FEDERAL RESERVE BANK OF DALLAS
DALLAS, TEXAS 75222

Circular No. 70-163
July 13, 1970

INTERPRETATION ON PREPAYMENT OF INTEREST ON DEPOSITS
(Regulations D and Q)

To All Member Banks
in the Eleventh Federal Reserve District:

In view of the number of questions we have been receiving on the subject of prepaid interest on deposits, we reproduce on the reverse of this circular an interpretation of the Board of Governors of the Federal Reserve System on this subject. The interpretation discusses this practice in the context of Regulation Q (Interest on Deposits) and Regulation D (Reserves of Member Banks).

Yours very truly,

P. E. Coldwell

President

INTERPRETATION OF REGULATIONS Q AND D

PREPAYMENT OF INTEREST ON DEPOSITS

The Board of Governors has considered the status under Regulations Q and D of certificates of deposit offered by a member bank with interest paid at the time of issuance.

Under the plan considered by the Board, the bank offers to prepay interest at the rate of 5 per cent per annum on a certificate of deposit in an amount less than $100,000 with a single maturity from two years to four years and eleven months. In the event the deposit is paid before maturity in accordance with § 217.4(d), relating to payment in emergencies, the deposit contract authorizes the bank to recoup from the principal an amount sufficient to reduce the depositor's yield on his investment to no more than 5¾ per cent on the funds withdrawn for the time such funds are on deposit (the current maximum rate on deposits of less than $100,000 with a maturity of at least two years).

If interest were prepaid at the rate of 5¾ per cent per annum, the bank would violate Regulation Q. In such a circumstance, the prepaid interest could be reinvested with the member bank and earn interest at the rate of 5¾ per cent. In such event, the aggregate amount of the prepaid interest plus interest thereon would exceed the maximum amount the bank could have paid at maturity of the certificate with interest computed at the current maximum permissible rate on the type of deposit involved (5¾ per cent).

Under the plan offered by the bank, the depositor receives a yield on his investment in excess of the amount of interest that a member bank may pay under Regulation Q for one year on the type of deposit involved. However, this consideration is not determinative in view of the maturity of the deposit. The significant consideration is whether the amount of prepaid interest plus interest thereon at the maximum rate that may be paid on the type of deposit involved exceeds the aggregate amount of interest that could have been paid on the deposit at maturity computed at the applicable maximum rate. Stated in another manner, the amount the depositor receives at maturity of the certificate may not exceed the amount he actually places with the bank at the time of issuance of the certificate (the face amount less the amount of prepaid interest) plus 5¾ per cent per annum on such amount for the life of the deposit.

Based upon these considerations, the Board concluded that the plan offered by the member bank is consistent with the provisions of Regulation Q. In view of § 217.6(f), relating to accuracy of advertising, the bank should avoid, as with respect to any other time deposit, any statement that might mislead potential depositors into believing that they may withdraw their deposit at any time before maturity with an appropriate deduction to adjust the effective yield on the deposit.

In view of the form of the contract, reserves should be maintained against the face amount of the certificate in accordance with Part 204 (Regulation D), without deduction for prepaid interest. If the form of the contract were on a discount basis so that the amount of the bank's obligation to the depositor increases over the life of the deposit, reserve requirements would initially apply only to the amount of funds received for the certificate, just as in the case of a certificate sold at the face amount with interest paid at maturity.