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George Mason University
PUBLIC INTEREST COMMENTS
BRIDGING THE GAP BETWEEN ACADEMIC IDEAS AND REAL WORLD PROBLEMS

Public Interest Comment on
Impacts of Overdraft Programs on Consumers[1]

The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, this response to the Bureau of Consumer Financial Protection's notice and request for information, hereafter referred to as the "notice," does not represent the views of any particular affected party or special interest group, but is designed to assist the Bureau of Consumer Financial Protection (CFPB) as it seeks to ascertain the effects of overdraft protection on consumers.

Introduction

This public interest comment is broken into two sections. The first raises concerns about the approach that the CFPB and other federal agencies have taken with regard to overdraft protection. Specifically, we will examine the guidance issued by the Federal Deposit and Insurance Corporation (FDIC), discuss who the typical users of overdraft protection are and why they choose to use it, examine overdraft protection's impact on competition, and look at how overdraft protection has helped spread the availability of free checking. The second part of our comment will address six of the specific questions asked by the CFPB in the notice. The Mercatus Center considers overdraft protection to be a beneficial service not just for those that directly utilize it, but for all consumers of U.S.-based banking services.

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[1] This comment is adapted from a published article by Todd Zywicki, "The Economics and Regulation of Bank Overdraft Protection," *Washington and Lee Law Review* 6, no. 1141 (2012).

Profits gained from overdraft protection have been used by banks to expand services and accessibility for customers both rich and poor, and limiting overdraft protection may threaten many of the benefits that it makes possible.

Users of Overdraft Protection

Contrary to many accounts, users of overdraft protection are not the very poor. By definition, overdraft borrowers have a bank account, which distinguishes them from many unbanked consumers and suggests that they have higher and more stable incomes than users of alternative financial products such as payday lending and pawnshops. Moreover, access to overdraft protection is commonly linked to the direct deposit of payroll checks, suggesting that many overdraft customers are also steadily employed. Finally, overdraft protection was originally a benefit offered to high-income customers, so there is no reason to presume that it is a product exclusively or even primarily meant for low-income customers.

Thus, according to the available research, the significant distinguishing feature of heavy overdraft users appears to be their credit score, not their income or another demographic attributes. After all, overdraft fees can be entirely avoided by using responsible financial management. One regional bank found, for example, that 71 percent of its free checking accounts with average balances of less than $250 incurred no overdraft fees in the one-year period between October 2009 and October 2010 (a total of 105,000 accounts).[2] Moreover, the percentage of low-balance accounts that incurred zero overdraft fees during that period (71 percent of all accounts) was actually *higher* than the overall percentage of *all* accounts at the bank that incurred no overdraft fees (62 percent).[3] Those who are financially responsible can and do manage even low-balance accounts without triggering overdraft fees. Regulators have implicitly assumed that overdraft fees are a function of income, and have overlooked the important role of consumer responsibility in avoiding overdraft fees.

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[2] Data on file with Todd Zywicki.

[3] This figure may not be entirely representative, since some consumers with low-balance free checking accounts may not be actively using those accounts and thus may not be incurring overdraft fees. But it does illustrate the point that whether overdraft fees are incurred is usually within the control of the consumer and cannot be simply assumed to be a product of low income.

Research has also shown that overdraft users are fully aware of the costs and risks of using overdraft protection. In connection with the Federal Reserve's amendments to Regulation E, Macro International Inc. conducted consumer surveys to see whether consumers understood standard disclosure forms regarding overdraft protection. They found that consumers understand the concept of overdraft protection—that the institution will cover its customers' overdrafts for a fee, and that they will be enrolled in the service automatically unless they opt out.[4] They also understood what would happen when they overdrew their account by using an ATM, a debit card, recurring debit, or a check transaction. Subsequent research confirmed that consumers are able to understand overdraft programs.[5]

FDIC Guidance

On November 24, 2010, the FDIC issued guidance regarding overdraft fees. Under the FDIC guidance, financial institutions must take several steps regarding their overdraft accounts. Among the FDIC's requirements is a provision that banks must "monitor [customer] accounts" and "take meaningful and effective action to limit [the] use" of overdraft protection. For example, the guidance stipulates that with respect to "excessive or chronic" users of overdraft protection—defined as those who overdraw their accounts on more than six occasions in a rolling 12-month period—the bank must take affirmative steps to provide the customers with a reasonable opportunity to choose a less costly alternative, such as linked savings account overdraft protection or a line of credit. Banks are required to institute "appropriate daily limits" on overdraft fees and consider eliminating overdraft fees for transactions that overdraw an account by a *de minimis* amount. Finally, banks are required to "not process transactions in a manner designed to maximize the cost to consumers," which has been interpreted as prohibiting posting larger withdrawals first.

