Analysis of the FDIC Final Overdraft Program Guidance

Sheshunoff
CONSULTING + SOLUTIONS

On November 24th 2010, the FDIC issued its final guidance and supervisory expectations for overdraft payment programs (see FIL-81-2010; the proposed guidance FIL-47-2010 was published in August 2010). The guidance has a mandatory compliance date of July 1, 2011. In this whitepaper, we discuss the potential impacts of the final guidance, what financial institutions should consider to help alleviate examiner concerns, and which parts of the guidance require institutions to construct their own roadmap. Unfortunately, the final guidance is very similar to the proposed guidance in that both use similar language and reference similar items for banks to "consider." It's this ambiguousness that has created an environment which increases the potential for disagreement about how to respond.

Supervisory Expectations

To start, let's analyze the points listed in the Supervisory Expectations section:

1. ***Ensure that the board of directors provides appropriate oversight of the overdraft program, including an annual review of the program's key features.***

While it will take time for the board of directors to get up to speed, and will probably add little benefit (after all, when was the last time you heard of a bank being taken over by the FDIC due to overdraft limits absorbing all of the capital?), it should be done. The first point is that the bank needs to decide what the key features are: price, cap, courtesy threshold, posting order, amount of overdraft limits, usage patterns? The next point is questioning what the competition is doing. If the majority of institutions you compete with have certain features in their overdraft program, should you? And how much weight do you give your competitor's key features when deciding about your own?'

2. ***Make sure marketing materials and disclosures are clear and attempt to "minimize potential customer confusion" and that they "promote responsible use."***

This point is a cornerstone of the guidance. It is emphasized in the Supervisory Expectations section and in many other sections as well. Various comments talk about how consumers don't fully understand the program risks, are confused about their account balance and that any changes that are made to overdraft payment programs in response to regulatory developments need to present information accurately and not mislead. The important takeaway here is to make sure the customer is fully informed and don't do what Wells Fargo did by burying the posting order deep within the account disclosure.

Regardless of whether you operate a disclosed/marketed or non-disclosed program, the material you give to customers should not promote usage but instead inform the customer of what the process is. We also suggest you clearly outline alternatives to the overdraft service, such as linked accounts, and state what the benefits of using those services are in place of using the overdraft service. Another consideration would be fully explaining your posting order and its potential impact on creating overdraft items. When you review your material, think like a consumer and make sure that all angles and questions are proactively answered. Be a consumer advocate for information!

3. ***Staff must be able to explain to the customer the features of the overdraft program and other choices available to the customer.***

This issue is clearly linked to the idea of materials being very clear and promoting responsible use and has become a soapbox issue for regulators and consumer advocates alike. If you offer alternative funding sources, such as a linked savings account, a line of credit or credit card, and the consumer qualifies and is interested, always offer this to the customer. For those of us who have studied this subject for years, we know that the probability of there being money in another account is low, but considering the current regulatory environment, we recommend that your premise should be why not link your account to another funding source? In addition, make sure that the front line staff details what the positives and negatives are of using the overdraft service and why other alternatives may be better. This conversation needs to strike the right tone so as not to scare the customer but to ensure the customer is fully informed. Revisit your current account opening scripts to determine whether they are appropriate and update as needed. You can then use them as a basis for training and most importantly include them in a procedure manual so you can show your examiner proof of what you are doing.

About the Author

Mark Groves is the Director of Consulting Analytics at Sheshunoff Consulting + Solutions. You can contact him directly at (512) 703-1520 or MGroves@smslp.com.

4. ***Prominently distinguish account balances from any overdraft coverage. (This is already a requirement under the update to Regulation DD which was effective on 1/1/2010.)***

Since Regulation DD covers all automated channels, the only conclusion we can draw as to why this is mentioned, other than being a reminder, is to suggest that every balance that is given out, regardless of channel, specifically states if it contains any overdraft coverage or not. The best approach for front line staff would seem to be to always quote a balance that does not include any overdraft coverage.

5. ***Monitor programs for excessive or chronic customer use and if a customer overdraws his account on more than six occasions where a fee is charged in a rolling 12 month period, undertake "meaningful and effective" follow up action. (The examples given suggest either a face-to-face conversation or a phone call.) The customer must also be given a reasonable opportunity to decide if he wants to continue in the overdraft program or choose another "available" alternative.***

This is perhaps the vaguest point in the entire guidance. It generates more questions than it answers.

