Small Dollar Credit

Millions of Small Needs Add Up to a Big Deal:
Banks Should Be Allowed to Offer Customers Multiple Choices
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The Core Principles for Regulating the United States Financial System, enumerated in Executive Order 13772, include the following that are particularly relevant to an evaluation of current U.S. small dollar credit rules and regulatory practices:

(a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
(c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;
(f) make regulation efficient, effective, and appropriately tailored; and
(g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

The American Bankers Association\textsuperscript{1} offers these views to the Secretary of the Treasury in relation to the Directive that he has received under Section 2 of the Executive Order.

- The demand for small dollar credit is sizeable and real. If needs are unmet by financial institutions, customers will be driven toward “informal” sources.
- Banks provide a variety of small dollar credit options, including credit cards, short-term installment loans, and overdraft services, among others.
- Small dollar credit supports local economic activity.
- Legislation and regulation have reduced customer access to small dollar credit, with further restrictions proposed and contemplated.
- The proposed/contemplated restrictions hang like a cloud over development of new small dollar credit offerings.
- OCC and FDIC should withdraw their “guidance” preventing offering of Direct Deposit Advance sources of small dollar credit.
- The FDIC should withdraw its overdraft “guidance.”
- The consumer Bureau should withdraw its proposed rule to constrain access to small dollar lending.

\textsuperscript{1} The American Bankers Association is the voice of the nation’s $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.
Introduction

The demand for small-dollar credit is significant, real, and cannot be wished away. Indeed, meeting those credit needs helps tens of millions of people each year while supporting local economic activity. According to a study by the Federal Reserve, nearly half of Americans—46%—could not cover an emergency expense that costs $400 without selling a possession or borrowing money. People of all walks of life rely upon small dollar credit for a variety of reasons, such as to pay emergency expenses, to manage misalignments in the timing of their expenses and income, to cover a transition period between jobs, or, for seasonal workers, to cover disruptions in pay.

Because borrowers’ needs are diverse, there should be a vibrant credit market with many choices for small dollar credit, including credit cards, installment loans, single payment loans, and overdraft protection services. Unfortunately, existing and proposed laws, regulations, and supervisory guidance have progressively stifled this market. When people in need cannot meet their credit needs through financial institutions, the need does not go away; instead, people are driven to “informal” sources. A change in policies can and should turn this around.

I. Legislative and Regulatory Obstacles to Small Dollar Credit Access

A. The CARD Act

Revolving credit card accounts offer the least expensive, flexible, and sustainable small dollar credit product, relied upon daily by most borrowers. The Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act) limited card issuers’ ability to adjust conditions (including rates and terms) to cover changes in risk. The consequence has affected access to credit cards. Between 2008 and 2016, the total number of credit card accounts belonging to prime customers decreased by 3%. Accounts held by subprime customers decreased by 19%.

B. Proposed Small Dollar Lending Regulations

Secured and unsecured installment loans provide another source of consumer small dollar credit offered by financial institutions. Historically, banks have been leading providers of personal installment loans. The costs, complexity, and compliance risks presented by consumer

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5 These data reflect analysis by Keybridge LLC of general purpose cards issued by companies that provide data to Argus Information and Advisory Services. These data are also consistent with Marshall Lux and Robert Greene’s 2016 report, which found that consumers with credit scores less than 680 originated 50% fewer credit card accounts in 2015 as compared with 2007, and are borrowing 19% less over this time period. Marshall Lux & Robert Greene, Out of Reach: Regressive Trends in Credit Card Access 10 & 12 (Apr. 2016), available at https://www.hks.harvard.edu/content/download/79658/1788126/version/1/file/Out_of_Reach_Lux_Greene_4_7.pdf.
protection rules are making that role more difficult for banks, earnings barely covering the origination and processing costs of small dollar installment loans.

In June 2016, the Bureau of Consumer Financial Protection (Bureau) proposed a 1,341-page rule that would impose elaborate, mortgage-like underwriting standards and restrictions on repeat usage of small dollar, short-term loans. Ostensibly intended to regulate payday and vehicle title loans, the proposed rule reaches to very traditional bank products. The proposed rule includes an exemption that the Bureau believes would permit bank small dollar installment lending to continue. While we appreciate the Bureau’s recognition of the positive value of bank-provided small dollar credits, in practice the exemption would be unworkable. The proposed additional requirements to allow a bank credit to qualify under the exemption would add significantly to existing regulatory barriers and costs, making these loans unsustainable. These requirements would include—

- Screening requirements to determine if the borrower has other outstanding small dollar loans;
- Portfolio default calculations to ensure that the default rate on covered loans does not exceed 5% in a 12-month period (which would require the lender to refund retroactively all origination fees paid by all borrowers of loans made under the exemption that year should default rates breach the 5% ceiling);
- Record retention requirements, including a requirement to retain the records in “electronic tabular format;” and
- Limits on borrowing (limited to two covered loans in 180 days).

If finalized as proposed, the rule would curtail, if not eliminate, the ability of banks to make small dollar loans, as the costs and compliance risks will be disproportionate to any reasonable return on these loans. The existence of the proposal has already provided a strong disincentive to banks that are interested in entering (or re-entering) this market.

C. Direct Deposit Advance Guidance

Direct Deposit Advance (DDA) services provided another sustainable and valued small dollar credit option within the regulated banking system. Despite the programs’ popularity among customers, the OCC and FDIC issued supervisory “guidance” in 2013 that forced all but one bank that offered the product to exit the market. The complexity and compliance risks of the Bureau’s proposed small dollar lending rule hang like a dark cloud over any innovation or development efforts by these or other banks to offer a new small dollar deposit-related credit product, despite customer and bank interest in offering a convenient and sustainable product.

