Overdraft Changes Bring a New Competitive Landscape

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Headlines

We've all seen the headlines. In April 2021, PNC announced that it was eliminating NSF (returned item) fees and capping overdraft fees at one per day. Following that, some other banks and credit unions made announcements that they were reducing or eliminating their fees, like Capital One's announcement in December 2021 that it would be eliminating overdraft fees.

A flurry of announcements kept coming from large banks. But what did they really say?

Truth

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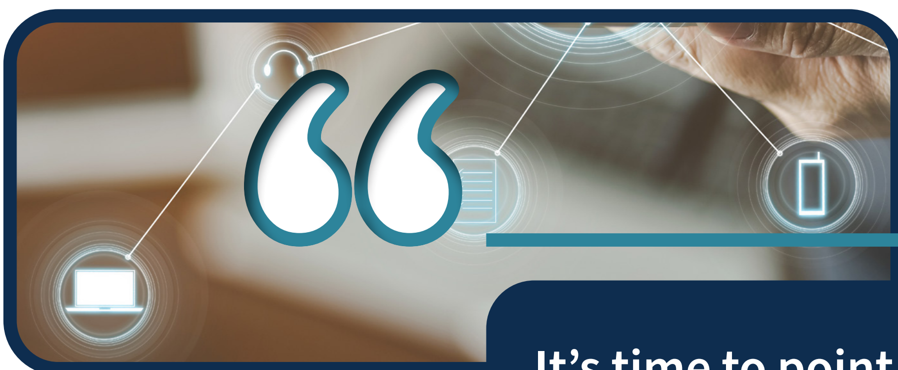

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First, it's important to remember the distinction between overdraft fees and NSF fees. Overdraft fees are when the financial institution ***pays*** an item. NSF fees are when the financial institution ***returns*** an item. NSF fees have come under fire because there's a question about what it really costs the institution to offer the service. It's not like the old days where all the returned items were paper checks and you had to physically touch and return them. Now they're largely ACH items, and what is the institution's real cost to return them? However, overdraft does have a real cost because the financial institution takes the risk of not getting repaid.

When you rank the top 20 banks by overdraft and NSF revenue, as the CFPB did in a chart (which has not yet been updated for a recent announcement from Citi), it is true that 10 out of those top 20 have announced they're eliminating NSF fees.

However, ***only 2 banks have recently eliminated overdraft fees*** (Capital One and Citi). To put the recent Citi announcement in perspective, they're 4th in the United States by assets but 15th by overdraft and NSF income, and these fees represent less than 0.2% of the bank's revenue. And, they haven't even paid everyday debit card and ATM transactions into overdraft in many years.

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Also, ***only 2 others out of the top 20 banks have reduced the amount of the fee*** (Bank of America and M&T).

The typical bank on this list still charges up to 3 or more overdraft fees a day with a median per-item fee of $35.

So while these announcements garnered headlines, they typically didn't clarify that what was being eliminated were NSF ***returned item*** fees, not ***overdraft*** fees, and they also didn't discuss the negative foreseeable consequences that invariably occur when these fees are reduced or eliminated.

Collateral Damage

Banks drastically cutting their fees will make up revenue somewhere else. It won't happen immediately, but these banks likely will increase their monthly fee for a checking account, or make it more difficult to have that fee waived. After all, they're businesses with shareholders, and their management is focused on their stock price and financial performance.

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But what also inevitably will happen is that ***access to overdraft liquidity will be reduced*** for those who use, need and value the service.

This is just common sense. Most of our clients offer a maximum overdraft limit for consumers of around $1,500. If you are running a bank and you just eliminated overdraft fees, are you really going to be willing to take the risk of paying items up to $1,500 for consumers when you will not be compensated for that risk? Of course not.

The prediction of increased monthly fees and reduced overdraft coverage isn't just speculation.

First, a 2021 Federal Reserve study showed that overdraft price caps lead to "reducing banking services for low-income households," as well as "constrain the supply of overdraft credit and reduce financial inclusion among lower income households."

Second, Truist's new "Truist One" account has no overdraft fees, but only covers a $100 "negative balance buffer". If you want more than that as an account holder, you have to look to their line of credit which will go "up to $750" (and for which fees and interest rates were not available at the time this white paper was written). And, the new accounts "may include a monthly fee."

