

The State of the Overdraft

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2009 was an interesting year for banking in general and overdraft programs specifically.

- The Federal Reserve announced changes to Reg DD, effective January 1 of this year, which required all banks to show NSF & OD fees paid "cycle to date" and "year-to-date" on consumer statements.
- In November the Fed published changes to Reg E affecting how banks charge for overdrafts on one-time debit card and ATM transactions.
- Congress is considering even more changes with the Wall Street Reform and Consumer Protection Act (HR 4173), which passed in the House by five votes back in December, and two new bills (HR 3904 and S 1799) currently in committee.

The implications from the changes to Reg E and the proposed legislation on Capitol Hill regarding overdrafts have the potential to make 2010 another very interesting year for bankers.

On November 12, 2009, the Federal Reserve Board announced a final rule (Final Rule) amending Reg E that prohibits banks from charging consumers fees for paying overdrafts on automated teller machine (ATM) and one-time debit card transactions, unless the consumer consents, or opts in, to the overdraft service for those types of transactions. The term "one-time debit card transactions" includes any non-recurring debit card transaction regardless of whether the card is used at a point of sale terminal, online transaction or a telephone transaction.

For all accounts opened on or after July 1, 2010, the bank will be required to obtain the account holder's affirmative consent before charging a fee on a one-time debit card transaction or ATM transaction pursuant to an overdraft service. For existing accounts, those opened before July 1, 2010, the effective date is August 15, 2010. Customers must be given a reasonable opportunity to opt-in to the service. A customer opts-in to the service only after the customer is notified of the bank's overdraft service, affirmatively consents to participate in the overdraft service for one time debit card and ATM transactions and receives a written confirmation of his or her decision to opt-in.

The challenge lies in how your bank can most effectively address these changes. Some of the questions that must be addressed are:

- How do you ensure that your customers who want access to your overdraft program for POS/ATM transactions can maintain that service?
- How do you ensure that your customers understand the new rules and the overdraft services they have to opt-in to and the overdraft services they can opt-out of?
- Will your core processor be ready and able to pay items into the overdraft by transaction type?

These are just a few of the questions that must be addressed. Bankers know that well-managed overdraft programs are valued by many consumers, regardless of the negative press that some poorly designed or managed programs get these days. Being successful "post - Reg E" this summer depends on

planning and training well before the second quarter to be ready to make sure that customers understand what they have to lose.

The challenge becomes even more critical when you consider the impact from the potential reduction in your bank's income. Debit card transactions are rapidly replacing check transactions and this trend shows no signs of slowing down. For most banks, 30 percent to 50 percent or more of their NSF/OD income comes from debit card transactions. In addition, NSF/OD income represents 25 percent of the average bank's net income. Losing this income will be hard to replace in what is looking like another difficult year in 2010. How and when you address the amendments to Reg E will have a dramatic effect on whether you are able to maintain income levels or at least minimize the potential losses.

We are seeing many signs that some bankers have not yet fully thought out the potential impact of Reg E. One bank estimated that the impact to their NSF/OD income would be less than 20 percent. Upon further investigation it was discovered that more than 60 percent of their NSF/OD income comes from debit card and ATM transactions. Another bank decided to "pre-empt" the regulation and just turn off access to their overdraft program for debit card and ATM transactions. They thought the financial impact from Reg E would have a minimal effect on their bottom line. This decision was going to cost the bank 40 percent of their net income.

The changes to Reg E will impact almost every bank in the country in some form or fashion. The difference will be whether you view these changes as just another compliance issue, and are preparing for the financial consequences, or whether you approach these changes proactively to maintain this income or at least mitigate the expected losses.

Managing the depth and width of "The Dip" will be paramount. On July 1 of this year, banks will begin to experience a decline in NSF/OD income. On August 15 banks will see a precipitous drop in NSF/OD income.

The depth of this "Dip" will be determined by how well your opt-in strategy performs and the success rate with which you acquire opt-ins before July 1. The width or length of the "Dip" will be determined not only by how well you sustain your opt-in strategy after August 15, but also the timing of the transactional events (declinations) that your customers, who have not opted-in, will experience. We all know that many of our customers read virtually nothing that we send them. Those customers will be in for a rude surprise when their debit card is declined at the gas pump, grocery store, pharmacy or restaurant. Embarrassed customers are going to be really angry at someone, and it probably won't be at themselves or the Federal Reserve . . . it will be at their bank. For that reason, and others, it will behoove all of us to design a level of "overkill" into our outreach efforts to our customers.

In addition to the amendments to Reg E there are bills proposed in Congress that could affect overdraft programs even more:

- HR 4173 - the Wall Street Reform and Consumer Protection Act
- HR 3904 - the Overdraft Protection Act of 2009
- S 1799 - the Fairness and Accountability in Receiving Overdraft Coverage Act of 2009

The change to Reg E is seen as a political move to pacify lawmakers and reverse momentum to pass legislation to strip the Fed of its supervisory powers and creating instead a new federal agency to protect consumers, but the Fed's move does not seem to go far enough for some legislators. The proposed bills would apply to every bank that pays an overdraft for a consumer, not just those institutions that have a formal "overdraft protection" program.

HR 4173 creates the Consumer Financial Protection Agency (CFPA) which would have rulemaking authority for all financial institution products and services, thereby separating consumer products and services from safety and soundness oversight.

HR 3904 and S 1799 are identical bills with many provisions that would affect how you manage overdrafts. But there are three major provisions in the proposed legislation from both the House and the Senate that will have a devastating effect for banks and consumers alike:

- They propose to prohibit banks from charging more than one overdraft fee per month and not more than six overdraft fees per year.
- They propose a general provision that requires any overdraft fee assessed to be reasonable and proportional to the cost of processing the transaction.
- They propose to require an effective APR calculation for each overdraft.

These provisions, if passed, will all but eliminate overdraft programs and cause the death of free checking accounts at most banks. This will have not only devastating consequences for banks, but it will deprive consumers of a much needed resource for short-term cash needs. Alternative short term cash providers will fill the void created by the elimination of formal overdraft programs. These alternatives are not as consumer friendly as the typical bank with a formal overdraft program. Consumers will realize reduced services and increased costs with the passage of these provisions and banks will lose accounts to "non-bank" competitors that can still offer free checking due to lower cost structures.

In recent weeks Senator Dodd has discussed the possibility of moving away from a stand-alone Consumer Financial Protection Agency. There also hasn't been much information coming out of the House and Senate banking committees regarding HR 3904 and S 1799, but House Financial Services Committee Chairman Barney Frank (D-MA) stated last year that he would pick up discussion on HR 3904 if CFPA legislation did not pass. In addition, President Obama continues to declare his support for such legislative actions. These bills may be stalled for the time being, but they are by no means dead.

The regulatory and legislative landscape regarding the payment of overdrafts and overdraft programs is changing and will most likely continue to evolve. It is extremely important to have a strategic plan of action in place to adapt to the current regulatory changes while preparing to address any future actions from the legislature or regulators.

For more information or help with managing these challenges, please contact Bob Shifflett at (800)728-3116 or bshifflett@strunklp.com.