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COMMENTARY: CFPB STUDY OF OVERDRAFT PROGRAMS

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ABSTRACT

The Consumer Financial Protection Bureau (CFPB) released its initial analysis of bank overdraft programs in a June 2013 white paper. We review the report and provide commentary on its methodology, its preliminary conclusions, and gaps in its analysis. We provide a synopsis of findings from previous third-party analyses to lay the foundation for our response, and then we follow the paper's organizational structure as we discuss specific points it makes. We also identify the larger policy questions of access to credit, alternative sources of credit, and the economic benefit attained by the use of overdrafts. These questions must be addressed before the bureau can make any findings of consumer harm that would justify new regulation and the resultant unintended consequences of limiting options to the consumers the CFPB is structured to protect.

JEL codes: D14, D18, G21, G28

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INTRODUCTION

Created as part of the Dodd-Frank financial reform legislation, the Consumer Financial Protection Bureau (CFPB) was established in response to the perception of widespread failures concerning financial products in the federal consumer protection regime. As part of its mission, the bureau has consistently pledged itself to ground consumer financial protection policy in data and empirical evidence so as "to enable informed decision-making in all internal and external functions."[1]

Pursuant to that mission, in April 2012 the CFPB announced a public inquiry and industry research study to gain insight into the impacts of overdraft (OD) protection on consumers.[2] In its Request for Information, the CFPB specifically sought public comment on how consumers use overdraft programs, the information they receive about various banking products, the impact of prior overdraft regulations, and the costs of providing overdraft protection. In the statement that is perhaps most relevant and important for policy purposes, the CFPB said that it was seeking to determine what "alternatives consumers have for meeting short-term shortfalls."[3]

In June 2013, the CFPB published a white paper that summarizes its findings on the usage of overdraft protection.[4] Notably, however, the white paper falls short of the CFPB's own proffered standards and guidelines for investigations regarding overdraft protection. Although the white paper suggests that it is merely a "first

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1. CFPB, *Consumer Financial Protection Bureau Strategic Plan FY 2013–FY 2017* (Washington, DC, April 2013), http://www.consumerfinance.gov/strategic-plan/.
2. See CFPB, "Impact of Overdraft Programs on Consumers," 77 Fed. Reg. 24687 (April 25, 2012), http://www.gpo.gov/fdsys/pkg/FR-2012-04-25/html/2012-9851.htm.
3. Gary Stein (deposits markets program manager at the CFPB), "Comment Period on Overdrafts Extended to June 29," CFPB blog, April 25, 2012, http://www.consumerfinance.gov/blog/category/overdrafts/.
4. CFPB, *CFPB Study of Overdraft Programs: A White Paper of Initial Data Findings*, June 2013, http://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf. Although the white paper provides some discussion of the cost of overdraft protection to consumers and its value to banks, it does not systematically attempt to determine what alternatives are available to consumers or whether consumers who reduce their use of overdraft protection increase their use of other expensive alternatives or whether less-expensive alternatives (such as a bank line of credit or linked savings account) are actually available to overdraft users.

step" toward understanding whether overdraft protection can harm consumers, it makes numerous inferences that the underlying analysis does not support.

The white paper organizes its analysis around potential consumer protection problems that it purports to identify. In this comment, we provide a synopsis of findings from previous analyses to lay the foundation for our response to the white paper. We then follow the paper's organizational structure as we discuss specific points it makes. However, unlike the white paper, we also identify the larger policy questions that must be addressed before the bureau can make any findings of consumer harm that would justify new regulation. What's more, these are questions that the CFPB itself said it intended to address in its research, but did not.

BACKGROUND

PRIOR ANALYSIS HAS consistently found that the consumers who use overdraft protection regularly are those with impaired credit who lack more attractive alternatives to credit, and thus that consumers who are unable to access overdraft protection are likely to turn to other, perhaps more expensive, alternatives.[5] Moebs Services research firm, for example, states that the only accurate predictor of the propensity to overdraft is credit score—those with lower credit scores are more likely to use overdraft protection.[6]

A survey conducted by Raddon Financial Group of customers of a large regional bank asked users of overdraft services where they would turn for emergency funds if they no longer had access to overdraft protection.[7] Fifty-three percent of "elevated users" of overdraft protection reported that if it were not available they would "not be able to get money," as opposed to only 16 percent of nonusers.[8] While 26 percent of nonusers of overdraft protection said they would "use a credit card" if overdraft protection were unavailable, only 10 percent of elevated users said they would use a credit card. Similarly, while only 6 percent of nonusers said they would seek a payday loan if overdraft protection were unavailable, 24 percent of elevated users reported that as their option (the second-highest response after "not be able to get money" for elevated users).[9] Moreover, while 56 percent of nonusers said that in such situations they would simply transfer the needed money from another account, presumably a savings account, only 13 percent of elevated

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5. See Todd J. Zywicki, "The Economics and Regulation of Bank Overdraft Protection," *Washington and Lee Law Review* 69 (2012): 1163–75.
6. Moebs Services, "Who Uses Overdrafts?," press release, Sept. 29, 2009, http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/%20ItemID/194/Default.aspx.
7. See Raddon Financial Group, "Custom Survey Research Findings," June 2011 (on file with Washington and Lee Law Review).
8. Ibid. Thirty percent of low users and 39 percent of moderate users said that they would be unable to get money.
9. Ibid.

users said they would do so, presumably reflecting the simple truth that they have no other accounts available.[10]

Regular users of overdraft protection have low credit quality and limited credit alternatives.[11] According to the Raddon survey, for example, only 7 percent of elevated users of overdraft protection describe their personal assessment of their credit rating as "excellent," while 70 percent describe their credit rating as "fair" or "poor" (38 percent and 32 percent, respectively). By contrast, 74 percent of nonusers of overdraft protection describe their credit rating as "excellent" or "good," and only 9 percent consider their credit rating "poor."[12] Thus, reducing access to overdraft protection likely would exacerbate the plight of those who rely on it because of the lack of better alternatives to replace it.

