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The New Overdraft Policies:
Toward a More Consumer-Friendly Environment

In December 2021, Capital One announced plans to eliminate nonsufficient funds (NSF) and overdraft (OD) fees, becoming the first major U.S. bank to adopt such a policy. The bank promoted its new policies as an altruistic decision to provide greater value to consumers. In reality, the motivating force may have been a desire to forestall regulatory mandates limiting NSF/OD fees amidst increased attention from federal agencies and Congress.

Regardless of the impetus for the changes, Capital One's customers stand to benefit, and the bank gained favorable publicity. In the ensuing months, numerous regional and national banks followed Capital One's lead, either because they viewed it a competitive imperative to match (or at least approach) the same pricing, or because of the same perceived regulatory pressures that Capital One may have sensed.

Any reduction in stated fees can lead to an increase in the volume of new-account sales; but unless the revenue those new accounts generate more than offsets the fee revenue the bank has sacrificed, then overall earnings will decline. This raises questions for banks and credit unions:

- *Have the actions of the national and regional banks created an imperative to reduce or eliminate NSF and OD fees, or can the institution continue to attract customers even while maintaining historic pricing levels?*
- *If the institution cannot "make it up on volume" – i.e., drive sufficient new-account volumes to offset the loss of per-account fee revenue – what other sources can it leverage to replace the foregone fee revenue?*

First, some definitions, as the terms **nonsufficient funds** and **overdraft** are not synonymous. A nonsufficient funds instance (also known as a returned item) occurs when a payee presents a check for payment, but the payor's account balance is below the amount of the written check; thus, the bank declines to pay the funds to the payee. Absent any fees, this action does not change the check writer's account balance. For example, the payee presents a check for $50 written on an account with a balance of $35, and the bank says, "Sorry, there's not enough money in the account to pay that check," sends the check back to the payee, and the payor's account balance remains at $35.

An overdraft instance occurs when the payor's account balance is below the amount of the written check, but the bank still pays the check, sending the payor's account balance negative. In the prior example, upon payment of the $50 check, the payor's balance falls from $35 to negative $15. In effect, the bank has now granted the account holder a small loan which, like any loan, will need to be collected via a payment or written off.

Historically, banks and credit unions have exacted fees for both types of actions: for the NSF presumably to cover its costs of returning the unpaid item, and for the overdraft as compensation for the risk the institution incurs in the loan and for the processing of that action. Fees have soared in recent years, exceeding $40 per instance at some institutions, and with no limit on the number of items on which the fee would apply. For example, if the bank receives five checks in one night's processing, and the account has funds to cover only one, the consumer would be charged $140 (four x $35 fee).

But now there may be a competitive imperative for all institutions to revisit NSF and OD fees. For the NSF fee, it is important to consider: is there any basis for a fee, given that we haven't provided the client with any specific service? In an electronic-driven world, the processing cost of an NSF item is minimal, so it would appear banks are charging fees for these items only because they can, *(continued on page 2)*

because all the others do. But now that "all the others" is no longer true, can smaller institutions maintain their NSF fees? And should they?

Keep in mind, the very action of charging an NSF fee can send the account into overdraft status: e.g., a client has $20 in their account, writes a check for $50; the bank rejects the check and imposes a $25 fee; and now the account has a negative $5 balance. This cascading fee model becomes tremendously consumer unfriendly. Perhaps such fees are appropriate for serial offenders (i.e., after "x" number of rejected checks per year), but in general, most banks and credit unions would be wise to join the multitude of large banks that have ceased charging fees for an action that provides no value to the client, beyond the stretch reasoning of, "We're saving them from getting in financial trouble (by rejecting versus paying the check), so that's worth $20."

The overdraft is more complicated: in that case, the institution is providing a valuable service for the client, saving the hassle of having to settle an unpaid item with the payee; and the institution is incurring credit risk in the overdrawn amount. For both of these reasons, some fee is warranted, even if the $35 - $40 fees of recent times may no longer be tenable. There are several decision points in crafting a fee structure for overdrafts.

First, do we apply different actions to electronic overdrafts occurring via a debit or ATM transaction (where the institution can render an immediate decision, or even consult the consumer via screen or text message) versus with a check-based overdraft? Second, are there different fee structures depending on how the consumer responds to the overdraft? And finally, should there be an institution-wide policy, or separate policies by account type?

