WHITE PAPER

Navigating the Changing Tides:

Potential Impact of Announced Reg E Changes

1 800 822 6758

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Executive Take-Aways

- By August 15, 2010, no retail accounts can be charged for overdraft fees under a bank's discretionary overdraft protection program unless the account owner has agreed to opt-in to the bank's program that allows overdraft access on POS and ATM transactions.
- This change by the Federal Reserve to Regulation E stands to dramatically affect many banks' non-interest income.
- FIS Consulting Services conducted research into the transaction patterns of a cross-section of their bank clients. We looked at customer transactions by channel for the three months beginning November 2008 and compared them with the three months starting a year later, in November 2009. If checks are replaced with transactions using the ATM and POS channels for the retail customer, the potential impact of the Reg E changes will grow with time, rather than diminish.
- For our sample banks, we found that they have 38.3% of their total NSF/OD revenue at risk. This is essentially the share of NSF/OD revenue derived from consumer ATM and POS transactions. In the case of each individual bank, this 38.3% represents millions of dollars of potentially lost revenue.
- Time is growing short. Every bank with retail revenue at risk needs to start addressing their opt-in situation now.
- Working backward: customer decisions will need to be entered into the system; customers need to be notified, and systems need to be modified to accept the decision criteria. An immense amount of work must get done before the summer of 2010.
- To help institutions navigate the fast-changing non-interest income landscape, we recommend they conduct a targeted Reg E impact assessment - as soon as possible.

Introduction

During the recent economic turbulence, a variety of banking industry's practices have faced strong criticism from many quarters. The industry's NSF/OD practices have served as a lightning rod attracting attention from consumer rights groups, media, legislatures, and even regulators. NSF/OD events are well disclosed, well defined, and easily understood by customers and media alike. Unfortunately, most of the understanding comes after an event rather than prior to one. In our consulting work with call centers, customer discussions regarding NSF/OD fees are the most frequent (and often emotional) topic.

Perhaps because the spirit of the "Joint Guidance on Overdraft Protection Programs" was not taken fully to heart, the Federal Reserve recently announced changes to Regulation E requiring customers to "Opt-In" to bank overdraft programs that allow Overdraft (OD) access at the POS and ATM channels.

Even before the Fed changes to Reg E were publicized, many banks announced pricing and policy changes to their NSF/OD practices anticipating the formal change. Obviously, these did not preempt Fed action.

Briefly, as of July 1, 2010, for new accounts, and August 15, 2010 for existing accounts, a bank will be prohibited from charging overdraft fees for POS and ATM transactions on any account that has not affirmatively opted-in to the bank's OD program. For the rest of this paper, we refer to this as "Opt-In."

Simply put, you must take action.

A bank must:

- Install the ability to distinguish between fees assessed for retail ATM and non-recurring POS transactions and fees assessed for other debits, such as check payments and ACH transactions.
- Obtain customers' Opt-In before assessing charges for retail ATM and non-recurring POS transactions.

- If you wish to preserve some of your NSF/OD revenues, you must:
- Persuade the appropriate retail customers it is in their best interest to Opt-In.
- Determine your approach to providing this valued service, or a mutually acceptable alternative.

Why must you take action? Your bank's revenue stream is at risk. Public estimates of the potential revenue change have ranged widely. However, the estimates provided to date are supposedly representative of the total industry. While there are many assumptions behind these estimates, we believe the following points are crucial:

One bank is not the entire industry and each is responsible for their individual results alone.

- Ultimately, these industry projections are likely incorrect. The estimates are based on assumptions that do not necessarily hold true for all banks; each bank can control these assumptions through positive action.
- Decisions made should be based on facts and a solid analysis, not a gut-level reaction to circumstances beyond your control.

Accordingly, we undertook research to gain insight into the following pressing questions:

1. What portion of a bank's NSF/OD revenue is at risk due to the change in regulations?
2. What share of this revenue is attributable to ATM transactions versus POS transactions?
3. What share of total transactions may be affected due to the change in regulations?

