THE FUTURE OF OVERDRAFTS

OVERDRAFTS IN THE REGULATORY CROSSHAIRS
WHAT'S YOUR PLAN?

Banking Industry Research by

strategycorps

SURVEY RESULTS

The Bankers' Perspective

THE FUTURE OF OVERDRAFTS

OVERDRAFTS IN THE REGULATORY CROSSHAIRS

WHAT'S YOUR PLAN?

SURVEY RESULTS | The Bankers' Perspective

Contents

strategycorps

The Purpose

Given the proposed CFPB rules that are going into effect regarding OD/NSF fees, it's the right time to find out how banks and credit unions are dealing and planning to deal with this dominant source of non-interest income being increasingly scrutinized (yep, it's classified as a "junk fee") and regulated to generate less revenue.

We surveyed hundreds of bank and credit union leaders, targeting a relatively equal universe of FIs over and under $10 billion in assets. The response breakdown was 98 percent were financial institutions under $10 billion in assets (referred to as "community FIs" hereafter).

This is noteworthy because the proposed CFPB laws will initially affect just FIs above $10 billion in assets. Maybe those bankers were too busy to respond or maybe those bankers have accepted that their OD/NSF pricing and policies are going to be exactly what the CFPB says it's going to be.

Nevertheless, it is insightful to learn whether community FIs were being proactive in their approach to these regulatory changes or adopting a "wait and see" approach to these significant changes. Why? Because the fact is this CFPB regulation of OD/NSF fees and policies will quickly and ultimately apply to the entire banking industry as market forces created by this regulation will reach down to impact community FIs.

We also wanted to explore if the anticipated impact on ODs/NSFs of retail accounts and small business (SMB) accounts differed or not.

Finally, we wanted to discover what current or future plans for fee income replacement revenue are, since those contingencies have to be discerned and justified before investment and rollout to customers/members.

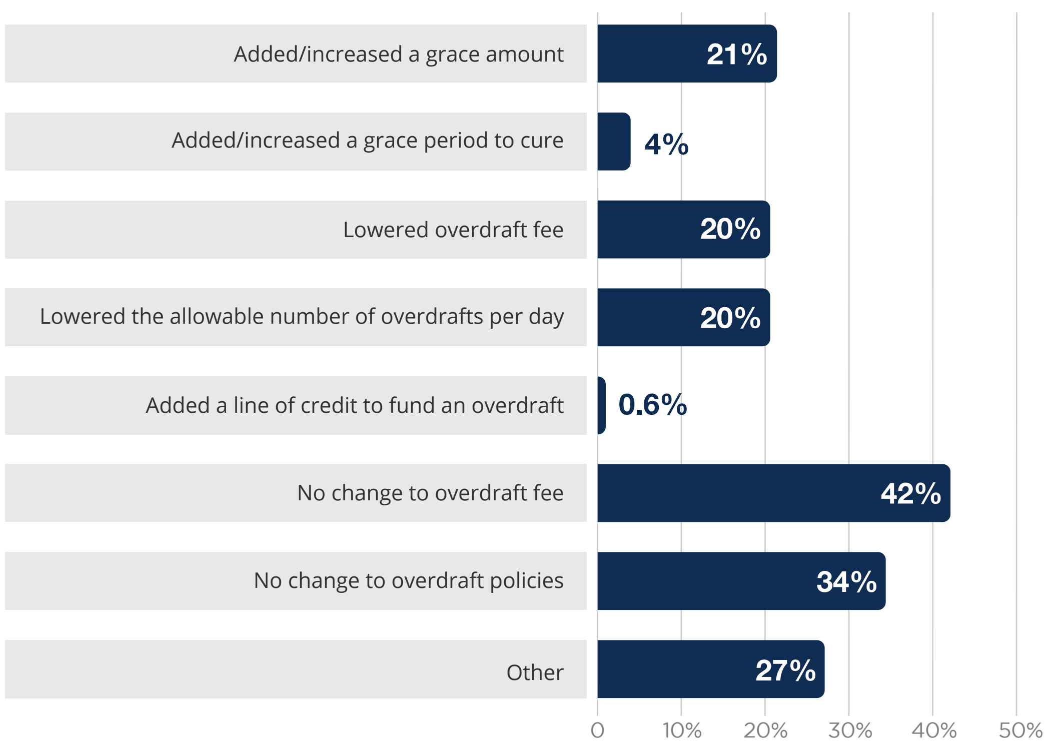
The Findings

Policy and Pricing Changes

Regarding changes to policies or pricing for OD/NSF fees for retail or SMB checking accounts, the results were surprisingly uniform. When asked what OD and NSF changes had already been made regarding retail and SMB checking accounts, only 20% or less had made changes to grace periods, grace amounts, overdraft fees or daily frequency limits. This means more than 75% of FIs reported a wait and see approach for both OD and NSF policies and pricing on their retail and SMB accounts. [See Question 2 - Question 5 in the appendix]

Question 2

What changes has your FI already made to its overdraft fee pricing and policies in the last 24 months for retail checking products? (check all that apply)

