STRIKING A BALANCE: ACHIEVING APPROPRIATE REGULATION OF OVERDRAFT PROGRAMS

Capstone Strategic Project for the American Bankers Association
Stonier Graduate School of Banking

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I. EXECUTIVE SUMMARY

The world of overdraft payment services and related regulation has evolved significantly in the past decade. Given the economic challenges embedded in this period, financial institutions have increasingly relied on overdraft income as a means of improving financial performance. This increased financial reliance created an environment with abundant risk of consumer harm. Regulators have responded largely with a fragmented approach to addressing these risks through updates to existing regulations, new regulatory requirements, and supervisory guidance. The lack of alignment in supervisory expectations has caused confusion in the industry and has left certain key consumer protection risks associated with overdraft payment services unmitigated. Considering the FDIC’s expert knowledge of overdraft practices, we should collaborate with the CFPB in its prospective overdraft rulemaking to ensure these risks are appropriately addressed.

Studies have revealed increased use of overdraft services by the most vulnerable groups of consumers, and regulatory examinations have discovered numerous instances of substantial financial harm to consumers caused by problematic overdraft practices. Studies have also revealed confusion surrounding overdraft practices; however, general demand for these services exists, demonstrating the important function they serve in the financial marketplace. Overly aggressive rulemaking could have the potential unintended consequence of reducing options for consumers and the possibility of their exiting mainstream banking. To ensure clarity and transparency of overdraft services and to prevent consumer harm, while at the same time preserving consumer choice and minimizing potential unintended consequences, the CFPB should consider amending Regulation DD – Truth in Savings to govern the following overdraft-related practices:
1) Require neutral and objective transaction processing. Neutral processing order may be best defined as order of presentment; on a first-in-first-out basis.

2) Prohibit the assessment of overdraft fees on an available balance basis.

3) Prohibit the assessment of continuous overdraft fees on non-business days.

4) Require the implementation of a transaction and/or balance-driven *de minimis* of no less than $10, under which an overdraft fee would not be imposed.

5) Prohibit the assessment of more than three overdraft fees daily.

There is a demonstrated need for additional consumer protections in the realm of overdraft services and increased uniformity in supervisory expectations; implementing regulatory requirements consistent with these recommendations would help ensure an appropriate balance in regulating overdraft practices.
II. STATEMENT OF PROBLEM

Over the course of the past decade, the banking industry experienced substantial growth in use and automation of overdraft programs. This increasing reliance by financial institutions on overdraft income inherently heightens the risk of consumer harm, especially to the most vulnerable consumers. For example, low-income consumers are twice as likely to incur overdraft fees when compared to consumers of higher income levels. In addition, young adults (age 18-25) are the most likely of all age groups to incur overdraft fees.¹

To illustrate the increase in financial institutions’ use of overdraft programs, total service charges on deposit accounts at institutions insured by the Federal Deposit Insurance Corporation (“FDIC”) stood at $34.5 billion in 2005, and increased by 22.9 percent to a peak of $42.4 billion in 2008. The 2008 financial crisis resulted in decreasing service charges on deposit accounts from 2009 through 2012; however, these charges stood at near-2005 levels of $34.1 billion in 2014.² Despite the historical limitation on overdraft data compared to service charges on deposit accounts, regulatory studies revealed that a significant portion, estimated at between 61.0 percent and 77.0 percent, of this income is attributed to overdraft fees.³ The impact of the financial crisis on profitability was driven by poor asset quality, which led financial institutions to pursue alternative means of generating earnings. In addition to increasing credit card and other fees to consumers, banks increased their implementation of automated overdraft programs to help drive profits.


Since 2005, the regulatory agencies comprising the Federal Financial Institutions Examination Council (“FFIEC”) have collectively, or individually, issued various guidance on overdraft practices and added requirements governing certain aspects of overdraft programs to existing regulations. In addition to the FRB’s addition of a requirement of a consumer opt-in to overdraft coverage for one-time debit card and Automated Teller Machine (“ATM”) transactions to Regulation E – Electronic Fund Transfers, the most recent supervisory expectations were communicated by the FDIC in its Overdraft Payment Supervisory Guidance (November 2010). The resulting piecemeal approach to regulation and supervisory guidance has increased regulatory burden and caused confusion in the industry. Recognizing the negative impact of disjointed regulatory efforts, the Office of the Comptroller of the Currency (“OCC”) withdrew its 2011 proposed guidance on overdraft programs in 2013.

The Consumer Financial Protection Bureau (“CFPB”) expressed several consumer protection-related concerns with overdraft programs in a white paper in June 2013 and a full report in 2014, both of which were based on its 2012 data-driven study of overdraft programs. More recently, the CFPB confirmed its intent to determine whether regulation of overdraft programs is appropriate, noting that a possible rulemaking might address disclosures as well as specific acts or practices.

It is paramount for the financial regulatory agencies, particularly the CFPB in its rulemaking capacity, to recognize all associated risks as well as the important function these services provide for consumers, and strike an appropriate balance in regulating overdraft


programs. The rulemaking process must consider the need for extending consumer protections, the financial impact on institutions, as well as potential unintended consequences.

Financial regulatory agencies’ studies of overdraft practices and findings during the examination process have identified several instances of substantial harm to consumers. Considering the high levels of actual consumer harm identified by regulators, and the potential for harm to occur, this project will address whether the implementation of new regulatory requirements governing overdraft practices is necessary, and in what specific areas additional consumer protections are warranted.

