

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 9358]
[September 3, 1982]

INTERPRETATION OF REGULATION Q

**Participation in the Establishment of a Secondary Market
for a Member Bank's Own Negotiable Time Deposits**

*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:

The Federal Reserve Board has issued an interpretation of its Regulation Q (Interest on Deposits) concerning arrangements a member bank may enter into in helping to provide a secondary market for negotiable time deposits issued by the bank.

Under the interpretation a member bank:

- May act on behalf of a depositor to find a purchaser of the depositor's time deposit;
- May enter into arrangements with an unaffiliated third party who stands ready to purchase negotiable time deposits issued by the bank (however, in such arrangements payment of a fee or provision of interim financing at other than market terms by a member bank are prohibited);
- May not enter into a reciprocal arrangement with other depository institutions under which each institution stands ready to purchase time deposits issued by the others.

The Board believes the types of transactions approved are not devices to avoid the interest penalty required for payment of a time deposit prior to maturity, while the third type of transaction would constitute such a device.

Enclosed is a copy of the text of the interpretation, which has been reprinted from the *Federal Register*. Questions thereon may be directed to our Consumer Affairs and Bank Regulations Department (Tel. No. 212-791-5914).

ANTHONY M. SOLOMON,
President.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

INTEREST ON DEPOSITS

INTERPRETATION OF REGULATION Q

(August 24, 1982)

FEDERAL RESERVE SYSTEM

12 CFR Part 217

[Docket No. R-0419]

Regulation Q; Interest on Deposits; Member Bank Participation in the Secondary Market for Its Own Time Deposits

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final interpretation.

SUMMARY: The Board of Governors has issued an interpretation of Regulation Q—Interest on Deposits (12 CFR Part 217) concerning arrangements entered into by a member bank to facilitate the secondary market for negotiable time deposits that it has issued as an alternative to its depositors incurring an early withdrawal penalty. Under the interpretation, a member bank may act on behalf of a depositor to find a purchaser of the depositor's negotiable time deposit issued by the member bank. In addition, a member bank may enter into an arrangement whereby an unaffiliated third party stands ready to purchase from depositors negotiable time deposits issued by the bank. However, a member bank may not repurchase its own time deposit or arrange for the sale to its affiliate of a time deposit that the bank has issued. Further, a member bank may not enter

into reciprocal arrangements with another depository institution to purchase each other's negotiable time deposits. In addition, a member bank may not pay a fee to a third party for the purchase of its time deposits or provide interim financing to such a party at other than market terms. The Board believes that such transactions constitute devices to avoid the interest penalty required for payment of a time deposit prior to maturity.

EFFECTIVE DATE: August 24, 1982.

FOR FURTHER INFORMATION CONTACT: Gilbert T. Schwartz, Associate General Counsel (202/452-3625), or Paul S. Pilecki, Senior Attorney (202/452-3281), Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

List of Subjects in 12 CFR Part 217

Advertising; Banks, banking; Federal Reserve System; Foreign banking.

SUPPLEMENTARY INFORMATION: Effective August 24, 1982, pursuant to its authority under section 19(a), 19(i), and 19(j) of the Federal Reserve Act (12 U.S.C. 461(a), 371a, 371b), the Board amends Regulation Q (12 CFR Part 217) by adding a new § 217.159 as follows:

PART 217—INTEREST ON DEPOSITS

§ 217.159 Member bank participation in the secondary market for its own time deposits.

(a) Effective May 1, 1982, the

Depository Institutions Deregulation Committee ("DIDC") authorized depository institutions, including member banks, to issue 3½ year or more time deposits not subject to an interest rate ceiling and 91-day, \$7,500 time deposits with an interest rate ceiling tied to the most recent 91-day Treasury bill rate. Such deposits may be issued in negotiable form, thereby facilitating the ability of depositors to liquidate the deposit through sales on the secondary market. Member banks have asked the extent to which they may participate in, or facilitate, the secondary market for such time deposits that they have issued.