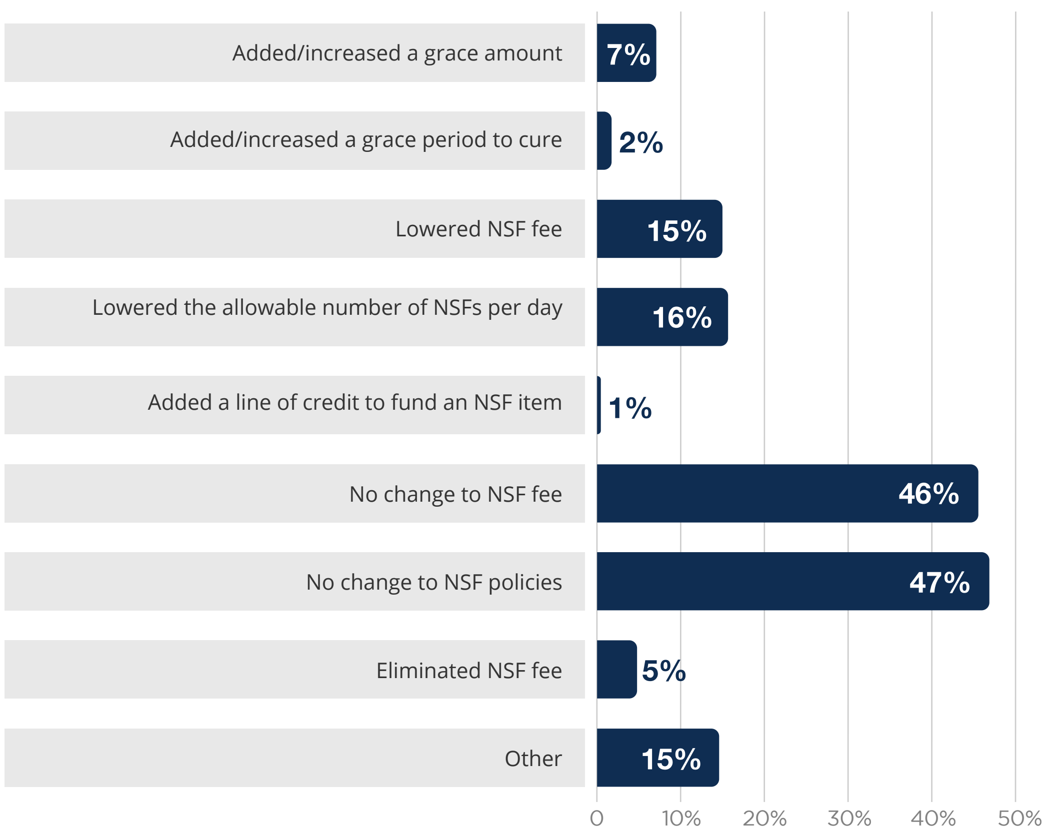


This squares with our tracking of OD/NSF changes publicly announced in the marketplace. Primarily the mega and regional banks were prompted to make early changes without the demand of new regulation with only a handful of community FIs doing so on their own. Most large digital banks and direct to consumer fintechs started their checking offerings with low/no OD/NSF fees as a competitive differentiator or were a first mover like Ally.

The next level of inquiry was to see how many respondents were preemptively planning to make changes given the CFPB proposal for either retail or SMB checking. It's not surprising

Question 5

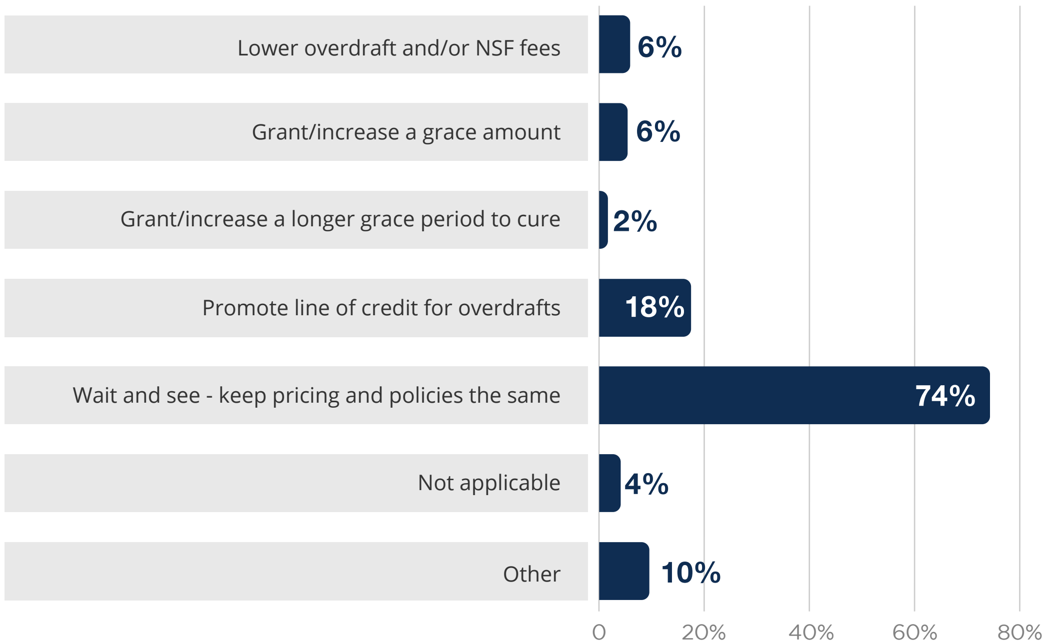
What changes has your FI already made to its NSF fee pricing and policies in the last 24 months for small business checking products? (check all that apply)



that nearly 76% of community FIs were taking a "wait and see" game plan (more on this later), dwarfing the next most popular response of promoting a line of credit for overdrafts among a variety of options.

