

Overdraft Fees: Widening the Compliance Lens

Complying with the recent changes in overdraft fee regulation requires utilizing customer information to build better pricing models and segment customers more effectively.

BAI Banking Strategies, June 1, 2010

By Jim Henschel

When Michael Jordan retired from the Chicago Bulls, he is said to have teased Bulls Coach Phil Jackson, “Now we’ll see if you can coach!”

Today the same might be said about consumer banking. As fee income plummets in the wake of Regulation E overdraft rule changes, we’ll now see who is good at the fundamentals of consumer banking. We’ll see who can win back that lost income with better, more transparent, customer-tailored banking.

From a pure compliance standpoint, the impact from the Reg E change is relatively slight. The regulation is clear and crisply written. In many cases, complying will not take much more than some DDA system changes, a disclosure notice of the opt-in procedures and the flip of a switch before July 1.

But is this about compliance, or is it a much-needed opportunity to change what was not sustainable anyway – an outsized reliance on overdraft fees – in favor of a more transparent, positive kind of consumer banking? (That the heaviest overdrafters were willing buyers and ungrudging payers at all income levels is true but ultimately beside the point, trumped by anecdotes of unwitting customers paying punitive fees for minor transgressions.)

We believe that banks can use this occasion (and all the other pending changes in Washington) to do what they have long resolved they must do: fully align their value propositions with the needs and sensitivities of different groups of customers. In doing so, they can gain competitive advantage and market share. Banks already have the technology, business intelligence, and analytics to accomplish this. Now they have the unavoidable impetus.

No Silver Bullet

Many banks will sustain a huge loss of fee income under the new rules at a time when bank revenue growth already faces strong headwinds. In addition, to the surprise of many, the recession has not caused an upturn in overdrafts. Consumers are managing their balances more attentively and simply spending less. For the first time in decades, they appear to desire a savings cushion more than credit in order to clean up their “personal balance sheets.”

While there is no silver bullet for replacing income of that magnitude, this situation is rife with opportunity for those who are willing to undertake a variety of incremental strategies, some inspired, some mundane, but all geared toward minimizing the loss of income and maximizing replacement opportunities.

The first priority is retaining as much of the current overdraft income as possible through customer communication as required under the new policy. A perfunctory notification with an opt-in opportunity takes care of the majority of customers who never or hardly ever overdraft. But making sure that the heaviest users continue to have access to

this service is worthy of more targeted tactics.

Each segment of overdrafters, as defined by frequency of use, requires a targeted communication designed to ensure customer awareness of the changes. The cost of a nuanced, effective opt-in outreach is small compared to the cost of replacing this income in a down economy. Then, it's time to widen the compliance lens to assess the impact of the new rules on customers in terms of all sources of income – historical, current and prospective.

Just as some customers willingly pay overdraft fees, others don't mind paying foreign ATM fees. Some value a safe deposit box far more than others. Some will pay for online banking while some think it should be free. Some cost the bank more than others by the way they use their accounts. Some are already bringing the bank substantial revenue by their frequent use of debit cards. All these factors should play a role in determining how much, if at all, a customer should be charged for a checking account.

Banks might want to consider a consumer version of the earnings credit rate which works so well for businesses by discounting service charges according to the size of customer balances. An earnings credit rate reflects the business's needs, behavior, and sensitivities and makes the pricing transparent. That is precisely what consumers are looking for today.

Defining these segments and responding effectively to them is what all those investments in Customer Relationship Management (CRM), data analytics and business intelligence were designed for – to know one customer from another and treat each appropriately. There has never been a better time or reason to deploy that powerful intelligence.

More from Washington

This is also the time to widen the lens to take in what else Washington has in the queue. Reacting to overdraft regulation as a stand-alone issue is shortsighted. Overdrafts, after all, have not been consumers' only path to short-term credit – think credit card convenience checks, payday loans, and deposit advances. Regulators are keeping a close eye on these products and continued change is likely.

The administration and Congress also have, in various stages of consideration, ambitious measures that target regulatory reform, bank interchange fees, a new consumer protection agency, small business lending, increased capital reserves and higher Federal Deposit Insurance Corp. premiums.

Some of these initiatives are sure to be enacted in one form or another and their impact will be profound. Modeling their potential outcomes will not give bankers precise answers about the best course of action but will help them recognize where potential risks lie and help work these risks into their budget calculations.

Then, it is time to widen the lens once more, this time beyond our borders. If regulators continue to scrutinize overdraft fees and processing, what are the viable alternatives? In many countries, including Canada and the UK, checking accounts come with an "authorized overdraft limit," disclosed when the account is opened. Usually, instead of a fee, overdrafters are assessed an interest rate on the overdraft amount for its duration.

In the past, such sources of income have not appealed to most U.S. bankers, but a closer look is warranted now. And

the positive revenue potential may come as a pleasant surprise. One lesson from foreign banks, as U.S. banks reengineer the checking account, is that customers welcome greater transparency about how transactions are handled and how and when overdraft limits are applied. That holds real benefit for future income.

The overdraft changes may have been conceived as a regulatory rebuke, but represent no ordinary compliance event. With so much at stake – profits, valuable customers and the certainty of ongoing regulatory change – it is time to finally execute the ambitious customer segmentation strategies that past investments have made possible.

Mr. Henschel is a managing partner in the Dallas office of ABeam. He can be reached at jhenschel@abeam.com.

Reprinted courtesy of BAI Banking Strategies Online magazine. For the latest issue, visit www.bankingstrategies.com.