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Before the U.S. House Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

Overdraft Protection: Fair Practices for Consumers
<u>July 11, 2007</u>

Chair Maloney, Ranking Member Gillmor, and members of the Committee, thank you for holding this hearing and bringing to light an abusive banking practice that is costing Americans $17.5 billion annually.

Many of our nation's largest financial institutions are betraying the trust of their account holders by quietly replacing a beneficial back-up system for checking accounts with a system of high-cost, unsolicited overdraft loans that drive their customers further into the red. Common banking practices now increase the number of overdrafts rather than minimize them, and can cost the account holder hundreds of dollars in a matter of hours, when they otherwise may have been overdrawn by just a few dollars for a few days or less. Debit card overdrafts are now the single largest source of overdraft fees and are especially costly for consumers because they carry the same high flat fee for smaller loans.

Abusive overdraft loans are costly for everyone, but are most destructive to people who are struggling to meet their financial obligations. In a system hugely out of balance, our big banks are collecting enormous fees from people who have nothing to spare, making them even less able to meet those obligations.

I serve as the director of the Washington, D.C. office of the Center for Responsible Lending (www.responsiblelending.org), a non-profit, non-partisan research and policy organization committed to protecting family wealth. CRL strongly supports HR 946 as a straightforward and powerful solution to the problem of abusive overdraft lending. HR 946 will help stop the abuse and help bring the system back into balance, without limiting the ability of banks to provide genuine protection for their customers.

CRL is an affiliate of Self Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families. It has been disheartening to see wealth stripped away by a variety of insidious predatory lending practices over the past decade, and now the very mainstream practice of abusive overdraft lending must be counted among them.

In my remarks today:

- I will describe the dysfunctional overdraft lending system that now dominates the market, and how it has changed drastically from a model that was once truly helpful;

- I will report that abusive overdraft lending now costs $17.5 billion per year, an estimate that CRL released today, based on our analysis of checking accounts from the nation's largest banks. Nearly half of these fees, $7.8 billion, come from overdrafts triggered by debit cards at the ATM or checkout counter—overdrafts that could be prevented with a simple warning or if the transaction was declined;

- And I will recommend that Congress pass HR 946 into law as a solution that will put the real protection back into overdraft policy.

I. Abusive Overdraft Lending Systematically Strips Funds from Checking Accounts

Abusive overdraft loans should not be confused with cheaper sources of back-up funds for checking accounts. Under traditional programs that link checking accounts to a savings account or line of credit, which are a legitimate money management tool, funds are transferred in increments when the checking account is temporarily overdrawn. Banks have offered such programs for decades.

Today, however, banks commonly enroll their checking account holders in a high-cost fee-based system automatically, with no chance to opt out, at the time they open a checking account. If an account dips into a negative balance, the bank routinely covers the overdraft—a change from past practices—paying the shortfall with a loan from the banks' funds. When the account holder makes their next deposit, the bank debits the account in the amount of the loan plus a fee, which now averages $34.

For low-income account holders who have no cushion of cash in their bank account, this $34 charge is difficult to make up before another debit hits their account, sending them further into the red, triggering another $34 fee, and accelerating a downward spiral of debt.

Indeed, in this age of fast-paced banking and electronic bill pay, anyone can temporarily slip into a negative balance. Check 21, passed in 2004, allows banks to debit accounts more quickly, while the rules for how long they can hold deposits before crediting accounts have not been updated in 20 years. A spokesperson for a large national bank recently told the Atlanta Journal Constitution that the bank holds some deposits for as long as the law allows, unless the account holder calls and asks for a quicker credit.[1] By treating credits and deposits so differently, banks subject account holders to a heightened risk of overdrafting.

Banks increase the risk of overdraft still further by manipulating the order in which they clear checks or debits that are posted in the same time period. Clearing a large debit first, for example, exhausts the funds in an account sooner and creates multiple opportunities to charge an overdraft fee for each of the smaller debits that follow. Buried in the 26-page "terms and conditions" of one major bank is this policy statement: "If we get a batch of such items in a day (checks typically come in batches), and if one, some or all of them would overdraw the account if paid, we can pay or refuse to pay them, in any order, or no order."[2] (See appendix for a comparison of the overdraft fee consequences of high-to-low debit ordering versus chronological ordering.)

