

Memo 1994-12 Regulation O - Overdrafts

To: Review Examiners  
From: William D. Grant Jr., General Counsel  
Date: 4/27/94

Re: Reg O; Negative Account Balances; Overdrafts

Facts:

A bank which uses a "pay all" system charges its customer a fee upon the creation of a negative account balance regardless of whether or not the customer corrects the negative account balance within 24 hours. The bank does NOT charge its officers or directors a fee for the creation of a negative account balance so long as the negative account balance is corrected by the officer or director within 24 hours.

Issue:

Does this practice constitute a violation of Regulation O (12 C.F.R. part 215)?

Analysis:

In general, Reg O prohibits the extension of credit to an officer, director, or principal shareholder (insiders) on terms preferential to those provided to non-insiders (12 C.F.R. 215.4). Two essential elements which must be present to constitute a violation of this prohibition are an "extension of credit" and "preferential terms" to the insider.

By using a pay-all system every check received by the bank, as drawee, is automatically posted, which may systematically create negative account balances. Then, at some time during the next 24 hours, the bank will make a decision whether to pay the item, thereby creating an overdraft, or to return the item and reverse the posted debit, thereby avoiding an overdraft. E. Compton, Principles of Banking 129 (1979).

While Reg O includes overdrafts in its definition of "extension of credit", the posting of the item under the pay-all system does not create an overdraft, only a negative account balance. According to 12 C.F.R. 215.3(a)(2), no extension of credit occurs until an "advance by means of an overdraft" is effectuated. If a negative account balance is corrected prior to the bank's decision to pay the item and create the overdraft, no "extension of credit" is present. Since an extension of credit is an essential element, there is no violation of the Reg O prohibition.

In this factual example, the fee charged to non-insiders which the insiders are not required to pay may be "preferential", but it falls outside the scope of Reg O because it is a "service fee" rather than a fee associated with an extension of credit.