- The first and totally rhetorical question is where did the greater than six come from to describe an excessive or chronic user?
- What is the definition of occasion? It appears that it could be read as an occurrence/daily event or per item or a complete overdraft episode (the account going overdrawn starts the "occasion" and it doesn't end until the account goes positive again). Clearly, if no fees are assessed then the "occasion" doesn't count towards the greater than six.
- Does a return item fee count towards the greater than six? While on the surface this appears to be a silly question, if the idea is to limit usage of the service, a guaranteed way to discourage it is to return items.
- When the customer reaches the seventh occasion, some form of contact should be attempted. But what is not clear is how often do you contact a customer? For example, what happens if two days later the same customer hits his eighth occasion and a month later a ninth occasion occurs? Do you call the customer again? If the customer responds to the communication attempts and says I do want to continue with fee-based overdraft coverage, do you still try to contact the customer on the next occasion, and the one following that? At what point does this turn into harassment and the customer changes phone numbers or even worse, banks? Equally significant, what happens if you never hear from the customer again?
- What form should the communication take? The FDIC really encourages a face-to-face conversation or a telephone call which translated means if the FDIC gives you an example using those two channels, you can assume that is what they want. Presumably, the in-person conversation occurs because the customer has walked into the branch and either the personal banker or teller has snagged the customer to discuss the issue in private. Can you also send a letter, or only send a letter? Could you attach a comment to the overdraft notice and consider the deed done? Does a robo dialer that leaves a discrete but clearly urgent message count?
- What does "meaningful and effective follow-up" mean? The use of the word "meaningful" probably suggests something more than a form letter, although to the right customer, that could be meaningful. Meaningful would seem to be a subjective term because it depends on the recipient's perception of whether an action is meaningful. The use of the word "effective" implies that the institution can change the customer's behavior, because if you don't change the customer's behavior how can it be considered effective? This is an almost impossible task: people tend to use a service they value, so should you remove people from the overdraft service because the FDIC believes they have "over used"? That undoubtedly raises more questions than it does answers. The impression this statement leaves is that a bank needs to actively pursue customers who fall into the specified group and do their absolute best to inform the customer that there are other available options.
- What is "reasonable opportunity" in the context of allowing the customer to have a reasonable opportunity to say I don't want to continue in the overdraft program? Interestingly, those two words appear in the Regulation E requirements section and are used to describe what the bank must do to allow the customer to opt in or out of POS/ATM overdrafts. There a "reasonable opportunity" was to allow customers to make the opt in/out choice via any channel where the bank offered it, including branches. So to do the same for overdrafts, it would seem that whenever the customer is reached following the magical seventh and subsequent occasions that the content of the message, however it is delivered, should allow the customer to decide whether to continue in the overdraft service. It would also seem appropriate to update the overdraft notice and other materials so they specifically state the customer can opt out at any time.

The consumer protection message found threaded throughout the guidance is apparent here too. The resounding response here should be to start monitoring your frequent users and write and implement a policy that fulfills the guidance requirements but also allows customers to use the service as they see fit.

6. ***Apply a daily NSF/OD fee cap.***

This idea is a recurring theme in regulatory requirements and has certainly become very common in the industry. Not to have one at this point would probably be hard to justify to the FDIC examiner. However, after you explain the benefits of having this cap to your front line staff, the bank should be able to use it to drive up your collection rate.

7. ***Apply a courtesy threshold or "de minimis" amount. (The footnote adds a distinctive twist to not having a courtesy threshold, indicating that if you do not have one and a fee is applied, it needs to be "reasonable and proportional" to the transaction amount.)***

This is the first time that a regulatory agency has said that a courtesy threshold is something to consider, and to impress us all with their linguistic expertise, they said it in Latin! The catch is the footnote which indicates they expect a proportional fee based on the transaction amount if you don't apply a courtesy threshold. Most core systems don't have this proportional fee capability so this would seem to make courtesy thresholds the latest defacto standard. The question is what is the right amount for a courtesy threshold? Naturally, to protect revenue as much as possible, $1 is the best way to go. From an industry perspective, we know that $5 and $10 courtesy thresholds exist, but why are they the right amounts? You might try setting it to a $1 and waiting to be told whether it is wrong or right.

We suggest you automate any courtesy threshold because we've observed that when they are handled manually, it is entirely normal to see the courtesy threshold amount "extended" by $2 to $3, maybe even up to $5. When branch personnel are making decisions about charging a customer, they tend to think there is no real difference between a $6 or $7 overdraft versus a $5 overdraft. There is however. Based on SCS' experience, we see with each $1 of courtesy threshold, a net income drop of 0.5%-0.75%, so an "increase" of $2 in your courtesy threshold can result in a 1%-1.5% decrease in income.

As with caps, applying a courtesy threshold can also be used to drive up the collection rate.

8. ***Use technology to alert customers when their balance is "at risk" of becoming overdrawn.***

No doubt this is a good idea, but even better, why not allow your customers to set the balance level they want to be alerted at? This is something you need to discuss with your IT/system providers to decide if it can be done and what method(s) of communication is best.

9. ***Consider providing information to consumers about how to access free or low-cost financial education workshops or individualized counseling.***

Although this is probably a waste of time, because the consumer is either not interested in financial education or can't change his or her behavior, it would be appropriate to provide some information and make it available in the branches and on your website. Probably the best approach is to use the FTC's resource website which is included in the guidance.