For many consumers who use overdraft protection regularly, the most likely alternative is either bounced checks and declined payments—with resulting nonsufficient funds (NSF) fees and perhaps termination of utilities and other dire consequences—or a payday loan.[13] Research by economists Morgan, Strain, and Seblani on the impact of state payday loan bans also shows that consumers substitute between the two products.[14] As predicted, they find that when a state bans payday lending, overdraft revenues increase at banks, whereas allowing payday lending results in a decline in bank overdraft fee revenue. While payday loans may often be less expensive than overdraft protection for those who choose between the products, the CFPB has also expressed concerns about the cost and usage of payday loans by consumers;[15] thus it is hard to believe that the CFPB would seek to adopt policies that might restrict the most cost-effective credit options to meet consumers' specific short-term credit needs, whether this be in the form of overdraft protection or payday loans.

Data from the International Bank of Commerce (IBC Bank), a regional bank in the southwest, indicate that over a period of one year (August 1, 2012–July 31, 2013) overdrafts (spending) totaling $437.6 million cost consumers $58.8 million.[16] That is, there was an economic benefit multiplier of 7.4 times the cost of the overdrafts. For point-of-sale (POS) and ATM overdrafts, the multiplier was 4.9 times. These multipliers are valid even if the consumer does not have access to overdrafts but chooses to use alternative credit providers (if the consumer qualifies). The multiplier

10. Raddon, "Custom Survey Research Findings."
11. Ibid.
12. Ibid.
13. Baselice & Associates, Inc., Banking Survey (Aug. 29–31, 2011), on file with authors.
14. Donald P. Morgan, Michael R. Strain, and Ihab Seblani, "How Payday Credit Access Affects Overdrafts and Other Outcomes," *Journal of Money, Credit, & Banking* 44 (2012): 519–31.
15. Todd J. Zywicki, "The Case against New Restrictions on Payday Lending" (Working Paper No. 09-28, Mercatus Center at George Mason University, Arlington, VA, 2009), http://mercatus.org/sites/default/files/publication/WP0928_Payday%20Lending.pdf.
16. IBC Bank, "Overdraft Data," on file with authors.

would be impacted if the purchase were merely deferred until funds were available. However, an economic disadvantage (additional costs) would accrue to consumers if overdrafts or other credit options were unavailable or the purchase were deferred. Possible disadvantages include late fees, utility disconnections, and forgoing necessary purchases (food, pharmaceuticals, auto repairs, etc.).

The CFPB is concerned about consumers who opt in for ATM and POS overdrafts. Our analysis of IBC Bank data shows that the majority of POS overdrafts were for necessities. The transactions were tracked by the Merchant Category Classification (MCC) code. Of the 380 categories in the MCC code, the top 11 accounted for 60 percent of the transactions and 55 percent of the principal overdrawn. As shown in table 1, these 11 categories are primarily for food, fuel, utilities, and financial services that one could reasonably consider necessities.

TABLE 1. TOP 11 CATEGORIES OF POINT-OF-SALE OVERDRAFTS BY MERCHANT CATEGORY CLASSIFICATION (MCC), AUGUST 1, 2012, TO JULY 31, 2013

MCC code	MCC description	Transaction amount (dollars)	Percentage	Cumulative percentage	Volume count	Percentage	Cumulative percentage
5411	Grocery stores	2,162,275.77	14.09	14.09	27,045	11.62	11.62
5542	Automated fuel dispensers	1,121,739.17	7.31	21.40	25,493	10.95	22.57
4814	Telephone services	910,065.21	5.93	27.33	7,029	3.02	25.59
4899	Cable and other pay television (previously "cable services")	747,709.03	4.87	32.21	7,081	3.04	28.63
5814	Fast-food restaurants	740,628.08	4.83	37.03	27,831	11.96	40.58
4900	Electric, gas, sanitary, and water utilities	641,218.88	4.18	41.21	4,526	1.94	42.53
5812	Eating places and restaurants	631,693.06	4.12	45.33	16,206	6.96	49.49
5541	Service stations (with or without ancillary services)	516,822.52	3.37	48.70	20,131	8.65	58.14
6300	Insurance sales, underwriting, and premiums	488,207.68	3.18	51.88	3,611	1.55	59.69
6012	Financial institutions: merchandise and services	246,607.62	1.61	53.49	703	0.30	59.99
4829	Money orders: wire transfer	208,566.64	1.36	54.85	572	0.25	60.24

Source: IBC Bank, "Overdraft Data," on file with authors.

The value of these overdraft programs for overdraft users is also revealed in a June 2011 survey by Raddon Financial Group of customers of one large regional bank. The survey found that, when asked to rank the value of overdraft protection from "extremely valuable" to "not at all valuable," 86 percent of elevated users stated that the availability of overdraft protection was extremely valuable; only 2 percent said it was not at all valuable.[17] Moreover, the percentage of those stating that overdraft protection was extremely valuable rose consistently with the intensity of use, from 57 percent for nonusers of overdraft protection to 86 percent for elevated users. Overall, of 2,009 respondents to the online survey, 71 percent said that access to overdraft protection was "extremely valuable" and another 21 percent said it was "somewhat valuable." Only 4 percent said it was "not at all valuable." These results are consistent with research findings on other forms of nontraditional credit, such as payday lending.