DDA services, as they were offered, permitted eligible customers, for a fee, to borrow funds that were deposited directly into the customer’s account. Banks underwrote the loans using information derived from the customer’s relationship with the bank, including the customer’s history of incoming credits. Because the underwriting process was thereby efficient, banks could offer the product at competitive rates, significantly lower than the typical rate charged by some nonbank providers. Knowledge of the customer’s borrowing history also allowed the bank to set reasonable limits on product use, without the need to resort to arbitrary and non-tailored limits. Customers appreciated that they could quickly access funds in a convenient manner (including
from the customer’s online bank account) and at a lower cost than competing non-bank short-term credit products.

In November 2013, raising unfounded and undemonstrated safety and soundness concerns, the OCC and FDIC published guidance that expressed the agencies’ “expectations” that banks would follow a prescriptive set of underwriting requirements in offering these credits, including the imposition of arbitrary cooling off periods on customers’ use of the product, inconsistent with the variable reality of life and customer credit needs. There was, however, no evidence offered to suggest that the operation of DDA programs presented operational, credit, or reputational risks that were not addressed adequately by existing supervisory policies, regulation, and guidance. As ABA noted at the time, the agencies’ assertion of safety and soundness concerns was a thinly disguised attempt to impose additional, unnecessary, and consumer-unfriendly requirements on a legal and functioning product that agency leadership disfavored.6

As a direct result of the guidance and simultaneous pressure that regulators exerted on individual banks, all banks that offered a DDA services exited the market or, in the case of one bank, limited use of the product to previously enrolled customers. Consumers lost another convenient, fair, and valued source of small dollar credit within the regulated banking industry.7

D. Overdraft Regulations and Guidance

Overdraft services offer another form of short-term liquidity to bank customers. These services are already subject to significant regulation. In 2009, the Board of Governors of the Federal Reserve System (Board) amended Regulation E to require bank customers to opt in to overdraft protection services before a bank could impose a fee for an overdraft resulting from a point of sale debit card or ATM transaction.8 In addition, the Board amended Regulation DD to require banks to provide consumers with clear disclosures on periodic statements of all overdraft fees and by requiring that institutions only disclose funds available for immediate use when disclosing automated account balances to a customer.9 These amendments have had a demonstrable effect of empowering customers to make informed and responsible account management choices when seeking or declining overdraft coverage to meet small dollar account shortfalls.

7 Customer reviews of deposit advance products were overwhelmingly positive, as demonstrated by the following results of surveys conducted by banks that offered the product:
   • One bank’s survey of its deposit advance customers found that 88% of customers were satisfied or very satisfied with the program. Of those customers who had also used a similar service offered by a nonbank, 95% preferred the bank’s product.
   • A second bank’s survey of its deposit advance customers found that customers rated their experience well (4.62 on a 5-point scale), and the overwhelming majority (80%) were “very likely” to use the service again.
   • In a third bank’s survey, 90% of its deposit advance customers rated their experience with the product as “good” or “excellent,” and 91% of customers planned to continue to use the product in the year after the survey was conducted.
9 12 C.F.R. §230.11.
Without any demonstration that further regulation of overdraft is necessary or desirable, other regulatory agencies, however, have imposed or are considering imposing additional restrictions on overdraft services. In 2010, the FDIC issued supervisory “guidance” that limits customer credit access by imposing expectations that banks would institute daily limits on overdraft fees and limit access to overdraft for certain customers.  

The Bureau has also cast its shadow over customer access to small dollar credit via overdrafts, suggesting that additional regulation of overdraft services may be warranted. The Bureau issued a request for information in 2012, published a white paper of “initial data findings” related to overdraft in 2013, and circulated a “data point” on overdraft in 2014. Additional regulation along the lines of the Bureau’s public musings could limit the availability of overdraft services for those who value them the most and may ultimately push millions more customers out of the banking system.

II. Economic Benefits of Access to Small Dollar Credit

Expanding access to a variety of small dollar credit products not only helps individual customers, it supports economic activity in the communities where these people live. Banks have been and should be major participants in the small dollar credit market, but banks need a regulatory environment that encourages a vibrant credit market with many choices for small dollar credit, rather than a regulatory environment that progressively chokes off customer access.

The attached ABA-sponsored research paper (see Annex) quantifies the economic benefit that one form of short-term small dollar credit—overdraft services—provides to customers and to the economy. The report’s most salient findings are—

- Users of overdraft protection realize a personal economic benefit of over seven to one of funds extended to fees charged for use of the service, providing an annual economic stimulus of $65.6 billion.
- Customers lose an average of $443 in purchasing power for each attempted check or ACH transaction that is returned due to insufficient funds in the customer’s account. The total annual lost purchasing power is at least $43.7 billion.

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14 The $43.7 billion amount does not include the additional costs associated with returned transactions such as merchant NSF fees and late charges on rent, utility, or loan payments. Thus, it may understate the true loss to customers and the economy caused by returned transactions.
Lower-income customers pay lower effective overdraft fees and use the service at lower rates than middle-income customers. This suggests that short-term credit, while important to lower-income customers, is needed by people across income levels.

III. Specific Recommendations

- **DDA Services.** The OCC and FDIC should rescind their 2013 guidance on DDA services, removing the cloud that they have cast over activities by banks to innovate and develop products to offer customers transparent, readily accessible, and sustainable small dollar credit options.\(^{15}\)

- **FDIC Overdraft Guidance.** The FDIC guidance was in fact thinly-disguised rule-writing, inconsistent with the Administrative Procedure Act. The guidance goes well beyond the actual regulations governing overdraft services and operates to reduce customer access to small dollar credit. On good government and customer interest grounds, the FDIC should withdraw its guidance.

- **The Bureau’s Proposed Small Dollar Lending Rules.** The Bureau should withdraw its proposed rule on small dollar lending. Its mere existence, with its credit-shrinking unworkable plans, acts as a cloud over further innovation and expansion of small dollar credit offerings to customers.

