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LEGAL HISTORY OF THE FEDERAL RESERVE SYSTEM

Outline by Howard Hackley

INTRODUCTION

General statement of purpose and plan, i.e., to review and discuss the legal aspects of the origin and development, both functionally and structurally, of the Federal Reserve System, including references to court decisions, opinions of the Attorney General, and regulations, rulings, and interpretations of the Board, with references to political and economic aspects limited to a minimum.

I. GENESIS

A. Background

General discussion of first and second banks of the United States, National Bank Act, and possibly some reference to foreign central banks. General indication of defects of the banking system before the Federal Reserve Act, i.e., inelastic currency, lack of reservoir of reserves, etc.

B. Early Proposals

—including studies of National Monetary Commission and Pujo Committee, with some discussion of proposals of Aldrich, Willis, Warburg, etc.

C. Legislative History

Discussion of major points of controversy; debates in Congress; reports of committees, etc.

D. The Original Act

General summary of provisions.

E. Legal Basis

—some discussion of court decisions as to constitutionality of Federal regulation of banking, etc.

II. FUNCTIONAL DEVELOPMENT

A. General

Outline statement of principal changes in the System since 1913, both functional and structural; shifts in emphasis, etc.

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B. The Currency Function

1. Federal Reserve notes

(a) Legal status

—including constitutionality

(b) Procedure for issuance

(c) Collateral requirements

—indicating shift in emphasis here

(d) Reserves

(e) Redemption

(f) Interest provisions

—how they have been used in lieu of franchise tax

2. Federal Reserve Bank notes

(a) 1913 provisions

(b) 1933 emergency provisions

3. Thomas Amendment

—legal tender, etc.

4. Gold Reserve Act

— effect on Federal Reserve Banks and currency

C. The Discounting Function

1. Original concept

2. General nature

—including discretionary nature

3. Eligibility requirements

4. Bankers' acceptances

—their purpose and development

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5. Agricultural credits

   —the 1923 Act, etc.

6. Emergency advances to nonmember banks and corporations

7. Shift in emphasis

   —1935 Banking Act; sec. 10(b); advances on Government operations; 1955 revision of Regulation A; etc.

8. Business loans

   —sec. 13b, its purpose, early use, and subsequent decline

9. Discount rates

   —their history, with particular reference to legal questions which have arisen

D. The Supervisory Function

1. General outline

2. Admission to membership

   —including conditions of membership, Lakewood Village case, etc.

3. Examinations and reports

4. Capital requirements

5. Branches

   —showing changes in the law and emphasis both as to domestic and foreign branches

6. Reserves

   (a) Shift in concept

   (b) "deposit liabilities"

   (c) Composition of reserves

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(d) Amount

(e) Reserve and central reserve cities

(f) Proposals for changes in law

7. Interest on deposits

(a) Purpose of 1933 Act

(b) Meaning of "interest"

--including some discussion of absorption of exchange charges

(c) Time deposits

--maximum rates and payment before maturity

(d) Savings deposits

8. Loans and investments

(a) Original provisions

(b) Effect of 1933 Banking Act

(c) Investment securities and corporate stocks

(d) Loans to affiliates

(e) Loans to executive officers

(f) Loans on stock and bond collateral

(g) Real estate loans

9. Relations with other institutions

(a) Interlocking directorates

(b) Securities companies

(c) Other affiliates

(d) Bank holding companies

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10. Mergers and consolidations

11. Trust powers of national banks

12. Foreign banking corporations

13. Enforcement measures

    --removal of directors and expulsion from membership

14. Relation with other bank supervisory agencies

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2. Status of Reserve Banks in collecting checks

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4. Relation with Treasury

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    (b) Genesis of Federal Open Market Committee

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2. Organization

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4. Relation to Board

5. Federal Reserve Agents

E. Member Banks

—effect of stock ownership, etc.

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F. Federal Advisory Council

IV. LEGAL STATUS OF THE SYSTEM IN THE GOVERNMENT

A. Board of Governors

B. Open Market Committee

C. Federal Reserve Banks

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Committee on the History of the Federal Reserve System

DATE 2/18/56

TO ATTACH TO HACKLEY MEMO

FROM

REMARKS

This is a memo written for inside circulation in the Board of Governors of the Federal Reserve System. It was given us as a demonstration of the kind of work to be expected, and may serve as a section of the projected legal history.

MA

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NOT FOR PUBLICATION

A Legal History of

Federal Regulation of

PAYMENT OF INTEREST ON DEPOSITS

BY MEMBER BANKS

Howard H. Hackley

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September 30, 1955.

A Legal History of Federal Regulation of PAYMENT OF INTEREST ON DEPOSITS BY MEMBER BANKS

I. INTRODUCTION

The original Federal Reserve Act contained relatively few provisions circumscribing the banking practices of member banks of the Federal Reserve System. It did not, for example, attempt in any way to restrict payment of interest on bank deposits. In 1927, Congress prohibited national banks from paying interest on time and savings deposits at a rate higher than that authorized by State law to be paid by State banks;[1] but this restriction was intended simply to avoid giving national banks an undue advantage over competing State banks and was not for the purpose of preventing unsound banking practices. It was not until the enactment of the Banking Act of 1933[2] that Congress undertook to impose restrictions on the payment of interest on deposits by member banks for supervisory reasons. That Act was a comprehensive measure designed to prevent the recurrence of banking crises like that of the early 1930's. To that end, it provided not only for the insurance of bank deposits but also for the regulation of certain practices which, in the judgment of Congress, had involved abuses that had contributed to the banking crisis. Among these practices was the payment of interest on deposits.

In the early 1930's, there had developed a feeling that the payment of interest on deposits by member banks of the Federal Reserve System should be subject to some regulation under Federal law. In competing for the deposit balances of country banks, some of the large city banks had been paying high rates of interest on such balances, thereby attracting an increasing volume of the surplus funds of the country banks. It was supposed that this practice had been partly responsible for the large number of bank failures which followed the 1929 market crash. Senator Carter Glass declared that "the payment of interest on demand deposits has resulted for years and years in stripping the country banks of all their spare funds, which have been sent to the money centers for stock speculative purposes."[3]

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1 Act of Feb. 25, 1927 (44 Stat. 1232). This provision, which has not been changed, is contained in section 24 of the Federal Reserve Act (12 U.S.C. 371). The provision was merely an incident to an amendment the principal purpose of which was to confirm the right of national banks to operate savings departments.

2 Approved June 16, 1933 (48 Stat. 162).

3 77 Cong. Record, Pt. 4, pp. 3729, 4165, 4166.

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In the early part of 1932, Senator Glass introduced a bill which, among other things, contained provisions relating to the payment of interest by member banks, not only on demand deposits but also on time deposits. That bill[4] would have prohibited member banks from paying interest on time deposits of other banks at a rate in excess of 2-1/2 per cent or the current Federal Reserve Bank discount rate, whichever was less, and on other time deposits at a rate greater than one-half the interest rate permitted to be charged on loans by national banks. Although it met with some objections,[5] the Glass proposal, in a modified form, was incorporated in the Banking Act of 1933[6] in the following year.

II. THE BANKING ACTS OF 1933 AND 1935

The Banking Act of 1933 added two new paragraphs to section 19 of the Federal Reserve Act, a section previously dealing chiefly with member bank reserve requirements. One paragraph prohibited member banks from paying any interest on demand deposits "directly or indirectly, by any device whatsoever", but with four specific exceptions from the prohibition which will be discussed at a later point. The second new paragraph directed the Federal Reserve Board to limit by regulation the rate of interest which might be paid by member banks on time and savings deposits and also absolutely prohibited any member bank from paying any time deposit before

4 S. 3215. In March 1932, Senator Glass introduced a new bill (S. 4115) which similarly would have limited the rate on time deposits but which omitted the prohibition of interest on checking accounts. However, provisions regarding interest on both demand and time deposits were included in a revised bill (S. 1631) which was introduced in May 1933 and enacted later as the Banking Act of 1933.

5 The Federal Reserve Board had told the Senate Banking and Currency Committee that, while "certain evils arise from the competitive bidding for deposits through the payment of unduly high rates, it is believed that it is undesirable to further regulate by law the rates of interest, which may be paid on deposits, especially since to do so would place member banks at a disadvantage in competition with nonmember banks." Memorandum enclosed with letter from Board, March 29, 1932, to Chairman, Senate Banking and Currency Committee. (See 1932 BULLETIN 206, 220). At the same time, the Federal Advisory Council pointed out that "money is a commodity like any other and that member banks should be free to pay the rates necessary to hold their deposits." 1932 BULLETIN 222.

