

FEDERAL RESERVE BANK OF DALLAS
DALLAS, TEXAS 75222

Circular No. 81-189
September 28, 1981

ALL SAVERS CERTIFICATES

Questions and Answers

TO ALL MEMBER BANKS IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

In response to public inquiries about All Savers Certificates, the Depository Institutions Deregulation Committee's staff has prepared an explanation on calculating interest rates. Enclosed are a copy of the press release containing the explanation and questions and answers that have been considered by the regulatory agency staff.

Questions regarding the All Savers Certificates should be directed to this Bank's Legal Department, Extension 6171.

Additional copies of this circular will be furnished upon request to the Department of Communications, Financial and Community Affairs of this Bank, Extension 6289.

Sincerely yours,



William H. Wallace
First Vice President

Enclosure

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

Washington, D.C. 20220

PRESS RELEASE

ALL-SAVERS CERTIFICATES -- Questions and Answers

The Depository Institutions Deregulation Committee (DIDC) issued regulations on September 3, 1981 authorizing all Federally-insured depository institutions to issue one-year, tax-exempt All-Savers Certificates (ASCs) (12 CFR § 1204.116). In response to public inquiries about All Savers Certificates, the DIDC staff has prepared the following explanation on calculating interest rates. In addition, other questions and answers considered by the regulatory agency staff are attached.

Payment of Interest

The DIDC All Savers Certificate regulations provided depository institutions with an option to pay-out, credit, post or make available to a depositor interest on ASCs periodically, as well as at maturity.

The annual investment yield (also equivalent to the annual effective yield) on the ASCs statutorily must be 70% of the average investment yield on 52-week Treasury bills in order for depositors to qualify for the tax-exempt status. The Treasury has the responsibility of calculating and releasing this rate. The ASC rate to be in effect for October 1, 2, and 3 will be 12.61%. An ASC of \$1,000 issued on October 1, 1981, from which the depositor withdraws all interest and principal only at maturity, will yield the depositor \$126.10 in interest on October 1, 1982. This dollar return is independent of how frequently the institution may choose to compound interest on the ASC account, assuming no interest is withdrawn.

Many depositors are used to receiving a monthly or quarterly payment of simple interest. For depositors who elect to withdraw interest periodically from an ASC, however, the DIDC regulations require that specific interest formulas be used to ensure that the annual investment yield on the ASC is equal to that required by statute. Institutions may not use the rate released by the Treasury as a simple interest rate when periodic payments on the ASC are made. Monthly payment of simple interest at the rate which is released by the Treasury will result in an annual investment yield greater than that permitted and, thus, will disqualify the ASC from tax exemption.

The formulas that must be used if an institution pays out interest other than at maturity are:

$$I = \left[(1 + c/100)^{(d/365)} \right] - 1$$

$$r = 100 \times (365/d) \times I$$

- where: I = the dollar payout per payment period for each dollar on deposit at the beginning of the compounding or the payment period;
- r = the corresponding nominal interest rate on an annual basis assuming interest is not compounded continuously [For continuous compounding, $r = 100 \times \ln(1 + c/100)$ where \ln is an abbreviation for the natural logarithm.];
- c = the required ASC annual investment yield (in percent per annum) announced by the Treasury; and
- d = the average number of days in the payment period (a 365 day year must be used).

Working through the formula for monthly payments on an ASC annual investment yield of 12.61% per annum results in the following intermediate steps:

$$\begin{aligned}
 1. \quad & \text{Dollar payout per dollar on deposit (e.g. monthly)} \\
 & = I = [(1 + c/100)^{(d/365)}] - 1 \\
 & = [(1.1261)^{(30.416667/365)}] - 1 \\
 & = .00994583
 \end{aligned}$$

$$\begin{aligned}
 2. \quad & \text{The Nominal Rate for Compounding} \\
 & = r = 100 \times (365/d) \times I \\
 & = 100 \times \frac{365}{30.416667} \times .00994583 \\
 & = 11.935
 \end{aligned}$$

For the current 12.61% All Savers Certificates annual investment yield, the formulas provide the following results:

<u>PAYOUT SCHEDULE</u>	<u>AVG NO DAYS IN PAYMENT PERIOD(d)</u>	<u>NOMINAL RATE</u>	<u>PAYOUT PER \$1,000 DEPOSIT</u>	<u>TOTAL INTEREST PAID OUT OVER 12 MONTHS</u>
DAILY	1.000000	11.878	\$ 0.3254	\$118.780
MONTHLY	30.416667	11.935	\$ 9.9458	\$119.350
QUARTERLY	91.250000	12.054	\$ 30.1352	\$120.541
SEMIANNUALLY	182.500000	12.236	\$ 61.1786	\$122.357
ANNUALLY	365.000000	12.61	\$126.1000	\$126.100

(Note: Numbers may vary due to rounding.)

