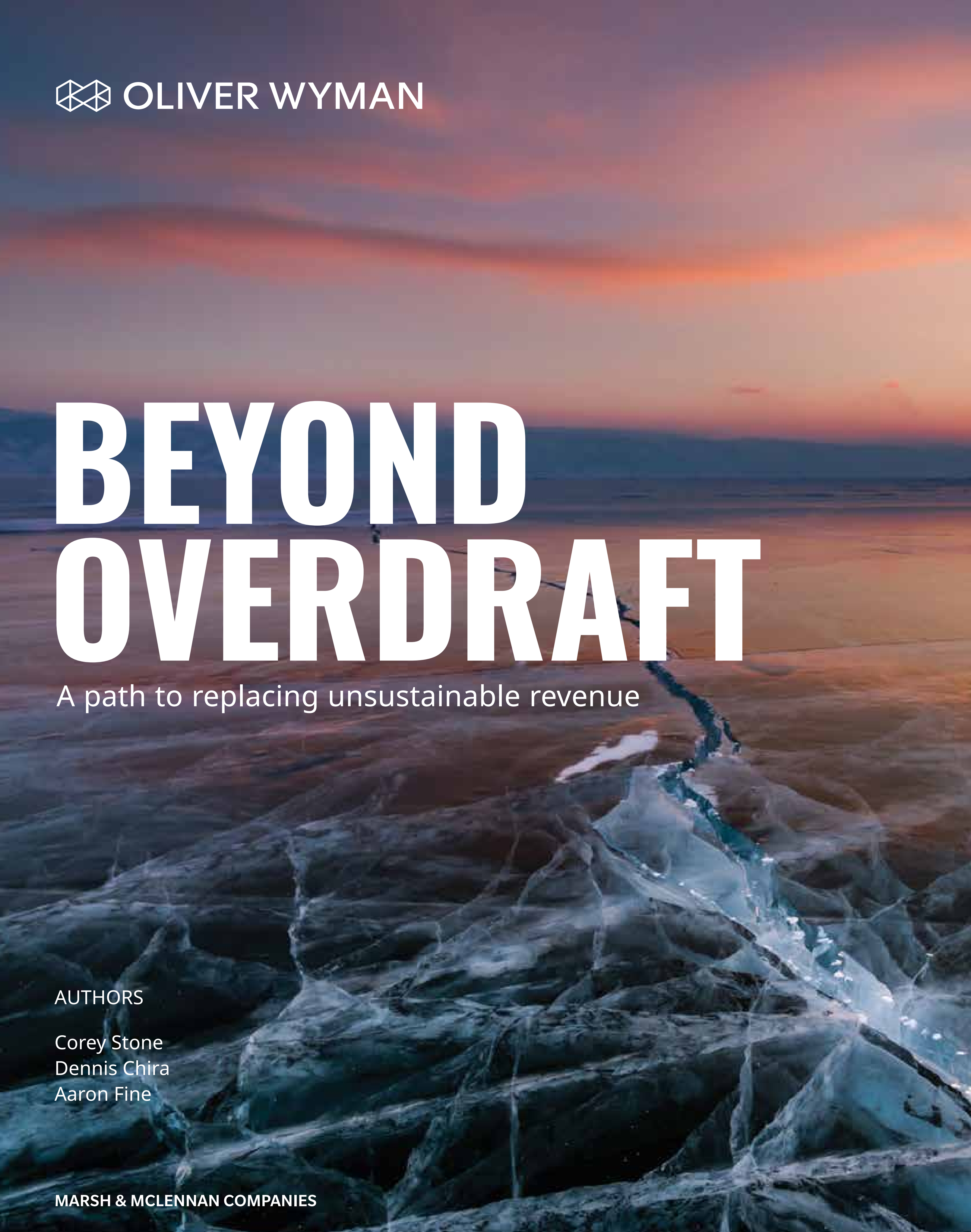

OLIVER WYMAN

BEYOND OVERDRAFT

A path to replacing unsustainable revenue

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FOREWORD

The COVID-19 pandemic and subsequent shutdowns have created a stress test for the financial health of millions of Americans. Less than a month into the economic crisis, 43 percent of people surveyed by the Pew Research Center in early April 2020 reported that they or someone in their household had already experienced a loss of income or employment.

Overdraft and NSF fees drew attention in the aftermath of the first wave of job losses as such fees would fall disproportionately on those most impacted by the crisis, exacerbating already difficult circumstances. To help customers, several banks announced fee waivers as part of hardship assistance. One leading challenger bank went further and used its “fee-free” overdraft line to advance federal stimulus check payments to selected customers, many of whom needed immediate access to such funds to replace lost income.

Expanded unemployment benefits and stimulus checks have created a temporary cushion to household balance sheets that has helped draw attention away from overdraft. But as the crisis unfolds, overdraft will likely garner attention and scrutiny again, both as household checking account balances shrink and as banks feel pressure to replace lost revenue.

What should banks do about overdraft?

We believe the crisis is accelerating the need to replace an antiquated product and an unsustainable value exchange. Our paper explains why and articulates a path forward.

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EXECUTIVE SUMMARY

Overdraft began as a courtesy exception banks once offered to customers in good standing who mistimed their check-writing and deposits. It was a service created to provide customers with convenience and build loyalty, with nominal revenue. A collision of trends including the emergence of debit card and digital payments, the marketing of "free" checking, strained banking economics, and income instability for large swaths of the population have, over the past 30 years, turned that model upside down.

Today, overdraft-related charges, levied largely on just 10 percent of checking accounts, generate fees equivalent to 9 percent of total pre-tax income for leading regional banks.

Many customers and bankers have long questioned the value exchange of overdraft fees. Overdrafts can help address short-term mismatches between expenses and income, be used as an emergency funding source, and help consumers avoid expensive service shut-offs or late fees. But for every true credit or emergency need met through an overdraft, CFPB research suggests that many more overdrafts result from timing errors or inattention.[1] As a result, the effective cost of each overdraft intentionally used to cover a short-term credit need may be many times higher than $35.

