issue brief

California Debt and Investment Advisory Commission

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The Use of Sweep Accounts by California Local Governments

Introduction

For nearly thirty years, sweep accounts have provided local governments and others with a means of earning interest income on unused cash that otherwise might sit idle in a zero-interest checking account. A sweep account acts as a "combination" account, linking a primary cash account with one or more secondary investment accounts, allowing funds to flow between them. Scheduled payments can be made from the liquid cash account while excess amounts over a predetermined balance can be transferred to short-term, interest-earning investments such as money market demand accounts and money market mutual funds. At the close of each business day, funds that exceed a certain "target balance" are automatically wired into one or more interest-earning investment accounts that have been pre-selected by the local agency.[1] This "sweep" of funds maximizes the agency's interest earnings while minimizing its involvement in day-to-day investment management. Typical sweep account providers include banks and brokerage firms ("sweep providers"), though terms, conditions, and costs vary among institutions.

The decision to use a sweep account comes with many choices. Not all local governments use them; those that do must determine the appropriate type of investment, necessary account services, and acceptable operational costs/fees for their agency. This issue brief addresses these factors as well as other issues for consideration. To provide additional context (albeit anecdotal) to this discussion, the issue brief also includes the results of an informal survey of local government sweep account usage. [2]

Why Use a Sweep Account?

Sweep accounts are designed to provide local governments with favorable rates of return on those assets which, though idle for a short period, must remain liquid for purposes of meeting local cash or financial needs. The accounts are managed by a private investment manager, so they do not require active investment management by the local government. As such, sweep accounts can be a useful tool in the local government's investment portfolio.

To better understand their utility in a portfolio, consider their history. They evolved as a response to competitive pressure from non-banks, such as mutual funds. In the early

1 Alternatively, if cash balances fall below a target balance, funds may be "swept" from investment accounts into the primary cash account.

2 CDIAC's survey was not constructed as an unbiased random sample of all California local governments; rather, it was a self-reported survey of local government investment officers. CDIAC sent out a brief survey to over 1,500 investment officers as identified by CDIAC staff and by trade associations, such as the California Municipal Treasurers Association (CMTA). It received 116 responses to the survey of which 55 local agencies stated that they use sweep accounts. Selected responses are included in the body of the issue brief with a more complete tally of results presented in the appendix. Because the survey was unscientific, the responses should not be viewed as representative of all local agencies; rather, they provide a collection of anecdotal viewpoints and practices from a small sample of local agencies.

1970s, non-bank financial institutions, such as mutual funds, began offering commercial accounts the opportunity to make short-term investments. These investments, nearly as liquid as demand accounts, provided higher rates of return than were available in typical demand accounts managed by banks, and drew millions of dollars from bank accounts.

Because federal regulation capped interest payments on demand accounts, banks could not directly respond to the competitive challenge. They developed instead, the sweep account, an investment instrument distinct from the demand account, but which could pay competitive interest rates within the regulatory restrictions. Soon, banks offered sweep accounts to non-commercial customers, including local governments.

Because sweep accounts evolved to compete directly with other short-term investment opportunities, local governments can consider them as an alternative or compliment to various short-term instruments. When setting their short-term investment policies, local governments may wish to consider when opening a sweep account may be appropriate.

Who Uses Sweep Accounts?

State law imposes some restrictions on local investment practices, but it is not directive about the use of sweep accounts. Though there are no data about how many local governments actually use sweep accounts, it appears that many local governments choose against opening an account. Because a local government has discretion about whether and how to use the accounts, its decision will reflect the governing board's assessment about the amount of its cash balances, investment needs, and access to alternative instruments. For example in CDIAC's survey, over half (53 percent) of the respondents reported they did not have a sweep account. When asked why they chose against opening an account, local governments said the primary reasons were low yields and limited availability. They also reported that they maintained insufficient balances to meet the minimum account requirements.

The decision to open an account may also depend on the size of the government and its investment portfolio. For example, half the cities that reported using the sweep accounts have portfolios smaller than $100 million. Two-thirds of the counties reporting the use of sweep accounts have portfolios greater than $500 million.

What Types of Investment Sweep Accounts are Available?

Most local agencies surveyed specified that their sweep provider offers two or more types of sweep account investments (58 percent). About 16 percent of these local agencies actually have multiple accounts with their sweep account provider. These accounts help local agencies manage multiple agency funds under their jurisdiction as well as deal with California Government Code restrictions regarding the amount of their portfolio invested in specific types of instruments (see discussion below).

According to the survey, sweep providers generally offer local agencies sweep account investments in money market demand (or deposit) accounts, money market mutual funds and/or repurchase agreements.

