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By Electronic Mail

November 4, 2019

Robert E. Feldman
Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th St. NW
Washington, DC 20429

Re: Interest Rate Restrictions on Institutions That Are Less Than Well Capitalized (RIN 3064–AF02)

Dear Sirs and Madams:

We appreciate the opportunity to comment on the notice of proposed rulemaking ("Proposal") by the Federal Deposit Insurance Corporation ("FDIC") to revise the interest rate restrictions that apply to less-than-well-capitalized insured depository institutions under Section 29 of the Federal Deposit Insurance Act ("FDIA").[1] We write on behalf of a well-capitalized midsized institution that competes both nationally and locally for a range of deposit products, and that strongly supports efforts to revise the current rate cap framework.

There is no indication that in directing the FDIC to establish deposit rate caps for less-than-well-capitalized institutions, Congress intended for the FDIC's rate caps to impair an institution's ability to compete on price in the ordinary course of business – or to exacerbate a liquidity crisis that an institution could avert by offering competitive rates. But in their current form, and due to intervening economic, technological, and regulatory developments, the rate caps can have just those pro-cyclical effects, by making it more difficult for a small or midsized institution experiencing stress to source or retain deposits. These results are antithetical to the purpose of the statute. Through the Proposal, however, the FDIC has the opportunity to develop a more balanced rate cap methodology that both protects the Deposit Insurance Fund and allows institutions to generate stable funding by paying competitive, but appropriate, prevailing rates.

For the reasons discussed throughout this letter, we believe the FDIC can best strike this balance by adopting a final rule that has the following features:

- ***"Higher of Two Previous Rate Caps" Approach to National Rate Cap.*** The final rule's national rate cap should use the "higher of two previous rate caps" alternative

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[1] 84 Fed. Reg. 46,470 (Sept. 4, 2019).

discussed in the Proposal, with certain modifications. Specifically, the national rate cap should be equal to 75 basis points plus the higher of: (1) a surveyed rate using the current methodology, but reflecting interest rates paid on all domestic deposits rather than deposits at branches; and (2) a rate using the methodology in place from 1992 to 2009, but substituting the Federal Funds rate for Treasury rates in the case of non-maturity deposits.

- ***More Competitive Local Rate Cap.*** The final rule should allow the FDIC, in granting waivers from the national rate cap in an institution's local markets, to set the institution's local rate cap at 95 to 100 percent of the highest interest rate paid on the particular deposit product in the local market, rather than 90 percent as proposed.

- ***Digital Deposit Market.*** To reflect the significant competition among institutions offering deposits through the digital space, which can resemble competition in local geographic markets, the final rule should treat the market for digital deposits as its own local market. This treatment would allow an institution that is subject to the national rate cap, but in receipt of a waiver from the FDIC, to continue to compete for deposits using existing digital strategies, rather than effectively be required to terminate those strategies.

- ***Operationally Simpler Definitions of "Accepted" and "Solicited."*** The final rule's definitions of the terms "accepted" and "solicited" should allow an institution subject to the rate caps to accept new funds into an existing customer non-maturity deposit account without the account becoming subject to the rate caps. This approach would be functionally similar to the Proposal, which would allow a customer's existing non-maturity deposit accounts not to be subject to rate caps so long as the institution placed new funds from the customer into a new account, but would provide more operational flexibility to institutions seeking to comply with the caps and would also be more consumer-friendly.

- ***Waivers to Protect the DIF.*** The final rule should establish a process for a less-than-well-capitalized institution to petition the FDIC for a waiver of both the national rate cap and the local rate cap where the institution can demonstrate that application of the caps could jeopardize the viability of the institution and therefore would create a greater risk of loss to the Deposit Insurance Fund.

The remainder of this letter discusses these recommendations in greater detail.

I. Economic, Technological, and Regulatory Developments Underscore the Need for More Dynamic Interest Rate Caps

Since Section 29 of the FDIA became law in 1989, the market for deposits has undergone significant change, and it continues to change rapidly today. Digital technologies are altering the way customers connect with insured depository institutions, and competition for deposits has gone national. Digital deposit strategies allow an institution to offer higher deposit rates without sacrificing efficiency, given that they do not require the expensive capital investments associated with brick and mortar strategies. In addition, nonbank deposit aggregators that are not subject to direct federal regulation often offer higher rates than traditional insured depository institutions. These changes underscore why the FDIC's final rule should adopt dynamic rate caps that reflect the current and evolving markets for deposits and allow institutions to compete effectively for deposits.