The problems that the FDIC's guidance can cause in practice are illustrated by the experience of one bank after it changed its policy in October 2010 to comply with the regulatory guidance to clear debit

[4] Macro International Inc., *Review and Testing of Overdraft Notices* at ii, submitted to the Board of Governors of the Federal Reserve System, December 8, 2008.
[5] ICF Macro, *Design and Testing of Overdraft Disclosures: Phase Two*, submitted to the Board of Governors of the Federal Reserve System, October 12, 2009.

card payments before checks since debit transactions are smaller in value than checks in general.[6] As a result, the bank has returned unpaid many more large payments than it had in the past. Comparing the two-month period before the rules went into effect with the two months following, the bank reports that the total number of checks and ACH items returned increased by 4 percent, but the dollar value of the rejected payments returned increased by 16 percent. Moreover, many of those rejected payments were important transactions like payments of mortgages, utilities, medical bills, student loans, rent, taxes, and even payday loans. Thus, while the rule may reduce the amount of the overdraft fees paid, it comes with a heightened risk of causing banks to reject larger, more important payments. It is far from obvious that this tradeoff improves consumer welfare.

The FDIC Guidance also requires banks to make special efforts to educate consumers who engage in "excessive or chronic use" of overdrafts, defined as making use of overdraft protection more than six times in a 12-month period. Defining "excessive or chronic" use as six instances in a 12-month period is, of course, entirely arbitrary. The rationale for this regulation appears to be that there is some arbitrary number of overdraft transactions that regulators consider to be simply "too many" transactions, and for which consumers would be better served by choosing some other means to meet their goals. The basis for this belief or this arbitrary number, however, is unclear. Indeed, actual consumer behavior and revealed consumer preferences suggest that this opinion is rooted in paternalism by FDIC officials and is based on little or no investigation of the habits of those who use overdraft protection regularly. There is no reason to believe that the most regular users of overdraft protection are unaware of its cost or of the available alternatives. According to a Raddon survey, although 89 percent of non-users of overdraft protection want to be contacted after six overdrafts occur within a year, only 60 percent of elevated users would like to be contacted. Elevated users are also those most likely to opt out of these notices if they can (33 percent). Thus, according to the survey, a majority of elevated users (those who are most likely to actually incur six overdrafts in a 12-month period) want to be alerted when they reach six occurrences. Therefore, it seems unlikely that these admonitions will cause many consumers to change their behavior.

[6] The information discussed in this paragraph was provided to the Mercatus Center by IBC.

To be sure, some minority of bank customers may misuse overdraft protection and incur substantial fees. But if the events of recent years have taught anything, it is that virtually every type of consumer credit product can be misused or overused—even traditional mortgages.

The FDIC Guidance also suggests that some customers may find it less expensive to open a bank line of credit. This is true—but almost certainly irrelevant for most overdraft users because acquiring a discretionary line of credit requires a standard loan application and approval, which requires a credit score far above that of most of the regional bank's overdraft users. Typically traditional credit is issued for a minimum of approximately $2,500, far exceeding the $300 to $800 available for overdraft protection. In fact, the spread of overdraft protection was hastened by the regulatory and economic difficulties involved in offering a line of credit to consumers.[7] Few of those who use overdraft protection are likely to be approved for such a large line of credit. But if a bank were to offer a smaller line of credit, then its cost would rise substantially.

Overdraft Protection and Free Checking

Overdraft protection also has many indirect benefits that extend beyond those who use the service. There is a very close link between the spread of overdraft protection and the spread of free checking. Although banks began mainstreaming free checking in the late 1990s, between 2001 and 2009 the percentage of accounts at large banks that qualified for free checking rose dramatically, from 7.5 percent to 76 percent, and the average minimum balance required for free checking fell from $440 in 2001 to $186 in 2009.[8] This growth in access to free checking appears to have arisen from two sources: a growth in the availability of overdraft protection and the simultaneous rapid increase in the use of debit cards and the interchange fee revenues that they generate. Bringing lower-income consumers with lower average balances into the banking system has also brought with it greater risk that those consumers will

[7] Comment of International Bancshares Corporation to the Federal Deposit Insurance Corporation at 6, September 24, 2010, http://www.fdic.gov/regulations/laws/publiccomments/overdraft_comments/2010-09-24-ibc.pdf.

