September 25, 2008

MEMORANDUM TO: The Board of Directors

FROM: Sara A. Kelsey
General Counsel

Sandra L. Thompson
Director
Division of Supervision and Consumer Protection

SUBJECT: Interim Rule to Simplify and Modernize
Deposit Insurance Rules on Revocable Trust Accounts

Recommendation

The staff recommends that the Board authorize the issuance of the attached draft interim rule simplifying and modernizing the deposit insurance coverage rules for revocable trust accounts. The interim rule would become effective immediately upon the board vote to approve it. It would then be published in the Federal Register with a sixty-day comment period.

Reason for the Rulemaking

The main reason for this recommended rulemaking is to make the coverage rules for revocable trust accounts simpler to understand and simpler to apply, without decreasing coverage currently available for revocable trust account owners. Also, staff believes the interim rule would result in faster deposit insurance determinations after bank closings and would help improve public confidence in the banking system.

Despite the FDIC's past efforts to simplify the coverage rules for revocable trust accounts, many depositors and depository-institution employees still are confused about the insurance coverage available on revocable trust accounts. This confusion is evidenced by the tens of thousands of deposit insurance inquiries we have received following recent depository institution failures. Also, upon an institution failure, because of the complexities of living trusts, FDIC determinations on the coverage available to owners of living trust accounts are often time consuming; thus, depositors are sometimes delayed in receiving their insured funds.

Overview of the Interim Rule

Under the new rules, a trust account owner with up to $500,000 in revocable trust accounts at one institution would be insured up to $100,000 per beneficiary. (This is the rule that would apply to the vast majority of revocable trust account owners.) Revocable trust account owners with more than $500,000 and more than five different beneficiaries named in the trust(s) would be insured for the greater of either: $500,000 or the aggregate amount of all the beneficiaries' proportional interests in the trust(s), limited to $100,000 per beneficiary.

Significantly, the interim rule would eliminate the concept of *qualifying beneficiaries* for all revocable trust accounts – a concept that has caused confusion and complaints of unfairness against the FDIC. The interim rule would further simplify the rules for revocable trust accounts of $500,000 or less by eliminating the existing requirement basing the revocable trust coverage on the proportional interests of the beneficiaries named in the trust.

Under the interim rule, coverage would be based on the existence of *any* beneficiary named in the revocable trust, as long as the beneficiary is a natural person, or a charity or other non-profit organization. For an account owner with combined revocable trust account balances of $500,000 or less (which staff believes is the vast majority of revocable trust account owners) the maximum available coverage would be determined simply by multiplying the number of different beneficiaries by $100,000.

<u>Current rules for revocable trust accounts</u>

There are two types of revocable trust accounts insured under the FDIC's coverage rules: informal trust accounts and formal trust accounts. Informal trust accounts are comprised simply of a signature card on which the owner designates the beneficiaries to whom the funds in the account will pass upon the owner's death. These are the most common type of revocable trust accounts and generally are referred to as "payable-on-death" ("POD") accounts. The other type of revocable trust accounts are accounts established in connection with formal revocable trusts. Formal revocable trusts are trusts created for estate planning purposes. They are commonly referred to as living trusts. Like an informal revocable trust, a living trust is a trust created by an owner (also known as a grantor or settlor) over which the owner retains control during his or her lifetime. Upon the owner's death, the trust generally becomes irrevocable.

The FDIC's rules provide that all revocable trust accounts (both POD accounts and living trust accounts) are insured up to $100,000 per "qualifying beneficiary" designated by the owner of the account. If there are multiple owners of a revocable trust account, coverage is available separately for each owner, per qualifying beneficiary as to each owner. Qualifying beneficiaries are defined as the owner's spouse, children, grandchildren, parents and siblings.

The per-qualifying beneficiary coverage available on revocable trust accounts is separate from the insurance coverage afforded to depositors in connection with other accounts they own in other ownership capacities at the same insured institution. That means, for example, if an individual has at the same insured depository institution a singleownership account with a balance of $100,000 and a POD account (naming at least one qualifying beneficiary) with a balance of $100,000, both accounts would be insured separately for a combined coverage amount of $200,000.

As explained above, both POD accounts and living trust accounts are types of revocable trust accounts insured under the revocable trust account category in the FDIC's coverage rules. Consequently, all funds that a depositor holds in both living trust accounts and POD accounts naming the same beneficiaries are aggregated for insurance purposes and insured to the applicable coverage limits.

<u>Eliminating the concept of "qualifying beneficiaries"</u>

Currently, revocable trust account coverage is based, in large part, on the number of qualifying beneficiaries named in the trust. Over the years and particularly recently, consumer groups and bankers have questioned the fairness of limiting the coverage on revocable trust accounts to the naming of certain beneficiaries. Many have argued that the FDIC should expand the definition of qualifying beneficiaries to include, among others, an account holder's nieces and nephew, in-laws, great-grandchildren, cousins, friends and charities. Historically, the FDIC's response to such complaints has been that there must be a reasonable limitation of the amount of coverage available on revocable trust accounts; otherwise, there would be potentially unlimited coverage under this account category. Hence, the FDIC has been reluctant to amend the rules to provide coverage based on any beneficiary(ies) named in a revocable trust. Under the interim rule, however, the staff believes the FDIC can achieve greater fairness under the revocable trust rules by basing coverage on the naming of any beneficiary in a revocable trust, but concurrently imposing coverage qualifications (discussed below) on accounts over $500,000.