The FDIC should leverage its significant level of expertise in the overdraft arena to help inform and advise the CFPB in its overdraft rulemaking process. Sharing this information with the CFPB will contribute toward establishing balanced regulation on overdraft practices. Providing expert input into rulemaking from the onset of the process will be beneficial, as it will improve the effectiveness of the CFPB’s proposed rulemaking and the issuance of final rules. FDIC involvement should continue through the duration of the process, especially in the prospective consideration of input provided during the comment period.
III. RESEARCH METHODOLOGY, DATA SOURCES AND ANALYSIS

I used a variety of internal and external sources in performing research for this project. Internal sources include confidential supervisory records subject to the confidentiality restrictions set forth in Part 309 of FDIC Rules and Regulations, formal enforcement actions, public financial institution data extracted from Reports of Condition and Income (“Call Reports”), and aggregated examination results. To the extent that I considered information subject to the confidentiality restrictions set forth in Part 309 of FDIC rules and regulations for this paper, I have omitted bank names and/or other identifying details. External and public sources include regulations, notices of proposed rulemaking, and official staff commentaries; supervisory guidance on overdraft programs; and, regulatory studies.

My research also included use of external sources such as non-profit, non-partisan studies and reports; industry group articles and letters responding to notices of proposed rulemaking or other regulatory issues, such as those published by the American Bankers Association (“ABA”); news articles and press releases; and, political letters, responses, and requests for information from regulatory agencies.

In addition to determining and presenting trends in overdraft usage based on resources such as Call Report data, regulatory and non-profit, non-partisan studies, I will collect and analyze primary data sources including examination findings and overdraft-specific consultations to identify practices that present the most significant risk of consumer harm. We have a great deal of subject matter expertise on overdraft programs in the FDIC, and I will interview individuals who possess this expertise to further target my research and recommendations.
An essential component of this project is to maintain a fair and balanced approach that considers the advantages and disadvantages of further regulation of overdraft programs. I will use external resources that present negative aspects of current and future regulation, as well as those in favor of additional regulation. I will weigh the consumer harm risks against potential financial impact to institutions and other possible unintended consequences.

One of the factors presenting a potential limitation on my research is the lack of quantifiable evidence supporting industry claims on consumers’ acceptance of, and demand for, overdraft programs. Given this limitation and considering the differences identified in regulatory studies, non-profit non-partisan studies, and industry publications, I will reconcile these various findings and observations to draw concrete, empirically based conclusions and formulate appropriate recommendations. Furthermore, data on financial institution expenses associated with overdrafts such as charge-offs is limited. Data relating to charged-off accounts, while reported by financial institutions, is not separated into categories that identify those charged-off due solely to overdraft activity.

I will use empirical data to support trends and discuss the potential financial impact of new regulations governing overdrafts. For example, I will use Call Report data to quantify the financial impact of the introduction of an opt-in requirement for overdraft program coverage of one-time debit card (point-of-sale or “POS”) and ATM transactions under Regulation E – EFT that took effect in July 2010. Until the first quarter of 2015, Report of Condition and Income (“Call Report”) data did not segregate overdraft fee or non-sufficient fee income from total service charges on deposit accounts. Beginning with first quarter 2015 Call Reports, only those institutions with total assets of $1 billion or more are required to separately report overdraft fees
as a sub-category of service charges on deposit accounts. Therefore, this threshold exempts 89 percent of the nation’s 6,348 banks from reporting separate overdraft data.⁶

This section details my research findings and conclusions based on a wide array of resources including the many regulations governing overdrafts; regulatory, independent, and industry research; and, examination and enforcement action activities.

**Background on Regulations and Supervisory Guidance Governing Overdraft Services**

Several regulations include provisions that directly or indirectly govern overdraft programs. This section details my analysis of each applicable regulation.

**Regulation DD – Truth in Savings**

Congress enacted the Truth in Savings Act (“TISA”) under Subtitle F of the Federal Deposit Insurance Corporation Improvement Act (“FDICIA”) of 1991. The broader intent of FDICIA was to expand the authority of the FDIC and to create new supervisory and regulatory examination standards. As part of these overall enhancements, Congress enacted TISA to establish uniformity in the disclosure of terms and conditions under which interest is paid and fees are assessed in conjunction with deposit accounts. Regulation DD, which implements TISA, went into effect in June 1993. Its purpose, as defined in the regulation itself, is to “…enable consumers to make informed decisions about their accounts at depository institutions through the use of uniform disclosures. Between the introduction of TISA in 1991 and the creation of the CFPB by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), authority for Regulation DD – TISA was under the purview of the FRB. The CFPB officially assumed authority for 14 consumer protection regulations, including Regulation DD, in July 2011. Prior to this transfer of rulemaking authority, the FRB amended Regulation DD by adding provisions governing the disclosure of overdraft and returned item fees.
on periodic statements and balance disclosures provided to consumers through automated systems. These rules first went into effect in July 2006, and were further modified by the FRB in January 2009.

The Federal Register publication of the final rule introducing overdraft fee disclosure requirements under Regulation DD indicates that the FRB’s study of overdraft services in 2002 identified several concerns. One major concern was the inadequacy of information provided to consumers whose accounts are eligible for the overdraft service. In addition, the FRB noted concerns related to the timeliness of notifications when consumers overdraw their accounts.