\(^{15}\) It is also worthwhile noting that the OCC and the FDIC, in justifying this clearly consumer regulatory guidance on safety and soundness grounds frustrated the purpose for the creation of the consumer Bureau to centralize consumer protection regulation in one agency. Moreover, regulatory agencies should use rulemaking, not guidance, when they impose requirements on banks and other financial institutions. The use of rulemaking for essentially binding pronouncements is consistent with the Administrative Procedure Act and Executive Order 12866, which together require an agency, when proposing a rule, to provide notice and an opportunity for public comment and to conduct a cost-benefit analysis of the proposed rule.
Annex
An Assessment of Usage of Overdraft Protection by American Consumers

By G. Michael Flores

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About the Author

G. Michael Flores is CEO of Bretton Woods, Inc. (www.bretton-woods.com) and is a researcher and business adviser who has studied financial services companies and consumer credit in general for over 30 years, with a focus on “alternative” credit programs for the last 10 years. Since 1995 he has been actively involved in advising banks seeking to establish their overdraft programs. He has written and published research papers on consumer credit in the United States and the United Kingdom, as well as papers on payments, including general-purpose reloadable and payroll prepaid cards. Based on these studies, he has testified before several House and Senate subcommittees and spoken to industry groups. He has also authored articles for industry publications. He is a faculty member with Pacific Coast Banking School at the University of Washington in Seattle.
Overview

Consumer use of overdraft protection services offered by financial institutions remains strong, fueling the debate about the “fairness” of overdraft programs and whether additional regulation is needed. However, missing from this debate has been a discussion of the economic impact that usage of overdraft services provides to individual consumers and to the larger economy, partly because the current literature fails to examine this important aspect of overdraft services. Another constant throughout the debate over overdraft services has been the lack of information about those consumers who regularly use overdraft services.

To fill these gaps, the American Bankers Association retained the author’s firm to compile and analyze account, transaction and overdraft data from multiple banks. We analyzed de-identified data from 4.6 million consumer deposit accounts from 11 banks located in 8 Federal Reserve districts. From this sample, 1.2 million of those accounts incurred overdraft (OD) and/or insufficient funds (NSF) activity during the 365-day period that we analyzed.

We examined the purchasing power that overdraft provides and estimated the impact these purchases have on the economy. In addition, we studied the incidence of overdraft activity – and fees assessed – by income group (using monthly deposits into a consumer checking account as a proxy for income) in order to shed light on the characteristics of consumers that use overdraft services.¹

Our primary findings are:

1. **Users of overdraft protection realize an economic benefit of over seven to one of funds extended to fees charged for use of the service, providing an annual stimulus to the economy of $65.6 billion.** For every dollar paid as a fee, the consumer can purchase an item or pay a bill that is more than seven times the amount of the overdraft fee. This equates to an annual economic stimulus of $65.6 billion.

2. **Consumers lose an average of $443 in purchasing power for each attempted check or ACH transaction that is returned due to insufficient funds in the consumer’s account.**² The total annual lost purchasing power is $43.7 billion. Each time a consumer seeks to purchase an item or pay a bill and the attempted transaction fails due to insufficient funds, the consumer’s

¹ We readily acknowledge that using monthly deposits as a proxy for income is imperfect, as it may not capture all the income that a household receives each month. We assume for purposes of our analysis, however, that most households have only one transaction (checking) account and that this account captures most of the income received by a household each month. More importantly, we believe that focusing on average monthly deposits is a more accurate measure of household income than average monthly balance, as many higher-income households may also have higher expenses and thus maintain lower average balances.

² ACH or “Automated Clearing House” transactions are also known as pre-authorized debits, which are typically used for recurring payments such as mortgage and car payments, utility payments, etc.
average lost purchasing power is $443 per occurrence ($420 reflecting the amount of the returned transaction, plus the $23 NSF fee). We extrapolate the total annual lost purchasing power to be $43.7 billion. This amount does not include the additional costs associated with returned transactions such as merchant NSF fees and late charges on rent, utility or loan payments. Thus, it may understate the true loss to consumers and the economy caused by returned transactions.

3. **We find that the median dollar amount of transactions paid into overdraft is smaller than the median size of payments returned for insufficient funds.** This suggests that changes to the posting sequence of daily transactions from “high-to-low” to “low-to-high” may not only have reduced the number of overdraft fees paid but also have reduced the benefit of overdraft protection for consumers by preventing larger and typically more important payments from being honored.3

This finding suggests an important caution—to the extent there is concern about the amount of an overdraft fee relative to the size of the underlying payment paid into overdraft,4 regulators should recognize that average size of the paid transaction is, in part, the result of their own statements questioning high-to-low posting that favor the payment of smaller transactions through overdraft and rejection of larger transactions. Therefore, although the change in posting order rules may have reduced the number of overdraft fees paid by consumers, it has also simultaneously reduced the benefit provided by overdraft protection to consumers by reducing the average size of the transactions that are paid and thus the average purchasing power of overdraft protection.

4. **The characterization of a typical overdraft protection user as a lower-income consumer is inconsistent with the data.** Middle-income consumers use overdraft protection at higher rates than lower-income consumers. In general, there is no “typical” user of overdraft protection; consumers across the income spectrum use overdraft protection and do so for many different reasons. However, our data show that accounts with higher monthly deposits exhibit a higher level of overdraft usage than accounts with lower monthly deposits. We hypothesize that one possible explanation for this incidence of overdraft usage by higher-income families is that overdraft protection is used

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3 As a general practice, financial institutions process transactions at the end of each day, and follow different internal rules for processing transactions that occurred that day (or, in certain cases, occurred on a prior day). “High-to-low” processing refers to the practice of processing the largest transaction first, followed by smaller transactions in descending order. “Low-to-high” processing entails processing transactions in reverse order.

by them to address volatility in their flow of income and/or misalignment of income and expenses.

5. **We find no evidence that overdraft protection is a product targeted to lower-income consumers.** In fact, overdraft fees actually paid by lower-income consumers are lower than fees paid by higher-income users due to a greater number of waivers and refunds given to consumers in the lower-income strata.

