FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 8473
December 15, 1978]

REGULATION Q

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

Interpretation—Withdrawal of Interest Earned on Time Deposits Without Penalty

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

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System announcing the adoption of an amendment to and an interpretation of its Regulation Q "Interest on Deposits":

The Board of Governors of the Federal Reserve System today [*December 11*] lightened the penalty required for early withdrawal of certain types of time deposits at member banks.

The Board said that its action 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.

At the same time the Board adopted an interpretation of Regulation Q, permitting withdrawal without penalty of interest earned on time deposits at member banks.

The change in the early withdrawal penalty rule under Regulation Q (Interest on Deposits) was adopted as proposed for comment in July. It 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 revision is effective immediately.

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The penalty for early withdrawal of all or part of a time account is reduction of the interest paid on the amount withdrawn to the passbook savings rate (5 percent at commercial banks) and forfeiture of 90 days interest at that rate. Generally, the interest forfeiture penalty on the amount withdrawn from a time account applies back to the original date of deposit of funds in the account.

The revised penalty rule requires, in the case of early withdrawal at a member bank from:

—*A notice account*, that the minimum penalty apply on the amount withdrawn for a period of time no greater than the required notice period.

—*A TDOA*, that the penalty on the amount withdrawn 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 minimum interest is to be paid on such accounts.

The interpretation of Regulation Q adopted by the Board provides that:

A member bank may permit a depositor to withdraw interest earned on a time certificate of deposit at any time before maturity without penalty, irrespective of the basis upon which the member bank compounds or credits the interest to the depositor's account. Previously, member banks had been advised that interest became part of the underlying principal deposit and, thus, was subject to Regulation Q early withdrawal penalty requirements when that interest was credited or posted to the depositor's account.

The interpretation is effective immediately.

Enclosed are copies of the amendment and interpretation. Questions thereon may be directed to our Consumer Affairs and Bank Regulations Department (Tel. No. 212-791-5919).

PAUL A. VOLCKER,
President.

Board of Governors of the Federal Reserve System

INTEREST ON DEPOSITS

AMENDMENT TO REGULATION Q

(*effective December 6, 1978*)

Penalty for Early Withdrawals

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final Rule.

SUMMARY: On July 12, 1978, the Board of Governors of the Federal Reserve System invited public comment on an amendment to Regulation Q (Interest on Deposits) that would modify the interest forfeiture penalty required to be imposed when funds are withdrawn from time deposits prior to maturity under certain circumstances (43 FR 32140). The period for receipt of public comment on the proposed amendment expired on August 30, 1978. After consideration of the comments, the Board has determined to adopt the amendment substantially as proposed, effective immediately. The amendment reduces the minimum required early withdrawal penalty as applied to Individual Retirement Account (IRA) or Keogh (H.R. 10) Plan time deposits and 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 also applies to time deposits that may not be withdrawn prior to the expiration of a specified period of notice (notice accounts). Under the amendment, the minimum early withdrawal penalty period for such accounts is 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 which provide that subsequent deposits to the account extend the term 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 generally is required to impose an interest forfeiture on the funds withdrawn back to their original date of deposit.

EFFECTIVE DATE: December 6, 1978.

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

SUPPLEMENTAL INFORMATION: Section 217.4(d) of the Board's Regulation Q (12 CFR 217.4(d)) provides that where all or a portion of a time deposit is paid prior to maturity, the member bank must reduce the rate of interest paid on the amount withdrawn to a rate not to exceed the rate currently prescribed for a savings deposit plus a forfeiture of three months' interest. Under the present requirement, where additional deposits to a time deposit account by the terms of the deposit agreement reset the maturity of all previous deposits to the account, a member bank generally is required to impose an interest forfeiture on any funds withdrawn prior to maturity back to the original date of deposit of those funds regardless of how long the funds have remained on deposit. 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 amendment modifies these requirements by reducing the period of time over which the penalty must be calculated to a period of no

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For this Regulation to be complete, retain:

1) Regulation Q pamphlet, effective December 4, 1975.
2) Amendments effective March 1, 1976, July 26, 1976, November 8, 1976, March 24, 1977, November 23, 1977, December 1, 1977, July 6, 1978, and November 1, 1978.
3) Supplement effective June 1, 1978.
4) This slip sheet.

more than the maturity or notice period specified for the deposit. The principal effect of the amendment is generally to equalize the early withdrawal penalty as applied to such accounts with the penalty applied to automatically renewable and single maturity time deposits. In particular, the amendment will reduce the potentially severe impact of the penalty on notice accounts and on long-term Individual Retirement Accounts (IRAs) and Keogh (H.R. 10) Plan accounts, many of which have been established in the form of time deposit, open accounts (TDOAs) which allow subsequent or additional deposits to the account without the necessity of issuing a new instrument.

The amendment substantially conforms application of the Board's penalty rule with application of the penalty required to be imposed on premature withdrawals from similar accounts by nonmember commercial banks, mutual savings banks and insured savings and loan associations under regulations promulgated by the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board. The amendment establishes a minimum penalty for early withdrawal, and member banks are permitted to specify an additional penalty in their deposit agreements. Examples of the application of the amended penalty rule are as follows:

Example 1

A depositor establishes an IRA in the form of a time deposit, open account with an original maturity of three years. The deposit agreement provides that subsequent deposits to the account reset the maturity of all funds on deposit in the account for an additional three years from the date of any subsequent deposit. The depositor then deposits $1,000 per year into the account for 10 years. The depositor closes the account at the end of the eleventh year and withdraws all of the funds.