ANALYSIS

THERE ARE SEVERAL aspects of the white paper that raise concerns, including the following:

- general statements that are not supported by rigorous analyses,
- selective quotations that do not provide context that would accurately portray the meaning as intended in the original source,
- leading statements in the body of the white paper that are then modified in footnotes,
- lack of discussion of the economic welfare overdraft protection provides to a population with few other options,
- no discussion of the democratization of providing overdrafts to low- to moderate-income consumers. (Historically, overdrafts were a service to the most highly valued customers, but now they are available to the vast majority of checking customers.)

More generally, there is a crucial, unexplored question that hangs over the entirety of the white paper's analysis and conclusions: Regardless of the cost or usage patterns of overdraft protection, do those consumers who use the product exhibit a reasonable understanding of their choices, their available alternatives, and the product's features?

Failure to recognize these limits of the white paper could lead to subsequent regulatory and enforcement actions that may be harmful to consumers and the

17. See Zywicki, "Economics and Regulation of Bank Overdraft Protection," 1173.

economy. It is our hope that future reports in this series will address these concerns and will, in fact, derive conclusions based on objective data.

We now address the areas where we agree and where we take issue with the white paper's key findings and discussions.

"Costly Service"

THE WHITE PAPER states that its investigation "indicate[s] that overdraft programs can be costly for the consumers who use them."[18] Although it is trivially true that overdraft protection can be "costly" in some absolute sense, this conclusion is largely irrelevant to the fundamental question that the CFPB sought to address: namely, what market alternatives are available to consumers who use overdraft protection regularly. This is a crucial question for the CFPB to consider in deciding whether to enact new regulations on overdraft protection.

Standard economic analysis recognizes that it is simply insufficient to classify a particular good or service as "costly" without also investigating the alternatives: "as compared to what?" On this crucial point, the white paper is largely silent.

Instead of focusing on the alternatives actually available to regular users of overdraft protection—namely, payday lending and other products—the white paper merely compares the cost of alternative bank products. In particular, the white paper states that approximately 90 percent of banks that offer overdraft protection also offer some sort of "linked credit line for overdraft protection."[19] The CFPB notes that these linked accounts "may include dedicated overdraft lines of credit—i.e., lines that are only accessible by overdrawing the associated checking accounts—as well as multipurpose personal lines of credit, credit cards, and home equity lines of credit."[20]

This observation, however, ultimately misses the point: determining the true alternatives to overdraft protection for those who rely on the product extensively and the effects its removal would have on consumers' welfare. It hardly seems plausible that many of those who frequently rely on overdraft protection could qualify for upper-class consumer credit products such as "multipurpose lines of credit, credit cards, and home equity lines of credit," yet routinely choose overdraft protection. Nor is a bank line of credit likely to be a realistic alternative for most overdraft users.[21] Approval for a bank line of credit requires a credit score far in excess of that of the typical overdraft user. In addition, a line of credit typically requires a minimum of approximately $2,500, far exceeding the $300–$800 available for overdraft protection. In fact, the spread of overdraft protection was

18. CFPB, *CFPB Study of Overdraft Programs*, 4.
19. Ibid., 51.
20. Ibid., 51–52.
21. See Zywicki, "Economics and Regulation of Bank Overdraft Protection," 1192.

hastened by the regulatory difficulties of offering a line of credit to consumers, for example those due to the Card Act, and the economic difficulties caused by the recession, which impaired consumers' ability to qualify for these products.[22] While it may be the case that 90 percent of banks offer products such as home equity lines of credit, credit cards, and general lines of credit, these products are likely unattainable by the credit-impaired consumers who rely on overdraft protection.

As a result, though the white paper states the obvious point—overdraft protection can be expensive—it fails to address its own central question, which is *whether less expensive alternatives are available to those who use it*. If regulation or other intervention has the effect of shifting consumers to *more* expensive alternatives, or to alternative types of credit that present similar consumer protection concerns, then intervention will be unlikely to help consumers.

In addition, there are several methodological problems that underlie the white paper's measurements. We discuss each of those specifically.

On page 15, the white paper states that "overdraft and NSF-related fees from consumer checking accounts constituted 61% of consumer and 37% of total deposit account service charges earned by these banks in 2011." It then alleges that an extrapolation would understate total industry overdraft revenue, referring to documents from publicly held banks that report OD and NSF revenue ranges from 41 percent to 56 percent of total deposit account service charges in 2012. The CFPB's premise considers *consumer-generated* NSF/OD revenue (37 percent of total service charge revenue) versus *total* NSF/OD revenue (41–56 percent of total service charge revenue). To be accurate, the comparison should be to *consumer-generated* NSF/OD revenue from the publicly traded banks. We reviewed the source information from footnote 12 of the white paper, and only total NSF/OD revenue is disclosed in the public documents.