Each bank's experience will vary based on their business model. An institution whose delivery model stresses electronic transactions and few branches—and has a focus on retail—w ill likely be heavily impacted. A bank focusing on corporate business will likely see a light impact.

The split between ATM and POS channels is important. It will strongly influence the success of any tactics adopted to address the situation. A bank's relative strengths in these delivery channels will likely prompt differing stances with the networks they participate in, their vendors, and most importantly, their approach to customers.

Finally, we wanted to determine the relative impact, not just of the retail ATM and POS channels, on other delivery channels and corporate business as well. Lacking a crystal ball, we believe the information provided here can help you prepare for future possibilities. We will also take a look back at the previous year to put things in perspective.

Research and Results

FIS Consulting Services solicited participation in this research project based on availability of detailed transaction data and familiarity with the business model of each bank. Included in the research are ten (10) banks representing a range of geography, size, and business orientation. All banks use the FIS Integrated Banking System (IBS), which provided FIS Consulting Services with access to detailed transaction level detail over a long course of time.

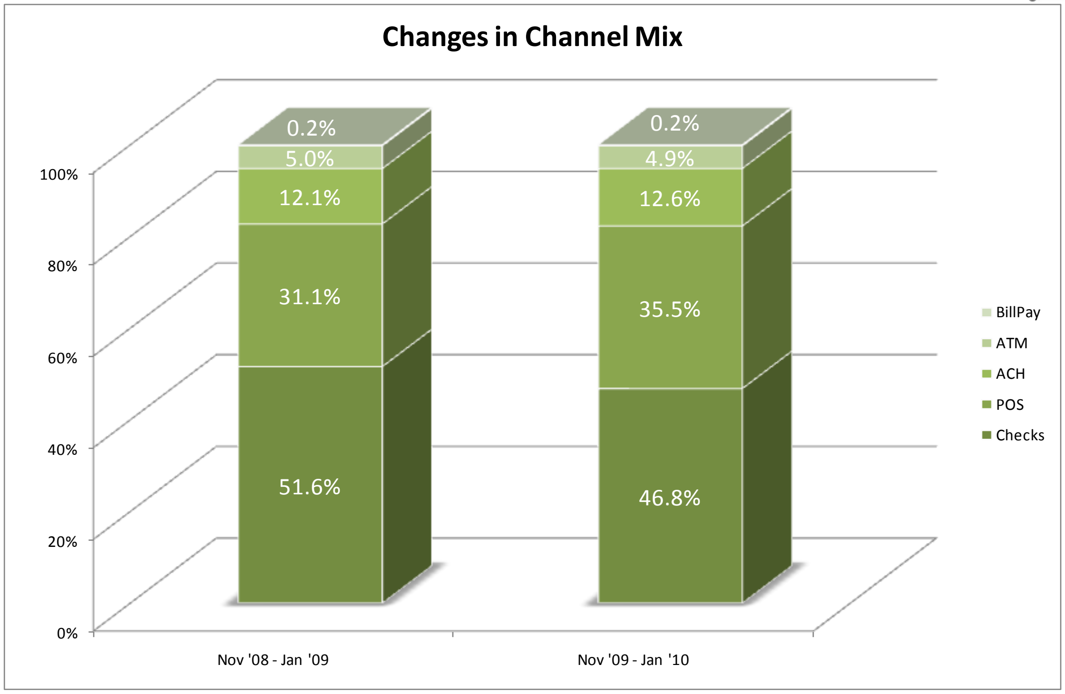
In our earlier white paper titled, "Navigating the Changing Tides Impacting Fee Income: Taking a Proactive Approach to Shifting Market Conditions,"[1] shifting patterns of channel use were identified. Accordingly, the data collected reflects the months of November 2009 to January 2010. A sufficient time period to smooth out cyclical effects of the holiday season was needed to firmly establish a solid baseline.