These concerns and consideration of public comments ultimately led to the adoption of a final rule that largely followed the proposed rule originally introduced in May 2004. With respect to periodic statements, the May 2005 final rule required institutions to disclose the total amount of fees for paying overdrafts and for returning items unpaid, including fees incurred during the statement period and for the calendar year-to-date. However, the requirement that went into effect in July 2006 only applied to institutions that promoted the payment of overdrafts. Furthermore, regardless of whether an institution promoted the payment of overdrafts, the final rule required institutions to include the categories of transactions for which an overdraft fee may be imposed in account opening disclosures. Advertisements for overdraft services are also required to contain specific disclosures concerning fees, transactions covered, the time period consumers have to repay, and the circumstances under which an institution would not pay an overdraft.

The FRB’s issuance of final rules under Regulation DD in January 2009 expanded the applicability of periodic statement disclosure requirements to all institutions, rather than only those that promoted the payment of overdrafts. This final rule, which went into effect in January
2010, also requires account balances disclosed to a consumer through any automated system (i.e. ATM, online banking, telephone banking system) to exclude additional amounts that the institution may provide or that may be transferred from another of the consumer’s accounts to cover an overdraft. The FRB did not finalize its proposal introducing a model opt-out form for overdraft services under Regulation DD; however, based on consideration of public comments and consumer testing, the FRB proposed rules under Regulation E. The following section discusses the proposed and final rules under Regulation E.

**Regulation E – Electronic Fund Transfers**

Congress enacted the EFT Act in 1978 to protect individual consumers in electronic transfers. Such transfers encompass those made through ATMs, POS terminals, automated clearing house (“ACH”) systems, remote banking programs, and remittance transfers. Similar to Regulation DD, rulemaking authority for Regulation E transferred from the FRB to the CFPB in July 2011. In 2009, recognizing the expansion of overdraft coverage beyond checks, the FRB expanded Regulation E to prohibit financial institutions from charging overdraft fees for ATM withdrawals and one-time debit card (POS) transactions, unless the consumer affirmatively consented to the overdraft service. The rulemaking process considered both industry and consumer advocate perspectives. One justification provided by the industry in defense of automated overdraft coverage was that such practice helps institutions reduce the expense associated with manual review of transactions that may result in a negative balance. Consumer advocates, however, expressed concern over the lack of consumer consent prior to imposing overdraft fees, and cited the high cost of an overdraft fee in relation to the amount of the transaction.
The Regulation E final rule went into effect in January 2010, with a mandatory compliance date of July 1, 2010. As a majority of consumers did not opt-in to overdraft coverage, this rule has had a significant financial impact on institutions.

**Section 5 of the Federal Trade Commission Act – Unfair or Deceptive Acts or Practices**

Section 5 of the Federal Trade Commission Act (“FTC Act”) declares that unfair or deceptive acts or practices (“UDAP”) affecting commerce are unlawful. In 2002, the FDIC issued Financial Institution Letter (“FIL”) 57-2002, which confirmed its intent to cite violations and take enforcement against state nonmember banks for UDAP violations. Such violations could exist across all areas of bank operations. Accordingly, the FDIC and the FRB issued supplemental guidance on March 11, 2004, indicating that acts or practices violating Section 5 of the FTC Act may also violate other laws or regulations. However, a bank may be in technical compliance with other fair lending or consumer protection regulations, even though an act or practice might violate Section 5 of the FTC Act.

In its *Compliance Examination Manual*, the FDIC conveys the standards by which it determines an act or practice to be unfair or deceptive, which mirror the standards set forth in Section 5 of the FTC Act. When determining whether an act or practice is unfair, examiners consider the following standards: 1) Causes or is likely to cause substantial injury to consumers; 2) cannot be reasonably avoided by consumers; and, 3) is not outweighed by countervailing benefits to consumers or to competition. Examiners apply the following standards when determining whether an act or practice is deceptive: 1) The representation, omission, or practice must mislead or be likely to mislead the consumer; 2) the consumer’s interpretation of the representation, omission, or practice must be reasonable under the circumstances; and, 3) the

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7 While regulatory and industry studies reveal varying opt-in rates, the studies consistently observed much higher rates of consumers that did not opt-in to overdraft coverage when compared to those that did.
misleading representation, omission, or practice must be material. It is important to note that the standards for determining unfairness and deception are independent of one another. In addition to laws and regulations directly and indirectly governing overdraft services, regulatory agencies have issued supervisory guidance, both collectively and individually. The following section details these key guidance documents.

**Supervisory Guidance**

**Joint Guidance on Overdraft Protection Programs**

To address concerns stemming from increased availability and consumer acceptance of automated overdraft programs, the FDIC, Board of Governors of the Federal Reserve System, OCC, and National Credit Union Administration issued the *Joint Guidance on Overdraft Protection Programs* in February 2005. The guidance addresses key compliance, legal, and risk management issues, and outlines a broad array of best practices for responsible administration and disclosure of overdraft programs. The “best practice” nature of this guidance, however, limits the authority of the primary federal regulators to require corrective actions or take enforcement action against institutions for non-adherence to the guidelines.8

The joint guidance provides a series of 17 best practice recommendations categorized by marketing and communications, and program features and operation. Key among these recommendations are those surrounding clear disclosure of program fees, explaining the impact of transaction clearing policies, and considering [emphasis added] daily limits on fees. While some of these best practices have since become law as addressed in the preceding sections, other components essential to ensuring consumer protection have not.9

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8 The final joint guidance explicitly states that the principles outlined are only enforceable to the extent they are required by law.
9 For example, opt-in and disclosure requirements have been incorporated into Regulation E and Regulation DD, respectively. Daily limits on fees, however, have not become law.
In November 2010, the FDIC further strengthened the message provided in the 2005 joint guidance, by issuing clear supervisory expectations\textsuperscript{10} for institutions to appropriately mitigate risks associated with overdraft payment programs, especially those which are automated.

