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THE ECONOMICS AND REGULATION OF BANK OVERDRAFT PROTECTION

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Abstract:

Consumer use of bank overdraft protection has risen rapidly over the past decade, leading to increased scrutiny and the imposition of new regulations. Public and political debate regarding overdraft protection has highlighted anecdotal stories about irresponsible college students who overdraw their accounts to buy a cup of coffee, thereby triggering substantial overdraft fees. But there has been little systematic examination of the safety and soundness or consumer protection issues implicated by the increased use of overdraft protection.

Available evidence indicates that those who rely on overdraft protection tend to have low credit ratings, use overdraft protection because it is sometimes less expensive, to maintain short-term liquidity needs, and more convenient than available alternatives. These alternatives include other credit options, such as payday lending, or options such as bounced checks or dishonored payments, which may result in eviction or termination of utilities or other services.

There is also no evidence that those who use overdraft protection are unaware of the cost or otherwise use overdraft protection foolishly or unknowingly. In addition, there is no evidence that banks are earning economic rents off the issuance of overdraft protection, as increases in overdraft revenues have been offset by dramatic increases in free checking, improved quality, and free services offered to bank customers. A serious reduction in overdraft revenues would reverse all of these trends and result in many consumers being driven out of the mainstream financial system, especially low-income consumers.

Absent a demonstrable market failure or demonstration of systematic consumer abuse, restriction on consumer choice of overdraft protection would likely impose substantial costs on consumers and banks with minimal gains.

The Economics and Regulation of Bank Overdraft Protection

Todd J. Zywicki¹

Consumer use of bank overdraft protection has risen rapidly over the past decade. In 2010, 13 million consumers used overdraft protection and banks generated \$35 billion in revenue, an important and growing part of total bank revenue. In turn, this growth has spawned increased media and regulatory attention focused on the product. Standard economic analysis recognizes that the increased demand for a product—including a financial product such as overdraft protection—as evidence of consumer satisfaction and demand for the product. Bank regulators, by contrast, have raised concerns about the increased use of overdraft protection by consumers and have issued regulatory guidance regarding the product under a safety and soundness rationale. In 2009, the Federal Reserve imposed new limits on overdraft protection that made it more difficult for banks to provide the service to consumers.² The Federal Deposit Insurance Corporation (FDIC)³ and the Office of the Comptroller of the Currency have also issued guidance on overdraft protection and pricing.⁴ In addition, the newly-created Federal Reserve Consumer Financial Protection Bureau (CFPB) created by the Dodd-Frank Financial

¹ George Mason University Foundation Professor of Law; Senior Scholar, Mercatus Center at George Mason University School of Law; Editor, *Supreme Court Economic Review*. Funding was provided by the Mercatus Center. Special thanks to International Bancshares Corp. (IBC), a major regional bank operating throughout Texas and the Southwest with approximately \$12 billion, which generously agreed to provide data on the use of overdraft protection courtesy loans by its customers. In terms of assets and customer base, IBC appears to be generally representative of major banks.

² Federal Reserve System, Amendments to Regulation E, 74 FED. REG. 59,033 (Nov. 17, 2009) (to be codified at 12 C.F.R. pt. 205).

³ Federal Deposit Insurance Corporation, Overdraft Payment Programs and Consumer Protection Final Overdraft Payment Supervisory Guidance, FIL-81-2010 (Nov. 24, 2010).

⁴ Department of the Treasury, Office of the Comptroller of the Currency, “Guidance on Deposit-Related Consumer Credit Products,” 76 FED. REG. No. 110, p. 33409 (June 8, 2011).

Regulatory Reform Legislation,⁵ is also expected to consider additional restrictions on overdraft protection through regulation or enforcement actions.

Public and political debate regarding overdraft protection has highlighted anecdotal stories about irresponsible college students who overdraw their accounts to buy a cup of coffee, thereby triggering substantial overdraft fees.⁶ Irresponsible college students who can't or won't balance their check books, however, are a small fraction of those who use overdraft protection in any given year. More important, although this subset of overdraft users might view the availability of overdraft as unnecessary or even a nuisance, for millions of others, overdraft can be a valuable tool to deal with short-term liquidity issues. The wisdom of imposing new guidance or regulations that could impair access to overdraft protection should be judged not by unrepresentative anecdotes but by seeking to understand the typical users of overdraft protection, why they use the product, and whether they understand its true cost relative to alternatives.

This paper seeks to take a first step toward answering those questions. To date, regulation has been promulgated despite an almost complete lack of knowledge about consumer demand for overdraft protection and any rigorous analysis of safety and soundness or consumer protection questions. Although the analysis presented here should also be understood as tentative, not comprehensive. But this first look at consumer use of overdraft protection suggests that those who use overdraft protection generally do so because the real-world alternatives that are available are more expensive or less flexible and convenient than overdraft protection, especially when the full cost of

⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, PUB. L. NO. 111-203 (July 21, 2010).

⁶ See Ron Lieber & Andrew Martin, *Overspending on Debit Cards is a Boon for Banks*, N.Y. TIMES (Sept. 8, 2009), available at <http://www.nytimes.com/2009/09/09/your-money/credit-and-debit-cards/09debit.html?em>.

alternatives is taken into account, including time, travel, and convenience. Moreover, those who use overdraft protection the most—and thus those about whom regulators appear to be most concerned—generally use the product rationally in light of available alternatives indicating that they are generally aware of the costs and benefits of overdraft protection and choose to use it anyway. In a free society, absent compelling evidence that consumers are ignorant or irremediably foolish—neither of which has been demonstrated with respect to overdraft protection—people are assumed to be the best judge of what is in their interests and should remain free to choose. If this is true, then restricting access to overdraft protection will harm most those supposedly sought to be helped.

To date, while regulators have imposed regulations and proposed still further interventions, they have provided no tangible evidence of safety and soundness risk, consumer harm, or other market failures from overdraft protection. Nor have they provided any evidence that consumers, especially high intensity users, are unaware of the cost of overdraft protection or other key terms of the contract or that they use overdraft protection irrationally in light of available alternatives. Most importantly, regulators have provided no evidence that curtailing access to overdraft protection would make better-off those consumers intended to be helped by the limitations. Those using overdraft protection generally do so because it is preferable to their available alternatives and forcibly reducing access will make many consumers significantly worse off by increasing the frequency of adverse events such as bounced checks, possible criminal prosecution, utility shut-offs, and evictions, or alternatively, forcing greater use of high-cost alternatives such as payday loans, pawn shops, rent-to-own, and even illegal lenders.

