Regulations Q and D
Interest on Demand Deposits/Reserve Requirements

Regulation Q (Prohibition against Payment of Interest on Demand Deposits) and Regulation D (Reserve Requirements of Depository Institutions) are two of the four regulations that examiners need to refer to when conducting the deposit operations segment of consumer compliance examinations. The other two regulations—Regulation CC (Availability of Funds and Collection of Checks) and Regulation DD (Truth in Savings)—are covered in subsequent chapters.

Regulation Q contains only a couple of important definitions. Regulation D, besides giving additional definitions, lays out rules governing such topics as penalties for early withdrawal and customer notices of intent to withdraw funds.

Background

Regulation Q originated in the 1930s as part of a congressional response to banking practices and problems encountered during the Depression. By the late 1970s and early 1980s, new types of accounts—such as money market mutual funds issued by investment companies and securities firms that were not subject to federal interest rate regulation—were giving commercial banks stiff competition for funds. In response to both bankers' concerns about the competition from these unregulated deposit accounts and the deregulatory environment that prevailed at the time, Congress passed the Depository Institutions Deregulation Act of 1980, with the purpose of eliminating all federal interest rate ceilings on deposit accounts within six years. The last remaining interest rate ceilings were removed in March 1986, and most of the remaining provisions of Regulation Q were subsequently transferred to Regulation D.

Today, Regulation Q is relatively short and includes only the definition of ''interest'' and the prohibition against the payment of interest on demand deposits. Regulation D now contains definitions for the various categories of deposit accounts (transaction, demand, time, and savings) and places certain types of accounts, such as NOW accounts and money market deposit accounts, within those categories. Regulation D also provides for mandatory penalties for early withdrawals from time deposits.

Technically, Regulation D is a monetary policy regulation, not a consumer regulation. It specifies how depository institutions must classify different types of deposit accounts for the purpose of complying with reserve requirements, an integral tool in implementing monetary policy.[1]

Definitions

Two key terms are referred to in the definitions of types of accounts:

- *Interest*—''Any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit. A member bank's absorption of expenses incident to providing a normal banking function or its forbearance from charging a fee in connection with such a service is not considered a payment of interest.'' (Regulation Q, section 217.2(d))
- *Natural person*—''An individual or a sole proprietorship. The term does not mean a corporation owned by an individual, a partnership or other association.'' (Regulation D, section 204.2(g))

Types of Accounts Covered

Regulation D defines *deposit* and divides deposit accounts into two categories—transaction and nontransaction accounts. Transaction accounts are the primary vehicle for calculating reserve requirements.

Transaction Accounts

A *transaction account* is an account from which the depositor or account holder is permitted to ''make transfers or withdrawals by negotiable or transferable instrument, payment order of withdrawal, telephone transfer, or other similar device for the purpose of making payments or transfers to third persons or others or from which the depositor may make third-party payments at an automated teller machine or a remote service unit, or other electronic device . . . .'' The following types of accounts are transaction accounts (section 204.2(e)):

- Demand deposit accounts
- NOW accounts
- ATS accounts

Savings deposit accounts are specifically excluded from the definition of transaction account, even though they permit third-party transfers.

1. All depository institutions, including commercial banks, savings banks, savings and loan associations, credit unions, and agencies and branches of foreign banks located in the United States, are subject to reserve requirements. Required reserves are maintained either in the form of vault cash or as non-interest-bearing balances at a Federal Reserve Bank or a correspondent.

Transaction accounts have the following characteristics:

- Limited to demand, NOW, and ATS accounts
- Permit a depositor or account holder to make unlimited transfers or payments to third parties
- Permit a depositor to make unlimited transfers between accounts of the same depositor at the same institution

Demand Deposit Accounts

Demand deposit accounts are payable on demand, or on less than seven days' notice. They generally have no maturity period and do not require the account holder to give notice of the intent to withdraw funds. If they do require notice of intent to withdraw funds, the notice period must be less than seven days and the requirement must be stated in the deposit contract. Both businesses and consumers may hold demand accounts. There are no eligibility restrictions on this type of account.

Demand deposits include deposits that for some reason have been reclassified as demand deposits—for example, matured certificates of deposit and savings deposits for which the transfer or withdrawal limitations have been exceeded.

Demand deposit accounts have the following characteristics:

- No maturity period (or maturity period of less than seven days)
- Payable on demand (or on less than seven days' notice)
- May not be interest-bearing
- No limit on the number of withdrawals or transfers an account holder may make
- No eligibility requirements

NOW Accounts

NOW (negotiable order of withdrawal) accounts allow unlimited transactions, and they are classified as transaction accounts for purposes of reserve requirements. They share certain characteristics with savings deposit accounts, in that banks must reserve the right to require seven days' notice of intent to withdraw funds from NOW accounts (in practice, this right is rarely, if ever, exercised). Unlike savings deposit accounts, however, NOW accounts are available only to individuals; sole proprietorships; governmental units; and corporations, partnerships, associations, and organizations that are operated primarily for religious, philanthropic, charitable, educational, fraternal, or other similar purposes and not for profit.