Money Market Demand Accounts. Money market demand accounts are interest-earning savings accounts upon which a limited number of checks may be drafted. These accounts are liabilities of the bank (that is, not linked to any specific investment assets) and are federally insured up to $100,000. They earn a short-term interest rate that is generally greater than a regular savings account because of restrictions such as a limited number of monthly account transactions or a higher minimum account balance requirement. Interest rates often are competitive with money market mutual funds (described below). Of those local agencies surveyed, 49 percent have money market demand sweep accounts. These accounts

Why Were Sweep Accounts Created?

Banks developed sweep accounts as interest-earning investment alternatives for commercial account holders. These account holders are restricted from earning interest on demand deposit accounts as a result of Regulation Q (enacted by Congress in the early 1930s). Prior to Regulation Q, it was common for banks to compete for commercial business by offering high interest rates on demand deposit accounts. The banks financed these high yields by investing in risky investments. Many of these investments lost principal value resulting in significant financial losses for the banks. These losses combined with other conditions at the time (e.g., lack of liquidity due to bank runs) resulted in many bank failures. To stabilize the banking system, Congress passed the Glass-Steagall Act (also know as the Banking Acts of 1933 and 1935), which included a variety of banking reforms including Regulation Q.

In the decades following these reforms, financial institutions developed a variety of alternative investment vehicles to attract commercial accounts. Money market mutual funds became available as an investment instrument in the United States in the early 1970s. Sweep accounts followed in the early 1980s, as banks were faced with the threat of losing some of their larger commercial customers' deposits to nonbank alternatives such as mutual funds.

appear most popular for local agencies surveyed with portfolios less than $100 million (56 percent of those holding money market demand account investments).

Money Market Mutual Funds. Money market mutual fund sweep accounts are high-quality, short-term mutual funds managed by either the sweep provider or a third-party fund manager. The funds most often used by sweep accounts are U.S. government or prime commercial paper funds. Money market mutual funds seek the preservation of capital as a primary goal while maintaining a high degree of liquidity (maximum maturities of investments not exceeding 397 days). Twenty-five percent of local agencies surveyed reported having money market mutual fund sweep accounts. Use of this type of account is fairly evenly dispersed across agencies regardless of portfolio size.

Larger banks or brokerage firms are more likely to offer proprietary mutual funds, because they have enough assets from within their own customer pool to do so. Third-party funds are used primarily by smaller banks to avoid the start-up costs of developing their own money market mutual fund. Use of a third-party fund also allows smaller banks to co-mingle customers' sweep account funds with a larger pool of assets in order to offer lower expenses and/or higher yields. Whether the sweep provider uses a proprietary or third-party money market mutual fund should not be of major concern to the investing agency. Rather, the agency should be comfortable with the risk/return components of the fund, which can be found in the fund prospectus.

Repurchase Agreements. As used in a sweep account, a repurchase agreement ("repo") is an agreement whereby the investor purchases a U.S. Government Treasury or Agency obligation from a financial institution and the financial institution agrees to buy it back the next day. U.S. Government obligations offer a high degree of safety and liquidity; however, because they are "overnight" investments, their yields are generally lower than longer-term investment options. However, the safety and liquidity aspects of these instruments make many investors likely to sweep at least a portion of their investment funds into repos. Indeed, 33 percent of local agencies surveyed report having repo sweep accounts.

Investment Restrictions. While sweep providers may offer a variety of sweep account investments, California Government Code and the individual local agency's investment policy establish parameters under which a local agency may invest its excess funds. California Government Code Section 53601 *et seq.* specifies, among other things, the types of investment instruments allowed as well as other limitations such as the percentage of the portfolio that may be invested in each investment type.[3] This includes:

- **Money Market Mutual Funds.** Government Code Section 53601(l)(5) states that no more than 20 percent of the agency's money may be invested in mutual funds, and no more than 10 percent of the agency's funds may be invested in any one mutual fund. Additionally, a mutual fund, including a money market mutual fund, must receive the highest ranking by not less than two nationally recognized rating agencies or the fund must retain an investment advisor who is registered with the Securities and Exchange Commission (or exempt from registration), has assets under management in excess of $500 million, and has at least five years experience investing in instruments authorized by Government Code Sections 53601 and 53635. For agencies that invest under Government Code Section 53601.7, subsection (c)(3) states that no more than 10 percent of the total assets of the investments held by a local agency may be invested in any one mutual fund.[4] Section 53601.7 also contains restrictions related to maturity length, credit quality, and issuer.