(b) The Board of Governors believes that a fundamental principle behind the penalty for payment of a time deposit prior to maturity is to distinguish time deposits from demand deposits. Under section 19(i) of the Federal Reserve Act (12 U.S.C. 371a), member banks are prohibited from paying interest on demand deposits. In addition, the early withdrawal penalty is intended to discourage depositors from withdrawing time deposit funds prior to maturity, thereby enabling member banks to better plan their asset and liability structures. The question of participation by a member bank in secondary market transactions involving its own time deposits raises the issue of whether such activity would circumvent the purposes intended to be served by the early withdrawal penalty.

(c) *Direct participation.* (1) The Board has concluded that if a member bank or one of its affiliates purchases a time deposit issued by the bank, the member bank should be regarded as having paid the deposit prior to maturity. The effect of the transaction is that the member bank has cancelled a liability as opposed to having acquired an asset for its portfolio. Thus, the member bank is required to impose the early withdrawal penalty on the party from whom it purchases the instrument. With respect to an affiliate making the purchase, the effect of the penalty rule could be easily circumvented by redemption of the time deposit by the affiliate at the member bank. Even if an early withdrawal penalty is imposed, because of the affiliate relationship, there likely would be no impact on the consolidated earnings of the entity comprising the member bank and the affiliate redeeming the deposit. Consequently, the Board believes that the purchase of a time deposit issued by a member bank by the bank itself or by one of its affiliates constitutes a payment of a deposit prior to maturity.

(2) Many member banks engage in secondary market activities in negotiable time certificates of deposit of \$100,000 or more ("CDs"). In many instances, sales and purchases of these CDs are negotiated primarily by rate and maturity and without regard to the specific identity of the issuing bank. In some cases a member bank might purchase a block of CDs of various obligors and later discover one of the CDs purchased to be its own. Since this situation appears to be one in which the

member bank has inadvertently purchased its own deposit, the Board believes that the member bank should not be required to impose an early withdrawal penalty; however, it must sell the CD in the secondary market as soon as possible after it has been received.

(d) *Participation as a "broker."* (1) The Board believes that it is permissible for a member bank to facilitate the secondary market for its own small denomination time deposits by arranging to find a purchaser for a time deposit that a customer is trying to sell. In such instances, the bank will not be paying out any of its own funds and the depositor does not have a guarantee that the member bank will actually be able to find a buyer. Member banks may establish and advertise arrangements whereby an unaffiliated third party agrees in advance to purchase time deposits issued by the bank. Such transactions would not be inconsistent with the purposes that the early withdrawal penalty is intended to serve. However, the Board believes that an arrangement established wherein a member bank pays a fee to a third party that purchases negotiable time deposits from the bank's depositors constitutes a device to avoid the early withdrawal penalty, and, thus, is prohibited. In addition any interim financing provided to such a third party by a member bank in connection with its secondary market activity involving the bank's small denomination time deposits must be made substantially on the same terms, including interest rates and collateral, as those prevailing at the same time for

comparable transactions with other similarly situated persons and may not involve more than the normal risk of repayment or present other unfavorable features.

(2) A member bank may enter into an arrangement with an unaffiliated third party wherein the third party agrees to stand ready to purchase time deposits held by the member bank's customers. However, the Board is of the opinion that a member bank may not establish reciprocal arrangements with another depository institution for purchases of each other's time deposits of less than \$100,000 held by customers. The Board believes that arrangements with such parties present serious potential for circumvention of the early withdrawal penalty rule and the purposes that it is designed to serve. In this regard, arrangements entered into with another depository institution to purchase time deposits of the other institution's customers could give rise to significant contingent liabilities for the entities agreeing to purchase the deposits. While the institution issuing the deposit might not be impaired in planning its asset and liability structure, the institution agreeing to purchase deposits from the customers of the issuing institution could be so affected. Such arrangements could have an adverse effect on the safety and soundness of member banks and other depository institutions.

By order of the Board of Governors, August 24, 1982.

William W. Wiles,
Secretary of the Board.