Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Deregulation and Withdrawal Penalties

Deposit deregulation often is thought of as synonymous with removing interest-rate ceilings. While deposit interest-rate ceilings certainly have attracted most of the attention, many other aspects of deposit account contracts also have been affected by deregulation. One of these is the early withdrawal penalty. Following the removal of rate ceilings and the reduction in the regulatory minimum withdrawal penalties on October 1, 1983, some institutions established their own more stringent withdrawal provisions, when, before deregulation, they more-or-less routinely adopted the minimum penalties specified by regulations as maximum penalties.

To provide some perspective on the changes in withdrawal penalties, we will examine the role early withdrawal penalties have played in deposit regulation and how the easing of the regulatory minimums fits into the overall scheme of deposit deregulation. We also will review the recent changes in the regulatory minimums and illustrate why the new minimum penalties do much less than the old ones to discourage withdrawals from time deposits during periods of rapidly rising interest rates. Finally, we will look at what commercial banks and thrift institutions are doing with regard to early withdrawal penalties.

Role of minimum penalties

Minimum early withdrawal penalties have been an integral part of deposit regulation. One of the arguments usually raised in support of setting regulatory minimum penalties is that they are necessary to protect depository institutions from liquidity and earnings pressures stemming from withdrawals of time deposits when interest rates increase substantially. Such protection often has been thought to be particularly important for thrift institutions and some smaller commercial banks that tend to invest in longer-term assets. But, if this were the only basis for establishing withdrawal penalties, regulatory minimums may never have been needed since depository institutions could be expected to set their own penalties or make other arrangements to be compensated for allowing premature withdrawals.

Minimum early withdrawal penalties, however, had another function that made them an important adjunct to interest-rate ceilings on deposits. For many years small-denomination deposits (less than $100,000) were subject to fixed interest rate ceilings. These ceilings were structured so that maximum rates payable were lower on short-term accounts than on longer-term accounts. In this context, early withdrawal penalties were needed to enforce the rate-ceiling differentials on the various time and savings accounts. For example, in the absence of regulatory minimum penalties, an institution would have been able to circumvent the lower ceiling on passbook savings accounts by issuing a higher-ceiling long-term time deposit that allowed immediate access to the funds without penalty. In the late 1970s and early 1980s, as fixed ceilings on some time deposits were replaced by indexed ceilings or were removed completely, early withdrawal penalties also were required to prevent *de facto* deregulation of all time and savings deposits.

For the most part, minimum early withdrawal penalties appear to have been, or at least were perceived to have been, sufficiently harsh to discourage massive early withdrawals by depositors merely to take advantage of sharp rises in interest rates. Data available on penalty income associated with premature withdrawals suggest that, while early withdrawals responded to increases in interest rates, the volume of withdrawals in the aggregate never represented a large fraction of total small-denomination time deposits. Minimum early withdrawal penalties also may have

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been successful to a certain extent in enforcing the interest-rate ceiling differentials. However, evaluating the impact of withdrawal penalties in this regard is difficult because incentives to circumvent ceilings were dampened by regulatory changes that permitted depository institutions to pay "market rates" on short-term deposits.

However well regulatory minimum withdrawal penalties performed in the past, they are not likely to be particularly useful in the future. On October 1, 1983, the deregulation of interest rates on deposits neared completion when the Depository Institutions Deregulation Committee lifted rate ceilings on time deposits with maturities of 32 days to 2½ years. The only remaining rate ceilings for non-transaction accounts are those on passbook savings and time deposits in denominations of less than $2,500 and with maturities of 7 to 32 days. Obviously, once these ceilings are gone, regulatory early withdrawal penalties will not be needed to enforce the ceiling-rate structure.

In addition, since the move to deregulate deposits reflects in part the desire of the Congress to reduce government involvement in private markets, it would be inconsistent to continue to regulate early withdrawal penalties as a means of "protecting" depository institutions. Finally, as will be shown below, the regulatory minimum early withdrawal penalties may have been reduced to the point where they already have little practical importance in the current deregulated environment.

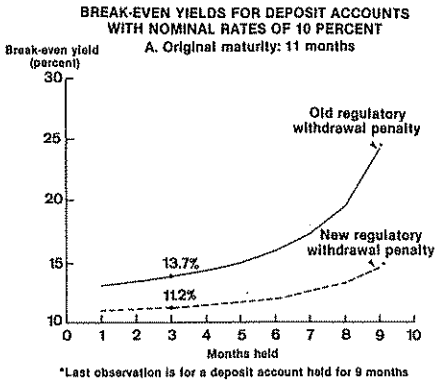
New minimum penalties

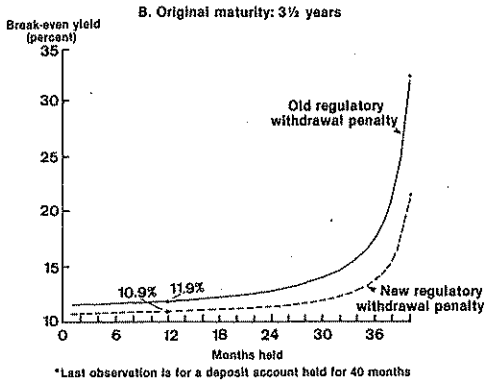
Effective October 1, 1983, the minimum regulatory early-withdrawal penalty on deposits with maturities of 32 days to 1 year was reduced to the loss of 1 month of simple interest from the previous 3 months of simple interest. The penalty for time deposits with maturities of 1 year or more was lowered from the loss of 6 months of simple interest to the loss of 3 months. The new minimum penalties apply only to time deposits issued on or after October 1, 1983. For time deposits with maturities of 7 to 32 days, the regulations concerning early withdrawal were not changed.

