

## **A fresh look at overdraft protection**

**By Barrett Nichols, founder and CEO, BSG Financial**

With the innumerable regulatory issues and fiduciary responsibilities of banks, it is not surprising that management and boards of directors must spend much of their time with issues of compliance, leaving little time to devote to innovation or examining new business models. This is not true, however, of their non-bank competitors. In today's economy, the line between what is a financial institution and what isn't is growing progressively thinner. Credit card issuers, consumer finance companies, secured lenders such as mortgage companies, automobile financiers and, now, even payday lenders have entered the market with creative ways to take business from banks, increase profits from users, and answer the needs of consumers.

A prime example is the temporary financial shortfall in which consumers often find themselves when a payment is due and there are no ready funds with which to pay. Usually, their only recourse is late payment, which can have serious or even catastrophic consequences, such as a poor credit score, which can prevent a family from buying a home or acquiring badly needed transportation. Late payments can also trigger automatic and astronomical increases in interest and penalties. For example, a credit card's "introductory" rate of 6.9 percent can jump to 18.5 percent or higher, with no chance of ever coming down to the low rate again.

There is an entire industry for small-dollar, short-term consumer funding. But this is a market that depository institutions have, to a large degree, wittingly or willingly ceded over the years to non-depository institutions due to consumer advocacy group criticism and unstructured regulatory guidelines.

### **Why have many banks avoided small-dollar, short-term funding?**

There are three primary reasons why banks have avoided this obvious financial need. These are: concerns about (1) usury laws and regulations, (2) extraordinary expense to underwrite loans and (3) customer or member relations. Banks also underestimate their customers' desire for better alternatives and the importance of this service.

On Feb. 18, 2005, the Office of Thrift Supervision (OTS) and Federal Reserve Board, Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA) and Office of the Comptroller of the Currency (OCC) announced final guidance on overdraft protection programs, which was first proposed in June 2004. The final guidance is intended to assist financial institutions in the responsible disclosure and administration of overdraft protection services.

### **Why courtesy overdraft protection is good for a bank's customers**

The previously mentioned credit card automatic interest escalation is just one example of the negative impact of a late payment. There are many other, often subtle, small-dollar short-term financing schemes. Some of these include a payment penalty (in addition to the higher interest rate) on a late credit card payment, a larger mortgage payment for later date payment, and even different amounts on utility bills, depending on when it is paid.

Why do these extra charges not result in irate customers? The primary reason is because they are triggered by their own action (or more accurately, their inaction). Oftentimes, a bank customer will knowingly make the choice to overdraw and pay the overdraft fee to avoid the alternative and more onerous penalties imposed by credit card companies, merchants, etc.

There are at least two compelling reasons why a bank's customers – especially those who may not qualify for traditional overdraft lines of credit or linked accounts – are better served by courtesy overdraft protection. First, it helps preserve the customer's good credit rating by avoiding late payments. Since virtually all credit decisioning today is based on credit scores, the availability of credit and its costs are directly related to this score. The savings to a bank's customer over the life of a long-term loan as a result of a lower rate can be astronomical.

Secondly, the fee for courtesy overdraft protection can cost less than alternative methods of small-dollar, short-term funding. Industry-wide practices call for financial institutions to charge non-sufficient fund fees – even if transactions are not paid, but returned. The avoidance of these returned checks and the resulting inconvenience and embarrassment are very compelling examples of how a bank's customers are well served by having courtesy overdraft protection.

### **How the bank benefits from a courtesy overdraft protection program**

There are two primary ways banks benefit from offering courtesy overdraft protection--improved customer relations and increased revenue.

As earlier mentioned, a responsible approach to courtesy overdraft protection also offers positive benefits to customers, which is beneficial to the bank's customer relations. One of the most important elements of the program is that a potentially negative customer contact (returned checks as a result of insufficient funds) is turned into one that delivers value. Banks can even take their help a step further by monitoring accounts in order to provide usage volume, profitability and credit performance as well as offering credit and debt counseling for accountholders with special financial needs.

