FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

August 16, 2019

MEMORANDUM TO: The Board of Directors

FROM: Doreen R. Eberley
Director, Division Risk Management Supervision

SUBJECT: Notice of Proposed Rulemaking—Interest Rate Restrictions

RECOMMENDATION

Staff recommends that the FDIC Board of Directors (the Board) authorize publication of the attached notice of proposed rulemaking (NPR or proposed rule) with a 60-day comment period.

SUMMARY

The proposed revisions relate to interest rate restrictions that apply to less than well capitalized insured depository institutions. Under the proposed rule, the FDIC would amend the methodology for calculating the national rate and national rate cap for specific deposit products. The national rate would be the weighted average of rates paid by all insured depository institutions on a given deposit product, for which data are available, where the weights are each institution's market share of domestic deposits. The national rate cap for particular products would be set at the higher of: (1) the 95th percentile of rates paid by insured depository institutions weighted by each institution's share of total domestic deposits; or (2) the proposed national rate plus 75 basis points.

The proposed rule would also seek comment on alternative approaches to setting the national rate caps, including setting the national rate cap at the higher of the current rate cap or the previous rate cap (120 percent, or 130 percent for wholesale deposits, of U.S. Treasury securities, plus 75 basis points).

The proposed rule would also greatly simplify the current local rate cap calculation and process by allowing less than well capitalized institutions to offer up to 90 percent of the highest rate paid on a particular deposit product in the institution's local market area under a simplified process.

Concur:

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Nicholas J. Podsiadly
General Counsel

BACKGROUND

Interest Rate Restrictions

Section 29 of the Federal Deposit Insurance Act (FDI Act) imposes interest rate restrictions on categories of insured depository institutions that are less than well capitalized.[1] These categories are: (1) adequately capitalized institutions with waivers to accept brokered deposits (including reciprocal deposits excluded from being considered brokered deposits); (2) adequately capitalized institutions without waivers to accept brokered deposits; and (3) undercapitalized institutions.

The statutory interest rate restrictions generally limit a less than well capitalized institution from offering rates on deposits that significantly exceed the prevailing rates in its market. The FDIC adopted two regulations, one in 1992 and another in 2009, to implement the rate restrictions, and in both of those rulemakings, interpreted "significantly exceeds" to mean a rate that was 75 basis points higher than either the national rate or an institution's local prevailing rate. In the 1992 rulemaking, the national rate was calculated using Treasury securities and in the 2009 rulemaking, the methodology was changed to use actual deposit rates offered as a reference. In both of those rulemakings, the FDIC's stated policy objective was to "allow depository institutions subject to the interest rate ceilings …to compete for funds within markets, and yet constrain their ability to attract funds by paying rates significantly higher than prevailing rates"[2]

Under the FDIC's current regulations, a bank that is not well capitalized generally may not offer deposit rates more than 75 basis points above the national rate for deposits of similar size and maturity.[3]

The national rate is currently defined as a simple average of rates paid by all insured depository institutions and branches that offer and publish rates for specific products. The FDIC receives interest rate data on various deposit products from a private data aggregator on a weekly basis. The data aggregator gathers the information and computes the simple averages for the various deposit products. The FDIC then verifies the information provided by the data aggregator and publishes, on a weekly basis, the national rate and corresponding national rate caps (by adding 75 basis points to each simple average) on its website.

If an institution believes that the posted national rates do not represent the actual rates in the bank's local market area, the bank may present evidence to the FDIC that the prevailing rate in a particular market is higher than the national rate. If the FDIC agrees with this evidence, the institution would be permitted to pay as much as 75 basis points above the local prevailing rate for deposits solicited in its local market area.