For each of the banks, information on every transaction that created an NSF/OD condition was collected to identify the channel, market segment, and revenues associated with the event. In reviewing the data from the ten banks, certain accommodations had to be made:

- It is important to note that sufficient information was lacking to uniformly identify recurring POS transactions as opposed to the one-up purchases impacted by the change in Reg E.
- Revenues were tracked separately by bank as each naturally sets their own price schedule.
- The volumes counted reflected events of NSF/OD occurrences, not the final disposition regarding to pay/return or charge/waive. Therefore, results may be over-stated for any bank with a penchant for waiving fees after the fact.

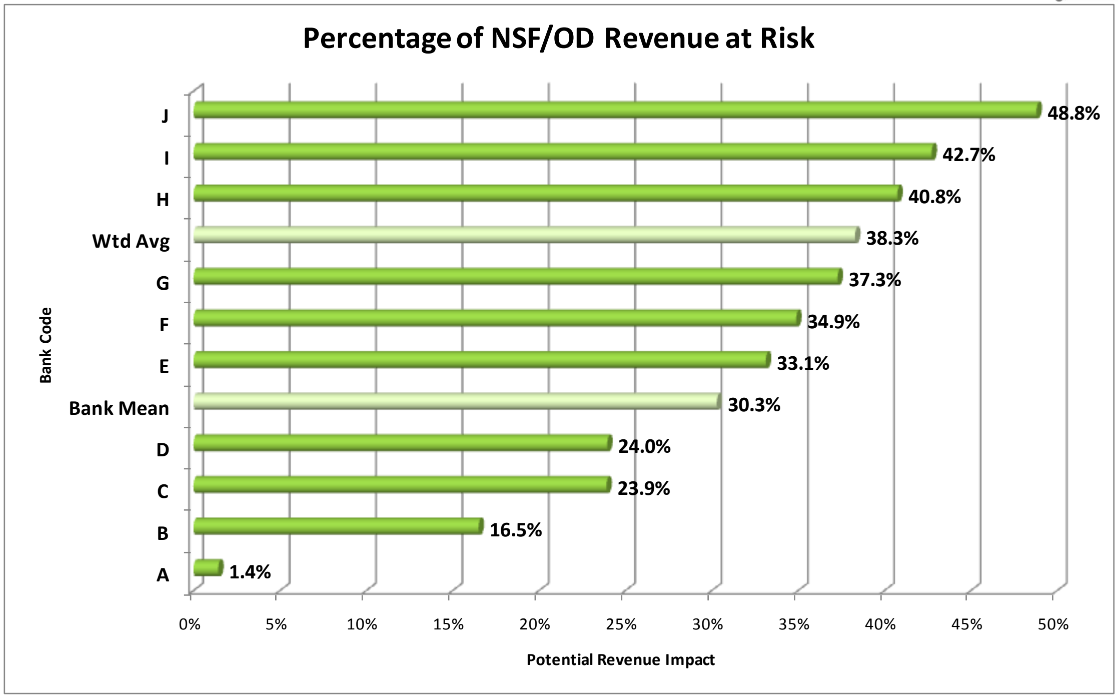
Finally, we looked at channel data from the three months starting November 2008 and compared them with three months starting November 2009. If checks are replaced with transactions using the ATM and POS channels for the retail customer, the potential impact of the Reg E changes will grow with time, rather than diminish.

[1] Lee Kremin and Shawn Rudisill, "Navigating the Changing Tide Impacting Fee Income, Taking a Proactive Approach to Shifting Market Conditions," FIS White Paper, October 2009



Overall, transaction volume in these ten banks is up 8.2% from a year earlier. At the same time, channel use is changing. In these ten banks, the share of checks fell from 51.6% to 46.8%, and POS increased from 31.1% to 35.5%—a decline in the portion of checks and an increase in the portion of POS. These numbers reflect all market segments.