Moreover, reporting these revenues in isolation can be confusing. As noted, the growth in revenues from overdraft protection was coterminous with a rise in free checking and the general decline of monthly maintenance fees at banks. Thus, while it is true that overdraft revenues comprise a substantial portion of bank service charges, this is due to the elimination of monthly maintenance fees with free checking. As banks are now reimposing new or higher monthly service charges as a result of lost overdraft revenues, it is true that the *percentage* of revenues attributable to overdraft protection will fall. But it is highly questionable whether consumers overall would be better off as a result of the higher maintenance fees and other restrictions (such as higher minimum balance requirements) that would accompany lost access to overdraft protection. Indeed, given the rapid spread of the free banking model in the first decade of the 21st century and its great popularity with consumers,

22. See Comment of International Bancshares Corp. to the Federal Deposit Insurance Corporation (Sept. 24, 2010), 4, http://www.fdic.gov/regulations/laws/publiccomments/overdraft_comments/2010-09-24-ibc.pdf.

it is doubtful that increased reliance on monthly maintenance fees would improve overall consumer welfare.

The next paragraph in the white paper states,

> The study banks, while representing a large share of consumer deposits, are banks serving large commercial clients as well as consumers. Smaller institutions are generally less likely to provide deposit services to large corporate clients and thus are likely to have a larger percent of their deposit service charges attributable to consumer accounts, and more specifically, to overdraft and NSF fees.

That statement is not supported by hard data.

The difference between small and large banks may not be very significant because total service charge income and NSF/OD revenue at larger banks with large corporate clients is understated in their call reports, since most large corporate customers are on account analysis where NSF/OD activity is analyzed with all other activity and where some or all of the fees are waived because of offsetting net investible balances. For the accounts where balances are insufficient to compensate for the activity, a net service charge may be booked and reflected in the reported "service charges on deposit accounts." Therefore, consumer NSF/OD fees may not be a significantly smaller percentage at larger banks.

Finally, the white paper refers to a community bank study[23] showing that "overdraft and NSF fees . . . compose 27.5% of respondent net income after taxes."[24] For the year 2011, we believe this is accurate. But to focus only on 2011 is highly selective and misleading. As a matter of fact, figure 1 shows how in the three years before 2011 service charge income was greater than or nearly equal to net income after taxes due to poor interest margins, increased loan losses, and higher operating expenses.

Without context, these statistics could lead readers of the white paper to think that NSF/OD fees provide a source of inordinate revenue for banks. NSF/OD fees may be a consistent source of bank revenue, but the other sources of profitability have been quite volatile in the last several years. Thus, the apparently disproportionate contribution of overdraft protection to bank profitability reflects the unusual *lack* of profitability of other bank margins in the post-crisis period, not unusually large profits from the provision of overdraft protection services.

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23. Independent Community Bankers of America, *The ICBA Overdraft Payment Services Study* (June 2012), http://www.icba.org/files/ICBASites/PDFs/2012OverdraftStudyFinalReport.pdf.
24. CFPB, *CFPB Study of Overdraft Programs*, 61.

FIGURE 1. COMMUNITY BANK INCOME FROM SERVICE CHARGES VS. NET AFTER-TAX INCOME

Note: Reporting banks are national commercial banks with assets between $100 million and $1 billion. Percentages are averages measured each year from a sample of more than 3,000 banks.

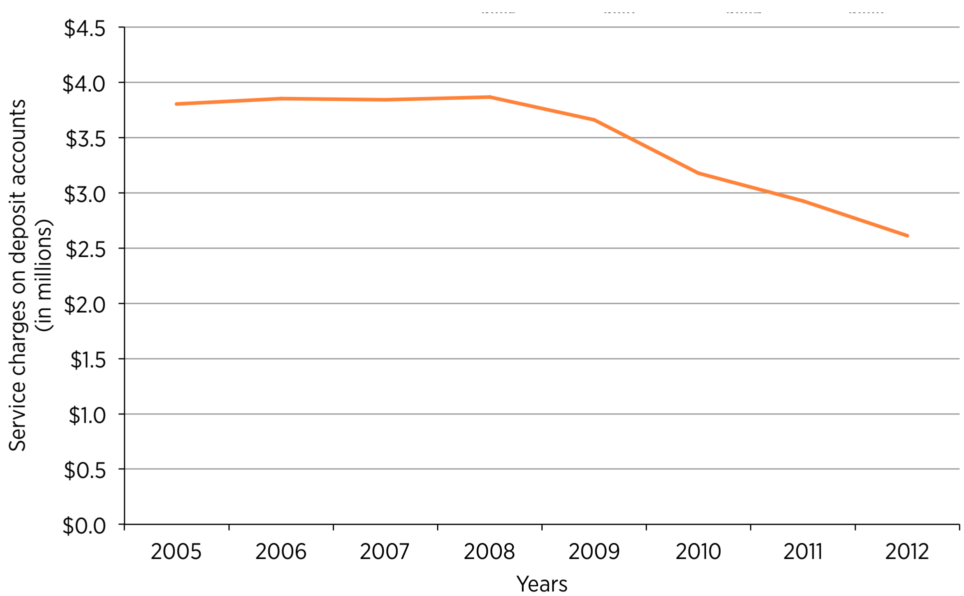
Source: FDIC, "Statistics on Depository Institutions," last modified June 26, 2013, http://www2.fdic.gov/sdi/index.asp.

When one looks at FDIC data for *all* community banks in the $100 million to $1 billion asset range from 2005 through 2012, as shown in figure 2, the trend statistics indicate that service charge income has been falling steadily since 2008[25]—well before implementation of revised Regulation E (Reg E) rules required by Dodd-Frank.[26] One possible explanation was and is the state of the economy and its effect on consumer spending patterns.

