



Regulation E: Don't let this be your institution's summer of discontent

by Mark Flamme and Cathy Pricco

The birds are singing, and the trees are budding. Spring is in the air, reminding many bankers that the July 1st deadline to implement the amended Regulation E Section 205 (“Reg E”) is right around the corner. Is your financial institution ready to comply with the regulation? How will your institution deal with potential lost fee income? Is this truly the end of free checking, as some have suggested?

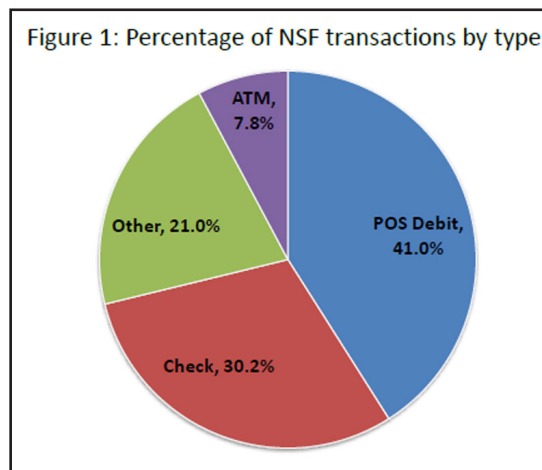
If your institution is wrestling with these questions, you are not alone. Based on recent conversations with our clients, many institutions are struggling with how to address Reg E. This white paper reviews the regulatory changes and potential impact; summarizes the range of industry responses being considered; and details specific tactics that have proven effective for garnering opt-in, increasing fee income and reducing DDA costs.

The change and its impact.

The changes to Regulation E are deceptively simple but carry large implications. In summary, Reg E:

- ◆ Requires affirmative consent (opt-in) on all accounts assessed overdraft (OD) fees for ATM and one-time (point of sale, or POS) debit transactions.
- ◆ Requires financial institutions to provide consumers with confirmation of affirmative consent.
- ◆ Mandates implementation by July 1st for new accounts and August 15th for existing accounts.
- ◆ Mandates the same account terms and conditions (interest rates, fees, etc.) for both opt-in and non-opt-in accounts, so that customers are not penalized if they choose not to opt-in.
- ◆ Mandates that the same overdraft decision criteria be applied to paying checks and ACH transactions for both opt-in and non-opt-in accounts.
- ◆ Allows no transaction exceptions; for example, even if the financial institution had reason to believe there were sufficient funds when the transaction was authorized but the account subsequently overdrafts, the financial institution cannot assess a fee.

The biggest and most obvious impact of Reg E is the potential for lost fee income. According to a recent FDIC study, POS debit and ATM transactions make up 48.8 percent of all NSF transactions.



The same FDIC study estimated that NSF fees comprise 74 percent of all deposit service charges—so, the total impact could be as high as 36 percent of all deposit service charges. Of course several factors influence the potential impact for any particular financial institution, including how often your customer base uses OD services, your customer mix, the potential for customers to

write more checks that overdraft if they know they can't overdraft with a debit card, other fee-generating products offered by your institution, etc. Multiple industry analysts, however, estimate the potential reduction in total deposit service charges to range from 20 to 30 percent.

At the same time, the cost of compliance is not insignificant. Banks can expect the costs to include:

- ◆ Third-party vendor fees or in-house development costs for opt-in tracking systems.
- ◆ Modifications to new account opening processes, forms, and systems to capture opt-in information during new account opening—in all channels.
- ◆ Staff or vendor expense for on-going maintenance of opt-in information.
- ◆ Incremental customer service staff to handle opt-in servicing transactions.
- ◆ Incremental branch and call center staff to handle customer complaints and education.
- ◆ Costs of opt-in communications via mail, phone, and Internet.
- ◆ System upgrades and changes, including transaction codes and processing routines to differentiate between POS and recurring debit transactions.
- ◆ On-going customer education around overdraft and opt-in processes.
- ◆ Incremental product development expenses to replace lost OD fee income.
- ◆ A potential increase in paper check volume as a replacement for previously authorized debit transactions that could now be denied.