If the bank chooses to pay the item on faith that the consumer will repay the overdraft, there are still circumstances that might mitigate the fee. Most commonly, some banks will waive the fee if the overdraft is resolved, i.e., the loan paid back, within a certain period (usually one business day). Others will not impose a fee if the overdraft lies within a certain threshold, most commonly $50 (i.e., no fee so long as the transaction does not create a balance below negative $50). And in a more complex variant, there may be restrictions to ensure the consumer is not abusing the overdraft privilege – e.g., no fee on overdrafts less than $50 or resolved within 24 hours, on up to three items per year.

Recent Changes in Overdraft Fees

Bank	NSF fee	Overdraft fee	Other overdraft policies	Overdraft protection use fee
Chase	Eliminated	No change	Extended buffer from $5 to $50, w/24 hours to resolve OD	Eliminated
Bank of America	Eliminated	Reduced from $35 to $10		Eliminated
Citi	Eliminated	Eliminated		Eliminated
Wells Fargo	Eliminated	No change	24 hours to resolve OD	Eliminated
US Bank	Eliminated	No change	Extended buffer from $5 to $50, w/24 hours to resolve OD	No change
Truist	Eliminated	Eliminated on selected accts	Extended buffer from $5 to $100	Eliminated
PNC	Eliminated	No change	24 hours to resolve OD	Eliminated
TD	No change	No change	Added buffer of $50, w/24 hours to resolve OD	Eliminated
Capital One	Eliminated	Eliminated		Eliminated
Fifth Third	Eliminated	No change		No change
Citizens	No change	No change	Added grace period in which OD fees can be rebated	No change
Key	Eliminated	Reduced from $35 to $20		Eliminated
Huntington	Eliminated	Reduced from $36 to $15	Added buffer of $50, w/24 hours to resolve OD	Eliminated
Regions	Eliminated	No change		Eliminated
BMO Harris	Eliminated	Reduced from $35 to $15		Eliminated
First Citizens	Eliminated	Reduced from $36 to $10		Eliminated
M&T	Eliminated	Reduced from $36 to $15		Eliminated
HSBC	No change	No change		No change
Union Bank	No change	No change		No change
Bank of the West	No change	No change		No change
Santander	No change	No change	Extended buffer from $5 to $100	Eliminated
Woodforest	No change	No change		No change

Banks have also added fee-free options for consumers to resolve overdrafts, in the form of transfers from other accounts. That is, if a check sends the account balance negative, the bank will "sweep" funds from another deposit account at the institution into the checking account to restore a positive balance, or draw the funds from a preexisting credit product at the bank. That preexisting credit product could be a credit card, home equity line, or a dedicated overdraft line of credit.

Prior to the raft of recent changes, prevailing fees were typically $5 or $10 per instance. But as with NSF fees, there is little rationale for *(continued on page 3)*

imposing these fees other than "because we can," and most leading banks have abandoned these fees. Keep in mind, in electronically moving $100 from a savings account or credit line into a checking account, the bank isn't doing anything the consumer couldn't do themselves on the bank's website, and the processing cost of the bank executing this for the customer is minimal.

While the NSF and overdraft-transfer fees will likely erode entirely (as they should), **the overdraft protection fee represents a legitimate fee for what some clients will deem a valuable service.** As such, banks and credit unions should think about creating two distinct checking account types. For the client who wants total control of their finances, with zero possibility of ever overdrawing their account, an electronic-only account with no checks. The client can choose to link a savings, credit card, or other account to fund overdrafts via sweeps, but there is no option for the institution to fund the overdraft. If the debit would overdraw the account and there is no linked sweep account or such accounts lack sufficient funds, then the transaction is rejected.

For the client who wants the flexibility of overdraft services, a traditional checking product where the client can opt in to overdraft services. In this model, at the point of sale, the bank's customer service representative can present the client with the option of overdraft services, on a standing basis for checks and on a standing or case-by-case basis for electronic items (where an electronic debit that would cause overdraft triggers a text to the consumer, who can then either abandon the transaction or authorize it proceeding – with a fee – with an affirmative response). Of course, this account could also include sweep options, and bankers should strive to match the grace amounts and periods adopted by many of the larger banks.

