

# Overdraft Protection Programs Subject of Regulatory Guidance

The regulatory agencies<sup>1</sup> (the Agencies) recently issued a final joint guidance document entitled, *Joint Guidance on Overdraft Protection Programs* (the Guidance). In an unusual move, the **Office of Thrift Supervision** (OTS) issued its own version of the document with the primary difference being that it omitted the discussion of legal risks which elicited substantial comment and controversy, particularly over whether overdrafts are credit for purposes of the *Truth In Lending Act* (TILA) and Regulation Z (Reg Z).

## What is Overdraft Protection?

Generally, there are two ways to cover overdrafts. In one scenario, the consumer is granted a true line of credit where there is an agreement with the financial institution to transfer an overdraft balance to the line. Both parties agree to the terms and conditions in advance and the arrangement is subject to Reg Z.

The second way to cover overdrafts is often termed an Overdraft Protection Program (ODP) or “bounce protection.” These programs are marketed to consumers essentially as short-term credit facilities. The programs typically provide consumers with an express overdraft “limit” that applies to their accounts. These programs are not officially loans and financial institutions reserve the right to pay or not pay an item. There is no commitment and the arrangement is not subject to Reg Z. There is a non-sufficient funds (NSF) fee applied to each item presented and that fee would be charged whether or not the item was paid. Sometimes there is also a daily fee charged on overdraft balances, if state law allows. The details of these programs vary from institution to institution.

## The Guidance

While these programs have become more and more popular because of their convenience and profitability, aspects of the marketing, disclosure, and implementation of some of the programs have raised concerns. Consequently, they have been reviewed numerous times by the Agencies to make sure they do not constitute loans subject to Reg Z and to be sure that consumers are not being harmed by their use of these programs. The Agencies determined that it would be helpful to issue the Guidance to assist insured depository institutions in the disclosure and administration of ODPs.

The Guidance is divided into three primary sections: Safety and Soundness Considerations; Legal Risks; and Best Practices.

### Safety and Soundness

In this section, the Agencies sought to ensure that financial institutions offering overdraft protection services adopt adequate policies and procedures to address the credit, operational, and other risks associated with these services. All overdrafts, whether or not subject to an ODP, are subject to the safety and soundness considerations contained in the Guidance.

Institutions must keep in mind that paying an overdraft is extending credit. There is exposure to loss and it is usually done without credit underwriting but rather based on circumstances such as the frequency and amount of deposits and the time the account has been open. This presents risk and is an issue that will be reviewed often. Institutions providing an ODP should adopt written policies and procedures adequate to address the credit, operational, and other risks associated with these types of programs. Policies should address the criteria for approving a customer for participation in the program. There should be reports sufficient to allow the institution to manage the program.

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<sup>1</sup> Regulatory agencies include the Federal Reserve Board (FRB); the Federal Deposit Insurance Corporation (FDIC); the National Credit Union Administration (NCUA); and the Office of the Comptroller of the Currency (OCC).

Specifically, the reports should include information about overdraft volume, profitability, anticipated losses and a mechanism to identify individual accounts that involve more risk than the institution is willing to accept. There should be a way to exclude identified accounts. Budgets must include loss estimates and allow for the fact that not all overdrafts will be paid. The Allowance for Loan and Lease Loss account must have specific provisions in it for the ODP. Overdraft losses should be charged off against this allowance.

The Agencies advise that overdraft balances should be reported as loans on regulatory reports. The Agencies expect proper risk-based capital treatment of outstanding overdrawn balances and unused commitments. The Guidance points out that if an institution advises account holders of the available amount of an overdraft protection when accounts are opened, or on the account statements, or ATM receipts, the institution should report the available amount of overdraft protection with legally binding commitments for Call Report and the NCUA 5300 Call Report purposes. These available amounts, therefore, should be reported as “unused commitments” in regulatory reports.

Following the aging of overdrawn accounts is a good way to manage the ODP. This allows more responsive collection practices and suspension from the program as well as adjustments to improve profitability. In the Guidance, the Agencies have extended the allowable time before charge-off to 60 days. (It should be noted that NCUA’s 45 day requirement has not changed.)

### **Legal Risks**

In this section, the Agencies outlined several federal consumer compliance laws and generally alerted institutions offering ODPs of the need to comply with all federal and state laws, and advised institutions to have their ODP reviewed by legal counsel to ensure overall compliance prior to implementation.

The federal laws and regulations specifically mentioned, include: the *Federal Trade Commission Act/Advertising Rules*, TILA, the *Equal Credit Opportunity Act*, the *Truth in Savings Act*, and the *Electronic Fund Transfer Act*. With regard to state law, institutions should look at usury and criminal laws as well as unfair or deceptive acts or practices laws. Institutions are advised to monitor applicable laws and regulations for revisions and to ensure their ODPs are fully compliant.

### **Best Practices**

This section sets out best practices that serve as positive examples of practices currently observed in, or recommended by, the industry. Broadly, these best practices address the marketing and communications that accompany the offering of overdraft protection services, as well as the disclosures, and operation of program features. Clear disclosures are among the most important aspects of these programs. They promote an understanding of the program itself and will facilitate responsible use and not encourage abuse. By minimizing consumer confusion, the institution also reduces the chances of a consumer complaint and lowers the risk of litigation.

Some of the best practices recommended in the Guidance include:

- Avoiding the promotion of poor account management;
- Clearly explaining the discretionary nature of the program;
- Clearly disclosing fees;
- Distinguishing overdraft protection services from “free” account features;
- Explaining the impact of transaction clearing policies;
- Monitoring ODP usage; and
- Training the staff to be able to explain the program features and other choices available.

## Conclusion

Senior management should carefully review the Guidance, apply the Agencies instructions, and implement as many of the Best Practices as may work in their particular institution. Institutions should document their decisions and be prepared to justify them in light of this Guidance. One can be sure the examiners will be armed with this information and will be looking even more closely at ODPs going forward.

The complete Guidance can be viewed at <http://a257.g.akamaitech.net/7/257/2422/01jan20051800/edocket.access.gpo.gov/2005/pdf/05-3499.pdf>. The OTS' version can be viewed at <http://a257.g.akamaitech.net/7/257/2422/01jan20051800/edocket.access.gpo.gov/2005/pdf/05-3195.pdf>.