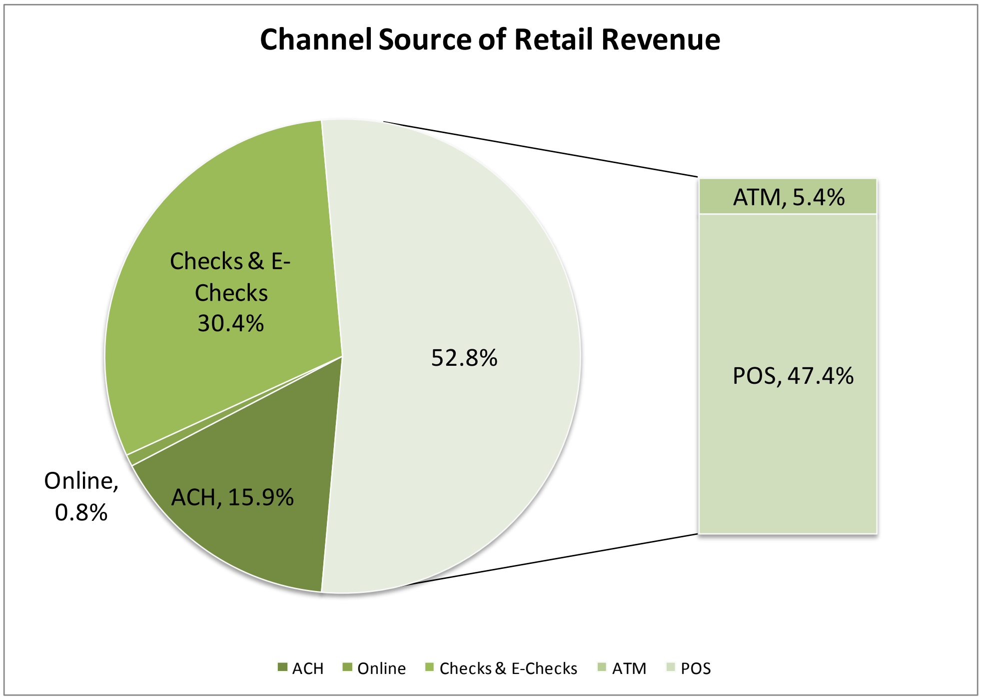
The primary question of this paper is: What is the potential revenue impact brought about by the changes to Reg E? The answer of course varies based on the considerations mentioned above. However, the weighted average of the ten banks in our sample show that they have 38.3% of their total NSF/OD revenue at risk. This is essentially the share of NSF/OD revenue derived from consumer ATM and POS transactions.



The mean of individual bank results is 30.3%. The difference between the two measures is due to the fact that larger banks, with more transactions and revenues, rely more heavily on the POS and ATM channels than some of the smaller banks.

In terms of business characteristics that shaped these findings, we note the following: One bank in our sample (Bank A) has low exposure because the vast bulk of its business model is serving corporate clients and other banks. If there is no retail business to speak of, the risk of losing revenue from retail POS transactions is very low.

On the other hand, if you are a bank with a strong retail orientation and a history of promoting use of the POS and ATM channels, you are more vulnerable and have a greater portion of your revenue stream at risk.

