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Financial Institution Deposits and U.S. Government Securities

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A variety of low-risk savings and investment alternatives are offered by financial institutions and the U.S. government. When savings and investment decisions are being made, yield and other selection criteria, in addition to risk, should be considered.

Financial Institution Deposits

Financial institutions (banks, savings and loan associations, and credit unions) offer a variety of ways to save, such as interest-bearing checking, savings or share accounts, and certificates of deposit (CDs) or share certificates.

You should make sure deposited funds are safe. Inquire if the bank or savings and loan association is insured by the Federal Deposit Insurance Corporation and credit union is insured by the National Credit Union Association, up to a maximum of $100,000 for each depositor.

Funds are liquid (although CDs are subject to early withdrawal penalties) and they earn interest. Interest is subject to federal, state, and local income taxes as it is earned and credited to your account.

Interest-bearing Checking

Checking accounts give individuals a safe, convenient way to pay financial obligations and to have a record of payments. The opportunity to earn interest on checking accounts was a feature first added in the mid-1970s at credit unions and in the early 1980s at banks and savings and loan associations.

Typically, banks and savings and loan associations refer to interest-bearing checking accounts as NOW (negotiable orders of withdrawal) accounts, SuperNOW accounts, and money market deposit accounts. Credit unions refer to interest-bearing checking accounts as share draft accounts.

The specifics of NOW and share draft accounts are established by the financial institution; therefore, services, fees, and interest rates vary. SuperNOW and money market deposit accounts are similar to NOW accounts, except they earn variable market rates, tend to have higher minimum required balances, and charge higher fees when minimum balances are not maintained. Some banks and savings and loans associations are combining SuperNOW and NOW accounts into one interest-bearing checking account with higher interest rates paid on higher balances.

Money market deposit accounts have limited check writing or electronic fund transfer (EFT) privileges (up to six indirect transactions per month, although the maximum number can be lower). In person transactions, such as cash withdrawals, are generally not limited.

Comparing interest-bearing checking accounts. Some factors to consider when comparing interest-bearing checking accounts include:

- What is the minimum deposit required to open an account? Is there a minimum required to maintain an account?
- What is the interest rate? Is the rate fixed or does it vary with market rates? Is the interest rate lower if you fail to maintain a specific minimum balance?
- What is the annual percentage yield (APY)? This takes into account the interest rate, as well as the frequency of compounding (that is, how often earnings are computed). The more frequent the compounding, the higher the annual percentage yield.

Under recent truth-in-savings regulations, APY is standardized, so savers can more readily compare different depository accounts. Compare the following features.

- Is there a monthly service charge? What is it? Does it change if your account drops below a certain minimum balance?
- If you close the account during the month, is interest paid during that month?
- What is the overdraft charge? How much is the returned check fee?
- Is there a charge for stop payment orders? How much is it?
- What conditions do you need to meet to qualify for free check-writing?
- What is the cost for printed, personalized checks? Are checks available free for first accounts, those keeping a large minimum balance, students, senior citizens, or other groups? Where else can you purchase checks?
- Are canceled checks returned or do you get an itemized statement? Can you get photocopies of canceled checks (and for how long and at what cost)?

- What other services are provided by the financial institution for this type of account (such as automatic bill payment services or deposit, withdrawal, transfer, and loan payment via cash machines)? What are the fees associated with these services?

Savings Accounts

Savings accounts are available at banks and savings and loan associations. Share accounts are available at credit unions. As mentioned earlier, recent truth-in-savings regulations make it easier for savers to compare certain features of various savings accounts (and other deposit accounts), such as the annual percentage yield (APY).

Selecting a savings account. Some factors to consider when selecting a savings account (or share account) include:

- What is the interest rate?
- How often is interest compounded (and thus, what is the annual percentage yield or APY)? The more frequently the interest is compounded, the higher the APY.
- When is interest actually paid to the account? What happens if the account is closed before that date?
- Are there any penalties or fees, such as those associated with withdrawals above a specified number?
- Is there a minimum balance required before interest is earned?
- Are there any fees (or is no interest earned) on inactive accounts? What is considered an inactive account?
- What other terms or conditions could affect earnings?
- What other services are offered by the financial institution? What are the fees for these other services?

