HIGH-COST OVERDRAFT PRACTICES

The State of Lending in America & its Impact on U.S. Households

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Lending Abuses and Predatory Practices

Many financial institutions use abusive overdraft programs to unfairly drain their customers' checking accounts, putting consumers on a treadmill of high-cost credit. Abusive overdraft programs drive consumers out of the banking system; indeed, they are the leading reason consumers lose their checking accounts (Campbell, Martinez & Tufano, 2008). Overdraft programs also crowd out better products by removing incentives for banks to offer lower-cost, manageable ways to deal with financial shortfalls (Bair, 2005).

Abusive overdraft programs drive consumers out of the banking system; indeed, they are the leading reason consumers lose their checking accounts.

Overdraft programs began as ad hoc courtesies banks would occasionally provide customers; they were never intended to become a routinely administered, extremely high-cost credit product.

Overdrafts occur when there are insufficient funds in a customer's checking account to cover a transaction, but the bank lends the money to the account holder and pays the transaction anyway. With high-cost overdraft programs, a fee is charged per overdraft transaction and the bank repays itself the overdraft amount and fees, in full, from the customer's next deposit. Banks often offer lower-cost overdraft products, like an overdraft line of credit carrying a reasonable annual percentage rate or an automatic transfer from a savings account or credit card, but financial institutions often automatically place, or steer, customers into the high-cost program. This chapter addresses high-cost overdraft programs.

The predatory characteristics of high-cost overdraft programs include:

- high cost, with the fee vastly disproportionate to the size of the overdraft
- balloon repayment
- very short repayment term
- lack of appropriate underwriting that assesses the customer's ability to repay the loan without taking out another loan shortly thereafter
- manipulation of posting order to increase fees
- the bank's repaying itself before all other debts or expenses, directly from the customer's next deposit of wages or exempt federal benefits (such as Social Security, disability, military or veteran's pay or benefits).

In 2012, the Consumer Financial Protection Bureau (CFPB) launched an inquiry into overdraft programs, noting that overdraft practices have the "capacity to inflict serious economic harm" (Cordray, 2012). In June 2013, CFPB released a white paper documenting its initial findings, concluding that concerns about overdraft practices that regulators have identified for years—including that a significant segment of consumers incur large numbers of overdraft fees, and that even those with "moderate" overdraft usage may pay hundreds of dollars annually—persist today (CFPB, 2013).

High-cost product: high fee, balloon repayment, very short repayment term

CRL's findings here confirm that overdraft programs charge an extremely high cost for credit. Our analysis of 2011 checking account data from Lightspeed Research[1] finds the median overdraft fee charged is $35. The average fee has not decreased in recent years (the median in 2007 was $34), despite decisions by some banks to offer "tiered" overdraft fees ($10 or $15 for the first overdraft and higher fees for subsequent overdrafts).

The effective cost of an overdraft is a function of the size of the transaction that triggered the overdraft and the number of days the overdraft is outstanding. Overdrafts are repaid when the bank repays itself from the borrower's next deposit within a short period, averaging three days for ATM transactions and two days for debit card purchases.

As transaction sizes can differ significantly by transaction type, we determine cost per dollar overdrawn by category based on the type of triggering transaction.

Because debit card transactions tend to be small and trigger average overdrafts of only $20, they incur the most expensive fees in terms of cost per dollar overdrawn ($1.75). Typically, the overdraft fee is nearly twice the size of the debit card overdraft itself. This is particularly striking since transactions on debit cards can be declined, at no cost to the consumer, when the account lacks sufficient funds.

The overdraft fee is nearly twice the size of the debit card overdraft itself.

Figure 1: Median Overdraft Statistics by Trigger Type

Transaction Type	Transaction Amount	Overdraft Amount	Days until Repayment	Overdraft Fee ($35) per $1 Overdrawn
Debit Card	$23	$20	2	$1.75
Other Electronic[2]	$50	$47	1	$0.73
Check	$72	$55	1	$0.56
ATM	$100	$90	3	$0.39

While the analysis above is based on a median overdraft fee of $35, many banks also add a "sustained overdraft fee" once the account has remained overdrawn for several days. At some banks, this is a one-time additional fee in the $35 range; at others, it is a fee in the $6-$8 range charged daily until the account balance is returned to positive. Some banks have implemented "limits" on overdraft fees in recent years, but these limits typically still allow for daily fees in the hundreds of dollars (Consumer Federation of America [CFA], 2012).

Extension of overdrafts to debit card transactions

Financial institutions transformed debit cards into high-cost overdraft products.

As recently as 2004, 80% of financial institutions declined debit card transactions that would have overdrawn a customer's account (Fusaro, 2007). But over the course of a few years, banks and credit unions regularly began allowing these transactions to go through, charging a large overdraft fee for each one.

1 Please see Appendix for discussion of methodology.

2 As discussed further below, "Other Electronic" transactions include automated clearinghouse (ACH) transactions, such as on-line bill payments, as well as purchases made on-line not clearly identified in the data as debit card transactions.

Banks and credit unions have long defended overdraft fees by saying they protect customers from bounced checks, which typically trigger insufficient funds (NSF) fees and potentially merchant fees. But the same justification could not be made for debit card purchases, since there are no NSF or merchant fees charged for debit card transactions that are declined at check-out when the customer's account is short.[3]

In addition to being unjustifiable as protection against NSF transactions, overdraft fees on debit cards tend to be particularly harmful because of their effective cost and their frequency. As discussed above, overdrafts triggered by debit cards tend to be smaller than the fees they trigger, and debit card transactions for everyday purchases tend to be more numerous than paper checks. Thus, there is significant potential for numerous overdrafts to be incurred over a short period of time at a very high cost.

Further, a large majority of consumers repeatedly have stated that they prefer that banks decline debit card overdrafts rather than approve them in exchange for the typical fee (Parrish, 2008) (The Pew Center on the States, 2012).