Financial institutions' response.

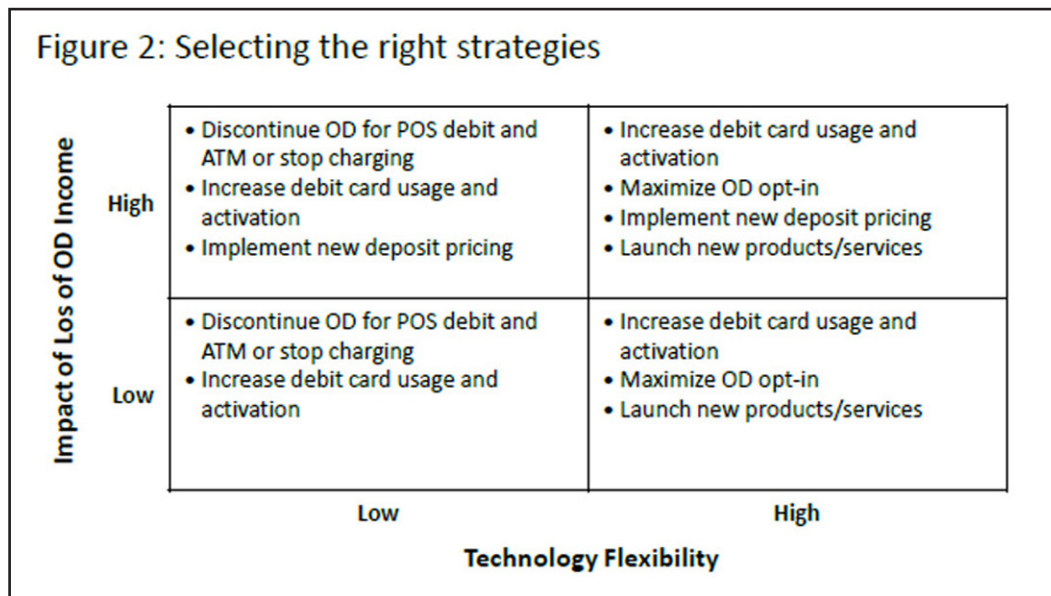
We have seen institutions pursue a wide array of strategies in response to these regulatory changes. These strategies typically include one or a combination of the following:

- ◆ Discontinue offering OD services altogether (other than those linked to credit or savings products) for debit POS and ATM transactions, as Bank of America has announced it will.
- ◆ Discontinue charging fees for overdrafting DDA from debit POS or ATM transactions.
- ◆ Maximize initial OD opt-in and engage in strategic on-going opt-in campaigns.
- ◆ Increase fee income by:
 - Increasing debit card activation and engaging in usage campaigns.
 - Implementing new deposit pricing.
 - Offering new products and services or bundling product sets together; for example, OD line of credit, linked accounts, prepaid “emergency funds” cards, transaction-by-transaction opt-in, requiring linked saving accounts for DDAs, etc.
- ◆ Reduce expenses for servicing DDAs.

Determining which strategy or strategies are right for your financial institution depends on several factors, including technology flexibility, DDA customer base and use of

OD, desired market image, competitive responses, and overall business strategy. A simplified way to view these strategies is across two dimensions: technology flexibility and impact of lost fee income, as illustrated in Figure 2 at left.

Strategically, if an institution has limited technology flexibility and its compliance costs could be high, discontinuing overdraft services for ATM and POS debit transactions may make sense, particularly if targeted customers are less



likely than average to use OD services. But even when the overdraft revenue is significant, as in the case of Bank of America, it may make sense to consider re-pricing deposits, reducing DDA costs, and focusing on debit card usage rather than undertaking a lengthy system overhaul and an expensive affirmative consent marketing campaign. Additionally, pursuing this strategy provides the opportunity to market the institution as “the trusted, consumer-friendly institution” that won’t assess fees for unwanted services—potentially yielding cross-selling advantages and deeper customer relationships that can replace lost fee income.

