INDEPENDENT BANKERS
ASSOCIATION OF TEXAS

1700 RIO GRANDE STREET
SUITE 100
AUSTIN, TEXAS 78701
P: 512.474.6889
F: 512.322.9004
WWW.IBAT.ORG

JIMMY RASMUSSEN
IBAT CHAIRMAN
JRASMUSSEN@HTBNA.COM
HOMETOWN BANK, N.A.,
GALVESTON

J. DAVID WILLIAMS
IBAT CHAIRMAN-ELECT
JD.WILLIAMS@HCSB.COM
HCSB, A STATE BANKING
ASSOCIATION, KERRVILLE

THOMAS C. SELLERS
IBAT VICE CHAIRMAN
TSELLERS@ALLIANCEBANK.COM
ALLIANCE BANK,
SULPHUR SPRINGS

SCOTT HEITKAMP
IBAT SECRETARY-TREASURER
SCOTTH@VBTEX.COM
VALUEBANK TEXAS,
CORPUS CHRISTI

TODD PRICE
LEADERSHIP DIVISION
PRESIDENT
TPRICE@FIRSTSTATEBANK.COM
FIRST STATE BANK
MESQUITE

MILTON McGEE
IMMEDIATE PAST CHAIRMAN
MMCGEE@CNBTEXAS.COM
CITIZENS NATIONAL BANK,
HENDERSON

CHRISTOPHER L. WILLISTON, CAE
PRESIDENT AND CEO
CWILLISTON@IBAT.ORG

STEPHEN Y. SCURLOCK
EXECUTIVE VICE PRESIDENT
SSCURLOCK@IBAT.ORG

CURT NELSON
IBAT SERVICES PRESIDENT
CNELSON@IBAT.ORG

RAMONA JONES
IBAT SERVICES VICE CHAIRMAN
RJONES@IBAT.ORG

MARY E. LANGE, CAE
IBAT EDUCATION FOUNDATION
PRESIDENT
MLANGE@IBAT.ORG

JANE HOLSTIEN
SENIOR VICE PRESIDENT
JHOLSTIEN@IBAT.ORG

URSULA L. JIMENEZ, CAE
SENIOR VICE PRESIDENT
UJIMENEZ@IBAT.ORG

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Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429-9990
OverdraftComments@fdic.gov *Transmitted via email*

RE: Comments on Overdraft Payment Supervisory Guidance

Ladies and Gentlemen:

The Independent Bankers Association of Texas (IBAT) represents over 500 independent community banks domiciled in Texas. Most of these members offer overdraft protection programs that are automated although some members still honor overdrafts on an ad hoc basis. The proposed guidance will significantly affect these members. As we will explain in more detail below, several of the proposed requirements in the guidance are not workable and are likely to have the effect of virtually eliminating overdraft programs. This in turn will eliminate a product that is desired by customers and which provides a stable source of fee income that supports free checking and other products of significant benefit to consumers.

The guidance also presents several legal questions. First, it is being proposed ad hoc, by the FDIC alone, unlike the original "best practices." This means that there is the potential for disparate treatment of overdraft protection based on the type of bank that is offering it. Second, it is based significantly on the FTC Act prohibition on unfair or deceptive acts or practices (UDAP). The FTC Act specifically delegates to the Federal Reserve the authority to issue regulations on point. The Fed considered UDAP in earlier regulatory efforts relating to overdraft programs and concluded, based on extensive comments, that requiring an "opt-in" process for coverage of debit cards was the most appropriate response. Further, the changes to Regulation E relating to debit card coverage in overdraft programs have just been fully implemented. It is premature to change the rules—again—before those regulations have an opportunity to take effect. Next, the guidance seems to largely track proposed legislation that did not pass in Congress.

Before we address the specific items in the proposed supervisory guidance, we will briefly provide an analysis of several legal and business considerations.

Background of overdraft payments. IBAT members have historically made overdraft coverage available—but on an ad-hoc basis. Before automation, every morning a list of potential overdrafts would be prepared and distributed for discussion at officers' meetings. Then, individual decisions would be made as to which overdraft might be paid. The result was that higher net worth customers tended to have

their overdrafts covered as the risk on these particular individuals was better understood by the institution and these customers were more likely to be known by officers. As a result, most checks were returned, and debit cards were uncommon. With the automation of the overdraft decision, there has been a democratization of the process with more customers covered. Now, more items are paid rather than returned.

