sweep arrangements under the Office of Thrift Supervision's ("OTS") four-part incidental powers test. Offering sweep arrangements is an activity that: (i) appears to be consistent with the purpose and function Congress envisioned for federal savings associations; (ii) is similar to, or facilitates the conduct of, expressly authorized activities for federal savings associations; (iii) relates to the financial intermediary role that federal savings associations were intended to play; and (iv) is necessary to enable federal savings associations to remain competitive and relevant in the modern economy. The more difficult issue is whether associations can structure sweep arrangements without violating any laws or regulations.

A. Applicable Statutes and Regulations

Depository institutions are generally prohibited from paying interest on commercial checking accounts. Section 5(b)(1) of the Home Owners' Loan Act ("HOLA") provides that "[a] Federal savings association may not pay interest on a demand account"² State savings associations and insured banks may not pay interest on commercial checking accounts,³ nor may Federal Reserve System member banks.⁴

A "demand account" is generally an account that has an original maturity or notice period of less than seven days, or for which the savings association does not reserve the right to require at least seven days' written notice prior to withdrawal, or an account held by a depositor ineligible to hold a negotiable order of withdrawal ("NOW") account under 12 U.S.C. § 1832.⁵

In addition to these statutory and regulatory provisions, the Federal Reserve Board's ("FRB") reserve requirements indirectly affect depository institutions' ability to offer sweep arrangements. The FRB's Regulation D requires depository institutions to hold reserves against demand deposits or "transaction accounts."⁶ Generally,

² 12 U.S.C.A. § 1464(b)(1)(B)(i) (West Supp. 1997). Because the prohibition is statutory, the OTS recently removed as unnecessary its regulation prohibiting the payment of interest on demand accounts. See Final Rule on Deposits, 62 Fed. Reg. 54759 (October 22, 1997) (effective January 1, 1998).

³ 12 U.S.C.A. § 1832 (West 1989). This provision authorizes depository institutions to offer interest bearing checking accounts to individuals, certain not-for-profit organizations, and for certain deposits of public funds. The authorization does not extend to commercial entities.

⁴ 12 U.S.C.A. §§ 371a (West 1989); 12 C.F.R. §§ 217.1 - 217.101 (1997). Additionally, the Federal Deposit Insurance Corporation ("FDIC") is required to prohibit banks, by regulation, from paying interest on demand deposits. 12 U.S.C.A. § 1828(g) (West 1989). The FDIC has promulgated such a regulation at 12 C.F.R. § 329.2 (1997). The Federal Reserve Board and the FDIC except premiums from the definition of interest under certain conditions. See 62 Fed. Reg. 26736 (May 15, 1997) interpreting 12 C.F.R. § 217.101 ("Premiums on Deposits") and 62 Fed. Reg. 40731 (July 30, 1997), interpreting 12 C.F.R. § 329.103 ("Premiums"). See also 62 Fed. Reg. 53769 (October 16, 1997) (FDIC proposed omnibus exception for insured nonmember banks that would parallel any exception available to member banks under 12 U.S.C. §§ 371a and 461, or by Federal Reserve Board regulation).

⁵ See 12 C.F.R. § 563.6 (1997). OTS recently removed this regulation. See 62 Fed. Reg. 54759 (October 22, 1997) (effective January 1, 1998). See also, the FDIC's definition of a "demand deposit" at 12 C.F.R. § 329.1(b)(3) (1997), which includes commercial deposits that are not subject to seven days' notice before withdrawals and that limit depositors to six withdrawals per month.

⁶ 12 C.F.R. §§ 204.1 - 204.136 (1997), implementing 12 U.S.C.A. § 461 (West 1989 & West Supp. 1997) (pertaining to reserve requirements).

Regulation D requires reserves only for deposits, including checking accounts, that may be withdrawn without seven days' notice to the institution.⁷ It does not require reserves for "time deposits," such as savings accounts or money market deposit accounts ("MMDAs"), that may require depositors to give seven days' notice before withdrawals and that are limited to six withdrawals per month.⁸

This six withdrawals per month limit effectively precludes the use of time deposits, which may pay interest, for sweeps. An institution could sweep excess funds daily out of checking accounts into time deposits, but to stay clear of Regulation D reserve requirements could allow no more than six transfers per month back into the checking accounts. Six transfers per month generally is not enough to make sweeps practical. The FRB has declined in the past to ease the six withdrawals per month limit.⁹ More recently, the FRB denied a petition for an expanded MMDA that would permit up to 24 withdrawals per month.¹⁰ Additionally, federal banking agencies have found such sweeps impermissible because they evade the ban on interest on commercial checking accounts, as discussed below.