This value exchange is unsustainable in a competitive marketplace, and broader industry trends are now in the process of resetting the market:

- Competitive forces are moving consumers away from overdraft, with both digital-only challenger banks and a growing number of large incumbents introducing accounts that do away with overdraft fees.
- Technological innovations and changes in regulatory guidance are bringing a range of lower priced just-in-time credit solutions to market from both primary banks and fintech disrupters.[2]
- In response to financial health challenges that have driven overdraft use, an array of tools is emerging to help consumers eliminate problems at their source. Solutions already in the market help track spending, impose budget discipline, and build emergency savings.

1. "CFPB Data Point: Frequent overdrafters," August 2017. Table 4 indicates that a great majority of overdrafts on debit card transactions occur when there are sufficient funds to cover the transaction at the time of authorization, but not at settlement.
2. See Federal Reserve, FDIC, NCUA, OCC. "Interagency Lending Principles for Offering Responsible Small-Dollar Loans," May 2020.

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The challenge of replacing the overdraft business model can be daunting, as the fees support not only shareholders, but also consumers. Nearly 60 percent of mass market checking accounts generate insufficient deposit interest income and fees to cover their all-in costs.[3] As a result, many institutions have deferred addressing the challenge into the future, hoping that the early signs that $17 billion of revenue are at severe risk will amount to nothing.[4]

The bad news is that the warnings signs are not going away. The good news is that there is a clear path forward for those institutions that move quickly and decisively to introduce new solutions that better meet the underlying needs of overdrafters. In doing so, firms can strengthen customer relationships, preserve near-term revenue, and enhance long-term prospects in the process.

While making the math work initially appears challenging, a simple formula can lead to transformative success:

$10, 1 and 1 = breakeven economics, stronger growth, and a foundation for the future

That is to say: design a solution that consumers are willing to pay $10 a month for, and if you can get one new frequent overdrafter to join the bank and one existing occasional overdrafter to take-up the solution for each existing frequent overdrafter you convert, then the math falls into place.

Easy? No. But relative to the alternatives it is impossible to believe the right decision is not to try. Because the scary news is that in this instance there is little room for "fast followership." Those institutions that wait will see the routes taken by others blocked. Instead they are likely to play the role of Blockbuster to Netflix in another cautionary tale of industry disruption.

3. In this paper, we focus upon mass market consumers exclusively. We define mass market checking accounts as accounts owned by US households with $5,000 or less in checking balances. This segment accounts for approximately 70% of US households (per the Federal Reserve's Survey of Consumer Finances).

4. Oliver Wyman estimate of 2019 industry overdraft revenue, including all banks and credit unions. Based upon analysis of FFIEC and NCUA call report data.

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AN OUTDATED SOLUTION TO A DIVERSITY OF NEEDS

In 2019, consumer overdraft-related fees generated $17 billion of revenues for the industry and represented 66 percent of consumer deposit-related fees for the nation's largest banks (those with more than $1 billion in assets).[5] Among the top 25 regional banks, consumer overdraft-related fees accounted for an average of 9 percent of pre-tax net income.

According to previously released research from the CFPB, most overdraft-related fees are generated by a small subset of consumers ("frequent overdrafters"),[6] who overdraw their accounts one or more times each month. These frequent overdrafters represent only about 10 percent of mass market consumers but generate more than 80 percent of all overdraft-related fee income.[7] We estimate that these same consumers contribute more than 50 percent of mass market checking account profitability, even after accounting for higher servicing costs, charge-offs, and churn. Frequent overdrafters effectively "pay for" the 60 percent of mass market accountholders who do not generate enough in interest income or fees to cover their fully loaded cost (Exhibit 1).

EXHIBIT 1: FREQUENT OVERDRAFTERS DRIVE FEE INCOME AND OVERALL PROFITABILITY FOR MASS MARKET CHECKING

Source: CFPB ("Data Point: Frequent Overdrafters", Aug 2017), Bank Call Reports, Oliver Wyman analysis

5. Industry overdraft fee income estimated by Oliver Wyman using bank and credit union call report data. Share of consumer deposit-related fees calculated only for banks with greater than $1 billion, since others not required to report standalone overdraft-related fee income.
6. Much of our analysis draws on research published by the CFPB Office of Research in "Data Point: Frequent overdrafters," August 2017. That paper characterizes frequent overdrafters' share of all customers of its sample of large banks. We have adjusted the analysis to focus more narrowly on mass market consumers exclusively, a somewhat larger proportion of whom are frequent overdrafters.
7. Throughout this paper we focus upon "mass market" consumers, which we define as those with checking accounts with less than $5,000 in balances. The purpose of this adjustment is to exclude high balance deposit accounts that skew profitability measures.

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This customer profit skew is challenging given how little value most overdrafts appear to provide many frequent overdrafters, especially those who opt-in to pay overdraft fees on debit card transactions.

OVERDRAFT IS A COSTLY ANACHRONISM

Overdraft fundamentally serves two needs: convenience, to clear payments when there are timing mismatches in funds, and credit, to fund longer imbalances in earnings and spending.

However, the majority of timing mismatches are caused by a combination of limitations in our payments systems and customer inattention or miscalculation. Many result from transactions in which debits are honored at payment authorization when a customer appears (both to the bank and to the customer) to have sufficient funds, but does not at the time of settlement.[8]

The nuances of the 2009 regulations governing debit card overdraft essentially mean that customers that do not "opt-in" receive overdraft coverage on many transactions for free (since they opt-out of paying for it, but the bank cannot opt-out of its commitment at authorization to pay the merchant). On the other hand, customers that "opt-in" to overdraft coverage agree to not only pay for transactions that the bank could stop, but also the ones that it cannot.

