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Checks and Balances

Doing overdraft protection coverage the right way

by Francis X. Grady, Esq.

Characterized by the Comptroller of the Currency in September, 2003 as an "accident waiting to happen," bounce protection (the service by which a bank *chooses* to pay a transaction account customer's NSF item and assess an overdraft fee for this prompt repayment obligation) has become subject to considerable bank regulatory and customer scrutiny. The Federal Reserve Board's rules and interpretations have made very clear over the years –

- that overdraft privilege programs are not "credit" governed by truth in lending Regulation Z, and, by implication, ECOA's Regulation B,
- that NSF charges imposed for retail checking account overdrafts are not "finance charges," and
- that overdraft privilege coverage is a valuable customer service with deep historical roots as a banking industry practice.

This well-settled position has recently been challenged by consumer activists who are taking up the cause of regulating overdraft programs, looking as always for the most sympathetic victims of bounce protection overdraft programs, and seeking to impose regulation on bounce protection overdraft programs of all banks.

Many smaller banks use bounce protection plans that are not dynamic as to an individual customer's behavior, assigning instead an arbitrary bounce protection limit by product type. Indeed, in its December 6, 2002 proposed update to the Regulation Z Official Staff Commentary inviting comment and information on the design and operation of bounce protection services, the Federal Reserve Board makes the statement that "under these bounce protection programs, the institution typically establishes a dollar

limit for the account holder, and then routinely pays overdrafts on the account up to that amount without a case-by-case assessment." In the comment letter submitted by the American Bankers Association (the "ABA"), the ABA noted that "[f]or some years, the trend has been to automate this practice [of handling overdrafts], using algorithms to minimize risks and identify those accounts most likely to be brought to positive balance." Automated bounce protection plans, according to that same ABA comment letter, nonetheless "allow small institutions to automate a *traditional practice*, thereby reducing costs and ensuring more consistent application." In connection with the automation of the process, smaller financial institutions often rely on vendor bounce protection "turnkey" programs where the financial institution discloses to consumers, either upon account opening or to existing accounts upon installation of the automated process, the criteria that are used in the overdraft decisioning process.

Until the advent of consultants selling turnkey bounce protection programs primarily to smaller banks, the details (much less the existence) of the practice of honoring checks that create overdrafts had never been disclosed to consumers. In that regard, the January 27, 2003 ABA comment letter submitted to the Federal Reserve Board noted that "the main difference between the traditional practice and the newer programs is that the criteria are disclosed to the consumer."

Bounce protection plans with a higher risk profile generally exhibit some, if not all, of the following characteristics:

- customers are led to believe that overdraft coverage can be relied upon, despite the fine print disclaimer that the bank is under no obligation to honor the overdraft and that payment of the NSF item is entirely discretionary on the bank's part;
- customers are advised what their individual "credit limits" are;
- customers with repeated overdrafts or large overdrafts are encouraged to repay the overdraft amount owing over time, rather than immediately;
- no procedures exist to punish repeated overdrafts or counsel customers to explore alternatives to relying on overdraft protection, for example by suspending overdraft protection or offering a loan to the customer as an alternative; and
- ATM screens and teller terminals show an available customer balance that fails to distinguish between the customer's actual ledger balance and the customer's available balance with bounce protection.

Some or all of the characteristics identified above are absent from traditional, time-honored bounce protection overdraft plans, the second type of such plans not so widely embraced by the community bank industry. Under these more benign courtesy overdraft protection plans, the following characteristics tend to predominate:

- the programs are not actively publicized or marketed to customers;
- banks require immediate payment of the overdraft;
- repeated use of courtesy overdraft protection is discouraged by reducing or shutting off overdraft "privileges," for example if the overdraft program is used as a "cash management" tool by the customer;
- no daily overdraft fee is added to the initial overdraft fee charged;
- customers are not informed that they have a credit limit" of $X; and
- instead of a fixed, arbitrary bounce protection limit assigned by product type that would hamper a bank's best customers by disregarding account history, overdraft decisioning relies on an active risk matrix to automate the pay/return decision process to help determine a courtesy overdraft limit tailored to each individual account.

