FEDERAL RESERVE BANK OF NEW YORK

[Circular No. 8392
July 21, 1978]

PROPOSED AMENDMENT TO REGULATION Q

Reduction of Penalty Required for Early Withdrawal of Certain Types of Time Deposits

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

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

The Board of Governors of the Federal Reserve System today [*July 14*] proposed to lighten the penalty required for early withdrawal of certain types of time deposits at member banks.

The Board said that its proposal is expected to benefit particularly time deposits in long-term Individual Retirement Accounts (IRAs) and Keogh Plan retirement accounts, thus furthering the Congressional aim of promoting retirement savings.

The Board asked for comment by August 30, 1978.

The proposed change in the early withdrawal penalty rules under Regulation Q (Interest on Deposits) would affect two types of time deposits:

—*Time Deposit Open Account* (TDOA), which is a type of deposit that may provide for subsequent deposits to the account that may be viewed either as (1) resetting the maturity of the entire amount on deposit, or (2) as having a separate and distinct maturity (equal to the same maturity as the original deposit).

—*Notice Accounts,* accounts that do not have a specified maturity but require the depositor to give notice (for instance, 90 days) of intent to withdraw all or part of the account.

The Board is aware that many member banks have established IRA and Keogh Plan retirement savings accounts as TDOA or notice accounts. These are special time accounts in which independently employed individuals (Keogh Plan) or persons working for companies without retirement plans (IRA) can save for their retirement under special tax deferral provisions.

The penalty for early withdrawal of all or part of a time account is reduction of the interest paid on the amount withdrawn to the passbook savings rate (5 percent at commercial banks) and forfeiture of 90 days interest at that rate. Generally, the interest forfeiture penalty on the amount withdrawn from a time account applies back to the original date of deposit of funds in the account.

Under the Board's proposal, in the case of early withdrawal at a member bank from:

—*A notice account,* the minimum penalty would apply on the amount withdrawn to a period of time no greater than the required notice period.

—*TDOA,* the penalty on the amount withdrawn would apply only to the length of the maturity period specified for the original deposit. The original maturity period for IRA and Keogh accounts must be at least three years if maximum interest is to be paid on such accounts.

Printed below is the text of the proposed amendment to Regulation Q. Comments should be submitted by August 30, and may be sent to our Consumer Affairs and Bank Regulations Department.

PAUL A. VOLCKER,
President.

INTEREST ON DEPOSITS

[Regulation Q; Docket No. R-0172]

Penalty for Early Withdrawals

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board of Governors of the Federal Reserve System proposes to amend the penalty required to be imposed upon the withdrawal of funds from time

deposits prior to maturity under certain limited circumstances. The amendment would modify the early withdrawal penalty as applied to Individual Retirement Account (IRA) time deposits or other time deposit agreements that provide that if additional funds are deposited to the account, such deposits extend the maturity of the existing funds on deposit. The amendment would also apply to time deposits that may not be withdrawn prior to the expiration of a certain specified period of notice (notice accounts). Under the proposed amendment, the minimum early withdrawal penalty would be reduced from the current requirement to no more than the maturity or notice period specified for the deposit. Under the Board's current regulations, in the event of a withdrawal of funds prior to maturity from time deposit agreements providing that subsequent deposits to the account extend the term or notice provision of all of the funds on deposit, or in the event of a withdrawal from a notice account prior to the expiration of the required notice period, a member bank is required to impose an interest forfeiture on the funds withdrawn back to their original date of deposit.

DATE: Comments must be received by August 30, 1978.

ADDRESS: Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. All material submitted should include the docket number R-0172.

FOR FURTHER INFORMATION CONTACT: Gilbert T. Schwartz, Senior Attorney (202-452-3623) or Anthony F. Cole, Attorney (202-452-3711), Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION: Section 217.4(d) of the Board's Regulation Q (12 CFR 217.4 (d)) provides that where a member bank agrees to pay a time deposit prior to maturity, the bank must impose an interest forfeiture penalty on the funds withdrawn equal to a reduction in the rate of interest paid to a rate not to exceed the rate currently prescribed for a savings deposit plus a forfeiture of three months interest at such rate. Pursuant to this provision, where additional deposits to a time deposit account are viewed under the deposit contract as resetting or extending the maturity of all previous deposits to the account, in the event of a withdrawal of funds from such account prior to maturity, a member bank is required to impose an interest forfeiture on the funds withdrawn back to the original date of deposit of those funds regardless of how long the funds have remained on deposit. (In the event the funds in such an account had matured and had been renewed prior to a subsequent deposit which reset their maturity, the penalty need only be assessed back to the date of renewal.) Similarly, if a depositor withdraws funds from a time deposit that is payable only after expiration of a required period of notice without giving such notice, or withdraws the funds prior to the expiration of such notice period, a member bank is required to impose the interest forfeiture penalty on the funds withdrawn back to the original date of deposit of those funds.