25. Data are from FDIC, "Statistics on Depository Institutions," last modified June 26, 2013, http://www2.fdic.gov/sdi/index.asp.

26. The overdraft services rule limits the ability of a financial institution to assess overdraft fees for paying ATM and one-time debit card transactions that overdraw a consumer's account unless the consumer affirmatively consents, or opts in, to the institution's payment of overdrafts for those transactions. This rule became effective July 1, 2010, for new account holders and August 15, 2010, for existing account holders. 12 C.F.R. 205.17. See also Office of the Comptroller of the Currency, "Electronic Fund Transfer Act—Regulation E" (bulletin, OCC 2011-43, Oct. 21, 2011), http://www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-43.html.

FIGURE 2. COMMUNITY BANK INCOME FROM SERVICE CHARGES ON DEPOSIT ACCOUNTS, 2005–2012



Note: Reporting banks are national commercial banks with assets between $100 million and $1 billion. Totals were collected each year from a sample of more the 3,000 banks.

Source: FDIC, "Statistics on Depository Institutions," last modified June 26, 2013, http://www2.fdic.gov/sdi/index.asp.

On page 16, the white paper reports that "the FDIC found in its study of bank overdraft programs that 41% of all NSF and overdraft transactions occurring in 2006 at banks with automated overdraft programs were related to use of debit cards at the point of sale." This is reasonable. Looking at the IBC Bank data, we found that 36 percent of consumer and 21 percent of commercial NSF/OD fees were attributable to POS transactions.[27] However, what does this mean? How does it compare to those banks without automated overdraft programs? Finally, how does this track with the general trend of consumers writing fewer checks and migrating to electronic transactions, including debit card transactions, and how many checks used to pay for purchases at the point of sale before the widespread use of debit cards were either returned NSF or paid into overdraft? If these questions are answered in subsequent releases of this report, then readers could draw better-informed conclusions.

Page 17 states that "evidence from multiple sources suggests that a substantial portion of the observed growth in deposit account service charges stems from growth in consumer checking account NSF and overdraft revenues." What this

27. IBC Bank, "Overdraft Data."

assertion misses is the counter-effect of banks instituting free checking. Therefore, the question is what the net impact of NSF/OD fees was after considering lower monthly maintenance service charges (as described earlier), as well as more efficient collection of fees. That is, before the year 2000, many banks waived or refunded service charges and NSF/OD fees as a standard practice. Many banks to which one of the authors provided advisory services collected less than 60 percent of assessed fees. Initially, automated overdraft programs tightened collections to over 90 percent of assessed fees and did not create more NSF/OD transactions.

"Heavy Overdrafters"

It is further noted on page 17 that banks "identified charged off account balances as the single largest cost associated with overdraft programs." While this is an accurate statement, it sheds no light on the validity of the programs or on their impacts, positive or negative, on the consumer. Before formal automated overdraft programs, this was the standard practice. Charged-off balances are primarily due to overdrafts, while a small percentage of charge-offs are due to fraud.

Page 18 asserts that "nine percent of accountholders incurred 10 or more overdraft or NSF transactions and accounted for 84% of all overdraft and NSF fees charged." This should not be surprising and cannot be used as an indictment of overdraft programs. The well-established economic concept of the Pareto Principle[28] states that in any group of things that contribute to a common effect, a relatively few contributors account for the majority of the effect. To illustrate the point, if the analysis eliminated the group with more than 10 overdrafts and then restratified the remaining accounts, a similar distribution would occur.

If the point of the white paper is to assert that a small group of consumers are subsidizing another group, it can be argued that overdraft fees allowed for the widespread use of free checking accounts and that the profile of many free checking customers mirrors the profile of overdraft users. Based on work one of the authors performed for banks since the 1980s, high-balance customers historically subsidized small-balance customers. Even before the advent of free checking, monthly service charges did not cover the cost of providing the services related to checking accounts with balances below $1,000. Such services typically cost a bank from $250 to $300 per year for each checking account.[29]

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28. Pareto is a decision-making technique that statistically separates a limited number of input factors as having the greatest impact on an outcome, either desirable or undesirable. Pareto analysis is based on the idea that 80 percent of a project's benefit can be achieved by doing 20 percent of the work, or conversely, 80 percent of problems are traced to 20 percent of the causes. See *Investopedia* dictionary, s.v. "Pareto Analysis," accessed Oct. 28, 2013, http://www.investopedia.com/terms/p/pareto-analysis.asp.
29. American Bankers Association, "The Cost of a Checking Account," June 2010, http://www.aba.com/Press/Documents/e7a636cc2d244ec998d2ed16c23d1955CostofCheckingAccountsOnePageronJusttheCostsofAcco.pdf.

The white paper subsequently asserts, “The study raised concerns that consumers from potentially vulnerable groups may shoulder a disproportionate share of NSF and overdraft fees and checking account costs.” We are concerned that statements of opinion like this one are inconclusive and may lead to erroneous conclusions, and we reiterate the findings of the Moebs Services study concluding that the only accurate predictor of the propensity to use overdraft protection is a consumer’s credit score—consumers with lower credit scores are more likely to use overdraft protection—and that all other demographic information, including income, is nonpredictive of overdraft protection use.[30] While it may be accurate that members of lower-income groups tend to have lower credit scores, lower credit scores are not necessarily limited to lower-income groups.