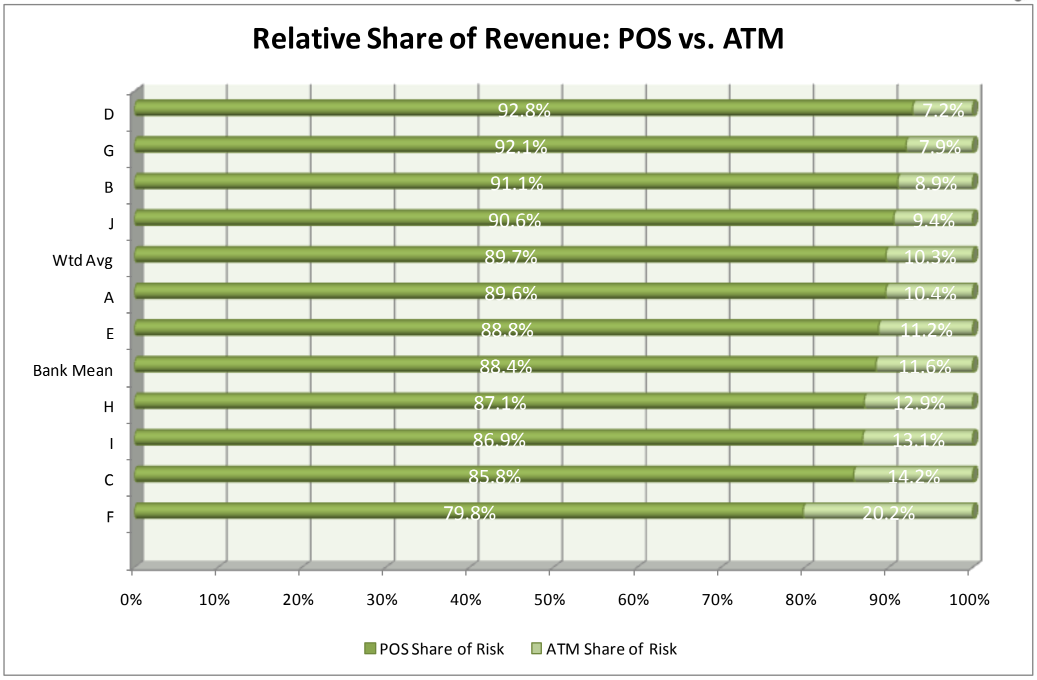


We also need to consider the delivery channel usage in our analysis. POS and ATM channels are both impacted while Check, ACH, and Bill Pay are not (yet). Obviously the delivery mechanisms and therefore, potential solutions will differ.

The preceding chart indicates the breakdown of NSF/OD revenue by channel. Overall 52.8% of the retail revenue is at risk (compared with the 38.3% of total NSF/OD revenue). The lion's share is POS—representing 47.4% of the retail revenue stream. The ATM channel provides 5.4% of the retail revenue stream.

Why does the POS channel provide nearly nine times as much revenue as the ATM channel? The answer is volume. The ATM channel is a mature one in terms of growth potential, while POS is still growing by displacing other payment means including checks and cash. Any speculation that the difference is communication with the customer will evaporate upon closer inspection.

Furthermore, customer actions while using the ATM channel can offer a reason for optimism in deploying a well developed Opt-In campaign. In previous studies, a detailed examination of ATM transactions revealed that 70%–75% of customers actually choose to continue with a transaction after being advised that it could overdraw their account. Admittedly the psychology behind the channel selection is different and no definitive experience is yet available to be drawn upon.



Potential Course of Action

Time is growing short. Every bank with retail revenue at risk needs to start right now.

Working backward: customer decisions will need to be entered into the system; customers will need to be notified, not once, possibly up to three times (as initial efforts may not be successful); systems need to be modified to accept the decision criteria; staff must be trained; a review of the overdraft service offerings should take place; your bank must develop tactics that fit with your strategy and philosophy of operation; your bank must gather and analyze data to understand the current state; and you must establish responsibility for results. All this takes precious time.

Banks must be able to accommodate the change in Reg E for new accounts by July 1, 2010. They must also be able to accommodate the changes for existing accounts by August 15, 2010.

To help institutions navigate these fast-changing tides, we recommend they conduct a targeted Reg E impact assessment.

First, understand the potential revenue impact at your bank. Once an understanding is developed of how much is at risk, establish priorities, develop an approach, and commit to the necessary tasks.