In either account type, the electronic only or the traditional checking variety, **branch personnel and follow-up cross-sell campaigns should actively promote sweep options such as linked savings, credit card, or standalone overdraft lines of credit** as a means to help consumers avoid overdrafts and the adverse consequences of such. Not only will this assist the consumer in managing their finances, it will also increase the likely tenure of the relationship, as clients with broader relationships (in terms of cross-sell ratio) show lesser attrition on average. Thus, by placing a second product with the checking client, the institution will increase the likelihood of retaining that relationship for many years

One final issue in NSF/OD policy involves presentment order. For years, many large banks have processed checks from largest to smallest: for example, an account has a balance of $100 and checks arrive that night for $60, $55, $20, $20, $20, $20. The rationale banks state is "we assume your largest check is the most important (e.g., your mortgage payment), so we'll pay that first because you wouldn't want your mortgage payment rejected." But in that example, if processing high to low, then the $60 check clears but the next five reject, creating five NSF fees for the client. However, if we process low to high, the four $20 checks all clear, leaving only two NSF items. So low to high is likely more consumer friendly, or the bank can also post in simple order of presentment; but high to low seems a deliberate scheme to maximize fees. Regardless, any decisions on NSF/OD policies should also include a discussion of presentment order policy.

> *Historically, banks and credit unions have exacted fees for both NSF and overdraft events. But now there may be a competitive imperative for all institutions to revisit NSF and OD fees.*

The above outlines an architecture for a more consumer-friendly approach to NSF and overdraft processing; and while institutions that adopt such policies should receive attractive boosts in new-account volumes and retention levels, they may still suffer an overall decline in revenues due to the reduced fees.

As such, bankers evaluating NSF/OD policies should be concurrently thinking of means to replace lost fees. There are multiple options across multiple lines of business for pursuing augmented fee revenue, but some possibilities include:

- Campaigns to incentivize debit and credit card use, to increase interchange revenue.
- For institutions where free checking products constitute nearly the entirety of the checking portfolio, addition of a fixed-fee / waive at $1,500+ balance product that includes an array of ancillary services, and relationship pricing waiver options; this ensures that, whether by fee or margin, the institution is obtaining some revenue from the client.
- Increased emphasis on wealth management products and services, framed in the context of holistically serving the consumer's financial needs.
- Purchase of or affiliation with insurance agencies.
- For credit unions, greater emphasis on business banking, and especially the development of cash management services.

Some of these are more challenging to implement than others, some more long term than immediate, but at a time when competitive imperatives dictate reducing fee structures from NSF and overdraft events – and where doing so represents a fairer treatment to the consumer – a comprehensive strategy toward noninterest revenues is critical. ■ ■ ■ ■

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We learn better, communicate more effectively, and build deeper personal relationships in person than online.

What Banking School Can Teach Us… About Branches

By Steven Reider

For the past 20 years, I've had the privilege of teaching at the ***American Bankers Association's Stonier Graduate School of Banking***, and each year it affords a great opportunity to catch up with fellow bankers to discuss the industry. If you've attended Stonier or one of the other banking schools across the nation, I'm sure you've found that to be a beneficial experience, adding to your capabilities as bankers and fostering your career development.

The Stonier program meets each June in Philadelphia at the University of Pennsylvania, but in 2020 and 2021 the school converted to a virtual / online environment, due to the COVID pandemic. Thankfully, this year we were able to return to in-person instruction. Beyond the actual curriculum, some of the general comments I heard that week were quite telling:

> *"So glad to be back in-person… I absorb so much more information during in-person classes."*
>
> *"I'm able to develop much stronger personal relationships with my fellow bankers here on campus; you couldn't really do that in the online environment."*
>
> *"I learn more effectively in person."*
>
> *"The dialog and discussions we have in the classroom, you can't replicate that online."*

EXACTLY. We learn better, communicate more effectively, and build deeper personal relationships in person than online. And isn't that exactly what we seek for our banking officers to accomplish with our clients: education, communication, and development of deep, enduring relationships? Only one channel provides that most effective degree of communication and relationship development. Yes, the near uniform contention of the bankers attending Stonier that the in-person banking-school experience was superior is a tremendous argument for the branch, and the irreplicable in-person experiences that channel allows.

As an instructor, I observed the same phenomena the students reported. It's so much easier to perceive if someone doesn't quite understand a concept and the topic merits more discussion; or if someone has a question they're just a bit hesitant to raise. Now think about the sale of a complex product such as a home equity line or an annuity. What channel gives the best opportunity to address any client questions and remove uncertainties that might pose a barrier to purchase? And to resolve questions prior to sale to avoid any post-purchase dissatisfaction due to a misunderstanding of terms and conditions?