Question 6

If your FI is less than $10 billion in assets, what's your next preemptive move in terms of overdraft pricing and policies given the CFPB proposal?
(check all that apply)



Replacement Revenue

Bank and credit union professionals also responded to what the FIs' top replacement revenue plans were for the potential negative impact on checking revenue for both retail and SMB checking accounts.

The responses for both retail and SMB checking products were similar here as well. The top choices for the top 5 plans (across the board out of 9 plan choices) were:

1. **Market debit card more aggressively to increase activation and usage**
2. **Develop reward programs to encourage more debit card use**
3. **Increase checking account fees to increase service charge income**
4. **Increase other miscellaneous fees**
5. **Wait and see - do nothing plan**

The most popular top choice on an individual stand-alone basis (without taking into account across the board ranking of all choices) was "Develop reward programs to encourage more debit card use", followed by "Market debit card more aggressively".

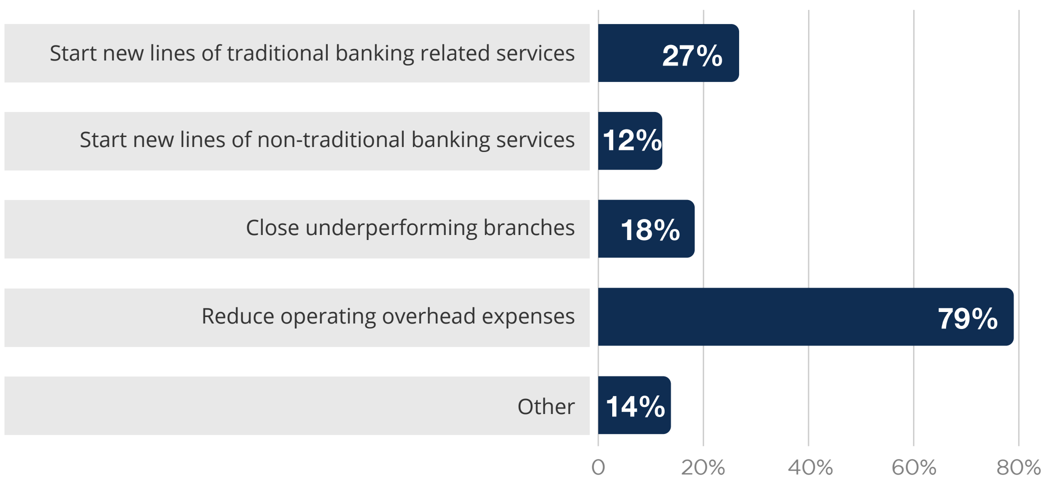
Interestingly, "Adding credit cards" or "Marketing existing credit cards" ranked similarly to "Start charging fees for products/services that are currently free". [See Question 8 - Question 9 in the appendix]

The final question posed was "What other replacement revenue plans do you have overall for the potential negative impact on revenue for OD/NSF changes?".

Of the 5 choices, the overwhelmingly most popular response was "Reduce operating overhead expenses" from nearly 80% of respondents. This was nearly three times more than the next popular response of "Start new lines of traditional banking services".

Question 10

What other replacement revenue plans overall are you considering for the potential negative impact on revenue of the CFPB's overdraft proposal? (check all that apply)



Some Observations

Given the uncertainty of any proposed CFPB regulatory action impacting overdrafts, it's not surprising that many leaders of FIs below $10 billion in assets are taking a "wait and see" strategy. **But, what is driving the intent behind this strategy is the next level inquiry.**

Is it being patient to make a more informed decision? Is it displacement and denial because it only applies to larger FIs? Is it naivety that larger FIs won't respond to this regulation by weaponizing it against smaller FIs to gain market share? Is it procrastination that this issue can be dealt with later (and maybe by someone else)? Is it fear of the material change in operations and products that the replacement revenue options will require?

The False Safety Net of Doing Nothing

Waiting and seeing is an active choice. However, in most situations it is the short-term or intermediate choice and seldom the final choice. **That's why the underlying intent of this choice is so important.**

Bankers taking a wait and see approach to make a more informed decision is much different from denial, displacement, inexperience, laziness and fear. By informed decision, we mean being more ready when the next decision must be made. For example, gathering and analyzing pertinent information, tracking market dynamics, studying moves by competitors, seeking out and employing relevant expertise, and proactively modeling different scenarios for organizational impact. **In other words, waiting and seeing is not doing nothing.**

A particular area that's concerning is smaller FIs tend to underestimate the impact to their customer/member base by the larger FIs. Many still have the illusions that their customer or member service is better than others or most consumers want to bank with a community FI or products don't really matter. This is not aligned with the reality of the market share gains made at their expense by the bigger FIs (and now the digital banks) due to believing some or all of these illusions.

More specifically regarding overdrafts, if you don't think your chronically or frequently overdrafting customers/members aren't going to price shop overdrafts when your FI is charging $30 and other FIs are charging $3-$14 or that the $10 billion+ asset size FIs aren't going to target market those same overdrafters with a message of why pay $30 for an overdraft when it only costs $3 here, you're falling into a false safety net.