[8] David S. Evans, Robert E. Litan, and Richard Schmalensee, "Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses," February 22, 2011, http://www.federalreserve.gov/SECRS/2011/March/20110308/R-1404/R-1404_030811_69120_621655419027_1.pdf. With the onset of the Durbin Amendment's price controls on interchange fees for large bank customers, by 2011 free checking had plummeted to only 45 percent of bank accounts. See Claes Bell, *Abracadabra: Free Checking Disappears*, Bankrate.com, September 26, 2011, http://www.bankrate.com/finance/checking/abracadabra-free-checking-disappears.aspx.

bounce checks or otherwise miss payments. If it was not for universal access to overdraft protection, it is likely that average minimum balances would be raised and monthly fees reimposed. To reduce risk exposure, many financial institutions also link the availability of free checking or the size of the available overdraft line of credit to a commitment to paycheck direct deposit.

The reduction in the availability of free checking in the immediate period after the Federal Reserve's amendments to Regulation E took effect illustrates the competitive nature of the market. According to David S. Evans, Robert E. Litan, and Richard Schmalensee, "within days" of the Fed's announcement of its new rules, banks starting scaling back access to free checking, imposing new fees, and eliminating services for customers. The number of accounts eligible for free checking fell by 11 percentage points—from 76 percent in 2009 to 65 percent in 2010—a figure that translates to approximately 20 million accounts.[9]

Other government actions such as the Durbin Amendment have had a negative effect on free checking as well. The Durbin Amendment creates a similar effect to that of decreasing overdraft protection, because both reduce the funds that banks have available to provide services like free checking.[10] A recent study done by Bankrate.com states that free checking has decreased to 45 percent of what it was when the Durbin Amendment was passed. Although some of these adjustments may be attributable to other factors, such as the ongoing banking crisis, much of this change is attributable to the new restrictions on overdraft protection and the impositions of the Durbin Amendment.

Market experience also suggests that overdraft protection is popular with consumers and that bank customers prefer the combination of zero up-front maintenance fees and lower required balances with overdraft protection to the traditional model of monthly maintenance fees and higher minimum required balances. Consumers have tended to migrate to banks that offer overdraft protection (and thus

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[9] David S. Evans, Robert E. Litan, & Richard Schmalensee, *Economic Analysis of the Effects of the Federal Reserve Board's Proposed Deb it Card Interchange Fee Regulations on Consumers and Small Businesses* (February 22, 2011), available at http://www.federalreserve.gov/SECRS/2011/March/20110308/R-1404/R-1404_030811_69120_621655419027_1.pdfIbid. With the onset of the Durbin Amendment's price controls on interchange fees for large bank customers, by 2011 free checking had plummeted to only 45 percent of bank accounts. See Bell, *Abracadabra*.
[10] Bankrate.com 2011 Checking Account Survey, http://www.bankrate.com/finance/checking/checking-account.aspx?ic_id=nwsltr_standalone_20110926.

lower required monthly fees), which has increased the market share of those banks and put competitive pressure on competitors to respond.[11] Access to overdraft protection allows consumers to hold smaller precautionary balances in low-interest demand deposit accounts, which also leads them to overdraw their accounts more often.[12]

The CFPB's Questions

Question 1: "What alternatives do institutions offer to overdraft protection programs and how much do consumers make use of these alternatives?"

Overdraft protection usually serves as a short-term source of small-dollar credit in order to meet a pressing need for funds and to prevent important payments such as utility bills, rent, or other bills from being denied for insufficient funds. Moreover, those who use overdraft protection do so because it is better than available alternatives. For many, the closest real-world alternative to overdraft protection is payday lending. Other sources of credit are either unavailable (such as credit cards), clearly inferior (such as pawnbrokers), or unwanted because they are longer-term or require borrowing larger amounts of money than desired (such as personal finance company installment loans).

It is often asserted without evidence that overdraft protection is used predominantly by low-income consumers. A study by Moebs research firm, however, concludes that the only accurate predictor of the propensity to overdraw is credit score—those with lower credit scores are more likely to use overdraft protection.[13] All other demographic information—including income—is non-predictive of the likelihood of using overdraft protection, and a reliable risk model has proven elusive.[14] Economist Marc Fusaro also finds that among frequent users of overdraft protection there is little correlation between

