

ASPIRIN FOR COMPLIANCE HEADACHES

JOHN M. FLOYD & ASSOCIATES WHITE PAPER

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I.

Introduction

Credit Unions are facing a number of issues in today's volatile market. Declining income opportunities due to a flat yield curve and more consumer loan options have both had a major impact nationwide. Overdraft privilege is a solution that increases both non-interest income and member satisfaction.

Whether you currently offer an overdraft program, or occasionally pay overdrafts, you will want to know how the new guidance will affect your institution or you'll wind up dealing with major headaches related to overdraft privilege compliance.

II.

Overdrafts Cause Headaches for Financial Institutions

Most consumers don't intend to overdraw their checking accounts. Although there are consumers whose plan is to use OPM (other peoples' money) and who constantly rob Peter to pay Paul, these represent a tiny minority of consumers.

Instead, people generally intend to manage their financial accounts so that they remain in the positive. For most members, they do pretty well. When overdrafts occur, there's often a pretty good excuse as to why it happened.

- Perhaps they intended to make a deposit, often even preparing the deposit slip in their home or office before they get to the teller line, but something happens and they don't ever get to the financial institution or ATM.
- Or, they think that they have more time before multiple debits will hit the account than they really do. This happens more often now that Check 21 and check conversion to ACH transactions are reducing the float.
- Or, a deposited item doesn't clear and their account is taken negative although they have deposit statements to demonstrate that the account should be positive.
- Or, an authorized transaction hits the account early, or in error or, worse yet, double-dings the account.

- Or, the financial institution makes a mistake in the handling of transactions and the member account is affected.
- Or, the member doesn't properly record a transaction in their register (ATM and debit card receipts are particularly slippery) and the miscalculation causes them to overspend.
- Or, perhaps illness, unemployment, or emergency situations cause them to risk an overdraft rather than avoid the expenditure.

Any of these conditions can occur in a consumer account on any day. That has been true for as long as financial institutions have existed. It is almost required that the credit unions must manage their members' knowledge of and effective response to overdrafts. That's where the headaches really come from.

Daily NSF decisions take branch staff away from helping new members and may harm existing relationships. The member you don't call about today's NSF could be pounding on your desk next week. The one you do call won't come in (although she promised she would) and make a deposit before the noon deadline. When the NSF is returned to the merchant unpaid, the member often resents the fee since "you didn't do anything for me." Yet, when you waive the fee they thank you by writing more NSF items. Every part of the process is troublesome. The real cost of overdraft handling includes the loss of potential fee income, back office and front line labor costs and ultimately, member satisfaction.

That's enough to give any executive a headache!

III. Headache Medicine for Overdrafts

Recent regulations have raised the bar for financial institutions and vendors. It is important that institutions that currently offer an overdraft privilege program or are considering implementing one completely understand these regulatory changes. They are complicated and require considerable time and effort to implement and maintain. A third-party solution for overdraft privilege can provide benefits to the credit union and its members.

Reduces Staff Labor

Overdraft privilege is an automated program created in the mid-eighties as a way to reduce the burden of manual back office processes and to save staff time processing NSF items. If the list of NSF items were reduced by 75% each day, branch officers would have more time to respond to new members. (The percentage of items reduced from manual decision-making is variable, but most member check amounts are small and can be easily paid by an overdraft privilege program.)

Increases Member Loyalty

These time savings result in more than expense savings to the credit union. An added, though unintentional benefit is enhanced service for the member. Since members don't intend to overdraw the account ("it was an accident," "my husband said he'd make the deposit," "my payday is tomorrow," etc.), and since most members won't close their account just because they are overdrawn, both the member and the credit union benefit from this service. Some members have always been given special treatment with overdraft handling, and they are the member whose deposit patterns and product utilization has demonstrated their loyalty to the credit union. By giving special treatment to all members, many credit unions have found that their members deposit more money, deposit more often, and utilize a wider range of products and services. When a member feels trusted by the credit union, they usually invest more in the credit union.

