Overdraft Isn't Over

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Overdraft is definitely in the news. Pundits are prognosticating on how overdraft is going away, and they try to create the impression that all consumers detest overdraft and want the service to end.

Our firm can provide a unique perspective on this issue, having worked with hundreds of financial institutions to create responsible consumer liquidity solutions for tens of millions of Americans.

While changes may occur, as they do in any industry, I'm here to say that overdraft is not going away.

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A The Value of Overdraft Services

First, let's start with the value proposition. Many recent articles make it sound like only a dunce would use overdraft, so why do people keep using this service?

The reality is that every year financial institutions provide liquidity to consumers of many billions of dollars through the overdraft services they offer. When a consumer has a purchase to make and there are insufficient funds, banks and credit unions are there to try to cover that purchase for the consumer.

And despite the headlines, the typical transaction isn't a $35 fee for a very small purchase. Recent Curinos research[1] found that "the average size of purchases that trigger overdraft fees has nearly quadrupled from $50 to almost $200."

A recent Morning Consult study[2] found that approximately half of Americans say that overdraft fees are fair. And the Curinos research shows that "two-thirds of consumers indicate that, while overdraft can be expensive, they don't want to see reductions in their access to the service."

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1. Available at https://curinos.com/insights/competition-drives-overdraft-disruption/.
2. Available at https://morningconsult.com/2021/06/15/banks-overdraft-fees-pandemic/.

Just as importantly, our community bank and credit union clients provide liquidity to consumers in small-town America, places that megabanks often have abandoned. These dollars are used by consumers to pay the merchants and service providers in those smaller towns, allowing them to make payroll and build a better financial life for themselves. Without those dollars, Main Street America economies across this country undoubtedly would be adversely affected.

The American Bankers Association commissioned a research paper[3] which analyzed one year's worth of de-identified data from 4.6 million consumer deposit accounts from 11 banks located in 8 Federal Reserve districts which use "dynamic" overdraft systems, meaning systems that set and adjust overdraft limits based on account activity, such as changes in the amount of deposits, the frequency of deposits, overdrawn balance repayment trends, etc. (In full disclosure, our firm provides software that does this.) Some of the report's key findings were :

1. Users of overdraft protection realize an economic benefit of over seven to one of funds extended to fees charged for use of the overdraft service, providing an annual stimulus to the economy of $65.6 billion.

2. Consumers lose an average of $443 in purchasing power for each attempted check or ACH transaction that is returned due to insufficient funds in the consumer's account. The total annual lost purchasing power is $43.7 billion.[4]

3. The characterization of a typical overdraft protection user as a lower-income consumer is inconsistent with the data. Middle-income consumers use overdraft protection at higher rates than lower-income consumers.

    a. Among consumers that use overdraft protection, lower-income consumers had significantly fewer overdrafts than higher-income consumers. Lower-income households (below $24,000 in annual deposits) averaged 10 items paid into overdraft annually compared to 18 items paid into overdraft annually by consumers in the highest income stratum (greater than $60,000 in annual deposits).

    b. Lower-income consumers do not incur a disproportionately large proportion of overdrafts compared to higher-income consumers. The study found that the percentage of overdrafts attributable to lower-income accounts (21.5%) is less than the overall percentage of lower-income accounts in the bank (41.3%).

    c. Lower-income customers are more likely to receive waivers and refunds of overdraft fees than higher-income customers. Lower-income customers paid, on average, lower effective overdraft charges than higher-income customers, after adjusting for waivers of fees that could be assessed and refunds of assessed fees.

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3. Available at https://www.aba.com/advocacy/policy-analysis/small-dollar-credit (login required) and http://users.neo.registeredsite.com/5/7/4/17535475/assets/ABA_Small_Dollar_Credit_White_Paper.pdf.
4. The ABA paper goes on to state, "The $43.7 billion amount does not include the additional costs associated with returned transactions such as merchant NSF fees and late charges on rent, utility, or loan payments. Thus, it may understate the true loss to customers and the economy caused by returned transactions."

4 The study found no evidence that overdraft protection is a product targeted to lower-income consumers. In fact, overdraft fees actually paid by lower-income consumers are lower than fees paid by higher-income users due in part to a greater number of waivers and refunds given to consumers in the lower-income strata.

B Overdraft Services Result in a Miniscule Percentage of Consumer Complaints

The overdraft service our financial institution clients provide is valued by consumers and very rarely results in complaints. Importantly, even in 2020 with a global pandemic and economic crisis raging, less than 0.15% of complaints to the Consumer Financial Protection Bureau (CFPB) were related to overdraft.[5]

The CFPB tells consumers on its website that "complaints play a role in everything we do, helping us to identify problems and prioritize our work."[6] If this is truly the case and complaints inform priorities on financial regulation, then overdraft would be at the bottom of the list of priorities at the CFPB in favor of work on more pressing matters where complaints are markedly higher.