[11] Marc Anthony Fusaro, "Consumers' Bank Choice and Overdraft Volume: An Empirical Study of Bounce Protection Programs" (working paper, 2003).
[12] Marc Anthony Fusaro, "Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks" *Journal of Family Economics* 29, nos. 251, 257, 260 (2008); Marc Anthony Fusaro, "Are 'Bounced Check Loans' Really Loans? Theory, Evidence and Policy," *Quarterly Review of Economics and Finance* 50, no. 492, 499 (2010).
[13] Moebs Services, "Who Uses Overdrafts?," press release, September 29, 2009, http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/194/Default.aspx.
[14] Data on file with the author.

income and overdraft usage—high-income individuals are just as likely as lower income individuals to overdraft—but higher-income customers' overdrafts typically are larger.[15]

Frequent users of overdraft protection also tend to be younger than less-frequent users.[16] An FDIC study in 2008 found that accounts held by customers in low-income geographic areas are more likely to incur overdraft charges and that use of overdraft protection is more common among younger bank customers than others. For example, according to the FDIC, 46.4 percent of those in the 18 to 25 age range overdrew their account in the 2006 study, while only 12.2 percent of seniors did. But the FDIC study did not control for credit score, which tends to be correlated with income and age; thus it cannot be determined whether the driving factor was creditworthiness or demographic variables.

Since overdraft users generally have a low credit score, traditional lines of credit besides overdraft protection are largely closed to them. This leaves options like payday lending, pawn shops, and rent-to-own stores. Of these real-world alternatives, payday loans are the most popular—but they carry their own disadvantages compared to overdraft protection. This means that limiting overdraft protection will make some consumers worse off.

Question 2: "To what extent do consumers avail themselves of alternatives to incurring overdraft fees?"

Evidence indicates that consumers generally act rationally when choosing between payday and overdraft credit. Federal Reserve economists Brian T. Melzer and Donald P. Morgan have studied consumer decision-making with respect to the choice between payday lending and overdraft protection. They note that the key difference in the way the two products are priced generates predictions about rational consumer behavior. Because the primary price component of overdraft protection is a flat fee (irrespective of the size of the overdraft) rather than a periodic interest rate, rational consumers would tend to use overdraft protection to cover *larger* transactions that otherwise would be declined for insufficient funds. The price of payday loans, by contrast, is tied to the size of the loan (e.g., $15 per $100

[15] Fusaro, "Hidden Consumer Loans;" Fusaro, "Are 'Bounced Check Loans' Really Loans?"
[16] Fusaro, "Are 'Bounced Check Loans' Really Loans?"

borrowed); thus consumers would be predicted to use them to cover *smaller* transactions. This pricing difference also creates a potential adverse selection problem, since consumers select the option that gives them the lowest price for any given transaction.[17]

The only conclusion that can be drawn from these findings is that customers are making the most rational decisions already when choosing between payday lending and overdraft protection. Removing one or the other will force customers into making a less beneficial choice. Research by policy analysts found a significant substitution effect between payday lending and overdraft protection. In a survey of Australian payday loan customers, they found that if payday loans were not available, approximately 20 percent of payday loan customers would make greater use of overdraft protection. Those who were most likely to shift to overdraft protection tended to be higher-income and have a greater number of alternative credit sources than payday loan customers on average. Economist Jonathan Zimmerman found that when Oregon imposed a cap on finance charges for payday loans, there was a dramatic drop in the number of licensed payday lenders, a short-term deterioration in the overall financial condition of Oregon households, and some evidence that the ban led to an increase in late bill payments and a greater use of overdraft protection by consumers. Because of this substitution effect, the reverse would also be true. The reduction of overdraft protection would drive customers to payday loans and there would be similar negative consequences to those found by Zimmerman in Oregon.

Most consumers of overdraft protection have indicated when surveyed that they would not use available alternatives if they had no access to overdrafts. Fifty-three percent of “Elevated users” of overdraft protection reported that if overdraft protection were not available they would “not be able to get money,” as opposed to only 16 percent of non-users, according to a Raddon survey.[18] And while 26 percent of non-users of overdraft protection said that 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

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[17] Brian T. Melzer and Donald P. Morgan, “Competition and Adverse Selection in a Consumer Loan Market: The Curious Case of Overdraft vs. Payday Credit” (working paper, 2009), http://www.clevelandfed.org/research/conferences/2010/9-9-2010_household-finance/Melzer_Morgan_2_16_2010.pdf.

[18] Raddon Financial Group Inc., *Custom Survey Research Findings*, June 2011, on file with Todd Zywicki.

only 6 percent of non-users said that they would seek a payday loan if overdraft protection were unavailable, 24 percent of elevated users reported that a payday loan would be their option (the second-highest response after "not able to get money" for elevated users). Moreover, while 56 percent of non-users said in such situations they would simply transfer the needed money from another account (presumably a savings account), only 13 percent of elevated users said that they would do so, presumably reflecting the simple truth that they have no other accounts available.