The CFPB study found that customers who had not opted-in overdrew their accounts on debit card transactions almost as much as those who had opted-in. Frequent overdrafters that opted-in overdrafted 23 times per year on debit card transactions, while those that did not opt-in still managed to overdraft 19 times per year, as bank systems authorized these transactions at the point of sale.[9]

In effect, those customers that opted-in to overdraft paid over $600 per year to receive just four more instances of debit card overdraft coverage than the frequent overdrafters that did not opt-in, a cost per incremental transaction of $150 – or more than 4x the per item cost of an overdraft.[10]

8. Such "authorize positive, settle negative" transactions can result from other pending transactions, such as ACH debits or checks the accountholder has written, that settle following authorization but before settlement of the debit card transaction. They can also result from purchases in which the authorization amounts are less than settlement amounts, as can be the case for restaurant bills where the tip is not included in the authorization, and some auto fuel purchases.
9. CFPB "Data Point: Frequent Overdrafters," August 2017. Table 4. Most of the banks represented in the CFPB's transactional data set did not supply the amount of available funds at the time they authorized debit card transactions of opted-in consumers, so the authors could not tell whether funds were sufficient or insufficient to cover the transactions at the time of authorization. But, based on authorization information from one or more banks that were able to supply it, the study's authors could determine that a majority of overdrafts incurred by the opted-in consumers occurred when funds were sufficient to cover the transactions at the time of authorization.
10. Assuming per-overdraft fees of $35.

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FREQUENT OVERDRAFTERS ARE NOT ALL THE SAME

A closer look at frequent overdrafters indicates at least four large segments of distinct credit and convenience needs.

"Consistent overdrafters" experience little month-to-month variation in income or expenses, yet overdraft in almost every month of the year. They maintain chronically low balances, and while some overdraft use may be intentional, a large portion of their many overdraft transactions (43 per year) are likely driven by unintentional actions or timing miscalculations, suggesting a need for better spending management and tracking tools.

"Frequent debit swipers" are heavy users of debit cards (52 debits per month), have relatively high incomes ($7,800 in deposits per month) but compromised credit and episodic cash shortfalls that result in multiple overdrafts. This cluster likely includes many two-earner couples with joint accounts and two debit cards, who may not coordinate their spending effectively, as well as some independent contractors, whose expenses and income vary from month to month. Their biggest needs may be better tools for coordinating spending and more formal lines of credit to cover inevitable timing mismatches between expenses and income.

"Volatile cashflow" overdrafters experience big swings in income and personal expenses (1.5 to 2.2 times greater monthly deposit variability than other clusters), likely because they include gig workers and other non-salaried employees. Their most important liquidity need is affordable small dollar credit or an emergency savings cushion that they can draw on between jobs or to pay for large expense items and then repay or replenish during busy periods.

"Young and unestablished" overdrafters are typically in their 20s or early 30s (median age of 29), have the lowest end-of-day balances (median of $140), more volatile income and expenses, and no established credit. Their greatest need is to stabilize income and expenses, establish a credit score, and start building an emergency savings cushion.

Two of these segments appear to have acute credit needs: Both frequent debit swipers and volatile cashflow clusters, who represent 22 percent of frequent overdrafters and a similar share of associated fees, include many customers who exhibit behaviors that suggest the need to fund periodic imbalances in earnings and spending. This subset of customers is likely receiving a real benefit from overdraft, but the current one-size-fits-all solution underserves and overcharges many of them relative to what could be offered from more fit-for-purpose solutions.

Because these clusters' respective needs were not historically served by fit-for-purpose solutions, overdraft has become an imperfect solution for all of them. But that is now changing.

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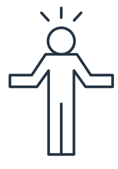
EXHIBIT 2: BEHAVIORAL CLUSTERING HIGHLIGHTS FOUR DIFFERENT BEHAVIORS AND NEEDS

	 CONSISTENT OVERDRAFTERS	FREQUENT DEBIT SWIPERS	VOLATILE CASHFLOW	YOUNG AND UNESTABLISHED
Differentiators	**Incur overdraft fees almost every month** Steadier cashflow and higher income, but small balance cushion	**Heavy debit card users, twice as much as others** Most financially capable of avoiding overdraft	**Suffer from extreme cashflow volatility** Gig economy or part-time laborer with inconsistent income	**Young and without a credit score** Have lowest account balances and no established credit
Greatest needs	Building savings cushion through better liquidity management tools	Better tools and small business credit lines	Better just-in-time credit	Building and preserving credit
% frequent overdrafters	23%	11%	11%	20%
% overdraft-related fees	41%	11%	10%	13%
Credit score	545	635	569	No credit score
Monthly deposits	$2,724	$7,828/mth	$1,516	$1,313
Debit-deposit mismatch	0.28	0.29	1.53 mismatch	0.43
% months with OD/NSF	83% of mths	42%	50%	55%
Annual count of OD/NSFs	43 OD/NSF per yr	22	20	20
End-of-day balance	$237	$1,403 avg balance	$270	$140 avg balance
Monthly ACH deposits	2.3	3.1 deposits/mth	0.8	1.3
Monthly debit card txns	28	52 debits/mth	22	22
Charge-off rate	4%	1%	13% charge-off	9%
Negative balance period	5.9	3.3	8.5 days	7.9
Share w/credit card	40%	80%	53%	6% with a CC
Age	38	44	36	29 years old

Note: Oliver Wyman descriptions of frequent overdrafter cluster analysis contained in CFPB "Data Point: Frequent overdrafters," August 2017. Tables 3 and 8.
Source: Exhibit includes only selected clusters of frequent overdrafters from CFPB analysis. Statistics above represent averages

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COMPETITIVE FORCES ARE DISRUPTING MASS MARKET BANKING

Reed Hastings has famously said that his inspiration for founding Netflix came when he received a $40 late fee for his 1997 Blockbuster rental of Apollo 13. Thirteen years later, Netflix reached a market cap of $8 billion and Blockbuster declared bankruptcy.