Within this statutory and regulatory framework, the federal banking agencies have examined and approved or disapproved various sweep arrangements.

⁷ 12 C.F.R. § 204.2(b)(1)(i) (1997).

⁸ 12 C.F.R. § 204.2(d)(2) (1997).

⁹ In discussing public comments on a proposed Regulation D interpretation, the FRB addressed arguments that sweeps allow banks to compete with nonbanking entities:

The Board notes, however, that while [a sweep arrangement using time deposits] enables depositors to earn a higher rate of return than would be possible in the absence of these practices, it does so by allowing the depository institution to reclassify transaction accounts as time deposits, thereby avoiding the transaction account reserve requirement. Even though these funds remain in the banking system, reservable liabilities and the reserve base may be substantially reduced, impairing the ability of the Federal Reserve to conduct monetary policy.

Final Rule, Reserve Requirements of Depository Institutions, 57 Fed. Reg. 38417, 38422-23 (August 25, 1992).

¹⁰ See Letter from Alan Greenspan, Chairman of the FRB, to Edward Yingling, Executive Director, Government Relations, American Bankers Association (July 10, 1997).

B. Particular Sweep Arrangements

1. *Repurchase Agreements* -- Sweep arrangements using repurchase agreements were approved for federal savings associations in 1988 by the OTS's predecessor, the Federal Home Loan Bank Board ("FHLBB"). In this arrangement, associations invest depositors' swept funds in federal government securities, under an agreement requiring the association to repurchase the government securities from the depositor when the depositor needs funds. Because savings associations have specific authority to offer repurchase agreements to their customers backed by government securities,¹¹ and because repurchase agreements backed by federal government securities are not "deposits" within Regulation D,¹² the FHLBB found these sweep arrangements permissible.¹³ The OTS continues to find them permissible.¹⁴

2. *Linked Accounts* -- The simplest and most practical sweep arrangement is the so-called "linked account" sweep using two accounts at the same depository institution, one a checking account and the other some type of interest-bearing, non-checking account, such as a savings account or a money market deposit account. However, the federal banking agencies generally have not allowed linked account sweeps arrangements, either because they appear to evade the prohibition on paying interest on commercial checking accounts or, in the FRB's case, because they interfere with the FRB's monetary policy.

In 1981, a federal appeals court held in Otero Savings & Loan Association v. FHLBB ("Otero"),¹⁵ that linked accounts were an illegal subterfuge to evade the prohibition of interest on demand deposits. In Otero, the association offered its customers a sweep arrangement linking a non interest-bearing checking account and an interest-bearing savings account. The checking account normally had a zero balance. Whenever a check was presented for payment, funds in the exact amount of the check

¹¹ 12 C.F.R. § 563.84 (1997).

¹² 12 C.F.R. § 204.2(a)(1)(vii)(B) (1997).

¹³ FHLBB Op. Deputy Gen. Counsel (June 28, 1988).

¹⁴ While permissible, this sweep mechanism is somewhat cumbersome. OTS requires substantial disclosures and a perfected security interest under state law for each sale subject to repurchase. 12 C.F.R. § 563.84(b) (1997). OTS has declined to waive the perfected security interest requirement. OTS Op. Chief Counsel (November 30, 1990). In addition, the Treasury Department requires written confirmation of each transaction. 17 C.F.R. § 403.5(d)(1)(ii) (1997).

¹⁵ 665 F.2d 279 (10th Cir. 1981).

would be automatically transferred from the savings account to the checking account. The court said “a fair reading of 12 U.S.C. § 1832(a) indicates that no depository institution may offer an interest bearing demand deposit account, whether operated directly as a one-account NOW system or indirectly as a two-account [automatic transfer] system.”¹⁶

Thereafter, the FHLBB opined that a sweep arrangement between a linked commercial checking account and an interest bearing savings account would amount to paying interest on the commercial checking account in violation of § 1832(a).¹⁷ Because of the “clear authority for [its] conclusion of illegality,” the FHLBB found it unnecessary to decide whether the arrangement also violated the HOLA § 5(b)(1)(B) prohibition on paying interest on demand deposits.¹⁸

The FHLBB later found prohibited an arrangement in which a commercial checking account was linked with an interest-bearing MMDA that limited the depositor to six monthly withdrawals.¹⁹ The six withdrawal limit avoids Regulation D reserve requirements. However, the FHLBB found the arrangement violated both the § 1832(a) prohibition on interest-bearing commercial checking accounts, and the HOLA § 5(b)(1)(B) prohibition on paying interest on demand deposits.

