

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 8087]
April 7, 1977

REGULATION Q

—Early Withdrawal Penalty

—Interest on Pooled Funds

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

Early Withdrawal Penalty

The Board of Governors of the Federal Reserve System has amended, effective March 24, 1977, its Regulation Q—Interest on Deposits—to clarify the early withdrawal penalty and to provide for an additional exception to that penalty. In submitting the amendments for publication in the *Federal Register*, the Board of Governors issued the following explanatory notice:

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System has approved two amendments to section 217.4(d) of Regulation Q (12 C.F.R. 217). The first amendment modifies the structure of the current paragraph of Regulation Q that states the Board's early withdrawal penalty rule and exceptions to that rule by providing a listing of those exceptions. This modification, which is intended to improve the clarity of the Board's penalty rule, is a structural change only and is not intended to alter the substance of the Board's penalty rule. The second amendment provides an additional exception to the Board's early withdrawal penalty rule. This amendment provides that where a depositor who maintains time deposits in two or more merging banks loses Federal deposit insurance coverage on a portion of his or her time deposits as a result of the merger, the surviving member bank may pay before maturity without imposing the Regulation Q penalty for early withdrawal that portion of the depositor's time deposit that is no longer covered by Federal deposit insurance.

EFFECTIVE DATE: March 24, 1977.

FOR FURTHER INFORMATION CONTACT: Allen L. Raiken, Assistant General Counsel, Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202-452-3625).

SUPPLEMENTARY INFORMATION: Section 19(j) of the Federal Reserve Act (12 U.S.C. 371b) forbids member banks from paying time deposits prior to maturity except in accordance with such regulations as the Board prescribes. The Regulation Q penalty (12 C.F.R. 217.4(d)), promulgated pursuant to section 19(j), provides that where a time deposit is paid before maturity, a member bank may pay interest on the amount withdrawn at a rate not to exceed that prescribed for a savings deposit; provided that the depositor shall forfeit three months of interest payable at such rate. If the amount withdrawn has remained on deposit for three months or less, the depositor forfeits all interest.

This penalty is designed to preserve the distinction between demand deposits and time deposits and to prevent depositors from using time accounts for transaction purposes like checking accounts. Under the Board's existing penalty rule, penalty-free withdrawals are permitted only upon the death of any person whose name appears on the time deposit passbook or certificate or in the event of withdrawals from Individual Retirement Accounts or Keogh plans where the depositor is age 59½ or is disabled.

Under current law, an individual depositor's accounts held in the same right and capacity in any one insured bank are insured by the Federal Deposit Insurance Corporation up to \$40,000 in the aggregate. Where the depositor maintains separate time deposits in two or more Federally insured banks which merge, the merger will result in the loss of Federal deposit insurance coverage on that portion of the depositor's funds in excess of \$40,000. The Board does not believe that the early withdrawal interest penalty requirement should be applied in the situation in which a depositor, solely as the result of the merger of Federally insured banks, loses the benefit of deposit insurance. It is recognized that Federal deposit insurance may be a major factor influencing an investor's decision to establish a time deposit at a Federally insured bank and that where a depositor, solely as the result of a merger, loses the benefit of Federal deposit insurance on some portion of the depositor's funds, equitable considerations require the availability of some form of relief. Accordingly, the Board has amended section 217.4(d) of Regulation Q to provide a third situation in which a member bank is permitted to pay a time deposit before maturity without imposing the Regulation Q penalty.

This amendment to section 217.4(d) of Regulation Q provides that where a depositor who maintains time deposits in two or more Federally insured banks which merge loses Federal deposit insurance coverage on a portion of his or her time deposits as a result of the merger, the surviving member bank may pay, for a period of up to one year from the date of the merger, that portion of the depositor's time deposit (or time deposits) that is no longer covered by Federal deposit insurance without imposing the Regulation Q penalty for early withdrawal. The Board believes that the one year time period will provide an adequate period to depositors to become aware of the merger and any resulting loss of insurance. The authority granted to member banks by this amendment should not be exercised to permit a penalty-free withdrawal where the member bank has knowledge that the depositor has obtained certificates of deposit of that member bank and another Federally insured bank, after the public announcement of the intended merger of those banks, principally for the purpose of circumventing the Regulation Q early withdrawal penalty provision.