Our analysis of checking accounts shows that 14 of the 15 largest banks slap a significant number of their account holders with high-cost overdraft loan charges that might otherwise be averted.[3]

The Federal Reserve Board has exempted abusive overdraft lending from the Truth-in-Lending Act (TILA),[4] so banks and credit unions do not have to disclose the astronomical interest rates that apply to these short-term, small-dollar overdraft loans.[5]

TILA was enacted to give consumers a meaningful way to compare the cost of credit. Nowhere is it more critical for cost information to be fully-disclosed than for abusive overdraft lending. The Federal Reserve Board acknowledged that fee-based overdraft coverage is, in fact, a loan, stating that "[w]hen overdrafts are paid, credit is extended."[6]

Despite its own findings, the Federal Reserve Board has refused to regulate the practice as a loan.

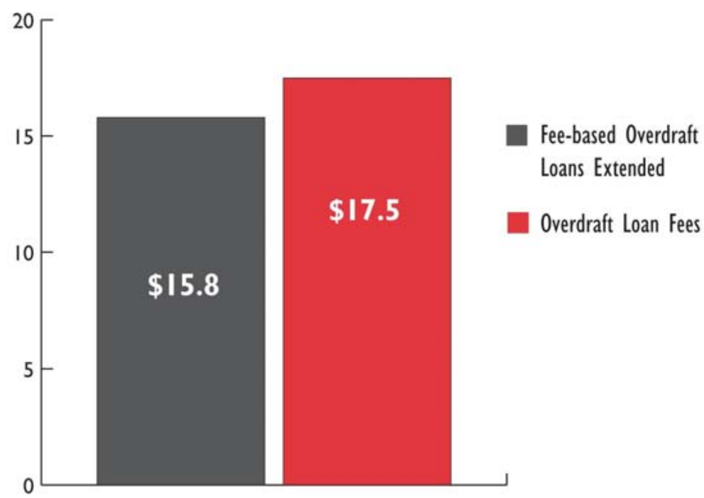
Marketed as "overdraft protection," in actuality, abusive overdraft lending protects only the banks' ability to maximize fees while jeopardizing the financial stability of many of its customers. Rather than competing by offering lower cost, truly beneficial overdraft products and services, many financial institutions are hiding behind a smokescreen of misleading terms and opaque practices that promote costly overdrafts.

II. Overdraft Lending Costs Americans $17.5 Billion in Abusive and Largely Preventable Fees

The Center for Responsible Lending is releasing a report today finding that abusive overdraft lending costs Americans $17.5 billion per year in fees, up from our 2005 estimate of $10.3 billion.[7]

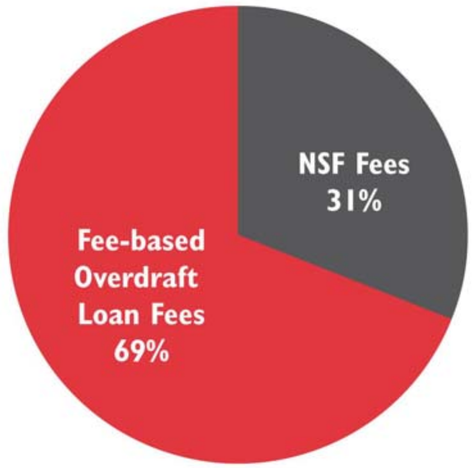
Americans, in fact, pay more in abusive overdraft loan fees than the amount of the loans themselves—$17.5 billion in fees for $15.8 billion in credit extended. This makes crystal clear the degree to which the cost of this so-called service is out of line with any benefit.

Figure 1. Consumers pay back more in overdraft fees than total loans extended



While banks and credit unions once covered overdrafts as an occasional "courtesy," they have now moved to a system that routinely approves overdrafts on all types of transactions, generating a fee for each incident. Overdraft loan fees now make up 69 percent of all overdraft-related fees, while traditional NSF fees make up only 31 percent. Abusive overdraft loans, once the exception, are now the rule.