Overdraft Fees. Texas chartered banks charge a single NSF fee for an overdraft. This is due to the usury laws of Texas and the limitations of the Texas Finance Code. The Texas Supreme Court clarified Texas law and concluded that an insufficient funds charge is actually a service fee for the process of determining whether to pay an item. *First Bank v. Tony's Tortilla Factory, Inc.,* 877 S.W.2d 285,288 (Tex. 1994). Therefore, that fee is not interest as defined by Texas law. An overdraft fee which is in addition to the NSF charge or which is higher than the NSF charge would constitute interest under this analysis. Due to the very short-term nature of overdrafts, a flat fee will virtually always result in a potential usury claim for a Texas institution. Therefore, Texas banks only charge the NSF fee and do not have a separate and distinct overdraft fee that is higher.

Consumer Alternatives: Open-End Lines of Credit. This product, which is common in other states, was unavailable through Texas commercial banks until very recently. Basically, limitations in the Texas usury laws kept such credit from being economically viable. In 1983, the Texas Legislature revised the usury laws relating to open end credit accounts so that the interest rate was capped at 14% and all fees were absolutely prohibited. This change applied to all consumer revolving credit accounts. As a result, consumer open-end credit became virtually unavailable with all of the major credit card operations terminating Texas operations. In fact, the major forms companies providing documents to Texas banks stopped providing the form for consumer open-end credit. The product was simply not available. It is only recently that the laws were changed through an amendment to Chapter 346 of the Texas Finance Code to permit an interest rate of up to 18% and modest fees. However, open-end credit is still not generally available at most Texas institutions.

This proposed guidance assumes that banks can (and should?) offer such open-end credit as an alternative to overdraft protection. Overdraft courtesy, while not an explicit line of credit and not guaranteed as available, has filled the void created by the actions of the Texas Legislature. Perhaps more significantly, this experience demonstrates that when products are restricted to fees that are not economically feasible, the products are eliminated. Banks are not in business to take losses. And the FDIC would not look kindly on banks that did not have adequate retained earnings to internally manage capital levels.

Customer Disclosures and Information Resources. The recent amendments to Regulation E have assured that consumers have a clear choice with regard to whether or not their occasional debit card or electronic transaction is subject to overdraft protection. Model debit card disclosures coupled with "Best Practices" suggestions for overdraft programs generally provide consumers with clear explanations of what is and is not covered along with the cost. Furthermore, virtually all banks now offer at least some level of on-line banking and voice response systems. Thus, customers have easy access to several methods for checking their statements and their balances on a regular basis. Paper statements have forms on the reverse of the statement to facilitate and make easy the reconciliation of the statement for the customer. In short, there are many aids provided to customers to help them keep up with their account balances and thus avoid an overdraft situation.

This guidance would appear to require banks to become extremely paternalistic and provide additional assistance to consumers, either individually or through classes, to counsel them on how to

manage personal finances. Texas banks, individually and through various groups, already make such financial literacy programs available throughout the state. IBAT was instrumental in legislative efforts that resulted in a requirement of financial literacy for graduation from high school in this state. In short, better consumer financial skills are a goal that the association and its members embrace. In particular, see the resources promoted through the IBAT Education Foundation: http://www.ibat.org/foundation. Our concern is the paternalistic tying of education to consumer usage of overdraft protection.

Data Processing and Technology Challenges. Online and mobile banking services give consumers more choice and more ways to manage their accounts. Consumers may dial in to sophisticated voice response programs to get the latest information on their account balances. And Check 21 certainly has resulted in more accurate and timely balance results—as to payments through checks. However, technology also presents new challenges to the banking system as it deals with different payment channels.

First, it is important to realize that at some ATMs, the participating bank may handle its transactions in a batch mode or in real time. Also, whether or not transactions can be handled in real time will depend on whether the customer is using the bank's proprietary ATM or a foreign one. Transactions will be processed based on the bank's BIN. Currently, there are some limitations with regard to the BIN and how it is recognized at a specific ATM machine. ATMs located in foreign countries offer their own set of challenges as well.

Next, each bank must deal with its own data processor and the software that is available to it in its handling of ATM cards and check cards. The data processor may have the capacity to identify debit card transactions in real time, but some operate in a batch mode. It may or may not have the capacity to provide messages to a bank's proprietary ATM with regard to ledger versus "courtesy" balance. Finally, even if the bank is operating in a "real time" mode, items are only memo posted during the day. Final settlement occurs at the end of the banking day.