Alternatively, if an institution has the flexibility to adjust to the new regulations more easily, dedicating the resources to gather affirmative consent up front makes sense. This can be followed by efforts to replace potential lost revenue by focusing on increased debit card usage, re-pricing deposits, and creating new products and services for those who opt out. Although the challenge is in execution, there is an opportunity to position the institution as “the trusted institution,” in this circumstance through flexibility. For example, acting in a consultative matter, advising customers when it might be in their interest to sign up for OD services and when to opt out, could create significant good will and trust.

Execution tactics and leading practices.

Once strategic direction has been set, how should an institution go about executing, and what are some of the leading practices it should employ?

First, ensure compliance through deployment of the appropriate solution (tracks opt-in, links to marketing campaigns, tracks responses, links to core systems to monitor customer OD behavior), educating all front-line staff and modifying procedures (for example, new account procedures) as necessary. Prior to selecting a tool, go through the exercise of detailing your institution’s requirements, including those for the longer-term use of the tool, such as studying customer overdraft behavior and making product recommendations. Carefully consider the range of vendor solutions as well as the option of developing an application in-house. There are differences in functionality that may get lost in the shuffle of becoming compliant but will become drawbacks as you execute your longer-term strategy.

To replace lost income, your main levers could include:

- ◆ Maximizing initial OD opt-in and engaging in a strategic on-going opt-in campaign.
- ◆ Optimizing debit card activation and engaging in a usage campaign.
- ◆ Implementing new deposit pricing.
- ◆ Launching new products/services or bundling product sets together.
- ◆ Reducing the costs of servicing DDA accounts.

Maximize initial OD opt-in.

Institutions that are seeing good results in driving opt-in have adopted a multi-channel communication approach targeted to specific segments. On average, 84 percent of NSF fees are generated by 8.9 percent of DDA accounts, according to a recent FDIC study. If your institution does not identify and reach these customers for opt-in prior to regulatory deadlines, not only will you lose a significant revenue opportunity; you risk upsetting a number of customers who rely on OD services but who will have their transactions suddenly declined. Which customers generate the majority of your financial institution’s overdraft income? What is their mix of overdraft transactions? Answering these questions will help focus communication efforts.

Institutions with successful opt-in efforts have:

1. Segmented their DDA accounts, identifying high-, medium-, low-, and no-overdraft segments (typically a one year of history is required to do this).
2. Created models to forecast expected levels of future profitability from different segments.
3. Developed communication plans/budgets by segment.
4. Leveraged multiple channels, including ATM messaging, statement messages, marketing emails, on-hold messaging, online banking messages, OD alert emails, alerts on OD notices, branch signage, and teller prompts to communicate the change and the need to consider opting in.
5. Used multiple channels to gather affirmative consent.
6. Created a communication matrix by segment, prioritizing marketing dollars to the high-overdraft segment; for example, no mailings to the no-overdraft segment, one mailing only to the low-overdraft segment, one mailing and teller prompts for the medium-use segment, one mailing and one follow-up mailing and outbound calls to the high-use segment.
7. Offered incentives and rewards—such as identity theft insurance or free gift cards—to high-volume segments for opting in.

Optimize debit card activation and usage.

Some institutions view the Reg E change as an opportunity to focus on optimizing debit card interchange income as a means of replacing lost OD income. Increasing interchange revenue through higher card activation and usage is a way to replace lost fee income without any negative customer impact. To increase activation, institutions are investing in instant-issue technology, training their front-line staff to better communicate the advantages of debit over cash and checks at the time of account creation, communicating the advantages of signature versus PIN transactions, and instituting debit-rewards programs as an additional incentive.