Economist Marc Anthony Fusaro finds that consumers of overdraft generate $50 a year on average in consumer surplus for each individual user, adding up to approximately $2 billion in consumer surplus for the entire U.S. economy. This surplus exists because overdraft protection is indeed the best option for many consumers, allowing them to avoid not sufficient funds fees and maintain lower precautionary balances.[19] Fusaro and Richard E. Ericson conclude that overdraft protection is generally welfare-improving for middle-class bank consumers, and neutral for low-income consumers.[20] Limiting overdraft protection simply does not achieve the goals that regulators wish to accomplish.

Question 7: "The Bureau is interested in the impact of the changes to Regulation E that took effect in 2010 on consumers."

The Federal Reserve's justification for its revision of Regulation E was its conclusion that, based on the responses of participants in a survey of just six people, "participants generally indicated that they would want their checks paid into overdraft." That "majority of participants [four out of six] also indicated that they would prefer an opt-in over an opt-out even if they would choose to have ATM and one-time debit card transactions paid." Even if the responses of this six-person study are generalizable, however, the Fed made no determination about the relative cost of opt-in versus opt-out options on the system as a whole. Thus, if an opt-in system would be substantially more expensive to obtain than an opt-

[19] Fusaro, "Are 'Bounced Check Loans' Really Loans?" 499n18.
[20] Marc Anthony Fusaro and Richard E. Ericson, "The Welfare Economics of "Bounce Protection" Programs," *Journal of Consumer Policy* 33, nos. 55, 71 (2010).

out system, it might still be more efficient to have an opt-out regime even if many consumers would actually choose to opt out.

In the context of securing consent for banking services such as overdraft protection, it is much easier for consumers to contact the bank than for the bank to track down consumers, especially those who have to be contacted at home. For example, when one large regional bank sought to contact its customers to give them the option to opt in to overdraft protection for debit cards and ATM transactions, it was unable to contact almost 10 percent of its customers, even after repeated efforts.[21] About 20 percent of banks increased the fee that they charged on overdrafts to offset lost revenues from those who opted out. Because of the cost and difficulty involved in contacting consumers, many banks chose to not even try to contact customers to solicit their opt-in, including both community banks for which it was too expensive relative to their somewhat smaller customer base and very large banks with such a large and transient customer base that it was financially infeasible to contact them. On the other hand, for the banks that made the effort to contact consumers, a high percentage of them chose to opt in, and the heaviest users were those most likely to choose to opt in. For example, one regional bank solicited opt-in for overdraft protection for debit card transactions from its most frequent overdraft users.[22] The bank sought permission from 499 customers that had made 25 or more overdraft transactions in 2010. Of the 499 customers, 466 (93 percent) opted in for debit card transactions and 33 (7 percent) opted out.[23] This willingness of the heaviest users to opt in to overdraft protection suggests that they value access to overdraft protection, notwithstanding its seemingly high cumulative cost. Overall, 73 percent of the bank's customers chose to opt in to debit card overdraft protection. A subsequent survey of the bank's customers by the Raddon Financial Group in June 2011 found that when asked to rank the value of overdraft courtesy protection from "extremely valuable" to "not at all valuable," 86 percent of elevated users stated that the availability of overdraft protection was extremely valuable (and only 2 percent said it

[21] Comment of International Bancshares Corporation to the Federal Deposit Insurance Corporation at 6.
[22] Data on file with the author.
[23] Information provided by International Bancshares Corporation to author.

was "not at all valuable").[24] Moreover, the percentage of those stating that overdraft protection is "extremely valuable" rose consistently with the intensity of use, from 57 percent for non-users 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."

Market surveys have suggested similar results. According to a survey by Moebs at various large banks, 60 to 80 percent of customers opted in to debit card overdraft protection, with a median opt-in rate of 75 percent.[25] According to analysis by the American Bankers Association, 46 percent of consumers opted in to one-time overdrafts on debit card and ATM transactions.[26] A study by the Center for Responsible Lending, by contrast, concluded that 33 percent opted in.[27] The recent experience of one bank is also illustrative with respect to overdraft fees at ATMs. Between April 7 and April 30 this year, the bank had 41,273 customers who were alerted when they sought to make an ATM withdrawal that doing so would overdraw their account, and asked whether to cancel the transaction or continue with an overdraft charge. Of that group, only 3,380 (8 percent) initially declined to have the transaction processed with an overdraft fee. Of that group of 3,380 who initially declined to have the transaction go forward, however, 1,470 (44 percent) came back within 24 hours and opted in to overdraft protection for ATM transactions. Within 24 hours, therefore, 95 percent of those who were originally given the opportunity to accept overdraft protection for an ATM withdrawal chose to do so. This real-world experience rebuts one of the rationales offered by the Federal Reserve—but one for which it offers no evidence or even serious theoretical support—that opt-in would protect frequent users of overdraft protection from overusing the product. Instead, these required opt-in models have caused great inconvenience to customers and banks while doing little to protect them. Standard economic analysis provides a straightforward explanation for

