With the recent implementation of Regulation E, bankers are once again faced with reviewing their overdraft programs. The latest key point surrounds whether a financial institution should disclose its overdraft program to its customers. This paper will provide some context for the overdraft environment in the wake of Reg E, outline how to evaluate whether a disclosed program is right for you, and describe what role Deposit Score can play.

4th Quarter 2010

To Disclose or Not to Disclose

Understanding Disclosed Limits

What is a Disclosed Program?

First, Sheshunoff Consulting + Solutions (SCS) defines a disclosed overdraft program as one that does some or all of the following:

- Proactively notifies the customer base that overdraft services are available
- Publishes the general criteria used to decide customer eligibility
- Allows "opt out" of the overdraft program for all items not just ATM and Point of Sale items
- Notifies individual customers of their personal maximum overdraft limit
- Includes overdraft limits in balances shown to customers

According to the 2008 FDIC Study of Bank Overdraft Programs, a significant number of financial institutions do choose to disclose their overdraft program.

Banks with automated overdraft programs in 2006 or 2007.	All	Asset Size <$250 Million	$250 Million to Less than $1 Billion	$1 Billion to $5 Billion	>$5 Billion
Total	474	253	138	53	30
Promoted	**374** **78.9%**	**211** **83.3%**	**114** **82.6%**	**38** **71.7%**	**11** **36.7%**
Non Promoted	100 21.1%	42 16.6%	24 17.4%	15 28.3%	19 63.3%

Source: FDIC Study of Bank Overdraft Programs – Released November 2008)

The FDIC definition of promoted and nonpromoted is as follows:

- *"Promoted" automated overdraft programs are those in which the customers are informed of the existence of the overdraft program.*
- *"Nonpromoted" automated overdraft programs are those in which customers are not informed of the existence of the overdraft program.*

The reason most bankers give for running an undisclosed overdraft program is that their organization considers it a discretionary program offered to customers on an as-needed basis. In other words, they want to avoid encouraging—or appearing to encourage—their customers in using or over-using overdraft services simply because the bank disclosed or marketed their availability. Bankers in this category generally prefer that customers know nothing about the overdraft service.

What Role Have Regulations Played In Changing the Overdraft Environment?

Regulatory oversight has had a profound impact on the overdraft environment. First, Regulation DD became effective January 1, 2010, requiring all financial institutions to display on their consumer statements the number and amount of NSF/OD fees that the customer had paid both cycle-to-date and year-to-date. Previously (since 2006, in fact), only those banks running disclosed overdraft programs faced this mandate, while those running undisclosed programs were exempted.

One interpretation of the pre-2010 differences in requirements for disclosed and undisclosed programs was that regulators believed that the "sticker shock" imposed on disclosed programs would dissuade customers from using them. This does not appear to have happened.

Second, Regulation DD also mandated that at least one of the balances displayed via electronic channels (including ATMs and internet banking) had to be the actual dollar amount in the account—not the dollar amount in addition to whatever funds the customer could access via overdraft. Financial institutions could still include the overdraft limit in the customer's balance, but that had to be displayed as a second balance, along with a description telling the customer what the balance contained. In theory, this portion of Reg DD allowed customers to make more informed purchasing decisions with the understanding of what portion of the balance was their own money and what portion was available from the overdraft program that the bank was running.

Finally, in July and August 2010, Regulation E became effective. From that point forward, financial institutions were required to obtain customer "opt in" to the organization's standard overdraft practices before charging the customer for POS/ATM items that overdraw their account. With this latest development, the Fed is clearly trying to make overdraft programs as transparent as possible. The A9 Model Consent Form for Overdraft Services requires organizations to list the transactions that are, and are not covered by their overdraft program along with any daily fee caps they apply.

Prior to this latest update, financial institutions have not been required to disclose fee caps.

Key Regulatory Developments That Shaped Overdraft Programs

Before we discuss the complex issue of how banks decide whether to offer disclosed or undisclosed overdraft programs, it is interesting to trace how we arrived where we are today.

Best Practices from the 2005 Joint Guidance

Perhaps the key regulatory development occurred in February 2005, when four (OCC, FDIC, NCUA and The Federal Reserve) of the regulating agencies jointly published their best practice recommendations for overdraft programs. Key among the best practices was guidance on how disclosed overdraft programs should be divulged to customers.

Undoubtedly, part of the reason for issuing the joint guidance was to respond to the increasing number of vendors offering overdraft programs and the increasing number of banks disclosing their overdraft services. In addition some of the marketing language that was being used to advertise overdraft programs was of concern to the regulators, including promotions like the following:

- *"Make a mistake, we've got you covered"*
- *"Never bounce a check again"*
- *"We will pay your checks if you remain in good standing"*

The general public could easily take these statements as encouraging them to use the NSF/OD service. To further such a perception, the explanatory language about how the bank assessed overdraft fees was often not as prominently displayed as the headlines.