Certificates of Deposit

An alternative to a regular savings account is a certificate of deposit (CD) from banks or savings and loan associations, or a share certificate from a credit union. Besides paying a higher interest rate, CDs and share certificates differ from savings accounts in two basic ways. First, you agree to leave your money with the financial institution for a specified period of time (that is why they are called "time" deposits). If you withdraw the funds prior to that date, you pay an interest penalty for early withdrawal. Second, the financial institution usually requires a minimum deposit. Generally, the larger the dollar value placed in the CD or share certificate and the longer you agree to leave your money with the financial institution, the higher the rate of return.

Interest rates may be fixed or variable. Deregulation has led to more competition among financial institutions, with interest rates and other specifics of the CDs or share certificate now established by each financial institution.

Selecting a certificate of deposit. Some factors to consider when selecting a certificate of deposit include:

- What is the minimum deposit amount required? Typical minimum deposits are $500 and $1,000, but the minimum can be more or less.
- What is the length of maturity? Typical maturities are seven to thirty-one days, three months, six months, and one, two, three, or more years. Some financial institutions allow flexible maturities, so savers can select the length of maturity that meets their specific needs.
- What is the interest rate? Is the rate fixed or does it vary with the economy (and what is the variable market rate tied to)?

Money Market Mutual Funds

Money market mutual funds, like money market deposit accounts (MMDAs), invest in short-term securities including:

- *U.S. Treasury bills and federal agency securities.* See the discussion beginning on page 3.
- *Negotiable certificates of deposit.* Large CDs have terms negotiated between the financial institution and the lender (investor).
- *Commercial paper.* As an alternative to borrowing from banks, large, creditworthy corporations may sell commercial paper, which are short-term, unsecured promissory notes in large denominations.
- *Bankers' acceptances.* These credit instruments are complicated transactions used in the export-import business.
- *Repurchase agreements.* With "repos," as often called, the security seller agrees to repurchase (buy back) the security at a set price (higher than the initial sale price) on a specific date. Generally, repurchase agreements are large, short-term loans (sometimes only for one day or a few days).

Unlike money market deposit accounts (MMDAs) offered at financial institutions, the principal and earnings from securities held in money market mutual funds are not federally insured. However, because of the short-term nature of the investments, money market mutual funds are considered highly liquid and low-risk (depending upon the investments held in the portfolio and whether they are privately insured).

Money market mutual funds generally offer somewhat higher rates of return than MMDAs, to compensate for the slightly higher risk.

- How often is the interest compounded? What is the annual percentage yield (APY)?
- How is interest paid? Typically, interest can be left in the certificate account and added to the balance (so you are earning interest on interest, as well as principal), mailed to you quarterly or monthly, or credited to your regular checking or savings account.
- What happens when the certificate matures? If you do nothing, is the money rolled over automatically into a new certificate with the same interest rate (or a newer, current interest rate)? Are funds transferred into a checking or savings account? Does the financial institution notify you of upcoming maturity dates?
- Does the financial institution offer other services that may influence your decision to save with them (such as monthly interest statements or preference for loan approval)?

It should be noted that some brokerage firms also offer certificates of deposit. They may pay higher rates of return. Some of these CDs may not have an early withdrawal penalty. However, they are not insured.

U.S. Government Securities

The U.S. Treasury Department issues a variety of marketable securities (bills, notes, and bonds), as well as nonmarketable securities (such as Series EE and HH savings bonds) to raise funds. All are backed by the full taxing power of the federal government; thus, the interest payments and the return of principal are fully guaranteed. Further, while interest earned on these Treasury securities is subject to federal income taxes, it is not subject to state or local taxes.

Treasury Bills

The major distinction between a Treasury bill, note, and bond is the term (or length of time until maturity) of the security. For example, Treasury bills (commonly called T-bills) are short-term securities issued with maturities of 13, 26, and 52 weeks.

Treasury bills are currently issued to individuals in book-entry form, that means you receive a statement of account from the U.S. Treasury or a financial institution rather than an engraved certificate as evidence of your purchase. With book-entry securities, payment of interest and face (par) value is handled quickly and easily. Further, this system offers protection against loss, theft, and counterfeiting.