Federal Reserve Board rule made modest regulatory improvements.

In response to widespread criticism and complaints around high-cost overdraft programs, in 2010 the Federal Reserve Board implemented a basic consent requirement for overdraft fees on everyday ("one-time") debit card purchases and ATM withdrawals (Federal Reserve Board, 2009). This rule required that financial institutions obtain a customer's "opt-in" to overdraft coverage on these types of transactions before they could charge an overdraft fee on them. However, requiring consumer consent did not alter the fundamentally abusive features of overdraft programs.

Still, the Board's opt-in rule coincided with a significant shift in the marketplace. The largest debit card issuer, Bank of America, stopped charging high-cost overdraft fees on everyday debit card transactions altogether, reporting afterward that customer complaints had dropped sharply and that satisfaction levels had risen (Moynihan, 2010). HSBC also stopped charging high-cost overdraft fees on one-time debit card transactions, as well as at the ATM. Citibank has never charged overdraft fees on debit card or ATM transactions. With these three banks' policies, 25% of the twelve largest banks, accounting for approximately 40% of the twelve largest banks' deposits, do not charge high-cost overdraft fees on everyday debit card purchases (CFA, 2011) (FDIC, 2011b). In addition, JPMorgan Chase Bank does not charge overdraft fees on ATM withdrawals.

The largest debit card issuer, Bank of America, stopped charging high-cost overdraft fees on everyday debit card transactions altogether.

Nonetheless, three-fourths of the nation's largest banks and large numbers of smaller banks and credit unions continue to charge overdraft fees on debit card purchases, ATM withdrawals, or both. Further, many financial institutions have aggressively marketed overdraft "opt-in," targeting customers who are likely to generate the most fees (Parrish, 2010) (CRL, 2011). CRL's 2011 survey found that the majority of customers who opted-in to overdraft programs misunderstood their options or were misled by information from the bank.[4] Clearly, consumer "opt-ins" are not evidence of consumer preference.

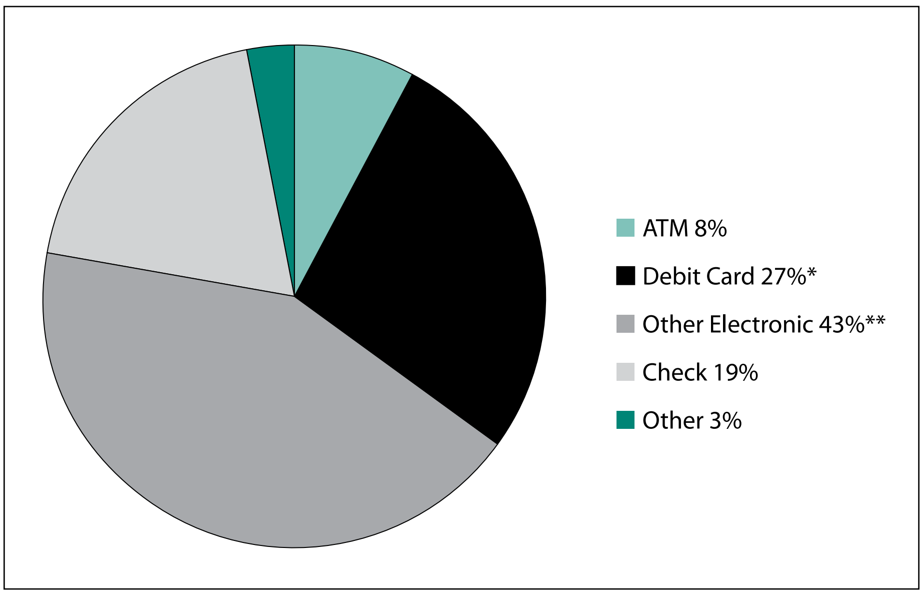
3 The Board has indicated that charging declined transaction fees on ATM or one-time debit card transactions "could raise significant fairness issues" (Federal Reserve Board, 2009).

4 For almost half of those who opted in, simply stopping the bank from bombarding them with opt-in messages by mail, phone, email, in person, and online banking was a factor in their decision. Sixty percent (60%) of consumers who opted in stated that an important reason they did so was to avoid a fee if their debit card transaction was declined. In fact, a declined debit card transaction costs consumers nothing. Sixty-four percent (64%) of consumers who opted in stated that an important reason they did so was to avoid bouncing paper checks. In fact, the opt-in rules cover only debit card and ATM transactions, not checks (CRL, 2011).

Our analysis of 2011 data—the first full year following implementation of the opt-in rule—indicates that the types of transactions the Board intended the opt-in rule to cover are still triggering a very large percentage of all overdraft fees: Debit card purchases and ATM transactions still triggered at least 35% of all overdraft fees. This figure likely understates the percentage of overdrafts subject to the opt-in rule; another 43% of overdrafts were triggered by on-line transactions, but whether these on-line transactions were one-time debit card transactions (subject to the opt-in rule) or recurring debit card or electronic automated clearinghouse (ACH) (e.g., bill pay) transactions (not subject to the opt-in rule), was not clearly discernible in the data.

Further, this 35% figure understates the percentage of overdraft fees triggered by the kinds of discretionary transactions the Board intended the opt-in rule to cover because it excludes ACH transactions—often discretionary in nature—made through payment services like Paypal. Whether these transactions are processed as a debit card or an ACH transaction depends only on whether a customer chooses a debit card number or a routing and checking account number for payment.[5] Discretionary transactions processed as ACH transactions are triggering overdraft fees regardless of whether or a not an account holder has opted in.

Figure 2: Percent of Overdraft Loans Triggered by Type of Transaction



* Transactions categorized as "Debit Card" are those that were clearly identifiable in the Lightspeed data as such. However, these likely do not represent the entire universe of "Debit Card" transactions in the data. See text above for further explanation.