Additionally, the reach of the rate caps has broadened since 1989. While the Proposal correctly focuses on the applicability of the rate caps to less-than-well-capitalized institutions, the national rate cap can also affect highly-capitalized institutions in two ways. First, the federal banking agencies may, through the Prompt Corrective Action ("PCA") framework in place since the passage of the Federal Deposit Insurance Act in 1991, reclassify an institution as less than "well-capitalized" for reasons that are unrelated or tangentially related to capital adequacy. For instance, a supervisor could reclassify a highly-capitalized institution as adequately capitalized for PCA purposes, and thereby subject it to the rate caps, based on a management or earnings issue. This authority, in conjunction with an artificially low rate cap, could create significant funding challenges that increase the institution's risk of failure. Second, many insured depository institutions, including well-capitalized institutions, conduct liquidity stress tests that, with supervisors' encouragement, incorporate the national rate cap in adverse scenarios. An artificially low rate cap may cause these healthy institutions to structure their liabilities in a way that is less efficient or desirable than if they were able to assume the application of a rate cap that more realistically reflects the rates at which institutions may source deposits. Taking these potential applications of the FDIC's rate caps into consideration, the caps can actually impact a substantial number of well-capitalized institutions in various ways.

II. The Final Rule Should Adopt the "Higher of Two Previous Rate Caps" Approach to the National Rate Cap, With Appropriate Modifications

Under the Proposal, the FDIC would calculate the average rate per institution for each product type, then calculate a weighted average rate based on each bank's market share of total domestic deposits. The Proposal would then set the national rate cap as the higher of the rate offered at the 95th percentile of these weighted rates or 75 basis points above the weighted average rate.

By including all domestic deposits rather than deposits at branches, the Proposal would produce more realistic national rate caps than the current methodology for some maturities. But the Proposal's reliance on available domestic deposit data to set national rates may still produce rate caps that do not reflect the rates insured depository institutions are actually paying, and that are not dynamic or responsive to changing economic environments, for several reasons.

- ***Overweighting of Large Institution Deposits.*** First, the Proposal's weighted average approach would continue to skew the national rate cap in favor of the lower rates that large banks tend to pay, and thereby fail to accommodate higher rates that small and midsized often must pay to compete with their larger peers. Large banks attract deposits using different methods than small and midsized institutions, leveraging their vast physical footprints, greater variety of non-deposit products and services, and other means of capitalizing on economies of scale. Thus, despite generally paying lower rates than many smaller and midsized institutions in recent economic environments, the four largest U.S. insured depository institutions have approximately 36 percent of total domestic deposits.[2] To compete with larger institutions in attracting deposits, a smaller or midsized institution often must pay higher rates and adopt a variety of strategies, including competing locally and digitally.

- ***Failure to Include Nontraditional Deposit Sources.*** Second, national rates as calculated under the Proposal would fail to reflect a substantial amount of higher-yielding deposits that institutions attract through CD specials, cash bonuses, and negotiated rates. CD specials often have nonstandard maturities with higher offered rates and an institution may offer them in conjunction with lower rates on traditional maturity deposits. Because the Proposal would only generate national rate caps for traditional maturity deposits, the higher rates paid on nonstandard maturity CDs would not be reflected in the rate caps. Moreover, the Proposal would require a less-than-well-capitalized institution that seeks to offer a nonstandard maturity CD to adhere to the rate cap for deposits with the next lowest maturity, which would be an apples-to-oranges comparison that effectively precludes use of the CD special, and therefore limits the institution's funding options. Likewise, institutions may use cash bonuses or negotiate rates that are well in excess of their published rates to source or retain rate-sensitive deposits in certain interest rate environments. Any failure to include these deposits in the weighted national average would artificially depress the national rate cap.

- ***Overreliance on Existing Deposit Balances.*** Third, the average rates that an institution pays on *existing* deposits is generally lower than the average rates that it must pay to raise *new* deposits. Generally, products with higher rates are most responsible for generating meaningful deposit inflows at an institution. Setting the national rate cap based on existing deposit balances would serve to limit the cap artificially.

