FEDERAL RESERVE BANK OF DALLAS
DALLAS, TEXAS 75222

Circular No. 83-106
September 7, 1983

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

REMOVAL OF INTEREST RATE CEILINGS ON TIME DEPOSITS

(Final Rule)

TO ALL MEMBER BANKS
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Depository Institutions Deregulation Committee (DIDC) has issued a final rule, effective October 1, 1983, for the removal of interest rate ceilings on time deposits. The DIDC has been authorized by the Depository Institutions Deregulation and Monetary Control Act of 1980 to phase out interest rate ceilings on deposit accounts. The proposal to accelerate the deregulation of interest rate ceilings was outlined in Circular No. 83-5, dated January 17, 1983.

The new regulations apply only to accounts opened, renewed, or extended on or after October 1, 1983. These regulations do not affect any accounts that have not matured prior to that date.

Attached are copies of the DIDC's regulatory ruling and an appendix for calculating certain early withdrawal penalties as submitted for publication in the Federal Register. Questions regarding the material contained in this circular should be directed to the Legal Department, Extension 6171.

Additional copies of this circular will be furnished upon request to the Public Affairs Department, Extension 6289.

Sincerely yours,

William H. Wallace

William H. Wallace
First Vice President

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

[12 C.F.R. PART 1204]

Docket No. 0031

Removal of Interest Rate Ceilings on Time Deposits

AGENCY: Depository Institutions Deregulation Committee.

ACTION: Final Rule.

SUMMARY: Effective October 1, 1983, the Depository Institutions Deregulation Committee ("Committee") has:

(1) eliminated all interest rate ceilings (a) on all time deposits with original maturities or required notice periods of more than 31 days, and (b) on time deposits of $2,500 or more with original maturities or required notice periods of seven to 31 days;

(2) eliminated other regulations on time deposits <u>except for</u>: (a) the minimum early withdrawal penalties; (b) a minimum denomination of $2,500 for ceiling-free time deposits with original maturities or required notice periods of seven to 31 days; (c) the current ceiling on time deposits of less than $2,500 with original maturities or required notice periods of seven to 31 days; and (d) the rules of the agencies requiring a one percentage point differential between a loan rate and the rate on a time deposit securing a loan; and

(3) established the following new minimum early withdrawal penalties: (a) for time deposits with original maturities or required notice periods of 32 days to one year, loss of one month's simple interest; and (b) for time deposits with original maturities or required notice periods

of more than one year, loss of three months' simple interest. (The current penalty for the seven to 31 day account set forth at 12 C.F.R. 1204.121 remains unchanged and applies to all time deposits with original maturities or required notice periods of seven to 31 days).

The new regulations apply only to accounts opened, renewed or extended on or after October 1, 1983. These regulations do not affect any accounts that have not matured prior to that date. The Committee's actions were taken to provide depository institutions with more flexibility in managing their asset-liability structures.

EFFECTIVE DATE: October 1, 1983. Certain conforming amendments to the Committee's rules will be effective November 1, 1983, and January 1, 1984.

FOR FURTHER INFORMATION CONTACT: Paul S. Pilecki, Senior Counsel, Board of Governors of the Federal Reserve System (202/452-3281); Alan Priest, Attorney, Office of the Comptroller of the Currency (202/447-1880); Jules Bernard, Senior Attorney, F. Douglas Birdzell, Counsel, Federal Deposit Insurance Corporation (202/389-4171); Robert H. Ledig, Attorney, Federal Home Loan Bank Board (202/377-7057); or Betty A. Whelchel, Attorney-Advisor, Treasury Department (202/566-8737).

List of Subjects in 12 CFR Part 1204: Banks, banking.

SUPPLEMENTARY INFORMATION; The Depository Institutions Deregulation Act of 1980 (Title II of P.L. No. 96-221, 12 U.S.C. 3501, <u>et. seq.</u>) ("DIDA") was enacted to provide for the orderly phaseout, and the ultimate elimination of, ceilings on the maximum rates of interest and dividends that may be paid on deposit accounts. Under the DIDA, the Committee is authorized to phase out interest rate ceilings by one or more of the methods specified in the Act, including the complete elimination of ceilings applicable to particular categories of accounts.

The Committee had adopted a deregulation schedule (12 C.F.R. 1204.119) that provides for the gradual removal of interest rate ceilings beginning with longer term accounts. Under this plan, there are no ceilings on time deposits with original maturities of 2-1/2 years or more issued on or after April 1, 1983. Ceilings were scheduled to be removed on accounts with maturities or required notice periods of 1-1/2 years or more on April 1, 1984; of 6 months or more on April 1, 1985; and of 14 days or more on March 31, 1986.