6 As section 11(b) of that Act (48 Stat. 181, 182).

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maturity or from waiving any notice required for payment of savings deposits unless it were waived for all savings deposits having the same requirement.

Pursuant to the new law the Federal Reserve Board on August 29, 1933, issued its Regulation Q, relating to payment of interest on deposits by member banks.[7] In addition to paraphrasing the statutory provisions, the Regulation undertook to define certain terms and fixed a uniform maximum interest rate of 3 per cent for both time and savings deposits.

In the administration of the new law various questions soon arose and defects were noted. As a consequence, some changes in the statute were made by the Banking Act of 1935, approved August 23, 1935.[8] The exceptions from the law were both narrowed and broadened in certain respects. Some of the exceptions from the prohibition against the payment of interest on demand deposits were continued only for a limited time. The Board was required, instead of merely authorized, to fix different maximum interest rates for time and savings deposits in accordance with specific standards stated in the law. The absolute prohibition against payment of time deposits before maturity was relaxed. An important change was the addition to the first paragraph of section 19 of the Federal Reserve Act of a provision expressly authorizing the Board to define certain terms, to determine what should be deemed to be a payment of interest, and to prescribe regulations to effectuate the purposes of the law and to prevent evasions. The nature and purpose of these various amendments to the law will be discussed in connection with the several phases of the subject to which they relate.

In addition, the Banking Act of 1935 sought to meet an objection which had been raised by the Board even before the enactment of the 1933 Act: that regulation of interest on deposits in the case of member banks would unfairly place such banks at a competitive disadvantage with nonmember banks. The 1935 Act amended the deposit insurance provisions of the law[9] to make nonmember insured banks subject to similar restrictions. Specifically, the board of directors of the Federal Deposit Insurance Corporation was directed to prohibit by regulation the payment of interest on demand deposits in insured nonmember banks, but with the same exceptions as those prescribed by section 19 of the Federal Reserve Act and regulations of the Federal Reserve Board with respect to interest on demand deposits in member banks. The board of directors of the Corporation was also directed

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7 1933 BULLETIN 571. As since revised and now in effect, this Regulation is to be found in the Code of Federal Regulations, Title 12, Part 217.

8 49 Stat. 684. See 1935 BULLETIN 602, 618.

9 Then contained in section 12B of the Federal Reserve Act which was later withdrawn and made a separate Act by the Act of Sept. 21, 1950 (64 Stat. 873). See 12 U.S.C. 1811 et seq.

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to limit the rate of interest or dividends payable by insured nonmember banks on time and savings deposits and to prohibit such banks from paying time deposits before maturity except in accordance with regulations prescribed by the directors. The directors were further authorized to define time and savings deposits, but were given no express authority, like that given the Federal Reserve Board, to determine what should be deemed to be a payment of interest.

The Banking Act of 1935 made it necessary for the Federal Reserve Board, now known as the "Board of Governors of the Federal Reserve System", to adopt a substantial revision of its Regulation Q on this subject. The revised Regulation, which became effective January 1, 1936,[10] included many changes necessary to conform to the amended law and was accompanied by a "Supplement" which, as required by the new law, fixed different maximum rates of interest payable by member banks on time and savings deposits, using different maturities as the basis for differentiation. One provision of the revised Regulation, however, did not become effective on January 1, 1936, along with the rest of the Regulation. That was a provision which undertook to define in detail what should be deemed to be a payment of interest under the Regulation. Because of a divergence of opinion between the Board and the FDIC on this point, this provision was at first deferred and later abandoned; and it was not until February 1937 that a shorter and more general definition of "interest" was finally made effective. A fuller account of this matter will be given at a later point.

Numerous questions arose in the course of administering the statute and the Board's regulations. These will be considered in the following discussion of particular aspects of this matter which, for convenience, will be treated under the following general headings: (1) the types of deposits, (2) the meaning of "interest", (3) maximum rates of interest, (4) withdrawals of time and savings deposits, and (5) exceptions from the statutory requirements.

III. THE DIFFERENT TYPES OF DEPOSITS

(A) DEMAND DEPOSITS

When the provisions regarding interest on deposits were added in 1933 to section 19 of the Federal Reserve Act there was already in that section a provision defining a "demand deposit" as

10 1935 BULLETIN 862. A minor revision of the Regulation had previously been made, effective February 1, 1935 (1934 BULLETIN 816); but it had made only a few changes, principally with respect to computation of interest.

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meaning any deposit payable within thirty days, as distinguished from a time deposit which was defined as a deposit payable within more than thirty days. These definitions had previously had significance only for the purposes of the member bank reserve provisions of section 19. With the enactment of the Banking Act of 1933 they became applicable also for purposes of the interest provisions of that section. In its 1933 Regulation Q, the Board made no attempt to define demand deposits further than already defined in the law.

The Banking Act of 1935 eliminated the statutory definitions of demand and time deposits and, instead, authorized the Board to define those and other terms for the purposes of section 19 of the Federal Reserve Act. Even under this authority, however, the Board in its 1936 revision of Regulation Q did not undertake to prescribe a positive definition of demand deposits. It defined a demand deposit negatively as including "every deposit which is not a 'time deposit' or 'savings deposit,'" as those terms were defined in the Regulation.[11]

In effect, therefore, the meaning of the term "demand deposit" is to be determined by a process of elimination: a deposit is a demand deposit if it is neither a time deposit nor a savings deposit as those types of deposits have been defined by the Board.

(B) TIME DEPOSITS

For many years prior to 1933 it had been necessary in the law and in the Board's regulations to distinguish between time and demand deposits for the purposes of the member bank reserves provisions of section 19 of the Federal Reserve Act. The statute defined "time deposits" as all deposits payable after 30 days and all savings accounts and certificates of deposit subject to not less than 30 days' notice before payment, and all postal savings deposits; and in its Regulation D, relating to reserves of member banks, the Board had set forth detailed descriptions of time certificates of deposit, time deposits, open accounts, and savings deposits.

As previously indicated, when the interest-on-deposit provisions were enacted by the Banking Act of 1933, it was apparently assumed that the existing definitions of demand and time deposits would suffice for the purposes of the new interest provisions, as well as the old reserve provisions, of that section; and in its new Regulation Q, relating to interest on deposits, the Board followed closely the definitions previously set forth in Regulation D.

11 Regulation Q, 1936, sec. 1(a); 1936 BULLETIN 863.

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One important distinction, however, had to be made. For reserve purposes, the essential difference was between time deposits and demand deposits, the latter requiring higher reserves under the law. For interest purposes, it was necessary, not only to distinguish between demand and time deposits, but also to make a sharper distinction between savings deposits and other types of time deposits, since the new law imposed special requirements on savings deposits not applicable to other time deposits. Savings deposits will be treated separately in a succeeding section; for present purposes "time deposits" are not considered as including savings deposits.

As first issued in 1933, the Board's Regulation Q divided time deposits into three categories: (1) time certificates of deposit; (2) time deposits, open account; and (3) Postal savings deposits.[12]

A "time certificate of deposit" was defined as including an instrument evidencing the deposit of a specified amount payable to bearer or to any specified person or his order, either -

(1) on a certain specified date not less than 30 days after the deposit,

(2) at the expiration of a specified period, in no case less than 30 days,

(3) upon notice in writing required to be given a certain number of days, not less than 30, before the date of withdrawal, and

(4) in all cases only upon presentation and surrender of the instrument.

In other words, a time certificate of deposit might be payable at a specified date, after a specified period, or after advance notice of a specified number of days, provided that in any case the 30-day requirement was actually observed. For example, if the bank merely reserved the right to require 30 days' notice of withdrawal but did not actually require such notice, the deposit would not conform to the definition.[13]

A "time deposit, open account" was defined in Regulation Q as meaning a deposit, other than a time certificate, a Postal savings deposit, or a savings deposit, with respect to which there was a contract under which neither the whole nor any part of the deposit

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12 Reg. Q, 1933, sec. III(a); 1933 BULLETIN 572

13 However, since deposits under which the bank merely reserved the right to require notice could, at that time, be classified as time deposits for reserve purposes, the Board stated that it would not object to payment of interest on such deposits if made before August 29, 1933, the effective date of Regulation Q, and if such certificates of deposit were terminated as soon as possible. 1933 BULLETIN 652.