Leveraging the 2005 joint guidance, the FDIC noted its expectation that institutions institute appropriate daily limits on overdraft fees and consider [emphasis added] eliminating fees for transactions that overdraw an account by a \textit{de minimis} amount. To provide clarification on specific expectations, the FDIC also issued a Frequently Asked Questions (“FAQ”) document. The FAQs provided measurable standards for several expectations, and gave examples of meaningful and effective follow-up. Several institutions responded appropriately to this supervisory guidance; however, similar to the 2005 joint guidance, these expectations lacked enforceability outside of areas governed by law. Given the flexibility afforded by the lack of enforceability, the significant consumer harm risks remain in key operational aspects of overdraft payment programs. The following section discusses research conducted by the FDIC and the CFPB, and highlights key findings and conclusions that help form the basis for the recommendations contained herein.

\textbf{Regulatory Agency Research}

The regulatory agencies not only examine for compliance with banking rules and regulations, but also conduct research on industry trends and areas that present potential risks, such as the evolution of overdraft practices. This section presents an analysis of the two primary studies conducted by the FDIC and the CFPB.

In response to the rapid expansion of automated overdraft programs, the FDIC initiated a study of empirical overdraft data from a sample of institutions it supervises. The FDIC conducted the study in two parts to gather information on program characteristics, features, fees, transaction processing, marketing, disclosures, internal controls, fee income and growth, and involvement by third parties.¹¹

This study revealed that non-sufficient funds (“NSF”) fees represented 74.0 percent of total service charges on deposit accounts as reported by the banks on their Call Reports in 2006. More concerning is that the rate of consumer complaints received by institutions operating an automated overdraft program was over 12 times greater than institutions offering a linked savings account option, and over 7 times greater than institutions offering an overdraft line of credit (“LOC”) option. This finding confirms that customers are generally dissatisfied with automated overdraft services.

As previously noted, the study included a review of transaction processing practices. Approximately 34.5 percent of institutions offering automated overdraft programs batch processed transactions from largest dollar amount to smallest (“largest-to-smallest”). This transaction processing methodology is more likely to generate a larger number of NSF fees as it depletes the account balance the fastest. A smallest-to-largest approach would generally result in a smaller number of NSF fees imposed against an account, while a neutral method such as order of presentation or item number would not tip the scales in either direction. Not surprisingly, institutions that batch processed largest-to-smallest generated higher levels of NSF fee income

¹¹ The study encompassed 1,135 institutions due for an on-site FDIC examination between May and December 2007, and 36 FDIC-supervised institutions with at least $5 billion in total assets. Of the study population of 1,171 banks, the survey was administered to a random sample of 462. The second part of the study collected transaction-level data from a subset of 39 institutions of the random sample of 462.
than those that processed according to other methods. This finding suggests there is an 
opportunity to minimize the potential for consumer harm by implementing regulatory 
requirements governing processing order.

Approximately 75.0 percent of consumer accounts held by banks involved in the 
transaction-level portion of the study had no NSF transactions and only 12.0 percent had 1-4 
NSF transactions in 2006. Therefore, only 13.0 percent of accounts represent 93.4 percent of all 
NSF fees. Highlighting the disproportionate impact by income level of consumer, the 
transaction-level study also found that a low-income customer was almost twice as likely to have 
an NSF transaction as an upper-income accountholder.\footnote{Income levels are determined by nine-digit ZIP code data for consumer accountholders. The median family income (MFI) of the census tract associated with the ZIP code data was compared against the MFI for the applicable metropolitan statistical area in which the tract is located.} Low-income accountholders were also 
found to have recurring overdrafts at a greater frequency than other income levels. For example, 
16.7 percent of low-income accounts had 1-4 NSF transactions; 7.6 percent had 5-9; and, 13.8 
percent had 10 or more NSF transactions. The percentages for upper-income accounts stood at 
10.5 percent, 4.2 percent, and 7.1 percent, for each range of NSF transactions, respectively. The 
following section discusses key findings of the CFPB’s study of overdraft programs.

\textit{Consumer Financial Protection Bureau – Study of Overdraft Programs: A white paper of initial data findings (June 2013) and Data Point: Checking Account Overdraft (July 2014)}

In February 2012, the CFPB initiated a public Request for Information (“RFI”) and a 
study of overdraft programs offered by a subset of institutions the agency supervises. The study 
focused on data from 2010 and 2011, and the CFPB presented its findings in the June 2013 white 
paper and the July 2014 Data Point. In conjunction with the roll-out of this study, CFPB 
Director Richard Cordray acknowledged that overdrafts may provide consumers with needed 
access to funds, but that financial harm to consumers through the use of such programs may also
occur. The white paper outlines the regulatory context by stating, “The published supervisory expectations of the various prudential regulators are not necessarily aligned and may be creating an unlevel playing field among depository institutions.”

Confirming what the FDIC identified in its 2008 study regarding institutions’ heavy reliance on overdraft fee income, the CFPB cites multiple sources revealing more recent data with similar results. For example, the Independent Community Bankers of America’s (“ICBA”) June 2012 study found that overdraft and NSF-related fee income accounted for 62 percent of deposit account service charges. In addition, Strunk and Associates, LP (“Strunk”) reported to the CFPB that the 1,800 predominantly small institutions it serves rely even more heavily on overdraft and NSF fee income; in 2012, 78.0 percent of deposit account service charges are attributed to such fees. The 2014 Data Point reiterates the disproportionate burden of overdraft fees on a small percentage of consumers. However, the study does not provide any insight on consumer demographics, such as income levels.