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[24] Raddon Financial Group Inc., *Custom Survey Research Findings*, June 2011, on file with author.
[25] "Overdrafts Pile Up as Opt-In Pays Off, but Were Consumers Misled?" *Payments Journal*, May 5, 2011, http://www.paymentsjournal.com/Featured_Stories/Overdrafts_Pile_Up_as_Opt-In_Pays_Off,_But_Were_Consumers_Misled_/.
[26] American Bankers Associations, "Half of Bank Customers Choose Overdraft Protection," press release, August 31, 2010, http://www.aba.com/Press+Room/083110OverdraftProtection.htm.
[27] Center for Responsible Lending, "Banks Collect Overdraft Opt-Ins through Misleading Marketing," April 26, 2011, http://www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/banks-misleading-marketing.html.

this observation: Regular users of overdraft protection are those who are most likely to be aware of its costs and to choose to use overdraft protection because they believe it to be superior to their available alternatives. Restriction has proven to just cost those who are supposedly being protected, with no obvious benefits.

Question 9: "The Bureau is aware that some institutions have recently changed their order of processing transactions in various ways, including, for example, adoption of a purely chronological system of posting debit transactions; adoption of a system that separates different types of debit transactions (e.g., ATM and point of sale debit, ACH, check, and various account fees) and applies different rules to order transactions in discrete buckets; and adoption of a system which orders debit transactions from smallest to highest dollar amount. The Bureau is interested in learning how these changes have affected consumers."

FDIC has stated that the practice of many banks of reordering transactions to clear payments from the largest- to smallest-value items is impermissible under the FDIC's guidance because this will "tend to increase the number of overdraft fees."[28] The FDIC's justification for the rule is the belief that it will improve consumer welfare by reducing the number of payments that bounce—by clearing multiple small payments first, the absolute number of payments that bounce will be reduced. The traditional convention of clearing larger payments first, by contrast, results in a more rapid depletion of funds, which then leads to a larger number of smaller payments being rejected later—thereby imposing a larger number of overdraft or bounced-check fees.

Although it is plausible that requiring smaller payments to be posted first will reduce the total amount of overdraft fees, the FDIC's narrow focus on minimizing the total *cost* of overdraft protection ignores the potential *benefit* of overdraft protection to the consumer. Requiring clearance from lowest to highest dollar value is contrary to the practice of many institutions, which has been to clear larger items

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[28] See FDIC Overdraft Payment Program Supervisory Guidance Frequently Asked Questions, No. III.4. According to a 2009 survey, approximately 20 percent of financial institutions reportedly used the practice of clearing transactions from larger to smaller obligations. Acording to Moebs, banks with over $50 billion in assets charge an average of $35 per overdrawn check compared to $26 for all institutions. Moebs Services, "Consumer Overdraft Fees Increase During Recession: First-Time Phenomenon," press release, July 15, 2009, http://www.moebs.com/AboutUs/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/65/Default.aspx.

first—usually checks and ACH payments—under the assumption that larger items tend to be more important items such as payments for a mortgage, rent, or utilities, or other high-priority payments that consumers want to be sure will be paid. Although a requirement that smaller payments be cleared first would likely reduce the cost of overdraft fees, it ignores the fact that the *benefit* of paying larger items is usually greater because the consequences of dishonoring larger payments are more severe. Overdraft protection programs limit the amount of overdraft credit that can be extended, from $300 for low-balance free checking accounts up to $500 or $800 for more stable accounts. As a result, one large check added on top of several previously-paid small debit card payments might exceed the credit balance available for overdraft protection, leading large and more important payments to be rejected. In fact, a report by the Raddon Financial Group about 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.[29] Government interference in contract terms typically is justified only if there is manifest evidence of a failure of market terms to reflect consumer preferences. The findings of the Raddon Report, while subject to qualification about its methodology, strongly suggest that more hard data is necessary before concluding that the contracted-for clearing order reflects a market failure rather than a term best established by competition and free choice, especially in the case of more frequent users.