Initially, T-bills are sold at auction in minimum amounts of $10,000 and in multiples of $1,000 above the minimum. Generally, auctions for thirteen-week and twenty-six-week bills are held every week (on Monday). Auctions for fifty-two-week bills are held every four weeks (on Thursday). They are preceded by the announcement of an "offering" during the previous week.

To purchase newly issued Treasury bills directly from the U.S. government, you must first submit a "tender" or offer to buy, either in person or by mail, to a Federal Reserve Bank (or branch). The price of the T-bills is set by competitive bidders (individual investors generally submit noncompetitive tenders, rather than competitive bids). Payment for the full face value of the Treasury bill must accompany the tender. The difference between the face value of the T-bill and the discounted price (purchase price is determined by the accepted competitive bids, based on a weighted average "discount" rate, at auction), is returned to you.

For example, you would receive a check for $400 if the issue price was $9,600 for a T-bill with a face amount of $10,000 (which represents a 4 percent discount, that is, you are paying 4 percent less than you will be paid back at maturity). The $400 "refund" represents the discount (as well as the interest). Taxes are payable on the interest when you sell the T-bill (before maturity) or when you receive the face value ($10,000) at maturity—whichever comes first—rather than when you purchase it.

Persons interested in purchasing newly issued T-bills can call the Federal Reserve bank serving Oklahoma (Federal Reserve Bank of Oklahoma City, 888-333-0014) to get the results of the most recent auction, or check *The Wall Street Journal*. Or write the Federal Reserve Bank, Oklahoma City Branch, 225 Dean A. McGee Avenue, P.O. Box 25129, Oklahoma City, OK 73125-0129 for a booklet about Treasury securities and help in establishing a "Treasury Direct" account (to receive interest and principal).

Newly issued T-bills can also be purchased through financial institutions. These purchases usually involve a fee for each transaction. Previously issued T-bills (ones that other investors purchased when they were newly issued and now want to sell before they reach maturity) can be purchased and sold privately or in the secondary market through stockbrokers and other securities dealers. Again, a fee is generally charged. Buying shares in mutual funds also offers a way to invest in T-bills, both newly issued and previously issued ones.

Secondary market bid (offers to buy) and ask (offers to sell) discount rates, as well as yield to maturity information, are often printed in daily newspapers and investor publications like *The Wall Street Journal* and *Barron's*. The annualized yield to maturity information is probably of most interest to beginning investors because it can be used when comparing rates of return on other investments.

If you held a T-bill until maturity, the face amount is paid to you through your financial institution. If you purchased one directly from a Federal Reserve Bank (or branch), you also have the option to note on the original tender form that you wish to reinvest the funds automatically (roll-over) at maturity.

Treasury Notes and Bonds

Treasury notes and bonds have longer maturities than Treasury bills. Notes have a fixed maturity of two to ten years from date of issue. Bonds have a fixed

maturity of over 10 years. Both may be issued for $1,000 and multiples thereof (with the exception of two and three year notes, when the minimum is $5,000). Like T-bills, currently Treasury notes and bonds are issued to individuals in book-entry form (although there are some older, registered notes and bonds still in the hands of investors).

The specific terms of newly issued notes or bonds (term, auction date, maturity date, minimum purchase, and closing time for the offering) are provided in the public offering announcement. The Federal Reserve Bank of Oklahoma City provides this information, as well as the results of recent auctions. This information can also be found in the *The Wall Street Journal*. The schedule for the sale of notes and bonds varies. As mentioned earlier, you can also write or call the Federal Reserve Bank for a booklet on buying Treasury securities and help in establishing a "Treasury Direct" account.

After the sale of Treasury notes or bonds is publicly announced, a prospective purchaser may apply in person or by mail at a Federal Reserve Bank (or branch), according to the time limits set by the Treasury for that particular offering. Newly issued notes and bonds may also be purchased though financial institutions—generally for a fee. Some mutual funds also invest in Treasury notes and bonds.

Treasury notes and bonds carry a fixed-interest (coupon) rate, that is established at the initial issue auction by competitive bidders. This fixed-interest rate enables purchasers to determine their annual interest earnings quickly by applying this rate to the face value of the note or bond. For example, a $1,000 note with a coupon rate of 9 percent provides earnings of $90 a year (as semiannual payments, in this case $45).