Subsequent events, however, have brought into question the need to continue the deregulation process in accordance with the Committee's deregulation schedule. In the Garn-St Germain Depository Institutions Act of 1982 (Pub. L. 97-320), Congress provided for both (1) the elimination of the interest rate differentials for all categories of insured accounts on or before January 1, 1984, and (2) the establishment of the ceiling-free money market deposit account ("MMDA") no later than December 14, 1982. Given these statutory mandates for the accelerated elimination of the differential and the establishment of the MMDA, the Committee began to question whether ceilings on time deposits are still necessary. Also, the authorization of the MMDA, and later the ceiling-free NOW account, created an anomalous situation where ceilings had been eliminated on highly liquid short-term accounts and on longer-term certificates of deposit, but not on the intermediate accounts. Depository institutions consequently began to find it difficult to balance properly their asset-liability structures.

The Committee, given the circumstances, decided at its December 6, 1982 meeting to seek public comment on eliminating the remaining ceilings and on several methods for accelerating the deregulation of time deposits. It received approximately 365 comments on those proposals. Over half of the commenters expressed the view that further deregulation should be postponed because more time was needed for depository institutions to absorb the changes that were taking place as a result of the MMDA and the ceiling-free NOW account. Many of the respondents commented that the Committee should abide by the schedule that was put in place in April 1982. The most typical response was that the Committee was issuing too many new regulations too fast, and that it was hard for the industry to keep up with all the DIDC changes, especially when there was short lead time to prepare for the changes. Commenters pointed out that it took time to teach employees about the accounts so they could explain the new rules to the customers, as well as make necessary data processing changes.

Over 40 percent of the commenters, however, indicated support for some form of accelerated deregulation. These commenters pointed out that depositors did not have the opportunity to invest in competitive, insured accounts with maturities between six and 30 months. In addition, these commenters indicated that deregulation of all accounts would allow depository institutions to price their deposits in a way that would attract funds in the maturity categories that best match the maturities of their loans and investments.

At its March 1, 1983 meeting, the Committee voted to table discussion of this issue and all the other agenda items until the June meeting. In part, that decision reflected the fact that the then prevailing deregulation schedule called for the minimum maturity of the long-term, ceiling-free account to be reduced on April 1, 1983, from 3-1/2 years to 2-1/2 years and the minimum maturity on the indexed small savers certificate to be reduced from 30 months to 18 months. Although institutions had known of these changes for over a year and had time to plan for them, the changes were significant and the Committee believed that institutions should be given additional time to adjust to them before further changes were made. Moreover, depository institutions were in the process of adjusting to the recently authorized MMDA and the ceiling-free NOW account.

At its June 30, 1983 meeting, the Committee determined that depository institutions had had sufficient time to adjust to past changes in account structures and to prepare for the complete elimination of all ceilings on accounts. Therefore, it decided, effective October 1, 1983, to eliminate virtually all interest rate ceilings and other regulations governing time deposits except for (1) required early withdrawal penalties; (2) the $2,500 minimum denomination on the ceiling-free, seven to 31- day account; and (3) the rules of the agencies requiring a one percentage point differential between a loan rate and the rate on a time deposit securing a loan.

Thus, regulations such as those requiring that time deposits of 1-1/2 years or more be made available in denominations of $500 or more, or those restricting the negotiability of the seven to 31 day account, have been eliminated with respect to accounts established on or after October 1, 1983. The new interest rate ceiling structure will be as follows:

Interest Rate Ceiling Structure

Effective October 1, 1983

Account	Required Minimum Deposit	Interest Rate Ceiling: Commercial Banks	Interest Rate Ceiling: Savings & Loan Associations and Savings Banks
NOW Accounts	0-$2,499	5-1/4%	5-1/4%
Ceiling-free NOW Accounts	$2,500	None	None
Passbook Savings	None	5-1/4%	5-1/2%
MMDA	$2,500	None	None
Time deposits of 7-31 days */	$0-$2,499	5-1/4%	5-1/2%
Time deposits of 7-31 days	$2,500	None	None
All time deposits of more than 31 days	None	None	None

*/ The agencies advise that depository institutions may continue to issue to governmental units time deposits of less than $2500 with maturities or required notice periods of seven to 31 days, subject to the current ceiling of eight percent in effect for such deposits.