This article explores the economics of overdraft usage by consumers and banks to understand the economic logic of the product. It then examines the recent regulatory initiatives by the Federal Reserve, FDIC, and OCC governing overdraft protection issued under the rubric of safety and soundness protection as well as purported consumer protection rationales that might prompt regulatory action by the CFPB. The case for regulation in this area under traditional safety and soundness is exceedingly weak and the evidence of harm that would justify action under a consumer protection rationale, such as evidence of a lack of consumer understanding of the product's terms or prices, is nearly nonexistent. Moreover, although some of the regulations that have been issued to date have been troublesome but not crippling, the unintended consequences that followed in the wake of the Federal Reserve's 2009 rules illustrate the potential for more serious harm that could follow from intrusive regulation that dramatically limits access to or the usefulness of overdraft protection. In particular, although prudential safety and soundness regulators have taken a relatively cautious approach to the issue, it is foreseeable that an activist CFPB could dramatically reduce access to and the usefulness of overdraft protection, with far-reaching consequences for consumers, the banking system, and the national economy.

Sensible regulation of courtesy overdraft-protection services begins with a sound understanding of who uses overdraft protection and why. For most consumers, the primary purpose of overdraft protection is as liquidity insurance for which there are few real substitutes: convenient short-term credit to ensure the payment of current obligations (avoiding bounced checks and the like), paid back in a short period of time, and used as an alternative to maintaining low-interest precautionary balances in savings and checking

accounts that can be accessed at the point of sale without a credit card. And even though some consumers use overdraft protection frequently, there is no evidence that they would be made better if their choices were restricted. Based on currently available evidence, the defining characteristic of frequent overdraft users is a low credit score and poor credit history, resulting in an a paucity of attractive alternatives, not low income or other demographic characteristics.

Although overdraft protection is relatively more expensive than many mainstream financial products (such as credit cards), there is no evidence that overdraft protection is systematically more expensive relative to the real-world alternatives available to those who use it regularly.⁷ More specifically, although overdraft protection may be more expensive than alternatives for some consumers, it may also be relatively superior for other consumers. This is especially so once the full costs of acquiring credit (including nonfinancial costs such as the time, travel, and convenience) are taken into account.

Overdraft protection also goes hand-in-hand with the availability of low minimum-balance, free checking accounts, which has provided access to the mainstream financial system for many low-income and young families. The rapid rise in the availability of free checking from 2001-2009 was aided by the spread of overdraft protection, and especially automated overdraft protection, as well as the increased use of debit cards.⁸ Instead of the monthly-fee based model that dominated consumer banking

⁷ It should be stressed at the outset that while the standard measure of lending cost—the “Annual Percentage Rate” or APR—might be a somewhat useful shorthand for describing the cost of loans, it is practically worthless in describing the real cost of a small-dollar short-term loan such as payday lending or overdraft protection, which is a loan for only a few weeks or even days. For example, the faster a consumer repays an overdraft loan the higher the APR, and the slower he repays it the lower the measured APR. This suggests the artificiality of APR as a measure of cost in the context of small-dollar short-term loans.

⁸ Increased access to free checking began around 1998 but remained modest in numbers until access rose dramatically beginning in 2001.

for decades, the spread of overdraft protection opened the doors of the banking system to consumers who previously could not afford monthly maintenance fees and who were thus excluded from the banking system. And while substitution from use of fixed monthly fees to overdraft fees has produced a different pattern of cross-subsidization among bank consumers, reducing access to overdraft protection in the name of a subjective definition of fairness would reduce the availability of free checking accounts and impose new limits on bank access, such as higher mandatory minimum balances.

Finally, although overdraft fees and revenues have increased during the past decade, there is no evidence to date that banks are earning economic profits or “rents” from the growing use of overdraft protection. Instead, the market for overdraft protection is competitive both among banks offering overdraft services and with comparable products, such as payday lending. There is no evidence of super-normal returns to the banking industry generally from the growth of overdraft protection or from overdraft protection specifically. In fact, there is clear evidence to the contrary. Although overdraft revenues have risen, the costs of retail banking have increased as well, due to a range of quality improvements, including increased innovation (including on-line and mobile banking), an expansion of free services, and increased banking hours and banking days. These quality improvements and service improvements have made banking more convenient and accessible for consumers and brought many consumers into the mainstream banking system for the first time. These developments were spurred by the need to “keep up” in the highly competitive retail banking marketplace and reflect the high degree of competition in the banking market, a reality that makes it highly implausible that banks could earn sustainable economic profits that are not competed

away. The decline in access to free checking in response to the Federal Reserve's imposition of regulations on overdraft protection in 2009 evidences the market's competitiveness and that where revenues fall and costs rise those costs are passed through to consumers. Absent any evidence of sustainable economic profits in this sector of the banking industry, regulations that limit revenues from overdraft protection or any other service will have to be made up elsewhere through new and increased banking fees or substantial reduction in retail banking services and quality. There is no reason to believe that this regulatory-induced equilibrium outcome would be economically superior to that chosen by voluntary choice in a competitive market, especially once these other offsetting price and quality adjustments occur.

Regulatory proposals offered in the name of consumer protection can be justified in two ways. Under a theory of information failure, it might be argued that consumers simply lack sufficient information about the products that they are using, such as cost or other elements of the contract. In that case, intervention might be justified to improve the flow of information in the market, such as be required standardized disclosure formats, to enable consumers to better match their preferences with the products available in the marketplace. Substantive regulation of terms, however, generally would not be justified under this theory. Alternatively, under a theory of paternalism, it might be argued that *even if* information is freely available to consumers, consumers should simply be prohibited from making certain choices. Regulation grounded in paternalism, however, is much more dangerous in the unintended consequences it can produce precisely because it overrides consumers' assessments of their own best interests in light of the options they have at any given time with the preferences of a bureaucratic agency unfamiliar with the

particular context of consumer decision-making. Using overdraft protection is usually cheaper and more sensible than bouncing payments for utilities, rent, credit card accounts, or other bills. Crude and narrow measures of cost, such as APR, exclude many of the important total costs of obtaining and using credit—time, flexibility, and convenience—as well as these other costs of eviction and termination of utility service. Taking away overdraft protection or making it less useful and flexible for consumers and financial institutions will likely result in consumer harm in terms of more dishonored payments, utility service shut-offs, evictions, and other hardship, as well as more time and travel wasted in order to borrow relatively small sums of money.