- The data show that the *effective* overdraft fee paid on the average transaction by lower-income consumers is less than the disclosed overdraft fee and less than the effective fee paid by higher-income consumers.

- The data also show that since the Federal Reserve amended Regulation E (Reg E) to require consumers to opt-in to overdraft protection for debit card point-of-sale (POS) and ATM transactions, lower-income consumers have opted-in at a *lower* rate than higher-income consumers. This finding is inconsistent with the claim that lower-income consumers are being “targeted,” or pushed to opt-in to overdraft services.

### Summary of Findings

Our review of the data reveals the following specific findings:

- **The purchasing power of transactions paid into overdraft for all channels is 7.6 times the aggregate overdraft fees paid regarding those transactions.** Overdraft and NSF fees assessed by banks with over $1 billion in assets totaled $11.16 billion in 2015, according to the Consumer Financial Protection Bureau (Bureau). Extrapolating to all banks, overdraft and NSF fees totaled $12.0 billion in 2015. Overdraft fees represent 71.9% of gross overdraft and NSF fees, or $8.6 billion. At an overall purchasing multiple of 7.6, $8.6 billion in overdraft fees account for $65.6 billion in product and services purchases.

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7 We arrived at the $12.0 billion figure as follows: Total service charge income of banks with assets under $1 billion represented 7.6% of the total service charge income of banks with assets greater than $1 billion. Hence, we increased $11.16 billion by 7.6%, which equals $12.0 billion.

8 The Bureau’s study of banks in 2014 found that overdraft fees comprised 71.9% of gross overdraft and NSF fees. **BUREAU, DATA POINT, supra note 4, at 10.**
• **Lost purchasing power through returned transactions and associated NSF fees is approximately $43.7 billion annually.** This figure is calculated by dividing total NSF fees of $2.3 billion ($12.0 billion total overdraft and NSF fees, with NSF fees accounting for 18.9%[^9]) by the average NSF fee paid of $23. The result of that calculation is 98.6 million returned items annually. That figure is multiplied by $443 (average returned amount of $420 plus the $23 NSF fee) to arrive at a total lost purchasing power of $43.7 billion annually.

• **Lower-income consumers are less likely to opt-in to ATM and debit card point-of-sale (POS) overdrafts under Regulation E than higher-income consumers.** Lower-income customers opt-in at a lower rate than higher-income customers (49% - 54% compared to 60% - 61%). This finding is consistent with the Bureau’s findings.^[10]

• **The median size of transactions returned for insufficient funds is larger than the median size of items paid by overdraft protection.** The median size of transactions returned for insufficient funds was $463, whereas the median amount of items paid by overdraft protection was $370. This likely reflects the change that most banks have made to move away from high-to-low posting order and to low-to-high posting order. Because smaller transactions are paid first under a low-to-high posting order, larger transactions are more likely to be declined, reducing the purchasing power of overdrafts and the benefit of having larger—and typically more important—transactions paid by overdraft protection.

• **Among consumers that use overdraft protection, lower-income consumers had significantly fewer overdrafts than higher-income consumers.** Households in the lower-income strata (below $24,000 in annual deposits) averaged 10 items paid into overdraft annually compared to 18 items paid into overdraft annually by consumers in the highest income stratum (greater than $60,000 in annual deposits). In other words, higher-income consumers had 80% more items paid into overdraft, on average, than lower-income consumers.

• **Lower-income consumers do not incur a disproportionately large proportion of overdrafts compared to higher-income consumers.** We find that the percentage of overdrafts attributable to lower-income accounts (21.5%) is less than the overall percentage of lower-income accounts in the bank (41.3%).

• **Lower-income customers are more likely to receive waivers and refunds of overdraft fees than higher-income customers.** Lower-income customers paid, on average, lower effective overdraft charges than higher-income customers, after adjusting for waivers of fees that could be assessed and refunds of assessed fees.

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[^9]: The 18.9% figure is also from the Bureau’s study of banks in 2014. *Id.*

Overall, lower-income consumers realized a 29% to 36% reduction of overdraft fees; this reduction was greater than the reduction realized by higher-income consumers, which ranged from 21% to 22%. Across all accounts, the overall average reduction was 28%. For example, for all consumers with less than $1,000 per month of average deposits, 36% of all overdraft fees were waived or refunded, whereas for consumers with average deposits of over $5,001 per month only 21% of fees were waived or refunded. This finding of increased waiver and refund rates for lower-income consumers is inconsistent with the narrative that overdraft protection unfairly targets lower- and moderate-income consumers.

- **Lower-income consumers have 4.0 debit card transactions declined annually, on average, compared to 2.3 debit card transactions declined annually, on average, for higher-income consumers.** This higher incidence of declined debit card transactions by lower-income consumers constitutes another data point that is inconsistent with the narrative that the payment of POS overdraft transactions for lower-income consumers threatens to ensnare them in a “debt trap” that could result in account closure and push them out of the banking system.

- **Accounts with higher monthly deposits exhibited more frequent use of overdraft services than accounts with lower monthly deposits.** Although this finding might seem anomalous, we hypothesize that many higher-income households have relatively higher expenses as compared to lower-income households, and thus, maintain lower precautionary balances. This relationship suggests that many higher-income households use overdraft protection as a liquidity product to address income volatility and misalignments of the timing of deposits and expenses.

- **Of all items presented for payment (including debit card POS transactions), 70% were paid, 18% were returned, and 12% were declined.**

**Background**

Overdraft protection services allow customers, for a fee, to have purchases and other transactions processed for payment when there are insufficient funds in an account to pay the transaction. In February 2012, the Bureau announced the initiation of a study of overdraft protection practices to assess the need for additional regulation that could curtail consumer access to the product, especially for high volume users.

The Bureau’s increased attention to overdraft services comes at a time when consumers have significant need for short-term liquidity, but fewer options for meeting that need. A report issued in May 2016 by the Board of Governors of the Federal Reserve

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11 This figure is consistent with other studies. See, e.g., BUREAU, DATA POINT, supra note 4, at 10.