The problems that the FDIC's guidance can cause in practice is illustrated by the experience of one bank after it changed its policy in October 2010 to comply with regulatory guidance to clear debit card payments before checks on the assumption that in general debit transactions are smaller in value than checks.[30] As a result, the bank has returned unpaid many more large payments than in the past. Comparing the two-month period before the rules went into effect with the two months following, the bank reports that the total number of checks and ACH items returned increased by 4 percent, but the dollar value of the rejected payments returned increased by 16 percent. Moreover, many of those returned payments were for important items like payments of mortgages, utility bills, medical bills, student loans,

[29] Raddon Financial Group Inc., *Custom Survey Research Findings*, June 2011, on file with author.
[30] The information discussed in this paragraph was provided to the Mercatus Center by Interactional Bancshares Corporation.

rent, taxes, and even payday loans. Thus imposing a largest to smallest order of payment seems to do little to improve consumer welfare.

Question 11: "The Bureau is interested in the economics of overdraft programs, including their contribution to overall costs and revenues associated with checking accounts. There is concern based on the FDIC study's data from 2006 that many institutions are reliant on fees from a small group of frequent overdrafters for a disproportionate share of revenue from checking accounts, while many other accountholders benefit as 'free riders.'"

As an initial matter, economics establishes that because use of overdraft is voluntary, its popularity points to the fact that they do receive value in excess of what they pay, albeit value not entirely in direct banking services but in convenience and avoidance of higher alternative costs. As has been shown above, when customers are asked to opt in to overdraft, almost all of them do so. The Macro International survey demonstrates that users of overdraft have a good understanding of the service and the costs and benefits involved, and they choose to opt in with this high level of information.[31]

The concern about free riders founders on another conceptual problem: Consumer cross-subsidies are ubiquitous in the modern economy, yet few people consider most of these cross-subsidies to be "unfair" in some way. That some bank consumers subsidize free checking for others through overdraft fees seems no more unfair than that some consumers pay full price or attend full-priced movies, thereby subsidizing others who are patient and buy tickets on sale. It cannot be contended that the simple existence of consumer cross-subsidies in the retail economy is inherently unfair, yet it is difficult to understand what the "fairness" critique of overdraft fees could mean.

Today, banks offer a wide variety of services (many of them provided for free), but all of these are funded by a relatively small number of revenue streams. Two important revenue streams for banks are overdraft fees and debit card interchange fees for large bank customers. The Durbin Amendment has

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[31] David S. Evans, Robert E. Litan, and Richard Schmalensee, "Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses," February 22, 2011, http://www.federalreserve.gov/SECRS/2011/March/20110308/R-1404/R-1404_030811_69120_621655419027_1.pdf.

already taken a large chunk of revenue that would have been generated from debit card fees, and there has been a drop-off in services offered by banks as a result.[32] By trying to remove these fees, regulators have simply pushed banks to introduce new revenue sources such as maintenance fees. These alternatives are often regressive. Consumers pay a monthly maintenance fee regardless of how much they use their accounts, and high-income people are most likely to be able to be able to waive monthly fees by maintaining a certain minimum balance. There doesn't seem to be any clear reason why having some overdraft users subsidize free checking for other consumers is any more or less fair than having poor people pay monthly fees that rich people don't have to.

Different customers use different services supported by these revenues and few consumers would prefer that every service be priced in an a la carte manner because it would be much more expensive for them. For example, some consumers physically go into branches to conduct transactions, thereby using the rent, heat, and employee time that others do not. Yet no banks charge a fee for those who use a teller window, even though those who do not use tellers are forced to subsidize those who do. Nor have bank regulators sought to prohibit this "unfair" cross-subsidization of those who use tellers. Similarly, banks that offer free parking or drive-through banking subsidize those who drive rather that walk or take public transportation. There is simply no sound policy justification for the arbitrary assertion that the only appropriate pricing scheme for banking services is one that is *a la carte* and that bundling services or cross-subsidizing consumers as competitive circumstances demand is a fundamentally flawed pricing scheme. Even more unsustainable is the notion that every one of these other cross-subsidies is "fair" and permissible and that overdraft protection alone can be condemned on this ground. In fact, like all these other market-driven cross-subsidies, the expansion of overdraft and the accompanying increase in access to free checking and other innovations is the product of competition among banks that has benefited consumers overall. For example, as free checking has expanded over the past decade so has the number of bank branches nationwide and the number of services offered, and banking hours generally have been

[32] With the onset of the Durbin Amendment's price controls on interchange fees for large bank customers, by 2011 free checking had plummeted to only 45 percent of bank accounts. See Bell, *Abracadabra*.

extended as well.[33] Rarely are consumers charged on a piecemeal basis for this increased choice and customer service, but rather all these efforts are funded out of a handful of revenue streams.