Within the last several years, overdraft protection plans have been subject to ever increasing

scrutiny by regulators, both federal and state. On August 3, 2001, the Office of the Comptroller of the Currency issued OCC Interpretive Letter #914, the first well publicized authoritative attempt by federal bank regulators to evaluate overdraft protection plans. The OCC was confronted with a bounce protection overdraft program that, in the OCC's opinion, encouraged banks to encourage bank customers to overdraw their account irresponsibly – simply for banks to make money. The program's materials apparently were so egregious that the OCC completely ignored the benefits to consumers afforded by soundly operated discretionary overdraft programs, in terms of time and convenience, in access to credit, and in lower costs (*e.g.*, paid versus returned, unpaid NSF check, etc.).

The Federal Reserve Board is deliberating currently about whether and how to regulate courtesy overdraft programs. In an April 2003 Regulation Z rulemaking revising the official staff commentary to Regulation Z, the Federal Reserve Board declined to take further action on the December 2002 Regulation Z proposal (67 *Fed. Register* 72618 (December 6, 2002)) in which Federal Reserve Board staff requested information on overdraft or "bounced check" protection services. In its April 2003 rulemaking, the Federal Reserve Board acknowledged that Federal Reserve Board staff is continuing to gather information on bounce protection services.

Rather than a truth-in-lending rulemaking being the basis for regulation of bounce protection programs, it is perhaps more likely that the Federal Reserve Board will instead issue a formal interpretation of its existing rules clarifying when courtesy overdraft programs could on one hand be subject to regulation under Regulation Z or another Federal Reserve Board regulation, such as Regulation AA (Unfair and Deceptive Acts and Practices), and when on the other hand courtesy overdraft programs will remain largely unregulated. The Federal Reserve Board might also propose an amendment of its truth-in-savings regulation, Regulation DD, perhaps requiring more disclosure about overdraft fees and prohibiting advertisement of an account as "free" if overdraft fees may be imposed for courtesy overdrafts.

In addition to the issues relating to whether discretionary overdrafts should be subject to Regulation Z truth-in-lending disclosure, some state banking departments have waded into the debate through issuance of cautionary advisory pronouncements. The Louisiana Office of Financial Institutions issued Bulletin 03-2003 on February 12, 2003, a helpful guide outlining several regulatory issues surrounding overdraft protection plans. In addition to emphasizing the points made by the OCC in Interpretive Letter #914, Bulletin 03-2003 noted that there is a "significant amount of reputational risk associated with a program that is not administered in a manner that customers perceive as being fair." The Bulletin notes that many overdraft protection plans would not be subject to regulation but include practices that would be viewed as unfair by current or potential customers.

As financial institutions attempt to evaluate the changing bank regulatory and consumer financial services litigation environment affecting courtesy overdraft protection services, bankers recognize the stakes have never been higher to distinguish between responsible courtesy overdraft programs versus unscrupulous, poorly conceived overdraft programs. In evaluation of the risk/reward continuum, a bank designing or implementing a courtesy overdraft protection service should take steps to mitigate the increased regulatory and litigation risk associated with the increase in overdraft income that any courtesy overdraft program produces.

All views expressed in this article are the author's. Francis X. Grady is the managing partner of Grady & Associates, a Cleveland, Ohio - based boutique banking law firm that provides bank regulatory counsel to 200 banks and thrifts across the country. Grady & Associates reviews legal, bank regulatory and litigation risks associated with bounce protection vendor selection, overdraft fees, program design, marketing, collection and administration. Mr. Grady combines both government and private practice experience, as an attorney with the Federal Deposit Insurance Corporation in Washington, D.C. and as an attorney in private practice in Washington, D.C. and Cleveland.

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