Federal Deposit Insurance Corporation
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Division of Depositor and Consumer Protection

June 21, 2011

MEMORANDUM TO: The Board of Directors

FROM: Mark E. Pearce
Director
Division of Depositor and
Consumer Protection

Michael H. Krimminger
General Counsel

SUBJECT: Final Rule Reflecting Repeal of
Prohibition on Paying Interest on Demand Deposits

RECOMMENDATION:

Staff recommends that the Board of Directors (the Board) issue a final rule:

1) Repealing Part 329 (Interest on Deposits) of the FDIC's Regulations; and

2) Amending Part 330 (Deposit Insurance Coverage) of the FDIC's Regulations to incorporate the Part 329 definition of "interest" and the FDIC's pre-existing interpretive rule on the treatment of "premiums" paid on deposit accounts.

The FDIC received eight comments on the notice of proposed rulemaking (NPR) to modify its regulations to reflect the provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the DFA) repealing the prohibition against the payment of interest on demand deposits. After considering the comments, staff recommends that the final rule be issued as indicated below.

BACKGROUND:

Section 343 of the DFA amended section 11(a)(1) of the Federal Deposit Insurance Act, 12 U.S.C. § 1821(a)(1), to provide temporary, full insurance coverage for depository institution noninterest-bearing transaction accounts. Also, section 627 of the DFA repealed the statutory prohibition against the payment of interest on demand deposits, effective one year from the date of the DFA's enactment, July 21, 2011.

In light of the prospective repeal of the demand deposit interest prohibition, the Board proposed to rescind 12 C.F.R. Part 329, the regulation which implements that prohibition with respect to SNM banks, to be effective on the same date as the statutory repeal, July 21, 2011. See 76 Federal Register 21265 (April 15, 2011). In that same NPR, the Board also proposed to retain

whether a deposit account qualifies as a noninterest-bearing transaction account under the DFA amendment providing temporary, unlimited deposit insurance coverage for such accounts by moving the definition to Part 330, the deposit insurance rules, specifically the definitions section at 12 C.F.R. § 330.1.[1]

Comment Summary

The FDIC received eight comments: three from community banks, one from a large depository institution, two from depository institution trade groups, one from a financial consulting firm, and one from a legal representative for a money market fund.

The chief points were:

1. The FDIC should stop or delay repeal of the prohibition (four commenters);

2. Community banks will be harmed by repeal of the prohibition (four commenters);

3. The FDIC should add the Part 329 section concerning premiums to Part 330 (three commenters); and

4. The FDIC should adopt or incorporate all Federal Reserve interpretations and advisory opinions pertaining to Regulation Q (two commenters).

Repeal or Delay Prohibition

Commenters opposed to immediate implementation of the repeal of the prohibition made several points. The commenters contended repeal would result in increased deposit volatility as depository institutions competed for an increased share of business deposits by offering continually higher rates of interest. Three of the four stated this would severely affect community banks. One commenter called for delay until the safety and soundness consequences of repeal are understood, arguing that the FDIC and the Federal Reserve have the authority to issue a statement of policy that would prevent interest payments on deposits. Another commenter recommended a phase-in with immediate implementation of the repeal followed by a twelve to eighteen month grandfather for Federal Reserve interpretations and advisory opinions concerning Regulation Q. Another commenter stated that efforts to repeal the prohibition should either cease or be delayed until its impact is understood.

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[1] In counterpart to this rulemaking, the Board of Governors of the Federal Reserve System (the Federal Reserve) issued a notice of proposed rulemaking to repeal 12 CFR Part 217, Prohibition Against Payment of Interest on Demand Deposits (Regulation Q). See 76 Federal Register 20892 (Apr. 14, 2011). Regulation Q implements the prohibition against the payment of interest on demand deposits with respect to member banks.

In response to these comments, staff notes that, pursuant to section 627 of the DFA, as of July 21, 2011, the prohibition against the payment of interest on demand deposits will be repealed as a matter of law.

Harm to Community Banks

Several commenters contended repeal would result in heightened competition for deposits. They stated that large banks will offer high rates of interest and lure away business depositors previously content to do business with community banks based on personal services (relationship deposits). Community banks would then be pressured to offer higher rates of interests in order to stay competitive, further cutting already thin marginal rates of return. Increased deposits might also mean added pressure for depository institutions to loan these new funds out, possibly leading to unsafe and unsound lending and further weakening depository institutions' fiscal health.

As potential responses to these anticipated negative consequences, one commenter recommended that the FDIC take a number of steps: a) the FDIC should consider issuing a statement of policy to warn depository institutions about the need for interest rate risk management; b) interest rate risk should be quantified and an increased capital charge should be imposed on depository institutions with heightened risk due to repeal of the statutory prohibition; c) stress tests should be performed on depository institutions before they are allowed to pay interest on business checking accounts; d) call reports should be modified to provide for the reporting of interest rate risk; and e) reserve requirements should be increased to reduce competition for deposits.