Once the trade-off between free checking and overdraft protection is recognized, the concern about whether the current allocation of banking fees is consistent with some arbitrary definition of "fairness" is overwhelmed by a more significant point: The development of the current pricing model has promoted competition and innovation, and expanded access to the mainstream banking system to many consumers who traditionally were excluded and the return to older fee structures. Replacing the outcomes of market competition and consumer free choice with those preferred by bureaucratic design of prices and products will reverse all these beneficial trends. Regulatory policies that result in the elimination of free checking and the imposition of higher fees will drive many consumers out of mainstream financial services and force them to rely on alternative financial products, such as check cashers, prepaid card issuers, and rent-to-own companies. While those credit providers play a crucial and valuable role in serving certain members of the economy, especially unbanked consumers, it is difficult to conceive of a justification for government policies that promote reduced access to mainstream banks and greater reliance on those products. Yet this is the predictable unintended consequence of the cascade of government regulation since the financial crisis. In fact, as restrictions on overdraft fees and the Durbin Amendment's price controls on debit card interchange fees have bitten deeper, these trends have been reversing. Fewer customers are now eligible for free checking, new fees have been imposed on existing services, quality and convenience have declined, and banks have begun closing branches. It is hard to see how these trends will benefit consumers.

Question 12: "The long term impact of overdraft programs on consumer behavior and options is of particular interest to the Bureau. Some have argued that overdraft programs allow consumers to meet liquidity challenges while others argue that overdraft eventually adds to liquidity issues because of the

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[33] The number of branches of commercial banks rose by 39 percent between 1988 and 2006. See Timothy H. Hannan and Gerald A. Nanweck, "Recent Trends in the Number and Size of Bank Branches: An Examination of Likely Determinants," *Journal of Financial Transformation* 23, no. 155 (2008) (Capco Institute).

high recurring fees that frequent overdrafters must pay. Further, there is concern that heavy use may lead a significant percentage of users to damage their credit records in databases institutions use to qualify consumers for checking accounts and thereby to lose access to the services of competing providers or to the banking system altogether. To what extent are these various perspectives valid?"

As has been pointed out in the previous responses, overdraft protection's primary purpose is to provide liquidity in short-term situations where it would otherwise not be available. There is no way to provide this sort of liquidity cheaply. Frequent users of overdraft protection seem to be well aware of the costs and risks associated with overdraft, and still use it as a preferred source of liquidity because their credit score does not give them access to affordable alternatives.

Conclusion

Regulators are targeting those borrowers who provide no safety and soundness risk to banks, and who generate a net profit for banks. Moreover, the heavy users of overdraft protection report that they are the least likely to have easy, low-cost alternatives to overdraft protection and thus are the most likely to be diligent in maintaining their access to overdraft loans in good standing. In the end, limiting overdraft protection will actually hurt the very people the regulatory agencies are trying to protect, by driving them to less-preferred forms of credit.

The Federal Reserve's amendments to Regulation E implemented last year dealt a major blow to the availability and usefulness of overdraft protection for many consumers. The FDIC's regulatory guidance threatens overdraft protection further. Undoubtedly, some consumers misuse overdraft protection. But as recent years have amply demonstrated, every type of consumer credit is potentially subject to misuse—even traditional mortgages. For millions of consumers, overdraft protection provides a short-term lifeline that enables them to avoid more expensive problems, such as bounced checks, eviction, late fees on credit cards, and utility shutoffs. Lacking overdraft protection, many of these consumers could turn to less-preferred alternatives such as payday lending. Regulators should be careful to ensure that in trying to prevent abuse or misuse of overdraft protection, they do not go too far in the direction of making it too difficult to use or obtain.

Government intervention into a competitive market is typically justified only by demonstrable evidence of a market failure and confidence that interventions will ameliorate, not exacerbate, market failures. To date, such evidence is lacking for overdraft protection. All that regulations limiting overdraft protection typically do is reduce access to one type of credit and, thereby, force consumers to make greater use of other, less-preferred products. Overdraft protection meets a unique need in the consumer credit marketplace—the need for a convenient, flexible line of credit accessible 24 hours a day on demand, anywhere in the world, at an ATM, point-of-sale purchase, or for a check to clear.