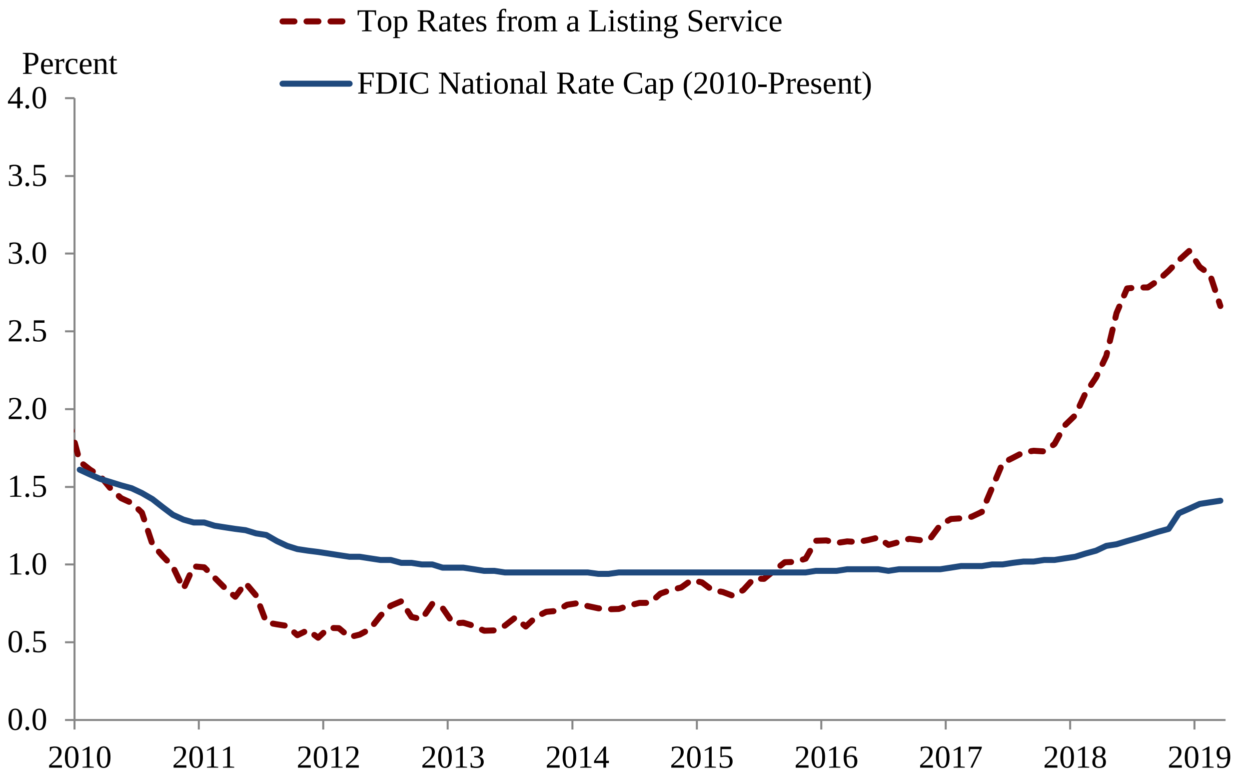
The Need to Revise the Current Regulation

Staff is recommending changing the method of calculating the rate cap to provide a more balanced, reflective, and dynamic national rate cap. The current regulations relating to the

[1] 12 U.S.C. 1831f.
[2] 57 FR 23933, 23939 (1992); 74 FR 26516, 26520 (2009).
[3] 12 CFR 337.6.

interest rate restrictions became effective in 2010. Chart 1 below reflects the current national rate cap and the average of the top ten rates paid for a 12-month CD, between 2010 and the present, as an example of market trends. The average of the top ten rates is used as a proxy to show the general direction of the movement of the market for deposit rates. Chart 1 illustrates that between 2010 and approximately the second quarter of 2015, rates on deposits were quite low, even for the top rate payers, given the prolonged period of low rates generally as the economy recovered from crisis. The current regulation's methodology for calculating the national rate, to which 75 basis points is added to arrive at the national rate cap, resulted in a national rate cap that allowed less than well capitalized institutions to easily compete with the highest rates paid on the 12-month CD.

CHART 1—12-Month CD, Comparison of Listing Service Top Ten Average Payers and the FDIC National Rate Cap, 2010 to Present



Source: QwickRate, RateWatch. Rate caps shown for non-jumbo deposits less than $100,000

Since July 2015, however, general interest rates have risen and market conditions, again, as demonstrated using top payers as a proxy for the shape of the market, have changed, but the rate cap has remained relatively unchanged. This has occurred for several reasons, including that the largest banks have been slow to raise published rates on deposits while at the same time, these banks and others have often offered special features, such as higher rates on off-tenor products, negotiated rates, and cash bonuses that are not factored into the national rates. The current methodology leads to a national rate for the 12-month CD that, when 75 basis points are added, produces a national rate cap that could restrict less than well capitalized institutions from competing for market-rate funding. Market conditions have caused similar changes in the rates of other deposit products compared to the applicable rate cap, although the timing when such changes occurred varied from product to product.