A key component to the CFPB white paper is that it addresses overdraft use following the 2010 opt-in requirement under Regulation E – EFT. It notes the varying approaches institutions implemented, such as offering the opt-in for ATM and one-time POS transactions; not authorizing any ATM/one-time POS transactions without adequate funds in the account; or, offering the opt-in for either ATM or POS transactions, but not both. The CFPB notes that the average opt-in rate across banks involved in the study was 16.1 percent as of December 31, 2011. Despite the 16.1 percent opt-in rate, the 2014 Data Point confirms that debit card transactions accounted for the largest portion of overdraft fee income, regardless of consumers’ opt-in status.

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13 The CFPB’s July 2014 Data Point notes that only 8 percent of consumers accounted for approximately 75 percent of all overdraft income.
Moreover, heavy users of overdraft services (defined as 10 or more overdraft occurrences in a calendar year) exercised their choice to not opt-in, and the impact was significant. These accountholders experienced a median decrease of over 13 overdraft transactions in the second half of 2010 (following Regulation E opt-in requirement implementation), which resulted in an average savings of over $450 (approximately 63 percent) for these consumers. Heavy users electing not to opt-in and the resulting reduction in fees to these consumers confirms the consumer protection successes of the Regulation E amendment, from which we can also infer consumers’ dissatisfaction with automated overdraft payment programs.

The white paper also addresses a particularly challenging element of overdraft payment services – calculating available funds. This area is significant because it is influenced by several areas including transaction authorization and settlement processes, deposit operations, and the funds availability requirements of Regulation CC – Expedited Funds Availability (“EFA”). This challenge is particularly evident when processing signature-based debit card transactions and in determining the availability of deposited funds. Signature-based debit card transactions are generally presented for settlement 1-2 business days following authorization. The CFPB notes that most institutions batch process transactions; therefore, upon authorizing a transaction, institutions “memo post” to reduce funds available to the consumer by the authorization amount. Differences between the authorization amount and the actual amount of the transaction are prevalent with purchases at gasoline stations, restaurants, and hotels. It is important for institutions to have controls in place to avoid double-charging overdraft fees in instances where an authorized transaction reduces available funds and the subsequent settlement of the transaction also results in an overdraft. I will discuss this further in the Examination Activities and Enforcement Action section.
Continuing along the lines of calculating available funds, Regulation CC also has considerable overdraft-related implications. Institutions are required to provide next-day availability for a minimum of the first $200 of checks deposited in-person at a bank branch. Automatic deposits made by ACH are generally subject to immediate availability. Banks may be in technical compliance with the funds availability rules of Regulation CC – EFA; however, there is the potential impact of consumer harm if availability practices are set-up in such a way that maximizes overdraft fees.

Industry Research and Comments

In addition to regulatory studies of overdraft programs and activity, industry groups have conducted separate studies resulting in recommendations to rulemaking agencies, and have provided comments on proposed rulemakings. This section analyzes various industry studies and comments.

Independent Community Bankers of America— The ICBA Overdraft Payment Services Study

In light of what the ICBA refers to as increased regulatory scrutiny of banks’ overdraft services, the industry group conducted a two-pronged study in June 2012 that included the assessment of 575 community banks’ overdraft programs and a random survey of 3,000 consumers to help determine the demand for overdraft services.\(^\text{14}\) The consumer survey component of the ICBA’s study resulted in seven key findings:

1) “Most consumers understand the potential consequences of returned payments and want important transactions paid by their financial institution (all fees being equal) even if those transactions result in an overdraft.

2) Consumers using overdraft payment programs are among the most knowledgeable of alternative services to avoid overdrafts.

\(^{14}\) While the universe of survey respondents is 575, it is important to note this as a limitation in the data, as this reflects only an 8.1 percent response rate from the group of 7,000 community banks to which the ICBA distributed the survey.
3) Consumers who use overdraft payment programs prefer them to other short-term funding options.

4) Most consumers avoided overdrafts in the previous 12 months.

5) Frequent account monitoring does not deter overdrafts.

6) Consumers who use overdraft services are more likely to take out a payday loan.

7) A consumer’s choice of financial institution makes a difference.”

Consistent with prior studies of overdraft payment programs, the ICBA study found that a majority of consumers (79.1 percent) did not incur an overdraft fee in the prior twelve months. The study offers several broad-sweeping recommendations for overdraft regulatory policy, including the following:

1) Regulatory policy and oversight should not impede community banks’ ability to offer a variety of overdraft payment services to meet their customers’ financial needs.

2) Consumers must retain the ability to choose overdraft services that best fit their financial needs.

3) The regulatory environment should distinguish between ad hoc overdraft payment and automated overdraft payment programs.

4) Overdraft regulation must avoid unreasonable and burdensome customer contact requirements.

5) Public policy must be crafted carefully to ensure consumers’ financial needs are met within the banking system. [emphasis added]

The most meaningful points from the community banker perspective are bolded above.

A potential unintended consequence of additional overdraft regulation may be that consumers would seek to meet their financial needs outside the banking system. Therefore, it is essential for the CFPB to target aspects of overdraft programs that will not restrict consumer choice within the banking system. The survey found that approximately one-fifth of consumers who overdrew their accounts in the prior twelve months had also taken out a payday loan. This finding
solidifies the risk of consumers exiting mainstream banking if financial institutions are not able to provide viable options. However, the ICBA’s recommendations are limited to conceptual considerations for the rulemaking process, rather than substantive concrete proposals on what the regulatory construct should or should not look like.

