



Opting In or Out: Protecting Revenue Under Overdraft Reform

Know the financial impact and be prepared to act

Number 19 — July 2009

The ink is finally dry on the Credit CARD Act of 2009, but the concern for the financial impact on banks is not over yet. The federal banking regulators are now focusing on overdraft products. Banks currently need to review how this could affect their bottom line and how they will recover from the impact on their income statement.

US banks currently generate approximately \$11 billion in fees from overdrafts. Nearly \$8 billion of those fees are generated from debits at point of sale using debit cards and ATM withdrawals. The FDIC determined that fee charges for overdrafts averaged \$27 on an average negative balance of \$17.

FICO has solutions and strategy consulting that can help you meet changing regulations, while increasing the profitability of your DDA portfolio.

The regulations are aimed at protecting the bottom 5% of consumers that generate the majority of the overdraft fee income. Even a fraction of consumers choosing to opt out will have a significant effect on non-interest income.

This white paper addresses:

- Today's overdraft policies and what's changing
- The likely financial impact
- How banks can respond strategically

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» Background

In the early 1990s, banks adopted conservative policies permitting overdrafts because writing “bad” checks was considered a crime. Banks did not want to be viewed as encouraging criminal behavior. The overdraft service was generally made available only to the higher valued customers as a courtesy.

However, as technology advanced and debit activity increased through channels other than paper checks, this view was relaxed. Banks recognized that the value of servicing the overdraft and the fee income subsequently generated helped to propagate free checking products. Overdraft protection became a small industry in itself, generating revenue for the banks and ensuring customer loyalty. Customers were grateful for avoiding the embarrassment of ‘bouncing a check’ at a merchant and incurring the merchant fee in addition to the bank’s NSF fee.

Bank revenues increasingly became more dependent on overdraft generated fees. Over time, banks changed their posting processes and policies to permit greater revenue generation from these fees. Free checking became a competitive product and overdrafts help to subsidize the expense of the free checking processing.

Increasing fees was viewed as a deterrent for the customer to overdraft their balance; however, the increased fee only slowed the overdraft behavior temporarily. In a tracking study, customers initially reduced their overdraft behavior, cutting revenue by 45%. In just three months, they habituated to the higher fees and the income generated increased accordingly.

» What’s changing

The overdraft regulations would potentially include the following changes:

- **Automatic enrollment into an overdraft program using shadow limits or risk-based rules, without the customer’s explicit request to participate, will be affected.** This type of service is the most expensive for the customer. The majority of these fees are generated from segments of customers least able to afford the service. Overdrafts of most concern are those generated at the debit card point of sale or the ATM where a warning message should be offered to the consumer giving the choice to opt out and prevent the fee.
- **Posting order is also under scrutiny.** Banks historically processed transactions from the largest amount to the smallest amount, which increased the number of overdraft occurrences. This is similar to issues with credit card payment postings that generate higher interest by applying payments to lower-interest balances before applying payments to higher-interest balances. The current posting order in deposit accounts depletes the available balance faster with larger amounts initially, causing a higher number of overdraft occurrences and therefore generating greater fee income.
- **Rules concerning overdrafts generated from bank actions such as deposit holds, memo holds or temporary freezes will be impacted.** The customers most likely to generate overdrafts are the same customers who are likely to incur the greatest numbers of holds on their deposits. Combining both posting order and holds without delaying in-clearing is a lot like holding all the cards in a poker game. The customer has no ability to decide or make an informed decision about how his/her money is spent.
- **Caps on daily or monthly totals for allowable overdrafts will require modification.** Often fees are regenerated or compounded each day an overdraft is not cleared, creating a spiral of fee expense that can easily exceed the overdraft balance. This type of action often impairs the customers’ ability to recover from the overdraft.

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Increasing pressure by the legislature for customer protection includes: (H.R. 1456) which extends the protections of the Truth in Lending Act to overdraft programs, requiring the customer's consent before an institution may initiate an overdraft service; (H.R.1608/S.500) which establishes a national usury rate; and (H.R. 1487) which requires customer notification before any fee is imposed in connection with electronic fund transfers such as ACH. Finally, the posting order is being evaluated to prevent "unjust enrichment of financial institutions from fees that accrue only by virtue of the order used by the institution for posting debits and deposits" (H.R.1488).

» The potential impact

Banks can expect a significant financial impact to their income statement through changes in non-interest income. They will need to compensate for the hit in revenue in order to continue offering free checking products and other more expensive services that customers have come to expect.

There are also dramatic systems implications with real-time possessing of available balance and communication back to customers at various points of sale. Several ledger systems operate in real time within their existing channels (e.g., ATM, online, core, debit card, ACH); however, these channels do not always reconcile until posting occurs at night. This lack of real-time reconciliation, coupled with the potential changes to posting order, could create an overdraft at an electronic channel that is not accurate or visible to the customer at the point of contact, making compliance difficult.

