COMPLIANCE & OPERATIONS ADVISOR

A HANDS-ON GUIDE TO RECENT DEVELOPMENTS

SWEEP ACCOUNTS: STRUCTURING PROPER DESIGN TO ATTAIN THE DESIRED COST CONTROL

December 2, 1996

OVERVIEW. Sweep accounts (an account arrangement under which a depositor's transaction account is linked with the depositor's time deposit account to lower Regulation D reserve requirements) are all the rage these days as part of financial institutions' efforts to enhance operating income. We have recently advised several bank and thrift clients concerning the legal requirements of structuring a sweep account that complies with Regulation D.

Regulation D imposes a substantial reserve requirement on so-called "transaction accounts," but no reserve requirement on other sorts of accounts. For purposes of reducing costs associated with the reserve requirement, it is in an institution's interest to characterize as many accounts as possible as savings accounts or to sweep funds from demand deposit (checking) or NOW accounts into savings accounts on a regular basis, because savings accounts have no associated reserve obligation, but common checking accounts and NOW accounts do.

Many institutions have attempted to minimize their reserve obligations by linking MMDA and demand deposit accounts, automatically sweeping into the MMDA account on a daily basis some or all of the funds left at the end of a day in a checking or NOW account, and transferring funds from the MMDA account in order to satisfy payment obligations with respect to the transaction account. The ways in which institutions attempted to accomplish this result varied from one institution to the next for a number of years, with some institutions maintaining clear separation between the two linked accounts and some treating the linked accounts essentially as one account.

REGULATORY GUIDELINES. Starting in the early 1990s, the Federal Reserve Board established what have become guidelines that all institutions must follow in order to link savings and demand deposit or NOW accounts for the purpose of reducing institutions' reserve obligations. Distilled to the essentials, a bank may link a transaction account (demand deposit or NOW account) to a savings account (most commonly an MMDA account) and transfer funds between the two accounts according to the following standards:

- no more than six transfers may be made out of the MMDA account in any month or statement cycle, and no more than three transfers may be by check, draft or debit card or similar order payable to third parties

- the MMDA account may be linked to no account other than the transaction account

- if an account holder or depositor exceeds the six-transfer limitation, the MMDA account should convert into the transaction account to which it is linked for the remainder of the statement cycle, although it may be reconstituted after the statement cycle has been completed. Commonly, the transaction account also establishes a threshold balance amount. When the balance falls below the threshold amount, funds are automatically swept into the transaction account from the MMDA account

- the account holder or depositor must affirmatively choose to have two accounts or two separate subaccounts, one a transaction account and the other a linked MMDA account. That is, the bank cannot of its volition establish the separate MMDA account for a depositor or account holder who has not requested such a linked account. The separate accounts must be established by the depositor or account holder and each account must constitute a separate contractual account obligation on the bank's part under state law

- the bank must have an adequate method of accounting for the separate transaction and MMDA accounts, with separate account identification numbers and separate records of activity for each account. For example, the bank should be able to identify on an ongoing basis the transaction activity in each separate account and the balance of each account

- the bank must have an adequate method in place for (i) keeping track of the number of transfers

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from an MMDA account on an ongoing basis and (ii) causing the entire MMDA account balance to be transferred to the transaction account when necessary in order to avoid a violation of the Regulation D six-transfer limitation. As a practical matter, this means that the sixth transfer by a customer in a statement cycle from an MMDA account should cause his entire MMDA balance to be transferred to the linked transaction account for the remainder of the statement cycle.

"Weak Links" in Sweep Account Design. The complexities of designing a linked sweep account are driven in large part by data processing capabilities. We have also found that many linked sweep accounts fail Federal Reserve Board guidelines by allowing the banks to unilaterally reclassify a customer's account. A deposit agreement amendment to create two separate accounts under a sweep account arrangement requires a customer's express affirmation, not a negatively stated passive authorization in which a customer's failure to object within a specified period of time means that the amendment is effective.

The compliance requirements to design a sweep account are murky at best. Knowledgeable oversight of your proposed sweep account represents a cost-effective investment to make certain your institution attains the tremendous cost savings inherent in lowered reserve requirements.

Grady & Associates Office Relocation

Effective **June 1, 1997**, *Grady & Associates* will relocate its offices to *20800 Center Ridge Road, Suite 116, Rocky River, Ohio 44116*. Our *telephone number* at that location will be *(216) 356-7255* and our *fax number* at that location is *(216) 356-7254*. As you know, our firm commenced operations on June 13, 1994 with 23 financial institution clients. Our client base now numbers over 85 financial institution clients across Ohio and the country. We do not believe that a presence in Downtown Cleveland near the Federal Reserve Bank of Cleveland is an indispensable part of our success and for that reason we are choosing to relocate to suburban quarters where our operating expenses are anticipated to be markedly lower. From your perspective, the relocation of our office should be transparent (other than reprogramming your telephone speed dial and facsimile machine for our new numbers).

Conference Events

Making a Market for Community Bank & Thrift Stock, Worthington, Ohio, April 8, 1997 -- Grady & Associates, in conjunction with Sweney Cartwright & Company, one of Ohio's leading market makers in community bank stocks, and Austin Financial Services, Inc., will host a conference which will focus on the development of a trading market for community bank stock. Over 20 community banks and thrifts are scheduled to attend. Registration information for this free conference is available at (800) 334-7481.

American Bankers Association 1997 National Regulatory Compliance Conference, Washington, D.C., June 9, 1997 -- Mr. Grady will be speaking on *Deposit Regulation and Operations Update: Using your Deposit Agreement as the Matrix for Ever-Changing Compliance Obligations.* This presentation provides an overview of the latest developments in deposit-side consumer compliance regulations and identifies fee income opportunities, as well as loss avoidance measures.
Conference registration information is available at (202) 663-5274.

AIC Conferences Sub-Prime Mortgage Receivables, Chicago, Illinois, June 24, 1997 -- Mr. Grady will speak on the topic of *Designing a Broker or Wholesale Correspondent Subprime Lending Program.* Conference registration information is available at (800) 409-4242.

Seminar handouts from these conferences are available.

Recent Projects:

¼ Bank holding company formation by an Ohio-chartered commercial bank.

¼ Thrift holding company formation by an Ohio-chartered savings bank making an election under Section 10(l) of the Home Owners' Loan Act to be regulated as a thrift holding company, rather than as a bank holding company.

¼ Counseling a thrift holding company/thrift on the establishment of an Ohio-based title insurance agency business.

¼ Advising wholesale residential mortgage lenders on RESPA compliance procedures in light of the recent wave of class action litigation challenging mortgage broker compensation. Deficient RESPA disclosure practices have been the Achilles heel exposing wholesale lenders to alleged RESPA kickback violations.

¼ Preparing an SEC Form S-8 Registration Statement for a thrift holding company's registration of the interests under a 401(k) profit sharing plan.

¼ Structuring a community bank holding company's odd lot tender offer for federal securities law compliance.