Setting the national rate cap too low could prohibit less than well capitalized banks from fairly competing for deposits and create an unintentional liquidity strain on those banks competing in national markets. For example, a national rate cap that is too low could destabilize a less than well capitalized bank just as it is working on improving its financial condition. Preventing such institutions from being competitive for deposits, when they are most in need of predictable liquidity, can create severe funding problems.

At the same time, however, the statute imposes interest rate restrictions on weak institutions. It has been the FDIC's experience that, while some banks recover from problems, others use high-rate funding and other available funds, not to recover, but to delay insolvency – a strategy that could lead to increased losses for the deposit insurance fund.

Advance Notice of Proposed Rulemaking and Issues Raised by Commenters

On February 6, 2019, the FDIC published in the Federal Register an Advance Notice of Proposed Rulemaking (ANPR) seeking comment on its regulations for the interest rate restrictions as well as for brokered deposits.[4] In response to the ANPR, the FDIC received over 130 comments from individuals, banking organizations, as well as industry and trade groups, representing banking, insurance, and the broader financial services industry. Of the total comments, 59 related to the FDIC's rules on the interest rate restrictions.

The majority of these commenters expressed concerns about the current national rate calculation and raised the same issues highlighted by the FDIC as part of the ANPR. Most commenters were of the view that the current national rate cap is too low and listed a number of reasons for their views, including opinions that banks with large branch networks are over-represented in the methodology, internet only banks are under-represented, and that special features and rates should be factored into the methodology. Commenters also had suggestions for alternatives to the current methodology.

A number of commenters stated that the interest rate restrictions are penalizing less than well capitalized institutions and increase the likelihood of a liquidity failure because such institutions are at a competitive disadvantage in raising deposit funding at the current rate caps.

Several commenters also raised concerns over examiners' use of the national rate cap as a proxy for "high risk" deposits for well capitalized banks. The FDIC has responded to these concerns by revising its Risk Management Supervision Manual of Examination Policies and clarifying to examiners that rate caps apply only to institutions that are less than well capitalized.

[4] 84 FR 2366 (Feb. 6, 2019)

PROPOSAL

The proposal would amend the national rate, the national rate cap, and the local rate cap. The proposal would also provide a new streamlined process for institutions that seek to offer a local market rate that exceeds the national rate cap.

National Rate Cap

National Rate. The national rate would be the weighted average of rates paid by all insured depository institutions on a given deposit product, for which data are available, where the weights are each institution's market share of domestic deposits. Through this proposal, the FDIC would continue to interpret the "prevailing rates of interest . . . in an institution's normal market area" to be the national rate, as defined by regulation. The key difference between the proposed national rate and the current national rate is that the calculation of the proposed national rate would be a weighted average based on an institution's share of total domestic deposits, while the current methodology is based on an institution's number of branches.

In determining the proposed national rate, the FDIC would calculate an average rate per institution for each specific deposit product that the institution offers, and for which data is available, including CDs of various tenors, as well as savings, checking and money market deposit accounts (MMDAs). The weighted average rate for a specific deposit product would be calculated by multiplying each bank's rate for that deposit product by its amount of domestic deposits, summing these values, and dividing by the total amount of domestic deposits held by such institutions.

National Rate Cap. The proposal would interpret that a rate of interest "significantly exceeds" the prevailing rate, or is "significantly higher" than the prevailing rate, if the rate of interest exceeds the national rate cap. The national rate cap would be set to the higher of (1) the rate offered at the 95th percentile of rates weighted by domestic deposit share or (2) the proposed national rate plus 75 basis points. The FDIC would compute the permissible national rate cap applicable for different deposit products and maturities and publish such information monthly on the FDIC's website.

Rates offered at the 95th Percentile. Through this proposal, one method for the national rate cap would be the rate offered at the 95th percentile of rates weighted by domestic deposit share. By definition, the rates that exceed the national cap would be part of the top 5 percent of rates offered, weighted by domestic deposit share. In other words, setting the threshold at the 95th percentile would allow institutions subject to the interest rate restrictions to compete with all but the top five percent of offered rates, weighted by domestic deposit share. The FDIC believes this approach sets a reasonable proxy for rates that "significantly exceed" the prevailing rate and the rate would allow less than well capitalized institutions to access market-rate funding. At the same time, it would constrain them from being at the very top of the market.