America's banking schools did noble work maintaining educational delivery through the pandemic, pivoting to online models when in-person meetings were not possible. But to all who have attended banking schools, ask yourself, which format is more effective? And if you answered "in person," then it's time to redouble efforts in the branch channel, to engage clients in person, to build effective two-way dialog that fosters trust, education, and understanding, and yields deep, enduring banker-client relationships.

Tactics for the Rising-Rate Environment

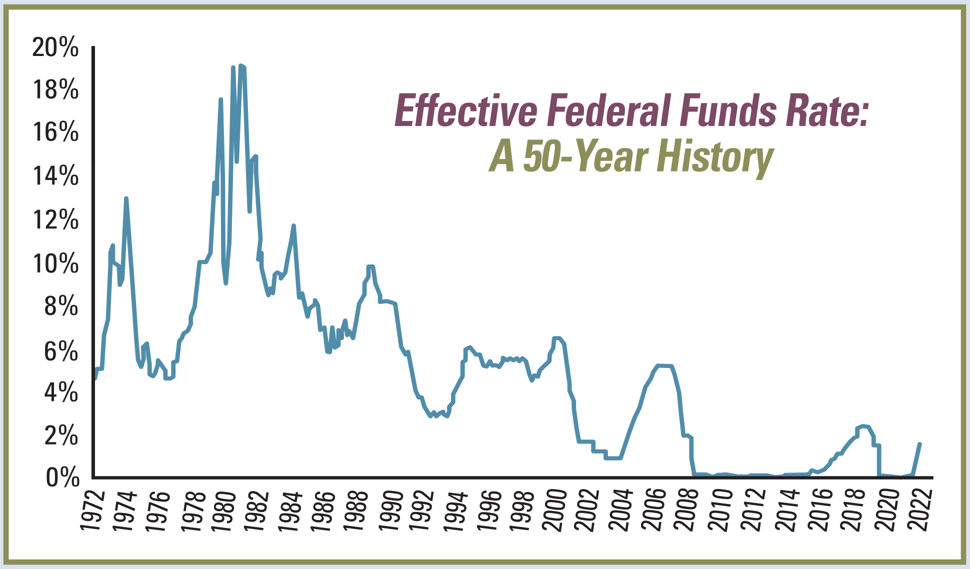
Farming is a challenging business. Get bad weather and the crop is ruined and you have nothing to sell; get great weather and there's a massive crop, and the glut causes prices to sink. So farmers fret and worry, often.

Bankers fret similarly over the interest rate environment. When rates remain low, our depositors grumble at us and our loans yield minimal revenue. When rates turn higher, our cost of funds soars and the cost of borrowing constrains loan demand. Somehow the industry has survived amidst both extremes and most places in between, but it isn't easy and there's always uncertainty and worry over what the next turn in rates will bring.

That latest turn arrived in March, when the Federal Reserve Board commenced a series of increases in the Federal Funds rate, in an effort to tamp down inflation that arose from an overheated economy, a robust housing market, and a sizzling employment market. From March through July, the Fed increased the target range for Fed Funds three times, taking that target from the 0 - 25 basis point range in March to the 1.5% - 1.75% range in June. Correspondingly, the Effective Federal Funds rate increased from 0.08% in March to 1.58% in July, a change of 150 basis points.

These changes, along with the FRB's cautions regarding potential future increases, have reverberated throughout the industry, manifested in both deposit and loan product rates, and causing angst for bankers nationwide. To help maintain profitability in this environment, a few tips follow.

First, keep context: rates aren't high! Yet, anyway. Today's 1.58% effective Fed Funds rate is the same level as in February 2020, the last month before the pandemic emerged in earnest. And in mid-2019, the rate hovered in the 2.40% range, nearly a full percentage point above today's rate. Rates have remained relatively low since the financial crisis of 2008 - 2009, but before that, the effective Fed Funds rate sat at 5.25%. And from a longer-term perspective, younger bankers should ask their parents about the rate at which they obtained their first mortgage; or see the chart below. Thus, the current rates, though above the near-zero levels of most of the 14-year period since the onset of the great financial crisis, are neither excessive nor unprecedented, and no cause for panic.