The Proposal discusses a number of alternative approaches that the FDIC has considered, including a framework called "Higher of Two Previous Rate Caps," which would set the national rate cap as 75 basis points plus the higher of the rate caps as generated under current methodology and under the methodology in use from 1992 to 2009 (*i.e.*, 120 percent or, 130 percent for wholesale deposits, of the applicable Treasury security rate, plus 75 basis points). The Proposal notes that "this alternative would be simple to administer and provide immediate and continuous relief to institutions subject to interest rate restrictions."[3]

We believe the alternative approach of the Higher of Two Previous Rate Caps, with certain modifications, would better achieve the Proposal's stated goal of "ensur[ing] that the rate

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2 *See* Latest Data Shows Intensifying Fight for Deposits as Online Banks Get Traction, S&P Global Market Intelligence (Sept. 17, 2018), available at https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/46516815 (reporting FDIC data as of June 30, 2018).

3 84 Fed. Reg. at 46,480.

caps are more dynamic in that they remain reflective of the prevailing rates offered through all stages of the economic and interest rate cycles."[4]

Using the higher of the two approaches would blunt the impact of the disadvantages of each approach when used in isolation. The methodology in place from 1992 to 2009 set rate caps based on Treasury rates, which are dynamic and generally track the economic environment. The financial crisis brought about a "global flight to safety," decreasing Treasury rates and prompting the FDIC to enact its current approach to national rate caps. However, economic recovery has resulted in the current approach producing artificially low rate caps. While it is true that "U.S. Treasury securities are not deposit rates and . . . do not always track deposit rates,"[5] by using the higher of two calculation methodologies the alternative approach would untether the rate caps from Treasury rates in times when prevailing deposit rates and Treasury rates diverge.

In adopting the alternative approach, the FDIC should make two modifications to the current methodology and the methodology in place from 1992 to 2009:

1. With respect to the current methodology, the FDIC should use deposit rates paid on all domestic deposits, rather than deposits at branches, to set the national average. Domestic deposits, unlike deposits at branches, include internet-sourced deposits, which are a significant and increasingly prevalent source of deposits for institutions of all sizes.

2. With respect to the methodology in place from 1992 to 2009, because "Treasury securities do not have the necessary range of maturities that are prevalent with deposit products, particularly with the recent popularity of non-maturity deposits,"[6] the FDIC should substitute the Federal Funds rate for Treasury rates in the case of non-maturity deposits, as the Proposal suggests in a footnote.[7] The 120 percent or 130 percent multipliers that applied to Treasury securities under this methodology should apply to the Federal Funds rate as well.

With these modifications, we believe the FDIC's alternative approach would produce a more accurate, practical national rate that would provide competitive flexibility, as well as meaningful limits, under diverse economic conditions.

III. The Final Rule Should Expand on the Proposal's Approach to Setting Local Rate Caps

The Proposal would allow a less-than-well-capitalized institution that is competing for locally sourced deposits to petition the FDIC and provide evidence that an institution in its area,

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[4] 84 Fed. Reg. at 46,474.

[5] 84 Fed. Reg. at 46,480.

[6] *Id.*

[7] *Id.* at n. 34.

including a credit union, is offering a rate on a particular product that is above the national rate cap. If the FDIC grants a waiver, the institution would be permitted to offer up to 90 percent of the competing institution's offered rate on the same deposit product. This process would recognize the price-sensitivity of customers in local markets. However, the local rate exception would better achieve its purpose of allowing a less-than-well-capitalized institution to compete for locally sourced deposits if FDIC waivers allowed such an institution to pay a more competitive local rate in two respects.

First, the regulation should allow the FDIC to set the local rate cap between 95 and 100 percent of a local competitors' offered rate. A local rate cap of up to 90 percent of a competitor's rate would continue to place a less-than-well-capitalized institution at a significant disadvantage when competing for local deposits. In local markets, the difference between offering 90 percent of a competitor's rates and being able to match the competitor's rates could be the deciding factor in whether an institution can acquire new deposits. A cap set between 95 and 100 percent of a competitor's rate would avoid artificially restricting an institution's ability to source and retain stable funding during a capital stress event.