Just study the past. These FIs have repeatedly weaponized whatever they can to differentiate themselves from smaller FIs. They have built analytical workshops with sleek digital banking products and operations and robust marketing to win at the cost of those FIs that don't have these resources, namely community FIs.

It's About the R's

Recognizing real replacement revenue strategies is restrictive but not difficult. Implementing replacement revenue strategies to realize relevant revenue is.

As your FI reviews the top 4 replacement revenue plans from this survey, there needs to be a reality check on what can actually be realized to offset what will be a major revenue hit.

Here's what we know from analyzing hundreds of FIs (big and small) relative to the top 5:

- Combining the first top 2 because they are linked - (1) **market debit card more aggressively** to increase activation and usage and (2) **develop reward programs to encourage more debit card use** because debit cards are so commoditized that unless there is some reward program attached to it, there's not much messaging to market.

  Here's the real scoop on these two. Unlike most other rewards programs outside the banking industry (like airlines, hotels, etc.), most debit card reward programs lack a progression to target and reward your best (most primary) customers/members differently than non-primary customers/members. (Primary meaning whether the customer/member views your FI as their primary FI; often referred to as primacy.)

Effectively, everyone is treated the same in terms of reward currency. **The result of this (and we have seen this too many times), is the FI's cost for the reward**, be it points-based for redemption of some consideration or straight cash-back, is an investment in customers/members that are already costing the FI money. This would be okay if the revenue lift were enough to move a material number of these non-primary relationships to primary, but they don't. Even when incremental cross-selling lift is projected to justify an acceptable financial return to invest in these programs, the elusiveness of the cross sale mitigates this projected contribution (the reasons why are too long to mention here) and these programs don't validate.

Secondarily, debit card rewards programs are inferior to credit card programs and consumers who are motivated to behave based on rewards will participate with credit cards over debit cards.

- Combining numbers 3 and 4 - (3) **increase checking account fees to increase service charge income** and

(4) **increase other miscellaneous fees** because raising fees with no commensurate value exchange for banking related services, even when blaming it on inflation, is a risky move due to its inherent consumer unfriendliness. Consistently at the top of reasons why consumers change FIs is because they thought fees were too high and/or unfair. Proceeding with this strategy is like swimming in the ocean when there are no lifeguards - do so at your own risk.

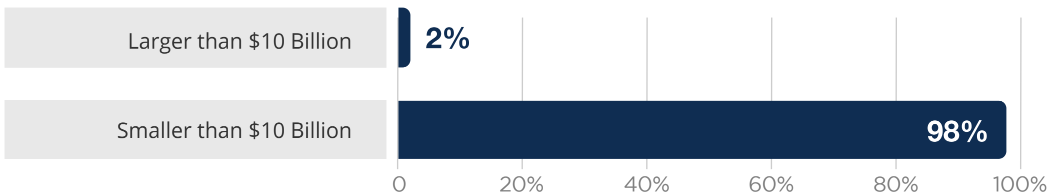
Revisiting question 10, “What ***other*** replacement revenue plans do you have overall for the potential negative impact on revenue for OD/NSF changes?”, the overwhelming top response of “reduce operating overhead expenses” **is a real bummer**. This plan essentially means headcount reductions and/or closing branches due to their fixed costs.

While it seems like it should be a plan of last resort, it is nonetheless representative of the magnitude and scale of revenue OD/NSF fees generate for community FIs and the actions that may have to happen if your FI doesn’t make the right decision regarding the impact of the forthcoming regulation.