12 The declined transactions comprise attempted POS and ATM transactions.
System (Federal Reserve) found that 46% of survey respondents could not pay a hypothetical emergency expense of $400 without selling a possession or borrowing money.\footnote{\textsc{Fed. Reserve Sys. Bd. of Governors, Report on the Economic Well-Being of U.S. Households in 2015}, at 22 (May 2016), available at \url{http://www.federalreserve.gov/2015-report-economic-well-being-us-households-201605.pdf}.} But the Bureau’s proposed rule for Payday, Vehicle Title, and Certain High-Cost Installment Loans (Small Dollar Lending Proposal) could reduce access to another form of short-term liquidity—payday loans—by up to 81%.\footnote{Proposed Rule, Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. 47,864, 48,122 (July 22, 2016) (calculating reduction in storefront payday lenders resulting from proposal).} Our prior studies and those by other researchers conclude that overdraft and payday loans are substitute products. As such, if the Bureau’s Small Dollar Lending Proposal is finalized without significant changes, it will increase the demand for other short-term liquidity products, including overdraft services. Accordingly, the adoption of additional rules that restrict access to overdraft services will leave millions of consumers with limited access to needed short-term liquidity products.

It is clear from the literature that automated overdraft protection programs have benefited many consumers. Traditionally, to protect against overdrawing one’s account, well-qualified customers could obtain an overdraft line of credit. For those without access to a line of credit, financial institutions might accommodate the customer and pay overdrafts on a discretionary, ad hoc basis. Automation has permitted access to overdraft protection to a broader range of bank customers, thereby relieving them of the anxiety of bounced checks and declined payments and enabling them to gain access to needed cash in an emergency. In addition, the product has allowed banks to reduce or eliminate the minimum balance requirement for customers, providing further benefit to consumers, although this trend is now slowing. The growth of overdraft protection is at least partly responsible for the growth of free checking during the 2000s, which opened access to the banking system to millions of new customers.\footnote{Todd J. Zywicki, \textit{The Economics and Regulation of Bank Overdraft Protection}, 69 \textit{Washington & Lee L. Rev.} 1141 (2012), available at \url{http://scholarlycommons.law.wlu.edu/wlulr/vol69/iss2/17}.} Indeed, the latest (2015) FDIC study on the unbanked and underbanked households states that the percentage of households that are unbanked decreased from 8.2% (9.9 million out of 120.4 million) of total households in 2011 to 7.0% (8.9 million of 127.5 million) of total households in 2015.\footnote{\textsc{Fed. Deposit Ins. Corp., FDIC National Survey of Unbanked and Underbanked Households 2 (2015)} (Table ES.1), available at \url{https://www.fdic.gov/householdsurvey/2015/2015report.pdf}.}

Against this backdrop, we assessed the benefits provided to consumers of overdraft and the demographic profile of those consumers who regularly use the product.
Scope and Methodology

This study provides new evidence to inform the debate over consumer usage of overdraft protection. We aggregated data from 11 community and regional banks with operations in 8 Federal Reserve districts encompassing 1.2 million consumer deposit accounts with NSF/OD activity. From this sample, we analyzed the following data:

- Percent of current customers that had opted-in to POS and ATM overdraft protection after the amendment of Regulation E, effective on July 1, 2010 (which, as mentioned above, required existing customers to proactively opt-in to overdraft coverage for ATM and POS debit card transactions).
- New accounts opened within the past year that opted-in to POS and ATM overdraft protection.
- Mean and median amounts of transactions paid into overdraft, by channel (check, ACH, POS/ATM).
- Mean and median amount of transactions declined or returned as NSF by channel (check, ACH, POS/ATM).
- Mean and median monthly deposits (credits to accounts).
- Mean and median monthly and annual account balances.
- Total number and dollar amount of items presented, paid, returned, and declined per account.
- Range of the dollar size of OD/NSF fees which could be assessed.
- Frequency of OD/NSF fees waived and refunded, and thus the actual effective fee per overdraft paid by the consumer.

Findings

Using the data described above, we examine several different questions. Using average monthly deposits as a proxy for income, we examine the usage of overdraft protection by different categories of consumers and the purchasing power it affords them. First, we find that overdraft protection provides significant purchasing power to consumers, allowing for an average purchase, payment, or other transaction in an amount that is more than seven times the dollar value of the fee assessed for the overdraft. Second, contrary to the perception that lower-income consumers are disproportionate users of overdraft protection, we find that the heaviest users of overdraft protection are middle-income consumers.

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17 The banks from which the study data were derived all have “dynamic” overdraft systems in place, meaning systems that set and adjust overdraft limits based on account activity, such as changes in the amount of deposits, the frequency of deposits, overdrawn balance repayment trends, etc.

18 Our data does not distinguish between POS and ATM transactions but does distinguish between those transactions and other uses of overdraft protection to cover check and ACH transactions.
A. Purchasing Power

Overdraft protection can provide an important source of liquidity for households. As such, it enables them to make purchases that they otherwise would not be able to make. Prior research by the author has found that overwhelmingly, overdraft protection is used to make purchases for what are likely to be essential goods and services—groceries, gasoline, utilities, insurance payments and the like. Access to overdraft protection also benefits merchants and local communities as it enables consumers to purchase goods and services they would otherwise have to go without.

Examining the current dataset, we find that overdraft protection provides consumers with substantial purchasing power. The typical transaction paid into overdraft is 7.6 times the size of the effective fee (once adjusted for waivers and refunds). That is, users of overdraft protection realize an economic benefit of over seven to one of funds extended to fees charged for use of the service.

Moreover, the purchasing power of consumers in the lowest income strata is higher than the average purchasing power multiple of the overall sample (7.9 times the effective overdraft fee versus 7.6 times). More generally, once waivers and refunds are considered, the purchasing power of overdraft protection is substantial across all income segments, as shown in Chart 1. This suggests that even though the average size of an overdraft transaction is larger for higher-income users, the value provided by overdraft protection is relatively consistent regardless of income level once waivers and refunds are considered.

