February 10, 1970.

To: Board of Governors

From: Governor Robertson

Subject: Interest on deposits: matters considered by Coordinating Committee.

This memorandum deals with seven matters, all relating to payment of interest on deposits, considered by the Coordinating Committee at meetings on January 27 and February 9, 1970. As to four of these matters, actions by the Board are recommended; the other three are reported for the Board's information.

1. Premiums

The Committee agrees that uniform rules should be prescribed regarding the giving of premiums to depositors by both banks and savings and loan associations. The consensus is that such premiums should be permitted only if given on a "nonrecurring" basis and only if the premium has a value or wholesale cost of not more than $5, except that the value or cost may not exceed $10 if the deposit amounts to $5,000 or more. The FDIC and the Home Loan Bank Board are prepared to amend their regulations to this effect, effective March 1.

I recommend that the Board approve an interpretation of Regulation Q to the same effect as set forth in Attachment A hereto.

2. Change in method of computing interest

The Committee has agreed that banks and savings and loan associations, in accordance with the spirit of the interest-rate advertising regulations, should inform depositors of the method used in computing interest on deposits and should notify depositors of any change in that method that will be less favorable to depositors. The FDIC and the Home Loan Bank Board are prepared to amend their regulations to that effect, effective immediately.

I recommend that the Board approve an interpretation of Regulation Q to the same effect as set forth in Attachment B hereto.

3. Interest on Christmas Club accounts

Last December, Representative Rosenthal wrote the Board urging that banks and savings and loan associations be required, in advertising Christmas Club accounts, to indicate whether interest will be paid on such accounts. The Coordinating Committee believes that data relating to such accounts should be obtained and that the question raised by Representative Rosenthal should be kept under consideration. On the basis of present evidence, however, it feels that the problem is not yet of such importance as to warrant regulatory provisions of the kind suggested.

HHH:vac
2/11/70

Legal Files

It is recommended that the Board reply to Representative Rosenthal along the lines of the attached letter identified as Attachment C.

4. Brokering of funds

For some time the Coordinating Committee has been concerned by the growth of a practice under which brokers solicit bank deposits by agreements to pay rates of interest higher than those permitted under regulations of the supervisory agencies. It has now been agreed that the four agencies should simultaneously send letters to the institutions under their supervision warning against the risks involved in this practice.

It is recommended that a letter in the form of Attachment D be addressed by the Board to all State member banks, with the understanding that the Comptroller, the FDIC, and the Home Loan Bank Board will send similar letters to the institutions supervised by them.

5. Subordinated notes

The Committee has been concerned by the possible growth of the practice on the part of banks (as well as savings and loan associations) of issuing subordinated notes on which interest is paid at rates in excess of those permitted by the interest-rate regulations. The Board's Regulation Q defines such notes as deposits if they have maturities of less than two years; but notes recently issued by First Pennsylvania with a maturity of 30 months escape the coverage of the Regulation. The FDIC feels that it cannot define subordinated notes as deposits, although it could limit the interest rate paid on such notes. All agree, however, that the issuance of such notes with relatively short maturities (e.g., of less than five years) is a device to evade deposit interest-rate limitations, that the practice may spread rapidly, and that some action should be taken before the problem becomes unmanageable. Although the FDIC has not yet been faced with the question, the Comptroller is deeply concerned and is anxious that early action be taken. (Some national banks have recently advertised 61-month notes bearing 8 per cent interest.)

The Committee agreed that an interagency staff group should promptly review the problem and be prepared to recommend alternative courses of action prior to the next meeting of the Committee on February 24, 1970.

6. Automatically renewable certificates

At the February 9 meeting of the Committee, reference was made to numerous complaints by banks with respect to advertisements by some savings and loan associations of automatically renewable one-year and two-year certificates at rates higher than those permitted for similar certificates issued by insured banks. Under Federal Reserve and FDIC regulations, the maximum rate is 5 per cent for any automatically renewable certificate, regardless of its maturity. The Home Loan Bank Board does not distinguish between "single-maturity" and "multiple-maturity" deposits as do the Board of Governors and the FDIC.

Chairman Martin indicated a willingness to restrict S&L's to the ceilings prescribed by the Federal Reserve and the FDIC for such automatically renewable certificates. However, Chairman Randall of the FDIC would prefer to amend present regulations to permit insured banks to pay the "single-maturity" maximum rates on one-year and two-year certificates that are automatically renewable - thus enabling banks to compete on the same basis with S&L's. I have serious reservations as to whether we should change our present 5 per cent maximum on multiple-maturity deposits, whatever the maturity.

7. "Super" Golden Passbook accounts

A few banks have recently advertised so-called "Passbook" accounts under which periodic deposits (such as each month) withdrawable after one year or two years are regarded as "single-maturity" deposits entitled to the premium rates permitted by the Board and the FDIC for one-year or two-year certificates of deposit. Obviously, such "super" Golden Passbook accounts could defeat the objectives of the regulations of the Board and the FDIC.

The FDIC has already taken the position that this practice is not permissible under present regulations since each deposit is not represented by a separate certificate of deposit. I would agree with the FDIC approach if it can be supported on legal grounds. The difficulty is that our regulations speak in terms of a single-maturity time "deposit"; they do not specifically refer to a "certificate" of deposit. It is arguable that a deposit entered in a passbook that may be withdrawn only at the end of one year is a single-maturity deposit even though not represented by a certificate.