Appendix

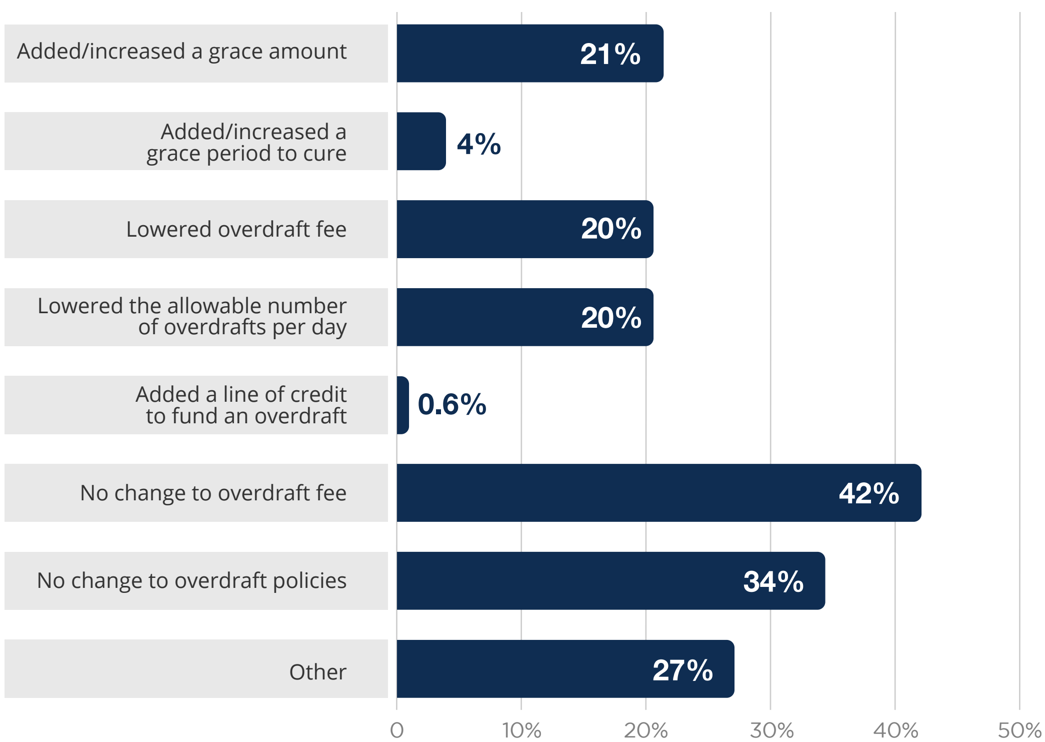
Question 1

Is your Financial Institution (FI) larger or smaller than $10 billion in assets?



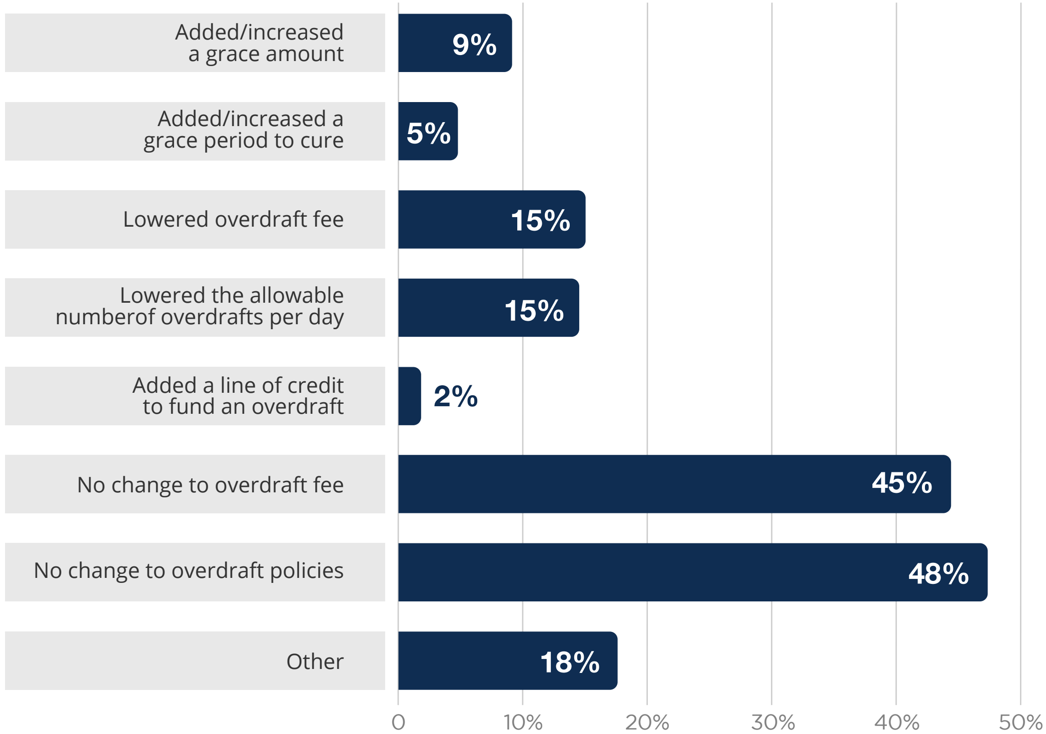
Question 2

What changes has your FI already made to its **overdraft fee pricing and policies** in the last 24 months for **retail checking products?** (check all that apply)