In 2000, late fees accounted for 16 percent of Blockbuster's annual revenues. While these fees represented their customers' number one complaint, the company was slow to address the problem. It waited until early 2005 to roll out a "no late fees" program, but only after falling behind new competition. By then it was too late.

The early stages of a parallel story may already be happening in mass market banking. While bank overdraft fees are certainly not the same as video rental late fees, they do share similarities. Both have been significant sources of revenue that have been viewed negatively by customers. And both have given impetus to new value propositions and digital competitors.

We highlight three competitive forces we believe are harbingers of disruption.

A. DIGITAL-ONLY CHALLENGERS AND TOP INCUMBENTS HAVE INTRODUCED ACCOUNTS THAT SIMPLY DON'T CHARGE OVERDRAFT FEES

All of the prominent digital-only banks currently feature accounts that do not charge overdraft fees. Collectively they have attracted millions of new accounts, many of which serve as their users' primary transaction accounts.

EXHIBIT 3: NEW CHECKING ACCOUNTS FEATURING "NO OVERDRAFT FEES"

	TRADITIONAL MODEL	NEW MODELS: 2014-PRESENT	
		NO OVERDRAFT FEES	**NO FEE OVERDRAFTS**
	$35 per overdraft	*"Use your debit card without the worries of overdraft fees"* *"Zero overdraft / insufficient funds fees"* *"We think overdraft fees are wrong, so we don't charge them"* *"...you'll never have to worry about bounced payments or overdrafts"*	*"No fee overdraft"* *"We'll spot you on debit card purchases with no overdraft fees"* *"We will allow you to overdraft up to $100 without charging a fee."*
Fintech/ Digital bank products		CHIME, MOVEN, ASPIRATION, SIMPLE, MONEYLION, VARO, GREENHOUSE	VARO's "No Fee Overdraft" introduced Aug 2019 CHIME's "SpotMe" introduced Sept 2019
Traditional bank products		4 of the top 5 banks offer basic checking accounts with no overdraft fees	Does not exist among traditional banks

Source: Oliver Wyman research, company websites

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Chime announced in February 2020 that it had reached 8 milllion customers, including about half that use their accounts for direct deposits. Two of the digital-only banks have also introduced "no fee overdraft" features that allow customers to overdraft up to $100 with no fees or interest charges.

Separately, many of the large incumbent banks have introduced basic checking accounts that feature no overdraft fees, including 4 of the top 5 banks. When funds are insufficient, these accounts decline all transactions, whether debit, check, or ACH. These simple, no-frills accounts have become popular with a broader audience than the low-income customers they were originally designed to serve when introduced in 2014.

To the extent that overdraft-eligible consumers are choosing these accounts, they are voting with their feet on overdraft.

B. NEW SOURCES OF SMALL DOLLAR CREDIT ARE PROVIDING AN ATTRACTIVE ALTERNATIVE TO OVERDRAFT AT A LOWER COST

New solutions developed by fintechs offer forms of just-in-time credit that either compete directly against overdraft or insure against it. Several firms now offer low-cost wage advances against hours already worked but not yet paid. Some of these are offered through employers. For example, more than 200,000 Walmart employees pay $6 each month for services from Even that combine wage advances with budgeting and savings tools.

EXHIBIT 4: NEW SOURCES OF SMALL DOLLAR CREDIT

Archetypes	Examples	Description/revenue model
ADVANCE EARNED WAGES Early access to earned wages often through integration with employer payroll	EVEN est. 2014	• "Instapay" feature is a part of the Even Plus premium service • $8/month subscription fee; typically subsidized by employer
	EARNIN est. 2013	• Provides immediate access to $100-500 per pay period • Paid for by users through voluntary "tips"
	FLEXWAGE est. 2009	• Provides access to earned wages, paid instantly to debit card • Typically $3-5/advance, paid by employee
PREVENT OVERDRAFT FEES Monitor and automatically send funds to accounts when balances are low and likely to overdraft	BRIGIT est. 2017	• Automatically moves up to $250 "to avoid overdrafts" • $9.99/month subscription fee
	DAVE est. 2016	• "True overdraft protection" alerts low balances with $100 advances available to help cover differences • $0.99/month subscription fee + voluntary "tips" model; also charge $4.99 for "express delivery" of advances (i.e. within 8 hours)
	OPORTUN est. 2005	• Offers ability to "top-up" between $25-100 at no cost to user when balances drop below $100

Source: Oliver Wyman research, company websites

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Others offer a service that, in return for a monthly subscription fee, prevents overdraft fees by automatically adding funds to the consumer's account when balances get too low. In addition, one large bank recently introduced a small dollar installment loan to its existing customers as a more transparent and affordable alternative to overdraft.

C. CONSUMERS ARE PAYING FOR NEW LIQUIDITY MANAGEMENT SOLUTIONS TO IMPROVE FINANCIAL HEALTH AND REDUCE RISK OF OVERDRAFTING

A separate group of fintechs, armed with indirect access to consumers' transaction account data, has introduced a variety of new solutions to help users plan, track, and manage their spending and liquidity. These solutions, including better expense tracking, earmarking of income, and automatic savings features, enable users to reduce their risk of overdrafting.

Some sell their services to consumers directly, others distribute their services through employers. Still others are seeking to become platforms to enhance incumbent financial institutions' offerings.