In addition to addressing the *fairness* issue, eliminating the concept of "qualifying beneficiaries" would make the coverage rules easier to understand. Depositors and bankers no longer would need to know who is a *qualifying beneficiary* and who is not. Also, this revision would obviate the need for FDIC claims agents, upon an institution's failure, to confirm that a beneficiary named in a revocable trust account is a *qualifying beneficiary*.

<u>For account owners with aggregate balances of $500,000 or less, determining coverage without regard to unequal beneficial interests</u>

One of the most complex aspects of determining revocable trust account coverage under the current rules is having to discern and consider unequal beneficial interests in revocable trusts. This issue typically arises in the context of a living trust that, for example, provides either varying lump-sum payments for designated beneficiaries or different percentage interests in trust assets to certain beneficiaries, or different *remainder* interests in the assets to the same or other beneficiaries. Consumers and bankers alike find applying the current revocable trust account rules to complicated living trusts, especially ones involving unequal beneficial interest, far too complex. Staff agrees. Therefore, a key component of the interim rule is the ability to determine coverage available to account owners without regard to unequal interests of the beneficiaries named in the revocable trust(s). Staff believes this rule change, coupled with the recognition of all beneficiaries, would make the revocable trust account rules simpler and more transparent.

Retaining current coverage levels for account owners with more than $500,000 in revocable trust accounts and more than five beneficiaries named in the trusts(s)

Based on our experience at recent institution failures, staff believes that the vast majority of revocable trust account owners have less than $500,000 in revocable trust accounts at one FDIC-insured institution. Thus, under the interim rule, coverage for an account owner's revocable trust accounts would be determined simply by multiplying the number of different beneficiaries named in the trust(s) by $100,000.

In order to retain reasonable limits on the maximum coverage available to revocable trust account owners and also to retain the coverage available to revocable trust account owners under the current coverage rules, the interim rule would provide special treatment for depositors with revocable trust accounts over $500,000 naming more than five beneficiaries. Under the interim rule, revocable trust account owners with more than $500,000 and more than five beneficiaries named in the trusts would be insured for the greater of either: $500,000 or the aggregate amount of all the beneficiaries' interests in the trusts(s), limited to $100,000 per beneficiary. This coverage is no less than the coverage afforded to such account owners under the current rules, particularly because under the interim rule the coverage would be based on the number of beneficiaries, not the number of "qualifying beneficiaries."

Staff believes that basing the coverage of trust accounts over $500,000 (with more than five different beneficiaries in the trust(s)) on the ownership interest of each beneficiary named in the applicable trust(s) would prevent the potential of providing unlimited coverage with respect to revocable trust accounts. Without such a limitation, an account owner could name a limitless number of beneficiaries each with a nominal interest in the trust and obtain coverage up to $100,000 for naming each such beneficiary. For example, a revocable trust account held in connection with a trust entitling one beneficiary to $1 million and entitling each of nine other beneficiaries to $1 would be insured for $1 million, without the limitation imposed under the interim rule.

Treatment of life-estate interests

Another complicating factor in determining the coverage for living trust accounts is determining the value of *life estate interests*. A life estate interest usually means the life-estate beneficiary is entitled to the income on the trust assets during his or her lifetime. A large percentage of living trusts provide a life estate interest for one or more beneficiaries. The FDIC's current rules provide that, in such situations, each life-estate holder and each remainder-man is deemed to have an equal interest in the trust assets for deposit insurance purposes. This rule has proven difficult to apply, especially where the living trust provides for lump-sum gifts for certain beneficiaries, life estate interests for others and different percentage interests for the remainder-men. In order to simplify the coverage rules, the interim rule would revise the current valuation method for life estate interests by deeming each all such interest equal to $100,000, for purposes of determining deposit insurance coverage.

Treatment of irrevocable trusts springing from a revocable trust

Another current complexity in determining coverage for living trust accounts is that, when it is created, a living trust is a revocable trust but, when the owner dies, the trust becomes irrevocable. At that stage in the lifecycle of the living trust, the funds corresponding to the irrevocable trust are insured under the FDIC's rules for irrevocable trust accounts. To eliminate this complexity and the confusion it generates, under the interim rule, the coverage available on a living trust account would continue to be based on the revocable trust rules. In the interim rule we ask for comments on whether the coverage rules for irrevocable trust accounts should be revised so that per-beneficiary coverage would no longer be based on the non-contingent interest of each trust beneficiary.

Related Recordkeeping and Disclosure Rules

Staff will soon recommend to the Board that it issue a proposed rule addressing deposit insurance disclosure rules and revised recordkeeping requirements for revocable trust accounts.

Conclusion

For the reasons discussed above, the staff recommends that the Board adopt the attached interim rule and authorize its issuance in the Federal Register.

Attachment

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