Since credit score is the only accurate predictor of overdraft use, building a reliable risk model has proven elusive.[31] Economist Marc Fusaro also found that among frequent users of overdraft protection there is little correlation between income and overdraft usage: high-income individuals are just as likely as lower-income individuals to overdraft, but high-income customers’ overdrafts are typically larger.[32] Frequent users of overdraft protection also tend to be younger than less-frequent users.[33]

On page 21 the white paper states that “analyses of . . . account-level data thus may result in adjustments to some of the findings derived from the aggregate-level data set forth in this report.” This supports the crux of our criticism. If the white paper merely disclosed the data analyzed to date without drawing any conclusions, then we would not be having this discussion. However, certain inferences are made without the benefit of complete data and may lead to an incomplete understanding of the issue by the public, the press, policymakers, and regulators.

"Involuntary Account Closures"

On page 24, the white paper asserts that “the negative balances caused by using overdraft programs can lead to a financial institution closing a consumer’s account.” This is a statement of the obvious and does not provide any valuable insight. It is axiomatic that an unpaid overdraft will result in an involuntarily closed account regardless of whether the overdraft was associated with a formal overdraft program.

30. See Moebs Services, “Who Uses Overdrafts?”

31. Moreover, the largest risk to banks of loss from overdraft programs is “hit-and-run” customers, not those who overdraft repeatedly. Zywicki, “Economics and Regulation of Bank Overdraft Protection,” 1154–55.

32. Marc Anthony Fusaro, “Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks,” *Journal of Family and Economic Issues* 29 (2008): 257, 260; Marc Anthony Fusaro, “Are ‘Bounced Check Loans’ Really Loans? Theory, Evidence and Policy,” *Quarterly Review of Economics and Finance* 50 (2010): 499.

33. Fusaro, “Bounced Check Loans,” 499; Independent Community Bankers of America, “ICBA Overdraft Payment Services Study,” 44.

Page 26 says, "However, consumers who heavily use overdraft programs may not be the same consumers whose accounts are involuntarily closed. Heavy users of overdraft programs may frequently incur NSF/OD items but quickly bring their account balances positive, which would prevent involuntary closure." The paragraph goes on to say that further analysis is needed to understand the relationship between use of overdraft programs and account closures. We wholeheartedly agree with the CFPB and trust that future analyses will be more thorough before drawing specific conclusions.

"Implementation of the Opt-In Requirement"

Page 30 states that "44.7% of accounts that had more than 10 NSF/OD items during the first six months of 2010 elected to opt in by the end of 2010." It continues, "In contrast, only 11% of accounts with no NSF or overdraft transactions from January through June of 2010 chose to opt in when given the opportunity to do so." It stands to reason that higher users of overdrafts would opt in for overdraft protection. As indicated earlier, higher users of overdrafts do not necessarily correlate to involuntarily closed accounts or to income strata.

Market surveys have shown similar results. According to a survey by Moebs Services, at various large banks 60–80 percent of customers opted in to debit card overdraft protection, with a median opt-in rate of 75 percent.[34] According to analysis by the American Bankers Association, 46 percent of consumers opted in to overdraft protection for one-time debit card and ATM transactions.[35] A study by the Center for Responsible Lending, by contrast, concludes that 33 percent opted in.[36]

Perhaps more significantly, Moebs Services has found that almost all consumers who use overdraft protection regularly—more than 10 times per year—opted in to coverage,[37] and JPMorgan reports that 53 percent of those who regularly use overdraft protection opted in.[38] Although these surveys and studies are not rigorously scientific, they suggest that the most frequent (and thus presumably

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34. Moebs Services, "Overdraft Fee Revenue Drops to 2008 Levels for Banks and Credit Unions," press release, Sept. 15, 2010, http://www.moebs.com/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/193/Default.aspx.
35. American Bankers Association, "Half of Bank Customers Choose Overdraft Protection," press release, Aug. 31, 2010. See also Todd J. Zywicki, "The Economics and Regulation of Bank Overdraft Protection," *Washington and Lee Law Review* 69 (2012): 1158.
36. Center for Responsible Lending, "Banks Collect Overdraft Opt-Ins Through Misleading Marketing," April 26, 2011, 2, http://www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/CRL-OD-Survey-Brief-final-2-4-25-11.pdf.
37. "Almost 100 percent of those using overdrafts 10 or more times in a year, and over 50 percent of those who never overdraw their account, opted-in for overdraft protection." Moebs Services, "Banks Lower Overdraft Fees as Consumers Choose to Opt-In," press release, Dec. 8, 2010, http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/197/Default.aspx.
38. David Benoit, "Customers Opt for Overdraft Protection," *Wall Street Journal*, Nov. 26, 2010.

the most knowledgeable) users of the product are those who are also most likely to opt in to overdraft protection when given the choice. We believe that a study should be conducted that stratifies the types of banks (community, regional, and national banks) and the market focus of these banks (consumer, small-business, corporate, etc.) to gain a better understanding of opt-in rates. As the analysts at Moebs Services put it, "The consumer no longer views overdrafts as a penalty like a parking ticket, but as a safety net."[39]

"Overdrafters Who Did and Did Not Opt In"

The basic argument posited on page 38 is that those customers who did not opt in for ATM and POS coverage experienced the greatest reduction in fees while those who did opt in experienced more modest reductions in fees. The analysis covers the first and second half of 2010 (pre– and post–Reg E implementation). Since heavy overdrafters who opted in also experienced a reduction, one must consider other variables, such as economic conditions, consumer spending patterns, and account holders' employment status, in order to ascertain all the reasons for the shift in usage. One final point: Reg E required consumers to make a choice, and with that choice one could argue that they made a rational decision that was in their best interest. This is an area of analysis that we trust will be addressed in future releases of this report from the CFPB.