Moreover, instances may arise where the data processor is providing "stand-in authorization." This type of authorization occurs when there is a problem in the telecommunications network. For example, if a tropical storm, hurricane, or tornado – events common in Texas – damages the network, a bank's data processor will stand in for the bank and approve transactions up to a pre-agreed limit. However, because the bank and the data processor cannot communicate, the data processor cannot obtain the account balance to determine whether the customer's transaction will result in an overdraft situation.

Automated teller machines have large screens typically and sophisticated keyboards by which customers can process their transactions. By contrast, check cards are used at point of sale in a simple scanner that reads the magnetic stripe. The point of sale machine has very little sophistication or capacity to provide information to the customer. In addition, the bank has no control over whether the merchant trains its cashiers to request PIN transactions or signature-based transactions. Similarly, the bank has no control over whether the customer elects to handle a check card point of sale transaction as though it is a credit card transaction on a signature basis rather than a PIN basis. Finally, some merchants will preauthorize transactions for amounts that do not match the ultimate transaction. Thus, restaurants may add on an estimate for a tip while the customer may leave it in cash or in a different amount. Hotels and rental car companies place significant holds on debit cards. Gas pumps may preauthorize for only $1 when the consumer may actually pump $50.

The debit card system is subject to system or network rules as well as the limitations of a variety of data processing systems. When a merchant swipes a card, the transaction is transmitted for preauthorization. The amount of the transaction is compared to the consumer's available funds. If the amount can be covered, then the transaction is preauthorized. At this point, the issuing bank must pay the transaction—even if the account is later overdrawn. The preauthorized transaction is placed in a "pending" status. Some data processing clears or drops pending items at the end of the business day, whether or not they have actually paid. Typically, the transaction will not post for several days. Thus, even though the customer may have had adequate funds for the transaction when it was preauthorized, the account balance is now inadequate to cover the full transaction. As noted above, regardless, the bank must pay the item.

Finally, customers have a wide array of payment mechanisms today including using paper checks, online bill pay, ACH transactions set up through bill payment services, check cards, ATM transactions including cash disbursal and transfers, mobile banking and other payment mechanisms such as stored value cards. Each of these has a different transaction code and has different implications for data processors. Again, the bank has no control over which mechanism the individual bank customer elects to use at any particular time. However, customers continue to press institutions to provide more choices and more flexibility in handling their payments. It is critical that innovation not be stifled.

Next, it is important to note that checks are not processed throughout the business day but rather are batched and processed after the bank's cutoff hour. It would not be feasible to post them in chronological order. Check processing is subject to an array of laws and regulations including Articles 3 and 4 of the Uniform Commercial Code, Regulation CC including Check 21, and clearinghouse rules. Specifically, Section 4.303 of the UCC permits a bank to pay items in any order.

Check clearing procedures. The proposals relating to check-clearing procedures absolutely ignore the data processing and technological issues discussed above. Clearing checks in order received is not feasible. Clearing debit card transactions in order received is meaningless without more clarity. Should such transactions be applied to available balance when the merchant obtains an authorization? At that point, the item is a "must pay" one and can't be returned. Arguably, this is when the item is "received."

Much of the posting sequence issues from consumer advocates relate to the concern that debit cards are paid largest to smallest as they are actually submitted by the merchants. We believe that consumers who are worried that they could wind up with a very expensive cup of coffee as a result of such posting are protected by the changes to Regulation E. Specifically, these customers have received the model notice and been given the opportunity to opt in (or out) of debit card coverage in their overdraft protection plan. Certainly when the Fed considered this issue earlier, it concluded that this approach better matched the feedback from consumers. (See 74 FR 59034-59035)
Also, we believe that, as to checks, community bank customers prefer that the largest items be paid first. The consequences of having a mortgage or rent check bounce or a car payment be rejected are extremely severe. Further, in order to mandate a specific check clearing sequence, the guidance would have to effectively preempt state law. Under the recently enacted Dodd-Frank Act, we do not believe that this preemption would withstand legal scrutiny.

The issues relating to order of processing are complex and affect an array of stakeholders. Before rules are set in this area, we would suggest that more analysis and the input of such stakeholders

would be appropriate. This would include not only banks but also data processors, merchants, as well as consumers.