» Respond strategically

What can be done by banks strategically and tactically? What opportunities exist for banks to leverage what they already know and have in place to offset the loss of revenue from the impending legislation?

There are three areas of opportunity that can be leveraged to counterbalance the negative impact to fee income:

- Fee Waivers
- Overdraft Management
- New Product Development

Fee Waivers

The first and most obvious place to look is to the existing fee waiver policies. How much of current fees are waived and therefore are not realized as non-interest income? For example, if you currently do not realize 6% of your revenue generation because of waivers, one strategy to mitigate the legislative impact and increase overall fee income could be through development of a more targeted fee waiver strategy based on risk, existing relationship and consistency.

Fee waiver strategies are often lax. Seldom do they target the segments of the portfolio that fee deterrence is intended to manage. Often a bank's best and highest-value customers receive an overdraft fee. This is usually received with insult and indignation, resulting in a call or calls to customer service demanding that the fee be waived. For these high-value customers, automating the waiver and not assessing the fee from the start provides a customer value message that can be converted to a cross sale opportunity. At the very least, this type of action promotes customer loyalty.

For customers of greater risk, fee waivers can help prevent or reduce the overdraft behavior. They can also provide an opportunity to sell a related deposit or savings account or credit product to provide overdraft protection.

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Having an analytic methodology to assess customer risk, exposure and value creates a systematic way to segment customers and target actions to their situation and need. Such specific actions help prevent the perception of usury behavior and provide an environment in which the fee revenue realized can be optimized.

Overdraft Management

The need for a systematic analytic-based methodology to segment the customer base and deliver appropriate overdraft decisions will be particularly critical should the new regulations pass. Understanding the deposit portfolio, customer risk and value help to create strategies that are based not on rules, but on the risk, value and compliance sensitivity of the customer.

New Product Development

Changes in regulations often lead to opportunities in new product development that can both promote revenue and satisfy the new regulatory standards. Products that have been traditionally managed as deposits can be converted to credit instruments. Examples include deposit advances, managed sweep accounts and new overdraft protection accounts. An important first step is to analytically identify appropriate target groups for promotion of new product cross sales to prevent any regulatory question.

New product offerings can also help to support revenue streams impacted by legislation—for example, moving from overdraft products based on fees to closed-end deposit advance products with credit-type terms. As a credit product, disclosure and opt in can be obtained prior to an overdraft event, enabling completion of the transaction and supporting a reasonable cost basis for the customer.

New overdraft protection products can be targeted to the customers in need, offering a lower-cost solution without additional regulatory impact.

» Three steps to readiness

Phase 1: Initial strategy development

The first step is to determine what initial strategies can slow the tide of revenue loss. These strategies must:

- Be based on knowing regulatory requirements and industry best practices
- Identify the appropriate target customers
- Design and test communications processes

While putting these initial strategies in place, it is important to assess the existing operational processes, procedures, resources and data to begin the planning process for additional phases: What systems are currently in place, and how must they be modified to provide the framework for more extensive data usage? What changes are needed to ensure that new strategies can be executed accurately, in real time, and at the point of sale? It is important to investigate and consider the impact on:

- Systems, posting, channels
- Analytics, scoring models
- Collections and recovery
- Fraud

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Of equal importance is the development of customer-centric views across product lines, metrics to define performance and customer value, and analyses to understand relevant portfolio segments. Analytics combined with systems preparations enable banks to move successfully to Phase 2.

Phase 2: Strategy refinement

Phase 2 allows organizations to focus on development of intermediate strategies based on additional analytic understanding of where revenue losses are occurring.

During this phase, banks must address:

- What segments of the portfolio at what pricing structure remain profitable?
- What segments continue to lose revenue, are most profitable or barely meet breakeven?
- What are the profiles of these segments?
- What alternative strategies can be put in place to modify the product or product pricing to bring each segment up to a level of profitability within regulatory requirements?
- What are the optimal channel and communications strategies that ensure customer satisfaction, responsiveness and stem attrition?
- What tracking mechanisms need to be developed or enhanced to understand ongoing performance at the segment level?
- How can the organization adopt a test-and-learn philosophy to understand what strategies are working and what strategies must be modified?

Phase 3: Decision optimization

Phase 3 advances the level of analytical understanding to include the use of decision optimization. Decision optimization uses analytical models and historical data to find the best ways to maximize revenue by balancing pricing, fees and product against competing business constraints.

The process provides a framework in which the organization can select the best course of action to meet its business goals and develop strategies at the customer level that balance business goals against constraints that are fixed—in the case of regulatory requirements—or flexible—for example, percent of overrides allowed or customers targeted for overdraft.

» Consider the impact and be prepared to act

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The approach that an individual bank may choose is related to its market share, risk appetite and product offerings. It is important to note that these proposed changes will affect every bank and can seriously impact customer attrition and income. Waiting until the first bank achieves compliance may not serve your institution well, especially since the solutions proposed here offer greater revenue value and customer management with or without the regulatory change.

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