Second, the FDIC should consider the market for deposits in the digital space as its own local market. If the FDIC finalizes the Proposal's methodology of basing the national rate on an institution-driven survey weighted by domestic deposits, a less-than-well-capitalized institution that has focused its strategy on competing in the digital space will be at a severe disadvantage. The rates that smaller and midsized institutions offer online are routinely higher than national average rates offered at brick and mortar branches. But the costs associated with these higher rates are offset by the fact that an institution competing for deposits digitally does not need to invest in capital intensive branch networks and branch staff to do so. An institution that competes for online deposits faces a distinct set of competitors that in many ways compete like competitors in a local market. These competitors should serve as the institution's "local market" for purposes of applying a local rate cap exception to digitally-sourced deposits.[8] Allowing a less-than-well-capitalized institution to petition the FDIC for a local rate exception for digital deposits would permit such institutions to continue to leverage what may be a key part of their funding strategies, rather than limit their funding options just when they need greater flexibility to restore their financial condition. This approach would be consistent with the purpose of the local rate cap exception.

IV. The Final Rule Should Provide More Flexibility for Institutions to Pay Higher Rates on Existing Balances

The Proposal contemplates that non-maturity deposits would be viewed as "accepted" and "solicited" for purposes of interest rate restrictions at the time any new non-maturity deposits are placed at an institution. This view would essentially exempt an existing balance in an existing non-maturity deposit account from interest rate caps at the time an institution becomes subject to interest rate restrictions, but would apply the caps to the entire existing balance if any new funds are deposited in the account after that time. Importantly, however, if

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8 Notably, Section 29 of the FDI Act does not use the term "geography" or "geographic market," and instead uses the term "normal market area."

an institution opened a *new* account for the customer, and deposited the new funds into such account, balances in the customer's existing non-maturity deposit account would remain exempt from the rate caps.

While the FDIC's proposed approach is a welcome change from the agency's previous interpretations of the terms "accepted" or "solicited," the proposed approach could create operational challenges in its application and result in customer confusion. An institution that becomes subject to interest rate restrictions would be incentivized to take actions to avoid subjecting existing balances to the restrictions, including establishing new accounts for existing customers. For a small and midsized institution, establishing new accounts could involve highly manual processes that strain back office operations for an extended period of time. Such an institution could also find it challenging to track specific accounts and pay different rates on different deposits by the same customer. An institution could also have difficulty explaining to customers that their rates will decrease if they make any additional deposits into their existing accounts, especially if customers do not make their deposits in a traditional branch setting. Collectively, these challenges could force a less-than-well-capitalized institution to invest heavily in back office and customer-facing operations at a time when its investment could be sorely needed elsewhere.

A more practical and consumer-friendly approach would be to interpret the terms "accepted" and "solicited" in a manner that exempts existing accounts from rate caps, regardless of whether the customer makes additional deposits into such accounts. The FDIC could deem solicitation to occur at the point in which the institution offers a rate to a customer, by defining solicitation as the offering of a rate for a prospective new account (whether to an existing or new customer). The FDIC could deem acceptance to occur when the institution accepts the customer's first deposit into the account, by defining acceptance as the point in which the institution has accepted the agreement with the customer to place deposits in an account at an agreed upon rate.

These interpretations would advance the overarching goals of the national rate cap framework. If customers are no longer allowed to add funds to their accounts at the rate to which they agreed, or are forced to open new accounts at lower rates, a less-than-well-capitalized institution could experience large outflows of non-maturity deposits at the very time that it most needs to maintain its funding to remain viable. Allowing such institutions to maintain existing relationships established prior to the application of interest rate restrictions, while subjecting all new accounts to the restrictions, would also eliminate operational challenges and customer confusion.

V. The Final Rule Should Adopt a Process to Apply for Waivers When Rate Caps Threaten the Institution's Viability

We encourage adoption of a process allowing less-than-well-capitalized institutions to petition the FDIC for waivers of the national and local rate caps in situations in which rate cap restrictions would potentially jeopardize the viability of the institution, consistent with the FDIC's supervisory discretion. To ensure that such waivers do not merely delay an institution's failure and increase the impact of such failure, the FDIC could require the institution requesting a waiver to make a reasonable showing that the waiver would not increase risk to the Deposit Insurance Fund.

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We appreciate the FDIC's consideration of our views. If you have any questions, please do not hesitate to contact the undersigned at (202) 662-5727 or mnonaka@cov.com, Jeremy Newell at (202) 662-5569 or jnewell@cov.com, or Randy Benjenk at (202) 662-5041 or rbenjenk@cov.com.

Sincerely

[redacted]

Michael Nonaka