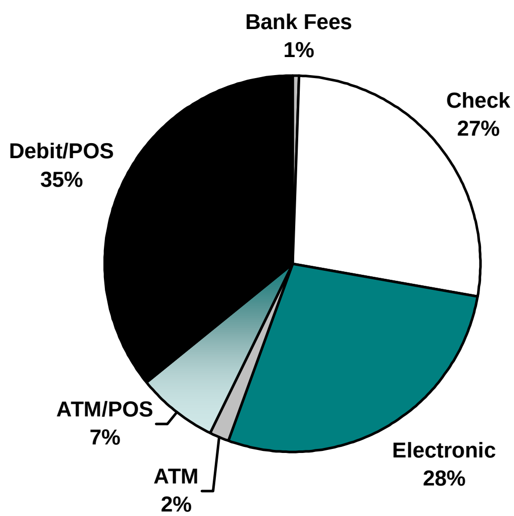
Figure 2. Overdraft-Related Fees by Type



Source: CRL Analysis of Ultimate Consumer Panel database

Today, banks swipe a large portion of these fees when their account holders swipe debit cards at ATMs and checkout counters. In a report we released in January, we found that 44 percent of overdrafts—nearly half—are now triggered by debit cards purchases at the checkout counter or cash withdrawals from the ATM.[8]

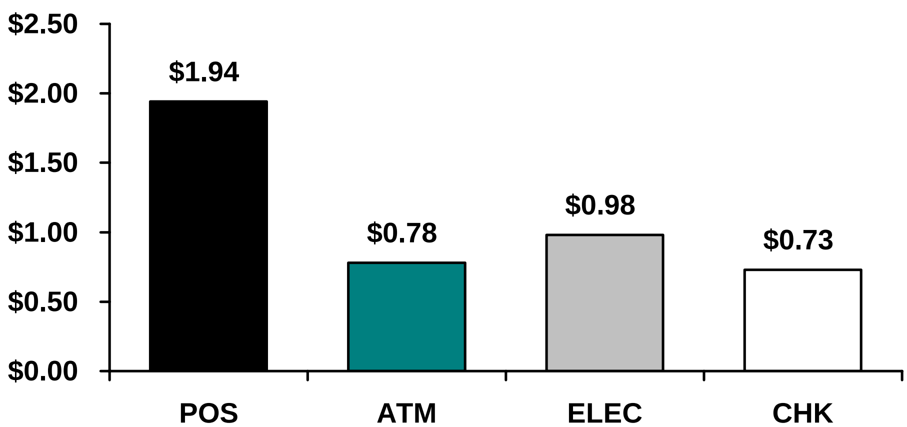
Figure 3. Identified Overdraft Fee Triggers



There is nothing inherently wrong with debit cards – when they first came into common use they promised the convenience of a credit card without the cost, because debit card users were required to have the funds in their account to cover their purchase or withdraw cash. As recently as 2004, 80 percent of banks still declined ATM and debit card transactions without charging a fee when account holders did not have sufficient funds in their account.[9] But banks now routinely authorize payments or cash withdrawals when a customer does not have enough money in their account to cover the transaction, so debit cards end up being very costly for many consumers.

In addition to being the more common trigger, these debit card overdrafts are more costly than overdrafts caused by paper checks. The average overdraft loan triggered by a debit card purchase is $16, and is paid back in fewer than five days. Given the average $34 fee, this means consumers pay $1.94 in fees for every one dollar borrowed to cover a debit card point-of-sale overdraft.[10]

Figure 4: Fees paid per dollar borrowed for overdraft loans, by trigger type



Taken as a whole, debit card and ATM overdrafts account for nearly half of the $17.5 billion in annual fees paid by account holders for abusive overdraft loans. **Debit card swipes cost Americans $7.8 billion per year in abusive overdraft lending fees.**[11]

Banks and credit unions could prevent every dollar of these debit card overdraft fee charges by simply notifying account holders when they are about to overdraw their accounts, or by declining a transaction when there is insufficient funds available, as they did in the past.[12] Instead, banks and credit unions routinely approve overdrafts and collect out-of-proportion fees without warning. Consumers want those warnings, according to our survey of account holders, and would most often cancel the transaction if given the chance.[13]

Unfortunately, abusive overdraft fees have the greatest impact on those who can least afford them. A CRL survey published in 2006 found that account holders who are repeatedly charged abusive overdraft loan fees are more often low-income, single and non-white.[14]

III. HR 946: Putting the Protection Back into Overdraft Policy

The good news is that the solution to this problem is simple; and it's nothing new. Banks and credit unions had it right the first time, with past policies that either charged a fee as a disincentive to bouncing a check, or linked their customers' checking accounts to a lower cost source of back-up funds—a savings account or line of credit.

HR 946, the Consumer Overdraft Protection Fair Practices Act, would not affect these real protection programs. It would only prevent abuses created by the relatively new system that is premised on generating fee revenue rather than protecting the funds of account holders.