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might be withdrawn prior to the maturity date, which was required to be not less than 30 days after the date of deposit or after the giving of not less than 30 days' written notice. The essential feature was that a time deposit, open account, unlike a time certificate, did not need to be represented by an instrument which must be presented and surrendered at the time of payment; and this was because the open account would be used continuously for deposits and withdrawals in varying amounts, whereas a time certificate evidenced a single fixed amount deposited at one time and normally withdrawn at one time.

"Postal savings deposits" were defined simply as deposits of funds consisting of Postal savings funds deposited under the Postal Savings Act. They did not conform to Regulation Q's definition of "savings deposit" (to be considered later); but, because of amendments made by the Postal Savings System to its own regulations so as to permit withdrawals only at the end of successive 30-day periods, the Board concluded that such funds, when deposited in member banks, might properly be classed as time deposits.[14]

In November 1933, the Board published four sample forms of certificates of deposit which would comply with the regulatory definitions.[15] However, no particular form was required; and the certificates used by member banks assumed a wide variety of forms. In some instances banks issued certificates which provided alternative maturities, for example, a specified maturity date and also provision for withdrawal prior to that date after a prescribed period of advance notice. The Board did not "look with favor" upon such certificates but nevertheless held that they complied with the Regulation.[16] Frequently, however, the major question was not whether the certificate met the requirements of the definition of a time certificate but whether the rate of interest provided for under such a certificate with alternate maturities was within the maximum rates prescribed by the Board. This matter will be dealt with in a later section.

Banking practices sometimes gave rise to a problem as to whether funds placed in a time deposit actually would not be withdrawn within 30 days. Thus, in 1950 such a question arose with respect to the deposit by the trust department of a member bank in its own commercial department of commingled uninvested funds belonging to various

14 1933 BULLETIN 768.

15 1933 BULLETIN 708.

16 In 1934, the Board approved a certificate payable at the end of six or twelve months but with a right in the depositor to withdraw the deposit at an earlier date upon giving thirty days' written notice. 1934 BULLETIN 43. In 1936, the Board raised no objection to a certificate payable three, six, nine, or twelve months after date. 1936 BULLETIN 247.

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trusts administered by the trust department. The funds deposited were not identified as belonging to particular trusts; yet it was known that in some instances the trust department might be required to disburse funds of certain trusts at any time without advance notice. The Board held, however, that such a deposit of commingled trust funds could be regarded as complying with the Regulation if the amount of the deposit was determined on "a reasonable and conservative basis" in the light of monthly reviews of anticipated requirements for the disbursement of trust funds by the trust department, if the deposit was subject to an agreement complying with the requirements of the Regulation, and if the bank was satisfied that the practice was not inconsistent with State law relating to trust administration or otherwise.[17]

In order to make administration of the law more "flexible", the Banking Act of 1935, as has been seen, gave the Board broad authority to define terms, including the term "time deposits." However, when the Board issued its revised Regulation Q, effective January 1, 1936,[18] it made few changes in the provisions defining the various types of time deposits, although the earlier definition of "Postal savings deposits" was omitted as no longer necessary.

One important change, however, was made by the 1936 revision of the Regulation. Before 1933 the Board, for reserve purposes, had ruled that a time deposit was to be considered as becoming a demand deposit as soon as it actually became payable "within 30 days."[19] The same position had been followed after 1933 under Regulation Q.[20] However, after the repeal in 1935 of the statutory definitions of time and demand deposits, the Board in its revision of Regulation Q took a different position. It made it clear that a deposit which met the definition of a time deposit at the time of its deposit continued to be a time deposit until its maturity or the expiration of the period of advance notice required, even though it became payable within 30 days; but <u>after</u> the maturity date or the expiration of the period of notice it <u>would</u> then become a demand deposit.

(C) SAVINGS DEPOSITS

Under the Board's regulations, the definition of the term "savings deposit" has always consisted of three elements: (1) reservation of the right to require notice of withdrawal; (2) the purpose of the deposit or the nature of the depositor; and (3) representation by a passbook or other form of receipt.

17 1950 BULLETIN 44.

18 Reg. Q, 1936, sec. I(b), (c), and (d); 1935 BULLETIN 863.

19 1919 BULLETIN 655.

20 1934 BULLETIN 180.

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As has been seen, the principal requirement of the definition of a "time deposit" is that it must be payable either on a specified date not less than 30 days after the date of deposit or be subject to not less than 30 days' written notice of withdrawal, and in the latter case such notice of withdrawal must actually be given in all cases. A deposit may be classified as a savings deposit, however, if (in addition to meeting the other requirements) it is subject to an agreement under which the depositor is required or may at any time be required by the bank to give notice in writing of an intended withdrawal not less than 30 days before the withdrawal is made.[21] The right to require notice need not be exercised by the bank; and, as a matter of practice, banks seldom exercise the right. Consequently, savings deposits, unlike other types of time deposits, are in effect payable on demand.

As the result of their actual availability for withdrawal at any time, savings deposits have always constituted an especially favored class of deposits both for reserve purposes and for purposes of payment of interest. On the one hand they are subject to far lower reserve requirements than demand deposits; on the other hand, unlike demand deposits, they may bear interest. It is because savings deposits have been accorded such special privileges that the Board has been careful to define and limit such deposits in a manner designed to prevent abuses of these privileges and make certain that any deposit classified as a savings deposit is, in fact, a deposit of savings rather than of funds which will be checked against and used for commercial purposes. The second and third of the elements of the definition of a "savings deposit" mentioned above are in the nature of safeguards against such abuses.

In its 1933 Regulation Q, the Board provided that, in order to constitute a "savings deposit", a deposit must consist of funds "accumulated for bona fide thrift purposes."[22] Recognizing that this was a purely subjective requirement - a matter of intent - the Board hesitated to elaborate on what was meant by "bona fide thrift purposes"; it felt that this should be left to the judgment of each member bank. Apparently, however, the Board was pressed for a further explanation; and in a published ruling it stated that "presumptively" the phrase would include deposits of funds of relatively small amounts accumulated by persons of limited financial means, and funds intended to provide

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21 Reg. Q, 1936, sec. 1(e); 1935 BULLETIN 863. A similar requirement had been applied to savings deposits for reserve purposes as early as 1915. See 1915 BULLETIN 173.

22 Reg. Q, 1933, sec. V(a); 1933 BULLETIN 573.

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for old age, unforeseen contingencies, or anticipated expenditures for such items as Christmas or vacation expenses, tax liabilities, and insurance premiums.[23] The Board also stated that deposits of corporations in most cases probably would not meet the test and that funds deposited by one bank in another bank would not constitute funds accumulated for bona fide thrift purposes. In the end, however, the Board conceded that none of these considerations could be regarded as conclusive.

Eventually the subjective requirement had to be abandoned. In its 1936 revision of Regulation Q the Board substituted a requirement related to the nature of the depositor rather than the purpose of the deposit. The revised Regulation provided[24] that a "savings deposit" must consist of funds -

> "* * * (i) deposited to the credit of one or more individuals, or of a corporation, association or other organization operated primarily for religious, philanthropic, charitable, educational, fraternal or other similar purposes and not operated for profit, or (ii) in which the entire beneficial interest is held by one or more individuals or by such a corporation, association or other organization, * * *."

The new test, in other words, was not the thrifty intent of the depositor but the character of the person or organization in whose name or for whose benefit the deposit was made. If the depositor was an individual his deposit could be classed as a savings deposit whether or not he had any savings purpose in mind.[25] A corporation, however, could have a savings deposit only if it was operated for one of the specified eleemosynary purposes <u>and</u> only if it was not operated for profit. An ordinary business corporation operated for profit could not have savings accounts.[26]

Such organizations as churches, charity hospitals, endowed educational institutions, and fraternal orders could clearly have savings deposits under the new definition. There were other types

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23 1934 BULLETIN 389.

24 Reg. Q, 1936, sec. 1(e); 1935 BULLETIN 863.

25 After the death of an individual depositor, the deposit could continue as a savings deposit if the entire beneficial interest would vest in other individuals or organizations of the kind mentioned in the Regulation; and where there was any uncertainty on this point, the Board offered no objection to continued classification as a savings deposit "for a reasonable time after the death of the depositor". 1939 BULLETIN 851.

26 1936 BULLETIN 191.