I. Overdraft Protection: Background

A. The History of Overdraft Protection

Traditionally, American consumers had three primary forms of payment available to them: cash, checks, and more recently, credit cards. The advent and rapid spread of debit cards has added an additional payment system, one which has highlighted the question of overdraft fees because of the perception that debit cards and ATM machines are unusually prone to triggering “unfair” overdraft charges.

When using cash, a consumer bears no risk of overdrawing his account because he is limited to the cash he has on hand. On the other hand, cash is inconvenient and time-consuming to obtain and the consumer bears the risk associated with its loss or theft. Many consumers are reluctant to carry large amounts of cash with them or to make frequent trips to the bank to obtain cash. This in turn creates a liquidity constraint for consumers who use cash because they lack sufficient cash on hand, thus they may be

unable to take advantage of a retailer's sale or to purchase goods or services in an emergency. Cash generally is not used to make larger purchases and some merchants will not accept large-denomination bills. Moreover, cash can only be used for face-to-face transactions and cannot be used to pay bills by mail. Accessing large amounts of cash may also arouse suspicion with law enforcement authorities. And while ATMs make it easier to obtain and use cash than in prior eras, there is still a substantial cost in terms of time and inconvenience from ATM visits. Consumers can reduce those costs by making more infrequent ATM visits, but that requires withdrawing and carrying a larger amount of cash per transaction, which raises problems of loss or theft. Using out-of-network ATMs reduce the transaction costs of obtaining cash but usually incurs fees. In addition, using ATMs to withdraw cash can create a risk of overdrafting one's account.

Checks are an ancient response to all of these limits on the usefulness of cash. Checks solve many of the problems inherent in cash by enabling parties to transfer funds among themselves through bank drafts, rather than physically. But checks create new problems of their own because the payment order is separated in time from the actual payment. Even if there were sufficient funds in the account at the time the check was written, there might not be at the time the check clears. This gives rise to the well-known danger that a check might "bounce" and be returned for insufficient funds. In fact, because of bounced check risk, delay in settlement, and the slowness of checks in the checkout line, many merchants today no longer accept checks or do so only under

limited, lower-risk circumstances, and instead prefer payment by electronic payment systems such as debit cards.⁹

Bounced checks can be very costly to consumers. Direct fees imposed for checks returned for insufficient funds are substantial. For example, a bounced check may lead to fees imposed by both the payee as well as the financial institution that may exceed \$60 total per transaction, an implied APR far higher than for high-cost loans such as payday loans.¹⁰ Moreover, bounced check fees are cumulative—bouncing several checks can result in the imposition of substantial fees each time from both the bank and injured merchants. Dishonored checks also impose indirect costs. If a check is for payment of insurance, the policy will be terminated, and if for utilities (such as telephone or electricity) the bounced check may lead to termination of service, penalties, and a substantial security deposit to reconnect service. Retailers may refuse future service to customers who bounce checks. Bounced checks may also result in termination of a bank account¹¹ and even a risk of criminal prosecution.¹² In all, these various penalties may exceed hundreds of dollars. Most bounced check occurrences also require physical redemption of the check with payment of cash, which is time-consuming and embarrassing. Bouncing a check is also very damaging to one's credit score, making subsequent access to credit even more difficult.

⁹ According to one recent study 40% of national retail merchants will not accept checks for the purchase of goods and services. See Ed Roberts, *Average Account Overdraft Is \$40, but Total Cost is \$58, Study Finds*, CREDIT CARD MANAGEMENT (Aug. 22, 2011).

¹⁰ Michael W. Lynch, *Legal Loan Sharking or Essential Service? The Great "Payday Loan" Controversy*, REASON (2002); Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 155 (2004).

¹¹ According to one news story, at most banks "if you've bounced too many checks you're banned for five to seven years." Douglas McGray, *Check Cashers, Redeemed*, N.Y. TIMES MAGAZINE (Nov. 9, 2008).

¹² Every state provides for criminal penalties for passing bad checks under some circumstances. See, e.g., National Check Fraud Center, *Bad Check Laws by State*, <http://www.ckfraud.org/penalties.html>.

B. The Growth of Overdraft Protection Programs

Instead of bouncing checks, many banks have instead offered overdraft protection, in which a bank advances funds to clear the check so that it is not returned. Historically, banks occasionally cleared some checks on an *ad hoc* basis that otherwise would bounce. But this courtesy service was highly limited and discretionary, reserved for high income customers with short-term liquidity problems.¹³ That overdraft protection traditionally was a benefit for high-income customers is relevant for understanding the current demographics of overdraft usage: the practice originated as an *ad hoc* courtesy service for high-income customers, not low income. Thus, although overdraft protection now has been made available to middle-class and lower-income bank customers as well, its origin was as a short-term liquidity source for high-income customers. Most customers were denied this *ad hoc* courtesy and, thus, were forced to deal with the cost, inconvenience, and potential criminal penalties of bounced checks.

Over time, access to overdraft protection has grown as automated overdraft protection has reduced its cost and risk and increased its scale. Automated overdraft protection removed much of the subjectivity and selectivity of discretionary overdraft protection, mainstreaming access to overdraft protection by using automated underwriting and processing systems to control risk and cost and increasing the scale of the program to mitigate risk. The FDIC found in its 2006 survey of 1,171 FDIC-supervised banks that 86% of banks “operated at least one formal overdraft program” and that 40.5% of all banks offered automated overdraft programs.¹⁴ Among larger banks with over \$1 billion in assets, 76.0% offered automated overdraft programs.

¹³ See Regulation E, *supra* note 2.

¹⁴ See FDIC STUDY OF BANK OVERDRAFT PROGRAMS 2-3 (Nov. 2008), available at http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_Final_v508.pdf.