- **Repurchase Agreements**. Government Code Section 53601(j)(2) states "Investments in repurchase agreements may be made, on any investment authorized in this section, when the term of the agreement does not exceed one year. The market value of securities that underlay a repurchase agreement shall be valued at 102 percent or greater of the funds borrowed against those securities and the value shall be adjusted no less than quarterly. Since the market value of the underlying securities is subject to daily market fluctuations, the investments in repurchase agreements shall be in compliance if the value of the underlying securities is brought back up to 102 percent no later than the next business day." Government Code Section 53601.7(e)(8) specifies similar restrictions.

A local agency's investment policy may have additional restrictions beyond what is specified in the Government Code.

Cost and Yield Issues are the Major Factors Influencing the Selection of a Sweep Account

In addition to the investment restrictions identified above, factors that play a key role in sweep account selection include transaction/management costs and yield on investment.[5] There are a wide range of cost/yield structures used by sweep account providers, but in general, they involve a combination of account fees, transaction fees, minimum target balances, and yields. There is a strong interplay between these components, and the type of accounts offered by each sweep provider may reflect the types of customers it is trying to attract. A high minimum target balance and low monthly fee combined with an attractive yield can encourage even smaller-size customers to bring external funds into the sweep whereas a high monthly fee, even though it may be combined with a low minimum target balance and attractive yield, may be unappealing to all but the largest investors. As such, a particular agency's financial institution may or may not offer the cost/yield structure that is most beneficial to the size and cash requirements of that agency.

Account Fees and Transaction Fees. Most sweep providers will charge a fee for operating a sweep account and allow a certain number of transactions per account before incurring extra transaction charges. The fee is a direct source of income to the provider. The amount of the fee often reflects

3 Additional information on local agency permissible investments can be found in CDIAC publications *Local Agency Investment Guidelines* and *California Public Investment Primer* at **www.treasurer.ca.gov/cdiac.**

4 This section applies to local agencies that are counties or a city and county and is used for short-term (under 397 days weighted average maturity) investment pools.

5 Sweep accounts are by design invested in highly liquid, highly rated investments; therefore, this section focuses on factors that may have greater variability and concern to local government investors.

the type of customers the sweep provider is trying to attract to the sweep account. Fifty percent of local agencies responding to this question reported being charged a monthly or annual account fee. Monthly flat fees reported range from $10 to $250. Thirteen percent of agencies reported being charged a fee on sweep account balances ranging from 0.25 percent to 1.0 percent. A lower fee (for example, a fee ranging from $10 to $50) may indicate the provider is targeting small account size customers to the sweep, whereas a higher fee (such as $100 or more) typifies a middle- to large-account size customer focus.

The definition of a transaction is set by each sweep provider and will be specified in the account agreement or contract. Examples of transactions include a check written on a money market demand account or a check deposited into the account. Any transactions over the maximum number specified can be subject to a separate transaction fee. Local agencies responding to CDIAC's survey reported transaction fees ranging from 7 cents to 15 cents per transaction.

Minimum Required Target Account Balance. The target balance is a predetermined account balance above which funds will be swept from the primary cash account into the sweep investment vehicle. Similarly, if the cash account balance falls below the target, funds will be redeemed from the investment and moved to the cash account. Most of the local agencies surveyed reported that their sweep provider did not require a minimum target account balance. Those that did (11 percent of those responding) reported minimum target account balance requirements ranging from $50,000 to $575,000.

Yield. The yield earned on a sweep account can be set in a variety of ways. The yield can be a "managed rate"—set at a percentage determined by the sweep provider and adjusted upward or downward at the provider's discretion. The yield may also be based upon a recognized market rate or index less a certain number of basis points; for example, 50 basis points less than the Federal Funds rate.[6] If the Federal Funds rate is 5 percent, then the yield on the sweep account will be 4.5 percent. Finally, if the sweep account is a third-party money market mutual fund, the yield will be determined each day by the money market mutual fund administrator. All shareholders of a money market mutual fund earn the same interest rate, although different classes of shares can have different management and selling fees, as detailed in the fund's prospectus. A sweep provider may offer tiered interest rates or yields in exchange for higher target balance accounts; that is, the first several thousand dollars will earn one rate, the next several thousand will earn a higher rate, etc.

What Additional Issues Should a Local Agency Consider?

In addition to ensuring the best cost/yield terms are achieved, there are several operational issues for local agencies to consider with respect to sweep accounts.