10. ***Ensure that your posting order does not maximize overdraft fees; the suggested approaches are order received or check number.***

Depending on your current posting order, this statement could severely cut into your overdraft revenue stream. While moving from high to low to any other sort order will reduce income, the degree of the change not only depends on the posting order moved to but also the mix of customer transactions.

Unfortunately, this guidance is incomplete. If you post by check number, how do you post the vast majority of the transactions that don't have a check number? While "order received" sounds great, in practice, a lot of systems do not offer this option, although there are some core providers that do. The ideal would be to use timestamps where available, and if there are none, use the "first time" the bank knew about the transaction. Check with your core vendor to find out when this option will be available.

Some core systems do have the ability to post in the "order on the file"; presumably, this would be a viable option. This usually results in a random posting sequence which is less harmful to income than using low to high.

Another approach is to argue about what the word "maximize" implies. There are various high to low posting methodologies, some of which create more overdrafts than others, and it is conceivable that you could claim that your version of high to low doesn't maximize overdrafts, it just increases the chances of an overdraft occurring. How effective this argument would be remains to be seen.

11. ***Ensure you are in compliance with all applicable statutes.***

Consumer Protection

The guidance contains multiple references to serious harm befalling the customer because of allowed overuse and the high costs of overdraft programs. For example, in the last paragraph in the “Overview of Comments Received” section, it says (emphasis added):

“The final guidance is intended to assist FDIC-supervised institutions in identifying, managing and mitigating risks... including risks that could result in *serious financial harm to certain consumers* relative to one of the core products...”

This statement clearly demonstrates the FDIC’s concern about banks taking advantage of customers who use the overdraft service, sounding very much like the Consumer Financial Protection Bureau (CFPB). This leads one to believe that the examiners will be even more concerned about how much the service is being used and how the bank can or should prevent that from happening. The key question is, if the consumer says yes I want to keep using the service because it is of value to me, then why does a bank need to pull them out of the program, either temporarily or permanently? The Regulation E opt in rule required customers to respond so those who wanted to continue in the program opted in which leads you to wonder why this same rule doesn’t apply to the whole program. If a bank decides that a customer needs to be “restrained” for their own good, that customer is likely to either leave your bank and find one that behaves differently or consider using a payday lender, which isn’t an improvement for the customer.

The FDIC goes to some length to point out that the guidance is not focused on ad hoc overdraft programs, which you most probably can interpret as manual pay/return decisions with no fixed overdraft limit being applied. This strikes us as strange. This approach is perhaps one that is most likely to subject the customer to unfair decision making. The worst case scenario would be where the branch personnel who make the decision know the customer and do not like him or her, thus returning all of their items and assessing all of the fees. Best case scenario would be where the customer is liked gets all of their items paid and the fees waived. Any decision that is highly subjective definitely has the potential to do harm to the consumer.

To further stress the consumer protection theme, the FDIC states in a section at the end of the guidance (emphasis added):

“The FDIC expects institutions to employ measured and appropriate follow-up with customers pursuant to this guidance, *as compared with inappropriate efforts to coerce consumers to opt-in*. Inconsistent application of waivers of overdraft fees will be evaluated in light of all applicable fair lending statutes and regulations.”

Use of UDAP

The FDIC states here that its examiners will be using UDAP (Unfair and Deceptive Acts and Practices) as a basis for evaluating overdraft programs. In both the Regulation E and Examinations sections they say they will determine whether a program is “fair” or “unfair”, “deceptive” or not, according to UDAP principles. They refer you to the FILs, the FTC statute and then top it off by stating:

“The prohibition against UDAPs applies to all products and services offered by financial institutions, including automated overdraft payment programs”.

We can all agree there is no room for unfair and deceptive acts in our industry, however the standard is subjective: it’s applied inconsistently because it’s based on what the examiner views as unfair and deceptive. How do we handle this problem? One answer is disclose, disclose, disclose! That way the customer is told everything about the program so there cannot be any “gotchas”. Disclosures could be included in any published material, website content and scripting for front line staff and call center personnel. Make sure that what you do and how you do it is clearly articulated. This is not a small task, but in the current environment and with the CFPB looming around the corner, a proactive stance may well help as we progress down the road to a more stringent regulatory environment.

Opting Out

Offering customers the ability to opt out is mentioned in two different sections. In the Highlights section, the FDIC talks about promptly honoring customer requests to opt out of non-electronic transactions. In the Regulation E Requirements section, the FDIC points out that the FRB didn’t address payment of overdrafts from non-electronic channels, but that the FDIC believes customers should be allowed to opt out completely of any overdraft program. This is a reasonable approach and we believe the banking industry should embrace it, which, for the most part, it has.

In Summary

This guidance is disappointing, since it preserves the issues that were present in the proposed guidance. It takes up the consumer protection cause with no cohesive policy or indeed collaboration with the other agencies, leaving FDIC regulated banks at a disadvantage. What the guidance does accomplish is it gives us insight into what we can potentially expect from the CFPB, so if you remember nothing from this article other than disclose, disclose, disclose and inform, inform, inform, you already have the key points. ■