Furthermore, the study isolates participants categorized as “frequent overdrafters,” defined as those who have overdrawn their accounts six or more times in the past twelve months, and draws some significant conclusions. Frequent overdrafters, representing only 1.6 percent of survey participants, are more likely than those consumers who overdrew their accounts less frequently to have lower incomes, and are less likely to have graduated college. These characteristics support the observations noted in the FDIC Overdraft Survey in 2008 – that a disproportionate share of overdraft fees are shouldered by more vulnerable groups of consumers.

The community bank survey component provides support for the recent nature of banks introducing automated overdraft programs to help bolster earnings. Specifically, 52.6 percent introduced an automated overdraft program within the past five years, with just under half having introduced an automated program in the past 5-10 years.

All 575 participating institutions indicated that they provide disclosures of their overdraft payment programs, and a vast majority disclose alternative overdraft services. Based on this information alone, the study tenuously concludes that community banks effectively disclose

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15 By income level, the group most likely to have incurred an overdraft fee was consumers with income between $20,000 and $30,000, at 26.1 percent. The group least likely to incur an overdraft fee was consumers with income between $75,000 and $100,000, at 15.0 percent. In addition, by education level, the group most likely to have incurred an overdraft fee was consumers who did not complete high school, at 28.6 percent. The group least likely to incur an overdraft fee was consumers who completed a post-graduate degree, at 18.6 percent.

16 Only 2.6 percent of respondent banks had an automated overdraft program in place longer than ten years.
features of overdraft programs and alternative services. This conclusion appears fundamentally flawed, as the study lacks a review to determine accuracy and effectiveness of these disclosures.

**American Bankers Association’s August 24, 2011 Letter to OCC, FRB, FDIC, and CFPB**

The primary purpose of this letter, entitled “Imposing Undue Regulatory Burden on Consumer Choice and Compliance,” was to highlight the potential consequence of a suboptimal future caused by the agencies each writing separate, conflicting guidance on overdraft programs. The letter requested that the OCC “back away” from its proposed overdraft guidance, and more importantly, encouraged each of the agencies to establish uniform supervisory expectations governing overdraft programs.

**American Bankers Association Survey of Consumers Who Regularly Use Overdraft Protection Services**

In a letter responding to the CFPB’s June 2013 *White Paper*, dated October 7, 2013, the ABA provided a summary of its own overdraft survey findings. Specifically, the ABA sponsored a survey of 501 consumers nationwide who had incurred an overdraft fee six times or more in a twelve-month period. The ABA noted in this letter that the CFPB’s white paper lacked demographic information on accountholders who use overdraft services the most. The ABA’s survey attempted to void the gap in demographic data.

In a subsequent letter to the CFPB, dated October 17, 2013, the ABA discloses its survey results and claims to support “a dramatically different picture of regular users” of overdraft protection than prior studies revealed. For example, the letter indicates that only 12 percent of

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17 Appendix F to the ICBA study is the “Community Bank Survey Instrument.” The survey includes five questions about when an institution discloses its overdraft program or alternatives and how consumers are informed of each; all questions have multiple choice responses.

18 The survey was conducted by The Mellman Group, Inc. Of the 501 survey participants, 39 percent incurred between 6 and 10 overdraft fees; 29 percent incurred 11-20 overdraft fees; and, 32 percent incurred 21 or more overdraft fees in one of two twelve month periods (July 1, 2011 through June 30, 2012, or June 30, 2012 through July 1, 2013). The 501 participants were selected from accountholders at 12 ABA-member institutions with total assets ranging from $300 million to $3 billion.
this targeted survey’s respondents earned $30,000 or less. The letter, however, obscures the fact that 30 percent of participants refused to provide income information. The survey appears flawed in its income assumptions as well, as it bases income determinations from a United States (“U.S.”) median household income of $52,000\(^{19}\). This assumption results in an artificially deflated threshold for the low-income category. To illustrate this point, the 2015 FFIEC-updated median family income (“MFI”) list by metropolitan statistical area (“MSA”), metropolitan division (“MD”), and statewide non-MSA shows that only 58 of 447 these MSAs, MDs or statewide non-MSA areas have a MFI of $52,000 or less. The range of MFI levels greater than $52,000 nationwide extends upward to $121,600, with two-thirds of these falling between $65,000 and $80,000. Therefore, an individual or family in areas where the MFI falls in this range would be classified as low- or moderate-income (at 50 percent and 80 percent of MFI, respectively) if their income was less than $52,000 to $64,000 depending on geographic location. The lack of consideration in this survey of geographic location and the impact that factor has on categorizing income levels results in potentially unsound conclusions.

The letter further claims that regular overdraft users are not vulnerable; a claim based on education levels of respondents. Responses to questions on education levels, opinions on participants’ financial management skills, and household income levels led to the ABA concluding that, “A dramatically different picture of regular users is emerging – that is, a significant majority are educated, middle- to upper-income individuals who have confidence in their ability to manage their financial affairs…including overdraft protection.” The survey, however, does not consider other potential indicators of vulnerability, such as age. The data points shared in the letter to the CFPB also do not appear to support the above-referenced claim identifying a “significant majority” of overdraft users.

\(^{19}\) U.S. Census Bureau data shows a 2013 median household income of $51,939.
While the letter presents claims to alter the CFPB’s view of potential regulation with the conclusions addressed above, it is in the more briefly mentioned points I draw important inferences. For example, the letter notes that less 10 percent of respondents would be willing to go to a payday lender, auto title lender, or pawnshop as an alternative to overdraft services. This provides evidence refuting claims made by the ABA that further overdraft regulation would force consumers to exit the traditional banking system. Moreover, nearly half of survey participants did not recall that they had opted-in to an overdraft program. This result indicates, despite most respondents having good confidence in their financial management abilities, that decisions specific to overdraft services may not have been well-informed.