EXHIBIT 5: NEW LIQUIDITY MANAGEMENT SOLUTIONS

Solution	DIGIT est. 2013	QAPITAL est. 2012	YNAB est. 2004	MVELOPES est. 2002
EARMARK INCOME To pay bills, save for specific purchases, help manage spending	◕ "Unlimited Goals"	● "Payday Divvy"	◕ "Budgeted"	◑ "Digital envelopes"
RESTORE THE CHECK REGISTER To maintain real-time account ledger; intelligently predict debits/credits; track what is safe to spend	○	◕ "Spending Sweet Spot"	◑ "Available"	○
AUTOMATE SAVINGS To reduce friction of saving, encourage positive behaviors, and build emergency savings	◕ "Automated Savings"	● Savings Rules (e.g. "Round Up")	○	○
Pricing and userbase				
SUBSCRIPTION FEE	**$5/month** (up from $2.99)	**$6/month**	**$6.99/month**	**$19/month**
WEBSITE ACTIVITY/ USERBASE	620K visits/month	130K visits/month	~5MM visits/month	–
	–	420,000+ users	–	500,000+ users

Robustness of solution: ● = High ◑ = Med ○ = Low

Source: Oliver Wyman research and analysis, Crunchbase, pricing as of fall of 2019. For Qapital and Mvelopes, which have tiered pricing, the mid-price is shown here.

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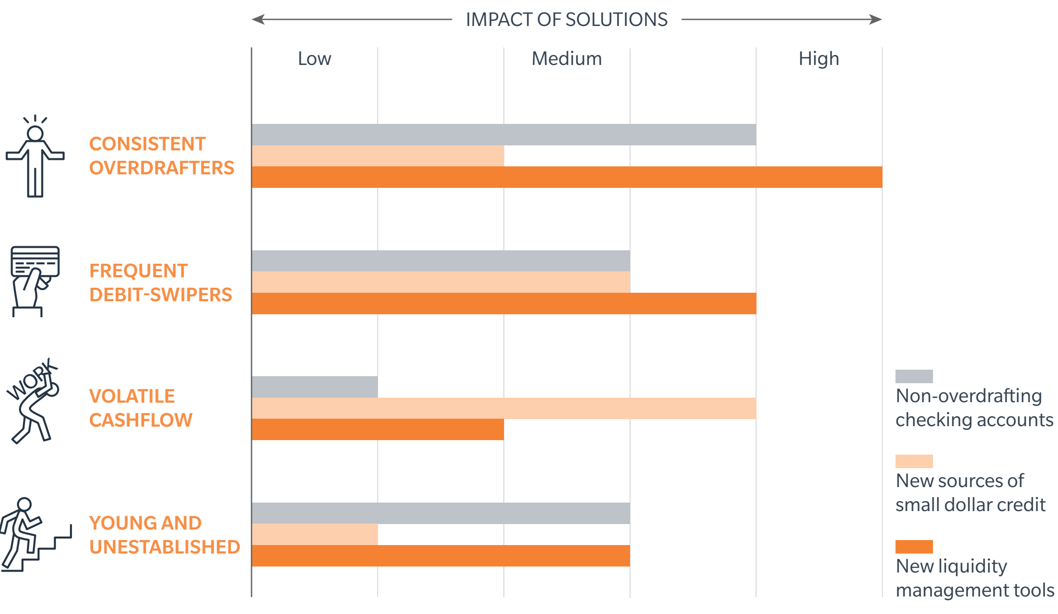
Because the fintechs cannot rely on revenue derived from account balances or payment transactions, many rely on low per-use fees or small monthly subscriptions to be viable. And millions of consumers are paying them.

In different ways, this broader choice of accounts and digital solutions helps address some of the liquidity and cash management challenges that frequent overdrafters face. Exhibit 6 summarizes how they might positively impact the financial lives of the different overdrafter clusters described earlier. As the exhibit suggests, meeting the unique needs of each segment requires different solutions.

While it's too early to tell if these competitive developments are leading to a true tipping point in overdraft usage, it appears they are beginning to bite. Banks' overdraft-related fee income growth has stagnated, growing by only 3 percent over 2015-18, despite 20 percent cumulative growth in debit card volume over the same period.[11]

That trend is likely to accelerate into a decline.[12]

EXHIBIT 6: IMPACT OF SOLUTION TO FREQUENT OVERDRAFT CLUSTER



11. FFIEC data and JP Morgan Payments Market Share Handbook

12. It is tempting to view growth in overdraft fee revenue during the last decade – and in particular, the years following the Federal Reserve's implementation of its 2009 amendments to Regulation E that require banks to obtain consumer permission to charge for overdrafts on ATM withdrawals and non-recurring debit card transactions – as indicative of strong consumer "demand" for overdraft. However, much if not all of that growth was likely driven by continued high increases in debit card use in place of cash. From 2012 to 2017, for example, the annual volume of consumers' non- prepaid debit card transactions grew cumulatively by 41%, considerably increasing the number of debit transactions on which an overdraft could occur. See, for example, The Federal Reserve System: "The Federal Reserve Payments Study 2018 Annual Supplement."

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REPLACING OVERDRAFT: MAKING THE MATH WORK

Offsetting the economic challenges of reducing a bank's reliance on overdraft will require hard work. Succeeding requires getting solutions to market first, targeting clients that will pay for them, and delivering a clearly superior proposition. If that can be accomplished, the math becomes less daunting, and an opportunity to increase mass market share presents itself.

For starters, several banks that have introduced non-overdrafting accounts to their full-service product offerings have applied non-waivable maintenance fees, typically $5 per month. Despite this, they have reported attracting and retaining customers. And at least one large bank has shown an ability to bend the math – realizing consumer deposit fees relative to debit purchase volume in line with competitors, despite overdraft-related fee revenue that is 20 percent lower than peers (Exhibit 7).

In addition, as the fintechs described earlier are demonstrating, many consumers already pay $5 to $10 in monthly fees for individual products and services that enable them to avoid overdraft fees, access more affordable just-in-time credit, and manage spending and liquidity. Thus, it is clear that there are large segments of consumers who will pay a monthly fee for comprehensive bundles of services that address liquidity management needs without relying on the current overdraft fee-based pricing model.

As these models continue to evolve, banks will have several distinct advantages relative to fintechs:

- **Customer data:** banks have uninhibited access to existing customer deposit, lending, wealth, and spending data (vs. fintechs, which rely on data aggregators that often encounter friction from ever evolving data security protocols).
- **Analytics:** banks have in-house credit risk and modeling expertise that will enable them to leverage the data in underwriting small dollar credit alternatives.
- **Infrastructure:** providing enhanced balance tracking and sub-accounts for automated savings and expense earmarking are simply matters of internal accounting and new interface development.