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C Do Proposed Overdraft Laws Achieve the Goal of Providing Consumer Choice?

While we applaud legislation with the intention of protecting consumers where a need for such protection exists, the legislation which has been proposed in Congress many times now will not achieve the stated goal of "providing … consumer choice in connection with overdraft coverage fees."

The Senate bill would prohibit overdraft fees for any "one-time debit card transaction." This is a clear way to deprive consumers of a choice that many of them already have made. Because of changes to Regulation E which took effect in 2010, consumers today must affirmatively opt-in to overdraft coverage for everyday debit card and ATM transactions, or financial institutions are not permitted to charge an overdraft fee on these transactions.

Consumers who opt-in to the service, by making this choice, have expressed their desire for how their transactions are to be handled when they have insufficient funds in their account. Information about the overdraft service, including the fees charged, must be disclosed to the consumer in a separate document (not buried within an account agreement, for example) before the consumer makes a decision.

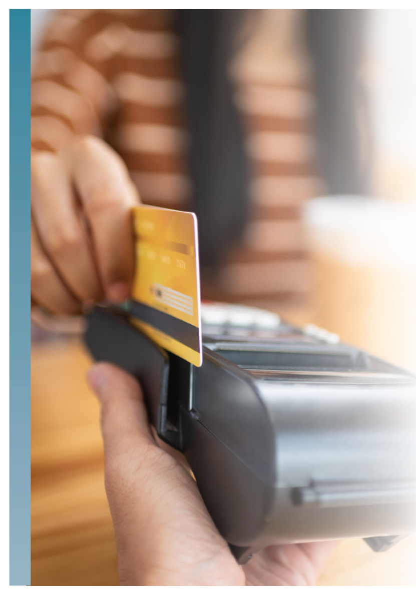
5. From January 1, 2020 through December 31, 2020, the 633 complaints related to "Overdrafts and overdraft fees" out of 443,138 total complaints during this time represents 0.1428% of the total. If the complaints are expanded to the broader issue of "Problem caused by your funds being low", then the number is still only 1,021 complaints, which is 0.2304% of 443,138..
6. https://www.consumerfinance.gov/complaint/ Retrieved August 22, 2021

Consumers also are free to change this decision at any time, and financial institutions provide multiple ways for the consumer to communicate that he or she no longer wishes to have these transactions covered. The continued usage of the overdraft service for everyday debit card transactions is therefore a testament to the desire of consumers to continue to use the overdraft service, one which they have opted into with knowledge of the fees and where they can opt-out of that service at any time.

Through the opt-in requirement of Regulation E, many consumers have decided that they want to use the overdraft service for their everyday debit card transactions and are willing to pay the fees. The purported findings of the legislation state that "practices in connection with overdraft coverage fees have deprived consumers of meaningful options". Ironically, the proposed legislation would most certainly "deprive[] consumers of meaningful options" by restricting the availability of overdraft coverage even in cases like the use of overdraft for everyday debit card transactions where consumers have affirmatively said they want the service and are willing to pay the fees.

D Disruption in Consumer Liquidity and Move to Payday Lenders

If the ability of banks and credit unions to charge overdraft fees were limited, then these financial institutions simply would not allow consumers to overdraw their accounts (or would curtail the coverage amount) once the financial institution no longer can assess a charge for that service.



This is not only based on a profit motive in collecting fees. From a risk perspective, it would create safety and soundness issues for banks and credit unions to take the risk of paying items into overdraft when the financial institution receives no compensation for that risk. Therefore, these institutions no longer would float consumers with a substantial source of liquidity for which the institution is not compensated.

Legislation proposed in Congress makes a purported finding that "depository institutions market a range of overdraft options but aggressively encourage consumers to consent to the most expensive option". This is not the case. Our clients take care to ensure that all options for what happens when consumers have insufficient funds are presented fairly, and many less expensive options are available.

As an example, many of our clients offer automated small-dollar short-term loans to consumers 24 hours a day, 7 days a week, at costs that are a small fraction of what payday lenders charge. However, until programs like this one are more broadly available from financial institutions, if overdraft availability is curtailed then consumers will seek payday loans, pawn loans and other alternative financing arrangements which are quite expensive and do not have the protections to which consumers are entitled by staying within the regulated banking system.

E Unintended Consequences for Financial Inclusion

The reality is that any laws or regulations which limit fees undoubtedly will foreclose access to overdraft as an important source of consumer liquidity. However, the untold story here is that such actions also will reduce the availability of deposit accounts to low-income consumers.

