January 22, 2009

MEMORANDUM TO: The Board of Directors

FROM: Sandra L. Thompson
Director
Division of Supervision and
Consumer Protection

John V. Thomas
Acting General Counsel

SUBJECT: Interest Rate Restrictions on Institutions
That Are Less Than Well-capitalized
Notice of Proposed Rulemaking

RECOMMENDATION:

We recommend that the Board of Directors ("Board") adopt a proposed rule (with request for comments) relating to the interest rate restrictions that apply to insured depository institutions that are less than well capitalized. The current restrictions are set forth in section 337.6 of the FDIC's regulations (12 C.F.R. § 337.6). The purpose of the proposed rule would be to provide depository institutions and examiners with a clear method for calculating applicable interest rate caps. Also, the proposed rule would more closely align the FDIC's regulation with the statutory intention of preventing institutions that are not well capitalized from paying interest rates on deposits that significantly exceed certain market averages.

BACKGROUND:

Under section 29 of the Federal Deposit Insurance Act ("FDI Act"), insured depository institutions that are less than well capitalized are restricted in paying interest on deposits. *See* 12 U.S.C. § 1831f. The interest rate restrictions may be summarized as follows:

Statutory Rules:

Well capitalized institutions: May pay interest rates without restriction.

Adequately capitalized institutions with waivers to accept brokered deposits: May not pay rates of interest that "significantly exceed" the following: (1) rates in the institution's "normal market area" for deposits accepted in that area; and (2) the "national rate" for brokered deposits accepted outside the "normal market area."

Adequately capitalized institutions without waivers to accept brokered deposits: May not pay rates of interest that are "significantly higher" than the rates in the institution's "normal market area" for deposits accepted anywhere.

Undercapitalized institutions: May not pay rates of interest that are "significantly higher" than either of the following: (1) the rates in the institution's "normal market area"; or (2) the rates in the "market area" from which the deposit is accepted.

The FDIC has implemented these statutory rules through section 337.6 of the FDIC's regulations (12 C.F.R. § 337.6). Through section 337.6, the FDIC has added the following regulatory definitions:

Regulatory Definitions:

"Significantly exceeds" and *"significantly higher"* mean that one rate exceeds another rate by more than 75 basis points.

"Normal market area" is not defined, but *"market area"* is defined as a "readily defined geographical area in which the rates offered by any one insured depository institution soliciting deposits in that area may affect the rates offered by other insured depository institutions operating in the same area."

"National rate" is defined as "(1) 120 percent of the current yield on similar maturity U.S. Treasury obligations; or (2) In the case of any deposit at least half of which is uninsured, 130 percent of such applicable yield."

Section 337.6 has proved difficult for depository institutions and examiners to apply. One problem is that the terms “market area” and “normal market area” could be defined in different ways. For example, these terms could be defined with reference to the locations of a depository institution’s headquarters and branches. In the alternative, these terms could be defined with reference to a depository institution’s marketing practices. At present, as quoted above, the FDIC’s regulations define “market area” but do not define “normal market area.” As a result, bankers and examiners have struggled in determining a bank’s “normal market area.” The uncertainty in the FDIC’s regulation has made it difficult for banks and regulators to administer the regulation and appears to have resulted in higher rates being paid by less than well capitalized banks as compared to other banks. For example, based on the most recent information currently available, the average 1-year certificate of deposit rate paid by less than well capitalized banks was 2.87 while the average 1-year certificate of deposit rate paid by all insured banks and branches over the same period for which the FDIC had data was 2.18 percent.

Another problem is the definition of the “national rate” (quoted above). Since the adoption of this definition in 1992, the relationship has changed between the yields on Treasury obligations and the interest rates paid by insured depository institutions. Under the current definition, the “national rate” produces a rate cap that is substantially below the average rates being paid on some deposits by insured depository institutions, which is inconsistent with the intent of the statute. For example, at January 4, 2009 the “national rate” as computed under section 337.6 for 1-year certificates of deposits was 0.48 percent while the average 1-year certificate of deposit rate paid by all insured banks and branches for which the FDIC had data was 1.95 percent.

In other words, due to the current low yields on Treasury securities, the national cap rate as computed under the FDIC’s regulations falls well short of the national average rates being paid by depository institutions on certificates of deposit. As a result, a depository institution that becomes adequately capitalized is not only prevented from paying a CD rate that significantly exceeds prevailing national rates, it is forced to pay substantially less than those prevailing rates.