Thus, for a depositor that elects to withdraw interest monthly on ASC deposits, the above formulas would result in equal monthly payments of \$9.9458 for each \$1,000 on deposit (or total annual interest payments of \$119.350) for a certificate issued on October 1, 1981. In this case, the corresponding nominal interest rate would be 11.935% assuming no compounding within the month. If the institution compounds daily within the month, the nominal rate would be 11.878%, and if it compounds continuously within the month, the nominal rate would be 11.876% per annum. The amount of interest paid monthly would be the same -- \$9.946 -- regardless of whether any compounding occurs within the month.

Attachment: ASC Questions and Answers

ASC QUESTIONS AND ANSWERS

1. Q. May premiums be given for the conversion of existing time deposits to new time deposits?
 - A. The Committee's regulations on All Savers' Certificates ("ASCs") stated that premiums may be offered in connection with ASCs under the limitations of the Committee's existing rules. The premium rules currently permit a depository institution to give a premium only when (1) a new account is opened, an existing account is renewed, or funds are added to an existing account; (2) no more than two premiums per account are given in a 12-month period; and (3) the value of the premium is no more than \$10 for deposits of less than \$5,000 or \$20 for deposits of \$5,000 or more. (12 C.F.R. § 1204.109). In addition, a depository institution is not permitted directly or indirectly to solicit or promote deposits from customers on the basis that the funds will be divided into more than one account by the institution for the purpose of providing more than two premiums per deposit within a 12-month period.

In order to enable depositors to convert existing time deposits to certificates paying a lower interest rate and thus capture the opportunity for benefit provided by the ASC legislation, the Federal Reserve, Federal Deposit Insurance Corporation and Federal Home Loan Bank Board described the conditions under which the conversions could be made without imposition of the early withdrawal penalty. These guidelines generally allow conversion by extending the maturity of an existing deposit at a rate less than or equal to the rate on the existing deposit with the mutual consent of the depositor and the institution. These conversions do not permit withdrawal of funds from the institutions. Transactions involving the transfer of funds to another depository institution are not conversions and the early withdrawal penalty will apply.

Ordinarily, conversions that are permitted under the agencies' guidelines would not qualify as new deposits or renewals of or additions to existing accounts. Therefore, the conversions would not ordinarily qualify for premiums. However, the Committee is aware that public confusion and misunderstandings have occurred as to whether premiums could be paid for conversions since many depository institutions had interpreted the guidance issued by the regulators as meaning that conversions from one instrument to another results in a "new" deposit. Although the regulatory agencies do not

agree with this conclusion as a general matter, the consensus of the agencies is to permit, for a period of six months from September 18, 1981, the payment of premiums on conversions to a different account such as an ASC. Premiums may not be given for conversions that simply extend the maturity of an existing account.

2. Q. Regulations of the various federal financial institutions regulatory agencies provide mandatory exceptions to the early withdrawal penalty where the owner of the time deposit has died or been declared incompetent. Do these exceptions apply to All-Savers' Certificates ("ASCs")?
 - A. Yes. However, penalty-free early withdrawals from ASCs required by these exceptions will cause the interest income on the ASC to lose its tax-exempt status.
3. Q. Who is eligible to purchase ASCs?
 - A. The Committee's regulation does not establish eligibility restrictions on purchasers of ASCs. Therefore, ASCs may be purchased by individuals, corporations, or any other entity eligible to maintain time deposits at depository institutions. However, it should be noted that the life-time exclusion from gross income for interest earned on ASCs is limited to individuals by section 128(a) of the Internal Revenue Code.
4. Q. May depositors convert existing time deposits (including 26-week money market certificates) to ASCs without imposition of the early withdrawal penalty?
 - A. Yes, provided that institutions comply with the conversion requirements of the individual agencies. The regulatory agencies generally provide that a penalty free conversion may occur in the following circumstances:
 - (1) the depositor and the institution must agree to the conversion;
 - (2) the original maturity of the new deposit must be equal to or in excess of the remaining maturity on the outstanding deposit; and
 - (3) the rate paid on the new deposit must not exceed the lower of (a) the rate being paid on the outstanding deposit, or (b) the regulatory ceiling rate, if any, applicable to the new deposit category at the time of conversion.

In order to determine whether the interest rate requirements are met with respect to (3), an institution may either compare the effective yield of the original deposit with the effective yield of the new deposit or compare the nominal (simple) rate on the original deposit with the nominal (simple) rate to be paid on the new deposit.

Interest earned to the date of conversion may also be carried with the funds converted.