**Independent Research**

Research on overdraft programs and usage has not only been limited to studies by regulatory agencies and industry groups. Independent studies have been conducted as well. This section provides detail on key research papers published by The Pew Charitable Trusts (“Pew”).

**Pew Charitable Trust – Background**

(“Overdrawn”) issued in June 2014. For purposes of this research, I will focus on the 2015 update to “Checks and Balances,” and “Overdrawn,” as these reports are the most current and relevant.

**Pew – Checks and Balances**

The *Checks and Balances* series focuses on three attributes of checking accounts: disclosures, overdraft practices, and error resolution procedures. I will summarize Pew’s analysis and conclusions from the 2015 report solely as they relate to overdraft practices. Pew examined the practices of 45 of the nation’s 50 largest banks, which account for approximately two-thirds of domestic deposits. The following points detail Pew’s overdraft-related recommendations to the CFPB:

1) Require depository institutions to provide accountholders with clear, comprehensive terms and pricing information for all available overdraft options when a customer is considering opting in to a plan.

2) Require that overdraft penalty fees be reasonable and proportional to the institution’s cost in providing the overdraft loan or to the size of the violation [amount of the transaction].

3) Require depository institutions to post deposits and withdrawals in a fully disclosed, objective, and neutral manner, such as in chronological order, which does not maximize overdraft fees.

While the current set of federal banking regulations require disclosure of overdraft terms and pricing, the subsequent Pew recommendations are either not addressed in regulations or regulatory guidance, or only addressed in regulatory guidance.
Of the 45 institutions studied, overdraft penalty fees ranged from $0 to $39, with a median overdraft penalty fee of $35. Due to these high fees on a per transaction basis, Pew identifies standard overdraft coverage as the most expensive form of overdraft service. Pew research revealed a positive trend of institutions not reordering transactions from high to low dollar amounts. Specifically, 41 percent of banks studied in 2013 did not reorder, which increased to 47 percent in 2014, and increased again to 56 percent in 2015. An even higher percentage (91 percent in 2015) of studied banks did not reorder at all, or only reordered transactions on a limited basis. Limited reordering would generally apply to less common transaction types (e.g. paper checks), but may still negatively impact neutrality in transaction processing. Please note that each of the percentages above include institutions that do not charge an overdraft fee.

Pew also analyzed *de minimis* thresholds across the 45 institutions studied. The 2015 *Checks and Balances* report notes that 69 percent of institutions had a *de minimis* threshold, either by transaction amount or by total negative balance. Similar to the increasing trend noted with respect to banks that do not reorder transactions, the percentage of banks with a transaction- or balance-driven *de minimis* threshold increased from 63 percent in 2013 to 75 percent in 2015 (again, these percentages include banks that do not charge an overdraft fee).

One negative trend that Pew identified was the increasing number of banks that charge an extended overdraft fee. A majority, or 58 percent, in 2015 charged an extended overdraft fee. The median amount of the fee was $15, and the range in days before the fee would be imposed ranged from 3 to 31 days. Furthermore, while a vast majority (91 percent) of institutions capped daily overdraft fees, the range was 1 to 10 instances of a fee, with a median of 5 fees. These caps are not meaningful, as significant financial harm to consumers may still result.
Pew – Overdrawn

Pew’s June 2014 “Overdrawn” brief outlines its research derived from a commissioned survey of checking accountholders. The survey included interviews of 1,804 consumers nationwide, and resulted in categorizing each respondent into the following categories:

1) Overdrafters: Paid an overdraft penalty fee for a debit card transaction.
2) Transferers: Paid an overdraft transfer fee for a debit card transaction.
3) Decliners: Had a debit card transaction declined instead of paying an overdraft fee.
4) Never-negatives: Never completed a debit card transaction that would have resulted in a negative account balance or had a transaction declined for insufficient funds.

Regardless of the category a surveyed accountholder was in, all expressed similar concerns about overdraft practices despite their different overdraft experiences. A large percentage of those who incurred fees were concerned about the high penalty and the practice of charging an extended overdraft fee, and an even larger percentage expressed a preference for a debit card transaction to be declined rather than incurring an overdraft penalty fee.

The Overdrawn brief presents a profile of consumers who overdraft. Of significance is that a 25-year old is more than two times more likely to pay an overdraft penalty fee than a 65-year old. Similarly, consumers with incomes less than $100,000 are twice as likely to incur an overdraft fee than consumers with incomes of $100,000 or more. Non-white (minority) consumers are almost twice as likely to pay an overdraft fee than white consumers. Each of these comparisons reflects a disparity in the likelihood of certain groups of consumers incurring overdraft penalty fees, and provides support to prior studies’ demographic observations that indicated vulnerable populations incurred overdraft fees at greater frequency than other groups.
Even more concerning is that over half of consumers surveyed indicated they did not recall opting in to overdraft coverage (2012-2013).

**Examination Activities and Enforcement Actions**

This section provides detail on regulatory examination findings, consultations, and enforcement actions related to overdraft practices.

The FDIC’s *Compliance Examination Manual* discusses the central concept of identifying, addressing, and preventing consumer harm in scoping its examination activities. This principle also applies to consideration of overdraft payment programs. While most often not resulting in the issuance of a formal enforcement action, such as a Restitution Order or the assessment of a civil money penalty (“CMP”), the FDIC has performed transaction testing of overdraft programs and identified several violations of Section 5 of the FTC Act and/or Regulation DD and Regulation E. The review of data between January 2012 and September 2015 revealed that examiners initiated a significant number of Regional and Washington Office consultations on potential unfair or deceptive overdraft practices.\(^{20}\) The following sections provide detail on more frequently occurring violations that involved consumer harm.