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of organizations, however, as to which the answer was not so clear and the Board received numerous inquiries on this point. Among those considered eligible to have savings deposits the Board listed professional associations, trade associations, businessmen's clubs, recreational and social clubs, labor unions, volunteer fire companies, cemetery associations, and police and firemen's pension or relief associations; but the Board held that the definition did not cover building and loan associations, mutual or cooperative insurance associations, cooperative marketing associations, credit unions, and States and municipalities.[27]

The Board adhered closely to the objective test of the nature of the depositor, regardless of the purpose for which the funds deposited were to be used. Thus, deposits made by an individual were held to be properly classed as savings deposits, even though they were to be used by the individual in his business.[28] On the other hand, funds deposited in the name of a municipality could not be considered savings deposits even though they were to be used for educational or charitable purposes, since the municipality was operated primarily for governmental rather than educational or charitable purposes.[29] By the same token, however, if the particular municipality was not a city or a county but a "school district" or "poor district", its primary purposes were educational or charitable and its funds, therefore, could be deposited in a savings account.

The "passbook" had long been one of the most characteristic indicia of savings deposits. As early as 1915, the Board had taken the position, for reserve purposes, that savings accounts must be "evidenced by pass book, certificate of deposit, or similar form of receipt" which had to be presented to the bank whenever any withdrawal was made.[30] These requirements, of course, were designed to prevent savings deposits from being used like ordinary checking accounts. A depositor could still pay a creditor by giving him a draft on his

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27 1937 BULLETIN 1073.

28 1936 BULLETIN 120.

29 1936 BULLETIN 247.

30 1915 BULLETIN 73.

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savings deposit; but, since the creditor could not cash the draft without presentation of the passbook, the draft would have to be accompanied by the passbook. Until the passbook was returned to him the depositor could not draw any additional drafts on his account. Only one such draft could be outstanding at any time.[31]

In its 1933 Regulation Q, relating to interest on deposits, the Board adopted the same requirements with respect to the necessity for passbooks in connection with savings deposits as had been followed in the past in applying the member bank reserve provisions of the law.[32] The Board also followed its earlier precedent that retention of the passbook by the bank was not sufficient; it must be held by the depositor and presented at the time of any withdrawal.[33]

The Board never attempted to define the term "passbook" with any particularity, although it has stated that a passbook "means an account book in which deposits and withdrawals are entered";[34] and that it should afford "a continuous record of the transactions in the account."[35]

Like earlier regulations relating to reserves of member banks, Regulation Q, as first issued in 1933, required that the passbook be presented when any withdrawal was made from a savings deposit, even when made by the depositor himself.[36] This requirement, however, was modified in the 1936 revision of the Regulation so as to permit

31 The reasons for requiring presentation of the passbook upon withdrawals do not apply to deposits in a savings account; a depositor could make deposits by mail without sending along his passbook. 1951 BULLETIN 19.

32 Reg. Q, 1933, sec. V(a); 1933 BULLETIN 573.

33 1934 BULLETIN 542.

34 In this case the Board held that a book used in connection with a Christmas Club account could not be considered a passbook within the meaning of the Regulation. 1936 BULLETIN 120. In another case the Board ruled that a certificate of deposit which contemplated that the full amount of the deposit would be repaid upon surrender of the certificate could not be regarded as an "other form of receipt." 1934 BULLETIN 390.

35 1954 BULLETIN 460.

36 Thus, under the Regulation as then worded a member bank was not permitted to charge a customer's savings deposit with the amount of payments due on the customer's note to the bank, even though under instructions from the customer, without presentation of the passbook in each such instance. 1935 BULLETIN 239.

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withdrawals by the depositor himself without presentation of the passbook; and it was made clear in a footnote that payment could be made to the depositor, not only over the counter at the bank, but also through the mails or otherwise. As to withdrawals by persons other than the depositor, even by an agent of the depositor, the rule was not changed; presentation of the passbook was still necessary.[37] Even as to withdrawals by the depositor himself the Board felt that some written order or receipt was desirable and that telephone or other oral requests for payment should not be approved.[38]

In one other respect the rules regarding passbooks were liberalized by the 1936 revision of Regulation Q. Previously, retention of the passbook by the bank had been deemed insufficient. The Regulation now made it permissible for the bank to hold the passbook where it was part of an estate being administered by the bank as trustee or where it was held by the bank as security for a loan.

As contrasted with these liberalizing changes, the 1936 revision of Regulation Q made one restrictive change. It eliminated the words "or other form of receipt", thus making it necessary thereafter for a savings deposit to be evidenced by a passbook in all cases.

The development of machine equipment for the processing of deposits gave rise in 1954 to a question as to whether punch-cards used in connection with a "payroll deduction savings plan" for the benefit of employees of a certain corporation could be regarded as "passbooks". The Board held that the punch-cards differed materially from a passbook as generally understood and that such accounts could not be classified as savings deposits.[39]

This interpretation was criticized as preventing member banks from performing economically a desirable service for which there was wide-spread demand. The Board adhered to its position that a punch-card could not be considered a passbook; but, in order to meet the situation, it amended Regulation Q, effective May 16, 1955,[40] so as

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37 The Board permitted one exception: It held that transfers from savings accounts to FHA mortgage accounts in payment of monthly installments due on insured mortgages, but without presentation of the passbook, would not be considered a violation of the Regulation. 1939 BULLETIN 850.

38 1936 BULLETIN 624.

39 1954 BULLETIN 460.

40 1955 BULLETIN 500. An identical amendment was made at the same time in the definition of "savings deposits" contained in Regulation D, relating to reserves of member banks. In addition, the FDIC adopted an identical amendment to its regulations relating to payment of interest on deposits by nonmember banks.

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to permit a member bank, if it so desired, to classify a deposit as a savings deposit, even though not represented by a passbook, provided withdrawals were permitted only through payment to the depositor himself and not to any other person, whether or not acting for the depositor. In other words, such a deposit, unlike one represented by a passbook, could in no event be paid to any third person.[41]

IV. THE MEANING OF "INTEREST"

Perhaps the most difficult problem encountered by the Board in its administration of the interest-on-deposit provisions of the law has been the difficulty of determining whether particular practices of member banks involve a payment of interest. The problem arises with respect to both demand deposits and time and savings deposits, although it is not, of course, of any significance in the case of time and savings deposits unless the stated rate paid by a member bank is the maximum rate authorized by the Board's regulations.

With respect to the prohibition against payment of interest on demand deposits, the language of the law is extremely broad. It prohibits payment of interest on such deposits directly or indirectly "by any device whatsoever". With respect to time and savings deposits, the law does not use such all-inclusive language, but, in its Regulation Q the Board has employed language as broad, if not broader, than that used in the law with respect to demand deposits. Section 3 of the Regulation provides that, except in accordance with the provisions of the Regulation, no member bank shall pay interest on any time or savings deposits "in any manner, directly or indirectly, or by any method, practice, or device whatsoever."

It seems obvious that the law and the Board's Regulation contemplate something more than the direct payment of interest at a stated rate. The problem arises in determining the extent to which it is necessary to go beyond the customary concept of interest in order to give full effect to the purposes of the law. A narrow construction of the meaning of the term "interest" could easily permit evasions of the law. On the other hand, a far-reaching construction might cover banking practices which are generally regarded in the banking world as legitimate advertising devices.

41 In an interpretation, the Board made it clear that, while the depositor could not draw a check on his account payable to a third party, it was not necessary for the depositor to go to the bank in person to make a withdrawal, since it would be permissible for the bank to mail him a check or deliver to a messenger a check payable to the depositor. 1955 BULLETIN 648.

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For a time the Board endeavored to give definite answers to the many inquiries received by it as to whether various practices involved an indirect payment of interest on deposits under the law and the Board's Regulation Q. Some of its answers were published in issues of the Federal Reserve Bulletin;[42] in many cases, however, they were contained in unpublished letters.

After it was given express statutory authority by the Banking Act of 1935 to define "interest", the Board sought, by a detailed regulatory definition, to set at rest some of the questions most frequently raised. Its 1936 revision of Regulation Q, as first approved by the Board, contained the following definition:[43]

> "The term 'interest' means a payment, credit, service, or other thing of value which is made or furnished by a bank as consideration for the use of the funds constituting a deposit and which involves the payment or absorption by the bank of out-of-pocket expenses (i.e., expenses arising out of specific transactions for specific customers and definitely attributable to such transactions as distinguished from overhead and general operating expenses), regardless of whether such payment, credit, service, or other thing of value varies with or bears a substantially direct relation to the amount of the depositor's balance.
>
> "The term 'interest' includes the payment or absorption of exchange and collection charges which involve out-of-pocket expenses, but does not include the payment or absorption of taxes upon deposits whether levied against the bank or the depositor nor the payment or absorption of premiums on bonds securing deposits where such bonds are required by or under authority of law.