Approximately 70 percent of banks with overdraft programs implemented their automated programs after 2001.¹⁵ As the use of ATMs and point-of-sale debit cards increased, banks have also extended overdraft protection to those products.¹⁶ As of 2007, the average fee for an overdraft was \$26 and larger banking institutions charge higher rates on average than smaller institutions.¹⁷

Bank revenues from overdraft fees rose from \$30 billion in 2005 to \$37 billion in 2009 before slipping back to \$35 billion in 2010 as a result of new Federal Reserve regulations that reduced the number of consumers using overdraft protection.¹⁸ Overdraft fees constitute a substantial portion of bank revenues, and an even larger percentage for credit unions.¹⁹ According to the FDIC's 2006 survey, overdraft fees on average represent 6% of total net operating revenues of FDIC-insured banks.²⁰ It is estimated that 90% of overdraft revenues are generated by a relatively small percentage of heavy users.²¹

¹⁵ *See id.* at 8.

¹⁶ According to the FDIC study, 81% of banks that operated automated overdraft programs allow overdrafts to be paid at ATMs and POS debit card terminals. *Id.* at 6.

¹⁷ *See* U.S. Government Accounting Office, *Bank Fees: Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts*, GAO REPORT 08-281 at 14 (Jan. 2008). According to Moebs, banks with over \$50 billion in assets charge an average of \$35 per overdrawn check compared to \$26 for all institutions. Press Release, Moebs Services, Consumer Overdraft Fees Increase During Recession: First-Time Phenomenon (Jul. 15, 2009), available at <http://www.moebs.com/AboutUs/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/65/Default.aspx>.

¹⁸ *Overdrafts Pile Up as Opt-In Pays Off, But Were Consumers Misled?*, PAYMENTS JOURNAL (May 5, 2011), available at http://www.paymentsjournal.com/Featured_Stories/Overdrafts_Pile_Up_as_Opt-In_Pays_Off,_But_Were_Consumers_Misled/.

¹⁹ Brian T. Melzer & Donald P. Morgan, *Competition and Adverse Selection in a Consumer Loan Market: The Curious Case of Overdraft vs. Payday Credit* (Working Paper, 2009) available at http://www.clevelandfed.org/research/conferences/2010/9-9-2010_household-finance/Melzer_Morgan_2_16_2010.pdf.

²⁰ FDIC Study, *supra* note 14, at iv.

²¹ Press Release, Moebs Services, Overdraft Fee Revenue Drops to 2008 Levels for Banks and Credit Unions (Sept. 15, 2010), available at <http://www.moebs.com/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/193/Default.aspx>.

This growth in the availability and usage of overdraft protection is consistent with consumer preferences. According to a 2009 survey by the American Bankers Association, of those consumers who had paid an overdraft fee in the past 12 months, 96% wanted the payment covered.²² A 2010 survey found that 69% of those who paid overdraft fees were happy that the payment was covered.²³ Four of six respondents in a small focus group research by ICF Macro conducted in connection with the Federal Reserve's promulgation of its amendments to Regulation E said that they were glad that their debit and ATM transactions were paid even though they triggered overdraft fees.²⁴ The vast majority of overdraft customers, therefore, self-report that they are happy that overdraft protection was available to cover their payments.

C. Risk of Overdraft Protection to Banks

The risk to banks of offering overdraft protection is nontrivial but reasonable. The historical chargeoff rate for overdraft loans is between 3-5%, comparable to the rate on many other unsecured bank loans such as credit cards.²⁵ Between 2001-2005 banks closed 30 million bank accounts for recidivist check bouncing.²⁶ And the average loss per bad account was \$310.²⁷ In the one year period between October 2009 and October 2010, for example, according to data provided, one bank charged-off 53,588 overdraft

²² Press Release, American Bankers Association, ABA Survey: More Consumers Avoid Overdraft Fees (Sept. 9, 2009), available at <http://www.aba.com/Press+Room/090909ConsumerSurveyOverdraftFees.htm>.

²³ Press Release, American Bankers Association, ABA Survey: Most Consumers Avoid Overdraft Fees (Sept. 15, 2010), available at <http://www.aba.com/Press+Room/091510ConsumerOverdraftSurvey.htm>.

²⁴ Macro International Inc., *Review and Testing of Overdraft Notices* at ii, submitted to Board of Governors of the Federal Reserve System (Dec. 8, 2008).

²⁵ American Bankers Association, Letter to John Walsh, et al., at 4 (Aug. 24, 2011).

²⁶ Dennis Campbell, Asis Martinez-Jerez, & Peter Tufano, *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures* (Working Paper, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335873.

²⁷ FDIC Study, *supra* note 14, at 62.

accounts for a total of \$18,733,457.²⁸ Even if every overdraft or non-sufficient funds charge generated \$30 in pure profit with no cost of provision, therefore, it would be necessary to process 10 repaid overdrafts for every account that went bad.

According to data provided by one regional bank, the largest loss risk for financial institutions from overdraft programs is not those customers who overdraft repeatedly although this seems to be a particular concern of the FDIC.²⁹ Instead, the largest risk arises from low-use or “hit-and-run” customers who open an account with the minimum required balance, conduct several overdrafts in short succession, and then abandon the account. The bank’s largest losses on its overdraft program are from new accounts less than three months old. Although frequent overdraft customers may eventually default on an overdraft loan, the fact that they have paid prior overdraft fees typically renders them profitable on average. For this bank, for example, the average chargeoff for free checking customers who default on one overdraft in a year is \$188.78. But the aggregate loss on all customers who default on one overdraft is \$838,733.80. Moreover, the bank reports that despite its best efforts to ascertain risk of new customers, accurate risk assessment on overdraft accounts remains elusive. Precisely because free checking makes banking available to nontraditional customers, it is difficult to predict who among those customers eventually will default on overdraft loans. Although the bank uses ChexSystem reports (a central reporting service for bounced checks and closed bank accounts) to try to predict risk, it provides little predictive weight for subsequent default on overdraft loans. The size of the first deposit made by a new customer also has no predictive value. Nor is account seniority very predictive: As noted, accounts of 1-3

²⁸ Data on file with author.

²⁹ Data on file with author.

months old are the riskiest ones for overdraft default losses but older accounts over 24 months old also present substantial risk of loss. It is actually those who overdraft infrequently who present the safety and soundness risk, not those who use the product regularly.