National Rate Plus 75 Basis Points. Through this proposal, the second method for the national rate cap methodology would be the proposed national rate plus 75 basis points. This method for the national rate cap would build upon the long-standing application that an amount that is 75 basis points above the average rates offered on a particular product is an appropriate proxy for a rate that "significantly exceeds" or is "significantly higher" than the prevailing rate. This national rate cap would also provide additional flexibility during low-rate environments or when the rate paid at the 95th percentile is low due to a convergence of rates being offered by banks with relatively large deposit shares for particular products.

Proposed Methodology. The FDIC believes that weighting the national rate and the national rate cap by domestic deposits is likely more representative of the amount of deposits placed at offered rates than weighting by branches (which is a feature of the current method), particularly for Internet-only banks that have a large share of deposits but few branches and tend to pay higher rates. Moreover, the use of percentiles decreases the effects of institutions that may be viewed as pushing down the average by offering very low published rates, but at the same time may offer special features, such as cash bonuses or negotiated rates, that result in an effective higher interest expense paid to depositors than is reflected in their published rates.

Additionally, utilizing a percentile methodology would improve the current national rate cap by providing a more dynamic calculation. This is because the distribution of rates offered often reflects a large mass of rates at the low end of the market and fewer rates offered at the high end of the market. As many commenters noted, this distribution has caused the current national rate caps (calculated using a simple average) to remain low even as more institutions begin to pay higher rates. Because the proposed national rate cap would be based on rates paid at the 95th percentile, rather than a simple average, the effect of having a large mass of rates at the low end of the market would not be as pronounced.

There are, however, potential data limitations with this proposed methodology. The data gathered from third party sources is based upon information provided directly by institutions or made available via public sources. As such, some rates being offered for certain products are left unreported or unpublished and therefore may not be captured as part of the data set used to determine the national rate caps. If a rate offered by an institution that has a sizeable market share of total domestic deposits is not included in the data sources, then the national rate cap may not be truly reflective of the market.

In some cases, if the data is not consistently reported or captured, the national rate cap could be subject to fluctuations from one month to the next due to the methodology's use of weighting. In an effort to ensure that all reported rates are incorporated in the national rate cap, the staff recommends that the FDIC review the data after submission to ensure that all rate information that has been provided is incorporated, before making the national rate cap available on its website.

There may be other factors (e.g., geopolitical changes, changes to the Federal Funds Rate) that could also have an impact on the rates offered by institutions and may cause fluctuations in the national rate cap. Moreover, it is possible that one institution, or a few institutions, with a large deposit share could affect the national rate cap by withdrawing that product from the market or introducing a product into the market. While such fluctuations, caused by factors other than data limitations, would be reflective of changes in the market, these changes could cause downward volatility in the national rate cap. To address the effect of this potential downward volatility, the FDIC proposes, that for institutions that are subject to the interest rate restrictions, any subsequent national rate cap, that is lower than the previously published national rate cap, take effect 3 days after publication. The previously posted national rate cap would remain in effect during this 3-day period. In the event of a substantial unexpected decrease in the national rate cap, the FDIC would have the discretion to delay the date on which that national rate cap takes effect. Until such time that the subsequent national rate cap takes effect, the previously published national rate cap would remain in effect.

Table 1 below compares the current and proposed national rate cap based upon the various deposit maturities using data from May 20, 2019, and provides the applicable rate cap that is based upon the higher of the two proposed national rate caps.

Table 1—Comparison of the Current National Rate Cap and the Proposed National Rate Cap for Various Deposit Products (as of May 20, 2019)

Deposit Products	Current National Rate Cap	Proposed National Rate Cap
Interest Checking	0.81	0.80*
Savings	0.84	1.05
MMDA	0.93	1.20
1 month CD	0.87	0.85*
3 month CD	0.97	0.94*
6 month CD	1.16	1.21
12 month CD	1.40	2.70
24 month CD	1.59	2.65
36 month CD	1.72	2.75
48 month CD	1.82	2.80
60 month CD	1.98	3.00

* For these products, the Proposed Rate Cap as of May 20, 2019, would be based on the weighted mean plus 75 basis points methodology as of March 2019.
Source: FDIC and RateWatch

As part of this proposal, the FDIC would continue to publish the national rate cap for the on-tenor maturities noted above in Table 1. If an institution seeks to offer a product with an off-tenor maturity for which a rate is not published by the FDIC, then the institution would be required to use the rate offered on the next lowest on-tenor maturity for that product as the applicable national rate cap. For example, an institution seeking to offer a 26-month CD product must use the rate offered for the 24-month CD product as the applicable national rate cap.

