INVESTMENTS FOR SMALL SAVERS AT COMMERCIAL BANKS

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When the Federal regulators of financial institutions issued new rules for the six-month money market certificate on March 8, 1979, they also stated that they were reviewing the terms on other types of deposits "with a view toward providing improved savings opportunities for the small saver."[1] This statement did not define the term small saver. However, from the nature of some of the regulatory changes that followed, the regulators clearly showed that they were concerned with savers having less than $1,000 available for deposit. The first group of regulatory changes became effective as of July 1, 1979. Additional changes became effective during the first half of 1980.

The main purpose of this article is to explain the array of these regulatory changes which were made as amendments to Regulation Q, and to show how they are designed to provide improved savings opportunities for the small saver. In addition, because these specific amendments affect those sections of Regulation Q pertaining to time and savings deposits, some attention is devoted to a review of these deposits as secure investments for the small saver. The initial section of this article compares the various time and savings deposits as investments for the small saver. The latter section, however, focuses on the time deposit specifically referred to as the Small Savers Certificate (SSC) by Federal regulators and analyzes some of the factors that the saver should consider before terminating this certificate before maturity.

CHANGES IN REGULATION Q

All of the regulatory changes designed to help the small saver were adopted and announced jointly by the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration. The changes, with respect to Federal Reserve member banks, were effected through amendments to Regulation Q by the Board of Governors of the Federal Reserve System.

Passbook Savings Accounts Prior to July 1, 1979, Regulation Q stipulated that no member bank could pay interest on any savings deposit at a rate in excess of 5 percent (12 CFR 217.7(c)). This regulation was amended by the Federal Reserve Board to increase from 5 percent to 5¼ percent the ceiling rate of interest payable on savings deposits by member banks. The ceiling rate for savings deposits that are subject to negotiable orders of withdrawal was left at 5 percent.[2]

These new ceiling rates still deprive the small saver of the higher rates available to investors in other financial instruments; however, such ceilings are scheduled to be phased out over a six-year period which began March 31, 1980. The ceiling rates on passbook savings accounts are expected to increase by at least a quarter of a percentage point within the first eighteen months, half a percentage point within the next eighteen months, and half a percentage point for each of the next three years.

Fixed-Rate Savings Certificates Prior to July 1, 1979, Federal regulations required a minimum deposit of $1,000 on fixed-rate time deposit certificates with maturities of four years or more (12 CFR 217.7). This requirement no longer exists although individual banks can set their own minimum deposits. Most banks are now issuing these certificates in amounts much less than $1,000, thus enabling many small savers to obtain a rate of interest greater than the passbook rate for a fixed period of time. The various maturities and maximum rates of interest for these fixed-rate certificates at member banks are as follows:

[1] Federal Reserve Board of Governors, **Federal Reserve Press Release,** March 8, 1979, p. 2.

[2] Effective December 31, 1980 the ceiling rate on negotiable orders of withdrawal accounts also will increase to 5¼ percent.

Maturity	Maximum Percent[3]
30 days or more but less than 90 days	5¼
90 days or more but less than 1 year	5¾
1 year or more but less than 30 months	6
30 months or more but less than 4 years	6½
4 years or more but less than 6 years	7¼
6 years or more but less than 8 years	7½
8 years or more	7¾

Before investing funds in one of these fixed-rate certificates, savers should understand that such certificates are nonnegotiable and are subject to a substantial penalty for early withdrawal.

Early Withdrawal Penalty Prior to July 1, 1979, Regulation Q provided that where a member bank agreed to pay a time deposit prior to maturity, the bank had to impose an early withdrawal penalty on the funds withdrawn (12 CFR 217.4(d)). The minimum required penalty was a reduction in the rate of interest paid on the funds withdrawn to a rate not to exceed the rate currently prescribed for a savings deposit (5 percent) plus a forfeiture of three months interest at such rate. Under this provision, the amount of the early withdrawal penalty increased significantly the longer the deposit was maintained.