We are attempting to obtain copies of the passbooks in question and plan to consider further the legal aspect of the matter.

Attachments

ATTACHMENT A

2/10/70

D R A F T

Premiums Not Considered Payment of Interest

Section 217.2(b) of the Board's Regulation Q, relating to the payment of interest on deposits, provides that, for purposes of the Regulation, "any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit shall be considered interest."

In applying this provision after March 1, 1970, the Board of Governors will regard premiums (whether in the form of merchandise, credit, or cash) given by member banks to their depositors as an advertising or promotional expense rather than a payment of interest if (a) the premium is given to a depositor only at the time of the opening of a new account or an addition to an existing account; (b) the premium is not given to any depositor on a recurring basis; and (c) the value of the premium or, in the case of articles of merchandise, the wholesale cost (excluding shipping and packaging costs) does not exceed $5.00, except that the value or wholesale cost may be not more than $10.00 if the amount of the deposit is $5,000 or more.

ATTACHMENT B

2/10/70

D R A F T

Information Regarding Computation of Interest on Deposits

Section 217.6(f) of the Board's Regulation Q, relating to payment of interest on deposits, provides:

> "(f) Accuracy of advertising. - No member bank 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."

Within the spirit of this provision and in order to avoid misunderstandings on the part of its customers, every member bank should inform the holder of a time or savings account at the time of the opening of such account as to the method that will be used in computing and paying interest on the account. In addition, if the bank subsequently makes a change in such method that will be less favorable to a depositor than the previous method, notice of such change should be mailed to each depositor at his last known address.

ATTACHMENT C

2/10/70

D R A F T

The Honorable Benjamin S. Rosenthal,
Chairman,
Special Consumer Inquiry,
Special Studies Subcommittee,
Committee on Government Operations,
House of Representatives,
Washington, D. C. 20515

Dear Mr. Chairman:

In my letter of December 19, 1969, acknowledging your letter to Chairman Martin of December 17, 1969, with respect to the advertising by banking institutions of Christmas Club and similar accounts, I indicated that, since the Board's authority to regulate advertising of interest on deposits may be exercised only after consultation with the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board, the subject of your letter would be placed on the agenda of the next meeting of the interagency Coordinating Committee. At a recent meeting of that Committee, attended by the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Federal Home Loan Bank Board, the Comptroller of the Currency, and me, the matter was discussed.

We recognize that some people may assume, when they first hear about Christmas Club accounts, that they bear interest. Nevertheless, it seems also reasonable to assume that people for whom interest or lack of it is a determining factor in regard to Christmas Club accounts would inquire about the rate of interest before opening an

account. The high rate of repeaters among those who have Christmas Club accounts suggests either that they do not realize they are not getting interest or that they are not motivated by interest-rate considerations when they establish the account. We believe the latter conclusion is the more reasonable. To require those who advertise for Christmas Club accounts to include in their advertising a statement that no interest is paid would seem justifiable only if the evidence pointed to the conclusion that this is really important to potential account-holders. But the evidence suggests that such accounts are popular with the public even though they do not bear interest, perhaps because they provide a convenient method of establishing a routine that helps people get ready for Christmas.

Accordingly, if any problem exists in this area, it does not appear to the Board to be of such magnitude as to warrant regulatory action at this time. The Board nevertheless will continue to review the matter in order to determine if and when the problem becomes of such significance as to call for regulatory action.

In your letter of December 17, 1969, you requested the Board's views as to the desirability of legislation that would require banking institutions to pay interest on Christmas Club and similar accounts. In the Board's opinion, such legislation would represent a departure from past practices and policies and would not be justified. Any statutory requirement that interest be paid

on such accounts could well have the net effect of depriving the public of a type of banking service that the public apparently wants in spite of the lack of payment of interest on such accounts.

Sincerely,

J. L. Robertson

ATTACHMENT D

2/10/70

D R A F T

TO THE PRESIDENTS OF ALL STATE MEMBER BANKS:

The use of brokered funds has been responsible for abuses in banking and has contributed to some recent bank closings, with consequent losses to depositors, other creditors, and shareholders. Bankers are again urged to be on the alert to schemes that would expose depositors' and shareholders' funds to the risks involved in loans based on brokered "deposits". They should be especially wary of related out-of-territory loans which may appear attractive because of the amount of brokered money that will be placed with the bank if the loan is made.

The advertisement of excessive yields on deposits solicited for federally supervised banks (whether the premium is provided by the bank or by others), moreover, is prohibited by substantially identical regulations issued by the Board of Governors and the FDIC. To the extent that a bank takes any part in these transactions it is considered to be evading the purposes of the interest-rate regulations. Where the bank pays a fee to a broker and knows or has reason to know that the fee is being shared with a depositor, the bank is also in violation of the interest-rate regulations to the extent the yield to the depositor exceeds the maximum permissible rate.

The Board is concerned that such activities can result in "unsafe and unsound" situations and could adversely affect the overall condition of the bank. Examiners, therefore, have been instructed to continue to report all cases where banks are obtaining deposits at premium rates, whatever the source of the premium, and also to scrutinize any tie-in loans. Appropriate corrective action will be required of all banks where such deposits and loans are found.

We understand that a similar letter is being addressed by the FDIC, the Comptroller of the Currency, and the Federal Home Loan Bank Board to institutions supervised by those agencies.

Sincerely,

Arthur F. Burns,
Chairman.

[or
J. L. Robertson,
Vice Chairman.]