The FDIC similarly declined to allow a state bank to offer a proposed sweep between a commercial demand deposit account and a linked, uncollateralized, uninsured investment account at the same bank.²⁰ The OCC found permissible an arrangement that linked a commercial demand deposit account and a certificate of deposit at the same national bank, with no restrictions on the number of transfers, where the bank reserved the right to require seven days’ notice before withdrawals from the certificate of deposit.²¹ Thereafter, however, the FRB announced that it

¹⁶ Id. at 282.

¹⁷ FHLBB Op. Gen. Counsel (October 4, 1984).

¹⁸ Id. at 2.

¹⁹ FHLBB Op. Gen. Counsel (October 21, 1985).

²⁰ FDIC Op. Asst. Gen. Counsel. No. 92-27 (April 28, 1992), 1992 FDIC Interpretive. Letter LEXIS 21. The FDIC based its decision on its regulatory prohibition of interest on demand deposits, 12 C.F.R. § 329.2 (1992). See also, FDIC Interpretive Letter No. 93-82 (December 6, 1993) (excess funds may not be swept between commercial depositor’s checking account and interest bearing secondary account).

²¹ OCC Interpretive Letter (May 25, 1988).

would treat linked account sweeps using time deposits as transaction accounts subject to Regulation D reserve requirements.²²

More recently, the FRB has addressed questions concerning two linked subaccounts of one account, where one subaccount would be either a demand deposit or NOW account and the other would be a savings or MMDA restricted to six monthly withdrawals.²³ The FRB found that the linked MMDA or savings subaccounts would not be subject to Regulation D reserve requirements. The FRB indicated, however, that where the demand deposit subaccount would not be a NOW account, this type of arrangement would violate the prohibition on interest payments on demand deposits.²⁴

It appears that no federal banking agency has since approved any sweep arrangement for commercial depositors that uses two linked deposit accounts within one depository institution. Focus has therefore turned to arrangements that sweep funds out of the depository institution or into non-deposit accounts.

3. *Sweep Arrangements Using Mutual Funds* -- Banks widely use an arrangement that sweeps funds out of checking accounts into money market mutual funds that operate independently of the bank. In this arrangement, an outside securities company receives the swept funds and invests them for bank customers in mutual funds.²⁵ The bank does not purchase any mutual fund shares for its own account. The OCC has approved this sweep mechanism, focusing on national banks' authority to act as securities brokers.²⁶

This is one area where the statutory and regulatory authorities of federal thrifts and national banks are different. National banks are specifically authorized by statute

²² "The Board . . . believes that permitting unlimited sweep arrangements within a depository institution could virtually eliminate transaction accounts and reduce reserve balances below the level necessary for the conduct of monetary policy. . . . Accordingly, the Board is exercising its authority . . . to treat such time deposits as transaction accounts." 57 Fed. Reg. 38417, 38424 (August 25, 1992).

²³ FRB Unpublished Letters (February 7, 1995; August 1, 1995; August 30, 1995).

²⁴ FRB Unpublished Letter (February 7, 1995).

²⁵ The swept funds are not insured deposits while they are in a money market mutual fund. 12 U.S.C.A. § 1813(m)(1) (West 1989 & West Supp. 1997).

²⁶ OCC Interpretive Letter No. 332 (March 8, 1985). "The use of a "sweep" service would not be inconsistent with the Glass-Steagall Act where securities are purchased solely upon the order, and for the account, of customers within the meaning of 12 U.S.C. § 24 (Seventh)." See also, FDIC Interpretive Letter No. 93-82 (December 6, 1993) (a bank may not sweep funds to a linked, interest-bearing account in the bank).

to buy and sell securities “upon the order, and for the account of,” their customers.²⁷ There is no similar explicit statutory authorization for federal savings associations. To date, federal savings associations have been authorized by regulation to conduct such activity through service corporations or with third party contractors.²⁸ Federal savings associations thus could transfer excess funds from deposits to a service corporation or third party broker-dealer. The service corporation or third party, pursuant to an agreement with the customer/depositor, could in turn buy mutual fund shares for the customers and sell those same investments the next day. Upon sale, the sale proceeds belong to the depositor, who may deposit the proceeds back into the checking account at the federal savings association.

