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Managing the risks and rewards of overdraft protection products

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Since its inception, the Consumer Financial Protection Bureau (CFPB) has focused largely on services provided and fees charged to consumers, including overdraft protection fees.

The bureau has included the issue of such fees on its three most recent rulemaking agendas, and all signs point to the release of new rules governing overdraft protection products in 2016. Many banks, however, already struggle to comply with the current regulatory requirements that date back to 2005 when the provincial regulators changed the tone. To avoid negative repercussions related to regulations and revenues, it's critical that banks understand the risks associated with offering overdraft products and take the necessary steps to mitigate those risks now.

The current environment

Overdraft programs currently are subject to extensive regulatory requirements, including those found in:

- The 2005 Interagency Statement titled "Joint Guidance on Overdraft Protection Programs"
- The 2006 changes to the *Truth in Savings Act* requiring the disclosure of promoted overdraft programs
- The 2010 amendments to the *Truth in Savings Act* requiring additional disclosures about overdraft fees and account balances
- The 2010 amendments to the *Electronic Fund Transfer Act* requiring affirmative consent from customers for overdraft coverage of ATM and nonrecurring debit card transactions
- The 2010 Federal Deposit Insurance Corp. (FDIC) Financial Institution Letter, "Overdraft Payment Programs and Consumer Protection"

The FDIC's 2010 Financial Institution Letter FIL-81-2010 requires banks to "[m]onitor and, where necessary, mitigate credit, legal, reputational, safety and soundness, and other risks, as appropriate."[1] In response to questions on the guidance, the FDIC has clarified that, while it doesn't require banks to close accounts with excessive use,

> "[i]nstitutions are expected to monitor usage and engage in meaningful and effective follow-up to inform excessive users of available alternatives. However, as discussed in the Guidance, a number of risks are associated with chronic or excessive use of automated overdraft programs, including reputational, compliance, safety-and-soundness, and litigation risks. If such risks are identified during the course of an institution's monitoring and oversight of an automated overdraft program, institutions should take appropriate action to mitigate risks, as has been the case in the past."[2]

The publication of such regulatory guidance, along with reporting requirements, has led to greater public awareness of the overdraft fees banks collect as well as to intensified regulatory scrutiny. For example, as we know, banks are required to file detailed quarterly public financial statements with their regulatory supervisors. Since 2015, banks with more than $1 billion in assets have been required to report certain categories of fees – including overdraft and nonsufficient funds (NSF) fees – earned on consumer accounts separately from other deposit service charges on these statements. Breaking out these fees accentuates the visibility and track trends on bank-by-bank and industrywide aggregate bases.

According to the CFPB, consumer overdraft and NSF fees in 2015 added up to $11.16 billion in revenue, which accounted for 8 percent of the reporting banks' total net income and 5.5 percent of their pretax profits. The fees represented 65.3 percent of all reported consumer deposit account fee revenues and 0.45 percent of the estimated average of total consumer checking and money market deposit balances.[3]

The CFPB has highlighted a number of possible consumer protection concerns, including how consumers consent (or "opt in") to overdraft coverage for certain electronic transactions, overdraft coverage limits, transaction posting order practices, overdraft and NSF fee structures, and involuntary account closures. In preparation for its impending rulemaking, the bureau is conducting additional research and has begun consumer testing initiatives related to the opt-in process. While the substance of the coming rules remains unknown, one thing is clear: Regulation of overdraft products will only increase, heightening the risk for banks.

Common risk factors for overdraft programs

Several risk factors increase the likelihood of drawing regulator scrutiny of overdraft products, including:

- Overdraft fees that generate a significant portion of the bank's revenue
- Automatic enrollment of customers into overdraft programs without disclosure of material facts
- The lack of proper opt-in disclosures and account coding
- Inaccurate or misleading advertisements promoting overdraft programs
- Limited review of transactional data to identify accounts that have been assessed an overdraft fee while not opted in
- Failure to consider regulatory guidance and industry best practices
- Failure to offer accounts that don't assess overdraft fees
- Failure to research data relating to the bank's overdraft programs, including identifying customers who have frequent overdrafts

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Mitigating the compliance risk

Financial institutions can implement a variety of measures to help reduce the odds of adverse regulatory outcomes related to overdraft products. For example, a bank should identify every type of overdraft program it offers and review the related marketing and disclosure practices to confirm that practices are in line with applicable requirements. It's also advisable to compare overdraft fees with those of other banks in the market that have similar programs. Significantly higher fees could catch regulators' eyes.

Banks should identify and review the accounts that pay high levels of overdraft and NSF fees and determine if they could impose some overall limitations to mitigate the possibility that regulators will deem such fees excessive and potentially abusive. Banks also should consider instituting proactive contact measures for customers who incur substantial fees and providing alternatives to overdraft programs (for example, funds transfers from a savings account).

In addition, a bank should work within its existing "three lines of defense" structure (that is, line of business, compliance department, and internal audit) to review the operations of overdraft programs. The reviews should consider how branches and front-line personnel can promote compliance (including active and timely monitoring), how the compliance department can review activity and the frontline monitoring, and how internal audit can validate the adequacy of both frontline monitoring and independent reviews.

Finally, in the face of evolving regulatory requirements, banks should have activated their regulatory change management process in response to recent guidance, publications, speeches, and proposed rules, such as the February 2016 CFPB letter urging the 25 largest retail banks to offer accounts without overdraft fees. Banks need to anticipate and promptly respond to relevant developments rather than simply sitting back on their heels waiting for new risks and requirements to be discussed in the context of an examination. Those that are able to provide a consumer-friendly yet profitable service are most likely to minimize their exposure to penalties and reduced revenues.

A balancing act

Overdraft programs can provide a valuable tool for customers and a revenue source for financial institutions. But the programs must be designed to include robust and risk-based oversight and monitoring processes that reflect a clear understanding of current regulatory requirements and that adapt to regulatory changes.

Learn more

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[1] https://www.fdic.gov/news/news/financial/2010/fil10081.html
[2] https://www.fdic.gov/news/conferences/overdraft/FAQ.html
[3] http://www.consumerfinance.gov/about-us/blog/new-insights-on-bank-overdraft-fees-and-4-ways-to-avoid-them/

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