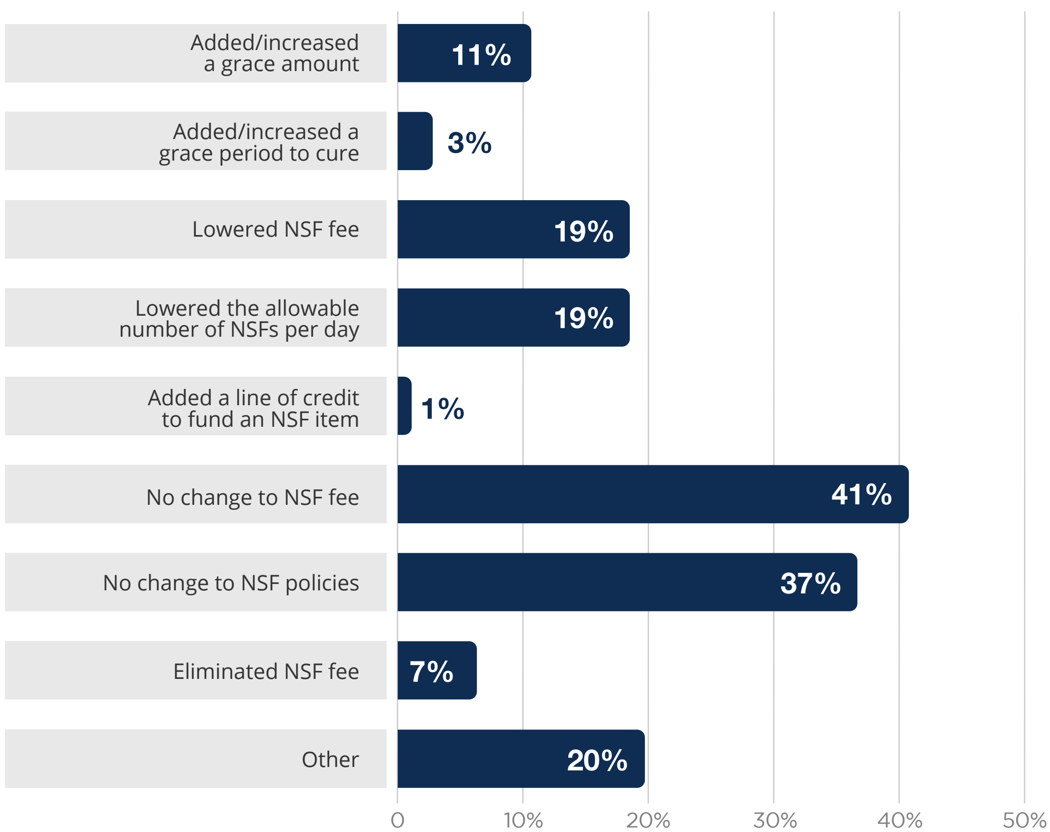
Question 3

What changes has your FI already made to its **overdraft fee pricing and policies** in the last 24 months for **small business checking products**? (check all that apply)



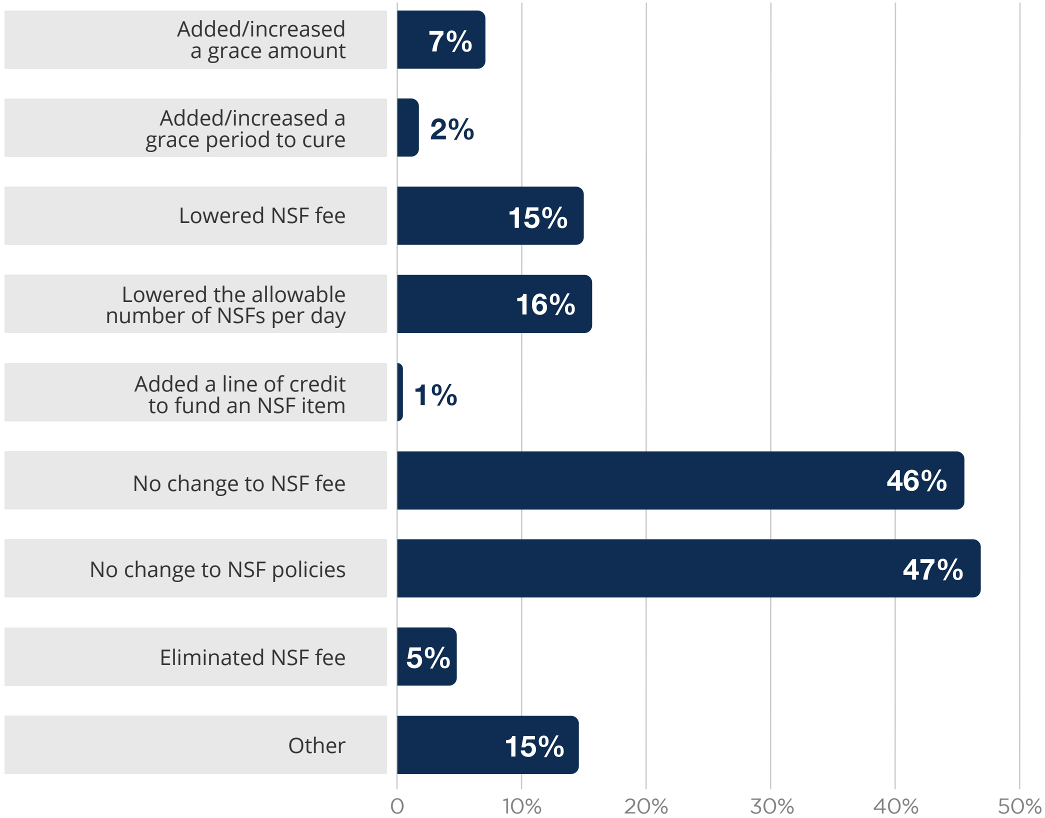
Question 4

What changes has your FI already made to its **NSF fee pricing and policies** in the last 24 months for **retail checking products?** (check all that apply)



