HUNTON& WILLIAMS

CLIENT ALERT

FINANCIAL INDUSTRY RECOVERY CENTER

February 2009

Contacts

Heather S. Archer
1900 K Street NW
Washington, DC 20006
(202) 955-1954
harcher@hunton.com

Interest Rate Restrictions on Institutions That Are Less Than Well-Capitalized

By Heather S. Archer

On February 3, 2009, the FDIC published a Notice of Proposed Rulemaking ("Proposed Rule") to implement new interest rate restrictions on depository institutions that are not well-capitalized. The Proposed Rule would limit the interest rate paid by such institutions to a national rate, as derived from the interest rate average of all institutions. If an institution could provide evidence that its local rate is higher, it would be permitted to offer the higher local rate plus 75 basis points. However, the ability of an institution to succeed in establishing evidence of a higher local rate appears to be very difficult under the Proposed Rule.

Section 29 of the Federal Deposit Insurance Act ("FDIA") limits the use of brokered deposits by institutions that are less than well-capitalized and allows the FDIC to place restrictions on interest rates that such institutions may pay. Section 29 separately speaks to institutions in different capital categories, taking into account whether such institutions have received waivers for brokered deposits. First, adequately capitalized institutions with waivers to accept brokered deposits may not pay a rate of interest that "significantly exceeds" rates on similar deposits for the institution's normal market area or the national rate on similar deposits outside the normal market area. Second, adequately capitalized institutions without waivers to accept brokered deposits may not offer deposit rates that "are significantly higher than the prevailing rates…of other institutions…in the normal market area." As a result of a circular analysis, the institution is prohibited from accepting deposits from itself (and therefor paying such deposit interest rates), if the rates are significantly higher than those of the institution's normal market area. Third, undercapitalized institutions may not offer rates that are significantly higher than prevailing rates in their normal market areas or "in the market area in which such deposits would otherwise be accepted." Therefore, all deposit rates of undercapitalized institutions must be in line with the institution's "normal market area."

The current regulations implementing Section 29, at 12 CFR 337.6, set forth definitions of *national rate*, *significantly exceeds*, *significantly higher*, and *market area*. *National rate* is based on a percentage of deposit yields that the FDIC has determined is outdated due to the fact that deposit rates no longer track closely to obligations of the U.S. Treasury Department. The definitions provide that an interest rate *significantly exceeds* or is *significantly higher* than another if it is 75 basis points higher. *Market area* is

any "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." The current regulations do not provide a definition of *normal market area*.

The Proposed Rule is intended to provide clarity in determining the highest permissible interest rates for institutions that become less than well-capitalized by defining the prevailing rates of interest for an institution's normal market area as the national rate, unless evidence sets forth a difference. The national rate determination would be the average interest rates paid by all insured institutions and branches for which data is available on deposits of similar size and maturity. The Proposed Rule also deletes determinations of effective yield in a market area and instead sets forth a presumption that the effective yield is the national rate unless there is evidence to the contrary.

The FDIC surmises that determining a permissible yield is now simplified because an institution compares national rate category information from the FDIC and ensures that it is not offering interest rates at an amount in excess of 75 basis points above the national rate. The FDIC will even do that math for the institution by publishing a rate cap, which is simply the national rate plus 75 basis points, the components of which will be updated weekly.

The FDIC claims that defining interest rates of any institution by the national rate provides sufficient precision because it might be unclear as to what the market rate would be otherwise, or there may be insufficient evidence to establish the market's rates. By its own comments, the FDIC seems to be saying that it will be very difficult to set forth evidence that an institution's market rate is different than the national rate. It even states that "in most cases…the FDIC expects that the highest permissible rate would be the national rate plus 75 basis points." Although deposits are increasingly national in scope, as the FDIC indicates in its Proposed Rule, it should not take such a bias against evidentiary proof to the contrary for certain regional or local markets.

Should the Proposed Rule be adopted in its current form, and if you are an institution serving a deposit market with higher than average interest rates, you should be prepared to provide evidence of competitive rates being offered to institutions that operate in your same geographic footprint. To the extent the pool of such competitors is not large enough to provide accurate statistical data, you may have to blend the rates of the various regions in which you operate. Any other evidence providing proof to demonstrate that the prevailing interest rate in your market exceeds the national rate should be documented so that your institution would be permitted to offer the higher rate.

The FDIC has requested comments on numerous aspects of the Proposed Rule, which are due April 6, 2009. Several of the questions presented by the FDIC address narrowing the national market average to a state average and providing a procedure for institutions to present evidence that their market rates are higher than the standards set by the FDIC. Hopefully, the FDIC will address these concerns prior to adoption of the final rule.