In addition, according to an internal study, BSG Financial found that bank clients with assets of \$500 million to \$1 billion could experience an annual increase of as much as two NSF's per demand deposit account when a responsible courtesy overdraft protection program is offered. Multiply this increase in NSF's by the total number of retail accounts and a bank's NSF fee, and you can easily

calculate the financial impact overdraft protection programs can have on an institution.

### **Delivering and selling positive value**

Because of the nature of a courtesy overdraft protection, it is very important that the program fully comply with all banking regulations and that it performs as both the bank and its customers expect. One of the best strategies for accomplishing this goal is to treat the program as a separate operation and profit center, managed by a top-tier manager with executive and board oversight.

### **What banks MUST know about guidance and structuring courtesy overdraft protection programs**

In February 2005, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA) issued joint guidance on overdraft protection programs. The Office of Thrift Supervision (OTS) separately issued similar guidance on overdraft protection programs. The joint guidance and OTS guidance address the disclosure, administration, safety and soundness, and legal risks of overdraft protection programs in order to ensure that all banks and overdraft program providers are moving in a customer-conscious direction.

The joint guidance and OTS guidance were not significantly different from the proposed interagency guidelines made available for comment in July 2004. The most notable differences include: the decision by OTS to issue its own guidelines, which exclude the legal risks section initially set forth in the proposed guidelines; the inclusion of a best practice not to manipulate transaction-clearing rules in the OTS guidance; and the extension by all regulatory agencies of the proposed 30-day charge-off period to 60 days for overdrawn accounts.

<b>SAFETY &amp; SOUNDNESS CONSIDERATIONS</b>	
1. Written Policies	Adopt express account eligibility standards and well-defined and properly documented dollar limit decision criteria.
2. Monitor Accounts	Monitor accounts on an ongoing basis and be able to identify consumers who may represent an undue credit risk.
3. Reports to Management	Provide reports to enable management to identify, measure, and manage overdraft volume, profitability, and credit performance on a regular basis.
4. Repayment	Establish specific timeframes for when consumers must pay off their overdraft balances.

5. Suspension	Establish procedures for the suspension of overdraft services when the accountholder no longer meets the eligibility criteria, as well as for when there is a lack of repayment of an overdraft.
6. Charge-Off Requirement	Charge off overdraft balances when considered uncollectible, but no later than 60 days from the date first overdrawn.
7. Repayment Plan	Guidelines allow an extended repayment plan “in some cases,” however the existence of the repayment plan would not extend the charge-off determination period beyond 60 days.
8. Recovery	Report as a recovery any payments received after the account is charged off (up to the amount charged off against allowance).
9. Overdraft Rewritten as Loan Obligations	Timeframes in the FFIEC Uniform Retail Credit Classification and Account Management Policy would apply when overdrafts are rewritten as loan obligations, in accordance with an institution’s loan policy and supported by a document assessment of that consumer’s ability to repay the charge-off.
10. Reporting of Income and Loss Recognition	Institutions should follow GAAP and if applicable the instruction for the Call Report and NCUA 5300 Call Report
11. Reporting on Regulatory Reports	Report overdraft balances as loans on regulatory reports. Accordingly, charge off overdraft losses against the allowance for loan and lease losses. [The OTS guidelines did not have a parallel provision.]
12. Loss Estimation	The agencies expect all institutions to adopt rigorous loss estimation processes to ensure that overdraft fee income is accurately measured. The OTS guidelines did not have a parallel provision.
13. Unused Commitments	If an institution advises accountholders of the available amount of overdraft protection, the institution should report the available amount of overdraft protection with legally binding commitments for Call Report, and NCUA 5300 Call Report purposes. These available amounts, therefore, should be reported as “unused commitments” in regulatory reports. The OTS guidelines did not have a parallel provision.
14. Risk-Based	The agencies also expect proper risk-based capital

Capital	treatment of outstanding overdrawn balances and unused commitments. Overdraft balances should be risk-weighted according to the obligor.
15. Due Diligence of Third-Party Vendors	Institutions entering into overdraft protection contracts with third-party vendors must conduct thorough due diligence reviews prior to signing a contract.