Economic Framework. Deposits are the primary (but not only) source of liquidity for funding of bank lending activities. Recent studies have concluded that the cost of opening an account runs between $150 and $200. In addition, each account costs typically about $300 per year just to maintain. These costs have been offset partially by certain revenue streams, including NSF charges and interchange. Accounts with average overdraft fees are not even breaking even at this time. Until the Federal Reserve issues rules relating to interchange fee caps, we do not know how much that revenue will be decreased.

The automated overdraft courtesy program works for banks and customers alike because it is offered across the board to a broad spectrum of customers. Thus, the cost of underwriting each customer individually is eliminated, and the broad portfolio of potential users spreads the risk.

Promotion of responsible use. The recent amendments to Regulations DD and E by the Federal Reserve have created the necessary framework for marketing and disclosures. However, we are concerned by the potential ambiguity of the term "responsible use." Conceptually, this would appear to be reasonable. However, without clear standards, what is "responsible use" could easily vary from examiner to examiner. Further, what actually constitutes "promotion" can vary widely. This particular bullet point also appears to take a swipe at consumers by assuming that they must be protected from their own decision making. Certainly marketing materials and disclosures must be clear and not misleading. However, the additional requirement that programs must "promote responsible use" appears patronizing to the public and ambiguous to the typical bank compliance team.

Excessive or chronic use. This bullet point would require the bank to take certain action if a customer overdraws his or her account and pays a fee on more than six occasions in a rolling twelve-month period. Based on input from IBAT members, this trigger point is far too low. It appears to be taken from recent proposed overdraft legislation that has not been approved by Congress. Furthermore, because the proposal uses a rolling twelve-month period, it is highly likely that the same customers will be contacted repeatedly, causing ill will and an enormous cost to banks.

The follow up action in the proposal would include contacting the customer in person or via telephone. There are numerous difficulties raised by this requirement. First, the telephone number may not be current. Many customers use cell phones and may change those regularly. The task of managing the phone contact information and then following up with customers through the call center will necessitate the hiring of significant additional staff for the banks.

Next, we believe that customers would be offended by this requirement—assuming that they would respond to a call. Often, customers are concerned that a call from their bank is only bad news—that they are in collection status. Thus, it is common to find that customers will dodge the banker's call out of anxiety.

Customers who are identified at the teller line in our crowded lobbies are not likely to appreciate having their overdraft status identified publicly. Tellers will be discreet, and hopefully only the next person in line will overhear the discussion. However, this will cause a public relations nightmare for the banks.

This section also assumes that consumers will either have a savings account that can be linked to their checking or that they can qualify for an open end line of credit or a small dollar loan. These options are typically offered up front when consumers open up their account. Many overdraft customers will not have savings accounts (or will exhaust them quickly). In addition, an automatic sweep from savings into checking is subject to the limitations in Regulation D so that no more than six transactions can be made per month. Further, there is no guarantee that overdraft users will qualify for unsecured open end credit.

The proposed guidance reminds banks of the potential fair lending pitfalls. However, the requirement to offer credit alternatives creates a true trap for the unwary. Lending policies should consider credit quality and risk in making the decision as to whether or not to extend an open end line of credit to the customer who is incapable of managing their checking account without overdraft coverage. If banks make such loans to customers with poor credit scores, surely safety and soundness examiners will criticize the practice. However, if banks don't make those offers, then apparently the compliance/CRA examiners will criticize them. This is a true "Catch 22" situation for bankers.

In short, this proposal will significantly add to the cost of the overdraft program through increased call center expenses, embarrass and annoy customers, and ultimately achieve very little.

Currently, when customers are not able to restore their accounts to positive balance, most banks will provide the customer a "fresh start" opportunity and counseling on how to manage their account effectively. We would suggest that the better test for excessive use is the failure of the consumer to restore his or her account to a positive status. Further, the offer of a fresh start loan is a better alternative then the options suggested in the guidance.

Daily limits. With the strict limitations in Texas law, the current fees do not always cover the cost of maintaining consumer accounts. Placing strict limits on the daily fees would simply provide a perverse incentive to some irresponsible customers to overdraw their accounts. Instead, as required under the Texas usury laws, there is <u>only</u> an initial fee. This approach, which prevents a subsequent fee on the same overdraft, is a better approach. Finally, it is important to note that this proposal elevates the "Best Practice" suggestion essentially to a requirement. As discussed herein, such a change should not be incorporated into a "guidance" if it is to be strictly enforced. Also, this creates disparate regulatory requirements depending on whether or not an institution is a nonmember bank subject to FDIC examination.