You receive interest payments up to the day the security is sold or at maturity, whichever occurs first. Treasury notes and bonds do not continue to earn interest after they reach maturity. Federal income taxes are payable on interest as received. Capital gains or losses occur if the purchase price and face value at maturity (or market value, if sold before maturity) differ.

Generally, Treasury notes and bonds are not "callable" (i.e., cannot be "called" or redeemed by the Treasury before maturity). However, they are highly marketable. Like T-bills, previously issued notes and bonds can be purchased and sold in the secondary market through stockbrokers and other securities dealers, as well as through mutual funds shares. A fee is often charged for these transactions.

If you hold a book-entry note or bond until maturity, the face amount is paid to you through your financial institution. Older, registered Treasury notes and bonds may be redeemed at Federal Reserve Banks (or branches) or through the Bureau of the Public Debt. If you purchased Treasury notes and bonds directly from a Federal Reserve Bank (or branch), you also have the option to reinvest the funds automatically (rollover) at maturity.

Savings Bonds

U.S. savings bonds are direct obligations of the U.S. Treasury and are considered to be a safe and secure savings vehicle. Over the years, the federal government has issued a variety of different series. Most series have been either replaced or discontinued. For example. Series E and H savings bonds are no longer being sold, although those less than forty years old continue to earn interest. Currently, Series EE and

Federal Agency Securities

Some U.S. government agencies, such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), Tennessee Valley Authority (TVA), Student Loan Marketing Administration (SLMA), and the Federal Home Loan Bank (FHLB) issue bonds. These federal agencies, among others, have been created by Congress over the years and operate under federal charter and supervision.

The bonds issued by federal agencies are not direct obligations of the U.S. Treasury, but they involve federal government backing or sponsorship in one way or another. While the U.S. government does not guarantee the interest or principal on these securities (with a few exceptions), they are often seen as very safe (it seems unlikely the federal government would let the debt of one of its agencies be in default).

Because these are not direct Treasury obligations, the returns on federal agency bonds are usually higher than on Treasury bills, notes, and bonds. Interest may or may not be subject to state and local income taxes, depending upon the issuer. The yields change from day to day and vary with the specific agency borrowing the funds.

Bid and ask prices, as well as yield to maturity information, are quoted similar to those of Treasury notes and bonds. This information can be found in large daily newspapers and investor publications, or obtained through securities dealers.

Some of these securities are short-term, others are long-term. Minimum investments also vary. Initial issues can be purchased though stockbrokers and other securities dealers. Previously issued securities can be purchased and sold in the secondary market. However, individual investors tend to hold agency debt only indirectly, such as through mutual funds or pension funds.

HH savings bonds are being issued. There are no purchase or sale fees charged when handling savings bonds transactions.

Bonds are registered Treasury securities and may be held in one of three ways:

- *Single ownership.* Only the owner can redeem the bond to determine who inherits it at his or her death (although a payable on death, or POD, clause can be used to identify who the bond goes to in the event of the owner's death);
- *Two persons are co-owners.* Either co-owner can redeem the bond and the surviving co-owner becomes sole owner at the death of the other co-owner; or
- *One owner and one beneficiary.* Only the registered owner can redeem the bond during his or her lifetime, but the beneficiary becomes the owner of the bond when the original owner dies.

Only under limited circumstances, such as a divorce, can savings bonds be transferred and reissued with a change in registration.

Series EE. Series EE savings bonds earn interest until they are redeemed (cashed), but not more than thirty years (final maturity). They are purchased for one-half of their face value (i.e., a $100 bond costs $50; a $200 bond costs $100) from financial institutions who are "qualified" as savings bonds agents and through employer-sponsored payroll savings plans. The issue date is the first day of the month in which the funds are received by the financial institution.

Bonds are available in $50, $75, $100, $200, $500, $1,000, $5,000, and $10,000 denominations (although not all denominations are available through payroll savings plans). There is a maximum per calendar year purchase limit of $30,000 face amount ($15,000 purchase price) on Series EE savings bonds. For purposes of the calendar-year limit, bond purchases by individuals (i.e., held in the person's name alone or with a beneficiary) are attributed to the individual, while purchases with others (as co-owners) can be attributed to either owner.