Since a minimum denomination of $2,500 will still be required on ceiling-free, seven to 31-day accounts, all regulations designed to uphold that requirement will remain in effect with respect to seven to 31-day accounts. Consequently, the restrictions on loans, additional deposits, and automatic transfers to other accounts set forth in Section 1204.121(b), (d), and (e) will still apply to such accounts. In addition, since interest ceilings remain in effect for NOW accounts and passbook accounts of less than $2,500, restrictions concerning withdrawals from seven to 31-day time deposits in Section 1204.121(f) will remain in effect.

Similarly, since ceilings will remain in effect with respect to time deposits of less than $2,500 with original maturities or required notice periods of seven to 31 days, all regulations designed to enforce ceilings shall remain in effect with respect to such accounts. Consequently, rules pertaining to premiums, finders' fees, prepayment of interest, and payment of interest in merchandise will still apply to those seven to 31-day accounts of less than $2,500.

The Committee also established the following new minimum early withdrawal penalties: (1) for accounts with original maturities or required notice periods of 32 days to one year, loss of one month's simple interest; and (2) for accounts with original maturities or required notice periods of more than one year, loss of three months' simple interest. It later clarified its action with respect to the seven to 31-day account by a notation vote, retaining the existing penalty and applying it to all time deposits of seven to 31 days. This penalty provides for the forfeiture of the greater of (1) all interest earned on the amount withdrawn from the most recent of the date of deposit, date of maturity, or date on which notice was given, or (2) all interest that could have been earned on the amount withdrawn during a period equal to one-half the maturity period or the required notice period.

Depository institutions are to invade the principal of the account, if necessary, to impose the early withdrawal penalty. To calculate the interest rate to be used in assessing the penalty on floating rate or variable rate time deposits, depository institutions should continue, after October 1, 1983, to use the procedures already established for such calculations, which are described in Appendix A.

The new minimum early withdrawal penalty will apply to all time deposit contracts entered into, renewed, or extended on or after October 1, 1983. Any time deposit issued before October 1, 1983, that is not renewed or extended on or after that date, will be subject to the early withdrawal penalty in effect at the time that the account was issued, renewed, or extended, whichever is later.

Since early withdrawal penalties continue to apply to time deposits, all regulations designed to enforce the penalties remain in effect. Consequently, any amendment of a time deposit that results in a reduction in the maturity of a deposit will continue to constitute the payment of a time deposit prior to maturity, requiring the imposition of the early withdrawal penalty. Also, certain grace periods during which an automatically renewed time deposit may be paid without the imposition of the penalty still will be permitted. Finally, all disclosure and advertising rules concerning early withdrawal penalties will remain in effect.

The new minimum early withdrawal penalty will be more severe than existing penalties under limited circumstances. For example, the current minimum early withdrawal penalty for 91-day, $2,500 time deposits is equal only to all interest earned on the amount withdrawn. The new minimum early withdrawal penalty on those 91-day instruments that are renewed or extended on or after October 1, 1983, will be more severe during the first 31 days of the accounts, since the new minimum penalty on the 91-day account is the loss of at least one month's simple interest.

All accounts that were issued with fixed maturities prior to October 1, 1983, that are renewed or extended on or after that date, will be subject to, and must be modified to reflect, the new early withdrawal penalties. With regard, however, to accounts that are subject only to required notice before withdrawal and which, because of their notice feature, may not actually be renewed or extended on or after October 1, 1983, depository institutions may elect either (1) to continue to apply the early withdrawal penalty established by the regulations applicable to the account prior to October 1, 1983; or (2) to modify the accounts to incorporate the new minimum early withdrawal penalties.

Both the early withdrawal penalties for time deposits and the $2,500 minimum denomination on the ceiling-free, seven to 31-day account were retained to prevent an accelerated outflow from passbook savings accounts. In addition, the early withdrawal penalty was believed to be desirable to protect depository institutions that invest in long-term assets on the planning presumption that the deposits will be maintained until maturity.

The new regulations effectively will eliminate all regulatory distinctions, other than the early withdrawal penalties, among those accounts established or renewed on or after October 1, 1983, that either (1) have original maturities of more than 31 days, or (2) are of $2,500 or more and have original maturities of 31 days or less. Thus, the Committee's action simplifies the current account structure and is intended to give depository institutions the flexibility to manage their liabilities in such a way as to attract deposits in maturities that match their asset maturities. In this context, it should be noted that the regulations establish the minimum early withdrawal penalties and requirements applicable to accounts. Depository institutions may establish stricter early withdrawal penalties, if they so desire. Similarly, depository institutions may limit the interest they pay on both ceiling-free accounts and accounts subject to ceilings, so long as the rate of interest paid in the latter case is less than the rate established by regulation. The regulations governing time deposits issued before October 1, 1983, passbook savings accounts, money market deposit accounts, and NOW accounts are not affected by the Committee's action.