5. Q. Does section 1204.116(c)(3)(A) of the Committee's regulation require NOW accounts and interest paid on NOW accounts to be included as "qualified net savings"?
- A. No. Section 128(d)(5) of the Internal Revenue Code (Section 301 of the Economic Recovery Tax Act of 1981) states that "qualified net savings" will be determined on the basis of passbook savings accounts, 6-month money market certificates, 30-month small saver certificates, time deposits with a face amount of less than \$100,000 and ASCs. NOW accounts and other types of accounts classified as transaction accounts under the Federal Reserve's Regulation D are not included as "qualified net savings." Therefore, interest paid on NOW accounts and other transaction accounts as well as additions to these accounts need not be considered as "qualified net savings." However, statement savings accounts must be included.
6. Q. If a depository institution extends qualified residential financing during one quarter in an amount in excess of the minimum amount required to be extended during that quarter to enable the institution to continue offering ASCs, may the excess be carried forward to the next quarter?
- A. No. Section 128(d)(1) of the Code and section 1204.116(c)(2) of the Committee's regulation requires that the qualified residential financing required to be made by a depository institution to enable the institution to continue offering ASCs must be made during the quarter subsequent to the quarter in which there has been the corresponding increase in "qualified net savings" or the proceeds of ASCs. The requirement that the financing be provided during the quarter subsequent to an increase in qualified net savings therefore prohibits carrying excess qualified residential financing from one quarter to the next quarter.
7. Q. If an institution makes a loan commitment in one quarter and the loan is made in a subsequent quarter, must the institution report the transaction as financing provided during the quarter in which the commitment was made?

- A. No. An institution may choose either the quarter in which the commitment was made or the quarter in which the loan was made as being the quarter in which the qualified residential financing was provided, but not both.
8. Q. May an institution's purchase of Farm Credit Administration securities be considered as providing "qualified residential financing"?
- A. No. Section 128(d)(3)(G) of the Internal Revenue Code states that, with regard to purchases of securities, "qualified residential financing" is limited to purchases of securities issued or guaranteed by FNMA, GNMA, or FHLMC, or securities issued by any other person if the securities are secured by mortgages issued by a qualified institution. Farm Credit Administration securities are not listed as being eligible for purchase and therefore may not be included as "qualified residential financing".
9. Q. If a depository institution purchases under a repurchase agreement "qualified residential financing" extended by a qualified institution, may the purchasing institution count the "purchased" financing as "qualified residential financing" extended by it?
- A. No. Repurchase agreements are borrowings and not purchases of the underlying financing.
10. Q. If a depository institution purchases qualified residential financing and subsequently sells the loans, may the purchasing institution count the loans as qualified residential financing extended by it?
- A. The purchasing institution may count the purchased loans as qualified residential financing provided the institution retains the loans until the quarter following the purchase.
11. Q. May an institution include loans made by a domestic office if the proceeds of the loan will be used to purchase a residence outside of the United States?
- A. Section 128 of the Internal Revenue Code does not differentiate between financing extended by a qualified institution on the basis of domestic or foreign use. Therefore, a domestic qualified institution may include as qualified residential financing loans made to foreign persons or to be used outside the United States if the loans are of the type listed in section 128(d)(3).

12. Q. May an ASC be automatically renewable?
- A. Yes, provided the ASC matures and is automatically renewed prior to January 1, 1983.
13. Q. If a depository institution wishes to waive service charges in connection with the maintenance of an ASC by a depositor, does the waiver of service charges jeopardize the tax-exempt status of the interest? If the institution, as a matter of normal practice, waives service charges for all depositors who maintain any time deposit in a particular denomination and a depositor meets this minimum denomination through the maintenance of an ASC, is the tax-exempt status of the ASC interest jeopardized?
- A. The Internal Revenue Service has indicated that the waiver of service charges to an owner of an ASC, regardless of whether the institution waives service charges for owners of other time deposits as a normal practice, may jeopardize the tax-exempt status of the ASC interest. The IRS regards situation number 8 of its Revenue Ruling (Revenue Ruling 81-218) as controlling. Consequently, if a depositor maintains an ASC in a denomination of less than \$5,000, the issuing institution may waive service charges of an aggregate value of \$10 during the life of the ASC. If the ASC is in a denomination of \$5,000 or more, total service charges of only \$20 may be waived. If an institution waives service charges in an amount exceeding these limits, the interest on the ASC would lose its tax-exempt status.
14. Q. May the maturity of an ASC be extended?
- A. The ASC has a required maturity of one year from date of deposit. Therefore, the maturity of an ASC may not be extended.
15. Q. Where the annual effective yield as announced by the Department of Treasury is advertised, is it necessary to also state the nominal (simple) rate of interest with equal prominence?
- A. Yes, as required by current regulations of the FDIC, FHLBB, and Federal Reserve. Additionally, if the institution permits interest to be withdrawn periodically, any advertisement or solicitation for ASCs that states a rate of interest should contain the following statement:

"If a depositor elects to withdraw interest on a periodic basis prior to maturity, the actual yield to the depositor will be lower than the effective yield."