**Safety and soundness – guidance recommendations**

The federal guidance recommends that banks should identify consumers who may represent an undue credit risk. Prudent overdraft protection providers suggest an automatic suspension of accounts that are 20 days overdrawn, helping banks identify consumers who may represent an undue credit risk. In addition, it is recommended that banks send frequent users a counseling letter and make follow-up phone calls to determine the reason for overdrawing the account on a regular basis.

Overdraft protection programs should be administered and adjusted, as needed, to ensure that credit risk remains in line with expectations. Banks should monitor charge-offs on a monthly basis for overdraft and non-overdraft accounts and compare them as a percent of revenue for each category. Large discrepancies between the two categories could indicate a need for changes to the screening criteria or suspension policy.

The safety and soundness guidance states overdraft balances should be charged off when considered uncollectible, but no later than 60 days from the date first overdrawn. Conservative overdraft program providers recommend banks charge off overdrawn balances at 45 days. The existence of a repayment plan does not extend the charge-off determination period beyond 60 days from the date of the original overdraft, which may require accounting adjustments to repayment programs.

If an institution advises accountholders of the available amount of overdraft protection – these amounts should be reported as “unused commitments” in regulatory reports. For most overdraft protection programs, banks will need to query “total commitments” or total available overdraft and subtract “used commitments” or the sum of overdraft balances to get “unused commitments.” The agencies expect proper risk-based capital treatment of outstanding overdrawn balances and unused commitments. Although this requirement will add to the administrative burden of taking overdraft balances and “unused commitments” into consideration, banks will not need to maintain additional capital reserves, since these commitments are less than one year maturity and unconditionally cancelable – resulting in a zero percent credit conversion factor.

**LEGAL RISKS (The final OTS guidelines do not have a legal risk section.)**

1. Review by Counsel	Institutions should have their overdraft protection programs reviewed by counsel for compliance with all applicable laws prior to implementation.
2. Monitor Applicable Laws and Regulations	Institutions should monitor applicable laws and regulations for revisions and to ensure that their overdraft protection programs are fully compliant.
3. Federal Trade Commission Act/ Advertising Rules	Institutions must avoid engaging in deceptive, inaccurate, misrepresentative, or unfair practices, and closely review all aspects of their overdraft protection programs, especially any material that informs consumers about the programs.
4. Truth in Lending Act/Regulation Z	Currently, fees for paying overdraft items are not considered finance charges if the institution has not agreed in writing to pay overdrafts; however, Regulation Z would be triggered if an overdraft repayment loan (usually offered to those who cannot repay their overdrafts) is payable by written agreement in more than four installments. Regulation Z will also be triggered where such loans are subject to a finance charge.
5. Equal Credit Opportunity Act	Under the ECOA and Regulation B, creditors are prohibited from discriminating against an applicant on a prohibited basis in any aspect of a credit transaction.
6. Truth in Savings Act	When overdraft protection services are added to an existing deposit account, advance notice to the accountholder may be required; for example, if the fee for the service exceeds the fee for accounts that do not have the service.
7. Electronic Fund Transfer Act	If, under an overdraft protection program, a consumer could overdraw an account by means of an ATM withdrawal or POS debit card transaction, both are EFTs subject to EFTA and Regulation E. As such, periodic statements must be readily understandable and accurate regarding debits made, current balances, and fees charged. Terminal receipts also must be readily understandable and accurate regarding the amount of the transfer.
<b><i>BEST PRACTICES</i></b>	
1. Avoid Promoting Poor Account	Institutions should not market the program in a manner that encourage routine or intentional overdrafts.