The Board believes that application of the penalty provision in the above described manner could have a potentially severe impact on the interest earned on time deposits held in long-term Individual Retirement Accounts (IRAs) and Keogh (H.R. 10) Plan accounts. In this connection, the Board is aware that many member banks have established such accounts in the form of time deposit open accounts (TDOAs). The TDOA form has the advantage of providing for subsequent or additional deposits to the account without the necessity of issuing a new instrument. As defined in section 217.1(d) of the Board's Regulation Q (12 CFR 217.1 (d)), a TDOA is a deposit with respect to which there is in force a written contract providing that neither the whole nor any part of such deposit may be withdrawn prior to maturity or prior to expiration of a period of notice given by the depositor to the bank in writing. Consistent with the deposit agreement, a subsequent deposit made to a TDOA may be viewed as either resetting the maturity of the entire amount on deposit or as having a separate and distinct maturity subject to the same time requirement as the original deposit.

In this connection, if the TDOA contract provides that subsequent deposits reset the maturity of all funds on deposit, the period during which the penalty for premature withdrawal of the funds must be assessed is lengthened. For example, a depositor establishes an IRA in the form of a TDOA with an original maturity of three years, and the deposit agreement provides that subsequent deposits reset the maturity of all funds on deposit for an additional three years from the date of subsequent deposits. The depositor then deposits $1,000 per year into the account for 10 years. Since each subsequent deposit resets the maturity of all previous deposits for an additional three years, none of the individual deposits to the account matures. If the depositor closes the account at the end of the eleventh year and withdraws all of the funds, a member bank, under the Board's current regulations, is required to impose the interest forfeiture penalty back to the date of original deposit of each component of the account. In the case of the initial $1,000 deposited to the account, the interest forfeiture penalty, thus, would be applied over an eleven year period despite the fact that these funds, at the time of withdrawal, had been on deposit for eight years in excess of the originally contracted maturity.

However, if the deposit contract provides that subsequent deposits to the TDOA have a separate and distinct maturity equal to the same maturity requirement as the original deposit to the account, the impact of the early withdrawal penalty is substantially reduced. For example, assuming the same facts as in the above example, when the depositor closes the account in the eleventh year and withdraws all of the funds, the penalty must be imposed on each component of the account that has already been on deposit for more than three years only back to the date of its most recent maturity or renewal in the account. A member bank is required to impose the penalty back to the original date of deposit only on those funds that have not already been on deposit for three years. Thus, in the case of the initial $1,000 deposited to the account and which amount had matured and rolled-over in the account in years three, six and nine, the minimum interest forfeiture penalty need be applied only back to the most recent maturity/renewal date (year nine), a period of two years, rather than back to the original date of deposit, a period of eleven years.

The proposed amendment would equalize application of the early withdrawal penalty rule with respect to those TDOA's that provide that subsequent deposits reset the maturity of all funds on deposit, with application of the penalty to TDOA's in which subsequent deposits have a separate and distinct maturity. The amendment would substantially conform application of the Board's early withdrawal penalty provision with application of the similar penalty required to be imposed on premature withdrawals from add-on certificates by savings and loan associations subject to the Federal Home Loan Bank Board's regulations. The proposed amendments would establish a minimum penalty for early withdrawal, and member banks would be permitted to impose an additional penalty if so desired.

The proposed amendment would similarly modify application of the penalty provision to time deposits that are payable only after expiration of a required notice period. Under the amendment, the minimum early withdrawal penalty would be reduced from the current requirement to no more than the specified notice period. Under the Board's current regulations, if a depositor withdraws funds from a 90-day notice account without giving the required 90-days notice, a member bank is required to impose an interest forfeiture on the funds withdrawn back to the date of original deposit even if the funds have been on deposit for a period in excess of 90 days. For example, if a depositor withdraws funds that have been on deposit for five years without giving the required 90-days notice, the interest forfeiture is imposed over the entire five year period. Under the proposed amendment, the minimum required penalty would be the forfeiture of 90 days interest. After adoption of the amendment, application of the Board's early withdrawal penalty provision with respect to premature withdrawals from notice accounts will substantially conform to the penalty required to be imposed by nonmember commercial banks on premature withdrawals from notice accounts under regulations promulgated by the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board.

To aid in consideration of this matter by the Board, interested persons are invited to submit relevant data, views or comments. Any such materials should be submitted in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, to be received by August 30, 1978. All material submitted should include the Docket Number R-0172. Such material will be made available for inspection and copying upon request except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR 261.6(a)).

Pursuant to its authority under § 19 of the Federal Reserve Act (12 U.S.C. § 371b), the Board of Governors proposes to amend § 217.4(d) of Regulation Q (12 CFR 217.4(d)) by adding the following sentence immediately following the third sentence of § 217.4(d) as follows:

SECTION 217.4—PAYMENT OF TIME DEPOSITS BEFORE MATURITY

* * *

(d) **Penalty for early withdrawals.***** With respect to a time deposit contract that provides that subsequent deposits will extend the maturity of all of the funds on deposit for a period equal to the maturity of the original deposit, or a time deposit that is payable only after expiration of a period of notice which must be given by the depositor in writing not less than 30 days in advance of withdrawal, a member bank may regard funds that have remained on deposit for a period in excess of the maturity of the original deposit or notice period as having been deposited on the last maturity date on which the funds could have been withdrawn if the maturity of such deposits had not been extended by subsequent deposits, or the last date on which notice could have been given in order to withdraw the funds without penalty.

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