At the same time, some regulatory constraints that have disadvantaged banks may be loosening: federal regulators have recently issued collective guidelines for "responsible" small dollar credit products that include pricing flexibility to yield "overall returns reasonably related to the financial institution's product risks and costs."[13]. And the CFPB has issued a no-action letter template for small dollar loan products that conform to certain consumer protection "guardrails."[14]

So what could the math of a future "no overdraft fee" revenue model look like? For a typical bank, shifting all frequent overdrafters to an account package that charges a $10 monthly fee and provides those clients with an average of two "just-in-time" loans at current market rates would reduce per-customer fee revenue for this segment from more than $700 per year today, to less than $300 per year.

13. See Interagency Lending Principles for Offering Responsible Small-Dollar Loans, May 2020. https://www.fdic.gov/news/news/press/2020/pr20061a.pdf
14. See CFPB: Letter Granting Application from the Bank Policy Institute for a No Action Letter Regarding Small Dollar Loans, May 2020. https://files.consumerfinance.gov/f/documents/cfpb_bpi_no-action-letter.pdf

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At first glance, this math is scary. Upon closer inspection, it becomes clear how manageable it may be:

$10, 1 and 1 = breakeven economics, stronger growth, and a foundation for the future

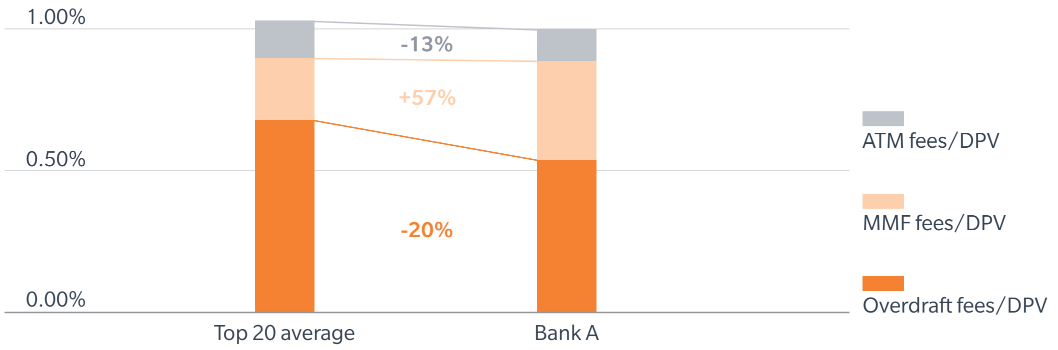
$10, 1 and 1 gets it done. That is to say, with a $10 monthly fee, a typical bank can convert all of its frequent overdrafters to a no-overdraft fee proposition and still breakeven if it just acquires one new frequent overdrafter and converts one existing occasional overdrafter with the new proposition.

Easy? No. Achievable? Yes. With a $5 monthly fee, which is more in line with the basic non-overdrafting accounts available today, the math becomes more challenging – one new client and four occasional overdrafter conversions would be required for each frequent overdrafter converted.

Nothing in this assessment suggests it's easy, but it does suggest that it's possible – if you move into the market quickly. Early entrants can defer lost revenue from existing customers by winning new frequent overdrafters from competitors.

In addition, any existing occasional overdrafter that is converted to the proposition would increase revenue by almost 2x (from $135 to $255 per account). On the surface that's a tough sell. But how many occasional overdrafters struggle with low balances and would be willing to pay more each year for the freedom not to worry about the occasional mistiming of payments, on-demand access to reasonably priced short-term credit, and a set of tools to help them dramatically improve their money management and avoid money crunches altogether in the future? Certainly some.

EXHIBIT 7: ONE LARGE BANK HAS BEGUN TO REPLACE OVERDRAFT FEE INCOME
TOTAL DEPOSIT FEE INCOME/DEBIT PURCHASE VOLUME (DPV)



Note: Top 20 average is the simple average of deposit-related fee income (i.e. OD, MMF, ATM) divided by debit purchase volume for the top 20 banks in 2017, ranked by consumer deposits, excluding Bank A.