The following critiques of the promotional language stand out among others from the 2005 Best Practices. Specifically, the guidance read that "*Some institutions have adopted marketing practices that appear to encourage consumers to overdraw their accounts*." Chief among the concerns was that banks reserved the right not to pay all overdrafts, despite the promotional language used to market the programs, indicating all items would be paid. Also, read the guidance, "*Some institutions may advertise accounts with overdraft protection coverage as 'free' accounts, and thereby lead consumers to believe that there are no fees associated with the account or the overdraft protection program*."

The joint regulatory agencies specifically addressed how to market overdraft programs and communicate with customers. For example, the agencies directly stated that banks should not use marketing language that would encourage either "routine or intentional overdrafts."

Banks were to train their customer-facing staff on all available overdraft products, including features, benefits, costs—and the ways to opt out of the services if the customers did not want to take advantage of them. According to the guidance, organizations must "*Clearly explain discretionary nature of program. If payment of an overdraft is discretionary, make this clear. Institutions should not represent that the payment of overdrafts is guaranteed or assured if the institution retains discretion not to pay an overdraft*."

Finally, the agencies stated that organizations who offered overdraft programs must "*distinguish overdraft protection services from 'free' account features. Institutions should not promote 'free' accounts and overdraft protection programs in the same advertisement in a manner that suggests the overdraft protection program is free of charges*."

2006 Revised Regulation DD

In May 2005, the Federal Reserve revised Regulation DD (effective July 2006), primarily providing requirements for disclosed overdraft programs. Essentially, organizations had to

- Disclose cycle-to-date and year-to-date overdraft fees on the customer's statement
- Distinguish the differences between their overdraft programs and more traditional lines of credit by clearly disclosing the details of their overdraft program
- Avoid misleading marketing statements or encouraging customers to inappropriately use overdraft services

The box to the right contains some of the language from the "Summary of Revisions to the Regulation."

With this update to Regulation DD, the Federal Reserve attempted to curb some of the deceptive practices that had become more common within the industry. At the same time, though, the Federal Reserve also made clear that they did not object to the institution informing the customer about its overdraft limit. They just wanted to make sure that the customer was informed appropriately.

The next significant development was the amended Regulation DD in January 2010, which we discussed earlier.

Why Have Financial Institutions Chosen To Disclose?

Up to now, one of the key reasons to disclose overdraft services was simply to provide a value-add service to customers, who based on the number and amount of overdraft fees clearly utilized the services. As customers realized that their banks offered overdraft programs, they took advantage of the services and this gave financial institutions an additional source of non-interest income.

Other industry advocates argued that disclosing overdraft programs gave bank customers an educated choice. Understanding that they were in a position to overdraw their account, a customer could conduct a personal cost/benefit analysis, and then decide whether to utilize the overdraft service with the full knowledge of the cost (the overdraft fee) for their behavior.

Consumer advocacy groups have argued that disclosed overdraft programs appeal to a certain socioeconomic segment of the population, a point of view that has never been substantiated with conclusive results. However, it is interesting to note that while consumer advocacy groups have rallied customers not to opt in to overdraft services, not all customers heeded that advice. According to recent polls and SCS proprietary research, approximately half of responders opted into their bank's overdraft program. In a

From the "Summary of Revisions to the Regulation" Section

"Institutions that promote the payment of overdrafts in an advertisement must separately disclose on their periodic statements, the total amount of fees or charges imposed on the deposit account for paying overdrafts and the total amount of fees charged for returning items unpaid."

"To avoid confusion with traditional lines of credit, institutions that promote the payment of overdrafts are required to include certain disclosures in their advertisements about the service: the applicable fees or charges, the categories of transactions covered, the time period consumers have to repay or cover any overdraft, and the circumstances under which the institution would not pay an overdraft."

"TISA's prohibition against advertisements, announcements, or solicitations that are misleading or that misrepresent the deposit contract is extended to communications with consumers about the terms of their existing accounts."

"The staff commentary is revised to provide five examples of advertisements that would ordinarily be deemed misleading:

(1) Representing an overdraft service as a "line of credit;"

(2) Representing that the institution will honor all checks or transactions, when the institution retains discretion at any time not to honor any transaction;

(3) Representing that consumers with an overdrawn account are allowed to maintain a negative balance when the terms of the account's overdraft service require consumers to promptly return the deposit account to a positive balance;

(4) Describing an overdraft service solely as protection against bounced checks, when the institution also permits overdrafts for a fee in connection with ATM withdrawals and other electronic fund transfers that permit consumers to overdraw their account; and

(5) Describing an account as "free" or "no cost" in an advertisement that also promotes a service for which there is a fee (including an overdraft service), unless the advertisement clearly and conspicuously indicates there is a cost associated with the service."

From the "Section by Section Analysis" Section

"The definition of "advertisement" is broad and includes "a commercial message appearing in any medium, that promotes directly or indirectly the availability" the terms of a deposit account. Thus, the rules for overdraft services would cover any type of promotion, regardless of the advertisement's content, format or the marketing channel."