** "Other Electronic" transactions include automated clearinghouse (ACH) transactions, such as on-line bill payments, as well as purchases made on-line not clearly identified in the data as debit card transactions. See text above for further explanation.

5 Though we observed a significant number of Paypal purchases in our data, we were unable to determine whether the purchase was processed as a debit card or an ACH transaction, and thus, whether the overdraft fee on the purchase would have been subject to the opt-in rule or not. All Paypal transactions are captured in the "Other Electronic" category.

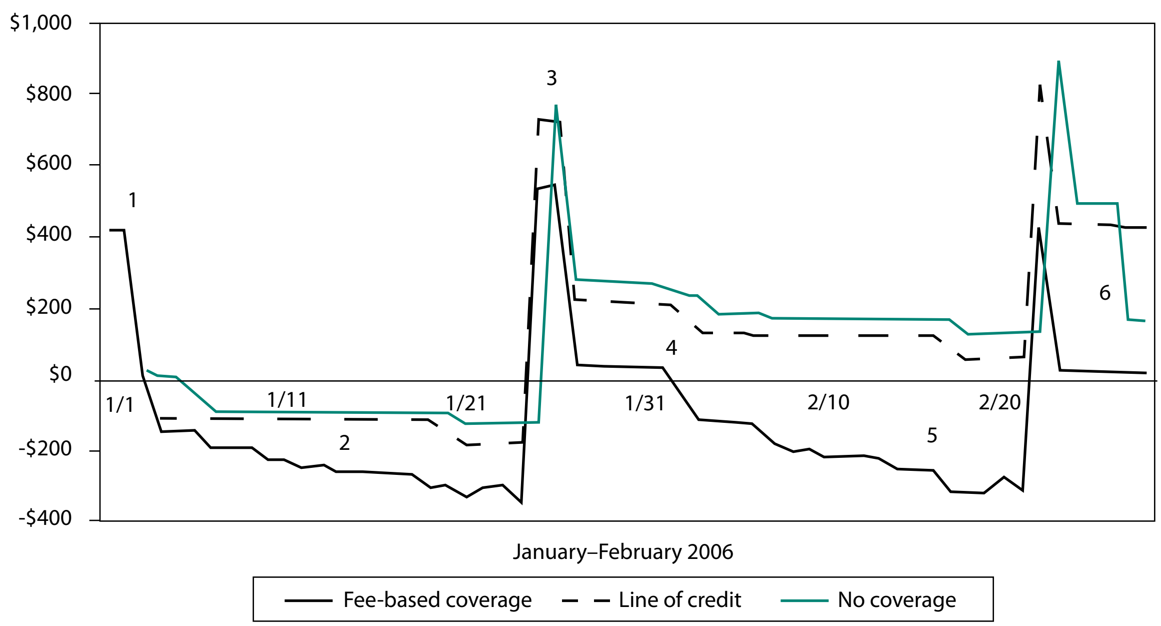
CFPB's recent white paper provides further evidence that the opt-in rule has not eliminated the substantial harm overdraft fees triggered by debit cards inflict. Frequent overdrafters whose debit cards could no longer trigger overdraft fees saved $694 on an annualized basis versus those from whom banks obtained consent forms and continued collecting these fees (CFPB, 2013).

The CFPB study further found that, at several banks studied, involuntary account closures (most commonly due to negative balances, which are most commonly due to overdrafts) were more than 2.5 times as high for customers who had opted in than for those who had not (CFPB, 2013).

No assessment of ability to repay, leaving borrowers worse off

In CRL's report on the impact of overdraft fees on older Americans, we graphed two months of actual checking account activity of one panelist (whom we call Mary) from our database.[6] Mary is entirely dependent on Social Security for her income. We also graphed what her activity would have been with an overdraft line of credit and with no overdraft coverage at all.

Mary's Balance: A Real-Life Case Study



1 - 1/3-Early-month expenses take Mary into overdraft

2 - 1/9-1/20-Non-fee-based overdraft balances remain constant here, while fee-based overdraft accumulates daily fees, forcing a utility bill to be rejected on 1/20

3 - 1/25-Social Security check brings Mary out of overdraft

4 - 2/2-Accumulated fees from January force Mary back into overdraft; with a Line of Credit or no coverage, she would have maintained a positive balance

5 - 2/17-Daily fees mount again, resulting in the rejection of another month's utility bill

6 - By the end of February, Mary has just $18.48 in her account. With a Line of Credit, she would have over $400.

6 CRL analyzed 18 months of bank account transactions, from January 2005 to June 2006, from participants in Lightspeed Research's Ultimate Consumer Panel (Halperin & Smith, 2007).

During January and February of 2006, Mary overdrew her account several times and was charged $448 in overdraft fees. At the end of February, she had $18.48 in her account. She was trapped in a destructive cycle, using the bulk of her monthly income to repay costly overdraft fees.

With an overdraft line of credit at 18% annual interest over the same period, Mary would have paid about $1 in total charges for her overdrafts instead of $448 in overdraft fees. Even if Mary had no overdraft coverage at all, she would have been better off than she was with high-cost overdraft. Five of her transactions, totaling $242, would have been declined—two point-of-sale transactions and three electronic transactions. She would have been charged no fee for the two point-of-sale transactions. She may have been charged an insufficient funds (NSF) fee and a merchant fee (for a returned transaction) for each of the three declined electronic transactions.[7] She also may have been charged late fees if any of the electronic transactions were bills. Even if Mary had been charged an NSF fee, a merchant fee, and a late fee for each of the three electronic transactions, her ending balance, after payment of the declined transactions, still would have been far higher than the $18.48 left in her account with fee-based overdraft coverage.