To reduce the severity of this penalty on small savers, the Federal Reserve Board created a new early withdrawal penalty by amending Section 217.4 (d) of Regulation Q (12 CFR 217.4(d)). In all deposit categories for new certificates issued or renewed after July 1, the minimum required early withdrawal penalty on time deposits with original maturities of one year or less was established as the forfeiture of three months interest on the amount withdrawn at the rate being paid on the deposit. If the amount withdrawn had been on deposit for less than three months, all interest was forfeited. The minimum required early withdrawal penalty on time deposits with original maturities of more than one year was the forfeiture of six months interest on the amount withdrawn at the rate being paid on the deposit. If the amount withdrawn had been on deposit for less than six months, all interest was forfeited. No reduction of interest to the savings rate was required, and the amount of the penalty did not exceed interest accrued or already paid.

Effective June 2, 1980, a further change was made in the penalty for early withdrawal of funds from time deposits. Under the new rules, for deposits with an original maturity of one year or less, the penalty is set at an amount equal to three months simple, nominal interest. For deposits with a maturity of more than one year, the penalty is set at an amount equal to six months simple, nominal interest. Unlike the previous minimum required penalty, this rule may require a reduction in the principal sum of the deposit if the withdrawal is made during the early months of the deposit.[4]

Indeed there are critics of the new penalty for early withdrawal because of the possibility that the saver could get back less than the original amount of savings placed in the deposit. However, it should be noted that a similar situation would also occur if the saver were to liquidate a market security prior to maturity in a rising interest rate environment. In this specific case regarding savings certificates, one should understand that much of the funds placed in these time deposits are in turn used by banks to finance certain credit needs of small savers. Thus, the small saver, having been provided a market-oriented rate of return on a term deposit is, in effect, asked to share more of the interest rate risk formerly borne by the banks, a risk that could limit the bank's willingness to commit funds to the credit needs of small savers.[5]

SMALL SAVERS CERTIFICATES

While the foregoing changes in Regulation Q were key elements in the effort to improve savings opportunities for the small saver, the major step in this direction was the creation of the new Small Savers Certificate (SSC). To accommodate the small saver, this certificate was authorized with no requirement for a minimum denomination.[6] The effective date for the issuance of this new certificate was July 1, 1979, and the certificate had a maturity of four years (or more), with a ceiling rate based on the yield for

[3] As the subsequent discussion on Small Savers Certificates will indicate, rates shown for maturities of 30 months or more in this table are not the maximum available to small savers who are able to meet a member bank's minimum denomination for a Small Savers Certificate.

[4] These new rules set the minimum penalty for early withdrawal of funds from time deposits. Member banks are free to set even more severe penalties.

[5] Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs, United States Senate, August 5, 1980, p. 8.

[6] Individual banks may set their own minimum denominations.

4-year Treasury securities. Specifically, the ceiling for member banks was set at 1¼ percentage points below the yield on 4-year Treasury securities.

During the first half of 1980, Federal regulators approved additional changes in the SSC to improve the savings opportunity for the small saver. One of these changes became effective on January 1, when the minimum maturity for the certificates was reduced from four years to two and a half years. Also, the yield on the new SSC was raised by setting the floating ceiling rate only ¾ percentage point below the 2½-year Treasury yield. Although the improvement in the form of a reduction in maturity was somewhat nullified on February 27 when a limitation on the rate of interest was set at 11.75 percent, small savers could still count on receiving a higher yield on their SSCs than they could earn on fixed-rate certificates during periods of high market rates. Effective June 3, three more changes brought pronounced improvement in the SSCs for small savers. One change allowed commercial banks to pay the ceiling rate of 11.75 percent after the Treasury yield goes above 12.00 percent. Prior to June 2, commercial banks had to wait until the Treasury yield went above 12.50 percent before they could pay the 11.75 percent ceiling. A second change allowed commercial banks to pay a rate ¼ percent below the Treasury yield instead of the ¾ percent allowed previously, although the 11.75 percent cap was maintained. A third change allowed commercial banks to pay a *minimum ceiling rate* of 9.25 percent on SSCs. That is, even when the yield on 2½-year Treasury securities falls below the rate at which the base ceiling would be activated (Treasury yield less ¼ percent), commercial banks would still be allowed to pay up to 9.25 percent.