II. The Regulatory Framework

A. Federal Reserve Regulation

In 2009, the Federal Reserve promulgated amendments to Regulation E, governing electronic transfers, to place new regulations on overdraft fees.³⁰ Under those rules, consumers must affirmatively choose to opt-in to overdraft protection for ATM and point-of-sale debit transactions. The Federal Reserve's justification for its action 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" but that the "majority of participants [4 of 6] 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."³¹ Even if the responses of this six-person study are generalizable, however, the Fed made no determination of the relative cost of opt-in versus opt-out options on the system as a whole. Thus, if opt-in is substantially more expensive to obtain than opt-out would be, it might still be more efficient to have an opt-out regime even if many consumers would actually choose to opt-out.³² In the context of securing

³⁰ 12 C.F.R. §205.17 (Nov. 17, 2009).

³¹ Regulation E, *supra* note 2, at 59,036.

³² For example, even though a majority of consumers arguably would choose to opt-out of telemarketing calls through the National-Do-Not-Call Registry created by the Federal Trade Commission, it might nonetheless be efficient for the rule to be set as an opt-out rather than opt-in rule in light of the relative ease by which consumers could opt out (by adding their phone numbers to the list) versus the high cost and difficulty that telemarketers would have to incur to contact and persuade consumers to opt-in. See Posting

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% of its customers even after repeated efforts.³³ I have located no authoritative estimate of the impact of adopting an opt-in regime on participation rates in overdraft protection programs, but news reports indicated that participation has declined. About 20% of banks increased the fee that they charged on overdrafts to offset lost revenues from those who opt-out.³⁴ Because of the cost and difficulty of contacting consumers, many banks chose to not even try to contact customers to solicit their opt in, which included both community banks for whom it was too expensive relative to their somewhat smaller customer base as well as very large banks with such a large and transient customer base that it was financially infeasible to contact them.

On the other hand, for those who have made the effort to contact consumers, a high percentage of consumers 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 largest overdraft users.³⁵ The bank sought permission from 499 customers that had 25 or more overdraft transactions in 2010. Of the 499 customers, 466 (93%) opted in for debit card transactions and 33 (7%) opted

of Todd J. Zywicki to the Volokh Conspiracy, Two New FTC Commissioners and the National Do-Not-Call Registry, *available at* <http://www.volokh.com/posts/1092515307.shtml>.

³³ Comment of International Bancshares Corporation to the Federal Deposit Insurance Corporation at 6 (Sept. 24, 2010), *available at* http://www.fdic.gov/regulations/laws/publiccomments/overdraft_comments/2010-09-24-ibc.pdf.

³⁴ In addition, opt-in may create an adverse selection problem as low-risk users who use the product rarely may be more likely not to opt-in.

³⁵ Data on file with author.

out.³⁶ 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% 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% of elevated users stated that the availability of overdraft protection was extremely valuable (only 2% said it was "Not at all valuable").³⁷ Moreover, the percentage of those stating that overdraft protection is "extremely valuable" rose consistently with the intensity of use, from 57% for non-users of overdraft protection to 86% for elevated users. Overall, of 2,009 respondents to the online survey, 71% said that access to overdraft protection is "Extremely valuable" and another 21% said it was "Somewhat valuable." Only 4% said it was "Not at all valuable."

Market surveys have suggested similar results. According to a survey by Moebs, at various large banks 60%-80% of customers opted-in to debit card overdraft protection, with a median opt-in rate of 75%.³⁸ According to analysis by the American Bankers Association, 46% of consumers opted-in to one-time debit card and ATM transactions.³⁹ A study by the Center for Responsible Lending, by contrast, concluded that 33% opted-in.⁴⁰

³⁶ Information provided by International Bancshares Corporation to author.

³⁷ Raddon Financial Group, Inc., *Custom Survey Research Findings* (June 2011), on file with author.

³⁸ Overdrafts Pile Up, *supra* note 18.

³⁹ Press Release, American Bankers Association, Half of Bank Customers Choose Overdraft Protection (Aug. 31, 2010), available at <http://www.aba.com/Press+Room/083110OverdraftProtection.htm>.

⁴⁰ Center for Responsible Lending, Banks Collect Overdraft Opt-Ins Through Misleading Marketing (Apr. 26, 2011), available at <http://www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/banks-misleading-marketing.html>.

Perhaps more significant, Moebs found that almost all of those who use overdraft protection regularly—more than 10 times per year—opted-in to coverage⁴¹ and JP Morgan reported that 53% of those who regularly use overdraft protection opted-in.⁴² Similarly, a survey by *Consumer Reports* found that a majority of those who had overdrawn their account in the past six months opted-in to overdraft protection.⁴³ Although these surveys and studies are not rigorously scientific, they suggest that the most frequent (and, thus, presumably the most knowledgeable) users of the product also are those who are most likely to opt-in to overdraft protection when given the choice. As the analysts at Moebs Services put it, “The consumer no longer views overdrafts as a penalty like a parking ticket, but as a safety net.”⁴⁴

The recent experience of one bank is also illustrative with respect to overdraft fees at ATMs.⁴⁵ 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%) 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%) came back within 24 hours and opted-in to overdraft protection for ATM transactions. Within 24 hours, therefore, 95%

⁴¹ Moebs Services Inc., Press Release, Banks Lower Overdraft Fees as Consumers Choose to Opt-In (Dec. 8, 2010), available at

<http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/197/Default.aspx>.

⁴² David Benoit, *Customers Opt for Overdraft Protection*, WALL ST. J. (Nov. 26, 2010), available in <http://online.wsj.com/article/SB10001424052748703678404575636884207120508.html>.

⁴³ Consumer Reports Poll (Nov. 16, 2010), available at http://www.consumersunion.org/pub/core_financial_services/017109.html.

⁴⁴ Moebs, Banks Lower Overdraft Fees, *supra* note 41.

⁴⁵ Data provided by IBC bank and on file with author.

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 proffered rationales offered by Federal Reserve—but one for which it offers no evidence or even serious theoretical support—that opt-in would paternalistically protect frequent users of overdraft protection from overusing the product.⁴⁶ According to Federal Reserve, requiring opt-in would make it more difficult for these consumers to access overdraft protection, which “could therefore best prevent these consumers from entering into a harmful cycle of repeated overdrafts.”⁴⁷ But experience shows that heavier users of overdraft protection are those who are most likely to opt in to overdraft protection. Standard economic analysis provides a straightforward explanation for 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. Consistent with standard economic analysis, and contrary to the Federal Reserve’s paternalistic approach, making overdraft protection more expensive and less available to the heaviest users is almost certainly likely to reduce their welfare and to impose unnecessary costs on the financial institution in order to reach the desired end by consumers and banks. Restriction has proven to just add cost to those that are supposedly being protected with no obvious benefits.