From a debit-card usage standpoint, institutions that have successfully boosted transactions per card by as few as one to two per month can see a large increase in fee income. They typically have followed a similar approach to the opt-in tactics described above:

1. Segmented the DDA account base on the basis of DDA behavior; for example, check writing, PIN debit, signature debit, ATM usage, etc.
2. Analyzed each segment to identify those with high potential. High-potential segments tend to be those that use debit cards but only in a limited capacity (perhaps they have an ATM card with PIN-transaction capabilities only) while also writing multiple checks. They are attractive demographically and large enough to make an impact if their behavior can be changed.
3. Developed communication plans, specific actions and incentives, and budgets by segment; for example, upgrade ATM card users to debit cards, offer debit rewards, or offer discounts for a period of time.
4. Educated front-line staff to promote debit card usage during new account opening and during servicing transactions.
5. Deployed bundled products where customers earn incentives (e.g., increased interest, fees waived or rewards, “bundling” incremental interest with debit card usage) for debit card usage.
6. Tracked results; institutions have seen usage increase by one to four transactions per month, per user.

Implement new deposit pricing.

Many banks and credit unions are evaluating their deposit account pricing. They are scrutinizing account minimums required to avoid fees, levels of maintenance fees, minimum balances for interest checking, and online banking and bill pay fees, as well as decreasing or eliminating interest on transaction accounts. Regardless of

the tactic employed, the challenge in implementing a price increase is minimizing customer attrition. Some banks and credit unions successfully:

1. Segmented the customer base and focused new offerings on a targeted set of customers.
2. Looked before they leapt—developing low-cost, low-risk experiments that tested different pricing tactics with a small subset of customers at one branch in a competitive market; then, monitored the experiment and captured attrition results.
3. Created a financial model to extrapolate the experiment results to the larger customer base in order to assess viability.
4. Studied price elasticity in the DDA base to determine whether they are overpaying in certain segments.
5. Bundled price increases with marketable new benefits.
6. Rolled pricing increases out to new customers or selected segments only and grandfathered other customers into their current pricing.

Launch new products and services.

Some institutions are developing innovative new products and services to generate new fee income. For example we are aware of institutions that have considered:

1. Transaction level OD notification: 7.9 percent of banks surveyed by the FDIC notify consumers that funds are insufficient before the transaction is completed, offering an opportunity to cancel the transaction and avoid the POS debit transaction fee; 23.5 percent did so for ATM transactions. By offering this flexibility, a financial institution could differentiate itself and garner a higher level of affirmative consent since consumers will have more control.
2. DDA overdraft products such as an OD line of credit or linked accounts. These provide opportunities to increase share of credit card or savings wallet and garner some fees on a transaction.
3. Bundled products; for example, requiring that a savings account be bundled with a DDA account and/or providing added value with bundled product offerings.
4. ACH-based returned check re-presentation for business customers who may face a higher volume of returned checks as a result of Reg E.

Reduce costs of servicing DDA accounts.

Finally, many institutions are scrutinizing their costs around DDA account servicing to identify cost-reduction opportunities. Cost-reduction opportunities can be divided into three types based on what drives the costs: Customer behavior, technology enablement, and processes.

Customer-behavior-driven cost-reduction opportunities are those requiring a change in customer behavior to capture the savings. Examples include creating incentives for customers to opt for electronic statements instead of paper, driving more service volume to lower-cost service channels such as mobile and online banking, increasing adoption of remote deposit capture among business customers, and curtailing the number of checks written.

Technology-enablement-driven cost-reduction opportunities are those that require the wider use or deployment of technology within the institution or the customer base to capture the savings. Examples include least-cost check presentment and routing and image capture enablement.

Process-driven cost-reduction opportunities require rethinking current DDA processes to capture the savings. Examples include outsourcing item processing, deploying branch imaging technology better, outsourcing statement production, and reducing statement stationary costs.

Conclusion.

It goes without saying that many financial institutions are not excited by the changes included in Reg E. Some leading institutions, however, are looking at compliance with this regulation as an opportunity to build a more trusted brand with their customers. In addition, they are working to replace lost revenue with new products, revising DDA pricing, and increasing debit card fee income. Each of these strategies has a few key elements at its core: a structured approach, alignment with the bank's strategy, a clear set of requirements, segmentation of the customer base, and prioritization of resources.

Invest the time and effort now so that beautiful spring weather does not turn into your institution's summer of discontent.

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