Another commenter recommended that the FDIC hold roundtables prior to the July 21, 2011, repeal date, urged the FDIC and the Federal Reserve to work together to clarify issues in connection with the repeal, and requested that the FDIC provide more time for compliance by depository institutions. This commenter noted that while the FDIC has no authority to delay or to phase in the statutory repeal, efforts still need to be made to provide depository institutions with clarity. The commenter noted the need to revise call reports and thrift financial reports to indicate interest-bearing demand deposit accounts. It also noted the need for clarity with respect to so-called "hybrid products," deposit accounts that both pay interest and offer earnings credits.

A third commenter urged that the Financial Stability Oversight Council (the FSOC) should address the systemic threat which the upcoming repeal poses to the "U.S. banking and financial system and the economy as a whole."[2]

After carefully considering these comments, it is the opinion of staff that the commenters raise valid concerns about potential risks arising from the repeal of the prohibition against paying interest on demand deposits. Based on currently available information, however, there are also potential benefits which may balance out or outweigh those risks. While it

[2] Created by section 111 of the DFA, the FSOC is charged with identifying threats to the financial stability of the U.S., promoting market discipline, and responding to emerging risks to the stability of the U.S. financial system.

is true that depository institutions may incur added expense by offering interest payments to accounts where it was previously unavailable such as business checking, they may also save funds by no longer having to waive expenses on such accounts (e.g., courier service), as an inducement to retain accountholders. Moreover, many institutions offer products to business customers that serve as a substitute for paying interest on demand deposit accounts. The most notable example is a repo sweep account in which funds are swept overnight from a demand deposit account to a repo account and swept back to the demand deposit account the next morning. The institution pays interest on the funds while they are in the repo account. Thus, for some institutions the repeal of the prohibition against paying interest on demand deposits will result in the replacement of indirect payments of interest on demand deposits with explicit, direct interest-bearing demand deposit accounts.

Repeal of the prohibition might directly benefit community banks by allowing them to attract more potentially stable deposits which could reduce their need for higher-cost, more volatile funding. This could lower community banks' funding costs and also allow them to plan business growth more dependably and rigorously. Interest rates are currently at historic lows. This should provide depository institutions with an adjustment period. If the cost of funds should increase, depository institutions should have time to make the necessary adjustments to protect profits and manage interest rate risk through measures such as changes to fee structures and rates to balance out increased interest expense. With regard to interest rate risk and potential liquidity issues, the FDIC and the other federal banking agencies have already provided depository institutions with detailed guidance which those institutions are expected to follow.

Add Part 329 Section on Premiums to Part 330

Three commenters stated that the Part 329 section pertaining to premiums should be added to Part 330 along with the definition of "interest." Section 329.103 describes the circumstances under which the provision of a premium to a depositor by a depository institution will not be considered a payment of interest. It is substantially identical to section 217.101 in Regulation Q. Commenters stated that retaining this section along with the definition of interest might prove useful in determining whether an account qualifies for unlimited insurance coverage as a noninterest-bearing transaction account.

In response, staff agrees with the commenters that there would be utility in incorporating section 329.103 into Part 330. Staff therefore recommends that the Board should approve importing section 329.103 into Part 330 as an interpretive rule, to be designated as section 330.101. This step is also consistent with our recommendation, as explained in more detail below, that the FDIC should continue to look to Regulation Q and Federal Reserve interpretations of that rule when construing section 343.

Retention of Federal Reserve Regulation Q Staff Opinions and Interpretive Letters

Two commenters requested retention of Federal Reserve staff opinions and interpretive letters concerning Regulation Q. They contended that these materials would continue to

be useful in determining whether depository institutions may continue to rely on practices established pursuant to these documents (one example given was third party payment programs). One commenter recommended that, as of July 21, 2011, the materials be retained for a period of eighteen months or more.

As noted previously, section 217.101 of Regulation Q is substantially identical to section 329.103. Moreover, the FDIC, along with other federal banking agencies, has regularly interpreted issues arising from the prohibition against the payment of interest on demand deposits in the same manner as the Federal Reserve. In light of this agency consistency and the continued potential instrumental value of agency interpretations regarding this issue, staff recommends that the Board determine that the FDIC will continue to rely upon Regulation Q and Federal Reserve interpretations of that regulation for purposes of implementing temporary, unlimited deposit insurance coverage pursuant to section 343 of the DFA.

CONCLUSION:

For the reasons explained above, the staff recommends that the Board approve the attached final rule to be published in the Federal Register.

Staff members knowledgeable about this case:

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Attachments