THE PROPOSED RULE:

To address the problems discussed above, the proposed rule would change the existing rules in two ways. First, the proposed rule would redefine the "national rate." This rate would be defined as "a simple average of rates paid by all insured depository institutions and branches for which data are available." Decoupling the definition of the "national rate" from the Treasury yield curve would allow the rate cap to be calculated in a way that prevents the payment of rates that significantly exceed prevailing national rates, but would allow depository institutions to pay the prevailing national rates. We note that the FDIC originally chose to link the definition of the "national rate" to the Treasury yield curve because it was difficult to obtain timely and reliable data on prevailing CD rates. We believe technological advances and the availability of more current information now make it possible to calculate prevailing national CD rates in a direct and timely manner.

Second, in the absence of contrary evidence as to the rates in a particular market, the proposed rule would specify that the prevailing rate in all market areas is presumed to be the "national rate" as defined by the FDIC. This approach recognizes that with the increasing prevalence of Internet deposits and Internet advertising of deposit rates, competition for deposit pricing has become more national in scope. Moreover, this approach recognizes and avoids the considerable practical difficulties that can exist with trying to ascertain the origin of a deposit and the boundaries of a depository institution's normal market area, and with then calculating the prevailing rates paid within that area.

At the same time, this approach recognizes legislative intent to allow depository institutions competing in market areas where prevailing rates truly are higher than average to be able to operate in such markets. Specifically, a depository institution that believes it is operating in such a high-cost market and does not wish to avail itself of the national average calculation referenced above, can define its market area and support its belief that the prevailing rates in that area are above the national average. The FDIC would assess such situations on a case-by-case basis, much as is done now.

In implementing the proposed rule, the FDIC would calculate and publish regularly a schedule of "national rates" by maturity dates and the associated national interest rate caps applicable to all insured depository institutions that are not well capitalized. In regard to determining averages, the FDIC would request comments on whether the FDIC should rely on data collected from private companies.

We note that the purpose of the interest rate restrictions is to prevent institutions that are less than well capitalized from evading the prohibition against the acceptance of brokered deposits by offering high rates (with or without the assistance of a broker), and more generally to prevent such institutions from inappropriately exploiting the guarantee provided by federal deposit insurance. Through the proposed rule, the FDIC would promote this purpose by requiring such institutions not to significantly exceed the average rates in the United States. Such a rule would prevent these institutions from offering the highest rates, while allowing these depository institutions (for liquidity purposes) to compete for deposits with other institutions.

As previously mentioned, the FDIC's authority to restrict interest rates and restrict the acceptance of brokered deposits by insured depository institutions that are not well capitalized derives from section 29 of the Federal Deposit Insurance Act (12 U.S.C. § 1831f). The legislative history indicates that Congress, in enacting the interest rate restrictions, sought to prohibit "the solicitation of deposits by in-house salaried employees through so-called money desk operations." Congress viewed the gathering of high-rate money desk deposits and deposits accepted through brokers (by insured depository institutions that are not well capitalized) as potentially "an unsafe or unsound practice." The proposed rule intends to simplify the interest rate restrictions without undermining this Congressional purpose.

Section 29 also authorizes the FDIC to impose "additional restrictions" on the acceptance of brokered deposits (such as restrictions not based on a depository institution's capital category). *See* 12 U.S.C. § 1831f(f). In publishing the proposed rule, the FDIC would request comments on whether any such additional restrictions should be adopted.

EXAMPLES OF THE EFFECTS OF THE PROPOSED RULE:

Using data available to the FDIC as of January 4, 2009, under this proposed rule, the FDIC would have published the following schedule of “national rates” and rate caps (national rate plus 75 basis points).

Deposit Products	National Rates	Rate Cap
Non-maturity Products	0.60	1.35
1 month CD	0.64	1.39
3 month CD	1.22	1.97
6 month CD	1.55	2.30
12 month CD	1.95	2.70
24 month CD	2.15	2.90
36 month CD	2.37	3.12
60 month CD	2.73	3.48

This table would be published on the FDIC Web site and updated weekly. These rate caps would apply to deposits solicited nationally by banks that are less than well capitalized. These rate caps would also apply presumptively to deposits solicited locally by less than well capitalized banks, unless the bank wishes to make a case to the FDIC that its local market area is characterized by higher deposit costs than those prevailing nationally.

CONCLUSION:

For the reasons explained above, the staff recommends that the Board authorize the publication in the Federal Register of the attached proposed rule.

Staff members knowledgeable about this case:

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