Steering. In the discussion of Regulation E requirements, the proposal appears to make the assumption that banks that have done a good job of educating their customers about their overdraft options and which have a significant number of customers opted in to debit card coverage must have impermissibly steered those customers. We believe that if banks have provided the model notice to their customers and their customers have elected overdraft coverage, then it is simply wrong for the FDIC to find that customers were "steered" into such product. The disclosures clearly identify alternative products for consumer consideration. Surely the FDIC is not suggesting that the Fed's model form does not adequately disclose critical information to the consumer? This section of the guidance should focus on whether banks have complied with Regulation E rather than veer off into hazy fair lending assumptions that are patronizing to the public.

Legal Underpinning for this Guidance. The proposal references the FDIC's 2004 guidance on *Unfair or Deceptive Acts or Practices by State-Chartered Banks* as support for criticism during

examinations with regard to overdraft programs. We are aware of formal orders published on the internet by various regulators that criticize banks for their overdraft programs, using Section 5 of the FTC Act (15 USC § 45(a)) as the authority. However, that Act specifically delegates to the Federal Reserve the authority to implement regulations for banks with regard to that section. In 2008, the Fed proposed amendments to Regulation DD relating to overdraft programs based on the FTC Act. Those amendments were not finalized. Rather, the Fed chose to propose and then finalize amendments to Regulation E to deal with the coverage of debit cards and other occasional electronic transactions in automatic overdraft programs. We would strongly suggest that if banks are to be subject to formal orders and civil money penalties under a UDAP theory, then there should be clear parameters in Regulation AA (the Fed's UDAP regulation)—not a "guidance"—to establish the duties and requirements of banks.

Standards for Unfairness under the FTC Act. As noted above, the FTC Act provides the Federal Reserve Board with responsibility for prescribing regulations defining unfair or deceptive acts or practices. Congress has codified standards developed by the Federal Trade Commission (FTC) in determining which acts are unfair. The FTC has no authority to declare an act or practice unfair unless (1) it causes or is likely to cause substantial injury to consumers; (2) the injury is not reasonably avoidable by consumers themselves; and (3) the injury is not outweighed by countervailing benefits to consumers or to competition.

Perhaps most significantly, the "injury" is reasonably avoidable by consumers themselves. With the new "opt-in" requirement in Regulation E for occasional debit card and ATM transactions, consumers can elect to avoid having their debit card transactions trigger overdrafts for their account. Then, responsible consumers can and should maintain their check register, review their balances online or by voice response, and avoid overdrafts as a result of their check or ACH transactions.

Macroeconomic Effect. The caps on daily fees, the unreasonably small limit on number of overdrafts before an account is considered to have excessive dependence on overdrafts, and the emphasis on offering alternatives that simply are not feasible (or reasonably available to many users) could lead a skeptic to believe that the ultimate objective of this proposed guidance is to eliminate this product. Retail deposits fund many banks' lending operations. Without a reasonable level of NSF charges, the community banking industry's capacity will be severely restricted. Retained earnings, an important component of capital, will shrink. The ripple effect on credit must not be ignored in the quest to craft cookie cutter retail products in Washington. Ultimately, this guidance will stifle the ability of many banks to offer new creative products and will disadvantage a vibrant community banking industry.

Conclusion. First, we strongly believe that the recent amendments to Regulations E and DD should be given a chance to take effect. If a review of the experience of banks and customers alike still shows possible abuses, then the Federal Reserve should exercise its statutory authority to amend Regulation AA to provide clear guidance for banks.

However, if this guidance is adopted, we urge the substitution of a "fresh start" loan approach to customers who do not bring their accounts current rather than the approach of contacting customers when they overdraw their accounts more than six times in a rolling twelve-month period.

Further, the check clearing procedures we believe would impermissibly preempt state law (UCC) under the new Dodd-Frank Act standard and are simply out of touch with real-world processes.

Finally, we would hope that as the insurer of banks the FDIC would seriously consider the economic implications of this proposal on the current banking system in the United States. The tenor of the guidance and the unrealistic assumptions made in it make it appear that the objective is to destroy overdraft protection programs rather than to assist banks in offering them in a responsible manner. Thus, we recommend a withdrawal of this proposal.

Thank you for this opportunity to comment.

Sincerely,

Christopher L. Williston, CAE
President and CEO