Mary's situation illustrates a problem common among the repeat overdrafters who pay the majority of overdraft fees: Overdraft fees beget more overdraft fees. Not only do overdraft programs not assess a borrower's ability to repay an overdraft loan without having to re-borrow shortly thereafter, but overdraft loans are structured in a way likely to lead to repeat overdrafts by those least able to afford them. Customers struggling financially are unlikely to be able to both repay one or a number of overdraft loans and the associated high fees in one lump sum and continue to meet ongoing expenses; as a result, consumers must borrow again before the end of the next pay cycle. Over time, the repeated fees strip away consumers' cash assets, leaving them financially worse off than when they first overdrafted and unable to meet obligations they otherwise could have met even with no overdraft overage at all. Former FDIC Chair Sheila Bair has noted that "'[r]epeat use of fee-based overdraft protection doesn't make sense for anyone'" (Block, 2010).

Manipulating posting order of transactions to increase fees

Another common practice in high-cost overdraft programs is reordering the customer's transactions to post larger dollar items before smaller ones. This practice drives the account negative more quickly so that each smaller transaction posted subsequently posts against a negative balance and triggers an additional overdraft fee. As a federal judge found in 2010, manipulation of posting order can turn what would have been one overdraft fee into ten (Gutierrez v. Wells, 2010).

Manipulation of posting order can turn what would have been one overdraft fee into ten.

7 When a financial institution bounces a check or electronic ACH transaction instead of paying it as an overdraft, the financial institution typically charges an insufficient funds (NSF) fee. A merchant may also charge a fee for the returned transaction.

The following example illustrates the practice of transaction reordering:

Scenario A

Starting balance $90	
Customer buys in this order:	
coffee	$5
gas	$30
clothing	$100*
*triggers a $34 overdraft fee	

Under A, the $100 clothing item came out of the checking account last, so there was enough money in the account to cover the previous expenses. The account holder was charged one $34 fee.

Scenario B

Starting balance $90			
		Bank subtracts in this order:	
~~coffee~~	$5	clothing	$100*
~~gas~~	$30	gas	$30*
~~clothing~~	$100	coffee	$5 *
		*triggers a $34 overdraft fee	

Under B, the bank subtracted the largest item first—$100 for clothing—even though that transaction actually occurred last. With high-to-low ordering, the actual order the transactions occurred in doesn't matter. The largest comes out first, which leaves less money in the account to cover the smaller ones. Under this scenario, the account holder was charged three overdraft fees, totaling $102.

Many banks maintain that posting transactions in order from highest to lowest amount benefits consumers because it helps to ensure that larger, and presumably more important, transactions are paid rather than declined. We know of no evidence that supports this contention.

With respect to debit card transactions, extensive litigation findings have completely discredited the supposed benefit of high-to-low posting (Gutierrez v. Wells, 2010). Once the bank authorizes a debit card transaction, the bank must pay the merchant for it; thus, all debit card transactions authorized are paid, regardless of whether there are sufficient funds in the account upon settlement and regardless of the order in which transactions are posted.

Many banks have been sued for high-to-low posting of debit card transactions. To date, at least 14 banks, including several large ones, have settled.[8] One prominent decision proceeded to trial and resulted in a $200 million judgment for the consumers after the trial judge held that Wells Fargo had violated California's state law prohibiting unfair and fraudulent practices. The judge found that "the only motives behind the challenged practices were gouging and profiteering" and that high-to-low transaction clearing is "a trap that would escalate a single overdraft into as many as ten through the gimmick of processing in descending order" (Gutierrez v. Wells Fargo, 2010). The Ninth Circuit overturned the unfairness holding, determining that the bank's posting order practices were preempted by federal regulation, but it upheld the holding that Wells Fargo had affirmatively misled its customers about its posting practices (Gutierrez v Wells Fargo, 2012).

Even for checks and ACH transactions, the asserted benefits of high-to-low posting are not compelling. Banks typically have a negative limit beyond which they will decline a customer's overdraft transaction; for example, they may pay transactions that put a customer's balance $300 or $500 below zero, but not further. If that negative limit is not reached, the only impact of high-to-low posting is that it maximizes fees. This is illustrated by the scenarios above, where the bank pays the clothing purchase under either scenario; the only difference in the scenarios is the number of fees the customer is charged. Further, if a transaction is large enough, it will often be declined because it exceeds the negative limit permitted on the account, regardless of the order in which the transactions are posted; again, the only impact of high-to-low posting is that it maximizes fees. Thus, the frequency with which high-to-low posting harms customers clearly far exceeds any rare occasion on which it may result in an important item being paid.

Routine high-to-low posting is a significant generator of repeat overdraft fees. And the reality, as demonstrated in our real-life case study above, is that for consumers paying the majority of overdraft fees, repeat overdraft fees actually make it less likely that any transaction, regardless of its size, will ultimately be paid.

8 The settlements that have been part of a large multi-district litigation (MDL), not all of which have received final court approval, include Bank of America ($410 million), Citizens Bank ($137.5 million), JPMorgan Chase Bank ($110 million), TD Bank ($62 million), Union Bank N.A. ($35 million), Bank of Oklahoma ($19 million), Commerce Bank ($18.3 million), Associated Bank ($13 million), Harris Bank ($9.4 million), Intrust Bank ($2.7 million), Iberia Bank ($2.5 million), and Great Western Bank ($2.2 million). Other settlements of cases related to transaction posting order that were not consolidated into the MDL include Bank of Hawaii ($9 million) and Fifth Third Bank ($9.5 million).

Manipulation of posting order continues to be a widespread problem: A recent Informa Research Service report found that at least 14 of the largest 20 banks post some transactions in order from highest to lowest (Informa Research Service, 2012). As ACH transactions proliferate and often account for numerous purchases in a single day, posting those transactions from highest to lowest can harm consumers on the same scale as posting debit card transactions from highest-to-lowest. Recognizing the impact that posting order of any transaction type has on its customers, in 2011, Citibank began posting checks and ACH transactions in order from lowest to highest, noting, "We think this is the right thing to do" (Carrns, 2011).

