Require TILA Disclosures For Overdraft Loans

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Overdraft loan programs (also called "bounced-check protection" or "courtesy overdraft protection") allow customers to incur debt when their checking account goes into a negative balance. Borrowers are charged a flat-fee per check or non-check overdraft and must bring their account to a positive balance within a short time period. The institutions that operate the programs do not disclose an annual percentage rate (APR) because they insist that overdraft loans are not covered by the Truth in Lending Act (TILA).

On May 28, 2004, the Federal Reserve Board issued two proposals related to overdraft loans: proposed amendments to Regulation DD, promulgated under the Truth in Savings Act (TISA), and interagency guidance issued jointly with the OCC, FDIC, NCUA, and OTS. The Board's proposed amendments to Regulation DD and proposed interagency guidance undermine the purposes of TILA, conflict with the Board's other regulations and commentary, and offer weak protections for borrowers. The Board should withdraw its proposal and regulate overdraft loan programs under TILA.

Why The Federal Reserve Board Should Require TILA Disclosures for Overdraft Loans

Overdraft loans are a form of extremely high cost short-term credit. TILA coverage would provide customers with the information necessary to compare its costs to other credit options and strong requirements, rather than the proposed weak guidance, would protect borrowers and ensure that the programs are operated in a safe and sound manner.

The Board Concludes That Overdraft Loans are Extensions of Credit, but Refuses to Regulate Overdraft Loans Under TILA.

In the analysis that accompanies the proposed amendments to Regulation DD and the interagency guidance, the Board concludes that overdraft loans are extensions of credit:

- The Board concludes that overdraft loan fees "relate to the institution's provision of credit as opposed to fees related to the use of the consumer's own funds in the account." (*See* Board's Proposed Amendments to Reg. DD, at p. 10).
- The Board also repeatedly characterizes overdraft loans as credit in the interagency guidance. For example the guidance states: "This credit service is sometimes offered to transaction account customers as an alternative to traditional ways of covering overdrafts." (*See* Interagency Guidance at p. 4; *see also Id.* at pp. 8, 7, and 11.)

Despite its conclusion that overdraft loans are credit, the Board exempts from TILA coverage discretionary programs and **non-discretionary programs** as long as the charge for extending an

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overdraft loan does not exceed the charge for refusing to pay an overdraft. According to the Board, the exemption from TILA applies if **either** the program is discretionary (*i.e.* the institution reserves the right not to pay an overdraft) **or** the institution charges the same fee to the customer who writes a NSF check whether or not the institution provides an overdraft loan in connection with the NSF check. (*See* Interagency Guidance, at p. 11).

The Board invokes these exemptions to rationalize its treatment of overdraft loans. However, these Board-created exceptions to what constitutes a finance charge under TILA were never intended to exempt products such as overdraft loans from TILA coverage.

- The "discretion exception" was originally created by the Board to allow institutions to use their discretion to pay an overdraft on an ad hoc basis without triggering TILA coverage. (*See* Proposed Amendments to Reg. DD, at p. 4).
    - Many of the overdraft loan programs that claim to be discretionary actually establish parameters for paying overdrafts without discretion (e.g. accounts must be open for 30 days and receive periodic direct deposit) and set credit limits for borrowers - thus functioning as lines of credit.
    - The "same fee as a non-credit transaction exception" was originally created to exempt from the finance charge a charge of a type payable in a comparable cash transaction. The Board's proposal extends the exception to an extension of credit for which there is no comparable cash transaction.

- The return of an NSF check, which is a service, is not a comparable transaction to an overdraft loan, which the Board admits is an extension of credit. The "same fee" exception is particularly inappropriate in the case of overdraft loans offered through ATM and debit cards where the customer pays no fee if the institution does not make an overdraft loan.
    - The Board's proposal relies on this exception to conclude that discretion is not a necessary requirement for an overdraft loan program to be exempt from TILA.

The Board's Proposal Conflicts With Its Own Analysis of TILA.

In March 2000, the Board concluded that payday loans should be covered by TILA and cited the following in support of its decision: "TILA, as implemented by Regulation Z, reflects the intent of the Congress to provide borrowers with uniform cost disclosures to promote the informed use of credit and assist borrowers in comparison shopping. **This purpose is furthered by applying the regulation to transactions, such as payday loans, that fall within the statutory definition of credit**…."[1]

Overdraft loans clearly satisfy TILA's definition of credit.[2] Thus according to the Board's own reasoning, the purposes of TILA would be furthered by applying Regulation Z to overdraft loans.

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[1] Truth in Lending, 65 FR 17129, 17130 (March 31, 2000).