HR 946 would put the protection back into overdraft policy by requiring financial institutions to fully inform account holders of the costs of fee-based overdraft systems, including their astronomical interest rates. Account holders would have to give specific written consent in order for financial institutions to enroll them in such a costly and problematic system. Banks and credit unions would have to warn account holders before making them a high-cost loan for an electronic transaction, and permit them to choose another payment option that will not cause an overdraft.

The bill would also prohibit manipulation of account activity if the result is to increase overdrafts. This would mean no debiting accounts with the highest dollar charge first in order to increase the number of overdraft fees an account holder is charged. No holding deposits before crediting accounts in order to create a negative balance and charge an overdraft fee. And again, authorizing electronic overdrafts without allowing an account holder to cancel the transaction, is itself another manipulation that increases overdrafts.

These protections are a simple matter of fairness and common sense. The abusive system of overdraft lending that dominates the market today is obscured behind a smokescreen that allows banks and credit unions to drive up overdrafts and drive up their fee income. These practices defeat the ability of consumers to assert meaningful control over their financial affairs and must be stopped. Banks must be required to compete fairly, based not on smokescreens and manipulation, but on offering beneficial products and services at a reasonable price.

APPENDIX

For an illustration of how the practice of clearing checks and debits from the largest dollar amount to the smallest could play out, assume an account holder has $750 in her checking account. Before she realizes she is not covered, she pays some bills and makes some small dollar purchases, putting her $143 in the negative.

The order in which these payments clear her checking account makes a big difference in the cost of that shortfall. If the payments were presented to the financial institution on the same day, in the order in Scenario A below, and if they were cleared in the order they were presented, she would be charged like this:

Scenario A: Chronological Ordering of Charges

Transaction	*Charge*	*Account Balance*	*Average Overdraft Fee*
		750	
Credit card payment – ACH	90	660	
Water bill - check	30	630	
Groceries purchase – debit card	65	565	
Gas purchase – debit card	25	540	
Lunch purchase – debit card	10	530	
Drugstore purchase – debit card	15	515	
Family gym fees– check	40	475	
Coffee purchase - debit	8	467	
Bookstore purchase – debit card	10	457	
Rent – check	600	(143)	$34
TOTAL OVERDRAFT LOANS		**$(143)**	
TOTAL OVERDRAFT FEES			**$34**
Balance with fees deducted		**$(177)**	

On the other hand, if the payments were cleared from the largest to the smallest, the amount by which her account was overdrawn would remain the same, but the charges would be significantly higher.

Scenario B: High-dollar Ordering of Charges

Transaction	*Charge*	*Account Balance*	*Average Overdraft Fee*
		750	
Rent – check	600	150	
Credit card payment – ACH	90	60	
Groceries purchase – debit card	65	(5)	34
Family gym fees – check	40	(45)	34
Water bill – check	30	(75)	34
Gas purchase – debit card	25	(100)	34
Drugstore purchase – debit card	15	(115)	34
Lunch purchase – debit card	10	(125)	34
Bookstore purchase – debit card	10	(135)	34
Coffee purchase – debit card	8	(143)	34
TOTAL OVERDRAFT LOANS		**$(143)**	
TOTAL OVERDRAFT FEES			**$272**
Balance with fees deducted		**$(415)**	

Banks and credit unions claim that their overdraft programs are providing customers a service—protection from returned check fees. But this argument is disingenuous, because in either scenario above, all the transactions are paid. The only difference is that in Scenario B, the bank or credit union increases their fee income by manipulating the order in which they clear the payments.

Of course, if the bank customer had no overdraft program in place at all, her rent would likely be paid late. But even if her landlord charged her a late fee of $30 (five percent of the rent) and her bank charged an NSF of $20, for a total of $50, she would still come out better than she would under Scenario B, which cost her $272.

NOTES

[1] Peralte C. Paul, *Whose Money is it? Checks Clear Faster than ever, but deposits tend to creep into accounts slowly. Watchdogs want banks to change.* Atlanta Journal Constitution, May 10, 2007.

[2] US Bank, *Terms and Conditions for Deposit Accounts*, effective October 15, 2006. Available at https://fastapp.usbank.com/fastapp/en_us/termsAndConditions/TandC/LinkDepositAgreementCurrent.jsp), last viewed June 20, 2007.

[3] Eric Halperin & Peter Smith, *Out of Balance: Consumers pay $17.5 billion per year in fees for abusive overdraft loans*, Center for Responsible Lending, July 11, 2007.