Next, develop a strategy incorporating the changed regulations and attempt to anticipate future possibilities. There are three common approaches to this:

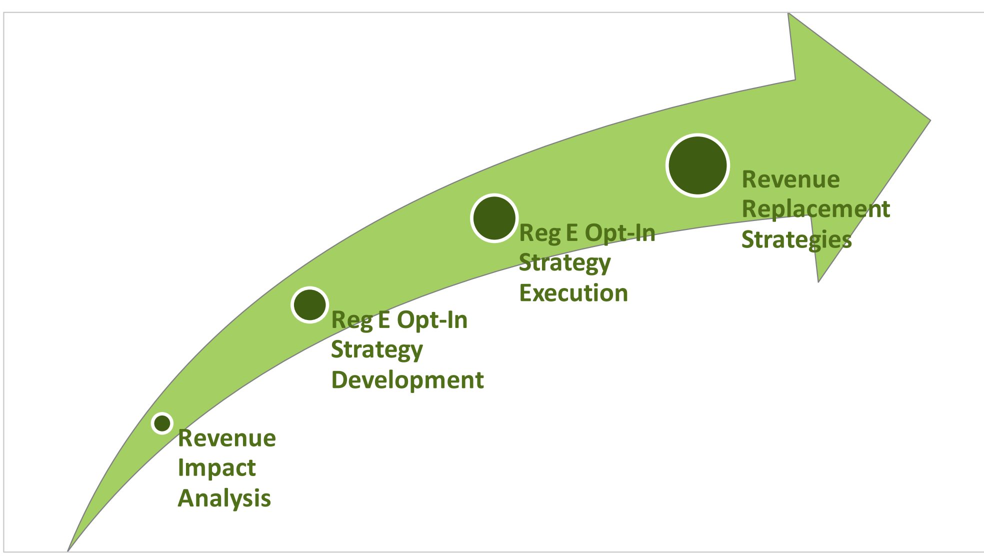
1. Appoint a senior executive to be responsible for developing the strategy. Most banks have in place a planning process that can be replicated.
2. Establish an Overdraft Action Team with representatives from all important stake holders within the organization.
3. Hire outside subject matter experts to assist in your development efforts.

These three approaches are not mutually exclusive; however, the combination you select must have several common factors:

- Establish the boundaries of the effort.
- Understand the current state of the bank's overdraft services and that of the industry as a whole. This should include a detailed study of the behavior patterns of your customers with emphasis placed on the most frequent users of overdrawn funds. This will allow you to make reasonable assumptions regarding:
  - The likelihood of opting-in.
  - Targeting of specific customer groups.
  - Refining estimates of risk.
- Develop an overdraft philosophy consistent with your bank's risk profile, customer service standards, and technological capability.
- Review and revise as necessary all the moving parts of NSF/OD processing and offerings, including product lines, sales / marketing efforts, system processes, procedures, and reporting to fit this philosophy.
- Communicate with your customers, develop informative materials consistent with your philosophy, develop customer migration strategies as appropriate, and design and deliver revised customer agreements and disclosures.
- Train, educate, and enlist employees—from the front-line to the back-room.

Third, execute on your new strategy and implement appropriate tactics. Poor execution of a good plan is no better than good execution of a bad plan. Establish your performance reporting and metrics in advance so you will know where you stand.

Reg E "Opt-In" – Strategy Development Approach



Finally, using the established base of common philosophy and the adopted strategy, begin consideration of alternative revenue replacement options.

Above all else, develop action plans now.

For More Information

The FIS Consulting Services team of specialists comprises practitioners in financial services, operations, technology, risk management, and retail and commercial banking. Our expertise spans the many facets of bank improvement efficiencies. We deliver measurable results to increase efficiency, grow revenue and improve profitability.

For more information on FIS Consulting, call 800-822-6758 and or visit fisglobal.com.

References and Links

To review the Federal Reserve Bank's press release, which contains separate links to the regulation, a "high-level" summary, and the model form, please go to:

http://www.federalreserve.gov/newsevents/press/bcreg/20091112a.htm

To review the "Joint Guidance on Overdraft Protection Programs" from 2005, the following website contains links and a downloadable PDF file, please go to:

http://www.fdic.gov/news/news/financial/2005/fil1105.html

To review a copy of FIS' earlier white paper: "Navigating the Changing Tides Impacting Fee Income: Taking a Proactive Approach to Shifting Market Conditions," please go to:

http://www.fisglobal.com/Services/Consulting/BusinessConsulting/index.htm

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