42 Thus, the Board held that payment of the premium on a bond given to secure deposits of public funds (1933 BULLETIN 500), absorption of exchange or collection charges (1934 BULLETIN 394), and the giving of an allowance for payment of a banker's acceptance before maturity (1934 BULLETIN 303) resulted in an indirect payment of interest. On the other hand, it held that absorption by a member bank of trivial amounts for expenses for such items as isolated exchange and collection charges, telephone calls, and telegrams would not be considered "interest" (1934 BULLETIN 814), and that an allowance of a credit equal to the earning value of a depositor's account in determining the amount of service charges to be assessed against the depositor did not involve an indirect payment of interest (1934 BULLETIN 43).

43 Reg. Q, 1936, sec. I(f); 1935 BULLETIN 863.

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"Notwithstanding the foregoing, the payment or absorption of isolated items of out-of-pocket expense in trivial amounts and not of a regularly recurrent nature, where the charging of such items to customers would cause undue friction or misunderstanding, will not be deemed to be a payment of interest, provided that the bank acts in good faith and does not utilize the absorption of such items as a basis for soliciting accounts or obtaining an advantage over competitors and provided further that the bank maintains and makes available to the examiners authorized to examine the bank a record showing the amounts of such items paid or absorbed by it, the dates of such payment or absorption, and the names of the customers for whom such items were paid or absorbed."

This comprehensive definition of "interest", however, never became effective.

The Banking Act of 1935, as previously noted, had made the restrictions on payment of interest on deposits applicable to nonmember insured banks as well as member banks, although with some differences. Under the amended law the FDIC had drafted its own regulation governing payment of interest by nonmember insured banks; and in general it was similar to the Board's revised Regulation Q. In one respect, however, there was a difference of opinion: the FDIC felt that absorption of exchange and collection charges should not be declared to be a payment of interest as contemplated by the Board's proposed definition. This particular question will be given special consideration at a later point. It is sufficient here to note that the Board's effort to define "interest" by regulation was unsuccessful and that, when the revised Regulation Q went into effect on January 1, 1936, the "interest" definition was not included.

Eventually, on February 11, 1937, the Board and the FDIC agreed to amend their respective regulations to include an identical definition of interest reading as follows:

"Within this regulation, any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit shall be considered interest."

In connection with this action the Board and the FDIC issued a joint announcement stating that the effect of this definition was to "declare existing law rather than to interpret and apply the law to particular practices" and that thereafter, under the regulations of both agencies,

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the question of what in a particular case would be considered a payment of interest would be "a matter of administrative determination under the general law in the light of experience and as specific cases may develop."[44]

About the same time - in the Spring of 1937 - the Board adopted a general policy of not attempting to issue detailed interpretations or rulings with respect to whether particular practices involve a payment of interest, except and until the facts and circumstances of a specific case might be developed by examinations of the member bank involved. The Board preferred to rely upon the cooperation and good faith of member banks in adapting their practices to conform to the spirit and purpose of the law. Many years later, in 1954, the Board stated that its general policy of not passing on such questions except after bank examinations had "proved to be the most feasible basis for dealing with questions of this kind."[45]

As a consequence of the adoption of that general policy the Board after 1937 published fewer interpretations as to the meaning of "interest" under Regulation Q.

In two instances, after development of the facts through examinations of the banks involved, the Board held that the practices in question resulted in indirect payments of interest on deposits. In the first case, the Board in 1943 took the position that absorption of exchange charges by a particular member bank involved an indirect payment of interest on demand deposits in violation of the law.[46] That ruling will be mentioned again at a later point. In 1954, the Board held that, where a member bank, in consideration of the maintenance by an insurance company of an increased deposit balance, made a payment to another depositor for the benefit of the insurance company, that payment was to be regarded as having been made "for the account of" the insurance company as compensation for the use of its funds on deposit and was therefore a violation of the law and the Board's Regulation.[47]

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44 1937 BULLETIN 187.

45 1954 BULLETIN 589.

46 1943 BULLETIN 817.

47 1954 BULLETIN 589.

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In some other instances, even though the facts were not developed through bank examinations, the Board departed from its general policy and published its views as to the effect of particular practices, apparently because the answers in these cases seemed reasonably clear.

Thus, in 1939 the Board held that a member bank's offer to give a $1.00 credit to any depositor who introduced a new depositor to the bank was not a payment of interest but merely a payment for the depositor's service in bringing a new customer to the bank.[48]

In 1944, the Board held that the use by a member bank of the typical monthly account analysis in determining the amount of service charges to be imposed against its depositors was simply an internal arrangement which involved no payment to the depositors or the giving of any credit which increased the amount of their balances and was not, therefore, a "payment of interest".[49] This case was distinguished from absorption of exchange charges on the ground that the latter involved a definite payment of actual out-of-pocket expenses on behalf of a depositor, while analyses of accounts for service charge purposes resulted in no payment to the depositor but only an omission by the bank to make a charge for its services in handling the depositor's account.

Again, in 1954, while referring to its general policy of not passing on "interest" questions in the absence of a bank examination, the Board held that, where a member bank, in calculating interest on a loan made to a depositor, first deducted from the principal the amount of a cash reserve set aside in a demand deposit account, the arrangement "would involve no question as to a payment of interest on the deposit."[50]

V. ABSORPTION OF EXCHANGE CHARGES

Reference has been made to the disagreement between the Board and the FDIC as to whether absorption of exchange charges should be regarded as an indirect payment of interest. Some further and special discussion of this matter seems warranted because it constituted one of the principal problems - and certainly the most notorious - that developed in the administration of the provisions of law relating to the payment of interest on deposits.

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48 1939 BULLETIN 559.

49 1944 BULLETIN 13.

50 1954 BULLETIN 589.

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It should first be understood that an "exchange charge" is a charge made by a bank when paying a check drawn upon it and presented through the mails for payment (as distinguished from presentation "over the counter"). Such charges are now made only by a relatively few banks - generally referred to as "nonpar" banks - in certain areas of the country.[51] The charge is made against the party presenting the check for payment - normally another bank - and usually amounts to 1/8 or 1/10 of one per cent of the amount of the check.

Obviously, the original payee of a check - one, for example, who accepts the check instead of cash in payment for an article sold by him - might very well complain if, when the check is paid, he received some amount less than the face value of the check. However, this seldom happens. Somewhere in the course of collection of the check one of the collecting banks "absorbs" the exchange charge. For example, a check for $1,000 on a nonpar bank is deposited by the payee in his own bank and that bank sends it to its city correspondent bank which in turn sends the check to the drawee nonpar bank for payment. The latter, after deducting a $1.00 exchange charge, remits $999 to the city correspondent; but the city correspondent credits the payee's own bank for the full $1,000 and that bank in turn credits the payee with the full amount of the check. In other words, the city bank has itself paid or absorbed the amount of the exchange charge. However, it did so for a price. It has an arrangement with the payee's bank under which that bank agrees to maintain a "compensating" deposit balance with the city bank in return for the latter's willingness to absorb exchange charges.

Before the enactment of the Banking Act of 1933 prohibiting the payment of interest on demand deposits, there were banks which absorbed exchange charges in the manner above outlined. However, after the prohibition was enacted, some banks, no longer able to pay interest on demand deposits directly, began actively to solicit the accounts of other banks by offering to absorb exchange; and their solicitations in some instances were extremely successful. Some of the absorbing banks benefited by a rapid and substantial increase in the volume of deposits carried with them by the banks for which they had agreed to absorb exchange charges.

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51 As of December 31, 1954, out of a total of 13,747 commercial banks, there were 1,787 nonpar banks, located principally in Alabama, Arkansas, Florida, Georgia, Louisiana, Minnesota, Mississippi, Missouri, North Carolina, North Dakota, South Carolina, South Dakota, Tennessee, and Texas.