Offers Competitive Advantage

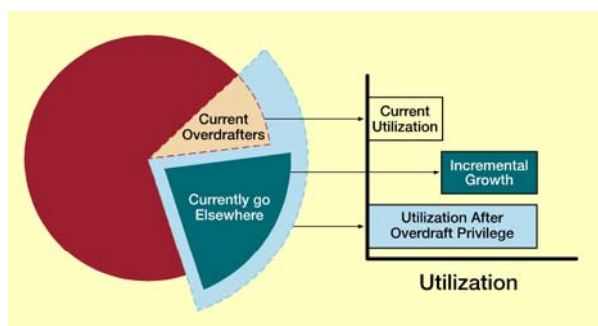
To attract new members, overdraft privilege services are becoming standard in the marketplace and are offered by financial institutions of all sizes. Multiple ATM locations, Internet banking and overdraft privilege are features that many members are no longer surprised to receive – they expect them. (Remember when mobile lines were a feature you used to help ‘sell’ your institution?)

Saves Members Money and Embarrassment

Overdraft privilege programs enable financial institutions to cover consumer checks or items up to a pre-defined overdraft limit while charging the standard NSF fee. When the item is paid by the institution and is not returned to the merchant unpaid, the consumer pays only one fee to the financial institution. That saves the consumer money since they don’t pay the merchant’s returned-check charge. More importantly, the consumer is spared the embarrassment of having an item returned and the repercussions to their reputation.

Increases Non-Interest Income

Overdraft privilege users include existing NSF-writers and many consumers who currently use other resources to address occasional shortfalls (e.g., borrowing from family, payday lenders, or payroll advances). Statistics indicate that financial institutions generally don’t experience a significant increase in the amount of NSF’s written by a single member. Instead, the institution makes available a resource that more members will be able to use.



Right now the members who experience an occasional shortfall may be paying their bills late, incurring even higher fees by merchants, and/or activating increased interest rates or other penalties. Many financial institutions have indeed realized significant fee income while providing a positive service.

**IV.
Regulatory Perspective on Overdraft Privilege**

Regulators have provided financial institutions with direction regarding the operation of overdraft privilege programs. In some cases, the direction involves changes to regulations (e.g., changes to 12 CFR Part 707) and in other cases the direction may be considered more discretionary (e.g., Final Guidance on Overdraft Protection programs or InterAgency Guidance).

InterAgency Guidance

The Interagency Guidance was established to provide financial institutions with guidelines to follow when offering overdraft programs to consumers as an alternative to traditional ways of covering overdrafts. The guidance helps eliminate such abuses as discriminatory availability, over-promotion, lack of communication with participants and any under-education of consumers on the program’s proper use.

A S P I R I N F O R C O M P L I A N C E H E A D A C H E S

Within the guidance, there are three primary sections: safety and soundness considerations, legal risks and best practices.

1. The first section of the Interagency Guidance, safety and soundness considerations, seeks to ensure that depository institutions offering overdraft protection adopt adequate policies and procedures to address credit, operational and other associated risks.
2. The second section on legal risks addresses how financial institutions need to comply with all applicable federal and state laws. State laws also may be applicable, including usury and criminal laws and laws on unfair or deceptive acts or practices. It is important that institutions have their overdraft protection programs reviewed by counsel for compliance prior to implementation. Remember, applicable laws and regulations are subject to amendment so institutions should monitor laws and regulations for revisions to ensure their overdraft protection programs are fully compliant.
3. Finally, the best practices section addresses the marketing and communications that accompany overdraft programs and the disclosure and operation of these programs.