Historical Data. In determining the appropriateness of the proposed methodology for the national rate and national rate cap, the FDIC reviewed and considered the proposed national rate cap's progression over time relative to the current and previous rate caps and top rates from a listing service. Appendix 1 to the preamble provides charts with historical data for the various product types and maturities. The charts illustrate that the proposed national rate cap set to the rate offered at the 95th percentile would be more reactive to and reflective of the fluctuations in the interest rate market than the current national rate cap for many of the maturities, particularly those with tenors of 12 months or more and money market deposit accounts.

To the extent that the rate offered at 95th percentile is flat, and does not react to the top payers due to a convergence of rates among the banks with the largest deposit shares for particular deposit products (as currently seen with the interest checking product and one and three-month CDs), then the national rate plus 75 basis points would provide flexibility for institutions to remain competitive (while still satisfying the statutory interest rate restrictions applicable to less than well capitalized institutions).

FDIC staff believes that this new approach to the national rate cap would provide more balance in that it provides less than well capitalized institutions additional flexibility to compete for funds in different interest rate environments, and yet continues to satisfy the statutory restrictions on offering rates that significantly exceed the prevailing rates.

Treatment of Non-Maturity Deposits for the Interest Rate Restrictions

For purposes of the interest rate restrictions, the preamble states that the FDIC has from time to time looked at the question of when non-maturity deposits in an existing account are considered "accepted" or "solicited." The FDIC, through this proposal, is considering an interpretation under which non-maturity deposits are viewed as "accepted" and "solicited" for purposes of the interest rate restrictions at the time any new non-maturity deposits are placed at an institution.

Under this proposed interpretation, balances in a money market demand account or other savings account, as well as transaction accounts, at the time an institution falls below well capitalized would not be subject to the interest rate restrictions. However, if funds were deposited to such an account after the institution became less than well capitalized, the entire balance of the account would be subject to the interest rate restrictions. If, however, the same customer deposited funds into a new account and the balance in that account was subject to the interest rate restrictions, the balance in the initial account would continue to not be subject to the interest rate restrictions so long as no additional funds were accepted. Interest rate restrictions also generally apply to any new non-maturity deposit accounts opened after the institution falls to below well capitalized.

The term "accept" is also used in Prompt Corrective Action-triggered restrictions (PCA) related to brokered deposits and employee benefit plan deposits. The preamble also indicates that the FDIC plans to address in a future rulemaking when deposits are "accepted" for purposes of these PCA-related restrictions as well as the interest rate restriction, both for non-maturity deposits, such as transaction accounts and money market demand accounts, as well as for certificates of deposits and other time deposits.

