FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 7663
July 1, 1975]

INDIVIDUAL RETIREMENT ACCOUNTS

Request for Comments on Issues Relating to Regulation Q

*To All Member Banks, and Others Concerned,
in the Second Federal Reserve District:*

Following is the text of a statement issued June 26 by the Board of Governors of the Federal Reserve System:

The Board of Governors of the Federal Reserve System today invited comment on a number of issues relative to its Regulation Q (Interest on Deposits), in connection with the offering by financial institutions of Individual Retirement Accounts.

Comment should be received by August 8, 1975. A similar announcement is being made by the Federal Deposit Insurance Corporation.

The Employee Retirement Income Security Act of 1974 permits individuals not covered by a retirement plan to establish an Individual Retirement Account (IRA). Individuals may deposit in these Accounts, for retirement purposes, tax-deferred contributions up to $1,500 a year, or 15 per cent of gross income, whichever is less. Such Accounts may be maintained at banks and other institutions.

In light of this Act, the Board on May 21 announced that State member banks not exercising trust powers could nevertheless act as trustee of IRAs, in specified circumstances, without prior Board approval. National banks had previously been authorized to offer IRAs by the Comptroller of the Currency.

The Board invited comment on the following issues:

1. Would existing penalty restrictions imposed upon early withdrawal of funds from a time deposit unnecessarily interfere with the distribution of all or part of an IRA deposit balance when a participant retires or becomes disabled prior to the maturity of the deposit in which his IRA funds are held?

—The Board's existing rules require that when funds subject to a deposit agreement are withdrawn before maturity, interest on the amount withdrawn must be reduced to the passbook savings rate and, in addition, three months' interest shall be forfeited.

2. Is the 10 per cent statutory penalty on early withdrawal of IRA deposits sufficient to deter early withdrawal without the imposition of the penalties for early withdrawal under Regulation Q?

3. In view of the intent of the Congress to encourage individuals to save for their retirement, and since IRA deposits may remain on deposit for very long periods should the existing ceiling on interest rates permitted to be paid on funds deposited in IRAs be increased and should the existing differential between the ceiling interest rates for savings institutions and commercial banks be eliminated? Further, should these ceiling rates be competitive with rates offered by insurance companies and mutual funds that also accept IRA deposits?

—Generally the differential on interest rate ceilings between commercial banks and thrift institutions is one-quarter of one per cent.

4. The Board would also like comment on the question whether disintermediation (drainage of funds from one or more types of investment or savings) might occur due to the potential for shifts of IRA funds from one to another type of institution or investment in order to increase earnings.

5. Finally, the Board would like comment on the question whether new types of deposit instruments

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should be created for IRA funds. The instruments under consideration might have the following general characteristics:

—An instrument of which the rate of interest would be permitted to increase over time, presenting an incentive, in the form of higher interest rate earnings, for leaving deposits in place for longer periods.

—An "IRA Payout Certificate" into which an IRA participant nearing retirement could convert an existing or maturing long-term deposit and from which the depositor would receive periodic, annuity-like payments, with no or reduced penalty for early withdrawal, in exchange for the depositor's undertaking to leave his IRA funds on deposit for a specified period.

Printed below is the text of the Board's statement as submitted for publication in the *Federal Register.* Comments thereon should be submitted by August 8, 1975, and may be sent to our Bank Regulations Department.

ALFRED HAYES,
President.

[Reg. Q]

INTEREST ON DEPOSITS

Request for Public Comments

Concerning Individual Retirement Accounts

The Board of Governors, in conjunction with the other Federal financial regulatory agencies, is considering the appropriateness of amendments to Regulation Q (Interest on Deposits) (12 CFR 217) in light of the recently enacted Employee Retirement Income Security Act of 1974 (Public Law 93-406) which, in part, provides for the establishment of Individual Retirement Accounts (IRAs). Prior to consideration of specific regulatory proposals, the Board desires to obtain a broad sampling of public opinion on several issues raised by member banks offering IRA plans under the Board's existing regulations.

IRAs, established pursuant to § 408 of the Internal Revenue Code (26 U.S.C. 408), are retirement plans which may be created by persons who otherwise are not participants in existing pension plans. The statute provides that an individual may deduct up to $1,500 or 15 per cent of the compensation includable in his gross income for the taxable year, whichever is less, from his gross income in determining his Federal income tax. In addition, earnings on the contributions to an IRA are not taxable until distributed to the individual. Other provisions of the statute specify when distributions may be made, impose a 10 per cent penalty for premature withdrawal of funds, and establish conditions under which IRA funds may be transferred from one trustee or custodian to another. It is expected that many IRAs will be maintained at banks pursuant to trust or custodial agreements created between banks and individuals.