The use of a service corporation to buy and sell securities raises another legal distinction between national banks and federal savings associations. Banks are exempt from broker-dealer registration requirements, while federal savings associations and their service corporations are not.²⁹ Sweeps using mutual funds may involve more steps for federal savings associations than for national banks, but appear to be permissible under applicable law.

The OCC recently approved sweeps using mutual fund shares that a national bank acquires and holds in its name.³⁰ In these instances, the bank purchases in its own name money market mutual fund shares solely for sweeps. The bank then sells fund shares to depositors to absorb swept funds, and repurchases the shares when depositors need funds transferred back to their demand deposit accounts. The bank must buy money market fund shares earlier in the day than it sells them to absorb swept funds and before the bank knows how much it will need to effectuate the sweeps that night. Therefore, the bank may buy more shares than it needs, hold all the shares in its own name for a few hours until the nightly sweep, and hold the excess shares overnight. In approving this type of sweep arrangement, the OCC observed that it involves activities specifically permitted national banks by statute in that it “essentially involves deposit taking and brokerage activity on behalf of [b]ank customers as permitted by 12 U.S.C.

²⁷ 12 U.S.C § 24 (Seventh) (West Supp. 1997).

²⁸ 12 C.F.R. §§ 545.74(a); 559.4(f) (1997) (service corporations may execute securities transactions for customers’ accounts); 12 C.F.R. § 545.17 (1997) (a federal savings association may transfer its customers’ funds from any account at the association or at another financial intermediary to third parties or to other customer accounts on the customer’s order or authorization).

²⁹ 15 U.S.C.A. § 78o(a)(1) (West 1997); 15 U.S.C.A. §§ 78c(3)(a)(6) (West 1997).

³⁰ OCC Interpretive Letter No. 688 (May 31, 1995); OCC Interpretive Letter No. 760 (November 14, 1996).

§ 24 (Seventh).”³¹ The OCC specifically restricted banks to buying shares of mutual funds that hold only bank-eligible investments.³²

In sweeps where a bank holds mutual fund shares in its own name, the restriction to bank-eligible investments highlights another distinction Congress made between national banks and federal savings associations. Savings associations and their subsidiaries currently are permitted to invest in corporate debt securities only if the debt securities are of investment grade.³³ National banks are not subject to such a restriction,³⁴ and, therefore, may buy shares in mutual funds that hold a broader range of corporate debt securities.

If a federal savings association were to offer mutual fund sweeps through a service corporation, it would have two options. Either it could provide that the service corporation never holds mutual fund shares in its own name, so the type of mutual fund investments would not be restricted to investments permissible for the service corporation. Or, the service corporation could buy mutual fund shares in its own name, but only shares of funds that restrict their investments to those that are permissible for savings association service corporations.

IV. CONCLUSION

Based on the foregoing, we conclude that sweep arrangements using government securities repurchases, consistent with the OTS’s November 1990 Opinion, the FHLBB’s June 1988 Opinion, and regulatory requirements, are permissible. Sweeps whereby funds are swept out of the depository institution to a third party, which then invests the funds in mutual funds overnight, also are permissible, subject the conditions discussed above.

³¹ OCC Interpretive Letter No. 688 (May 31, 1995). Accord OCC Interpretive Letter No. 760 (November 14, 1996).

³² OCC Interpretive Letter No. 688 (May 31, 1995) (“[i]nvestment by the Bank in these money market mutual funds will be within the authority of permissible bank investments under 12 U.S.C. § 24 (Seventh) because these funds will consist solely of bank-eligible securities.”) Accord OCC Interpretive Letter No. 760 (November 14, 1996).

³³ 12 U.S.C.A. §§ 1831e(d)(1); 1831e(d)(4)(A) (West 1989); 12 C.F.R. § 560.40(a)(2)(ii) (1997) (corporate debt securities must be rated in one of the four highest categories by a nationally recognized ratings service).

³⁴ 12 U.S.C.A. § 24 (Seventh) (West Supp. 1997); 12 C.F.R. § 1.3 (1997).

In the absence of new legislation, we expect federal savings associations to continue to seek to arrange permissible sweep programs. OTS welcomes specific proposals for particular sweep arrangements savings associations desire to employ. Interested associations should explain their specific proposals, supported by detailed factual information, and provide well reasoned legal analyses that address such concerns as legal authority, Regulation D, the prohibition on paying interest on demand deposits, possible conflicts of interest, transactions with affiliates issues, federal securities laws, and other relevant issues.

If you have any questions about this matter, please feel free to call Christine Harrington, Counsel (Banking and Finance), at (202) 906-7957.