⁴⁶ Regulation E, *supra* note 2, at 59,038.

⁴⁷ *Id.* On March 1, 2010, the Federal Reserve promulgated additional amendments to Regulation E clarifying some questions raised by the prior rulemaking. 75 Fed. Reg. 9120 (March 1, 2010).

B. FDIC Guidance

On November 24, 2010, the FDIC issued guidance regarding overdraft fees.⁴⁸ Under the FDIC Guidance, financial institutions must take several steps regarding their overdraft accounts. Among its requirements, banks must “monitor [customer] accounts” and “take meaningful and effective action to limit use by customers” of overdraft protection. For example, the guidance provides 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 twelve-month period—the bank must take affirmative steps to provide the customer with reasonable opportunity to choose a less costly alternative, such as linked savings account overdraft protection or a line of credit.⁴⁹ 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 to prohibit posting larger items first.

⁴⁸ Overdraft Payment Programs, *supra* note 3.

⁴⁹ Since the initial announcement of the Guidance the FDIC has clarified that this requirement can be satisfied by a statement on a customer’s monthly statement. *See* FDIC Overdraft Payment Program Supervisory Guidance Frequently Asked Questions, *available at* <http://www.fdic.gov/news/conferences/overdraft/FAQ.html>. Research suggests that this simple statement may be sufficient to persuade consumers to avoid use of overdraft fees by raising the salience of the issue even if it does not directly lead to a shift to substitute products. *See* Victor Stango & Jonathan Zinman, *Limited and Varying Consumer Attention: Evidence from Shocks to the Salience of Bank Overdraft Fees* (Nat’l Bureau of Econ. Research, Working Paper No. w17028, 2011).

C. OCC Guidance

In June 2011, the Office of the Comptroller of the Currency also issued proposed “Guidance on Deposit-Related Credit Products.”⁵⁰ The OCC guidance describes several principles that the OCC expects national banks to follow in connection with any deposit-related consumer credit product, and specifically automated overdraft protection programs and deposit advance products. The OCC contends that the purpose of its program is to provide “a high degree of flexibility” for banks to “structure and operate their programs in a prudent and safe and sound manner” that also “provides for fair treatment of customers without dictating specific product terms.” Although the rules purport to be only guidance and not to impose specific prescriptive requirements, it is likely to be interpreted as dictating specific requirements.

The OCC’s guidance imposes several different requirements. First, it requires disclosure not only of the terms of the overdraft protection program offered but also of any alternative deposit-related credit products offered by the bank (such as tied savings protection). The OCC guidance also requires banks to provide customers with clear disclosure about the order of processing transactions as well as to inform consumers that the order in which they are processed can affect the total amount of fees incurred. Second, the OCC rules urge banks to adopt an opt-in approach for all overdraft protection products, including checks, ACH, and recurring debit card transactions.⁵¹ Unlike overdraft protection for one-time debit transactions and ATM transactions (for which consumer testing by the Federal Reserve suggested about half of consumers preferred to be opt-in), available evidence clearly indicates that an overwhelming majority of

⁵⁰ Office of the Comptroller, Guidance, *supra* note 4.

⁵¹ For check, ACH and recurring debit transactions the opt-in requirement is prospective only.

consumers want overdraft protection for these larger and more important transactions, so requiring opt-in seems like an unnecessary logistical hurdle. Third, pursuant to safety and soundness requirements, the OCC guidance requires the bank to conduct sufficient analysis to ensure that the customer will be able to manage and repay the credit obligations arising from the product. Fourth, the OCC requires banks to adopt “prudent programmatic limitations” on the usage of overdraft protection in terms of the number of overdrafts and the total amount of fees that may be imposed per day and per month and any *de minimis* levels.

D. Rationales for Regulation

To date, regulation of overdraft protection has been grounded in purported safety and soundness concerns. But safety and soundness concerns are obviously misplaced. The provision of overdraft protection is a net financial asset to banks that provide it—there is no evidence that banks lose money from it. Individual overdraft loans are quite small, just a few hundred dollars or up to \$1,000. In addition, regulators have claimed that there is an undefined “reputation risk” from overdraft protection, a completely unsubstantiated assertion and hard to square with the market trend toward greater availability of overdraft protection for customers. Those who use overdraft protection most regularly—who regularly borrow and repay overdraft loans—provide the *smallest* safety and soundness risk, as they are the customers most likely to generate revenues from overdraft loans that exceed the costs or risk of loss to the bank. Thus, although safety and soundness regulation has focused on heavier users of overdraft protection as presenting particular risk, this focus is obviously nonsensical from a traditional safety and

soundness perspective. Overdraft programs are highly effective from a risk-mitigation perspective because of their large scale and small dollar exposure per account, i.e., a large number of accounts with small average balance. On the other hand, safety and soundness can become a real concern if regulators continue to carve away at the revenues generated from overdraft programs, thereby subjecting banks to greater and greater exposure from declining revenues, a reduction in the scale of the program that would spread the risk across a smaller number of customers, and heightened risk of adverse selection. When combined with the negative impact of the Durbin Amendment on interchange fee revenue, excessive interference with overdraft protection could imperil the solvency of the retail banking system as it exists today, producing its own safety and soundness concerns and eventually leading to a major restructuring and retrenchment in retail banking.

On the other hand, purported safety and soundness concerns actually appear to be poorly disguised consumer protection concerns. One suspects that the concern of bank regulators is not that banks will *lose* too much money from the issuance of overdraft protection thereby imperiling safety and soundness, but rather that banks will *make* too much money on the product which many activists believe to be an undesirable product for consumers, notwithstanding their decision to use it. It is precisely because overdraft protection is profitable that it is criticized.

Unlike purported safety and soundness rationales which are completely backward, consumer protection at least provides a coherent (although questionable) rationale for heightened regulation of overdraft protection. But without understanding who uses

overdraft protection and why, regulation runs a serious threat of imposing greater cost in the form of unintended consequences than benefits.