Management	Institutions should instead present that program as a customer service that may cover inadvertent consumer overdrafts.
2. Overdraft Protection Programs vs. Alternatives	Fairly represent overdraft protection programs and alternatives. When informing consumers about an overdraft protection program, inform consumers generally of other overdraft services and credit products, if any, that are available at the institution and how the terms, including fees, for these services and products differ.
3. Staff Training	Train staff to explain program features and other choices. Train customer service or consumer complaint processing staff to explain their overdraft protection program's features, costs, and terms, including how to opt out of the service.
4. Discretionary Nature	Clearly explain discretionary nature of the program.
5. Overdraft Protection Service vs. "Free" Account Features	Distinguish overdraft protection services from "free account features." Institutions should not promote "free" account and overdraft protection programs in the same advertisement in a manner that suggests the overdraft protection program is free of charges.
6. Overdraft Protection Program Fees	In communications about overdraft protection programs, clearly disclose the dollar amount of the fee for each overdraft and any interest rate or other fees that may apply.
7. Overdraft Fees and the Overdraft Protection Dollar Limit	Clarify that fees count against the disclosed overdraft protection dollar limit.
8. Multiple Fees	Demonstrate when multiple fees will be charged.
9. Transaction Clearing Policies	<p>Explain impact of transaction clearing policies. Transactions might not be processed in the order in which they occurred, and the order in which the institutions processes and receives transactions can affect the total amount of overdraft fees incurred.</p> <p>Savings associations should also clearly disclose rules for processing and clearing transaction. [See also item 18 below.]</p>
10. Type of	Illustrate the type of transactions covered. Clearly

Transactions Covered	disclose that overdraft fees may be imposed on transactions such as ATM withdrawals, debit card transactions, etc.
11. Election or Opt-Out Service	Provide election or opt-out of service. Obtain affirmative consent of consumers to receive overdraft protection. Alternatively, where overdraft protection is automatically provided, permit consumers to “opt-out” of the program and provide a clear consumer disclosure of this option.
12. Transactions that Trigger Fees	<p>Alert consumers before a transaction triggers any fees. When consumers attempt to withdraw or transfer funds made available through an overdraft protection program, provide a specific consumer notice, where feasible, that completing the withdrawal may trigger the overdraft fees. This notice should be presented in a manner that permits consumers to cancel the attempted withdrawal or transfer after receiving the notice. If this is not feasible, then post notices (e.g., on proprietary ATMs) explaining that transactions may be approved that overdraw the account and fees may be incurred.</p> <p>OTS guidelines only – If canceling the transaction is not feasible for a particular type of transaction, then savings associations should allow consumers the choice to make access to the overdraft protection program unavailable by transaction type, even if it results in limiting access to the overdraft protection amount only to check transactions. [This sentence is unique to the OTS guidelines.]</p>
13. Distinguish Balances from Overdraft Protections Funds	Prominently distinguish balances from overdraft protection funds availability.
14. Notice to Consumers	Promptly notify consumers of overdraft protection program usage each time used.
15. Daily Limits	Consider imposing a cap on consumers’ potential daily costs from the overdraft program.
16. Monitor Usage	Monitor excessive consumer usage, which may indicate a need for alternative credit arrangements or other services, and inform consumers of these available options.

17. Fairly Report Program Usage	Institutions should not report negative information to consumer reporting agencies when the overdrafts are paid under the terms of the overdraft protection programs.
18. Manipulation of Transaction Clearing Rules	OTS guidelines only – Do not manipulate transaction-clearing rules. Transaction-clearing rules (including check-clearing and batch debit processing) should not be administered unfairly or manipulated to inflate fees. [This sentence is unique to the OTS guidelines.]