If overdraft fees were limited, what will happen to free or low-cost checking accounts? Most low-income consumers are able to get free or low-cost checking accounts because other people's overdraft fees subsidize the cost of those accounts. In overdraft programs that are run appropriately (particularly those focused on consumers' ability to repay the overdrawn balance and the fees, a capability permitted by currently available software), only those consumers who can afford the service are the ones subsidizing others who cannot afford the service.

If overdraft fees are substantially reduced, it would not be surprising to see banks charging $20 or more per month just to have a checking account, which would drive many low-income consumers out of the banking system. The consumers who will be able to get these monthly account fees waived will be those with higher incomes and higher balances. Low-income Americans will not have the kind of deposits or balances to have the fees waived, and they simply cannot afford $200-$300 per year for a checking account, so they just will not have one. This absolutely runs counter to any goal the government may have of promoting economic inclusion for low-income populations, instead having the effect of driving low-income Americans out of the regulated banking system.

The likelihood of this unintended consequence happening is not just our opinion. A recently-published study from the Federal Reserve Bank of New York entitled "Who Pays the Price? Overdraft Fee Ceilings and the Unbanked"[7] finds that overdraft "price ceilings caus[e] the rationing of both overdraft and banking services." Key passages:

> Regarding public policy, our results highlight a trade-off that has not received due attention in the policy debate: consumer protection via overdraft restrictions comes at the cost of reducing banking services for low-income households. …
>
> Our paper highlights the ways in which well-meaning attempts to protect consumers by limiting overdraft fees could have unintended effects. We find that fee caps limit fees as intended, but also constrain the supply of overdraft credit and reduce financial inclusion among lower income households.

F Unworkable Provisions for Community Financial Institutions

In addition to all of the negative consequences to consumers and the American economy, several of the provisions of proposed legislation are simply unworkable or do not make sense in practice for the banks and credit unions that would have to comply with them.

7. Full research paper available at https://www.newyorkfed.org/research/staff_reports/sr973

As an example, the proposed legislation would require financial institutions to "post transactions with respect to accounts in such a manner that minimizes overdraft coverage fees and nonsufficient fund fees." However, one posting order will not result in the lowest number of overdraft and NSF fees in all situations. Core processing systems available to community financial institutions cannot calculate every possible scenario of posting order every time there is a set of transactions and adopt the one that would result in the lowest possible fees given that set of transactions. Further, this would make it impossible to disclose a posting order process to consumers that is both clear and fair, which has long been a goal of both regulators and financial institutions.

Further, the provision on debit holds punishes financial institutions for factors beyond their control. The proposed provision reads: "No financial institution may charge an overdraft coverage fee on any category of transaction, if the overdraft results solely from a debit hold amount placed on a [*sic*] account that exceeds the actual dollar amount of the transaction." It is important to remember that when a hold is placed on the account, the financial institution is legally responsible for paying up to the full amount of the hold. And, recalculating each time whether a fee may be imposed based on the finally-settled amount of the transaction as compared to the debit hold amount is also impractical using core processing systems available to community financial institutions.

As another example, the requirement that the overdraft coverage fee be stated "as an annual percentage rate, so as to permit consumers to meaningfully compare the overdraft coverage to alternative forms of overdraft options and other sources of credit" does not accomplish the stated goal. Overdrafts do not have a specific date for repayment – instead, the consumer is to bring the account back to a positive balance immediately. Therefore, there is no date which can be used to calculate the time over which an APR is to be calculated. A consumer who repays an overdrawn balance in 10 days will have a higher APR than a consumer who repays an overdrawn balance in 60 days, for example. This makes it impossible to "compare the overdraft coverage to alternative forms of overdraft options and other sources of credit" which are calculated using a stated date for repayment.

F Summary

In summary, coming out of the economic aftermath of a global pandemic is not the time to enact sweeping changes which would:

1. **Deprive consumers of a major source** of consumer liquidity from which consumers realize an economic benefit of over seven to one,
2. **Constrict the flow of dollars** consumers receive from overdraft which they spend in their communities, representing annual stimulus to the economy of over $65 billion,
3. **Force consumers** into the arms of payday lenders and pawn shops for access to other sources of consumer liquidity available to them,
4. **Deprive consumers of a service** – debit card overdraft coverage – which millions of Americans have affirmatively said they want after being informed of how it works,
5. **Push low-income consumers out** of the regulated banking system when monthly deposit account fees inevitably rise,
6. Solve a **"problem"** that simply **does not exist** on a broad scale given a complaint rate of less than 0.15%,
7. Act on a **false assumption** that lower-income consumers pay the most overdraft fees, when lower-income consumers actually have significantly fewer overdrafts than higher-income consumers and pay lower effective overdraft charges than higher-income consumers, and
8. **Create excessive burdens** on community banks by imposing requirements with which they simply will not be able to comply given existing technology available to them.