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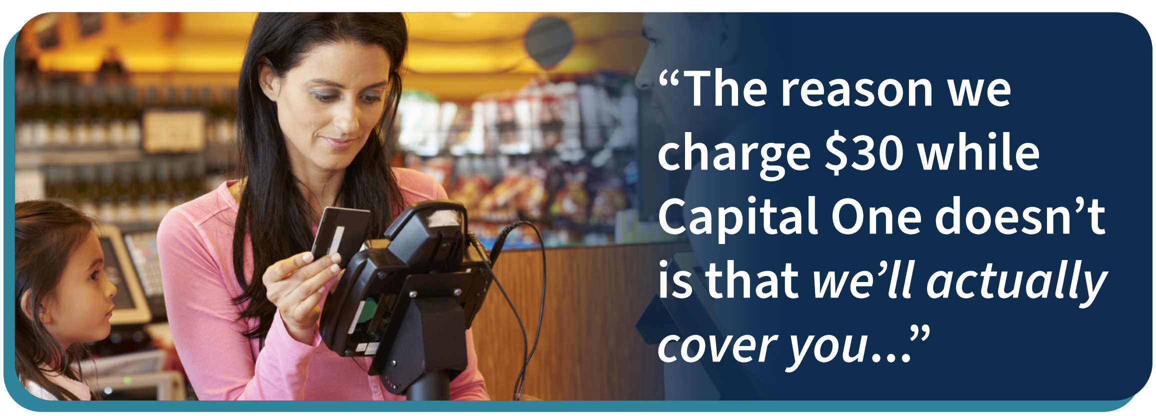
People who regularly use overdraft are not going to find a $100 limit very useful. Said plainly, banks reducing or eliminating overdraft fees also will reduce or eliminate their payment of most overdraft transactions. And, disliked monthly account fees potentially affect all account holders, not a small subset of those who've opted in and agreed to pay overdraft fees.



A New Competitive Landscape Emerges

Banks that are leaving consumers in the lurch for transactions they used to cover will open up a new competitive landscape for financial institutions that will pay larger amounts of insufficient funds transactions into overdraft.

You can do this in a responsible way, by setting overdraft limits at the account level based on ability to repay. And, you can publish those limits to consumers, something none of banks eliminating fees will do now that they only cover embarrassingly small overdrawn balances.

This gives you very clear cover to respond to what otherwise might be a difficult question about why Capital One doesn't charge an overdraft fee but your financial institution is still charging $30. The answer then becomes: "The reason we charge $30 while Capital One doesn't is that we'll actually cover you – we'll actually pay your items to the extent you need coverage instead of a small limit. And we'll clearly tell you what that limit is, which Capital One won't do."

Make no mistake – megabanks see their fee reduction moves as another way they can squeeze community financial institutions. Don't let them. Because of their size and scale, the megabanks have many other ways to make up this lost income, like Capital One's massive credit card portfolio and monetizing data obtained from both its credit card and deposit account portfolio.

And speaking of data, look at yours.

What Does Your Data Show?

After all of the recent overdraft fee reduction announcements, does your data show that you're seeing significant overdraft users leave? In other words, is the competitive pressure actually affecting you? If not, does it make good business sense to make changes? Said another way, are you listening to the media or are you listening to your account holders?

Morning Consult, based on its survey data, determined that banks like PNC and Ally which have made drastic changes to overdraft policies "aren't seeing a favorability boost."

So if your current account base isn't leaving, and new potential account holders don't see you more favorably if you make significant changes to your overdraft fees and policies, then why would you change them?

The Reg. E Example of Changes to Overdraft

There is a precedent for major changes to overdraft that shook up the competitive dynamic.

In 2010, changes to Regulation E went into effect that required financial institutions to obtain the affirmative consent of consumers before the financial institution could charge them an overdraft fee on everyday debit card and ATM transactions. This was a prime example of listening to your account holders by giving them the option to opt in to the service and not charging them fees if they didn't do so, and many banks and credit unions panicked and thought that their overdraft programs would go away.

Bank of America famously made the announcement that it would not be undertaking an opt-in campaign, and instead would start denying everyday debit card and ATM transactions instead of offering to pay them into overdraft.

Despite this announcement from one of the largest banks in the country, most other financial institutions didn't follow Bank of America's course. Instead, they did the work and opted in the people who wanted the service. And by doing this, they made billions of dollars.

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If you didn't follow Bank of America in 2010, why follow them or any of the other big banks this time if it's not the right path for your financial institution?

And, while Citi's February 2022 announcement says it is eliminating overdraft fees, like Bank of America, Citi hasn't paid point-of-sale debit card transactions into overdraft for many years. This is a big reason why overdraft fees constitute less than 0.2% of Citi's revenue, and makes Citi's announcement unremarkable despite the broad headlines.

Motivations and Fears

Also bear in mind that Capital One, Citi, Bank of America and the other megabanks have different motivations and reasons (and, frankly, fears) for the decisions they make which are different than those of community financial institutions.

These are among the most highly-regulated businesses on the planet. Representatives of the Consumer Financial Protection Bureau are constantly in their offices examining every corner of their business.

This is radically different for financial institutions under $10 billion in assets, for whom the CFPB has absolutely no supervision or enforcement authority. The parallel also applies even to banks over $10 billion but under roughly $100 billion, for whom CFPB scrutiny is certainly less than it is for Citi, Bank of America, Chase, Wells Fargo, US Bank, PNC, etc.