The concept of minimum ceilings (which, at the time the decision was made, were at levels near or below those prevailing) was adopted in part in recognition of the fact that Treasury security yields are frequently below other market rates and generally lead declines in other rates available to savers. Thus, floating deposit rate ceilings related to such instruments would decline more rapidly than yields on other available savings opportunities, such as those that include money market instruments.

The changes in ceiling rates on SSCs that became effective on June 3, 1980 are shown in Table I.

The basic ceiling interest rate on SSCs is determined by the U. S. Treasury Department every two weeks and is announced late each Monday or early Tuesday to become effective the following Thursday. If Monday is a holiday, the average yield will be based on the average for the five business days ending the preceding Friday, instead of Monday, and will still be effective on the following Thursday. Once the rate is determined for a specific SSC, that particular rate is paid throughout the 2½ years or more that the deposit is outstanding. The interest may be compounded and computed by member banks in accordance with any of the methods authorized by Section 217.3 of Regulation Q.

As a time deposit with a maturity of more than one year, the SSC carries an early withdrawal penalty equal to six months simple, nominal interest. As stated earlier, savers should be aware that such a penalty could require a reduction in the principal sum of the certificate. If savers withdraw their funds early for reasons other than a personal emergency, savers should compute precisely the terms on which they would have to reinvest their funds in order to justify such a withdrawal. Table II illustrates these terms when the rate is 9.25 percent, the maximum that member banks can pay when the average yield on 2½-year Treasury securities is below 9.50 percent.

Table I

SMALL SAVERS CERTIFICATES: CEILING RATES BEFORE AND AFTER JUNE 2, 1980

Before June 2, 1980		After June 2, 1980	
When the 2½-year Treasury Security Yield Is:	Member Banks May Pay	When the 2½-year Treasury Security Yield Is:	Member Banks May Pay
Above 12.50	11.75	Above 12.00	11.75
12.50 and below	2½-year bond rate minus 75 basis points	9.50 to 12.00	2½-year bond rate minus 25 basis points
		Below 9.50	9.25

Source: May 28, 1980 telegram to the Presidents of all Federal Reserve Banks from the Depository Institutions Deregulation Committee.

Table II

COST OF TERMINATING A SMALL SAVERS CERTIFICATE

With a Deposit of $500

Two-and-One-half-Year Notes, At 9¼%, Compounded Daily

End of Month	Balance on Account	Penalty for Withdrawal	Rate Needed to Break Even
3	$512	$23.125	12.72% (2.25 years)
6	524	23.125	13.15% (2 years)
12	549	23.125	14.09% (1.5 years)
15	562	23.125	14.85% (1.25 years)
18	575	23.125	15.93% (1 year)
24	603	23.125	20.67% (0.5 year)
30	632	23.125	20.67% (0.5 year)

ADDITIONAL AID FOR SMALL SAVERS

Generally, small savers are persons of very modest means, thus the safety of their savings is important to them. To provide this safety, passbook savings accounts, fixed-rate savings certificates, and small savers certificates issued by member banks are insured up to $100,000 by an agency of the Federal Government, namely the Federal Deposit Insurance Corporation.

Interest earnings from passbook savings accounts, fixed-rate savings certificates, and small savers certificates are subject to local, state, and Federal income taxes. However, effective with the 1981 tax year, any combination of interest earnings and dividends may be excluded from taxable income up to $200 per taxpayer on the Federal tax return ($400 on a joint return).