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Banks sometimes point to testing or surveys to support the notion that consumers want checks and ACH transactions posted from high-to-low. But these instruments usually ask consumers only whether they would like their most important items to be paid first and don't mention that posting order would usually make very little difference in whether or not an important item is paid. These surveys also do not ask whether having an important item paid on a rare occasion is worth being charged a large number of overdraft fees on many other occasions.

There are still further indications that high-to-low posting does not benefit consumers. Banks using automated programs, which rely on computerized decision-making, are far more likely to post transactions high-to-low than banks without automated programs (FDIC, 2008). Consultants marketing automated overdraft programs have long promised massive increases in fee revenues (Impact Financial Services, 2013), but we have seen no marketing promising that the automated programs help to ensure consumers' most important items get paid. In addition, financial institutions don't market the "benefit" of high-to-low posting to their customers; even in their account disclosures, they often simply say they post transactions "at their discretion" or that they "reserve the right to" post high-to-low.

Finally, not all banks engage in this practice; in fact, many likely never have. After many of the largest banks had long been posting high-to-low (Fox, 2005), the FDIC found that 58% of banks without automated programs, and even 30% of banks with automated programs, were posting transactions from smallest to largest (FDIC, 2008).

Automatic repayment from the customer's account

The bank virtually guarantees itself repayment of overdrafts and fees by taking the entire overdraft amount plus the associated fees immediately from the customer's next deposit in one balloon repayment, before any other payments from the account are made. This automatic repayment severely limits the consumer's ability to make a measured decision about the order in which to cover his or her debts and other, often essential, expenses, such as food or prescription medicines. It also discourages sound underwriting, as the bank, likely to be able to collect the overdrafts and fees directly from the next deposit, has little incentive to ensure overdrafts are affordable for the borrower. Not only does this practice harm banks' customers, but it also harms other lenders and businesses by leaving their customers financially worse off.

An emerging problem: overdraft fees on prepaid cards

Prepaid debit cards are a rapidly growing market. In 2009, there were six billion prepaid transactions totaling $140 billion, marking an average annual increase of 22% since 2006 (Federal Reserve System, 2011). Research has shown that prepaid card users are often more vulnerable consumers—unbanked or underbanked, lower income, or public benefit recipients (National Consumer Law Center [NCLC] on behalf of its low income clients, CRL, & CFA, 2012).

Like purchases made with traditional debit cards, purchases on prepaid cards can be declined at the time of purchase. But many prepaid card issuers will pay the transaction anyway and charge a high fee for each overdraft, turning a prepaid card into a postpaid one. This is particularly problematic since many card users may be using prepaid cards because overdraft fees drove them out of the banking system in the first place.[9]

9 Please see NCLC, CRL, and CFA, 2013, for a more detailed discussion of the problems with associated with credit features on prepaid cards.

IMPACT ON U.S. HOUSEHOLDS

CRL's analysis of 2011 data estimates that over 36 million Americans' checking accounts become overdrawn annually, with almost eight million account holders incurring more than six overdraft fees each year. Almost four million Americans incur more than 12 overdraft fees within a one-year period. Nearly two million Americans pay over 20 or more overdraft fees per year, translating to $700 or more in overdraft fees annually.

The FDIC's 2010 overdraft guidance cautioned that repeat overdraft fees can result in "[s]erious financial harm" for "customers with a low or fixed income." That guidance advised that more than six overdraft fees within a twelve-month period was excessive for any account holder. But our analysis of 2011 data finds that two-thirds of overdraft fees are incurred by account holders paying more than six fees per year.

Figure 3: Distribution of Repeat Overdraft Users

Percent of account holders who overdraft	Number of fees incurred	Percent of all overdraft fees paid
21.6%	More than 6	66.4%
10.8%	More than 12	47.1%
5%	20 or more	28.7%

Source: Lightspeed 2011 data

CFPB's recent study similarly found that approximately 28% of consumer accounts at the study banks experienced an overdraft or NSF incident in 2011, and over a quarter of those accounts incurred more than 10 overdraft or NSF fees during the year (CFPB, 2013).

Two CRL surveys, in 2006 and 2008, found that account holders who overdrew frequently were more likely to be lower income, non-white, single, and renters when compared to the general population. Respondents reporting the most overdraft incidents were those earning below $50,000 (Parrish, 2008).

Communities of color, seniors, young adults, and military families are also hit hard by overdraft fees:

- Communities of color. Multiple surveys have found that communities of color bear a disproportionate share of high-cost overdrafts (CFA, 2005) (James & Smith, 2006). Civil rights groups have expressed concern about the impact these fees have on communities they represent (Leadership Conference on Civil and Human Rights, 2010a and 2010b).

- Seniors. Older Americans aged 55 and over paid $6.2 billion in overdraft fees in 2008—$2.5 billion for debit card/ATM transactions alone—and those heavily dependent on Social Security paid $1.4 billion (Parrish & Smith, 2008) (Parrish, 2009). Banks repay themselves and collect fees directly from Social Security income, which would be protected from creditors in other creditor/debtor contexts.[10]

- Young adults. Young adults, who tend to earn relatively little as students or new members of the workforce, paid $1.3 billion in overdraft fees in 2008 (Parrish & Smith, 2007) (Parrish, 2009). Because they are more likely to use a debit card for small transactions than older adults, they were paying $3 in fees for every $1 overdrawn on a debit card when the national average was $2 in fees for every $1 overdrawn (Parrish & Smith, 2007). The 2008 FDIC Survey found that young adults were the most likely to overdraw their accounts, with 46% of all young adults overdrawing their accounts in the previous year (FDIC, 2008).

  The problem is exacerbated by deals banks make with universities to provide school ID cards that double as debit cards. Banks pay the partner school for exclusive access to the student population and sometimes split the fee revenue they collect on debit card transactions with the university (Parrish & Smith, 2007). These programs, already popular before the Credit CARD Act of 2009 (the CARD Act), have only grown more so as an alternative to campus credit card marketing after the CARD Act made the latter more difficult (Dilworth, 2012).

