STATE OF WASHINGTON
Department of Financial Institutions

OVERDRAFT PROTECTION PROGRAMS

September 19, 2003

INTRODUCTION

Recently, there has been much debate regarding overdraft protection programs offered at financial institutions (See the appendix for the definition of overdraft protection programs). Concerns have been raised that financial institutions offering overdraft protection programs charge customers high fees, do not provide adequate disclosures, and encourage customers to overdraw their bank accounts. Others argue that customers want overdraft protection programs to avoid the embarrassment of a returned check, to avoid the associated merchant returned-check fees, and to maintain a clean credit history.

In 2001 the Office of the Comptroller of the Currency raised supervisory and policy concerns regarding the use of overdraft protection programs. Since March 2001 several states, including Colorado, Indiana, Michigan, and Oklahoma, issued policy statements regarding overdraft protection programs at state-chartered financial institutions. At the end of last year, the Federal Reserve asked for comments about the design and operation of these programs. Recently, in response to the inquiries from federal regulators, the Conference of State Bank Supervisors (CSBS) sent out a survey with detailed questions about overdraft protection programs. During the 2003 Legislative session, the Department of Financial Institutions (DFI) received several information requests from Legislators regarding overdraft protection programs at our state-chartered financial institutions.

Publications as diverse as The New York Times, Newsweek, and CBS MarketWatch reported on overdraft protection programs in early 2003. In the spring of 2003, these overdraft protection programs became the subject of discussion locally when King 5 TV interviewed a financial institution customer who overdrew her account at an Automated Teller Machine (ATM). The customer was never informed of her negative balance or that she was being charged $28.50 each time she withdrew money from the ATM.

At the time the Department of Financial Institutions (DFI) received the CSBS and Legislative inquiries, the Department did not have complete information about which institutions offer overdraft protection programs, or how they are offered. The Department needed more information to assess the impact of this issue in our state, and what, if any, actions needed to be taken to address the issue. In an effort to collect such data, DFI conducted an examination by questionnaire about overdraft protection practices at Washington state-chartered financial institutions. The examination asked questions about how financial institutions advertise and market overdraft protection programs to customers and how the programs are designed and operated. DFI conducted an examination, rather than a survey, in order to protect financial institutions' proprietary information provided in answers to the questionnaire. Under our examination statutes we must keep information obtained in conducting examinations and investigations confidential, privileged, and not subject to public disclosure.

DFI sent the exam questionnaire to financial institutions on June 18, 2003. DFI met twice with the industry trade groups during the examination process, once before DFI sent the exam to financial institutions and once after compiling the exam results and before the House hearing in September. Before finalizing it, DFI will circulate draft guidance and seek comment from the industry.

EXAMINATION

The examination questionnaire covered numerous issues relevant to the way financial institutions offer overdraft protection programs including:

(1) advertising and marketing;
(2) availability and notice;
(3) third party vendors;
(4) disclosure;
(5) dollar limits;
(6) pay/no pay decisions;
(7) overdraft charges;
(8) available balance issues;
(9) ATM issues; and
(10) whether the customer has the choice to be included or not included in the program.

We found that most institutions act reasonably and responsibly in offering this program to consumers. However, we did find some areas where institutions have the opportunity for improvement. Since the results of our exam with regard to specific financial institutions are confidential, we are providing you with a summary of our findings.

GENERAL STATISTICS

Ten credit unions (out of 90) currently offer overdraft protection programs, while 19 banks/thrifts (out of 80) currently offer overdraft protection programs. Fourteen credit unions and nine banks/thrifts are contemplating offering this type of program in the future.

The percentage of customers with overdraft protection programs ranges from 45 to 100 percent for banks/thrifts and credit unions, but the vast majority of customers who are covered by such programs do not use them.

The questionnaire also asked about the number of customer complaints and what categories the complaints covered. Generally, the number of reported customer complaints in our exam was low, however, most institutions do not have the ability to fully track customer complaints since many complaints are made and resolved at the branch level. Thus, our exam was unable to accurately assess the true volume and nature of the complaints regarding overdraft protection programs. The subject matter of customer complaints includes disclosure of terms, payment of fees, availability and notice, and not understanding ATM balances if they include overdraft protection programs.

Credit Unions

On average for credit unions:

- 78 percent of customers with overdraft protection programs never use the program.
- Of the customers who use the program, 16 percent use the program 1 to 2 times per month,
- 4 percent use the program 2 to 5 times per month, and
- 2 percent use the program over 5 times per month.

Banks/Thrifts

On average for banks/thrifts;

- 85 percent of customers with overdraft protection programs never use the program.
- Of the customers who use the program, 12 percent use the program 1 to 2 times per month,
- 1 percent use the program 2 to 5 times per month, and
- 2 percent use the program over 5 times per month.

ADVERTISING AND MARKETING

Some institutions advertise overdraft protection programs on the Internet, in their branch lobbies, and in the media. A concern is that advertising could trigger federal Truth-in-Lending disclosure requirements if the program is not advertised as a discretionary program.