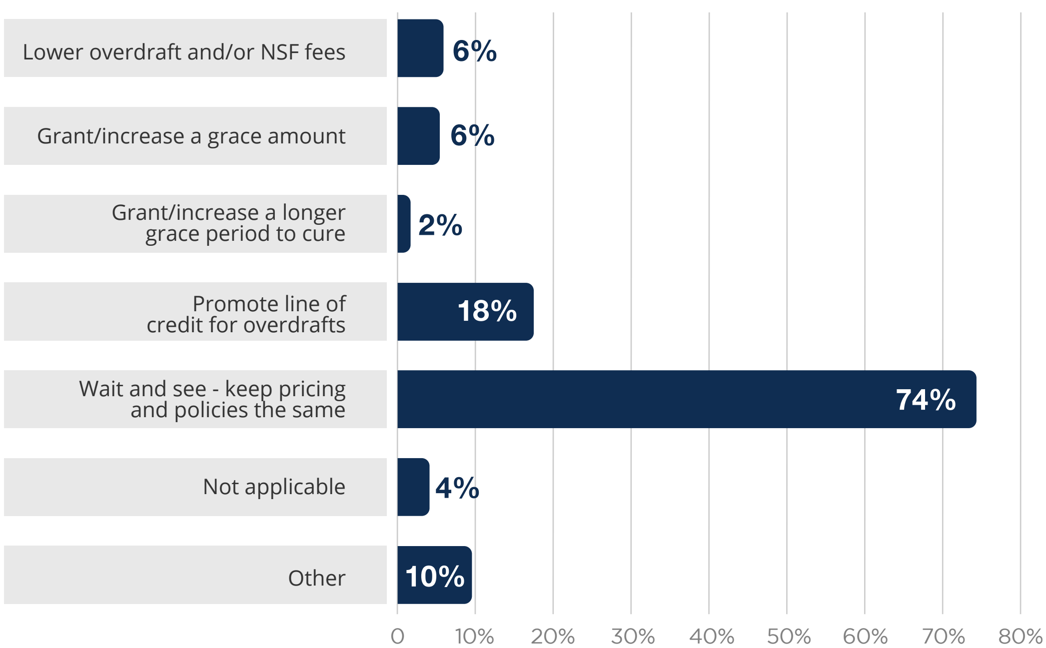
Question 5

What changes has your FI already made to its **NSF fee pricing and policies** in the last 24 months for **small business checking** products? (check all that apply)



Question 6

If your FI is **less than $10 billion in assets**, what's your next preemptive move in terms of overdraft pricing and policies given the CFPB proposal? (check all that apply)

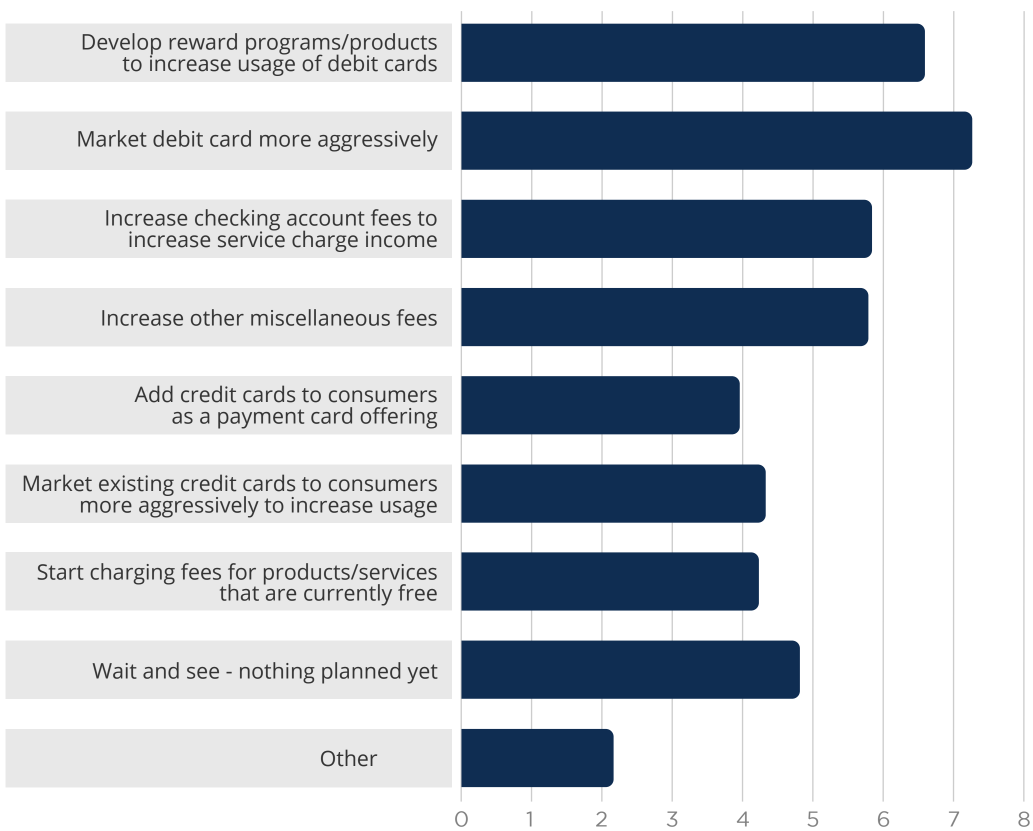


Question 7

If your FI is **more than $10 billion in assets**, what's your next preemptive move in terms of overdraft pricing and policies given the CFPB proposal? (check all that apply)