Chart 1. Effective Purchasing Power of Overdraft

We also examine the purchasing power of different types of transactions, such as checks, ACH transactions, and POS/ATM transactions. As one would expect, checks and ACH have the highest multiples, 13.0 and 7.7 respectively, with ATM/POS transactions.

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accounting for a 2.4 purchasing multiple. It is likely that the purchase price multiplier for POS transactions would be higher but for litigation and regulatory expectations that have encouraged financial institutions to adopt low-to-high posting, which in turn has reduced the average size of the transactions that are paid into overdraft.

The foregoing findings dispel the claim made by some that overdraft protection is predominantly used by individuals to purchase a small-dollar, non-necessity item—the much maligned “$35 cup of coffee.” As described above, the average use of overdraft protection permits the consumer to purchase or pay for an item whose value is over seven times the amount of the overdraft fee. This represents significant value for the consumer.

We also examine data on the lost purchasing power for returned items (i.e., returned checks) that were not honored by overdraft protection. The average size of transactions returned for insufficient funds across all channels was $420, reflecting a significant loss in purchasing power of $443 per declined transaction (including an average NSF fee of $23).

Additionally, we see that the median size of items paid into overdraft is smaller than the size of transactions returned for insufficient funds: $370 is the median size of paid items and $463 is the median size of returned transactions. The fact that the median size of returned items exceeds that of paid items may reflect changes bankers have made over the last several years to post smaller payments first. The consequence is that larger and presumably more important transactions may not be paid and the consumer will be required to pay additional fees on these returned items in the form of potential second presentment fees charged by the bank, NSF fees charged by the merchant, late fees on loan payments, utility disconnect/reconnect fees, etc.

The following chart indicates that larger transactions are being returned rather than paid.
This finding that larger items are being returned and smaller items are being paid through overdraft bears consideration. If one measure of consumer benefit from overdraft protection is the purchasing power generated by overdraft services, it should be recognized that this benefit is a function, in part, of transaction posting order. Thus, if smaller items are paid through overdraft and larger items are declined, the average purchasing power will fall. In contrast, under a high-to-low posting order, the average purchasing power of overdraft transactions (and thus the benefit) would increase and the average size of rejected payments would decrease. Regulators should keep these consequences in mind when evaluating the overall impact on consumer welfare of regulating posting order.

B. Lower-Income Consumers Are Not the Primary Users of Overdraft Protection

A common criticism of overdraft protection, and the impetus for calls for regulation, is the claim that overdraft protection is a product that may harm lower-income consumers if excessive use results in involuntary account closure and pushes the consumers out of the financial system. However, the data we reviewed are inconsistent with that claim.

20 This contention that overdraft protection is targeted to lower-income consumers is based largely on conjecture. The only basis for the claim is a passing reference in a 2008 report by the Federal Deposit...
We test this claim in four different ways. First, we find that, on average, lower-income consumers had significantly fewer overdrafts than higher-income consumers. Second, we find that the percentage of total overdrafts at the study banks that are attributable to lower-income households is lower than the overall percentage of accounts at the bank that belong to lower-income households. This indicates that lower-income households are not paying a disproportionate share of overdraft fees. Third, lower-income households are much more likely to receive fee waivers or refunds for overdraft transactions than higher-income households. Fourth, lower-income households are more likely to have POS debit card transactions declined rather than paid through overdraft.

At the outset of this section, we note that the data we analyzed reveal that only 29% of all DDA customers presented items against insufficient funds. That finding is consistent with the Bureau’s 2014 study, which found that most bank customers never overdraw their accounts. Thus, most consumers—lower-income or otherwise—never experience the need to access overdraft services.

Insurance Corporation (FDIC) that found that usage of overdraft protection was higher in lower-income census tracts than in wealthier tracts. Fed. Deposit Ins. Corp., FDIC Study of Bank Overdraft Programs 77-78 (2008), available at https://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_Final_v508.pdf. However, the FDIC report failed to determine what factor—creditworthiness or demographic variables—is causally linked to, as opposed to correlated with, overdraft usage. See id. at 81 (grouping participants by age and income but not by credit score). The FDIC study did not control for credit score, which tends to be correlated with income and age. The FDIC report also did not examine whether other relevant characteristics, such as lack of access to other forms of credit or writing dishonored checks, were also correlated with use of overdraft. If such characteristics correlated with overdraft, it would suggest that the underlying income characteristics of the consumer—not marketing—was determinant of the consumer’s use of overdrafts.

The FDIC also provided no information on how heavily various strata of consumers used overdraft protection. For example, it could be that a higher number of lower-income consumers use overdraft protection in a given year, but that heavier users of overdraft protection are more likely to be high-income consumers. Subsequent CFPB reports have examined various elements of consumer usage of overdraft protection but have done little to illuminate consumer decision-making about this product.

21 We define “lower-income” households as those with gross annual income of less than $26,741 or less than $20,056 net after-tax income, which equates to $1,671 per month. Our strata of households group households who receive monthly deposits of $1,000 - $1,500 and $1,501 - $2,000; we chose to use the higher stratum to define the upper limit of lower-income. We arrived at this definition of lower-income as follows: The Federal Financial Institutions Examination Council (FFIEC) defines “lower-income” as those households that have income of less than 50% of median household income. Fed. Fin. Insts. Examination Council, FFIEC Geocoding System, https://www.ffiec.gov/geocode/help3.aspx. The U.S. Census Bureau reported that median household income was $53,482 in 2014. U.S. Census Bureau, American FactFinder, https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk. Fifty percent of $53,482 is $26,741. Our proxy for income is the annual deposits (net income) made to a checking account. We conservatively estimate that take-home pay is 75% of gross income. Seventy-five percent of $26,741 is $20,056.