[4] Final Rule Amended Regulation DD, 70 FR 29582-01 (May 24, 2005).

[5] Because these loans average $27, less than the average fee of $34, and typically last only a few days, the effective annual interest rates reach triple or quadruple digits.

[6] See Joint Guidance on Overdraft Protection Programs, 70 Fed. Reg. 36,9127, 36,0129 (Feb. 24, 2005).

[7] See *Halperin & Smith*, endnote 3.

	2004	2006
Non-interest fee income/service charges[7] (A)	$38.0 billion	$42.2 billion
Estimated percent of non-interest fee income attributable to overdraft loan and NSF fees combined (B)	45%	60%
Overdraft loan and NSF fees combined (C) = (A) * (B)	$17.1 billion	$25.3 billion
Estimated percent of overdraft/NSF fees due only to fee-based overdraft loans (D)	60%	69%
Estimated fee-based overdraft loan fees (C) * (D)	**$10.3 billion**	**$17.5 billion**

[8] Eric Halperin, Lisa James and Peter Smith, *Debit Card Danger: Banks offer little warning and few choices as customers pay a high price for debit card overdrafts*, Center for Responsible Lending, January 25, 2007. Available at http://www.responsiblelending.org/pdfs/Debit-Card-Danger-report.pdf.

[9] Mark Fusaro, *Are "Bounced Check Loans" Really Loans?*, February 2007, at fn4, p6. Available at http://personal.ecu.edu/fusarom/fusarobpintentional.pdf.

[10] Eric Halperin, Lisa James and Peter Smith, *Debit Card Danger: Banks offer little warning and few choices as customers pay a high price for debit card overdrafts*, Center for Responsible Lending, January 25, 2007 at p8. Available at http://www.responsiblelending.org/pdfs/Debit-Card-Danger-report.pdf. Median values by type of overdraft:

	Fee Amount	Txn Amount	Loan Amount	Days	Fee per Dollar Borrowed
POS	$34.00	$20.00	$16.46	5	$1.94
ATM	$34.00	$40.00	$40.00	3	$0.78
ELEC	$34.00	$29.14	$27.95	4	$0.98
CHK	$34.00	$60.00	$41.38	2	$0.73

[11] See *Halperin & Smith*, endnote 3.

[12] For all ATM withdrawals and for the vast majority of debit card POS transactions, a swipe of the card sends a balance inquiry over the network before the transaction is approved. See Ron Borzekowski, Elizabeth Kiser, and Shaista Ahmed, *Consumers' Use of Debit Cards: Patterns, Preferences, and Price Response*, Federal Reserve Board, Washington, D.C., April 2006, endnote 6 at p5. All banks have the ability to deny transactions that would cause an overdraft, and some currently maintain a policy of rejecting ATM or debit card transactions that cause overdrafts for some or all customers. Examples include the Overdraft Protection and Salary Advance programs of the North Carolina State Employees' Credit Union, available at http://www.ncsecu.org/Products.aspx, last viewed January 18, 2007, and http://www.ncsecu.org/Services.aspx?page=1&item=4&Name=cntlOverdraft and http://www.ncsecu.org/Resources/Publications/PDF/Brochures/Rules_Reg.pdf and USAA Overdraft Protection program, available at https://www.usaa.com/pdf/DaD0406_BillPay0704_SvcFee0606.pdf?cacheid=57814416. Because these transactions occur electronically, banks can identify a potential overdraft and alert a customer before it's too late. Some banks reportedly have already begun warning their account holders about potential overdrafts at their own ATMs. Banks do, however, have the ability to warn even at ATM machines they do not own.

[13] In our survey, 75 percent of respondents wanted to be warned if they attempted to withdraw more money at an ATM than they had in their account. Only 2 percent of those surveyed said that, if warned and given the choice of continuing or canceling the withdrawal, they would complete the transaction despite the overdraft fee. If a debit card purchase at a checkout cost more than they had in their account, 61 percent of whose with a preference said they would rather "have the bank automatically decline [their] debit card transaction to avoid the overdraft." See *Halperin et al*, endnote 2 at p9.

[14] Lisa James and Peter Smith, *Overdraft Loans: Survey Finds Growing Problem for Consumers*, Center for Responsible Lending, April 24, 2006. Available at http://www.responsiblelending.org/pdfs/ip013-Overdraft_Survey-0406.pdf.