The Committee, as is required by the Regulatory Flexibility Act (5 U.S.C. 603, et seq.), considered the potential effect on small entities of removing interest rate ceilings and regulations on time deposits with original maturities or required notice periods of more than 31 days and time deposits of $2,500 or more with original maturities or required notice periods of 31 days or less. The Committee's action in this regard will not impose any new reporting or record-keeping requirements. Small entities which are depositors should benefit generally from the Committee's proposal, since they will have a wider selection of instruments that will pay a market rate of return. Small entities which are depository institutions also should benefit generally from the Committee's proposal, since they will be better able to properly balance their asset-liability structures. If, however, low-yielding deposits shift into the ceiling-free accounts as a result of the Committee's action, small entities which are depository institutions may experience increased costs. The staff study, however, concluded that any shift of low-yielding deposits into the ceiling-free accounts due to the Committee's action is likely to be minimal, most such transfers having taken place upon the authorization of the money market deposit account and the ceiling-free NOW account. The Committee further imposed a $2,500 minimum on ceiling-free accounts with original maturities or required notice periods of less than 31 days to discourage sudden shifts from low-yielding short-term deposits to ceiling-free accounts.

Pursuant to its authority under Title II of Public Law 96-221 (94 Stat. 142; 12 U.S.C. Sec. 3501, et seq.) to prescribe rules governing the payment of interest and dividends on deposits and accounts of federally insured commercial banks, savings and loan associations, and savings banks, the Committee amends Part 1204 -- Interest on Deposits, as follows:

1. Effective October 1, 1983, by adding a new section 1204.123 to read as follows:

SECTION 1204.123 - Payment of Interest on Time Deposits Issued On or After October 1, 1983.

(a) Notwithstanding any other provision of Part 1204, a commercial bank, savings bank or savings and loan association may pay interest at any rate agreed to by the depositor on any time deposit issued, renewed, or extended on or after October 1, 1983, that either (1) is in an amount of $2,500 or more, or (2) has an original maturity or required notice period prior to withdrawal of more than 31 days.

(b) An institution may permit additional deposits to be made to any time deposit issued pursuant to this section at any time prior to its maturity without extending the maturity of all or a portion of the entire balance in the account.

2. Effective October 1, 1983, by designating section 1204.103 as paragraph (a), by adding a new sentence at the beginning thereof, and by adding new paragraphs (b), (c), and (d) to read as follows:

SECTION 1204.103 -- Penalty for Early Withdrawals

(a) The following minimum early withdrawal penalties apply only to time deposit contracts entered into, renewed, or extended between June 2, 1980, and September 30, 1983, and that have not been renewed or extended on or after October 1, 1983.

* * * *

(b) The following minimum early withdrawal penalties shall apply to time deposit contracts entered into, renewed or extended on or after October 1, 1983:

(1) Where a time deposit with an original maturity or required notice period of seven to 31 days, or any portion thereof, is paid before maturity, a depositor shall forfeit an amount equal to the greater of (i) all interest earned on the amount withdrawn from the most recent of the date of deposit, date of maturity, or date on which notice was given, or (ii) all interest that could have been earned on the amount withdrawn during a period equal to one-half the maturity period or the required notice period.

(2) Where a time deposit with an original maturity or required notice period of 32 days to one year, or any portion thereof, is paid before maturity, a depositor shall forfeit an amount at least equal to one month's interest earned, or that could have been earned, on the amount withdrawn at the nominal (simple) interest rate being paid on the deposit, regardless of the length of time the funds withdrawn have remained on deposit.

(3) Where a time deposit with an original maturity or required notice period of more than one year, or any portion thereof, is paid before maturity, the depositor shall forfeit an amount at least equal to three months' interest earned, or that could have been earned, on the amount withdrawn at the nominal (simple) interest rate being paid on the deposit, regardless of the length of time the funds withdrawn have remained on deposit.

(c) Notwithstanding paragraph (a), where a time deposit of $2,500 to less than $100,000, with an original maturity of 91 days, that has been issued, renewed or extended before October 1, 1983, but not renewed or extended on or after that date, is paid before maturity, a depositor shall forfeit an amount equal to at least all interest earned on the amount withdrawn.