From the "Official Staff Interpretations" Section

"Examples of institutions promoting the payment of overdrafts. A depository institution would be required to include the advertising disclosures…if the institution:

i. Promotes the institution's policy or practice of paying overdrafts (unless the service would be subject to the Board's Regulation Z). This includes advertisements using print media such as newspapers or brochures, telephone solicitations, electronic mail, or messages posted on an Internet site.

ii. Includes a message on a periodic statement informing the consumer of an overdraft limit or the amount of funds available for overdrafts.

iii. Discloses an overdraft limit or includes the dollar amount of an overdraft limit in a balance disclosed on an automated system, such as a telephone response machine, ATM screen or the institution's Internet site."

March 2010 Neilsen Financial Track report, those who opted in were most likely to be part of what Nielsen calls the "upscale earners" demographic, precisely that segment of customers who is often most attractive as a profitable banking customer.

Why Have Financial Institutions Chosen Not To Disclose?

Conversely, the decision to not disclose the service is often multi-faceted, based on a variety of factors such as the financial institution's philosophy, its relationship with its regulator, and how the institution balances the risk vs. reward equation.

In that same March 2010 Nielsen Financial Track study, 39% of consumers had not yet decided whether to opt into overdraft services. Those consumers were more likely to be less financially savvy, lower income, and perhaps in need of more financial advice than their "upscale earner" counterparts.

Thus many organizations have hesitated to disclose the often complex practice of fluctuating overdraft limits based on key customer behaviors. To disclose a fluctuating overdraft limit to the customer results in a detailed explanation of what the financial institution is doing, which often is not what the financial institution wants to do.

Other organizations have chosen not to disclose their overdraft program purely as part of a positive public relations strategy, shying away from the negative press surrounding the earlier promoted overdraft programs.

Where We Are Now

After the latest change to Reg E, many organizations are now reconsidering whether to disclose their overdraft programs, regardless of whether they had previously run disclosed or undisclosed programs.

With the extensive mainstream media coverage of overdraft, the mandated opt in and inclusion of fees on consumer statements, the mystery around NSF/OD has largely been removed. A study by Mintel Compremedia indicated that 60% of adults polled online knew about the changes in overdraft regulation.

Several years have passed from the onslaught of promoted overdraft programs and due to the tightened regulations the concerns around them have abated, and it is now commonplace among those disclosing their programs to just provide a one page overview at the time of the account opening, and display two balances at the electronic channels so the customer is aware of their balance and their associated overdraft limit.

Now that all financial institutions—not just those who choose to disclose their overdraft programs—have to disclose overdraft fees on monthly statements, the distinction between the two programs and the perceived advantage of an undisclosed program have largely disappeared. This point leads us to the crux of the question: when should a financial institution disclose and when should they not? Often this decision will depend on the culture of the financial institution and how they feel it would be received by their customer base. However, there are other things to consider:

1. Could disclosing your overdraft limit create a competitive advantage?
2. How does your branch and call center personnel, actually describe the service that you operate today, to customers? Do they disclose the overdraft limit?
3. Have customers actively asked what their overdraft limit is?
4. Can your electronic delivery systems accommodate such a change?
5. What level of Regulation E opt-in rate do you have?
6. Would it be easier to get new accounts to opt in, if you disclose your overdraft program?
7. How did you arrive at your overdraft program today?
8. Do you believe that with the latest changes to Regulations DD and E the Fed intended to make overdraft programs more open and transparent?
9. Has your overdraft income only trended downwards over the past couple of years?

While the renewed decision to disclose or not disclose overdraft services will be unique to each bank, these questions can help you toward more fully understanding the culture of your organization and how overdraft disclosure is best approached in your own individual markets.

Summary

There is no right or wrong answer when it comes to deciding if you should disclose your overdraft program. But given the changes that have occurred in the regulatory environment, at a minimum, it may be a good time to review the approach that your financial institution is using to determine whether a change is appropriate.

About the Author

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What Deposit Score Can Do

One of the key items highlighted in the list (number 4, left) is system capability. Thankfully, Deposit Score has the ability to drive any overdraft program, due to its ability to monitor key customer indicators, such as deposit activity and repayment trends. Deposit Score was designed to fulfill the breadth of needs within the overdraft world and has always been able to support both disclosed and non-disclosed programs. SCS's approach has always been to implement Deposit Score in a manner that is most suited to the financial institution's needs. Often this has meant a non- disclosed program, but due to the changes in the overdraft environment, it is perhaps time to highlight Deposit Score's ability to also drive a disclosed program.

In regards to calculating overdraft limits, Deposit Score can create any of the following:

- Fixed overdraft limits by account segment
- Multi-tier fixed overdraft limits by account segment
- Fixed overdraft limit adjustments based on user-defined time periods
- Variable overdraft limits by account segment

In addition, Deposit Score also focuses on reducing risk whenever pertinent to do so. To do this, it employs a sophisticated trending analysis engine that can identify when customer activity indicates that removing/reducing the overdraft limit is appropriate.

This provides a significant benefit: instead of waiting for the account to be continuously overdrawn for 20 or 30 days before the overdraft limit is removed, as is often the case in "stock" programs, Deposit Score can remove the fixed overdraft limit based on customer behavior or number of days continuously overdrawn, hence making the engine much more responsive to customer activity and giving the financial institution much more flexibility on how they balance the risk vs. reward equation.

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