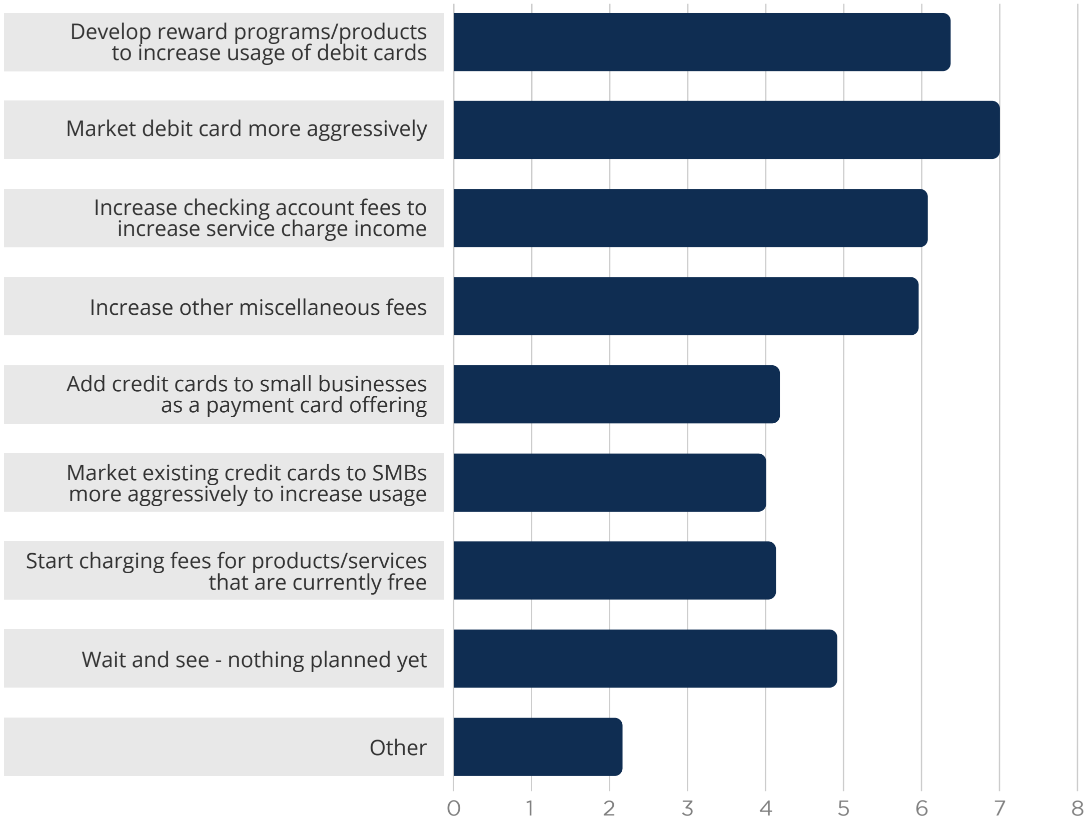
Question 8

What are your top 5 (in rank order) **replacement fee revenue plans** for the potential negative impact of the CFPB's overdraft proposal on **retail checking revenue**?



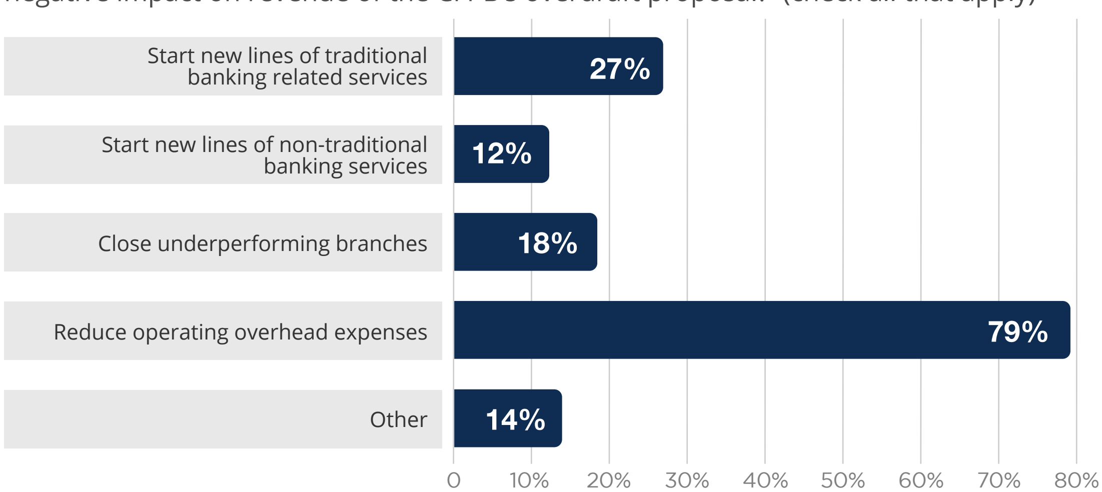
Question 9

What are your top 5 (in rank order) **replacement fee revenue plans** for the potential negative impact of the CFPB's overdraft proposal on **small business checking** revenue?



Question 10

What other **replacement revenue plans overall** are you considering for the potential negative impact on revenue of the CFPB's overdraft proposal? (check all that apply)



Need Help Making the Right Decision?

We don't have all the answers and we're not miracle workers, but for more than two decades we've helped 400+ community FIs:

- Analyze the performance of every retail and small business relationship to determine who is primary (profitable) and who isn't
- Diversify from over-reliance on OD/NSF fees
- Grow deposits organically without the risk and expense of acquisition efforts
- Simplify unmanageable grandfathered and "zombie" accounts
- Better engage with modern checking products to increase customer/member primacy

Learn more about us at www.strategycorps.com.

strategycorps

(888) 577-6933

info@strategycorps.com

strategycorps.com