FEDERAL RESERVE BANK
OF NEW YORK

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May 19, 1982]

Board Staff Rulings on New Ceiling-Free Deposits

*To All Depository Institutions, and Others Concerned,
in the Second Federal Reserve District:*

Printed on the following pages is a letter from the Board of Governors of the Federal Reserve System containing rulings by the Board's staff regarding the new ceiling-free deposits authorized by the Depository Institutions Deregulation Committee.

The rulings address:

— Conversion between fixed and variable rates on ceiling-free accounts.
— Advertising of ceiling-free accounts.

Questions thereon may be directed to our Regulations Division (Tel. No. 212-791-5914).

ANTHONY M. SOLOMON,
President.

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

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

May 12, 1982

The Depository Institutions Deregulation Committee (the "Committee") has authorized depository institutions to issue two new categories of time deposits not subject to an interest rate ceiling. These new categories include 1-1/2 year or more time deposits available to IRA and Keogh Plan depositors effective December 1, 1981, and 3-1/2 year or more time deposits that became available effective May 1, 1982. In recent weeks, inquiries from depository institutions have raised questions concerning conversion of such deposits from fixed rates to variable rates and advertising of such accounts.

Institutions have asked whether time deposits not subject to an interest rate limitation may include a provision in a deposit contract giving an option to the depositor, at his or her discretion, to convert the account from a variable rate to a fixed rate. Under this arrangement, the fixed rate could be established by the deposit contract or determined by agreement of the institution and the customer. The staff believes that it is permissible under the Committee's rules to establish IRA/Keogh Plan or 3-1/2 year or more time deposits in this manner. The staff is of the view that the fixed rate to which converted does not have to be equal to or lower than the variable rate in effect at the time of conversion and that the maturity of the time deposit need not be extended beyond its original maturity date. Similarly, a provision could be included in deposit contracts for such time deposits that gives the customer the option to convert from a fixed rate to a variable rate.

The question also has arisen as to whether an existing fixed rate time deposit that was not subject from its initial establishment to an option to convert to a variable rate may be converted into a variable rate time deposit without the triggering of an early withdrawal penalty. The staffs of the Federal Reserve Board, the FDIC and the FHLBB have determined that the conversion rules ordinarily applicable to changes in interest rates on time deposits do apply in this instance; that is, in order for an interest rate change not to be regarded as a payment of a time deposit before maturity, the interest rate on the new time deposit must be no higher than the rate of the original time deposit, and the maturity of the new deposit must be no shorter than the remaining maturity of the original deposit. If a time deposit is converted from a fixed rate to a floating rate, a penalty-free conversion is made if the interest rate payable on the new instrument on the date of conversion is less than or equal to the interest rate of the original time deposit. At the time of conversion, an institution could not provide for a subsequent change in the index used to determine the rate that would result in a higher rate than the fixed rate on the date of conversion. For example, assume that at the time of conversion the fixed rate on a time deposit is a rate that equals the current 26-week Treasury bill rate. Upon conversion to a variable rate, the interest rate will be indexed to the 26-week Treasury bill rate minus 25 basis points. No early withdrawal penalty would be required since, at the time of conversion, the variable rate was less than or equal to the fixed rate on the instrument. The contract could not provide that 30 days after conversion the index will change to the 26-week Treasury bill rate plus 25 basis points, because, when viewed from the time of conversion, the second index will result in a higher interest rate than was being paid on the fixed rate instrument. If the new instrument has an interest rate based on a predetermined schedule, the rate paid on that instrument may not exceed the rate paid on the original instrument until the maturity date of the original time deposit.

A final matter which also has arisen recently concerns the advertising of time deposits not subject to Federal interest rate limitations. Several of the advertisements bring into question whether meaningful information is being provided to depositors. A number of advertisements have offered a simple interest rate far in excess of the effective annual yield on the deposit.

The regulations of the Board state a general rule that no institution shall make any advertisement, announcement, or solicitation relating to the interest paid on deposits that is inaccurate or misleading or that misrepresents its deposit contracts. Prior to the August 1, 1981 effective date for the long-term deregulation schedule adopted by the Committee at its June 1981 meeting, several depository institutions ran advertisements soliciting funds for long-term deposit accounts that would not be subject to an interest rate ceiling. For example, an institution offered a time deposit with a 5-1/2 year maturity at simple annual interest rate of 20 per cent. The rate was applied only to the amount of the original deposit and not to any interest earned during the life of the instrument. Withdrawal of interest from the account was not permitted under the terms offered by the institution. Thus, the effective annual yield on a deposit held to maturity was only 14.44 per cent.

Under Regulation Q and similar rules of the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board, depository institutions are required to state advertisements of interest rates in terms of the annual rate of simple interest. In this regard, the deposit interest rate limitations also are stated in terms of annual rates of simple interest. However, institutions are permitted to compound interest and thereby pay a higher effective annual yield on time deposits subject to interest rate ceilings since the effects of compounding are not taken into account in determining compliance with deposit interest rate ceilings. In addition, the agency regulations prohibit the advertisement of an average annual yield achieved by compounding interest during a period in excess of one year. These rules were adopted in 1969 in an effort to end confusion among consumers with respect to the accuracy of rates being paid and to make comparison of deposit interest rates more meaningful.

Payment of interest on deposits with at least annual compounding has become customary in the depository industry. Thus, depositors may be misled by advertisements for deposit products where no compounding occurs during the life of the instrument. For these time deposits, the average effective annual yield is less than the annual rate of simple interest. The difference between the average effective annual yield and the annual rate of simple interest is exacerbated for longer-term deposits where there is no compounding. Consequently, the staff of the Board will regard any advertisement for a time deposit that states an annual rate of simple interest in excess of the average effective annual yield as inaccurate, misleading and as misrepresentative of its deposit contracts.

Sincerely yours,

William W. Wiles

William W. Wiles
Secretary

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