Source: Bank Call Report data, Oliver Wyman analysis

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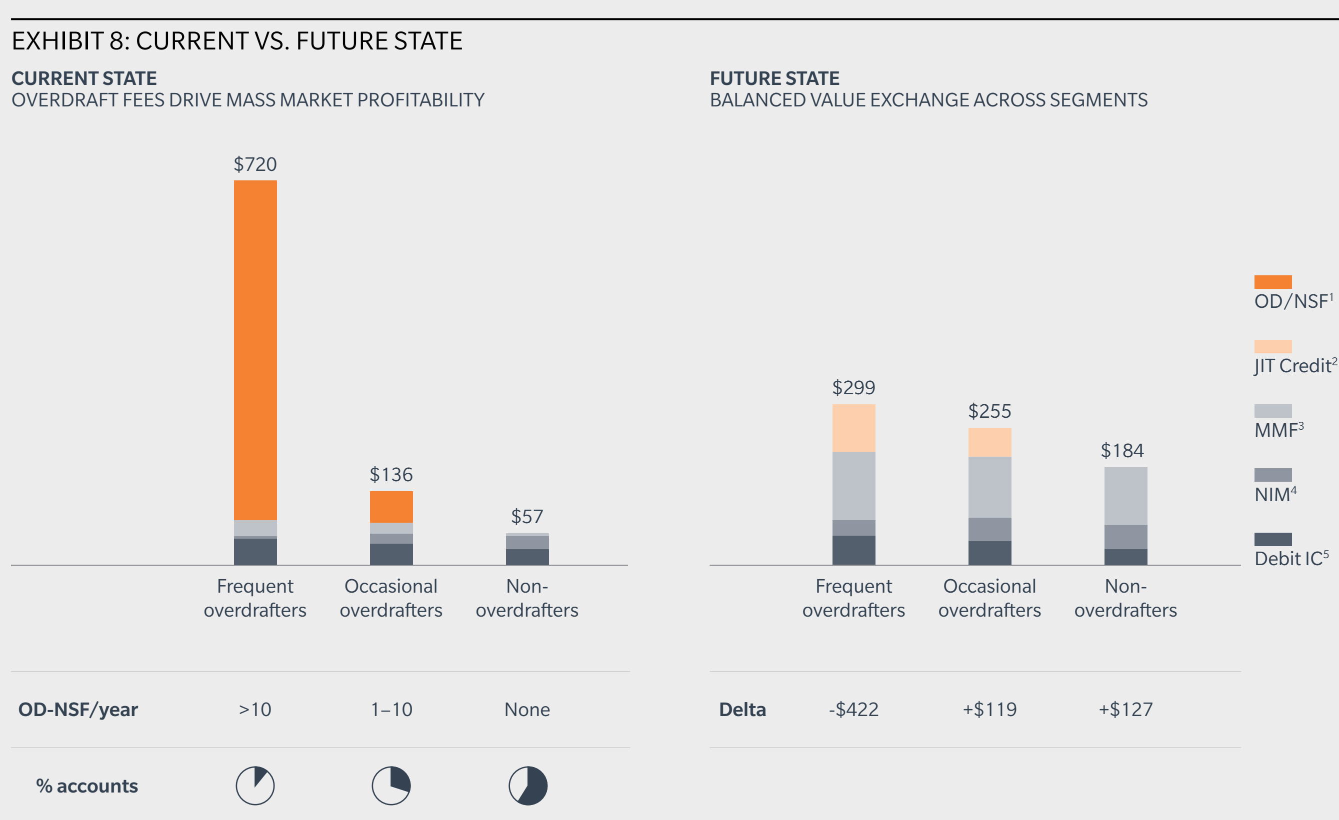
CONVERSION ECONOMICS

We estimated the impact of an existing customer converting from their existing checking product to the new offering, taking into account different sources of revenues and costs across three segments: frequent overdrafters, occasional overdrafters, and non-overdrafters.

The exercise yielded the following findings:

- Per-customer contribution drops from $720 to $299 per year when a frequent overdrafter converts to the new service bundle; lost overdraft fees are only partly offset by incremental subscriptions fees, lower servicing costs, and income from just-in-time credit.
- But when an occasional overdrafter or a non-overdrafter converts, per-customer contribution increases by an average of $123, largely driven by the new subscription fees.
- As a result, to get to breakeven following the conversion of a frequent overdrafter, a bank must also convert occasional or non-overdrafters and/or acquire new customers to the bank through the new offering.

EXHIBIT 8: CURRENT VS. FUTURE STATE



1. OD/NSF = Overdraft and Non-Sufficient Funds fees; 2. JIT Credit = Just-In-Time Credit fee; 3. MMF = Monthly Maintenance Fee; 4. NIM = Net Interest Margin; 5. Debit IC = Debit interchange fee income

Note: Values represent marginal profitability and are net of amortized acquisition costs, servicing costs, and charge-offs. Cost savings from the current to future state are allocated to both the monthly subscription fees and NIM

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A ROAD MAP TO SUSTAINABLE MASS MARKET REVENUES

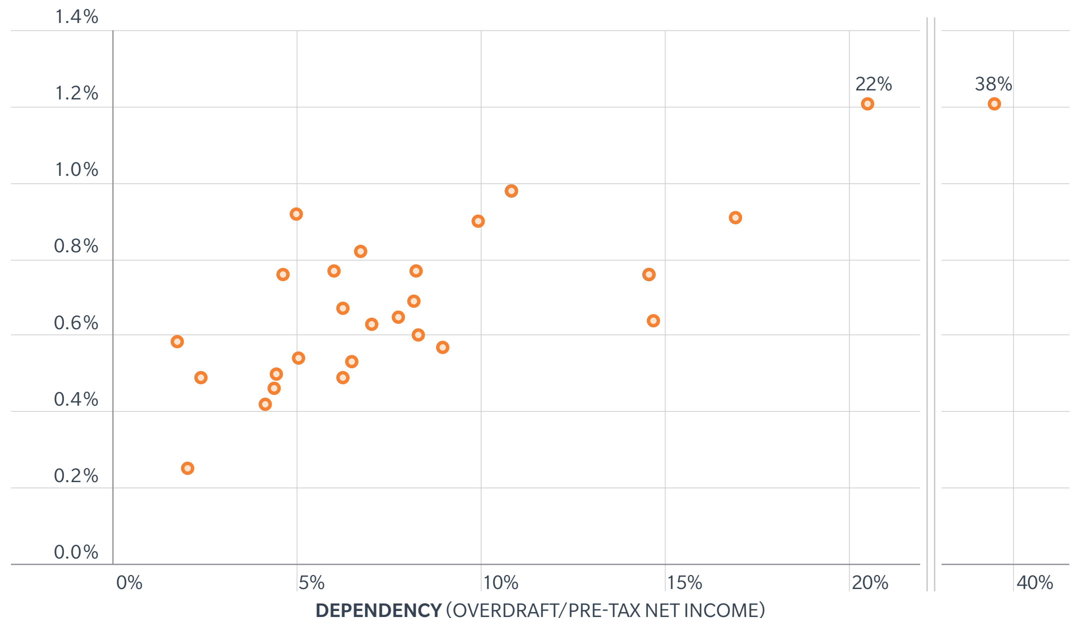
Transitioning away from dependency on overdraft won't be easy. But recognizing that both overdraft revenue and customer relationships are at risk creates an organizational imperative to generate new customer value by solving hitherto unmet needs and to earn new sources of revenue in return. We highlight four key steps along this journey:

A. ESTABLISH THE CASE FOR CHANGE

Each bank will experience the disruption to overdraft in different ways. For some, it is a nearly transcendental threat, with vast amounts of earnings at risk. For others, it is a huge opportunity – with little risk of loss, and large potential to win share from competitors. Regardless of the situation, success will require significant effort and a strong business case for change.