III. Consumer Protection and Overdraft Regulation

A. *Who Uses Overdraft Protection?*

The overwhelming majority of bank customers in the United States never use overdraft protection. According to the FDIC, in 2006, 75% of bank customers never overdrew their bank accounts and 12% overdrew only one to four times. A 2009 survey by the American Bankers Association found that 83% of consumers did not overdraft their account during the past year and that of the 17% who did overdraw, 64% used overdraft protection four or fewer times.⁵² A 2010 survey by the American Bankers Association found that 77% of consumers paid no overdraft fees and of those who did, 64% paid four or fewer.⁵³ Melzer and Morgan found that 86% of bank customers take out fewer than 4 overdrafts per year.⁵⁴ On the other hand, some bank customers use overdraft protection dozens of times over the span of a year or two and incur hundreds of dollars in overdraft fees as a result.

Overdraft protection traditionally was used by high-income consumers to address short term liquidity problems. Even though the customer base eligible for overdraft protection has broadened most still use overdraft protection to meet short-term liquidity needs—even if sometimes recurrent liquidity issues—rather than as a source of long-term borrowing. According to data provided by a major regional bank, approximately one-

⁵² Sept. 9, 2009 ABA Survey, *supra* note 22.

⁵³ Sept. 15, 2009 ABA Survey, *supra* note 23.

⁵⁴ Melzer & Morgan, *supra* note 19.

third of all overdraft loans are repaid within 10 days and approximately 90 percent are paid off within a month of the initial credit extension.

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 overdraft is credit score—those with lower credit scores are more likely to use overdraft protection.⁵⁵ All other demographic information—including income—is non-predictive of the likelihood of using overdraft protection and building a reliable risk model has proven elusive.⁵⁶

Economist Marc Fusaro also finds that among frequent users of overdraft protection there is little correlation between income and overdraft usage: high-income individuals are just as likely as lower income individuals to overdraft, but that higher-income customers' overdrafts typically are larger.⁵⁷ Frequent users of overdraft protection also tend to be younger than less-frequent users.⁵⁸

The FDIC study 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% of those in the 18-25 age range overdrew their account in the 2006 study, while only 12.2% 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.

⁵⁵ Press Release, Moebs Services, Who Uses Overdrafts? (Sept. 29, 2009), available at <http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/194/Default.aspx>.

⁵⁶ See *supra* note 29 and accompanying text.

⁵⁷ Marc Anthony Fusaro, *Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks*, 29 J. FAM. ECON. ISS. 251, 257, 260 (2008); Marc Anthony Fusaro, *Are "Bounced Check Loans" Really Loans? Theory, Evidence and Policy*, 50 Q. REV. OF ECON. & FIN 492, 499 (2010).

⁵⁸ Fusaro, *Are Bounced Checks*, *supra* note 57, at 499.

There are other reasons to think that overdraft customers are not particularly 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 income than users of alternative financial products such as payday lending and pawnshops. Moreover, access to overdraft protection is commonly linked to direct deposit of payroll checks, suggesting that many overdraft customers are also steadily employed. Finally, recall that overdraft protection was originally a benefit offered to high-income customers, thus there is no reason to presume that it is a product exclusively or even primarily for low-income customers.

Thus, according to available research, the significant distinguishing feature of heavy overdraft users appears to be their credit score, not their income or other demographic status. After all, overdraft fees can be entirely avoided through responsible financial management: one regional bank found, for example, that 71% 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).⁵⁹ Moreover, the percentage of low-balance accounts that incurred zero overdraft fees during that period (71% of all accounts) was actually *higher* than the overall percentage of *all* accounts at the bank that incurred no overdraft fees (62%).⁶⁰ Those who are financially responsible can and do manage even low balance accounts without triggering overdraft fees. Because of their paternalistic focus on protecting irresponsible consumers from overdraft fees, however, regulators have implicitly

⁵⁹ Data on file with author.

⁶⁰ This figure may not be entirely representative as some of those 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 within the control of the consumer and cannot be simply assumed to be a low-income product.

assumed that overdraft fees are a function of income and have overlooked the important role of consumer responsibility in avoiding overdraft fees.

Infrequent users of overdraft protection exhibit distinct patterns of behavior. Fusaro finds those who overdraft only occasionally (1-10 times in his study) generally make overdrafts that are much larger in size than those who overdraft frequently. He finds that the average overdraft size for those who overdraft occasionally is \$306, as compared with \$90 for those who overdraft chronically (over 100 overdrafts).⁶¹ This might be explained in several ways. It is consistent with the hypothesis that infrequent overdraft users use overdraft protection to ensure payment of large and important checks, such as for utilities, mortgage payments, rent, or the like. If this is so, it seems unlikely that these occasional users are simply being tripped up by inadvertent use of their debit cards, rather than choosing to use overdraft to clear large and important payment obligations.⁶² Alternatively, it might reflect usage by “hit and run” scammers who open a bank account and exploit overdraft protection in several short-term transactions that they never intend to repay.

B. Why Consumers Use Overdraft Protection

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 utilities, 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

⁶¹ Fusaro, *Hidden Consumer Loans*, *supra* note 57, at 259.

⁶² Note that this feature also makes the requirement of opt-in for checks, ACH transactions, and recurrent debit card payments extremely cumbersome and counterproductive for infrequent users, as those most likely to use it for that purpose may be the least likely to anticipate their subsequent need for it and, thus, to opt-in.

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). According to research by Moebs Services, about 19 million Americans use payday lenders and 13 million use overdraft protection every year.⁶³ Thus, both are popular products with significant market demand. How then do consumers choose between payday loans and overdraft protection—and do they do so rationally?⁶⁴

For most consumers, both payday lending and overdraft protection are fairly expensive compared to mainstream credit offerings such as credit cards.⁶⁵ This is to be expected: fundamentally it is and always has been the case that the cost of making small loans to consumers is high relative to the size of the loan. And these costs are reflected in a variety of forms—fees, interest rate, time, search costs, convenience and many others. For example, even if a consumer could shop around and find a slightly lower rate for a payday loan than an overdraft loan, doing so would incur time and shoe leather costs of searching around, the risk of being rejected for the loan, or having to process paperwork and wait for the money. Many of these costs (such as the time spent traveling from store to store, paperwork time, and approval delays) are incurred regardless of the size of the loan and thus are especially costly in relation to the small size of these loans. Similarly, many of the costs of making small loans such as store rent, employee time, paperwork,

⁶³ Press Release, Moebs Services, Payday Loans are a Better Deal for Consumers than Overdraft Fees (Jul. 7, 2010), *available at* <http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/169/Default.aspx>.

