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Do You Know Your Paid vs. Returned Overdraft Ratio?

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For the Intelligent Banker

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Your Paid vs. Return Ratio

Protect Income as the Next Shoe Falls

Overdraft revenues are often a significant source of Non-Interest Income for financial institutions. Could recent regulatory proposals be a hint at the start of a forthcoming change in interpretation of banking regulations that could further erode this important source of revenue?

For years organizations have offered the convenience of Overdraft Privilege as a means to allow customers access to additional liquidity, or the ability to "play the float" on expected deposits. Financial Institutions have accepted the risk on non-payment of the overdraft in exchange for a fee per transaction. Many customers view this as a safety net for a potential error or misjudgment on their personal record keeping. Some customers embrace this ability to overdraw their account as a mechanism to maintain personal liquidity, at a defined cost. Whatever the case, regulatory attention on Overdraft Privilege has been heightened and has caused revision to these programs over the last five years.

The Slippery Slope

Since its inception, the Consumer Financial Protection Bureau (CFPB) has viewed the business practice of allowing customers the ability to overdraw deposit accounts as a satanic service. The CFPB's published disdain on overdraft privilege programs was contained in the CFPB Director's quote in the June 2013 report on the impact of overdraft services on consumers:

"Consumers need to be able to anticipate and avoid unnecessary fees on their checking accounts. But we are concerned that overdraft programs at some banks may be increasing consumer costs," said CFPB Director Richard Cordray. He went on to say that, "What is often marketed as overdraft protection

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may actually be putting consumers at greater risk of harm."

In our thinking, consumers can avoid unnecessary fees on their checking account by keeping a check register, balancing their account back to their required monthly statement, and not spending more than you have in your account. Personal financial responsibility is not an option, and is taught starting at the elementary grade levels.

Within that same June 2013 report, the CFPB self-described their mission and their focus upon overdraft programs:

"The Consumer Financial Protection Bureau is a 21st century agency that helps consumer finance markets work by making rules more effective, by consistently and fairly enforcing those rules, and by empowering consumers to take more control over their economic lives."

"If the CFPB finds that" *overdraft and Non-sufficient funds* "policies or practices do not protect consumers in accordance with federal consumer protection law, it will use its authorities to provide such protection. The goal is to make checking accounts more fair, transparent, and competitive and to ensure consumers are empowered to take control over their economic lives."

Formal guidance was provided by the FDIC to all banks with the November 24, 2010 Overdraft Payment Supervisory Guidance (2010 Supervisory Guidance). Automated Overdraft programs were the self-stated focus of the *2010 Supervisory Guidance*. By the FDIC definition, *"*automated overdraft payment programs typically rely on computerized decision-making and use pre-established criteria to pay or return specific items. There is little to no case-by-case review and decision-making with respect to an individual customer or item."

Reviewing the most recent FDIC Compliance Manual, multiple layers of regulatory pronouncements and guidance were published. This included warnings with regards to Unfair or Deceptive Acts or Practices (UDAP) as covered in Section 5 of the FTC Act (Federal Trade Commission), and the definition of how organizations are to teach customers as to product offerings and alternatives and limit their own fee assessments:

Give customers the opportunity to affirmatively choose the credit product most suitable for their financial needs, including overdraft payment products

Ensure that customers understand overdraft payment programs and alternative product choices

Appropriately monitor accounts and take meaningful and effective action to reach customers frequently using automated overdraft programs to inform them of lower-cost alternatives

Structure transaction clearing practices in a neutral manner not intended to maximize overdraft-related fees charged to customers

Establish appropriate daily limits on fees.

Changes to Regulation E became enforceable on July 1, 2010. Consumers were required to Opt-In to be allowed to overdraw their account with debit/ATM cards at a point of sale terminal or at an ATM. The end result five years later was that many more customers than the CFPB would have expected have chosen to Opt-In. There is even a narrative that Banks, through education and persuasion have a higher level of Opt-In customers than Credit Unions, implying that Credit Unions are more customer centric. And now, as result of the Dodd-Frank Act, the CFPB is the regulatory owner of Regulation E. Consumer advocacy groups like the Pew Charitable Trusts, continue to produce misleading statistics and information with which they lobby the CFPB as to consumer acceptance and understanding of overdrafts Overdrawn Persistent Confusion and Concern About Bank Overdraft Practices; June 2014). It would seem that overdrawing your account and having someone else make good on your obligations is a right and not a privilege.