Under the Board's current regulation, 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, and a member bank is required to impose the interest forfeiture penalty back to the date of original deposit of each component of the account. For example, in the case of the initial $1,000 deposited to the account, the penalty would consist of a reduction in the rate of interest paid to the savings rate over the entire period the funds had been on deposit plus the forfeiture of 90 days' interest at the savings rate.

Under the regulation as amended, for purposes of calculating the minimum required penalty, a member bank may regard funds that have remained on deposit for a period in excess of three years (the term specified in the deposit agreement) as having matured and been redeposited every three years. Accordingly, the initial $1,000 deposited to the account in the case above is treated as if it had matured and "rolled-over" in years three, six, and nine, and the penalty is assessed only for a period of two years (back to year nine), rather than back to the original date of deposit.

The minimum required penalty on the additional components of the account is calculated in a similar manner. For example, with respect to the second $1,000 deposited to the account, that amount is treated as if it had matured and "rolled-over" in years four, seven, and ten, and the penalty is assessed for a period of one year (back to the "roll-over" date in year ten).

Example 2

A depositor establishes a time deposit that is payable only upon the expiration of a one-year period of notice required to be given by the depositor. Five years later the member bank permits the depositor to withdraw all of the funds in the account without giving the bank the required notice. Under the Board's current regulation, the member bank is required to impose an interest forfeiture on the funds withdrawn back to the date of original deposit. The penalty would consist of a reduction in the rate of interest paid to the savings rate over the entire five-year period plus a forfeiture of 90 days' interest at the savings rate. Under the regulation as amended, the required minimum interest forfeiture would be calculated over a period of one year, which is the notice period required.

This amendment is adopted effective immediately since it relieves an existing regulatory restriction. Therefore, pursuant to § 19 of the Federal Reserve Act (12 U.S.C. § 371b), effective immediately, § 217.4(d) of Regulation Q (12 CFR 217.4(d)) is amended by adding the following two sentences as a new paragraph at the end of 217.4(d) as follows:

SECTION 217.4—PAYMENT OF TIME DEPOSITS BEFORE MATURITY

* * *

(d) *Penalty for early withdrawals.* * * *

Under a time deposit agreement where subsequent deposits reset the maturity of the entire account, each deposit maintained in the account for at least a period equal to the original maturity of the deposit may be regarded as having matured individually and been redeposited at intervals equal to such period. When a time deposit is payable only after notice, for funds on deposit for at least the notice period, the penalty for early withdrawal shall be imposed for at least the notice period.

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Board of Governors of the Federal Reserve System

INTEREST ON DEPOSITS

INTERPRETATION OF REGULATION Q

Withdrawal of Interest

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final Rule.

SUMMARY: The Board of Governors has issued an interpretation regarding the treatment of interest earned on time deposit funds for purposes of the Board's Regulation Q. Pursuant to this interpretation, a member bank may permit a depositor to withdraw interest earned on a time certificate of deposit at any time before maturity without penalty, irrespective of the basis upon which the member bank compounds or credits the interest to the depositor's account. Previously, member banks had been advised that interest became part of the underlying principal deposit and, thus, was subject to Regulation Q early withdrawal penalty requirements when that interest was credited or posted to the depositor's account.

FOR FURTHER INFORMATION CONTACT: Allen L. Raiken, Associate General Counsel (202/452-3625) or Anthony F. Cole, Attorney (202/452-3711), Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

Effective immediately, section 217.154 (12 CFR § 217.154) is added to read as follows:

Section 217.154—"Withdrawal of Interest"

(a) The Board has been asked to review the question of when interest earned on a time deposit becomes part of the principal deposit for purposes of the early withdrawal penalty requirements contained in section 217.4(d) of Regulation Q. As noted in the requests, the Board's staff has previously advised that interest becomes part of the underlying principal when it is credited or posted to the depositor's account. Under this position, where a depositor is permitted to make an early withdrawal of time deposit funds, the depositor will incur an early withdrawal penalty pursuant to section 217.4(d) on all of the funds withdrawn to the extent that the amount withdrawn reflects the original principal and any earned interest that has been credited or posted to the account.

(b) The Board does not believe that the frequency of compounding or the method of crediting or posting interest to the account is necessarily determinative of when interest should be viewed as part of the underlying principal for purposes of application of the Regulation Q early withdrawal restrictions. Adoption of such a position is unnecessary to effectuate the purposes of interest rate control, including the prohibition against payment of interest on demand deposits. In addition, the Board notes that the outstanding position that interest becomes part of the underlying principal when credited or posted to the account and, thus, is subject to Regulation Q early withdrawal restrictions, places member banks at a competitive disadvantage with respect to nonmember insured commercial banks that are permitted to pay accrued interest on a time deposit at anytime during the initial term of the deposit contract.

(c) In view of the above considerations, the Board has concluded that a member bank may permit a depositor to withdraw the interest earned on a time deposit at any time before maturity, irrespective of the method that the bank uses to compound or credit (post) interest to the depositor's account. The Board has concluded, however, that if a time deposit is renewed upon its original maturity or if a depositor takes action to extend the maturity of the time deposit during the original maturity period, interest earned to the date of renewal or extension, unless withdrawn, must be viewed as part of principal subject to Regulation Q withdrawal restrictions.

(d) This interpretation does not affect the treatment of interest as principal for purposes of assessing required reserves under Regulation D (12 CFR § 204). For purposes of determining required reserves, interest that has been credited or posted to a time deposit account will continue to be viewed as a deposit on which reserves must be maintained at the appropriate time deposit level.

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The Board has issued this interpretation based upon its statutory authority under section 19 of the Federal Reserve Act, 12 U.S.C. §§ 461, 371b.

Board of Governors of the Federal Reserve System, December 6, 1978.