Because NOW accounts are transaction accounts, the funds in a NOW account may be accessed in several ways. For example, account holders may use negotiable instruments (checks), drafts, telephonic or electronic orders or instructions, or other similar devices to make payments or transfers to third persons or to others. The account holder may make an unlimited number of transfers to another of his or her accounts at the same institution.

NOW accounts have the following characteristics:

- Have no maturity date
- Bank must reserve the right to require at least seven days' prior written notice of intent to withdraw or transfer funds
- May be interest-bearing
- Permit unlimited transactions (transfers and withdrawals)
- May be accessed by check, draft, telephonic or electronic order or instruction, or other similar instrument to
  - Pay third parties or others
  - Transfer funds to another of the depositor's accounts at the same institution
- May be held only by individuals, sole proprietorships, governmental units, and nonprofit organizations
- Are classified as transaction accounts under Regulation D

ATS Accounts

ATS (automatic transfer service) accounts, which are classified as transaction accounts for reserve requirement purposes, are accounts that provide for transfers or withdrawals to be made automatically to the bank itself or to another of the depositor's accounts at the same institution. ATS accounts were relatively common in the past but are rarely seen today. As with NOW accounts and savings deposit accounts, banks must reserve the right to require seven days' notice of intent to withdraw funds from ATS accounts. Unlike NOW accounts and savings deposit accounts, eligibility for ATS accounts is limited to individuals (including sole proprietorships). Businesses, governmental units, and nonprofit organizations are not eligible for ATS accounts.

ATS accounts have the following characteristics:

- Must reserve the right to require at least seven days' notice of intent to withdraw funds
- Provide for automatic transfers between at least two accounts at the same financial institution
- Eligibility limited to individuals (including sole proprietorships)
- Are classified as transaction accounts under Regulation D

Nontransaction Accounts

Time Deposit Accounts

Time deposit accounts have a maturity of at least seven days from the date of deposit. They may be payable on a specified date not less than seven days after the date of deposit or after the expiration of a specified period of time not less than seven days after the date of deposit (for example, thirty days after the date of deposit). Or they may be payable upon receipt of written notice from the depositor (required in the contract) not less than seven days prior to withdrawal. If funds are withdrawn from a time deposit account within six days of the date of deposit or within six days of the most recent partial withdrawal, the specified early withdrawal penalty must be imposed (see ''Early Withdrawal Penalties,'' below). There are no restrictions on who may hold a time deposit account.

Club accounts, such as Christmas or vacation club accounts, are considered time deposit accounts. Generally, funds are deposited into club accounts under a written contract that prohibits withdrawal until a certain number of deposits have been made during a period of not less than three months (even though some of the deposits may be made within six days from the end of the period).

Time deposits may be negotiable or nonnegotiable, transferable or nontransferable. They may be represented by a certificate, instrument, passbook, statement, book-entry notation, or otherwise. If the deposit is automatically renewable, that fact should be indicated on the certificate or other representation, along with the terms of renewal.

Time deposit accounts have the following characteristics:

- Must have a maturity of at least seven days from the date of deposit
- May require at least seven days' prior written notice of intent to withdraw funds
- Must be subject to early withdrawal penalties if funds are withdrawn within six days of the date of deposit or the date of the immediately preceding partial withdrawal
- May be interest-bearing
- May be evidenced by a negotiable or nonnegotiable, transferable or nontransferable certificate, instrument, passbook, book entry, or other similar instrument
- Include club accounts (such as Christmas club or vacation club accounts)
- No eligibility requirements

Early Withdrawal Penalties. The presence (or absence) of an early withdrawal penalty differentiates time deposit accounts on the one hand and savings deposit accounts and transaction accounts on the other hand. The early withdrawal penalty must be at least seven days' simple interest on amounts withdrawn within the first six days after deposit or within six days after the most recent partial withdrawal. If funds are withdrawn more than six days after the date of deposit or more than six days after the most recent partial withdrawal, no interest penalty is required by federal law.

Penalties listed under Regulation D are the minimum federal penalties required by Regulation D and the Federal Reserve Act. Banks are free to impose greater penalties by contract with the depositor.

If a bank fails to impose early withdrawal penalties when they are required by Regulation D, the account ceases to be a time deposit account. If the account meets all the necessary requirements for a savings deposit account, the bank could reclassify it as such. Otherwise, the account may have to be reclassified as a transaction account.

The penalty provisions of time deposit accounts should be disclosed in writing to the customer at the time the account is opened. During the compliance examination, examiners should check that the bank has penalties in place that are at least equal to those required by Regulation D. As part of the examination, examiners should also verify the accuracy of the interest penalties assessed on a sample of time deposit accounts from which early withdrawals were permitted.

Savings Deposit Accounts

Savings deposit accounts are a subcategory of ''time deposits,'' but they generally have no specified maturity period. They may be interest-bearing, with interest computed or paid daily, weekly, quarterly, or on any other basis.