12 CFR Part 707

12 CFR Part 707 implements the Truth in Savings Act that requires the disclosure of the amount of any fee charged for paying a check written on an account. The regulation changes that take effect on October 1, 2006 have caused a great deal of discussion. Some institutions are uncertain about whether to disclose overdraft programs in light of these regulatory changes. To avoid new disclosure requirements, they may decide to stop disclosing their overdraft programs on October 1, 2006. Compliance experts don't think that the recent regulatory direction is intended to stop financial institutions from providing their members with information about overdraft privilege programs. Regulators are not in the business of preventing financial institutions from providing their members with accurate information.

Federal Brochure

The InterAgency Guidance and the revisions to Regulation DD (12 CFR Part 707) represent two of the three elements of regulatory response to the overdraft privilege service. The third element is the Protecting Yourself from Overdraft and Bounced-Check Fees brochure which was issued in December, 2004. All three of these elements reflect the regulatory concern that in order to evaluate alternatives to having items returned unpaid (through the use of personal account management or transfers/loan/overdraft protection sources), consumers who use overdraft privilege programs should be given information about their use, fees and access options, and that periodic statements should inform consumers about the actual cost of overdrafts.



ECOA and Reg B

Regulation B implements the Equal Credit Opportunity Act (ECOA), which prohibits creditors from discriminating in providing credit to applicants based on race, color, religion, national origin, sex, marital status, age or if an applicant's income is derived from public assistance. FDIC comments regarding the application of the Equal Credit Opportunity Act and Regulation B to overdraft privilege programs raised the issue of discrimination against consumers on a prohibited basis. This discussion may appear to discourage the use of overdraft privilege for selected accounts. In fact, offering overdraft privilege to all eligible members, regardless of protected class (race, color, religion, national origin, sex, marital status, age, or the fact that all or part of the applicant's income

derives from a public assistance program and the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act), is appropriate. Overdraft privilege programs should not steer or target certain consumers. Instead, all eligible accounts should be given the overdraft privilege and financial institutions should inform consumers of other overdraft services and credit products.

Reg Z

Regulation Z implements the Truth in Lending Act, requiring the disclosure of consumer credit terms and costs, regulating certain credit card practices and providing ways to resolve credit billing disputes. Some financial institution executives have disputed whether overdraft privilege programs should be treated as loans. According to the InterAgency Guidance issued in February 2005, the following description of why overdraft privilege is not a loan appears under the heading Truth in Lending Act in the subsection **Legal Risks**: “Under Regulation Z, fees for paying overdraft items currently are not considered finance charges if the institution has not agreed in writing to pay overdrafts. Even where the institution agrees in writing to pay overdrafts as part of the deposit account agreement, fees assessed against a transaction account for overdraft protection services are finance charges only to the extent the fees exceed the charges imposed for paying or returning overdrafts on a similar transaction account that does not have overdraft protection.” Since overdraft privilege programs are discretionary services when properly implemented, they are not lending products subject to Reg Z.

Regulatory Conclusion

Each financial institution should evaluate their program in light of the importance of completing its members’ payment transactions and these regulatory concerns. If the consumer is educated about the alternatives to overdraft privilege programs and the associated fees, if the consumer understands the program’s operation and his or her responsibility to return their accounts to a positive balance, and if the periodic statement accurately describes the financial impact of overdraft privilege program usage to the consumer account, the consumer and regulatory concerns are well-served.

V. Conclusion

When you combine compliance efforts for overdraft privilege-related regulations with compliance related to all the other regulations your financial institution must address, it can seem overwhelming. So, unless you have the personnel available and the time necessary to focus on compliance issues related to overdraft privilege, you will be well served to find a quality overdraft privilege provider to help you manage that process. That third party provider will quickly become “the aspirin for your overdraft privilege compliance headaches.”

About JMFA

JMFA is a leading provider of overdraft privilege programs, implementing more than 1,000 of such programs and servicing more than 2,000 banks and credit unions in 49 states and Central America. The company is also recognized nationally for training, incentive and earnings enhancement programs as well as product, service, pricing and technology improvement consulting.

For more information or to learn more about JMFA, visit www.JMFA.com or call 800-809-2307.