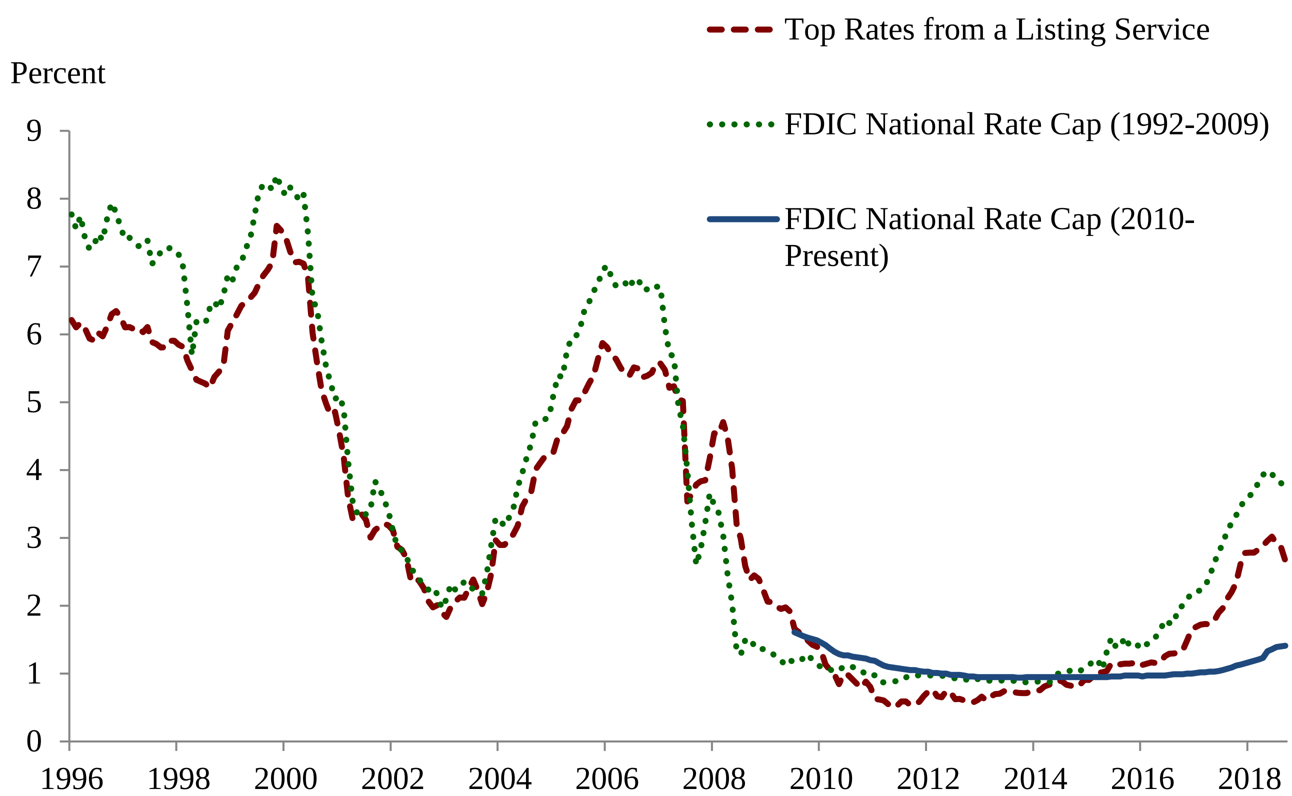
Alternative Proposals for the National Rate Cap

Below are alternatives to the national rate cap methodology that are discussed in the NPR, and on which staff recommends that the FDIC seek comment.

Higher of Two Previous Rate Caps. As an alternative to replacing the 75 basis points as the threshold for "significantly exceeds" and the current simple average methodology for the national rate, the FDIC is considering retaining the current threshold but modifying it so that, for a particular deposit product, the national rate cap would be 75 basis points added to the higher of: (1) the current simple average calculation; or (2) the methodology used by the FDIC between 1992 and 2009, i.e., 120 percent, or 130 percent for wholesale deposits, of the applicable Treasury security rate, plus 75 basis points.

Chart 2 below shows the national rate cap based on Treasury securities from 1996 through when it was replaced with the current simple average methodology, extended to the present. Chart 2 also shows the current rate cap as well as the average of the top listing service rates.

CHART 2—12 Month CD, Comparison of Top Listing Service Rates, the FDIC National Rate Caps in Effect from 1996 to 2009 and from 2010 to Present



Source: QwickRate, U.S. Treasury, RateWatch. Rate caps shown for non-jumbo deposits less than $100,000.

In 2008, the rates on Treasury obligations dropped dramatically because there was a flight to quality during the financial crisis. Consequently, the yields on U.S. Treasuries fell faster than deposit rates and no longer tracked the rates available on deposits, thereby prompting the FDIC to change the national rate to the current simple average approach. The current approach provided institutions much needed relief during the post-crisis years up until 2015 when rates started increasing and the national rate cap lagged behind. At the same time, however, the current methodology in that environment was so permissive that it effectively made the interest rate restrictions non-constraining for less than well capitalized institutions for several years.

Today, with the benefit of having data to review the ability of previous and current national rate calculations to capture deposit market conditions, it is apparent that neither measure works in all interest rate environments. Given that the method used to calculate the national rate cap tied to U.S. Treasury securities works well under certain economic conditions (high-rate or rising-rate environments) and the current method of calculating the national rate cap works well under other economic conditions (falling-rate environment), the staff considered setting the national rate cap applicable to less than well capitalized institutions at the higher of the previous and current rate caps.

The staff also considered whether the U.S. Treasury securities index would need the 120 or 130 percent multiplier plus 75 basis points, as previously provided.