- Military families. Military families remain vulnerable to overdraft programs, even though Congress took action to protect them from payday loans and other predatory lending practices through the Military Lending Act of 2006. Financial institutions have taken advantage of their ability to charge overdraft fees to a captive audience on bases. An executive of one turnkey overdraft system vendor has said, "If you happen to be a bank that's on a military post, you're probably doing twice as much [overdraft] activity as any other bank" (Berenson, 2003).

Overdraft and bounced check fees are also the leading cause of involuntary bank account closures and a significant cause of voluntary account closures, resulting in greater numbers of unbanked households (FDIC, 2009) (Barr, 2008) (Campbell, Martinez & Tufano, 2008).

10 Federal law protects Social Security benefits from garnishment by creditors (Social Security Act, 1939) but does not apply when the bank repays itself as creditor, as with overdraft loans and fees.

MARKET AND INDUSTRY OVERVIEW

Fifteen years ago, overdraft programs were low-cost or free courtesy services—transfers from a consumer's other accounts or low-cost lines of credit—and they were used primarily to cover paper checks. Since then, overdraft programs have evolved into a high-cost credit product, applied primarily to electronic transactions, that strips money from consumers' accounts and drives them into debt. Ultimately, abusive overdraft programs make it harder for struggling consumers to meet their obligations, lead to account closures, and drive families out of the banking system.

CRL estimates that overdraft fees cost consumers $16.7 billion in 2011.

Growth of these high-cost overdraft programs was spurred in the 1990s and early 2000s by consultants marketing automated overdraft programs promising dramatic fee revenue increases to banks (Impact Financial Services, 2008 & 2013) (Moebs $ervices, Inc., 2008 & 2013). Some consultants offered the software at no risk, instead charging banks a percentage of the increased fee revenue generated (Impact Financial Services, 2008 & 2013).[11]

Growth of these programs was also facilitated by federal regulators, who, as described in the following section, failed to take meaningful action while these programs became ubiquitous.

CRL estimates that overdraft fees cost consumers $16.7 billion in 2011.[12] Overdraft fees exploded for a decade, reaching $23.7 billion in 2008 and continuing to climb through 2009 (Parrish, 2008). Since then, overdraft fees have declined but still remain significantly higher than in 2004 when CRL first estimated annual overdraft fees (Duby, Halperin, & James, 2005).

The decline since 2009 is likely due in part to changes in regulations effective mid-2010; the decision by some large banks, including Bank of America and HSBC, to stop charging overdraft fees on one-time debit card transactions; some banks' elimination of high-to-low posting order on debit card transactions in response to extensive litigation challenges; and some banks' imposition of daily limits on the number of fees or de minimus overdraft thresholds under which the banks do not charge a fee. It appears likely that, absent meaningful reform, overdraft fees paid annually will only increase going forward as banks succeed in collecting opt-in forms from new customers at the time of account opening. Indeed, CFPB recently found that opt-in rates among study banks of accounts that were opened during 2011 were generally higher than for existing accounts (CFPB, 2013).

11 For an early discussion on the growing problem of overdraft fees, see CFA and NCLC, 2003.

12 This figure does not include non-sufficient funds (NSF) fees banks charge when they bounce checks or ACH payments. See appendix for calculation of the estimate.

LEGISLATION AND REGULATION

Overdraft fees grow as bank regulators fail to act consistently

As mentioned above, the growth in high-cost overdraft programs has been fostered by federal banking regulators, whose lack of meaningful action has allowed overdraft abuses to persist and to grow.

The national bank regulator, the Office of the Comptroller of the Currency (OCC), recognized several overdraft practices as problematic as early as 2001, when a bank asked the OCC for a "comfort letter," or explicit approval, for the high-cost overdraft program it wanted to implement. Rather than providing this approval, the OCC articulated a number of compliance concerns about the program, including (a) "the complete lack of consumer safeguards" including the lack of limits on the numbers of fees charged per month, (b) similarities between overdraft fees and other "high interest rate credit," and (c) lack of efforts by banks to identify customers with excessive overdrafts and meet those customers' needs in a more economical way (OCC, 2001).

Despite these concerns, the OCC and other federal banking regulators failed to act on overdraft practices until 2005. At that time, the Federal Reserve Board chose to regulate high-cost overdraft programs under the Truth in Savings Act's Regulation DD instead of the Truth in Lending Act's Regulation Z (Federal Reserve Board, 2005), even while acknowledging that overdrafts are "credit" (OCC, Federal Reserve Board, FDIC & National Credit Union Administration, 2005).

This decision had several harmful implications, including that the cost of overdraft loans was not required to be disclosed in annual percentage rate (APR) terms, as credit typically is. This makes it difficult for consumers to compare the cost of overdraft loans to lower-cost credit options, like lines of credit or credit cards. It also enabled financial institutions to more easily characterize overdrafts as a courtesy service rather than high-cost credit.

Also in 2005, the banking regulators issued joint supervisory guidance applicable to high-cost overdraft programs (OCC, Federal Reserve Board, FDIC, & National Credit Union Administration, 2005). This guidance included best practices for administering overdraft programs, including limiting overdraft coverage to checks alone (i.e., excluding debit card and other transaction types); establishing daily limits on fees; monitoring excessive usage; and obtaining affirmative consent to overdraft coverage. The guidance also cautioned banks against potential violations under the Equal Credit Opportunity Act for steering or targeting customers for high-cost overdraft programs. But regulators generally did not enforce the guidance, and banks widely ignored it. In fact, in the seven years following the issuance of the guidance, the OCC has taken only one enforcement action against one small bank using the guidance (OCC, 2010).

