FEDERAL RESERVE BANK
OF NEW YORK

Circular No. 9112
July 30, 1981

VARIABLE RATE TIME DEPOSITS

Effect of Recent DIDC Actions

*To All Member Banks
in the Second Federal Reserve District:*

As you know, the Depository Institutions Deregulation Committee has eliminated interest rate ceilings on new time deposits with original maturities of four years or more, effective August 1, 1981. Since the announcement of that action, several member banks have inquired as to whether a variable interest rate may be offered on time deposits not subject to an interest rate ceiling and as to the rules that would apply if variable rates are permitted.

Enclosed is the text of an interpretation by the staff of the Board of Governors of the Federal Reserve System on this matter. Questions regarding the ruling may be directed to our Consumer Affairs and Bank Regulations Department (Tel. No. 212-791-5910).

ANTHONY M. SOLOMON,
President.

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Federal Reserve Bank of St. Louis

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 27, 1981

At its June 25, 1981 meeting, the Depository Institutions Deregulation Committee ("DIDC") established a schedule for the deregulation of interest rates on deposits. As of August 1, 1981, interest rate ceilings will be eliminated for new time deposit accounts issued with original maturities of four years or more. As a result of the DIDC's action, the Federal Reserve has received a number of inquiries from member banks on whether a variable interest rate may be offered on time deposits not subject to an interest rate ceiling and the rules that would apply if variable rates are permitted. This letter responds to the questions most frequently asked.

It will be permissible for member banks to offer variable interest rates on new time deposit accounts with original maturities of four years or more if the terms of the deposit agreement so provide-- regardless of the amount of the initial deposit. A variable rate deposit may not be established where the rate will fluctuate at the discretion of the member bank, but must be based on an index or schedule over which the bank does not have any control or discretion or which is established by contract. The method of determining how the rate would fluctuate must be readily ascertainable. For example, the rate may be pegged to the rate based on the yield for a particular category of U. S. Treasury securities. In addition, a member bank may use an index based on any other market based yield, an unaffiliated bank's published prime rate, or any other independently determined rate. The rate also can be established in accordance with a predetermined schedule (e.g. 12 per cent per annum for the first year, with an increase of 1 per cent per annum for each year thereafter.) In any event, the method of rate determination must be made clear to the customer, consistent with ¶3005 of the Board's Published Interpretations (12 CFR 217.148) which provides that every member bank should inform the holder of a time deposit at the time of opening the account as to the method that will be used in computing and paying interest on the account.

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The six-month penalty for early withdrawal under the Board's and the DIDC's penalty rule will continue to apply where a time deposit with an original maturity of more than one year, or any portion of the deposit, is paid prior to maturity, regardless of how long the funds have been on deposit (12 CFR §§ 1204.103 and 217.4(d)(iii)(C)). Under such rules, the required penalty is the forefeiture of an amount equal to at least six months' interest on the funds withdrawn at the nominal (simple interest) rate of interest being paid on the time deposit. It should be noted that the penalty provided in Regulation Q is a minimum penalty and member banks may provide by contract for a more severe penalty. In addition, the interest penalty applies only to the amount withdrawn. The method to be used to calculate the penalty is a matter of contract between the bank and the customer and must be fully disclosed to the customer when the time deposit account is opened (12 CFR § 217.4(e)).

The minimum penalty for a variable rate time deposit with a maturity of more than one year is an amount equal to six months' simple interest computed using an 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 (i.e. the rate is established once a month and remains in effect for one month), the average simple interest rate would be 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 a period varies the computation would be a weighted average based upon the shortest period a rate was in effect. For example, if such a deposit was established on August 15, 1981, and withdrawn on October 7, 1981, and the interest rate on the deposit varies monthly, the penalty rate to be applied will be the average of the August, September, and October rates. The dollar penalty would be the calculated average penalty interest rate times the amount withdrawn divided by two.[1/]

Regulation Q currently provides that an amendment to a time deposit agreement that increases the interest rate triggers application of the early withdrawal penalty (12 CFR § 217.4(d)). However, under variable rate time deposits, the rates of interest paid during the life of a deposit will fluctuate and, at times, will increase between periods. Thus, the early withdrawal penalty does not apply to such increases

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1/ In the case of lump-sum payments of cash or merchandise that would be regarded as interest under 12 CFR 1204.108, such payments 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 member bank.

(continued on next page)

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under variable rate time deposits since the method of determining the rate or the schedule of interest rate changes is determined at the start of the time deposit contract. In other words, the fact that the interest rate could increase on a variable rate time deposit during its life does not trigger the penalty so long as the deposit contract provides for a method of determining the interest rate payable and the rate is not subject to the discretion of the bank. However, should the bank increase the spread between the contract rate and the index rate, or should the index itself be changed from the original deposit contract index resulting in an increase in the rate to which the contract rate is pegged, the penalty provisions would apply.

For example, under a deposit contract with a fixed rate of 8 per cent, an increase in the contract rate from 8 per cent to any higher rate would be regarded as a payment of the time deposit prior to maturity and requires the imposition of an early withdrawal penalty. Under a variable rate time deposit where the prior agreement provides that the rate changes monthly based on the average yield for 4-year U. S. Treasury securities, an increase in the rate payable from one month to another would not be regarded as an increase in the rate triggering the early withdrawal penalty since the method of determining the rate did not change. Similarly, a rising rate certificate that has a preestablished interest rate payment schedule would not trigger the early withdrawal penalty provisions. However, if a member bank changed an index, say from the average yield on 4-year Treasury securities to the average yield on 4-year Treasury securities plus 100 basis points, such change would be regarded as an increase in the contract rate and would require imposition of the early withdrawal penalty.

Variable rate time deposits may provide for additional deposits to be made to the account. However, it should be noted the additional amount deposited must be regarded as either representing a new deposit account with a separate maturity, or triggering the automatic extension of the maturity of the entire account for a period equal to the original deposit term.

1/ (continued)

For example, assume that cash or merchandise worth $100 that would be regarded as interest was given to a depositor at the opening of a $1,000, 4-year variable rate time deposit, that the entire amount is withdrawn after one year, and that the average of the rates paid on the deposit during the time it was outstanding was 12 per cent. The lump-sum of $100 would be regarded as a payment of interest and must be taken into account in computing the penalty rate. Since the deposit was outstanding for one-fourth of its expected life, a corresponding amount of the lump sum must be taken into account in computing the penalty rate. Thus, 2.5 per cent (25 divided by 1,000) must be added to the average of the rates paid during the time the deposit was outstanding (12 per cent) to achieve a penalty rate of 14.5 per cent. The remaining three-fourths of interest ($75) would be regarded as unearned interest and would be returned to the member bank. Thus, the amount that the customer would return would be $147.50.

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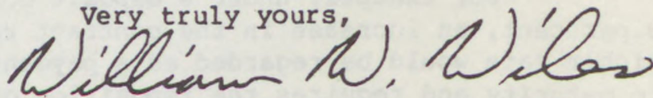
Advertising of variable rate time deposits must comply with all provisions of Regulation Q that require certain disclosures with respect to time requirements and early withdrawal penalties. In this regard, advertisements for such deposits must set forth any time and amount requirements (12 CFR 217.6(d)). Since the rate in effect at the opening of a variable rate time deposit likely will change, advertisements that include the initial rate should clearly indicate the time period during which the rate will be effective and the basis on which future fluctuations in rates will occur.

Very truly yours,



William W. Wiles
Secretary

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS
AND OFFICERS IN CHARGE OF BRANCHES

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