**Best practices—guidance recommendations**

When explaining the impact of transaction-clearing policies, the guidance recommends including a statement in customer communication. The statement should explain that transactions might not be processed in the order in which they occurred, and the order in which transactions are processed can affect the total amount of overdraft fees incurred. It is recommended that to provide sufficient disclosure, banks add the information to the deposit agreement and service policy/brochure.

It is important to note that only the OTS guidance included a ruling stating that banks may not manipulate transaction-clearing rules. The OTS guidance specifically states, “transaction-clearing rules (including check-clearing and batch debit processing) should not be administered unfairly or manipulated to inflate fees.” Responsible overdraft protection providers recommend banks should identify which transactions types are grouped together, in what order these groups are processed and the order within the group that items are processed. From here, banks can evaluate transaction-clearing policies and clearly address practices.

When consumers attempt to withdraw or transfer funds made available through an overdraft protection program, provide a specific consumer notice, where feasible, which states that completing the withdrawal may trigger overdraft fees and permit consumers to cancel the attempted withdrawal or transfer after receiving the notice.

Most banks will not be able to provide an interactive alert without incurring significant costs. If this is the case, cautious overdraft protection providers recommend documenting the reason this solution is not feasible. While most banks may not be able to limit the program on an ad hoc basis by transaction type, banks that allow consumers to opt out of the entire program at any time should address these concerns.

When disclosing a single balance for an account by any means, banks should not include overdraft protection funds in the account balance. The amount disclosed at an ATM or through the Internet or telephone access should represent the accountholder’s available funds without any overdraft protection

funds included. Banks may provide more than one balance, if it prominently identifies the balance without overdraft protection funds included.

<b>REGULATION DD AMENDMENTS</b>	
1. Effective Date	July 1, 2006
2. Opening Account Disclosures	Must state categories of account transactions for which an overdraft fee may be imposed in account opening disclosures.
3. Advertisement Disclosures**	All advertisements of overdraft protection services must include disclosure of the overdraft fee; the categories of transactions for which an overdraft fee may be imposed; repayment time period; and circumstances under which an institution will not pay on overdraft.
4. Periodic Statements**	If overdraft protection services are promoted by advertisement, the institution is required to provide periodic statements, which include separate disclosures of total dollar amount of fees imposed for 1) returning items NSF and 2) imposed for paying overdrafts.

\*\* Regulation DD provides examples of advertisements pertaining to overdraft programs that would be considered misleading, inaccurate, or misrepresent a depository institution's deposit account.

### **Regulation DD--guidance recommendations**

It is important to note that on May 19, 2005, the Federal Reserve announced final amendments to Regulation DD as it pertains to overdraft and bounce protection services. The joint guidance, OTS guidance and Regulation DD amendments apply to all automated or manually administered overdraft protection programs. While following the guidance was immediately effective, the Regulation DD amendments will become mandatory July 1, 2006.

Of particular significance in the amendments is the requirement that banks include on periodic statements (a) the total dollar amount of fees imposed for paying overdrafts, and (b) the total dollar amount of fees imposed for returning items NSF for the statement period and for the calendar year-to-date *if* the overdraft program is considered "promoting the payments of overdrafts." Regulation DD does not offer rules for determining what distinguishes a communication or advertisement as one that "promotes the payment of overdrafts." However, based on the examples provided, a qualification letter to an accountholder – even one that responsibly explains how overdrafts will be handled, discloses the qualified limit (rather than promotes the use of the

service), reveals alternatives to the courtesy overdraft program, and explains that the payment of overdrafts is not a line of credit—might now be interpreted by regulators as promoting the payment of overdrafts.

Until further clarification is provided, banks currently implementing responsible and compliant courtesy overdraft programs should continue to send qualification letters as usual until June 30, 2006. Hopefully, at that time, the definition of “promoting the payment of overdrafts” will be clarified.

As the amendments to Regulation DD are now stated, many institutions and their core system vendors – to err on the side of caution – may be required to alter monthly statements to re-state fees, which are already available to their customers.

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