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Shortly after the new law was passed the Board took the position that absorption of exchange as a means of attracting and retaining deposits was an indirect payment of interest if the amount absorbed bore a direct relation to the amount of the deposit.[52] Later, as previously noted, the Board proposed in its 1936 revision of Regulation Q to declare that absorption of exchange was a payment of interest, whether or not the amount absorbed varied with the amount of the deposit balance. It was at this point that the FDIC expressed its disagreement with the Board's position. In the hope of achieving harmony, the effective date of the proposed definition was deferred; but efforts to reach an agreement were not successful. Finally, on February 11, 1937, as already indicated, the Board and the FDIC adopted an identical definition of "interest" which was couched in general language and made no reference to the matter of absorption of exchange.

In September 1943, the Board published its ruling that under the facts of a particular case, developed by successive bank examinations, the absorption of exchange by a certain national bank constituted an indirect payment of interest on demand deposits in violation of the law.[53] This ruling brought immediate protests from nonpar banks.

Among other things, the Board was charged with attempting to force par clearance upon nonpar banks. In fact, the heart of the matter was not so much the question of payment of interest on deposits; that question was inextricably interwoven with an older and more fundamental question relating to the propriety of exchange charges themselves - the so-called "par clearance controversy" which had raged in the 1920's when the Federal Reserve System had sought to bring about nationwide par collection of checks. If banks were precluded from absorbing exchange charges as a consequence of the Board's ruling and if the charges had to be passed back to the payees of checks drawn on nonpar banks, those banks would undoubtedly be faced with complaints from their own customers and might be forced to discontinue the making of such charges - a practice which the nonpar banks readily admitted was a lucrative source of revenue.

The Board's 1943 ruling revived the par clearance controversy. In January 1944, there was introduced in Congress a bill[54] designed to nullify the effect of that ruling. It would have amended the interest provisions of section 19 of the Federal Reserve Act to declare expressly

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52 1934 BULLETIN 394.

53 1943 BULLETIN 817.

54 H. R. 3956, 78th Cong., 2d. Sess.

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that the prohibition against the payment of interest on demand deposits should "not be deemed to prohibit the absorption of exchange or collection charges by member banks." In March 1944 this bill passed the House of Representatives, but in December of that year it was defeated in the Senate by a vote of 45 to 25.[55]

While member banks, following the Board's ruling, generally ceased to absorb exchange charges, insured banks which were not members of the System continued the practice. The FDIC amended its interest regulations by adding a footnote which stated that the absorption of exchange charges in connection with the routine collection of checks drawn on other banks would not constitute a payment of interest.[56]

Meanwhile, the Board, in an effort to alleviate the problem, sent to all member banks on June 25, 1945 a circular letter[57] stating that, as an administrative matter, the absorption of exchange charges in amounts aggregating not more than $2 for any one depositor in any calendar month would be considered as trivial and disregarded, provided the bank kept such records as the appropriate supervisory authority might require for reconcilement purposes.

This action, of course, did not resolve all the difficulties. The problem continues to exist, sometimes acutely, in certain parts of the country. Since insured nonmember banks may freely absorb exchange charges, member banks are placed at a competitive disadvantage; yet both classes of banks operate under substantially similar provisions of law. The situation has caused some member banks to arrange with nonmember insured banks for the absorption of exchange on nonpar checks sent to them by the member bank, provided the member bank maintains a "compensating" deposit balance with the nonmember bank. By such an arrangement a member bank is enabled to solicit deposits by offering to collect nonpar items at par, without itself absorbing the exchange charges on such items.

VI. INTEREST ON TIME AND SAVINGS DEPOSITS

(A) MAXIMUM RATES

The Banking Act of 1933 authorized the Board to prescribe different maximum rates of interest on time and savings deposits according to different maturities, different conditions as to withdrawal, or different locations. In its 1933 Regulation, however, the Board chose to fix the same maximum rate - 3 per cent - for all time and

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55 For a detailed account of the absorption of exchange charge controversy, see 30 VIRGINIA LAW REVIEW 603.

56 See 12 Code of Federal Regulations, § 329.2, footnote 6.

57 1945 BULLETIN 564.

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savings deposits.[58] Subsequently, effective February 1, 1935, the Board reduced the maximum to 2-1/2 per cent, again for all types of deposits.[59]

The Banking Act of 1935 made it mandatory for the Board to prescribe different maximum rates according to one or more of the three standards previously stated or a fourth standard of differentiation added by the amending Act: varying Federal Reserve Bank discount rates. In compliance with this statutory mandate, the Board selected different maturities as the most appropriate basis for fixing different maximum rates of interest. In a separate "Supplement" accompanying its 1936 revision of Regulation Q, the Board prescribed the following maximum rates of interest accruing after January 31, 1936:[60]

> 2-1/2 per cent for savings deposits, Postal savings deposits, and time deposits having a stated maturity of 6 months or more[61] or payable on written notice of 6 months or more;
>
> 2 per cent for time deposits with maturities (or a period of notice) of less than 6 months but not less than 90 days; and
>
> 1 per cent for time deposits with maturities (or a period of notice) of less than 90 days.

These requirements have never since been changed.

On each of the occasions when maximum rates were fixed by the Board, an exception was allowed with respect to deposit contracts entered into in good faith prior to a specified date antedating the effective date of the new rates. Thus, rates higher than the 3 per cent maximum fixed by the Board in 1933 could be paid on such contracts entered into before June 16, 1933. When the rate was reduced to 2-1/2 per cent effective February 1, 1935, contracts calling for a higher rate were not disturbed if executed before December 18, 1934. Finally, the 1936 Supplement permitted higher rates than those prescribed by it to be paid on deposits entered into before December 1, 1935. In each instance, however, it was made clear that the exception applied only to contracts which could not legally be terminated or modified by the member bank at its option and without liability.

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58 Reg. Q, 1933, secs. III(c) and V(c); 1933 BULLETIN 573, 574. The maximum was made effective as to any interest accruing after October 31, 1933.

59 Reg. Q, 1935, secs. III(c) and V(c); 1934 BULLETIN 817, 818.

60 1935 BULLETIN 867.

61 Though "six months" normally means six calendar months, the Board offered no objection to payment of interest at a rate of 2-1/2 per cent on a deposit maturing 180 days after date. 1951 BULLETIN 273.

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In order that depositors might have actual knowledge that the rate of interest paid on their deposits would be subject to modification if the Board should change the maximums, the Board suggested that banks stamp on each time certificate of deposit a legend to the effect that the rate was subject to change to such extent as might be necessary to comply with requirements of the Board made from time to time pursuant to the law.[62]

In addition to being limited by the maximum rates of interest specifically fixed by the Board, member banks are subject to a further limitation in this respect. A provision of section 24 of the Federal Reserve Act, enacted in 1927, prohibits any national bank from paying interest on time and savings deposits at a rate higher than that authorized to be paid on such deposits by State banks in the State in which the national bank is located. Consequently, if State law happens to prescribe for State banks a maximum rate lower than that fixed by the Board in its Supplement to Regulation Q, neither a member State bank nor a national bank in that State could pay interest at a rate greater than the State maximum. Regulation Q itself explicitly recognizes this fact in a provision stating that the rate paid by any member bank shall not exceed whichever is the lesser of the rate fixed by the Supplement to the Regulation or the rate fixed under the laws of the State.[63]

It should be noted that prior to the Banking Act of 1935, the statutory provisions with respect to interest on time and savings deposits applied to deposits received by foreign branches of member banks, even though the prohibition against the payment of interest on demand deposits was specifically made inapplicable to deposits received only at offices located in foreign countries. Recognizing that competitive conditions in foreign countries might justify different treatment, the Board provided in its Regulation[64] that the rate payable on deposits at offices located outside the United States should not exceed the maximum rate generally prescribed by the Regulation or "such higher maximum rate" as the Board might prescribe for payment in the localities

62 1933 BULLETIN 768. However, when the maximum rate was reduced to 2-1/2 per cent in 1935, the Board held that a member bank could continue to pay a higher rate on a certificate having a definite maturity, even though it bore the legend referred to above; but, if the deposit was payable after 30 days' notice or was a savings deposit which could be terminated by the bank after reasonable notice to the depositor, the Board held that the deposit could and should be modified to conform to the reduced maximum rate. 1935 BULLETIN 107.

63 Reg. Q, 1936, sec. 3(c). While many States prescribe no maximum interest rates, there are some which fix a statutory maximum and others which authorize the State banking authorities to prescribe maximum rates of interest. In the latter cases, whenever the rates were lowered or raised by the State authorities it was necessary for the Board to determine whether the State rate was actually applicable to all State banks and trust companies so that it would also be applicable to national banks in that State.