FDIC Insurance. The Federal Deposit Insurance Corporation (FDIC) insures deposit accounts of FDIC-insured banks and savings associations up to $100,000. These accounts include checking accounts, savings accounts, certificates of deposit, and money market demand accounts. It does not include mutual funds or municipal securities. Therefore, while a money market demand sweep account may be FDIC-insured, a money market mutual fund sweep account is not. Moreover, deposits in excess of $100,000 are not insured. Therefore, the local agency should require collateral for any excess above the insured amount or consider alternatives for ensuring that these amounts are safe (such as investing at a different FDIC-insured bank). In addition, since brokerage firms are not FDIC insured, cash accounts should be collateralized.

6 A basis point is 1/100 of one percent.

Fifteen agencies surveyed indicated that they have collateralization agreements associated with their sweep accounts. Several local agencies specifically stated that they require U.S. Treasuries and Agency obligations as collateral.

Monitoring. While sweep accounts relieve the local agency's need to dedicate additional time to conducting investment transactions, these accounts should be monitored regularly, if not daily, to ensure compliance with state law and the agency's investment policy. Indeed, almost all agencies surveyed (95 percent) indicated that they monitor their sweep account; 67 percent responded that they do so daily. The local agency should respond within a reasonable time frame to address investments that fall outside statutory or investment policy provisions regarding credit quality or allowable portfolio percentages. The agency also should communicate such information to its legislative body.

In addition, the local agency should review a sweep account provider's contract as well as the prospectus of any investment fund being considered, prior to investing to ensure compliance with the California Government Code/local agency investment policy and adjust its contract specifications as necessary.

Transfer Restrictions. To ensure that their accounts function efficiently and within state law and local government investment policy restrictions, local agencies may specify transfer restrictions on account balances. These restrictions can be on the balance to remain in the cash account and/or the amount to be transferred to any one type of investment account. Transfer restrictions may vary depending on the needs of the agency. While most agencies responding do not specify transfer restrictions for their sweep accounts (73 percent), those that did chose to specify a specific amount over which investments are swept into a specific investment. In addition, some of these agencies specify a maximum investment amount that can be transferred to any one investment type or fund. Those surveyed limit the level of investment to the more restrictive of either state law or their investment policy.

If the local agency actively invests in similar types of investments outside of their sweep account, it may wish to set the maximum transfer amount even lower to ensure compliance. If the cash account only specifies a target balance with the remainder swept into an investment account, it could exceed levels specified in statute or investment policy if the agency receives a large, one-time deposit into the account. For example, if funds are set to be swept into a mutual fund and the agency receives a large one-time deposit, the combination of sweep account and other outstanding mutual fund investments may cause the investment portfolio to be out of compliance.

Conclusions

Sweep accounts provide liquidity and a return on investment to local agencies without requiring active investment management. While not a primary investment vehicle, sweep accounts facilitate investment into instruments in an efficient manner without the need to contact a broker/dealer or investment advisor. Types of sweep account investments vary widely from provider to provider, as do account costs, transaction fees, and yields on investments; therefore, it is vital that local agencies review sweep account contracts and investment fund prospectuses on accounts offered to ensure that all terms and conditions are acceptable and that costs are within suitable levels to ensure an acceptable return on investment. Local agencies using sweep accounts also should consider features such as transfer restrictions that may provide additional security in ensuring compliance with state law and local agency investment policies.

APPENDIX

Sweep Account Survey Results

The commission conducted an informal survey of investment account practices. It mailed over 1,500 surveys to local government investment officers. The surveyed officers were identified by staff of the commission and by trade organizations, such as the California Municipal Treasurers Association (CMTA). The responses were voluntary and unaudited. As such, the survey results cannot be easily generalized to characterize “typical” industry practice. Table 1 summarizes the responses by type of government. We note that 20 counties responded, representing about one-third of all counties, while 62 cities (less than 15 percent) responded. Special districts had an even lower response rate.

Table 1
Distribution of Survey Respondents by Local Government Type and Investment Portfolio Size

Portfolio Size	City	County	Special District	Other	Total	Percent
Under $100 million	37	4	14	4	59	51%
$100 million to $499 million	20	5	6	3	34	29%
$500 million to $999 million	4	3	2	2	11	9%
Over $1 billion	1	8	2	1	12	10%
Total	62	20	24	10	116	100%
Percent	53%	17%	21%	9%	100%	

The results are best considered unscientific and anecdotal. They are reproduced here to reflect the occasional practice of local governments.