Credit Unions

In general, credit unions with overdraft protection programs provide clear advertising that states the program is discretionary, and none of the marketing materials promote overdraft protection programs as a long-term source of funds.

Banks/Thrifts

There were some instances where banks/thrifts could improve advertising. Some advertising misrepresents the scope of the program. Examples of these statements include: "Make a mistake-you're covered" "Write a check or use an ATM for more than you have in the bank –you're covered." "Money may not grow on trees, but here's the next best thing."

Best Practices

One best practice is a bank that advertises the difference between the overdraft program and other products, clearly stating the discretionary nature of the program, and providing a customer service hotline. Institutions should be careful to ensure that their advertising is not misleading and does not lead the customer to believe this program provides answers to long-term financial problems, and does not promote irresponsible customer behavior.

NOTIFICATION ABOUT THE PROGRAM AND DISCLOSURE OF TERMS

Financial institutions notify customers about the program when the customer opens an account, when the customer uses the program, and/or when the customer becomes eligible for the program. The institutions use a variety of methods for notification including deposit contracts, brochures, general letter, or policy statements. A question raised by the data is which method is the most effective way of notifying the customer about the program. Other issues presented by the exam include: whether institutions inform customers about the program in a timely manner; whether notices contain information useful to the customer; and whether notices are adequate to describe the program.

Credit Unions

Nine out of the ten credit unions with overdraft protection programs inform customers about the program when they sign up for the account. One credit union provides verbal information only when asked by the customer, or when the customer uses the program.

Banks/Thrifts

Ten banks/thrifts do not inform customers when they sign up for an account, and nine banks/thrifts do inform customers at account opening. Three of the ten that do not inform customers at account opening send a letter when the customer qualifies. Four banks/thrifts do not provide any information to the customer either at account opening or by letter, and the customer only finds out about the program when the customer uses it.

Best Practices

Notices should be clear and in plain English. The best practices of the institutions we examined include providing disclosures separate from deposit contracts, and providing disclosure to the customer at the time the customer signs up for an account. In addition, disclosures provide the following information:

(1) how the program is used and how it is not to be used;

(2) eligibility;

(3) notice;

(4) overdraft limits;

(5) repayment;

(6) costs/fees;

(7) discretionary nature of the service; and

(8) whether or not the program is included in a customer's available balance.

For example, one institution allows the customer to fill out a form and make choices about whether or not the customer will use the program. It would not be a best practice to inform the customer about the program only when the customer uses the program. In addition, some institutions provide a method to contact the financial institution to ask questions.

PAY/NO PAY DECISIONS

There are four methods that banks use to decide which overdrafts to pay first: highest to lowest amount of a check; lowest to highest amount of a check; check number; and order in which the check is presented for payment. When DFI developed the exam questionnaire there were concerns that some financial institutions might change payment decisions in an attempt to generate additional fee income. The exam findings show no evidence of this practice in Washington State. In fact, most institutions make payment decisions in a consistent manner, and have not changed their practices since they began offering overdraft protection programs.

Credit Unions

The following is a list of the order checks are honored or paid:

Number of CUs	ORDER OF PAYMENT
2	Lowest amount to highest amount
2	Sequential check number
2	Highest amount to lowest amount
4	In the order presented for payment

Banks/Thrifts

The following is the order checks are honored or paid:

Number of Banks	ORDER OF PAYMENT
8	Lowest amount to highest amount
6	Sequential check number
3	Highest amount to lowest amount
2	In the order presented for payment

Best Practices

A best practice is consistency with regard to the order in which checks are honored or paid.

FEES AND DOLLAR LIMITS

Usually financial institutions charge a fee to the customer for using overdraft protection programs. These fees generally range from \$18 to \$32. The NSF (Not Sufficient Funds) fee at the same institutions ranges from \$18 to \$27.

Some financial institutions not only charge an overdraft protection fee, but also charge a daily fee for the service. These daily fees in addition to overdraft fees could make the institutions' programs subject to the requirements of the federal Truth-in-Lending law.

All financial institutions place a dollar limit on the amount of overdraft protection offered to the customer. These limits range from $100 to $1,000 depending on a customer's account type. (One credit union has a limit of $1400). We found that financial institutions apply the dollar limit with consistency.

Credit Unions

Four credit unions have overdraft fees that exceed NSF fees, while six credit unions have overdraft fees that equal NSF fees. For credit unions, the highest overdraft protection fee is $25 and the lowest fee is $18. One credit union charges a one-time overdraft fee of $5 on the fifth banking day during a negative balance cycle.

Banks/Thrifts

Three banks/thrifts have overdraft fees that exceed NSF fees, while sixteen banks/thrifts have overdraft fees that equal NSF fees. For banks/thrifts the highest overdraft protection fee is $32 and the lowest fee is $18. Some of the banks/thrifts have daily limits on fees charged or checks processed through the program. One bank/thrift has a $240 daily maximum on overdraft protection fees, one has a $200 daily maximum, and two banks/thrifts have daily maximums of $120. One bank/thrift sets the number of NSF transactions at four per day, and a limit of $72.