More importantly, the fact that those who chose not to opt in experienced a reduction in *overdraft* fees does not mean that the same people experienced a reduction in *all* fees. In particular, while it is true that those who did not opt in experienced a reduction in overdraft fees, this fact alone cannot support an inference that consumers were better off as a result. As noted above, that question can be answered only by determining what happened to those consumers who *would have used* overdraft protection but did not. In particular, it is necessary to determine whether those consumers instead turned to other high-cost—and potentially higher-cost—alternatives, such as payday lenders, pawnbrokers, title lenders, and the like, that may have led to higher fees overall than the amounts that they would have paid if they had used overdraft protection.

Just as importantly, if these consumers were not able to avail themselves of other credit alternatives, what were the ramifications of unpaid bills (rent, car loans, utilities, etc.) or necessities not purchased (medications, food, gasoline, car repairs, etc.)? Many economic studies have shown a substitution effect among competing types of credit; thus it is virtually unquestionable that some of those who reduced their use of overdraft protection increased their use of alternatives such as payday lending or pawnbrokers. For example, where states have eliminated payday lending,

39. Moebs Services, "Banks Lower Overdraft Fees."

consumers have frequently shifted to alternatives such as pawn shops, overdraft protection, credit card cash advances, and online payday lending that may result in paying higher fees overall. Thus, while those who did not opt in experienced a reduction in overdraft fees, it is possible that they more than offset any cost savings by paying for more costly alternatives.

"Variations in Overdraft Policies and Practices"

This section of the white paper describes the various decisions banks make about available funds calculations, batching by transaction types, and transaction and posting sequences. Structuring payment sequences is not new and has not been instituted primarily to maximize NSF/OD revenue.

One of the authors began his career working with correspondent banks in the 1970s to convert their accounting systems from manual ledger cards to first-generation computer systems. One of the many decisions bank executives needed to make was how to process checks, including paying teller cash-out items and internally generated transactions before other transactions in order to avoid taking losses and creating "cash items" that bank personnel have to collect. That is, checks that could be returned to the presenting banks were processed last because if sufficient funds were not available to pay the items, they were returned and the account holder's bank would not face a potential loss.

When banks employed bookkeepers to manually review all insufficient funds checks, for many community banks it was more operationally efficient to pay from low value to high value in order to reduce the number of items the bank employee had to review. Automation of the pay/return decisions allowed banks to eliminate this bookkeeping function and choose alternative processing sequences. This new automation also replaced the practice of manually deciding to charge the NSF/OD fee. Historically when banks enjoyed higher net interest margins, there was little focus on fee income and a significant amount of fee income was waived or refunded in the name of customer service. Automation eliminated human intervention and therefore the number of waivers. While some may argue that customer service suffered, it must be remembered that the fees were always there to be charged based on the customer's behavior. Another issue that automation eliminated was the potential for inadvertent discriminatory decisions: for example, in the past a bookkeeper could decide to pay an item for one customer with insufficient funds and return an item for another, even if the two customers had similar account characteristics, because the bookkeeper happened to know one customer and did not know the other.

Using automation, banks could start paying items from high value to low value in order to pay what most consumers deemed their most important payments (e.g., mortgage payments, rent, car loan payments). In fact, a report by Raddon Financial Group on one bank's overdraft program found that 58 percent of its customers preferred that larger items be posted *first*, even though that might result in more overdraft charges in total.[40] Among elevated users of overdraft protection the percentage that preferred larger items to be posted first rose to 60 percent.[41]

Yes, the result is that more items may draw on insufficient funds and therefore more fees may be generated. Since the CFPB has stated its concern about payment sequence, it is to be hoped that further analysis by the CFPB will investigate consumers' preferences to determine whether they believe that paying high-value items first is more beneficial to them. Today's systems allow for a variety of sequencing options, even down to the account level.

The CFPB should also be wary of imposing rules on overdraft protection that will create artificial uniformity and stifle competition and innovation in this market. While it is true that variation among products can result in consumer confusion,[42] it is equally true that consumers typically benefit from variety in the offerings presented, and that the competitive process generates variety. Thus, while consumer confusion is undoubtedly a valid regulatory concern for the CFPB, the bureau should be careful not to assume that variation in overdraft programs will necessarily produce consumer confusion and should be careful to avoid the imposition of uniform terms and conditions that could stifle competition and innovation in the market.

Available research indicates that consumers generally understand how overdraft protection works and the standard terms and conditions of overdraft protection programs.[43] In addition, those who rely on overdraft protection most heavily—and thus are those about whom the CFPB is likely to be most concerned—are also likely to be the most informed about overdraft terms and account options.

More importantly, as it attempts to determine the overall consumer welfare effect of overdraft protection the CFPB must consider not only the cost of overdraft protection but also the potential benefit. For example, while adopting a rule requiring payments to be posted and cleared from the smallest to the largest dollar amount would minimize the cost of overdraft protection fees (by clearing more payments), it is not clear that doing so would maximize the net benefit of overdraft protection services to consumers. For example, many larger payment items are among the more important payments for a household, such as mortgage payments, rent, utilities, and other high-priority payments that consumers want to be sure are paid. Because the consequences of nonpayment of these bills can be severe, many consumers rationally prefer to ensure that these extremely important payments are honored, even if this increases overdraft fees for other payments.