The Board requests public comments on the following issues relating to IRAs and Regulation Q:

(1) *Would existing restrictions of Regulation Q relating to withdrawal of time deposits prior to maturity (12 CFR 217.4) unnecessarily interfere with the distribution of all or a part of the IRA deposit balance when the participant retires or becomes disabled?*

The Board's existing regulations state that where a deposit is withdrawn prior to the maturity date of the deposit agreement, interest paid on the amount withdrawn may not exceed the savings rate and, in addition, three months of interest shall be forfeited. Consequently, IRA participants who choose to invest their funds in time deposits with long-term maturities in order to obtain higher rates of interest may incur a substantial interest penalty if these deposit instruments have not matured when the individual reaches retirement age (age 59½ pursuant to the statute) or when the individual becomes disabled and the IRA participant receives payment of all or part of his IRA funds. (A recent amendment to Regulation Q exempts from the interest penalty provision any funds withdrawn prior to maturity in the event of the depositor's death.)

In order to minimize the effect of the Board's existing interest penalty provision upon payout at retirement or disability, the Board wishes to receive comments on whether IRA participants and member banks offering IRA plans should be required to structure the maturities of their deposit agreements so that they come due at intervals coinciding with distribution pursuant to the IRA agreement entered into with the bank. Would such requirements unduly complicate the functioning of the IRAs and impose an undue burden on individuals and banks in keeping track of maturing deposits and in planning distribution schedules at retirement such as to discourage participation in IRA offerings?

An alternative available under present regulations would be to invest IRAs into savings deposits or deposits with short-term maturities or notice requirement periods. Under existing rate structures, however, such action could result in a substantially lower overall rate of interest earned on IRA funds than would be possible if instruments with longer-term maturities or notice period requirements were available. Accordingly, the Board is interested in soliciting the views of the public on the question of whether an exception to the early

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withdrawal provision of Regulation Q is necessary to facilitate distribution of these funds when the individual retires or becomes disabled.

(2) *In view of the 10 per cent penalty for early distribution of IRA funds, imposed by the IRA statute, does the existing penalty for withdrawal prior to maturity established by Regulation Q impose an unnecessary deterrent such that an exception to the Board's penalty rule should be considered for all withdrawals of IRA funds regardless of when made?*

Title 26 U.S.C. § 408 provides that where any distribution from an IRA is made before the individual attains age 59½ or becomes disabled, the participant shall incur a penalty in the amount of 10 per cent of the funds distributed. The Board's present penalty rule is intended to enforce the statutory prohibition against payment of a time deposit before maturity. The Board is interested in comments on whether the 10 per cent penalty on early distribution of IRA funds is sufficient to deter early withdrawal of IRA deposits such that the Board need not require member banks to impose the Regulation Q penalty for early withdrawal when IRA deposits are withdrawn prior to maturity.

(3) *In view of the intent of Congress to encourage individuals to save for their retirement and in view of the fact that IRA deposits may remain on deposit at financial institutions for very long periods of time, should the existing schedule of ceiling interest rates that can be paid by banks on IRA deposits be increased and should member banks be permitted to pay interest on IRA deposits at rates that are equal to those that may be paid by savings and loan associations and mutual savings banks? Should these rates be competitive with those offered by insurance companies and mutual funds that also accept IRA funds?*

Due to the long-term nature of IRA deposits and due to the effects of compounding, the ¼ per cent interest rate differential that exists between commercial banks and thrift institutions can result in a substantial difference in the amount of interest a participant can earn on his IRA funds. Further, Congress intended that individuals be encouraged to establish IRAs with a view toward accumulating assets sufficient to provide them with funds for their retirement period. Consequently, the higher the rate of interest that may be paid, the greater will be the amount of interest accumulated. In addition, there is the question as to whether the custodial or trustee nature of the IRA agreement places a fiduciary obligation upon the IRA custodian or trustee to place IRA funds only in institutions that may pay the highest rate of interest permitted by law.

(4) The Board is also interested in receiving comments on the effect of longer-term certificates on the stability of sources of funds for member banks and thrift institutions and the consequent insulation from disintermediation during periods of high market interest rates. The Board requests comments concerning the potential for disintermediation brought about by shifting of IRA funds among investment alternatives by trustees and custodians of IRA deposits and due to "rollover" of IRAs from one trustee or custodian to another.

Generally, trustees and custodians are authorized to place funds in various types of investment. In addition, participants are permitted to "rollover" their IRA funds to another custodian or trustee once in three years without penalty. Accordingly, the Board is interested in obtaining public comments on the potential effects that the opportunity for such changes could have upon financial institutions.

(5) The Board requests comment on the question of the creation of new types of deposit instruments for IRA funds. These instruments might have the following characteristics:

(a) The rate of interest permitted to be paid on the instrument would increase over time such that banks would be permitted to pay higher rates of interest on IRA deposits that remain in the bank for correspondingly longer periods of time;

(b) An IRA participant nearing retirement would be permitted to convert an existing or maturing long-term time deposit to an "IRA Payout Certificate" that would permit the depositor to receive periodic payouts at no or reduced interest penalty in exchange for the customer's commitment to retain his IRA funds on deposit for a specified period of time.

To aid in the consideration of this matter by the Board, interested persons are invited to submit relevant data, views, or arguments in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D. C. 20551, to be received not later than August 8, 1975. Such material will be made available for inspection and copying upon request except as provided in 12 CFR 261.6(a) of the Board's Rules Regarding Availability of Information.

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