A simple evaluation of one's relative overdraft intensity and overdraft dependency can help to assess this case (Exhibit 9).

EXHIBIT 9: OVERDRAFT INTENSITY VS. DEPENDENCY
TOP 3 NATIONAL AND TOP 25 REGIONAL BANKS



Source: Bank Call Reports, Nilson Report, Oliver Wyman analysis

Overdraft intensity (overdraft fees/debit purchase volume) signifies how much a bank's typical mass market customer is charged overdraft fees. Banks with high overdraft intensity are more at risk since their customers will receive the greatest value in switching to alternatives.

Overdraft dependency (overdraft fees/pre-tax net income) reflects the contribution of overdraft to overall bank economics. Banks that depend more heavily upon overdraft fees will find it more difficult to make the internal case for transitioning away from the current model.

Where an individual bank is located within this matrix will determine whether it pursues more defensive or offensive strategies. Banks with relatively low overdraft intensity (toward the bottom of chart), or low overdraft dependency (toward the left of chart), have the most to gain by aggressively targeting their competitors' overdrafters with a superior package of solutions. Banks in the upper right have the greatest need to develop defensive strategies that migrate their own overdrafters to services that offer greater customer value.

B. IDENTIFY CUSTOMERS' GREATEST LIQUIDITY MANAGEMENT NEEDS AND BUILD PRODUCTS TO SERVE THEM

The cash flow management challenges of frequent overdrafters vary. In this paper, four significant segments of customers were identified, each with a different core need. Successfully targeting each of these segments (not to mention the many customers that weren't specifically classified) requires designing an end-to-end solution for each need and delivering it to the market effectively. Cash-flow management, budgeting, short-term credit, and credit building are just some of the needs to be met. The more that can be identified and effectively served, the more customers for which "win-win" propositions can be developed (those where economics for both the bank and the client are beneficial).

Banks arguably have more extensive, timely, and reliable information about their customers' liquidity challenges than their fintech competitors. This advantage can help them construct a more accurate understanding of customers' behaviors, needs, and context, and ultimately allow them to roll out digital services that deliver better user experiences. The Financial Health Network has recently identified a cluster of such services inspired by solutions from an analog world.

To successfully leverage this advantage, banks must help ensure the solutions are adopted and used in ways that positively impact the financial health of their clients. This means the solutions must be designed to not only serve the functional needs of a consumer – such as providing them with an affordable short-term loan or more effective expense management – but also their experiential needs, from being easy to understand and use, to building a consumer's confidence and compensating for human error.

C. STAGE AND TARGET EFFORTS TO THE CUSTOMERS WHO ARE MOST AT RISK OF DEFECTION WHILE MINIMIZING NEAR-TERM RISK TO REVENUES

While the “making the math work” section theorized a world where all frequent overdrafters are converted to a new checking product without overdraft fees, that is an artificial construct. Rather, banks launching a new product can carefully control where the product is offered and how it is targeted. Banks can launch the product in markets where they don’t have a presence or where the intensity of overdraft is particularly low. Or the banks can offer the product in all markets, but focus initial marketing on new or at-risk clients.

For example, the subset of customers who overdraft month after month (consistent overdrafters) may be particularly vulnerable to attrition, given their low risk of default and the high price they pay in fees for their accounts. Indeed, many of these customers may already be leaving the bank, making the true cost of cannibalization far lower than initially thought. But they may also be happy to stay if a better product is put on offer.

By staging the rollout, significant earnings growth can be attained in the near-term, while minimizing the risk of outsized losses due to cannibalization. Managing this transition effectively can greatly reduce the possibility of any quarters of revenue decline.

D. EVOLVE THE SOLUTION…WITH A LONG VIEW IN MIND

Ultimately, overcoming today’s overdraft dependence requires finding value propositions that will make the math work for a huge number of customers. As many as 70 percent of mass market households currently have value exchanges that don’t work – 10 percent pay far too much for the value they receive, and 60 percent don’t pay enough to cover the costs that they incur. Shifting this model will require identifying all the needs that can be served and building propositions for each of them over time. As we’ve suggested previously,[14] only by serving the full set of financial needs – across lending, saving, protecting, transferring, earning, and spending – can an institution reconstruct the proposition of basic banking in a way that will work for everyone.

This isn’t a journey that can be made overnight. It will require new proposition design and vast improvements in operational efficiency to lower costs, much of which will be enabled by a migration to a flexible digital infrastructure. It is also a journey that will require iteration and experimentation. Successful institutions will commit to this long-term journey and build both the necessary capabilities (e.g. incubation units to stimulate new value innovations) and culture (e.g. commitment to testing and learning).

14. See our 2018 paper, “The Customer Value Gap: Re-calculating Route”

CONCLUSION

Overdraft began as a courtesy exception banks once offered to customers in good standing who mistimed their check-writing and deposits. In the digital era it has become a staple revenue source, earned largely from a subset of mass market users who face recurring cash flow challenges, lack alternative sources of liquidity, and simply make mistakes.

Digital innovators, using access to the payment system and customer account data, have begun to address these customers' unmet liquidity management needs in ways that compete directly with overdraft. Tools that help manage day-to-day spending and keep balances from going too close to zero, and inexpensive just-in-time credit that avoids fees when they do, provide superior value to these customers. Given the new solutions and new non-overdrafting account options, incumbents are at risk of losing a growing number of customers to better solutions.

Banks that proactively introduce and refine such services will find both a path to capturing market share in the mass market and a means to expand customer lifetime value in what was once – but is no longer – a monoline business. Banks that ignore the new services will face eventual erosion of their fee income and defections by customers who find better value elsewhere.

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