64 Reg. Q, 1935, sec. III(c)(5); 1934 BULLETIN 817.

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in which such offices were located. The Board did in fact prescribe separate and higher rates for foreign branches of member banks in certain countries; and the member banks complained that this action made it difficult for them to compete with the local banks in those countries.

The problem was resolved by the Banking Act of 1935, which made the provisions with respect to time and savings deposits, as well as those relating to demand deposits, inapplicable to deposits payable at offices of member banks outside the States of the United States and the District of Columbia.

(B) DETERMINATION OF APPLICABLE MAXIMUM RATE

Prior to January 1, 1936, there had been no problem in determining the maximum rate of interest which could be paid on a particular time deposit, for the simple reason that the maximum rate was the same for all time and savings deposits. After that date, however, when different maximum rates were prescribed for time deposits according to different maturities, it sometimes became necessary to determine which of the several maximum rates was applicable in a particular case. The question arose principally with respect to certificates of deposit of the kind heretofore mentioned which made provision for two or more alternate maturities and for the payment of different rates of interest depending upon the withdrawal privilege ultimately chosen by the depositor.

The Board had held at an early date that the applicable maximum rate did not depend upon the length of time a deposit was left in the bank. Thus, it ruled that a certificate payable upon 30 days' notice could not provide for interest at one per cent if left for 30 days, 2 per cent if left on deposit 90 days, and 2-1/2 per cent if left 6 months or longer.[65] Since such a certificate was at all times payable after 30 days' notice the maximum rate payable under the Supplement to Regulation Q was one per cent, regardless of the length of time the deposit was left in the bank.

In the late 1940's competition led some member banks to issue certificates providing for gradually increasing interest rates the longer the funds were on deposit. One such certificate offered one per cent if withdrawn between 6 months and one year after deposit upon 30 days' notice, 1-1/4 per cent if withdrawn during the second year upon 90 days' notice, and so on, with the rate increasing each

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65 1936 BULLETIN 548. Similarly, a certificate payable after 6 months' notice, but providing that the bank might call the certificate for payment at any time after giving 30 days' notice to the depositor, was held to be subject to the one per cent maximum rate. 1936 BULLETIN 419.

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year until, if withdrawn at the end of 5 years after 6 months' notice, the deposit would bear 2-1/2 per cent interest for the full 5-year period.

The Board held that in the case of such a certificate the maximum interest rate payable would depend upon which of the several withdrawal privileges might be elected by the depositor and upon the rate applicable under Regulation Q to the particular withdrawal privilege so elected. Thus, if the certificate provided a stated maturity of 5 years after date with interest at 2-1/2 per cent but permitted withdrawal before that date after 90 days' notice with interest at 2 per cent, the certificate was regarded as complying with the requirements of the Regulation.[66] In other words, however long the deposit was left with the bank, interest could be paid at gradually increasing rates if the rate paid upon actual withdrawal was within the specified maximum rate for withdrawals after the period of notice required and given as to that particular withdrawal.[67]

(C) COMPUTATION OF INTEREST

When first issued in 1933, Regulation Q provided that the rate of interest paid on a time or savings deposit should not exceed the then specified rate of 3 per cent per annum, compounded semi-annually, regardless of the basis upon which the interest was computed by the bank; but the bank was not prevented from compounding interest at other than semiannual intervals provided the aggregate amount of interest paid did not exceed the amount which would be payable at a rate of 3 per cent compounded semiannually.[68] In 1935 the Board amended the Regulation to provide for determination of the maximum rate on the basis of compounding interest quarterly rather than semiannually, but again it was made clear that member banks were free to compound interest on any other basis provided only that the interest paid would not exceed the amount which would be payable if compounded on a quarterly basis.[69]

Originally, the Board held that interest could not be computed in such manner as to cover any days prior to the date of deposit or after the date of withdrawal, unless the rate was less than the prescribed maximum so that the amount of interest paid for the period during which the deposit was actually in the bank would not exceed the

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66 1953 BULLETIN 721

67 The same principle was applied to "time deposits, open account", as well as to time certificates of deposit. 1953 BULLETIN 1050.

68 Reg. Q, sec. III(c)(1) and V(c)(1), and footnotes 6 and 9; 1933 BULLETIN 573, 574

69 Reg. Q, 1935; 1934 BULLETIN 817,818

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maximum rate.[70] However, in its 1935 revision of Regulation Q the Board expressly permitted interest to be paid, even at the maximum rate, from the first day of any calendar month on a time or savings deposit received during the first 5 days of such month.[71] When the Regulation was again revised effective January 1, 1936, the "grace period" allowed as to time deposits was omitted but was continued in the case of savings deposits.[72] Still later, the allowance for savings deposits was further liberalized. By a specific amendment to the Regulation effective July 1, 1952, member banks were permitted, not only to compute interest from the first day of any calendar month on deposits received during the first 5 business days of such month, but also to pay interest at the maximum rate from the first day of a calendar month commencing a regular quarterly or semiannual interest period on any savings deposit received during the first 10 business days of such month and to pay interest at the maximum rate until the end of a month ending such a quarterly or semiannual period on a savings deposit withdrawn during the last three business days of such month.[73]

In connection with the renewal of time certificates a computation problem arose, not because of a possiblity of exceeding the maximum rate, but because of the rule that a time deposit immediately upon its maturity becomes a demand deposit on which, of course, no interest at all may be paid. At first, the Board held that, where a time certificate was renewed after its original maturity date, no interest could be paid for the period intervening between such original maturity date and the date of renewal.[74] Later, however, this position was modified so as to permit member banks to pay interest covering the intervening period provided the certificate was renewed within 10 days after the original maturity date.[75]

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70 1933 BULLETIN 652. However, the Board did go so far as to permit computation of interest from the first day of a calendar month, where that day was a Sunday or holiday, on a deposit received on the first business day of such month. 1934 BULLETIN 304.

71 Reg. Q, 1935, secs. III(c)(4) and V(c)(4); 1934 BULLETIN 817, 818.

72 Reg. Q, 1936, sec. 3(d); 1935 BULLETIN 864.

73 Reg. Q, 1936, sec. 3(d); 1952 BULLETIN 650.

74 1934 BULLETIN 609. The Board had previously held that interest could not be paid for the intervening period even though the renewal certificate was dated back to the original maturity date. 1933 BULLETIN 707.

75 1936 BULLETIN 419.

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VII. WITHDRAWAL RESTRICTIONS

(A) PAYMENT OF TIME DEPOSITS BEFORE MATURITY

It has been noted that, by definition, a deposit cannot qualify as a time deposit unless it is payable at a specified date not less than 30 days after the date of deposit or unless it is payable after not less than 30 days' written notice which must actually be given in the event of withdrawal. It has also been noted that a deposit will not meet the definition of a savings deposit unless it is subject to an agreement under which the bank reserves the right (though it need not be exercised) to require not less than 30 days' notice in writing before any withdrawal is made. In addition to these definitive requirements relating to withdrawals, the law imposes special restrictions on the payment of both time and savings deposits.

The Banking Act of 1933 provided that "no member bank shall pay any time deposit before its maturity." No exceptions were made; and the Board's 1933 Regulation Q merely spelled out the statutory prohibition, making it clear that the prohibition applied even though no interest was paid on the deposit.[76]

By 1935, however, it appears to have been generally agreed that the absolute prohibition against payment of time deposits before maturity should be relaxed.[77] Accordingly, the Banking Act of 1935 amended the provision to permit payment before maturity upon such conditions and in accordance with such rules and regulations as the Board might prescribe.[78]

Pursuant to this change in law the Board, in its 1936 revision of Regulation Q[79] permitted member banks to pay a time deposit before its maturity but only "in an emergency when it is necessary to prevent great hardship to the depositor", and then only if the

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76 Regulation Q, 1933, sec. IV; 1933 BULLETIN 573. The Board by interpretation held the prohibition inapplicable in one exceptional type of case: where a member bank, to prevent its closing, had entered into a deferred payment agreement with its depositors and later found itself in a position to make payment before the date specified. 1934 BULLETIN 244.

77 See Conference Report, Aug. 17, 1935, Rep. No. 1822, p. 45.

78 49 Stat. 714.