(d) Notwithstanding paragraph (a), where a nonnegotiable time deposit of $2,500 or more, with an original maturity or required notice period of seven to 31 days, that has been issued renewed or extended before October 1, 1983, but not renewed or extended on or after that date, is paid before maturity, the depositor shall forfeit an amount equal to at least the greater of --

(i) all interest earned on the amount withdrawn from the most recent of the date of deposit, date of maturity, or date on which notice was given, or

(ii) all interest that could have been earned on the amount withdrawn during a period equal to one-half the maturity period or required notice period.

3. Effective October 1, 1983, Section 1204.121 is amended as follows:

(a) by designating the name of the section to be "seven to 31-day time deposits";

(b) by deleting the word "nonnegotiable" from paragraph (a) thereof;

(c) by revising paragraph (c) to read as follows:

"(c) Section 102 of this part shall not apply to time deposits issued under this section. Where all or any part of a time deposit issued under this section is withdrawn within one business day after the maturity date of the deposit or the date of expiration of notice of withdrawal, no early withdrawal penalty is required to be applied on the amount withdrawn."

4. Effective October 1, 1983, the following sections of Part 1204 are repealed: 1204.104, 1204.105, 1204.106, 1204.112, 1204.114, 1204.116, 1204.118, 1204.119, and 1204.120.

5. Effective January 1, 1984, paragraphs (c) and (d) of section 1204.103 are repealed.

By Order of the Committee, August 18, 1983.

Mark G. Bender

Mark G. Bender
Executive Secretary

APPENDIX A

Calculating the Early Withdrawal Penalty for Floating Rate Time Deposits

If an interest rate on a time deposit is tied to an index that is beyond the depository institution's control (e.g., Treasury security rate, commercial paper rate, Federal funds rate, Federal Reserve discount rate) for the entire term of the deposit, the institution may base the simple interest rate, for purposes of calculating the minimum early withdrawal penalty, on the rate in effect on the date the account was opened, or on the date of withdrawal, or on an average of the rates in effect during the term of the deposit. The institution must specify, however, whether it will use the initial interest rate, the rate on the date of withdrawal, or the average rate. If the interest rate on a time deposit is not tied to an index, but instead varies in a precise way over the term of the deposit, or the relationship of the rate changes in regard to the index (e.g., the commercial paper rate minus 50 basis points for the first six months of the instrument and the commercial paper rate minus 100 basis points thereafter), then the depository institution must compute the minimum early withdrawal penalty using the average of the simple interest rates on the deposit during the time period that the deposit was outstanding.

If the interest rate is established at regular intervals and remains in effect for regular periods (e.g., the rate is established once a month and remains in effect for one month), the depository institution must calculate the average simple interest rate by taking the sum of the rates established at each interval while the funds were on deposit, divided by the number of periods the funds were on deposit. Each partial period will be considered a full period for the purpose of this calculation.

If the length of the periods for which rates are effective varies, the depository institution must calculate the average simple interest rate by dividing the amount of time a deposit was outstanding into equal periods and then adding the rates that were in effect during those periods and dividing by the number of periods. The period used should be the shortest period for which a rate was in effect. For example, a time deposit might have the following rates in effect for the following periods at the time a depositor wished to withdraw the funds:

6 months (percent) 15

1-1/2 years (percent) 16

1 year (percent) 14

The total amount of time the deposit was outstanding was 3 years (6 months + 1-1/2 years + 1 year). This 3-year period would then be divided into 6 periods of 6 months each. Then the rates in effect for each period would be:

1st six month period (percent) 15

2nd six month period (percent) 16

3rd six month period (percent) 16

4th six month period (percent) 16

5th six month period (percent) 14

6th six month period (percent) 14

To calculate the average simple interest rate, the rate in effect during each period would be added together--

$$15 + 16 + 16 + 16 + 14 + 14 = 91$$

The resulting sum would then be divided by the number of periods-- 91 divided by 6-- to yield an average simple interest rate of 15.17 percent.

Lump sum payments of cash that would be regarded as interest (see 12 CFR 1204.109 and 12 CFR 1204.111), must be taken into account in computing the penalty rate. Any lump-sum payment must be prorated over the life of the deposit. The portion that is attributed to the time period during which the deposit was outstanding must be regarded as interest for purposes of computing the penalty rate. The portion attributable to the remaining life of the deposit is regarded as unearned interest and must be deducted from the principal amount of the deposit and returned to the institution.