Negotiation skills will become important again. Any branch manager who joined the industry in 2009 or later has rarely had to compete for deposits, with the leftmost digit on the rate board at zero for virtually every product type. Thus, consumers were not choosing institutions based on deposit rates. But as rates increase, consumers will start comparison shopping for deposit products, and bankers will need to negotiate to win those relationships. It will be important for each institution to understand their clients' rate sensitivity – how many basis points they can hover below the top-of-market rate and still maintain relationships. For example, for a 24-month CD where top-of-market is at 2.00%, can you keep your customers with a rate 10 basis points lesser? Probably. But at 50 basis points less? Probably not.

It is critical to understand that tolerance range, and that range is a direct reflection of the institution's brand strength. The best indicator of brand strength is cost of funds: the stronger the brand, the lower the cost of funds. Consider if your bank is offering 50 basis points and the competing bank is offering 75 basis points, why should the client stay with you? Why should the client forgo 25 basis points of yield? Of course, there can be multiple reasons; and price is rarely the sole determinant of choice. Perhaps they prefer your bank's service. Or convenience; or the quality of your bank's electronic channels; or its philanthropic activities in the community. Regardless, when clients are willing to forgo their own income to bank with your institution, then other aspects of the value proposition – i.e., the tenets of the institution's brand – are outweighing yield alone. As rates rise, it becomes essential to consider what non-price values our institution can offer to win / maintain relationships, even at a price disadvantage.

Revisit the product offerings. In a higher-rate environment, the mix and type of products consumers are seeking will change. On the credit side, as higher rates for fixed-rate mortgage take hold, adjustable-rate mortgages (ARMs) will garner greater interest. For ARMs kept in portfolio, *(continued on page 6)*

this creates risk when the balloon payment comes due. But keep in mind, Americans have become increasingly more transitory; and before the pandemic took hold, the median tenure between moves had fallen to seven years – less than half the tenure of a generation prior. As a result, many ARMs, especially those with seven-year terms, will never reach the balloon payment date, as residents will have sold the house and moved before that payment obligation arrives.

Also in the secured real estate category, home equity lines of credit may become more attractive as rates rise. HELOCs have fallen out of favor with consumers since the great financial crisis, and the aggregate balance of home equity lines and loans has declined from $1.2 trillion nationwide in 2008 to about $450B today. One reason for that decline is the lessening value of a primary benefit of home equity lines in a low-rate environment. In most cases, the interest payments on equity lines and loans are tax deductible; but that deduction lessens as rates decline. For example, a $10,000 average balance at 3% interest creates $300 per year in interest payments. So to a consumer with an effective tax rate of 25%, the deductibility feature of the equity line/loan creates a $75 tax savings. Nice to have, but not dramatic and likely not offsetting the costs of establishing the equity loan. But if the rate on the HELOC rises to 10%, that effective tax savings rises to $250, giving a much greater incentive to, for example, purchase a vehicle using a HELOC draw versus with an installment loan where interest is not deductible.

For credit cards, the top opportunity in a rising-rate environment may lie in management of the upper part of the portfolio, from a risk standpoint. Rising rates will affect lower-income consumers to a greater extent than more affluent consumers, so a uniform ratcheting upward of rates across all credit tiers may leave the lowest-risk tier at a rate above what their risk level would warrant, and thus vulnerable to superior offers from competitors. If bankers can effectively parse those lowest-risk clients from the remainder of the portfolio, they can maintain current rate levels (or at least impose lesser basis-point increases) and ensure retention.

Finally, on the deposit side, a rising-rate environment may revive consideration of CDs, which in the past decade have been relegated to a consumer afterthought. Before the financial crisis of 2008 - 2009, US consumers held nearly half of all deposits in CDs. In the 10 years that followed, that proportion plummeted below 15%. With rates now at a point where consumers will discern meaningful annual returns from that product, bankers may wish to lock in longer-term relationships with those clients. The reemergence of CDs as a viable option, especially coupled with the recent volatility in stocks, real estate, and other investment options, also gives bankers the opportunity to engage consumers – a justification for a phone call to discuss product offerings and present advice that can improve the consumers' financial health.

Rates have remained relatively low since the financial crisis of 2008 - 2009. And from a longer-term perspective, younger bankers should ask their parents about the rate at which they obtained their first mortgage

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