However, financial institutions need to reassess how their overdraft programs work and strive to identify practices that cause consumers harm while offering alternatives. For example:

1. Many financial institutions give all consumers who sign up for the same type of account the same overdraft limit (for example, $750). This really is not defensible. In what other scenario do you completely ignore a consumer's ability to repay when you extend liquidity? For example, how are you going to address a scenario where someone has your standard $750 overdraft limit but only has $650 in deposits each month? That is just setting up the consumer for harm by being charged off and potentially unable to open another account since this negative information can be reported to consumer reporting agencies.

2. Are your Reg. E opt-in practices clear, compliant and focused on the consumer's choice? The largest CFPB actions against banks related to overdraft have been for opt-in practices. Do you have a training program (or use a third party with one) that is documented, reviewed by counsel, and regularly provided to front-line staff? Or do your representatives go unscripted, making up the conversation as they go along?

3. Do you have a cap on the number of fees you charge in a day? While this is not technically required by regulation (although it is mentioned in the FDIC's 2010 overdraft guidance), it is a consumer-friendly best practice and one we encourage our clients to have in place.

4. Is there a minimum overdraft amount below which you will not charge a fee? There are a couple of different ways to provide a de minimis exception: (1) on a per-item basis (e.g., if the item is less than $5, then no overdraft fee is charged), or (2) on a per-day basis (e.g., if the account is overdrawn by less than $10 at the end of the day, then no overdraft fees will be charged that day). Or, it's possible to have both of these in place should you want to provide the most consumer-friendly practice. Like the daily cap, having a de minimis waiver policy is not a requirement, but is seen as a consumer-friendly practice that can avoid the "$30 fee for a $3 cup of coffee" scenario that can grab headlines.

5. Have you considered implementing a fees-to-deposits limitation? For example, if a consumer has $1,000 a month in deposits but is paying you 5 overdraft fees a month at $30 each (i.e., $150 in fees), should you automatically curtail use of the overdraft service in this case?

6. Do you have a program in place to proactively notify consumers who are heavy overdraft users, and offer less-expensive alternatives as well as the opportunity to opt-out of the overdraft program?

Finally, perhaps the most important question to ask is whether overdraft is the only real option for small-dollar consumer liquidity at your bank or credit union. All five primary federal regulators are encouraging financial institutions to offer small-dollar short-term loans. If you would give a consumer up to $500 in overdraft coverage (for example), why not make some or all of that amount available in a fully-amortizing loan repayable over a three-month period? You could then reduce the available overdraft limit by the loan amount so your total exposure does not change.

> **All five primary federal regulators are encouraging financial institutions to offer small-dollar short-term loans.**

We see these small loans as the best option for answering the questions being asked today about overdraft. Consumers should be offered the choice on how they prefer to manage their accounts including the option of a convenient small loan, and in return, legislators and regulators should ensure that consumers continue to have real choices, including to use overdraft if that is their preference.

Overdraft provides a valued service to some consumers, and as long as those consumers are not tricked into using the service and have the ability to stop using it, they should be able to choose to continuing using a program that provides substantial liquidity to both those consumers and the American economy.

2022 Velocity Executive Summits
If you would like to learn more on this topic, please be our guest at one of the 2022 Velocity Executive Summits. Our Summits are informative, educational sessions that are 100% complimentary to qualified bank and credit union executives. Velocity CEO, Christopher Leonard will cover the latest overdraft news and developments, along with providing his unique perspective on the topic.
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Christopher Leonard
CEO Velocity Solutions

Christopher Leonard serves as Chief Executive Officer of Velocity Solutions. Before becoming CEO, Christopher served as President of the company from 2012 to 2014, and previously as Chief Operating Officer & General Counsel from 2005 to 2011. Prior to joining the company in 2005, Christopher was a partner in one of North Carolina's top law firms, where he worked with private and publicly-held businesses in transactional, compliance and advisory capacities. He also served as counsel to Velocity Solutions advising on legal and regulatory issues affecting the financial industry. He still stays up to date on these issues, which allows him to serve as a key resource for our clients. While in law practice, Christopher received the New Hanover County Bar Association's Pro Bono Award and was included in Super Lawyers.

Founded in 1995 and servicing the transaction accounts of over 30 million consumers and business owners, Velocity Solutions is the leading provider of revenue-driving solutions for community banks and credit unions. Our Velocity Intelligent Platform® powers all of Velocity's solutions, using machine-led intelligence that delivers powerful analytics and drives revenue, loans, account holder engagement and non-interest income to our client financial institutions.

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