22 Bureau, Data Point, supra note 4, at 12.
1. Higher-Income Households Use Overdraft Protection More Frequently Than Lower-Income Households

Lower-income customers averaged significantly fewer overdrafts each month as compared to higher-income customers. As shown in Chart 3, of the accounts that had at least one overdraft, the ones in the lower-income strata (the four strata with annual deposits below $24,000) averaged 10.0 items annually paid into overdraft compared to an average of 18.5 items paid into overdraft annually for accounts in the upper-income strata.

Chart 3. Overdrafts by Average Deposit Amounts for Accounts with One or More Overdrafts

Chart 4. Overdraft Activity by Average Monthly Balance for Accounts with One or More Overdrafts

Examining these two charts together shows that overdraft usage is highest among those accounts that have the highest level of deposits but also the lowest average monthly
balances. One possible explanation for this relationship is related to income volatility and the flow of income through a particular household—it may be that many middle-income households have high monthly expenses and thus retain only a modest average balance in their accounts. For these higher-income households, overdraft protection provides liquidity to smooth short-term misalignments between income and expenses and is an alternative to maintaining higher precautionary balances, which might be difficult. By contrast, lower-income consumers, especially those with impaired credit and limited credit options, use overdraft protection less frequently, sometimes intentionally as a short-term liquidity alternative to payday loans, late bill payments, or other less desirable options to pay unexpected bills or other emergency expenses.

The foregoing finding explains why certain households simultaneously have (1) high average deposits per month, (2) low average balances per month, and (3) high usage of overdraft protection. These households are acting rationally to obtain needed funds in the least expensive manner from the choices available. This finding also contradicts the claim that overdraft protection programs are used disproportionately by lower-income consumers.

Although this finding runs against the grain of conventional wisdom, it should not be surprising from an historical perspective. Overdraft protection originally emerged as a convenience for middle- and upper-income bank customers with short-term liquidity needs. Our data suggests that these customers continue to be the primary frequent users of overdraft protection.

2. **Lower-Income Accounts Do Not Incur a Disproportionate Percentage of Overdrafts**

Next, we examined whether lower-income accounts incur a disproportionate number of overdrafts by comparing the percentage of bank accounts, in eight of the eleven banks in the sample that provided the relevant data, that were below the poverty line (as measured by annual deposits) with the percentage of overdraft items incurred by those accounts. If overdraft protection programs were targeted at lower-income consumers, we would expect a higher percentage of overdrafts among lower-income accounts than would be expected based on their share of deposits.

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24 See *Should You Use Payday Loans or Overdraft Checks?*, Making Money, http://money-things.communizine.net/should-you-use-payday-loans-or-overdraft-checks/. Bretton Woods calculated that at the $25.56 average effective overdraft cost per transaction, it is less expensive for a consumer to pay for an overdraft of $170 or more than to use a payday loan at a cost of $15 per $100 advanced. Also, the average payday loan advance of $350 would cost the consumer $52.50 versus $25.56 for an overdraft of the same amount.

25 We have data on eight of the eleven banks in the study related to the number of accounts below the poverty level and the number of overdraft items associated with these accounts.

26 Accounts below the poverty line are defined as households with less than or equal to $18,636 in annual deposits with at least 10 deposits over the course of the year and that had been open at least 365 days.
consumers, one would predict that lower-income accounts would incur a disproportionate number of overdrafts, i.e., the percentage of overdraft items paid by lower-income accounts would exceed the percentage of lower-income accounts at the banks studied.

As seen in Table 1, the percentage of overdraft items attributable to accounts of lower-income consumers (21.5%) was less than the percentage those accounts comprised at the bank during the relevant time-period (41.3%). In several cases, there were twice as many accounts beneath the poverty line, in percentage terms, than overdraft items paid by those accounts.

Table 1. Analysis of Personal Accounts Below the Poverty Line

<table>
<thead>
<tr>
<th>Bank</th>
<th>Total Accounts (calculated)</th>
<th>Accounts Below Poverty Line</th>
<th>% Accounts Below Poverty Line</th>
<th>Total Items (calculated)</th>
<th>Items Below Poverty Line</th>
<th>% Items from Accounts Below Poverty Line</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>47,633</td>
<td>15,221</td>
<td>32.4%</td>
<td>276,520</td>
<td>49,053</td>
<td>17.7%</td>
</tr>
<tr>
<td>2</td>
<td>26,875</td>
<td>12,223</td>
<td>45.5%</td>
<td>91,458</td>
<td>28,199</td>
<td>30.8%</td>
</tr>
<tr>
<td>3</td>
<td>154,920</td>
<td>54,735</td>
<td>35.3%</td>
<td>809,547</td>
<td>150,678</td>
<td>18.6%</td>
</tr>
<tr>
<td>4</td>
<td>79,561</td>
<td>29,757</td>
<td>37.4%</td>
<td>578,673</td>
<td>96,168</td>
<td>16.6%</td>
</tr>
<tr>
<td>5</td>
<td>135,989</td>
<td>40,770</td>
<td>30.2%</td>
<td>173,310</td>
<td>28,386</td>
<td>16.4%</td>
</tr>
<tr>
<td>6</td>
<td>263,693</td>
<td>79,971</td>
<td>30.3%</td>
<td>435,205</td>
<td>64,015</td>
<td>14.7%</td>
</tr>
<tr>
<td>7</td>
<td>236,731</td>
<td>65,811</td>
<td>27.9%</td>
<td>974,370</td>
<td>129,581</td>
<td>13.3%</td>
</tr>
<tr>
<td>8</td>
<td>1,890,675</td>
<td>872,109</td>
<td>46.1%</td>
<td>9,637,146</td>
<td>2,237,627</td>
<td>23.2%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>2,834,086</td>
<td>1,170,597</td>
<td>41.3%</td>
<td>12,977,229</td>
<td>2,783,707</td>
<td>21.5%</td>
</tr>
</tbody>
</table>

This finding provides perspective with respect to an ongoing debate over whether the heavy use of overdraft protection by some consumers creates an undesirable cross-subsidy for other consumers. These findings suggest that if there is a cross-subsidy, it is likely progressive and not regressive. Higher-income households pay a disproportionate share of overdraft fees relative to lower-income households. Furthermore, these cross-subsidies have dramatically reduced the cost of a checking account to consumers, permitting more consumers to have access to the banking system. The latest annual study (2015) by the American Bankers Association indicates that 61% of consumers pay no monthly fees for a checking account and an additional 11% pay $3 or less per month.