The Next Shoe?

Financial Institutions have been living within this labyrinth of regulatory scrutiny on the changing view of banking business practices for the past five years. But where is all of this overdraft privilege attention headed? The answer might be found in the CFPB proposed rule that was put out for public comment on November 10, 2014, <u>Prepaid Accounts under the Electronic Fund Transfer Act (Regulation E) and the Truth in Lending Act (Regulation Z)</u>. Many may not initially draw the connection of overdraft privilege to prepaid cards (defined as reloadable and payroll cards), as this is a product that few institutions directly offer. But the American Bankers Association certainly drew the connection and submitted on March 23, 2015 a lengthy commentary which in part stated, "the proposal amounts to an effective ban on offering overdraft services or credit through a prepaid card because of the operational and compliance costs and risks. While we support the Bureau's goal to protect consumers, the proposal will harm consumers by limiting consumer access to overdrafts services and credit. Moreover, as the Bureau's own consumer testing demonstrates, the proposal will sacrifice the preferences of those who are interested in overdraft services." The most egregious element in our opinion of the proposal if enacted (in its 870 page entirety) would make Regulation Z, the governance for customer terms and overdraft fees on prepaid (and payroll) cards.

If Regulation Z succeeds in being applied to the terms and overdrafts on Prepaid and Payroll cards*, is it* a huge leap of faith to see this approach applied to card-based transactions on checking accounts; a trade of Reg E for Reg Z? What would be the impact to Overdraft Revenues if this were to become the adopted methodology at some future date?

Getting Out In Front

Faced with a dramatic decrease in allowable fees on overdrafts, is it unreasonable to think that we will be headed back three decades with the acceptance of presentments. Said another way, are we destined to return (no pun intended) to the time when Non-Sufficient Fund returns are the predominate method of posting? If so, what will be the outrage from our retail customers? What will be the outrage from our merchant customers? As was suggested by a CEO friend of CMPG, maybe as an industry we ought to revisit for all concerned what a month of 100% returns does to the payments eco-system.

We see the key issue as being the paid versus return ratio on nightly posted transactions. For Regulation Z to apply, in our view, a payment of a presentment where there are insufficient funds in the account has to be made. Even the FDIC's *2010 Supervisory Guidance* is shorthand for Overdraft *Payment* Supervisory Guidance. One of the problems with the card-based activity is you cannot return a card-initiated pinned ATM transaction, because the money has 'left the building'. Pinned point of sale transactions operate instantly like an ATM transaction. Signature-based point of sale transactions use an authorization and upon authorization must be honored when the settlement of the transaction is presented, even if it occurs days later than the authorization. Then you add the complication as to whether a charge can be levied for having to force-post a transaction (to an account without a Reg E Opt-In) that you are obligated to accept and post.

That is a lot of moving parts to rationalize and understand. Below, are some of what we see as some of the potential discussion and data points you need to have identified prior to your next strategy sessions:

What is your percentage of items that are paid Overdrafts versus returned Non-Sufficient Funds (NSF)?

How many of your paid overdrafts are force posted?

How many of your paid overdrafts are without fees?

What are your fee structures for Overdrafts versus NSFs?

How have you chosen to address customer Opt-In for overdrafts caused by card transactions?

Do you use a continuous overdraft fee, and if so how much of your revenue is derived from this fee?

Do you utilize a limit for either Overdrafts, NSFs or a combination daily?

When do you post transactions to your 'account of record', and in what order or sequence?

What are the criteria being used to determine whether an item is paid versus returned?

Given the number of paid items that could be at risk in the future, what would you change in your criteria to reduce your paid item percentage?

Do you have an ability to test your assumptions to be prepared for any change circumstance?

Does it make sense to begin the process of moving these percentages of paid versus return ahead of any regulatory pronouncement or action to slow customer impact?

Would you continue to offer paid overdraft privilege in the face of drastically reduced income for the risk and efforts of this service?

Does this change you loss provision strategies?

Are you sufficiently staffed in your returns area for an operational reversion?

While still admittedly conjecture at this point, as the comments to the CFPB on the Prepaid Card proposal have only recently been sent, it is never too early to begin the strategic thought process on a topic that represents such a major element of profitability for most organizations.

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