Five years later, in 2010, the Federal Reserve Board implemented the opt-in rule for one-time debit card transactions discussed earlier. Although a helpful advance, this guidance still failed to address fundamental problems with the product, including failing to provide limits on the frequency or size of overdraft fees.

Recognizing the need for more substantial action, the FDIC implemented its own guidance in mid-2011 applicable to the state-chartered banks it supervises. The guidance advised banks to curb excessive overdraft fees—identifying more than six fees in a 12-month period as "excessive"—and advising banks to stop posting transactions in order from highest to lowest (FDIC, 2010) (FDIC, 2011a). Unfortunately, no other regulators have followed suit.

As a result, banks and credit unions today have differing overdraft practices, either voluntarily or because they are subject to differing guidelines from their prudential regulator. Most large banks charge overdraft fees on debit card and ATM transactions, while a few don't. Most large banks continue posting transactions in order from highest-to-lowest, while some have stopped. Regulators have created an unlevel playing field, and financial institutions continue to have strong incentives to engage in a race to the bottom.

Congressional proposals have not advanced

Because regulators have failed to act, there have been several attempts in the past decade by members of Congress to reform overdraft through legislation. Their proposals include the following:

- Prohibiting overdraft fees on debit card and ATM transactions for members of the military
- Prohibiting reordering transactions to increase overdraft fees
- Requiring that overdraft fees to be "reasonable and proportional" to the cost of the transaction
- Limiting the number of overdraft fees that can be charged to six per year

To date, these legislative efforts have not advanced.

Consumer Financial Protection Bureau

In February 2012, the Consumer Financial Protection Bureau (CFPB) announced that addressing high-cost overdraft programs was an early priority. It noted that overdraft programs can cause serious economic harm and disproportionately impact more vulnerable consumers. CFPB solicited public input on consumer experiences with overdraft practices (CFPB, 2012) and launched a study based on data it is collecting from a number of the largest banks (Cordray, 2012).

"[O]verdraft practices have the capacity to inflict serious economic harm." – Richard Cordray, Director, Consumer Financial Protection Bureau

In June 2013, CFPB released a white paper detailing its initial findings. Its study found that customers who are charged overdraft fees on debit cards are at greater risk of paying high fees and are more likely to have their account involuntarily closed. CFPB concluded that the range of complex practices banks engage in that impact overdraft fees "raises questions about the degree to which even the most sophisticated consumer could readily anticipate and manage the cost of engaging in a series of transactions . . . ." It further concluded that certain practices and procedures may be causing the "kind of consumer harm that the federal consumer protections laws are designed to prevent" (CFPB, 2013). CFPB's study of overdraft practices, including analysis of account-level data, is ongoing.

POLICY RECOMMENDATIONS

Effective reform of today's overdraft practices is needed to ensure that bank accounts are a safe place for all consumers to protect their earnings and save for the future. Such reform must address the key harmful features of the product. It cannot be limited to curbing deceptive marketing or improving disclosures. Requiring financial institutions to obtain consumers' "opt-in" only establishes the basic consent requirement that already exists for most financial products. Consent requirements did not remove the need for substantive reforms for mortgage or credit card practices, and the same is true of overdraft programs.

Without substantive reform of the product, the fees overdrafts generate provide financial institutions too powerful an incentive to ensure that customers continue to incur overdraft fees—an incentive that will continue to outweigh even the best disclosures.

Our preferred policy prescription is the prohibition of overdraft fees on debit card and ATM transactions paired with provisions that prevent maximizing fees from overdraft fees on checks and other electronic transactions. Absent prohibition of all debit card and ATM overdraft fees, policymakers should limit the number of such fees that can be charged and mandate that the dollar amount of those fees be reasonable and proportional to the bank's cost of providing the service.

Prohibit overdraft fees on debit card and ATM transactions, which financial institutions can easily decline at no cost to the customer.[13] As CFPB's recent study indicates, ending fees triggered by debit card and ATM transactions would limit a significant number of excessive fees. Citibank has never charged such fees, and HSBC has stopped charging them. Bank of America, the largest debit card issuer, stopped overdraft fees on one-time debit card transactions in 2010. JPMorgan Chase does not charge these fees on ATM withdrawals. Policymakers should level the playing field for all banking institutions, preventing a "race to the bottom."

Prohibit overdraft fees on prepaid cards. As with other debit cards, transactions on prepaid cards when the card lacks sufficient funds can easily be declined at the point of purchase. Further, a card whose name indicates it is "prepaid," and which many consumers use to avoid overspending, should have no credit feature at all; it is not a postpaid card, after all.

Assess the implications of the increasing percentage of overdraft fees triggered by electronic transactions, including one-time ACH transactions that are substantively indistinguishable from one-time debit card purchases.

Prohibit manipulation of posting order to increase fees. Financial institutions should be required to minimize fees through posting order whenever feasible. A safe harbor should be provided for banks that post checks and electronic transactions in order from lowest to highest and that post no transactions in order from highest to lowest. Consistent with the FDIC's 2011 guidance, posting transactions in order from highest to lowest is inappropriate for any transaction type, including checks and ACH transactions.

13 If overdrafts continue to be allowed on debit cards, then debit cards with overdrafts should be regulated as credit cards under the Truth in Lending Act.

Limit the number of overdraft fees, including "sustained" overdraft fees, that financial institutions can charge customers, consistent with FDIC guidance that charging more than six overdraft fees in a 12-month period is excessive. Repeated overdrafts function as an exorbitantly priced credit product that is not appropriate for anyone on a routine basis.

Require that overdraft fees be reasonable and proportional to the amount of the underlying transaction and to the cost to the bank of covering the overdraft. This is consistent with the FDIC's overdraft guidance and rules governing penalty fees on credit cards.

Require that the cost of overdrafts be disclosed as an annual percentage rate. Regulators acknowledge that overdraft payments by financial institutions are indeed credit, and all credit products should carry price tags that allow for consistent comparison to other credit products.