Consumers Value Overdraft

When thinking about whether you want to make changes to your overdraft program, it's very important to recognize that there is real consumer demand for the product.

Here's proof:

1. **Remember that millions of people have opted-in to overdraft under Reg. E and have said they are willing to pay a fee for the service of having debit card transactions covered. Those millions of decisions confirm that consumers value the overdraft service, even if it comes with fees.**

2. **A Morning Consult survey showed that about half of Americans think overdraft fees are fair.**

3. **Backing that up is the fact that less than 0.15% of complaints to the CFPB during a raging global pandemic in 2020 were about overdraft.**

4. **And studies have shown that responsibly-run programs provide benefits to consumers that are many times the amount of the overdraft fee.**

Changes Community Financial Institutions Can Make

So from a competitive standpoint, if you're not going to follow the megabanks' moves directly, is there anything you should do?

We believe there are three primary things that create responsible, defensible and consumer-friendly overdraft programs:

1. **Consumers should be provided an overdraft limit that is commensurate with their ability to repay the overdrawn balance.**

A lot of community financial institutions give every account holder a flat $500 overdraft limit. Where else would you do this? Would you give people car loans with a $500 monthly payment when those people only make $400 each month in deposits? This is one of the ultimate ways of doing right by consumers – make sure not to extend an overdraft limit that is more than they can repay, and underwrite the limits at least monthly at the account level.

2. **Monitor and address situations where people are paying a disproportionate share of their income in overdraft fees.**

For example, if you're making $2,000 a month but paying $400 a month in overdraft fees, that needs to stop. In full disclosure, Velocity Solutions provides a program that can manage this situation.* Our system can automatically reduce the consumer's overdraft limit based on a fees-to-deposits ratio which can stop the consumer from spending a disproportionate amount of his or her deposits in overdraft fees.

3. **Offer an alternative to overdraft that provides real short-term small-dollar liquidity to consumers.**

Community financial institutions can offer small-dollar loans with reasonable interest rates and fees in an automated way that does not require a FICO score.* This addresses the growing number of consumers (about 1 in every 9 Americans) who are "credit invisible" and do not have credit scores. It also helps consumers who may have had trouble which caused a low score and now who have recovered from that short-term difficulty, but they find that their score hasn't caught up as quickly as their financial recovery.

From a competitive standpoint, be proud of the liquidity that you offer your consumers based on their ability to repay as discussed above. You can use the appropriate software to set an overdraft limit for each individual account every month, and you can publish that limit to account holders so you're clearly telling them the amount of the overdraft limit the consumer can access with your institution where Capital One, Wells Fargo, PNC, etc. won't do that.

And, you can lead on alternatives for short-term liquidity through responsible small-dollar short-term loans using cash flow underwriting based on data you already have in the consumer's transaction account instead of a FICO score.

The function of offering short-term liquidity isn't going away for financial institutions. Consumers will always need this functionality, so why not offer programs that are responsible and provide real liquidity to consumers that the megabanks have forsaken, while still generating fee income that allows you to offer banking services without hated monthly fees?

*The Intelligent Limit System® is an overdraft management and reporting system providing financial institutions with the automated tools and technology they need to manage overdraft services with managed limits and program flexibility. The system assigns account level overdraft limits based on the consumer's ability to repay. Velocity's small-dollar consumer loan platform, CashPlease®, is an affordable, responsible and compliant way for community financial institutions to provide an alternative form of short-term liquidity to their account holders. Velocity has the capability to reduce the consumer's overdraft limit by the amount of the small-dollar loan, mitigating risk for the financial institution and the account holder.

Christopher Leonard
CEO Velocity Solutions

Christopher Leonard serves as Chief Executive Officer of Velocity Solutions. Before becoming CEO, Christopher served as President of the company from 2012 to 2014, and previously as Chief Operating Officer & General Counsel from 2005 to 2011. Prior to joining the company in 2005, Christopher was a partner in one of North Carolina's top law firms, where he worked with private and publicly-held businesses in transactional, compliance and advisory capacities. He also served as counsel to Velocity Solutions advising on legal and regulatory issues affecting the financial industry. He still stays up to date on these issues, which allows him to serve as a key resource for our clients. While in law practice, Christopher received the New Hanover County Bar Association's Pro Bono Award and was included in Super Lawyers.

Founded in 1995 and servicing the transaction accounts of over 30 million consumers and business owners, Velocity Solutions is the leading provider of technology solutions that drive revenue, service and compliance for community banks and credit unions. Our Velocity Intelligent Platform® powers all of Velocity's solutions, using machine-led intelligence that delivers powerful analytics, manages risk, and drives revenue, loans, account holder engagement and non-interest income to our client financial institutions.

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