One frequently identified issue related to institutions’ unfair and deceptive practices in the disclosure and assessment of continuous overdraft fees. The common theme across these cases was misalignment between the institutions’ disclosures and actual practices of imposing continuous overdraft fees. For example, one institution assessed a continuous overdraft fee retroactively; whereas, the disclosure indicated the fee would be assessed on the second day the account remained negative and each subsequent day until the account was returned to a positive balance. Another institution disclosed that it would assess its continuous overdraft fee beginning

\(^{20}\) The FDIC’s *Compliance Examination Manual* requires examiners to consult with the Regional and Washington Offices when considering potential UDAP violations.
on the fourth day, but actually charged at the end of the third day. This practice resulted in an unavoidable fee for an extra day.

Several case consultations highlighted the inherently unfair nature of assessing a continuous overdraft fee on a calendar day basis, while the consumer only has the opportunity to cure the overdraft on business days. This practice resulted in some instances where extra fees for up to three non-business days were assessed, but were unavoidable for the consumer. This situation would arise when a federal holiday immediately preceded or followed a weekend.

In addition, an examination of a large, regional institution revealed multiple unfair and deceptive overdraft practices. Of particular note were UDAP violations surrounding deceptive disclosures on the Regulation E opt-in notice, and material omissions and misrepresentations related to an overdraft transfer program. In this case, the FDIC ordered the institution to provide $2.4 million in restitution to nearly 50,000 consumers impacted by the deceptive overdraft practices and pay a $2 million civil money penalty.

Several consultations addressed the topic of payment processing and excessive overdraft fees imposed due to the manner in which signature-based debit card (POS) transactions were processed. As previously discussed, merchants generally submit preauthorization requests upon a consumer engaging in a POS transaction. This results in a hold being placed against the debit card user’s available balance, despite the ledger balance remaining unaffected. Such holds reduce the available balance until the transaction posts; generally within one or two business days. Assessing overdraft fees on an available balance basis may result in fees that would not have been imposed using the actual, or ledger, balance. Depending on the specific facts and circumstances of each case, assessing overdraft fees on an available balance basis may be unfair and deceptive, or just unfair.
Most cases did not reveal any concern of willful non-compliance. Rather, erroneous system settings, of which bank management was unaware, was at the root of most violations, thus causing consumer harm inadvertently. While formal enforcement actions such as Restitution Orders and/or CMPs were not always necessary, corrective actions common across all cases included reimbursement to customers; updating disclosures and/or system settings; and instituting improvements to applicable components of the compliance management system. Considering that circumstances varied significantly across cases, the level of the violation, restitution, and enforcement action depended on analyses of objective factors such as management’s cooperation and willingness to make restitution, egregiousness of the violation, and intent.

In a highly publicized move on April 28, 2015, the CFPB announced its first enforcement action against an institution for charging overdraft fees to consumers who had not opted in to overdraft coverage. The CFPB cited the institution for violations of Regulation E and of Section 1036(a)(1)(B) of the Consumer Financial Protection Act, which prohibits unfair, deceptive, or abusive acts or practices. While multiple issues were noted, the primary violation of Regulation E stemmed from bank management’s erroneous determination that opt-in requirements did not apply to customers who had a savings account linked to a checking account for overdraft coverage. The practice impacted hundreds of thousands of customers, resulting in financial harm of approximately $49 million. The CFPB assessed a $7.5 million penalty against the institution as well.
V. RECOMMENDATIONS

Based on the findings of my research, I recommend that the FDIC provide the following input for the CFPB’s consideration in their rulemaking surrounding overdraft payment services. Each recommended provision would be appropriately housed in Regulation DD – Truth in Savings.

1) Transaction processing order – Require institutions to process transactions in a neutral and objective manner. Institutions should not have the flexibility to re-order transactions in a manner that maximizes overdraft fee income.

2) Calculation of account balances – Prohibit the assessment of overdraft fees on an available balance basis. Available balance determination is often complex, lacks transparency to consumers, and can result in additional, unavoidable overdraft fees; therefore, assessing fees on a ledger balance basis would ensure clarity and fairness in imposing overdraft fees.

3) Continuous overdraft fees – Prohibit the assessment of such fees on non-business days. Assessing such fees for days in which the consumer does not have the opportunity to return an account to a positive balance is an inherently unfair practice.

4) De minimis thresholds – Require a transaction amount or balance-driven *de minimis* of no less than $10, below which overdraft fees would not be imposed. Implementing a required threshold would help ensure that the expense to the consumer bears a reasonable relationship to the risks borne by the institution in allowing consumers to overdraw their accounts.
5) **Meaningful limits on fees** – Prohibit the assessment of more than three overdraft fees daily. Implementing effective limits on overdraft fees would help ensure a reasonable relationship between the fee(s) and the costs or risks to an institution associated with covering multiple overdrafts.

These recommendations are data-driven, considering the findings of various regulatory, industry, and independent studies, as well as regulatory examination findings and enforcement actions. The significant level of consumer harm these proposed requirements set out to prevent far outweighs potential related decreases to financial institutions’ fee income. In addition, none of these requirements should dissuade financial institutions from providing overdraft services, and would not likely result in consumers exiting mainstream banking.
VI. SOURCES