3. Lower-Income Households are More Likely to Receive Fee Waivers and Refunds Than Higher-Income Households

Many previous studies and reports equate the cost of an overdraft to the fee disclosed in each bank’s deposit account contract. Our analysis measures the actual cost of the overdraft to the consumer, which is the disclosed overdraft fee less waivers and post-transaction refunds. For all study banks, 22% of chargeable fees were waived at the time of processing, with an additional 6% refunded sometime after the transaction, for an average of 28% of fees waived or refunded. Overall, our study banks averaged a disclosed fee of $35.50 per overdraft, but after adjusting for waivers and refunds, the average effective overdraft fee was approximately $25.56.
We also find that study banks’ propensity to grant fee waivers and refunds varies with income. The data indicate that once waivers and refunds are considered, more than 36% of overdraft fees that could be assessed against lower-income households are not, as compared with only a 21% reduction in overdraft fees assessed against high-income households.

**Chart 5. Waiver and Refund Analysis by Average Monthly Deposit Segment**

Because of this higher waiver and refund rate, lower-income households pay not only an *effective fee* that is approximately 36% lower than the disclosed fee at a given bank, but also, they pay a lower effective average overdraft fee than higher-income households, who are less likely to have fees waived or refunded.

4. **Lower-Income Households are More Likely to Have Fewer Overdrafts Paid and More POS and ATM Transactions Declined**

Our data indicate also that lower-income consumers experience a larger number of declined POS debit card transactions and a smaller number of overdrafts paid annually as compared with higher-income consumers. This results in fewer overdraft fees paid by this consumer segment than by higher-income consumers, on average.
As can be seen in this chart, the average number of overdrafts paid annually is lower and the average number of annual declined debit card transactions is higher for low-deposit accounts than for high-deposit accounts. Therefore, lower-income consumers, including those who have opted-in to ATM and debit card overdrafts, are much more likely to have a debit card transaction declined for insufficient funds than paid into overdraft as compared with higher-income consumers. This result is inconsistent with the claim that lower-income consumers are disproportionately represented among overdraft users and that their overdraft usage may trap them in a cycle of debt, which if not resolved could result in involuntary account closure and loss of access to the financial system.

5. **Lower-income Consumers Are Less Likely to Opt-in to ATM and Debit Card POS Overdrafts**

In 2010, the Federal Reserve amended Regulation E to require new customers to “opt-in” to overdraft protection for point-of-sale debit card transactions and ATM transactions.27 Chart 7 shows that lower-income consumers are less likely than higher-income consumers to opt-in for these overdrafts. Specifically, those consumers with less than $500 in monthly deposits have an opt-in rate of approximately 50%, compared with an opt-in rate of approximately 60% for those consumers with greater than $5,000 in monthly deposits. This finding is also consistent with the patterns depicted in Chart 6 that lower-income consumers used overdraft protection less frequently than higher-income

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27 Final Rule, Amendment to Regulation E, 74 Fed. Reg. at 59,033.
consumers. These data points are also inconsistent with the claim that financial institutions target their overdraft marketing to lower-income consumers.

**Chart 7. Opt-In Rates by Average Deposit**

![Chart 7](image)

**D. Impact of Policies**

Policy changes influence the value that a financial product provides to a consumer. Historically, many banks processed higher-dollar transactions before lower-dollar transactions in the belief that consumers wanted their larger and, presumably, more important payments prioritized for payment. When a larger item like a utility bill or rent payment was returned, it could lead to the cessation of the utility service, late fees, eviction, or other adverse consequences.

For a variety of reasons, many banks have changed that high-to-low policy in favor of a policy that processes low-dollar transactions first, in order to pay as many items as possible before returning others for insufficient funds. This has reduced the number of items paid into overdraft and thus lowered the fees charged to consumers. However, the consequence of this policy change is that consumers increasingly have larger transactions returned for insufficient funds, thereby causing additional costs in the form of second presentment fees, merchant NSF fees, late charges for rent, car or mortgage payments, utility disconnect/reconnect fees, and the like.
Summary and Conclusions

We find that overdraft services provide a significant benefit to individual users and to the economy as a whole. The users of overdraft realize an economic benefit of over seven to one of funds extended to fees charged for the use of the service, pumping $65.6 billion annually into the larger economy. We also find that consumers lose an average of $443 in purchasing power for each transaction that is declined, instead of paid into overdraft, due to insufficient funds in the user’s account, preventing $43.7 billion from entering our nation’s economy.

We also find that lower-income consumers use overdraft services less frequently than do middle-income consumers. The data show that lower-income consumers pay lower actual fees than higher-income consumers, because lower-income consumers receive a greater number of waivers and refunds. This refutes the claim that overdraft is targeted to lower-income consumers.

Our findings suggest that consumers use overdraft protection for a variety of diverse ends. Higher-income consumers who use overdraft protection likely do so as a short-term liquidity product to offset the need to maintain high precautionary balances in their checking accounts. Lower-income consumers use overdraft protection less often and may do so as a planned short-term liquidity product to pay emergency or other unexpected expenses, rather than as a product to address timing issues in deposits.

The proposed Payday, Vehicle Title, and Certain High-Cost Installment Loans rule is projected to reduce the availability of storefront payday lenders by up to 81%. Because payday lending and overdraft protection are close substitutes for many consumers, the elimination of small-dollar alternatives will likely cause many consumers to turn to overdraft protection. Further restrictions of overdrafts will leave millions of consumers without viable (legal) options or to bounce more checks with the accompanying fees and other consequences.

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