Series EE bonds purchased on or after March 1, 1993, and before May 1, 1995, have an original maturity of eighteen years (the period of time it takes to reach face value at the guaranteed minimum interest rate at time of issue). The guaranteed minimum rate of return for these bonds if 4 percent, compounded semiannually (which represents a 4.04 percent annual percentage yield or APY).

Since November of 1982, Series EE bonds held five years or longer earn market-based interest rates that are tied to Treasury notes (with five years left until maturity). Since May 1, 1995, Series II bonds earn market rates beginning at purchase. You can get the current market rate by calling 1-800-4US-BOND (1-800-487-2663).

Bonds must be held for at least six months after the issue date before they can be redeemed. They can be redeemed at financial institutions, at which time the interest which has been earned is subject to federal income taxes (although the bond owner has the option to pay taxes on interest as it accrues, rather than wait until it is redeemed or at final maturity). When Series EE bonds (or E bonds) reach final maturity, the owner has one year to decide whether to redeem the bonds (and pay any income tax due on the accrued interest) or exchange the bonds for Series HH bonds (and further defer the tax liability on the accrued interest from the older bonds for up to 20 years, the total life of a Series HH bond).

Saving for Education Costs

Beginning with Series EE savings bonds issued on or after January 1, 1990, eligible taxpayers may be able to redeem them free of federal income tax (as well as state and local taxes) on the accrued interest. For the interest to be totally excluded from federal taxes, the bond owner must spend an amount equal to the bond proceeds (principal and interest) on higher education for themselves, their spouse, or a dependent. If the bond proceeds are greater than the "qualified" educational expense, only a proportionate share of the interest is not subject to federal tax.

The owner of the bond has to be at least 24 years of age. The bond proceeds must be used for qualified educational expenses, including tuition and fees (with a few exceptions), but do not include room, board, and books. Bonds issued in the name of a child (as owner or co-owner) are not eligible for this tax exclusion (although the tax exclusion may be used if a child is registered as the beneficiary). The bond can be purchased by anyone, but to qualify for this tax exclusion, the educational expenses must be for the bond owner, a spouse, or a dependent.

Income limits apply in the year the bonds are redeemed. For the 1996 tax year, single persons with modified adjusted gross incomes (which includes the bonds' interest before the exclusion) of $50,850 or less and married persons filing joint returns with modified adjusted gross incomes of $76,250 or less are eligible for the full interest exclusion. For incomes between $50,850 and $65,850 for single filers ($76,250 and $106,250 for joint filers), the exclusion is phased out proportionally. Married couples filing separately cannot take advantage of this tax exclusion. The income levels are indexed for inflation each year, rounded to the nearest multiple of $50.

Series HH. Series HH bonds provide current income and are purchased at face value in denominations of $500, $1,000, $5,000, and $10,000. They cannot be purchased with cash, however, but must be obtained in exchange for Series EE bonds that are at least six months old (or Series E bonds, U.S. Savings Notes, or reinvested, matured Series H bonds). If the value of the savings bonds to be exchanged is more than $500, but not enough for the next larger size HH bond, enough cash may be added to purchase a bond of the next higher $500 multiple.

Interest is paid semiannually at a fixed rate for the first ten years the bond is held. The rate can change for an additional ten years. After final maturity (20 years), they no longer earn interest. Interest payments are deposited in the owner's financial institution by direct deposit.

The application for exchanging other bonds for Series HH bonds is handled by qualified financial institutions who can also process requests for redeeming (cashing) them. The Series HH bonds themselves are issued by a Federal Reserve Bank.

This publication is not intended to provide a complete and in-depth discussion on savings and investments. Rather, it is designed to provide an introduction to common savings and investment planning and to help the beginning investor start to design and implement a savings and investment plan. Investment alternatives more suited to a discussion on retirement planning or insurance, those which require greater expertise on the part of the investor, and those which generally involve a higher degree of risk are also not included in this publication.

Information in this publication is based on the laws in force and information available on the date of publication.

The use of trade names is not intended as an endorsement, nor is criticism of unnamed firms and products implied.

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