GRADY & ASSOCIATES
ATTORNEYS & COUNSELORS AT LAW

20950 CENTER RIDGE ROAD, SUITE 100
ROCKY RIVER, OHIO 44116-4307

(440) 356-7255
Fax (440) 356-7254

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Bounce Protection Overdraft Coverage: Doing It the Right Way

by Francis X. Grady, Esq.

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Overview. 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 — not to be confused with a customer's more formal overdraft line of credit tied to a transaction account) has recently become subject to considerable bank regulatory and customer scrutiny. Bankers and bank regulatory agencies have devoted considerable time and energy to considering how and under what circumstances banks should provide so-called courtesy overdraft protection for retail checking accounts. This article discusses the legal and practical realities a bank faces when evaluating and choosing to implement courtesy overdraft protection for transaction account customers.

Historical Regulatory Treatment. 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.

Consumer and Media Recent Adverse Scrutiny. This well-settled position has only recently been challenged, principally because of a growing incidence of abusive practices that aggressively promote near-term fee-income growth at the expense of the financially weakest customers. Banks that implement automated bounce protection overdraft programs generally experience increases in the number of per account overdraft occurrences and consequently report significantly increased fee income (a not insignificant achievement in a period when net interest margins are experiencing serious compression). Not surprisingly, consumer activists are therefore also taking up the cause of regulating overdraft programs, looking as always for the most egregious cases of bounce protection overdraft programs and the most sympathetic victims of careless or unscrupulous banks, and seeking to impose regulation on bounce protection overdraft programs of all banks.

Banking Industry Bounce Protection Models. A number of vendors offer "turnkey" programs and expertise enabling banks to establish overdraft protection plans. Generally, these plans can be broadly classified into two distinct groups. Many smaller banks use vendor-designed, "static" 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 nation's leading trade association for the banking industry, 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." While the systems adopted by the largest institutions have been developed internally, relying on their own empirical data and statistics, some institutions have begun to rely on systems developed by third-party vendors that may incorporate the standards, criteria and customer- or item-specific attributes selected by the institution or developed by the vendor. While such systems may not be as empirically or statistically complex as those developed by larger financial institutions, vendor-"packaged" 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.

In contrast, banks not dependent on vendor-packaged bounce protection plans tend not to communicate the overdraft payment criteria to customers, much less the existence of any bounce protection service. Just as residential mortgage lending has moved from judgmental underwriting by a human underwriter to automated underwriting pursuant to customer-specific credit factors, larger banks pioneered the formalization of bounce protection services, automating what had been a haphazard, judgmental practice through modeling of customer-specific, objective account behavior attributes. Until the advent of consultants selling turnkey bounce protection programs primarily to smaller banks, however, 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 "sold" to the community banking industry (recent entrants to a product offering "space" only available to the nation's largest banks in the not too distant past) are often actively and aggressively marketed to bank customers. These programs 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 encouraged to use the overdraft feature as a kind of cash-management tool, a substitute for "payday" loans;
- 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 and 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, less aggressively marketed 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;
- the customer's account agreement makes very clear that the customer must pay overdraft fees, and makes equally clear that the bank may – *but is not required to* – pay overdrafts;
- the overdraft fee practices retain a close connection to the cost of the extra services that are necessary to support courtesy overdrafts. In other words, the bank can plausibly justify its overdraft fee practices based on the extra costs and risks, rather than basing the bank's practices on fee-income growth; 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.

Banks offering bounce protection programs featuring the above characteristics argue that such programs simply automate the established banking practice of periodically covering overdrafts for valued customers. Thus, when offered to the customer as a courtesy, privilege overdraft protection service is a means of promoting customer goodwill in the long term with the incidental effect of enhancing fee income in the short term. Courtesy overdraft programs have been in existence for years and are now simply becoming more uniform as banks embrace technology as a means of avoiding manual, case-by-case review. Most bank regulators seem inclined to agree. Existing regulatory pronouncements tend to favor less aggressively marketed overdraft protection services. In that regard, bankers are advised to remember that the claimed service element inherent in these programs is a two-way street. As such, a customer who objects to his silent enrollment in a bounce protection service should be allowed to opt out if he so desires.

Bank Regulatory Bounce Protection Pronouncements. 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 letter indicated a number of areas of concern and potential regulatory compliance issues, including the Truth in Lending Act/Regulation Z, the Truth in Savings Act/Regulation DD, the Electronic Funds Transfer Act/Regulation E, the Equal Credit Opportunity Act/Regulation B, the Federal Trade Commission Act prohibition on deceptive practices and Regulation O. The overdraft program reviewed by the OCC was a vendor "turnkey" program that was woefully deficient in many respects, and most likely violated many of the laws and regulations noted.

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 properly drafted and 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.).

Regulatory Changes are Possible. The Federal Reserve Board is deliberating currently about whether and how to regulate courtesy overdraft programs. 67 *Fed. Register* 72618 (December 6, 2002). The Federal Reserve Board is in the earliest stages of its deliberation and has not yet even decided *whether* to regulate courtesy overdraft programs, let alone how to regulate them. It is possible that the Federal Reserve Board will seek to regulate courtesy overdraft programs by rule under the Truth-in-Lending Act and Regulation Z, which would require a rulemaking proposal and an attendant public comment period. The rulemaking process inevitably involves a delay of many months before new rules become final. 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 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 soliciting comment and information from the public about how the bounce protection services are designed and operated, to determine the need for additional guidance to financial institutions under Regulation Z or other laws. 300 comment letters responded to the request to provide information about the various ways that depository institutions offer bounced check protection services. According to an April 2003 Regulation Z rulemaking, the Federal Reserve Board staff is continuing to gather information on bounce protection services.

It is also possible, and 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 would, in the latter case, distinguish between responsible courtesy overdraft programs versus what we politely call "other overdraft programs." 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. It remains to be seen what, if any, action will be taken with respect to the regulatory treatment of overdraft protection plans.

State Regulation of Bounce Protection. 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. We believe the Louisiana Office of Financial Institutions' advice is sage counsel for any bank to follow before implementing an overdraft protection plan.

Conclusion. 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 the unscrupulous, poorly conceived overdraft programs promoted by some vendors of bounce protection plans that are crudely rigged to provide the quickest and largest possible payoff to the consultant through the few years in which the consulting contract rewards the consultant with percentage billing on overdraft income revenue enhancement. We believe that federal and state banking regulators, as well as potential consumer financial services litigants, are unlikely to act in a way that punishes well-managed and responsible courtesy overdraft programs. In evaluation of the risk/reward continuum, a bank designing or implementing a courtesy overdraft protection service must be cognizant of the increased regulatory and litigation risk associated with the dramatic increase in overdraft income that any courtesy overdraft program produces.

Mr. 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.