Table 2
Distribution of Local Agencies that Do Not Use Sweep Accounts

Portfolio Size	City	County	Special District	Other	Total	Percent
Under $100 million	21	2	13	2	38	62%
$100 million to $499 million	6	4	1	1	12	20%
$500 million to $999 million	2	1	1	1	5	8%
Over $1 billion	1	4	1	0	6	10%
Total	30	11	16	4	61	100%
Percent	49%	18%	26%	7%	100%	

Reasons for Not Using Sweep Accounts:	**Number of Respondents**
low agency balances	4
costs too high	1
yield too low	9
operation problems with bank	2
bank does not offer service	5
not recommended by advisors	1

Table 3
Distribution of Local Agencies that Use Sweep Accounts

Portfolio Size	City	County	Special District	Other	Total	Percent
Under $100 million	16	2	1	2	21	38%
$100 million to $499 million	14	1	5	2	22	40%
$500 million to $999 million	2	2	1	1	6	11%
Over $1 billion	0	4	1	1	6	11%
Total	32	9	8	6	55	100%
Percent	58%	16%	15%	11%	100%	

Table 4
Distribution of Local Agencies that Address Sweep Accounts in their Investment Policies

Portfolio Size	City	County	Special District	Other	Total	Percent of Total Sweep Acct. Users
Under $100 million	4	1	1	1	7	13%
$100 million to $499 million	7	0	0	1	8	15%
$500 million to $999 million	1	2	1	0	4	7%
Over $1 billion	0	2	1	1	4	7%
Total	12	5	3	3	23	42%

Table 5
Number of Different Investment Accounts Offered

Number of Investment Types Offered	Number of Banks Offering	Percent of Total
1	23	42%
2	6	11%
3	5	9%
4 or more	17	31%
No response	4	7%
Total	55	100%
Number of Local Agencies Using Multiple Investment Types	5	9%
Number of Local Agencies Using Multiple Investment Accounts	9	16%

Table 6

Distribution of Investment Accounts Held by Local Agency Portfolio Size

Portfolio Size	Money Market Demand Account	Money Market Mutual Fund	Repurchase Agreement	Collateralization Agreement in Place
Under $100 million	15	4	4	5
$100 million to $499 million	9	4	9	4
$500 million to $999 million	2	3	2	4
Over $1 billion	1	3	3	2
Total	27	14	18	15

Table 7

Distribution and Frequency of Local Agencies Monitoring Sweep Account(s)

Portfolio Size	Regularly Monitoring Account	No Regular Monitoring of Account	Frequency of Monitoring		
			Daily	Weekly	Monthly
Under $100 million	18	3	7	2	9
$100 million to $499 million	22	0	18	1	3
$500 million to $999 million	6	0	6	0	0
Over $1 billion	6	0	4	1	1
Total	52	3	35	4	13
Percent of Total	95%	5%	67%	8%	25%

Table 8

Distribution of Local Agencies Specifying a Transfer Restriction

Portfolio Size	No Transfer Restriction on Account(s)	Transfer Restriction on Account(s)	Transfer Restricted Accounts as a % of Total Sweep Accounts Surveyed
Under $100 million	14	7	13%
$100 million to $499 million	16	6	11%
$500 million to $999 million	6	0	0%
Over $1 billion	4	2	4%
Total	40	15	27%

Table 9

Distribution of Local Agencies
Specifying a Minimum Target Balance

Portfolio Size	No Minimum Target Balance on Account	Minimum Target Balance on Account	Min. Target Balance Accounts as a % of Total Sweep Accounts Surveyed
Under $100 million	18	3	5%
$100 million to $499 million	19	3	5%
$500 million to $999 million	6	0	0%
Over $1 billion	6	0	0%
Total	49	6	11%

Table 10

Distribution of Local Agencies
Specifying Separate Account Fees/Charges [1]

Portfolio Size	No Separate Account Fees/Charges	Separate Account Fees/Charges	Separate Account Fees/Charges as a % of Total Sweep Accounts Surveyed
Under $100 million	11	8	15%
$100 million to $499 million	9	12	22%
$500 million to $999 million	3	2	4%
Over $1 billion	2	3	5%
Total	25	25	45%

[1] Five agencies with sweep accounts did not respond to this question.

Table 11

Distribution of Local Agencies
Specifying Separate Bank Charges Assessed on Sweep Accounts [1]

Type of Charge	Number of Agencies Responding	Percent of Total Sweep Accounts Surveyed
Monthly/Annual Flat Fee[2]	15	27%
Per Transaction Fee[3]	6	11%
Percent of Current Account Balance Fee	7	13%
No Separate Fees/Charges	25	45%
No Response	5	9%
Total	58	105%

[1]Total number of agencies responding exceeds survey total because three agencies specified multiple charges. Two agencies reported incurring a monthly/annual fee and a per transaction charge and one agency reported incurring a percent of current balance charge and a per transaction charge.

[2] Amounts specified ranged from $15 to $250 per month and up to $1,200 per year.

[3] Amount specified ranged from $.07 to $.11 per transaction.

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