One bank/thrift charges a daily fee of $3 per day the account has a negative balance, two banks/thrifts charge $5 per day starting on the 5th day that a customer has a negative balance; one bank/thrift charges $5 daily overdraft fee beginning on the fourth day of the negative balance, and one charges overdraft interest after 3 business days at prime plus 2 percent.

Best Practices

A best practice and the predominant practice by the financial institutions examined is when the NSF fees equal overdraft protection program fees. Institutions that do not state that overdraft protection programs are discretionary, and charge higher overdraft protection fees than their NSF fees may need to disclose the overdraft protection fees as a finance charge under the requirements of federal law. Currently, federal regulators are reviewing whether or not such disclosures would be required.

BALANCE DISCLOSURE

Balance disclosure raises two key issues: (1) whether or not the overdraft protection amount is included in the balance of an account when the customer makes an inquiry over the phone, at the ATM, on the Internet, or at the teller's window; and (2) whether the fee and negative dollar amount is reflected in the balance once the customer uses the overdraft program.

Most financial institutions do not include the overdraft protection amount when a customer asks about his or her balance. An example how an institution includes the program in a customer's balance is as follows: the customer has zero dollars in his or her account and an overdraft protection program up to $200, and the account balance shows a $200 balance. This practice is misleading to customers, and may actually encourage overdrafts.

Many of our financial institutions post the fees and overdraft amount as soon as the item is processed. Usually the customer receives a letter from the financial institution within two days of the overdraft. One issue that could arise is that a customer could overdraft at an ATM, not know about it for two days, and continue to overdraft. The overdraft protection fees could be significant.

Credit Unions

The credit unions with overdraft protection programs do not include the overdraft protection amount in balance inquiries.

Banks/Thrifts

Four banks/thrifts include the overdraft protection amount in balance inquiries.

Best Practices

A best practice is when institutions (1) do not include the overdraft protection amount in a customer's balance whenever the customer asks about his or her balance by ATM, phone, Internet, or teller window. (2) show that the customer has used the program by reflecting the overdraft and the fees in balance inquiries within 24 hours of when a transaction occurs.

NOTIFICATION REGARDING USE OF THE PROGRAM

Once a customer uses the program, most institutions notify the customer with a letter. Generally institutions mail these letters within one or two days of the overdraft. The letter indicates the amount overdrawn, fees, total amount due, and timing of repayment.

Credit Unions

All ten credit unions that have overdraft protection programs report sending out mail notification when an account becomes overdrawn. Some credit unions also contact the customer by phone. Follow-up letters are generally sent when accounts remain overdrawn for 10-15-20-30 days.

Banks

All nineteen banks/thrifts that have overdraft protection programs report sending out mail notification when an account becomes overdrawn. Some banks/thrifts also contact the customer by phone. Follow-up letters are generally sent when accounts remain overdrawn for 10-15-20-30 days.

Best Practices

One best practice is when the customer receives his or her first notification letter about using the program, the customer also receives another disclosure about the program (this is in addition to the disclosure at account creation).   In addition, some institutions provide customers with a hotline on the notification letter that can answer any questions they may have about overdraft protection programs.

APPENDIX

WHAT ARE OVERDRAFT PROTECTION PROGRAMS?

Typically overdraft protection programs generate fee income by covering overdrafts up to a specified predetermined limit. These programs differ from traditional overdraft protection programs because the customer does not obtain prior credit approval for the program, nor does the program utilize a credit card, line of credit, or savings account, in order to cover the overdraft.

Although there are many variations of overdraft protection programs, most programs have the following standard features:

- Financial institutions make the program available to customers whose account is in "good standing." Financial institutions define "good standing" differently. For example "good standing" may be defined as an account that has been open for 30 to 60 days with regular deposits made to the account, or it could be defined as an account where the customer makes regular deposits and the account has a positive balance at least once every 20 days.

- The customer receives some type of overdraft protection coverage with a dollar limit. The predetermined limits range from $100 to $1,000.

- Customers usually do not apply for these programs or sign anything to apply for the programs.

- Customers gain access to the programs through:

    - ❖ Checks and other withdrawals at teller windows;
    - ❖ ATM cards or Check cards (for example Visa Check Card);
    - ❖ ACH withdrawal transactions;
    - ❖ Checks issued to a third party;
    - ❖ Online banking or a voice banking line;
    - ❖ Debit and point of sale transactions;
    - ❖ Any other transactions honored through a personal checking account.

- Customers are charged an overdraft fee for each payment made by the financial institution up to the program limit. In addition, some institutions may charge other fees including daily overdraft fees.

Customers are required to bring their account to a positive balance at least once in a stated time period (for example, once every 20 or 30 days). There are varied consequences if an account is not brought to a positive balance. For instance some institutions close the account and revoke the privilege, while others revoke only the privilege.