The effects of lowering the minimum early-withdrawal penalties are illustrated in the charts. They show "break-even" yields for time deposits with original nominal yields of 10 percent under the new and old penalty rules. A "break-even" yield represents the annualized nominal interest rate necessary on an alternative instrument with a maturity equal to that remaining on the deposit withdrawn to compensate the depositor for the penalty incurred. These figures do not take into account that the tax laws allow the penalties to be deducted from taxable income. This tax advantage would reduce the break-even yields under both sets of withdrawal penalties in relation to an individual's marginal tax rate.

The charts show that the new minimum penalties do much less to deter early withdrawals than did the old ones. As can be seen in Panel A, for a 10 percent, 11-month time deposit that already has been held for 3 months, the interest rate on a time deposit account (or other interest-bearing instrument with the appropriate 8-month maturity) would have to be only about 11.2 percent, or 1.2 percentage points higher, for a depositor to be compensated for terminating the existing account and establishing a new one under the current minimum penalty. Given the same set of circumstances, the minimum withdrawal penalty effective before October 1 would have required the interest rate differential on the new and old deposit accounts to have been three times larger, or 3.7 percentage points higher, before a depositor could have taken advantage of the higher yields.

For the longer-term deposit (3½-year account) shown in Panel B, the differences in the break-even yields under the old and new rules are particularly noticeable as an





account approaches maturity. Under the new rules, rates would not have to rise by very much for early withdrawals to be profitable even for long-term deposits that have been held for some time. For example, applying the current minimum penalty, even a year after opening a 3½-year account, a depositor could earn a higher return by investing the funds in a new account if rates were to increase by a little more than one percentage point. Such an increase is small compared to the movements in interest rates over the past few years.

Reaction of institutions

The combination of reducing regulatory early withdrawal penalties and lifting interest rate ceilings has given depository institutions greater flexibility in setting their own provisions on withdrawals. Among institutions in the West, many apparently have incorporated the new regulatory minimum penalties in their deposit account agreements, but a number of institutions have selected more stringent measures. Among the institutions adopting more forceful stances, some have set the penalties equal to the regulatory minimum in effect before October 1, 1983. Other depository institutions have established withdrawal penalties that are between the new and the old regulatory minimums. At least one institution has instituted withdrawal penalties that virtually wipe out any gains related to a rise in interest rates when funds are withdrawn from a time deposit prior to maturity. It accomplishes this by applying the greater of either the regulatory minimum penalty or a penalty based on the difference between the interest rates on the deposits to be withdrawn and the interest being paid on new deposits, the amount withdrawn, and the time remaining to maturity on the deposits withdrawn.

Under the last arrangement, depositors have access to funds held in time accounts when interest rates rise, but they must incur an explicit penalty equal to the value of the withdrawal option, much like the discount on a bond traded in the secondary market.

With other withdrawal penalties which do not vary with interest rates, commercial banks and thrift institutions continue to bear some of the risk of a rise in interest rates. However, depository institutions still could be compensated for providing withdrawal options and bearing risk if depositors were willing to accept a lower explicit interest rate. The rate concession required by an institution would depend in part on the stringency of the withdrawal penalty and expectations concerning the volatility and the direction of changes in interest rates.

Conclusion

Regulatory minimums on early withdrawal penalties were logical companions to interest-rate ceilings on deposits. As deposit rate ceilings were removed, relaxing minimum penalties was equally logical. Although further reduction and the eventual elimination of regulatory minimum penalties can be expected, they already may have shrunk to the point where they are no longer binding.

The fading importance of regulations on withdrawal penalties does not mean the disappearance of such penalties, however. Commercial banks and thrifts have an incentive to provide compensation to themselves for offering withdrawal options. With policies decided on an individual basis, withdrawal penalties are not likely to be as uniform as they have been in the past. As deposit deregulation approaches completion, depositors may find that there are tradeoffs between the interest rates offered on deposits and the stringency of early withdrawal penalties.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/23/83	Change from 11/16/83	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	163,112	− 135	851	0.5
Loans (gross, adjusted) — total#	142,976	− 114	1,197	0.8
Commercial and industrial	43,588	− 44	− 1,399	− 3.1
Real estate	57,500	8	250	0.4
Loans to individuals	25,096	83	1,538	6.5
Securities loans	2,830	30	401	16.5
U.S. Treasury securities*	7,701	9	1,111	16.9
Other securities*	12,434	− 30	− 1,457	− 10.5
Demand deposits — total#	41,550	−1,919	847	2.1
Demand deposits — adjusted	28,300	−1,480	684	2.5
Savings deposits — total†	66,032	− 43	33,646	103.9
Time deposits — total#	70,290	869	− 28,853	− 29.1
Individuals, part. & corp.	64,596	749	− 24,448	− 27.5
(Large negotiable CD's)	17,484	525	− 17,860	− 50.5

Weekly Averages of Daily Figures	Week ended 11/23/83	Week ended 11/16/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	38	135	118
Borrowings	5	13	0
Net free reserves (+)/Net borrowed(−)	33	122	118

* Excludes trading account securities.
# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

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