Thus, although the CFPB is correct to note the value of consistency in enabling consumers to shop among competing service providers, the bureau should not mistake uniformity and simplicity for ends in themselves. Instead, the bureau should

40. Raddon, "Custom Survey Research Findings."

41. Ibid.

42. CFPB, *CFPB Study of Overdraft Programs*, 63.

43. See Zywicki, "Economics and Regulation of Bank Overdraft Protection," 1176.

seek to promote an optimal level of disclosure uniformity that also allows a variety of overdraft service options (payment sequencing, first overdraft grace period, etc.) to empower consumers to find the products that best match their needs. The CFPB should be particularly cautious about imposing uniform rules that contradict consumer preferences.

"Accountholder Behavioral Characteristics and Screening Policies"

Page 59 states,

> These different approaches to account screening may result in differences in the consumers who hold accounts, and thus explain some portion of the differences across institutions in the numbers of customers who carry low balances or manage their accounts in ways that put them at risk of incurring overdrafts or of experiencing involuntary closures.

One hopes that the CFPB is not suggesting that certain banks are intentionally targeting groups who are high overdrafters. If that is what the CFPB is suggesting, then is the implication that banks should not take on customers who exhibit a propensity to overdraw their accounts? One can imagine how this type of screening could result in a disparate impact to protected groups by not allowing them access to a vital form of short-term credit.

For example, studies indicate that younger consumers are more likely to use overdraft protection than older consumers.[44] This could be because less-experienced consumers are more likely to overdraw their accounts than older consumers, because younger consumers have fewer credit alternatives, or simply because younger consumers have less savings and thus lower levels of precautionary savings. The mere observation that younger consumers are more likely to use overdraft protection may simply be a reflection of the demographic customer base of a particular bank or some other factor that causes younger consumers to be overrepresented in the bank's customer pool.

Moreover, the CFPB should also be wary of taking action on overdraft protection that would have adverse effects on consumer banking more generally. For example, according to data provided by one regional bank, 63 percent of its low-balance free checking customers *never* overdraft their accounts.[45] For these low-income consumers free checking is exactly that—free. In addition, so-called "free checking" accounts typically include a variety of additional services beyond simple checking,

44. Fusaro, "Bounced Check Loans," 499; Independent Community Bankers of America, "ICBA Overdraft Payment Services Study," 44.
45. See Zywicki, "Economics and Regulation of Bank Overdraft Protection," 1165–66.

including free debit card usage, free online banking, free mobile banking, and free ATM access.[46] Moreover, while the white paper expresses concern about the comparatively large number of overdrafts by other consumers, the fact remains that those consumers are paying their overdraft fees voluntarily and knowingly, suggesting that they believe themselves to be better off overall than they would be without overdraft protection. To the extent that paternalistic regulatory action to "protect" heavy (but voluntary) overdraft users leads to increased account maintenance fees and eventually the loss of bank accounts for other consumers, it is difficult to see how this strategy is likely to benefit either group of consumers.

CONCLUSION

We hope that a full exploration of the benefits the consumer enjoys from overdraft programs will be accomplished in the next report release. Available credible economic research indicates that on net, access to overdraft protection can be highly valuable for consumers and the economy. Economist Marc Fusaro estimates that, on average, consumers gain a surplus of approximately $50 per year, or $2 billion economy-wide, from the availability of overdraft protection, plus the accompanying benefits of avoiding NSF fees and maintaining lower precautionary balances.[47] Fusaro and Ericson conclude that overdraft protection is generally welfare-improving for middle-class bank consumers and neutral for low-income consumers. They conclude that eliminating overdraft protection "through excess regulation would hurt the most vulnerable population the most, as they have the fewest alternatives to maintain necessary liquidity."[48]

As always, the possibility of regulation raises concerns about unintended consequences. Consider as well the problem of looking at overdraft in a vacuum. Payday loans are a substitute for overdraft protection and may be more or less expensive than overdrafts depending on the specific transaction. Reducing overdraft fees has caused many banks to eliminate free checking. Higher-cost checking is moving some consumers to general-purpose, reloadable, prepaid cards. Both payday loans and prepaid cards are being reviewed by the CFPB, but this review should

46. One bank estimates the value of the various services included in its "free checking" bundle at $751 per year. Although this precise dollar value is an estimate, it does illustrate that consumers receive a variety of services for which they otherwise would have to pay. See Comment of International Bancshares Corporation to the FDIC, Sept. 24, 2010, p. 4, http://www.fdic.gov/regulations/laws/publiccomments/overdraft_comments/2010-09-24-ibc.pdf. International Bancshares Corporation also notes that it attempted to contact 367,355 customers and was unable to reach 31,369 (8.5%) of these, even after numerous attempts in many different ways. Ibid., 6.
47. Marc Anthony Fusaro, "Consumers' Bank Choice and Overdraft Volume: An Empirical Study of Bounce Protection Programs" (working paper, December 2003), http://faculty.atu.edu/mfusaro/fusaro overdraftvolume.pdf.
48. See Marc Anthony Fusaro and Richard E. Ericson, "The Welfare Economics of 'Bounce Protection' Programs," *Journal of Consumer Policy* 33 (2010): 71.

be done in a holistic manner because of the demonstrated relationships among these three products.

The initial white paper from the CFPB shows a tendency to pick and choose data points. We trust that the next iteration will broaden the exploration and look at other factors and variables in order to avoid the out-of-context preliminary conclusions depicted in this version and give readers a more complete understanding of the situation.