Because the first amendment is technical in nature only and does not result in any substantive changes to the provisions of Regulation Q, and in view of the substantial public benefits that will immediately result from adoption of the second amendment, which permits member banks to immediately pay without imposition of an interest penalty that portion of a depositor's funds held in a time deposit (or time deposits) on which Federal deposit insurance has been lost as the result of the merger of Federally insured banks, the Board has determined that notice and public participation with respect to these amendments is unnecessary and contrary to the public interest. In view of the technical nature of the first amendment and in view of the fact that the second amendment relieves an existing regulatory restriction, the Board has also determined that good cause exists for promulgating these amendments without deferring the effective date thereof for the 30 day period referred to in 5 U.S.C. 553(d).

Enclosed is a copy of the amendments to Regulation Q. Additional copies of the enclosure will be furnished upon request.

Interest on Pooled Funds

The Board of Governors has decided *not* to adopt a proposed amendment to prohibit member banks from paying interest on pooled time deposits of \$100,000 or more at a rate above the Regulation Q ceilings. This proposal was issued with our Circular No. 7837, dated March 12, 1976. Following is the text of a statement issued by the Board on April 1 regarding this matter:

The Board of Governors of the Federal Reserve System today announced it has determined not to adopt at this time a regulatory proposal to prohibit member banks from paying interest on pooled time deposits of \$100,000 or more at a rate above Regulation Q ceilings.

The proposal, issued by the Board in March 1976, would have applied in circumstances where the member bank knew or had reason to know that the pooled time deposit was formed primarily to obtain exemption from Regulation Q rate ceilings.

In deciding not to adopt the proposed amendment, the Board noted that in February the Federal Deposit Insurance Corporation limited the amount of Federal deposit insurance coverage for certain pooled deposits to \$40,000 in any one bank. The Board said it believed the FDIC action may minimize the potential for disruptive shifts of funds among depository institutions as a result of pooling.

The Board is directed by law to establish ceiling interest rates on time deposits in member banks of less than \$100,000. The Board's proposal was aimed at the practice of pooling funds to aggregate \$100,000 or more, in order to negotiate a rate of interest that was above the Regulation Q ceilings.

Printed below is the text of the Board's order in this matter. Questions thereon may be directed to our Consumer Affairs and Bank Regulations Department.

PAUL A. VOLCKER,
President.

(Reg. Q)

INTEREST ON DEPOSITS

[Docket No. R-0024]

Pooling of Funds

By notice published in the *Federal Register* (41 FR 10917), the Board of Governors on March 8, 1976 proposed to amend Regulation Q (12 CFR 217) to prohibit member banks from paying interest on time deposits of \$100,000 or more at rates in excess of those

established by Regulation Q for deposits of less than \$100,000, where the bank knows or has reason to know that such time deposits consist of funds acquired or solicited for the purpose of pooling such funds primarily to obtain the exemption from interest rate ceilings pro-

vided in § 217.7(a). Subsequently, the period for receipt of public comments on this proposal was extended to July 9, 1976 (41 FR 20590).

Public Law 93-123 (87 Stat. 448) directs the Board to establish maximum rates of interest that may be paid by member banks on time deposits of less than \$100,000. The Board's regulatory proposal to prohibit the practice of pooling funds to obtain higher rates of interest was based in part upon the belief that pooling violates Regulation Q interest rate ceiling limitations since it enables depositors who would otherwise be subject to the ceiling rates of interest prescribed by Regulation Q to obtain the generally higher rates that may be available on large denomination certificates of deposit (CDs). The Board's proposal was also based on the belief that pooling may have potentially adverse effects on member banks and nonmember financial institutions due to the potential for disruptive shifts of funds as a consequence of active soliciting of funds by prospective poolers.

The Board has reviewed the one hundred seventy-one comments received from the public on the pooling proposal. One hundred forty-one of these comments opposed adoption of the pooling proposal and thirty favored adoption of the proposed amendment. Those opposed to the adoption of the amendment expressed the view that the proposal was unfair to small depositors and would result in a shifting of funds from bank CDs to other forms of investments such as commercial paper. Several respondents indicated that the proposal would not pre-

vent the practice of pooling since CDs would be available on the secondary market. Those who favored adoption of the proposal generally recognized that pooling results in a circumvention of the Regulation Q interest rate ceilings. Several banks expressed the view that pooling could lead to disruptive shifts of funds especially from institutions outside large money centers.