[2] TILA states that "[c]redit means the right granted by a creditor to a debtor to defer payment of debt or incur debt and defer its payment." 15 U.S.C. § 1602(e). The Board's proposal does not suggest that institutions that offer overdraft loan programs are not creditors under TILA. Nor is there any basis to do so, especially for those

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An Overdraft Loan is Comparable to Payday Lending Without TILA Disclosures

There are many similarities between overdraft loans and payday lending. Both are presented as a means to tide borrowers over during a shortfall, but trap borrowers in a cycle of debt.

- Payday lending and overdraft loans both have high interest rates. Based on an $80 overdraft and a fee of $21.80,[3] a seven-day overdraft loan translates into a 1420.90% APR, a 15-day loan, 663.10% APR, and a 30-day loan (usually the maximum), 331.50% APR.

- Overdraft loans and payday lending both are marketed to customers as ways to manage short-term cash flow problems. Some financial institutions promote overdraft loans as providing funds if you "run short on cash between paydays."

- Both products trap borrowers in cycles of debt. Four percent of overdraft loan customers are responsible for 50% of overdraft loan fees.[4] According to a study conducted by the Washington State Department of Financial Institutions, over 20% of borrowers who incur overdraft loan fees are charged such fees two or more times per month.[5]

- Payday loans and overdraft loans are both targeted at low- and moderate-income customers. One consultant encourages institutions to maximize overdraft fees by opening branches "in supermarkets, particularly supermarkets with a middle to down market and family target market."[6] Low- and moderate-income customers pay a disproportionate amount of the overdraft loan fees.[7]

- Purveyors of payday loans and overdraft loans both argue that they are not covered by TILA. In March 2000, the Board, over the objections of the payday lending industry, issued a staff commentary clarifying that payday loans are subject to TILA and that payday lenders must disclose an APR for their loans. The Board should take the same action with respect to overdraft loans.

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institutions that offer overdraft loans through ATM or debit cards. *See* 15 U.S.C. § 1602(f) (defining creditor under TILA).

[3] *See* Allan Sloan, *"Free" Checking's Big Asterisk Won't Bite Your Wallet if You Don't Let It*, WASHINGTON POST, Nov, 12, 2002, at E3 (stating that a bounce protection vendor estimates that $80 is the average amount of an overdraft); Board of Governors of the Federal Reserve System, *Annual Report to the Congress on Retail Fees and Services of Repository Institutions*, June 2003, at p. 5 (finding that the average overdraft fee is 21.80).

[4] Alex Berenson, *Some Banks Encourage Overdrafts, Reaping Profit*, N.Y. TIMES, Jan. 22, 2003.

[5] The study found that 20% of customers who incur overdraft loan fees charged by a bank, and 27.3% of credit union customers who pay overdraft loan fees, are charged such fees 2 or more times per month. Washington Department of Financial Institutions, *Overdraft Protection Programs*, (September 19, 2003) at p. 4, available at http://www.dfi.wa.gov/Legislative%20report.pdf.

[6] Ralph Haberfied, *Breaking the $200 Barrier: With the Right Strategy That's How Much a Bank Can Generate in Fee's Per Account*, Bankstocks.com, September 25, 2001, available at http://www.bankstocks.com/article.asp?id=425.

[7] Alex Berenson, *Federal Reserve Says Banks Can Continue Overdraft Plans,* N.Y. TIMES, June 8, 2004.

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TILA Promotes Competition And Informs Borrowers.

TILA coverage of overdraft loans is consistent with the purpose of the act: to promote the informed use of consumer credit by providing disclosures about its terms and costs. TILA requires creditors to disclose the cost of credit as a dollar amount (the finance charge) and an APR. Uniformity in disclosure:

- Promotes competition among financial institutions.
- Allows customers to evaluate the true cost of credit.

Most financial institutions offer alternative loan products that are far cheaper than overdraft loans, and TILA would make clear the relative costs of these products.

The Board's Proposals are Inadequate to Protect Borrowers.

The list of non-binding best practices set forth in the proposed interagency guidance provides little protection for borrowers. It threatens no consequences for financial institutions that fail to follow them and will do little to stop the abuses inherent in this highly lucrative product. For example:

The Board advises financial institutions to inform borrowers, "**when feasible,**" that a non-check transaction will trigger overdraft fees. An institution should not be permitted to dispense overdraft loans through non-check transactions without first warning the consumer that a fee will be assessed and providing the consumer with the option of canceling the transaction. The Board's guidance does not directly address the following scenario, which can result in repeated overdrafts in a short period of time:

- Borrowers overdraw their accounts through non-check transactions and incur an overdraft fee.
- Since the transactions go through, they believe they have a positive balance and complete additional non-check transactions.
- Several more overdraft fees are incurred before borrowers receive notification of the original overdraft through the mail.

The Board also suggests that financial institutions "**consider**" daily limits on the amount of credit extended or the number of fees. The guidance does nothing to prevent institutions from allowing borrowers to overdraw their accounts repeatedly, trapping them in a cycle of debt.

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