The most significant feature of savings deposit accounts is the regulatory limit on the number of ''convenient'' transfers or withdrawals that may be made per month (or per statement cycle of at least four weeks) from the account. A depositor may make no more than six ''convenient'' transfers per month from a savings deposit account, and no more than three of these transfers may be made by check, debit card, or similar order made by the depositor and payable to third parties. ''Convenient'' transfers, for purposes of this limit, include preauthorized or automatic transfers (such as overdraft-protection transfers and direct bill payments) and transfers initiated by a depositor by telephone, facsimile, or computer. Other, less-convenient types of transfers, such as withdrawals or transfers made in person at the bank, by mail, or by using an ATM, do not count toward the six-per-month limit and do not affect the account's status as a savings account. Also, a withdrawal request by telephone does not count toward the limit, provided that the withdrawal is disbursed via check mailed to the depositor.

Examiners should be particularly wary of a bank's practices for handling telephone transfers. As noted, an unlimited number of telephone-initiated withdrawals are allowed so long as a check for the withdrawn funds is mailed to the depositor. Otherwise, the limit is six telephone transfers per month. The limit applies to telephonic transfers to move savings deposit funds to another type of deposit account and to make payments to third parties.

The limit on telephone transfers applies to both business and personal accounts, but banks should handle accounts that exceed the limit differently. Generally, if a savings deposit account exceeds, or is authorized to exceed, the ''convenient'' transfer limit, the bank should take away the transfer and draft capabilities of the account or close the account and place the funds in another account that the depositor is eligible to maintain. If the depositor is a natural person, the funds may be placed in a NOW account. If the depositor is not a natural person, the bank may be required to reclassify the account as a demand account, as businesses are not allowed to hold NOW accounts.

Savings deposit accounts have the following characteristics:

- Have no set maturity
- Bank must reserve the right to require at least seven days' notice of intent to withdraw funds (in practice, this right is rarely, if ever, exercised)
- May be interest-bearing
- Allow no more than six transfers or withdrawals per calendar month or statement cycle of at least four weeks for the purpose of transferring funds to another of the depositor's accounts at the same institution or making third-party payments by means of preauthorized, automatic, or telephonic transfers
- Allow no more than three of the six transfers to be made by check, draft, debit card, or similar order made by the depositor and payable to third parties
- Allow unlimited withdrawals by mail, messenger, ATM, in person, or by telephone (via check mailed to the depositor)
- Have no eligibility requirements
- May be reclassified as demand deposit accounts if held by a non-natural person and the withdrawal or transfer limit is exceeded
- May be reclassified as NOW accounts if held by a natural person and the withdrawal or transfer limit is exceeded
- Include money market deposit accounts (MMDAs)

Money Market Deposit Accounts

Before the mid-1980s, money market deposit accounts (MMDAs) had characteristics that distinguished them from ordinary savings deposit accounts. Now, however, they have the same characteristics as savings deposit accounts and are subject to the same transfer and withdrawal limits.

Highlights of Regulations Q and D that Affect Consumers

Seven-Day Notice Period

Banks must reserve the right to require at least seven days' notice of a customer's intent to withdraw funds from savings accounts, NOW accounts, and ATS accounts. Banks have the option of enforcing this notice requirement, and in practice it is rarely, if ever, enforced.

If all or a portion of the funds in a time deposit account are withdrawn within six days of the date of deposit or of the most recent partial withdrawal, the account must be subject to an early withdrawal penalty. This penalty, which is the minimum penalty that may be imposed, is the loss of seven days' simple interest on the amount withdrawn.

If a bank allows customers to make partial withdrawals from time deposit accounts, the bank must impose the early withdrawal penalty on amounts withdrawn. For example, suppose a customer deposits $1,000 into a new time deposit on the 1st of the month, withdraws $100 on the 4th, and another $100 on the 9th. The customer would be subject to an early withdrawal penalty for the first $100 withdrawal in the amount of seven days' simple interest on $100, and another early withdrawal penalty for the second $100 withdrawal in the amount of seven days' simple interest on $100 because the second withdrawal occurred within six days of the first withdrawal. If the bank does not impose the second early withdrawal penalty, the account ceases to be a time deposit account and should be reclassified as either a savings account (provided the account meets the characteristics of a savings account) or a transaction account.

Interest-Period Extension

''Time deposits,'' as defined in Regulation D, include ''time deposits that have matured or time deposits upon which the contractual required notice of withdrawal was given and the notice period has expired and which have not been renewed. . . .'' Nonetheless, banks are permitted, under Regulation Q, to continue to pay interest on a matured time deposit for up to ten days after its maturity under certain conditions. First, interest may be paid during such a period if the deposit account agreement specifies that interest will continue to be paid if the funds are withdrawn within ten days after the maturity date. Second, interest may be paid during the time between maturity and renewal of the time deposit account (either automatically or by action of the depositor) if the renewal occurs within ten days or less of the maturity date. Otherwise, if the contract is not automatically renewable (or is not renewed) within ten days of the date of maturity and the bank continues to pay interest on the account during that period, the bank would be considered to be paying interest on a demand deposit.