FDIC staff believe that this alternative would be simple to administer and provide immediate and continuous relief to institutions subject to the interest rate restrictions. However, the US Treasury securities are not deposit rates and, as indicated by the chart above, do not always track deposit rates. Moreover, U.S. Treasury securities do not have the necessary range of maturities that are prevalent with deposit products, particularly with the recent popularity of raising non-maturity deposits.

Average of the top-payers. Some commenters suggested that the FDIC use some average of the top rates paid as the national rate cap. As an example, the FDIC could set the national rate cap based upon the average of the top-25 rates offered (by product type). Under this approach, the FDIC would interpret that a less than well capitalized institution "significantly exceeds the prevailing rate in its normal market area" if it offers a rate that is above the average of the top rates offered in the country. This approach would be simple to administer and the FDIC would be able to provide real-time rate caps because it would no longer need to extensively review the data it receives from third party data providers to calculate averages.

At the same time, this approach would allow less than well capitalized institutions to offer a rate that is in line with the very highest rates in the country.

<u>Local Rate Cap</u>

The proposal would simplify the process for allowing less than well capitalized institutions to provide evidence that any institution (including banks and credit unions) in its local market provides a rate on particular deposit product in excess of the national rate cap.

An institution's local market rate cap would be based upon the rate offered on a particular deposit product type and maturity period by an insured depository institution or credit union that is accepting deposits at a physical location within the institution's local market area. If sufficient evidence is provided, the less than well capitalized institution would be allowed to offer 90 percent of the competing institution's rate on the particular product. The current process requires institutions to calculate the average rate for competitors in the local market, and then adds 75 basis points to the result, but does not allow for special features. Under the proposed methodology, an institution, for example, seeking to offer a 26-month CD product could use 90 percent of the rate offered by a local competitor's 26-month product. If a 26-month product was not being offered by a local competitor, then the institution would use the rate offered on a local competitor's 24-month CD product to calculate the institution's local market rate cap.

FDIC staff believes that the proposal to amend the local rate cap would greatly simplify the current local rate cap process and provide additional flexibility for less than well capitalized institutions to compete against local competition offering rates in excess of the national rate cap. This proposal would also address a popular promotional method of attracting new time deposits by offering higher rates on off-tenor products.

REQUEST FOR COMMENTS

The FDIC would seek comment on all aspects of the rule and in response to a series of specific questions.

CONCLUSION

The proposed rule is intended to allow less than well capitalized insured depository institutions subject to the interest rate caps to reasonably compete for funds within markets, and yet constrain them from offering a rate that significantly exceeds the prevailing rate for a particular product, in accordance with Section 29. FDIC staff recommends that the Board approve the NPR for publication in the Federal Register.

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RESOLUTION

WHEREAS, section 29 of the Federal Deposit Insurance Act restricts the rate of interest that a less than well capitalized insured depository institution may pay on deposits;

WHEREAS, the FDIC has adopted regulations that implement section 29 in section 337.6 of Title 12 of the Code of Federal Regulations (CFR);

WHEREAS, since July 2015, market conditions have changed so the current methodology set out in the FDIC's regulations results in a national rate cap that could unduly restrict an insured depository institution from accessing market-rate funding;

WHEREAS, on February 6, 2019, the FDIC published in the Federal Register an Advance Notice of Proposed Rulemaking (ANPR) seeking comment on how it may revise its regulations related to its regulations for interest rate restrictions, as well as restrictions on brokered deposits and, in response, received 59 comments that address interest rate restrictions;

WHEREAS, staff have reviewed the comments submitted in response to the ANPR recommends that the Board approve for publication the attached Notice of Proposed Rulemaking (NPR) that seeks public comment on a proposal to amend the regulations that implement the interest rate restrictions;

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby approves the issuance of the NPR with a 60-day period for public comment, and authorizes the Executive Secretary, or his designee, to publish the NPR in the Federal Register in a form and manner acceptable to the Executive Secretary, or his designee, and the General Counsel, or his designee.

BE IT FURTHER RESOLVED, that the Board hereby authorizes the Executive Secretary, or his designee, and the General Counsel, or his designee, to make such technical, non-substantive, or conforming changes to the text of the NPR to ensure that the FDIC can publish this document in the *Federal Register*, and to take such other actions and issue such other documents incident and related to the foregoing as they deem necessary or appropriate to fulfill the Board's objectives in connection with this matter.