After consideration of the comments received and other available information, the Board has determined not to adopt the proposed amendment to Regulation Q to prohibit pooling of funds at this time. In making this determination the Board notes the action of the Federal Deposit Insurance Corporation in February 1977 to limit the Federal deposit insurance coverage to \$40,000 in any one insured bank of any trust or other business arrangement that has registered or is required to register with the Securities and Exchange Commission as an investment company under Section 8 of the Investment Company Act of 1940. The Board believes that the action of the FDIC to limit deposit insurance coverage of such organizations may minimize the potential for disruptive shifts of funds among depository institutions as a result of pooling. Accordingly, the Board has determined not to adopt the proposed regulation at this time and hereby terminates the rulemaking proceeding initiated on March 8, 1976.

Board of Governors of the Federal Reserve System,
March 31, 1977.

Board of Governors of the Federal Reserve System

INTEREST ON DEPOSITS

AMENDMENT TO REGULATION Q

Effective March 24, 1977, Section 217.4 (d) is amended to read as follows:

SECTION 217.4—PAYMENT OF TIME DEPOSITS BEFORE MATURITY

* * *

(d) **Penalty for early withdrawals.** Where a time deposit, or any portion thereof, is paid before maturity, a member bank may pay interest on the amount withdrawn at a rate not to exceed that currently prescribed in § 217.7 for a savings deposit: *Provided*, That the depositor shall forfeit three months of interest payable at such rate. If, however, the amount withdrawn has remained on deposit for three months or less, all interest shall be forfeited. Where necessary to comply with the requirements of this paragraph, any interest already paid to or for the account of the depositor shall be deducted from the amount requested to be withdrawn.^{6a} Any amendment of a time deposit contract that results in an increase in the rate of interest paid

^{6a}The provisions of this paragraph apply to all time deposit contracts entered into after July 5, 1973, and to all existing time deposit contracts that are extended or renewed (whether by automatic renewal or otherwise) after such date, and to all time deposit contracts that are amended after such date so as to increase the rate of interest paid. All contracts not subject to the provisions of this paragraph shall be subject to the restrictions of § 217.4(d) in effect prior to July 5, 1973, which permitted payment of a time deposit before maturity only in an emergency where necessary to prevent great hardship to the depositor, and which required the forfeiture of accrued and unpaid interest for a period of not less than 3 months on the amount withdrawn if an amount equal to the amount withdrawn had been on deposit for 3 months or longer, and the forfeiture of all accrued and unpaid interest on the amount withdrawn if an amount equal to the amount withdrawn had been on deposit less than 3 months.

or in a change on the maturity of the deposit constitutes a payment of the time deposit before maturity. *Provided further*, That Investment Certificates issued in negotiable form by a member bank pursuant to subpart 3 of § 217.7(b) may not be paid before maturity. This provision does not prevent a member bank from arranging the sale or purchase of such a certificate on behalf of the holder or prospective purchaser of a certificate issued under that subpart. A member bank may not, however, repurchase such certificates for its own account. *Provided further*, That a time deposit may be paid before maturity without a reduction or forfeiture of interest as prescribed by this paragraph in the following circumstances:

(1) where a member bank pays all or a portion of a time deposit upon the death of any person whose name appears on the time deposit passbook or certificate;

(2) where a member bank pays all or a portion of a time deposit representing funds contributed to an Individual Retirement Account or a Keogh (H.R. 10) plan established pursuant to 26 U.S.C. (I.R.C. 1954) §§ 408, 401 when the individual for whose benefit the account is maintained attains age 59½ or is disabled (as defined in 26 U.S.C. (I.R.C. 1954) § 72(m) (7)) or thereafter; or

(3) where a member bank pays that portion of a time deposit on which Federal deposit insurance has been lost as the result of the merger of two or more Federally insured banks in which the depositor previously maintained separate time deposits, for a period of one year from the date of the merger.

For this Regulation to be complete, retain:

- 1) Regulation Q pamphlet, effective December 4, 1975.
- 2) Amendments effective March 1, 1976, July 26, 1976, and November 8, 1976.
- 3) Supplement effective December 4, 1975.
- 4) This slip sheet.

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