Prohibit overdrafts and fees from being repaid automatically from the customer's checking account. This is especially important when the customer's funds are exempt funds that are protected from debt collection in other contexts. This would be consistent with (1) longstanding prohibitions on wage garnishment; (2) a more recent Treasury rule prohibiting deposit of Social Security funds to prepaid cards with payday loans where repayment is triggered by the deposit; and (3) the prohibition against offsetting a depositor's debt against funds the bank holds on deposit, already applicable to credit cards under the Truth in Lending Act.

For our analyses of 2011 data, we examined the transactional data of 1,582 checking accounts from a nationwide sample of U.S. credit card holders, generally representative across geography, household income, and credit scores, tracked by Lightspeed Research Inc.[14] Participating account holders provide Lightspeed access to all of their checking account activity occurring during their period of participation, including deposits, paper checks, electronic bill payments, debit card purchases, fees, and miscellaneous charges or credits that are posted to the account.

2011 Overdraft Market Calculation

To develop our estimate of the size of the overdraft market, we apply the same general methodology we applied to obtain our 2008 estimate:

(A) Total population age 18 and over* 240 million
(B) Population without a bank account** 28 million
(C) Total adults with a bank account (C = A - B) 212 million
(D) Adults impacted by at least one overdraft incident (C x 17.2%^) 36 million

*US Census
**The FDIC's Alliance for Economic Inclusion estimates that as many as 28 million people in the United States are Unbanked.
^CRL LightSpeed analysis finds that 17.2% of checking accounts incurred an overdraft fee in 2011.

2011 Overdraft Fee Volume Calculation

To develop our 2011 estimate of total overdraft fee volume, we apply the same general methodology we applied to obtain our 2008 and 2006 estimates—drawing service charge revenue from publicly available call report data, and estimating the portion of that service charge revenue that is attributable first to overdraft and insufficient (NSF) fees together, and then to overdraft fees alone.

CFPB's June 2013 white paper provides the share of service charges on deposit accounts that is attributable to overdraft/NSF fees for the small sample of large banks it studied. That share is 37%. We tally the service charge revenue from the ten largest banks (ranked by total deposits)[15] from those banks' publicly available FDIC 2011 Call Report Data, which equals $19.5 billion. We then apply the 37% to that figure, estimating that the overdraft/NSF fees generated by the ten largest banks equal $7.2 billion.

As CFPB notes, the portion of service charges on deposit accounts generated by overdraft/NSF fees at large banks tends to be smaller than it is at smaller banks given the larger portion of deposit account revenue generated by commercial accounts at larger banks. Thus, for all other banks and credit unions, we apply a ratio of 62% which, as CFPB notes, was reported by the Independent Community Bankers of America in its 2012 survey of member banks as the portion of those banks'

14 Lightspeed requires that participants have internet access, which may lead to selection bias. A survey conducted by the Pew Internet & American Life Project from November 14-December 8, 2012, reveals higher internet usage among younger Americans versus older Americans and among higher income Americans versus lower income Americans (Pew, 2012).

15 CFPB has not disclosed which or how many banks it studied. For purposes of our estimate, we apply the 37% ratio to the ten largest banks ranked by deposit size: JPMorgan Chase Bank, Bank of America, Citibank, Wells Fargo Bank, U.S. Bank, PNC Bank, TD Bank, HSBC, BB&T, SunTrust Bank.

service charges attributable to overdraft/NSF fees. We sum all service charges on deposit accounts at all banks except the ten largest banks from the FDIC Call Report Data ($14.7 billion) and total fee income from credit unions per the National Credit Union Administration (NCUA) Call Report Data ($6.9 billion). Together, these total $21.6 billion in total service charges. We then apply the 62% to that figure, estimating that the overdraft/NSF fees generated by all financial institutions except the ten largest banks as $13.4 billion.

We then sum $7.2 billion and $13.4 billion to reach estimated total overdraft/NSF fees from all financial institutions of $20.6 billion.

Finally, to disaggregate that $20.6 billion to determine the portion of it that is solely attributable to overdraft fees, we use transaction descriptions in the 2011 Lightspeed Research Database to compute that 81.2% of the overdraft/NSF fees in the database were overdraft fees.[16] We apply that 81.2% to the $20.6 billion to determine a final estimate of total overdraft fee volume of $16.7 billion.

Dollars in Billions

Service charge income from largest 10 banks by total deposits	$ 19.4	*
Estimated share generated by overdraft and NSF fees	37%	^
Estimated overdraft/NSF fees collected from largest 10 banks	$ 7.2	(A)
Service charge income from all other banks	$ 14.7	*
Service charge income from all credit unions	6.9	**
Total service charge income from all other banks + all credit unions	$ 21.6	
Estimated share generated by overdraft and NSF fees	62%	^^
Estimated overdraft/NSF fees collected from all other banks + credit unions	$ 13.4	(B)
Total overdraft and NSF fees collected	$ 20.6	(A) + (B)
Estimated share of total overdraft/NSF fees attributable to overdraft fees alone	81%	^^^
Estimated total overdraft fees alone	$ 16.7	

*	Computed from FDIC 2011 Statistics on Depository Institutions
**	Per NCUA 2011 Call Report Data
^	Per 2013 CFPB Study of Overdraft Programs (reflecting 2011 data)
^^	Per 2012 ICBA Overdraft Payment Services Study
^^^	Per CRL analysis of 2011 LightSpeed Research Database

16 Overdraft fees are denoted in the data by such terms as "overdraft fee," "returned item paid," or "OD fee." NSF fees are denoted in the data by such terms as "insufficient funds fee," "returned item unpaid," or "NSF fee."

The CFPB's recent study similarly found that, at the median, study banks paid 83% of transactions that exceeded the customer's available balance in 2011 and returned 17% unpaid (CFPB, 2013).

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