79 Reg. Q, 1936, sec 4; 1935 BULLETIN 865.

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depositor's application fully describing the circumstances is certified by an officer of the bank. Moreover, upon any such payment before maturity the depositor was required to forfeit all accrued and unpaid interest on the deposit for a period of not less than three months. Recognizing that a depositor could circumvent the Regulation merely by borrowing from the bank on the security of his time deposit, the Regulation further provided that, while a member bank could make such a loan, the rate of interest charged on the loan must be not less than 2 per cent higher than the rate of interest payable on the deposit.[80]

(B) WAIVING NOTICE OF WITHDRAWAL OF SAVINGS DEPOSITS

As has previously been indicated, a "savings deposit" must be subject to an agreement under which the bank reserves the right to require at least 30 days' notice of withdrawal, but member banks need not exercise that right and, as a matter of practice, seldom require notice before withdrawal of savings deposits.

In the event, however, that a member bank should decide to exercise its right to require advance notice of withdrawal of savings deposits, it would be prohibited by specific provisions of the law from waiving any such requirement of notice in paying any savings deposit "except as to all savings deposits having the same requirement." Presumably, this provision was designed to provide equal treatment for all savings depositors.

80 The Board has published only a few interpretations of the provisions of the Regulation regarding payment before maturity. It has held that a certificate maturing on a Sunday might be renewed prior to maturity provided the renewal certificate was dated as of the date of maturity of the original certificate, but that, if not renewed, the certificate could not be paid on Saturday where State law provided that an instrument maturing on Sunday should become due on the next business day. 1939 BULLETIN 850. Where a time deposit calling for 30 days' notice and bearing interest at one per cent was amended to provide for 90 days' notice and interest at 1-1/4 per cent, the Board ruled that there was no payment before maturity. 1951 BULLETIN 19. Finally, in the case of a loan made on the security of a time certificate having a stated maturity but permitting earlier withdrawal after 90 days' notice, with the rate of interest dependent upon the withdrawal privilege actually exercised, the Board held that the loan should bear interest at a rate not less than 2 per cent higher than the rate of interest which the depositor would receive if he should elect to withdraw the deposit at the time of the maturity of the loan. 1953 BULLETIN 950.

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In its 1933 Regulation Q, the Board elaborated on the statutory prohibition. The Regulation provided[81] that, if a member bank waived notice as to any "portion or percentage" of the savings deposit of one depositor, it should also waive notice as to the same portion or percentage of the deposits of every other depositor subject to the same requirement; and that, conversely, if the bank required notice before payment of any portion or percentage of the deposit of one depositor, it should require the same notice before paying the same portion or percentage of the deposits of all other depositors subject to the same requirement. In addition, a bank was required to observe certain requirements before it made any change in its practice in requiring or waiving notice of withdrawal.

These detailed regulatory provisions never proved to be of any great significance, presumably because the banking situation improved after 1933, and there was consequently no need for banks to exert their right to require advance notice before payment of savings deposits.

Only once was the Board called upon to interpret these provisions of the Regulation. Late in 1933 it held that the word "portion", which appeared several times in the Regulation, should be construed as including a specified amount, so that a member bank waiving notice as to a certain amount of the deposit of one depositor would be obliged to pay the same amount, without notice, of the deposit of any other depositor subject to the same requirement.[82]

When Regulation Q was revised following the Banking Act of 1935, the provisions regarding waiver of notice of withdrawal of savings deposits were changed in only a few minor respects.[83] Conforming to the interpretation above mentioned, the word "portion" was changed to "amount". It was provided that, if a bank should follow the practice of requiring notice before withdrawal, the rate of interest charged on any loan made on the security of a savings deposit should be not less than 2 per cent higher than the rate of interest paid on the deposit. This was in conformity with the similar requirement made by the revised Regulation with respect to loans on time deposits.

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81 Reg. Q, 1933, sec. VI; 1933 BULLETIN 574.

82 1933 BULLETIN 768.

83 Reg. Q, 1936, sec. 5; 1935 BULLETIN 865.

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VIII. EXCEPTIONS FROM THE STATUTE

As originally enacted in 1933, the prohibition against the payment of interest on demand deposits was made subject to four specific exceptions. It did not apply -

(1) to the payment of interest in accordance with any deposit contract which had been entered into in good faith before the passage of the Banking Act of 1933;

(2) to any deposit of a member bank which was payable only at an office located in a foreign country;

(3) to any deposit made in a member bank by a mutual savings bank; or

(4) to any deposit of "public funds" made in a member bank by any State, county, school district, or other subdivision or municipality, if interest was required to be paid on such deposit under State law.

The first exception - that with respect to previously made contracts - was obviously desirable. However, the law made it clear that no such contract could be renewed or extended unless modified to conform to the law and that a member bank should take such action as might be necessary to conform to the law as soon as possible "consistently with its contractual obligations."

The exception as to deposits payable only at an office located in a foreign country was apparently intended to enable member banks with foreign branches to compete on equal terms with the foreign banks in the countries in which the branches were located. Moreover, the motivating reasons behind the prohibition of interest on demand deposits were not applicable to demand deposits received at an office in a foreign country. Subsequently, the scope of the exception was broadened by the Banking Act of 1935 to extend to deposits received at any offices of member banks "located outside of the States of the United States and the District of Columbia."

The purpose of the third exception with respect to demand deposits of mutual savings banks is not entirely clear.[84] It was repealed by the Banking Act of 1935, subject to a "grace period" of two years terminating August 23, 1937.

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84 In construing this exception, the Board held that Massachusetts cooperative banks and building and loan associations were not "mutual savings banks" and that interest could not be paid, therefore, on demand deposits made in member banks by such institutions. 1933 BULLETIN 568; 1933 BULLETIN 653.

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The final exception was presumably made in order to give recognition to the laws of some States which expressly required payment of interest on demand deposits made by the State Governments and their instrumentalities.[85] However, when the interest-on-deposit provisions were being reconsidered in Congress in 1935, it was apparently felt that this exception, like the one with respect to mutual savings banks, was not actually warranted. In the Banking Act of 1935 these two exceptions were permitted to continue for only two more years, until August 23, 1937. After that date, member banks were prohibited from paying interest on demand deposits of public funds of States and municipalities.

It should be noted that the payment of interest on demand deposits of funds of the Federal Government was never excepted from the statutory prohibition. However, there were some Federal statutes which required interest on deposits of certain Government funds; and, in order to eliminate this conflict, the Banking Act of 1935 expressly provided that any such statutes should be deemed to be repealed to the extent that they were inconsistent with the prohbition against the payment of interest by member banks on demand deposits.[86]

In 1933 the Board had ruled that demand deposits of trust funds made by the trust department of a member bank in its commercial department were subject to the statutory prohibition.[87] Subsequently, however, the Banking Act of 1935 put demand deposits of trust funds in the same category as deposits of public funds, permitting interest to be paid on such deposits if required by State law, but only until August 23, 1937.

Accordingly, since August 23, 1937, the only demand deposits in member banks which have been permitted to bear interest have been deposits received at offices outside the United States and deposits made in accordance with contracts executed prior to June 16, 1933, and the latter exception is, of course, no longer of any great significance.

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85 The Board construed this exception as applying to deposits of public funds even though the State law requiring interest was enacted after the passage of the Banking Act of 1933. 1933 BULLETIN 500. However, the Board held that a municipal ordinance was not a "State law" within the meaning of the exception (1934 BULLETIN 121), and that deposits of moneys paid into a State court pending the outcome of litigation were not deposits of "public funds". 1933 BULLETIN 500.

86 See 1937 BULLETIN 113.

87 1933 BULLETIN 568.

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The provisions of the law directing the Board to limit the rate of interest payable by member banks on time and savings deposits, as originally enacted in 1933, contained no exceptions. However, in exercising the discretion given it by the statute, the Board by regulation allowed an exception with respect to contracts entered into in good faith prior to the adoption by the Board of each change in the maximum rates, so that deposits bearing a higher rate under such contracts could continue to bear such higher rate unless and until the contracts would be terminated or modified without legal liability. Thus, the Board applied to time and savings deposits the principle of the statutory exception with respect to the payment of interest on demand deposits in accordance with prior contracts.

The Banking Act of 1935 amended the law to make the limitations on the rate of interest payable on time and savings deposits inapplicable to deposits received at offices of member banks located outside the States of the United States and the District of Columbia. At the same time the statutory prohibition against payment of time deposits before maturity was relaxed to permit such exceptions as might be allowed under regulations prescribed by the Board. These matters have been considered in an earlier section.

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