⁶⁴ Available evidence indicates that consumers generally use payday loans rationally. See Todd J. Zywicki, The Case Against New Restrictions on Payday Lending (George Mason University Mercatus Ctr., Working Paper No. 09-28, 2009).

⁶⁵ Credit cards are not always a less-expensive alternative than payday lending and overdraft protection for those whose usage tends to trigger substantial behavior-based fees.

and credit checks are expensive to amortize over small, risky loans of a few hundred dollars. In light of these basic economics, there simply is no foundation for thinking that the total cost of overdraft loans is exorbitant when compared to alternatives. High price relative to the size of the loan is simply inherent in small loans. But even then, many of the real costs of a small loan are not directly financial at all but include a variety of transaction costs in terms of time, effort, and convenience, none of which is captured in a crude and limited measure of cost such as APR and which generally are invariant of loan size.

Payday and overdraft loans share these fundamental economic characteristics that explain why their prices seem high. But payday loans and overdraft protection also differ in several significant ways. First, payday loans are less convenient and flexible than traditional overdraft loans, including the time and “shoe leather” costs of going to a payday lender, waiting in line, and then delivering the cash to a bank or to pay a bill. In fact, payday loans might not even be realistically available in some situations, such as when traveling or in an emergency. Overdraft protection, by contrast, is processed automatically and immediately, 24 hours a day from anywhere in the world, and can be directly triggered by retail or online transactions rather than having to make a special trip to acquire the funds from a payday lender. Consumers who place a higher value on their time or convenience might therefore prefer using overdraft protection rather than going to a payday lender even if payday lending is less expensive. Second, there is a possible psychological cost of payday loans for some consumers in that they might feel embarrassed to be seen patronizing a payday lending storefront or otherwise uncomfortable with going to a payday lending store. By contrast, overdraft protection is

done privately, instantaneously, and electronically so there is no concern about outsiders becoming aware of their borrowing.⁶⁶ Third, although the fees may be high relative to the amount borrowed, overdraft protection in fact permits the consumer to borrow exactly the amount needed (plus the fee), no more and no less. Moreover, overdraft loans must be paid back within 45 days or the account will be terminated. For payday loans, by contrast, consumers may be tempted to borrow more than they need for immediate purposes and while the overwhelming majority of payday loan customers benefit from and value the option to revolve their payday loan at the end of the loan period, this can lead some borrowers to fall into a “debt trap” of rolling over payday loans or credit card balances. Thus, if consumers fear their inability to precommit to timely repayment, then they might prefer overdraft protection. Finally, consumers who have defaulted on a payday loan simply may find themselves unable to acquire payday loan credit in the future—so payday loans may no longer be an available option. For those consumers, overdraft protection may be the best alternative available in a group of options limited to pawnshops, auto title loans, rent-to-own and other options.

Overdraft protection also benefits consumers by reducing their need to maintain precautionary bank account balances, and in fact those who have bounce protection generally hold smaller precautionary balances. This is valuable for many consumers because checking accounts, especially free checking accounts, often pay no interest. Thus, the ability to reduce precautionary balances enables consumers to keep more of their funds in less-liquid but higher earning accounts.

⁶⁶ For example, the upper-income professionals for whom overdraft protection originally was created might be unwilling to patronize payday lenders or other storefront small-loan lenders.

Overdraft loans also provide a degree of flexibility that many other products lack. For example, when overdraft protection is combined with a debit card it can be used functionally like a credit card, allowing purchases to be made immediately with payment to come later (albeit an expensive credit card). Because overdraft can be used to pay bills, it can also be used to protect access to other types of credit, such as utilities, medical treatment, credit cards, or even payday lending, as overdraft can be used to make sure those payments are honored and thus to avoid costly penalties and termination of service. For example, the effective APR on a bounced check is many times higher than for overdraft or payday loans once all fees are assessed and this doesn't even include the threat of criminal prosecution and bank account termination. A simple financial measure of cost such as APR does not include the value of maintaining access to other types of credit or avoiding the costs associated with not performing on them.

In addition, although payday loans often are less expensive than overdraft fees, this is not always the case. Leaving aside the benefits of overdraft protection in terms of convenience, privacy, and time and shoe-leather costs, there are important differences in the pricing scheme that are relevant to understanding consumer behavior. Payday loans typically charge \$15 for every \$100 borrowed. Overdraft loans, by contrast, typically charge a fee of \$26-\$35 *regardless* of the amount advanced. For loans to cover a single small expense of \$100 or less, therefore, payday loans are typically less expensive than overdraft loans.⁶⁷ For loans of about \$200, the price is about equal, and for loans of \$300 or above, a single overdraft loan typically will be less expensive. This calculation will vary, of course, depending on whether the consumer is making one overdraft or more. But that is precisely the point—freedom of contract is most likely to more efficient than

⁶⁷ Moebs Services, Payday Loans, *supra* note 63.

regulation when consumer preferences are heterogeneous and knowledge of one's needs is highly personal.

In fact, 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.⁶⁸ 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 borrowed), thus consumers would be predicted to use them to cover *smaller* transactions. This pricing difference also creates a potential adverse selection problem as consumers select the option that gives them the lowest price for any given-sized transaction.

Melzer and Morgan's analysis confirms that consumers generally use overdraft and payday lending in the manner predicted by economic theory. Moreover, they find that in markets where payday loans are available, the number of overdraft attempts and bounced checks *fall* in number (as consumers use payday loans to cover some transactions that otherwise might bounce) but *rise* in average dollar amounts as payday loans continue to be used to cover larger transactions. They find further that in markets where payday credit is available banks reduce the availability of "free" checking for those accounts *without* direct deposit, but not those *with* direct deposit. This is because

⁶⁸ Melzer & Morgan, *supra* note 19.

the presence of direct deposit is a sort of insurance for the bank against “hit and run” customers who open an account without direct deposit anticipating large overdrafts that will never be repaid and then switch to using payday loans to meet short-term credit needs.

Economist Jonathan Zinman also found evidence of substitution between payday lending and overdraft protection. He found that when Oregon imposed a cap on the finance charge that could be assessed on payday loans, there was a dramatic drop in the number of licensed payday lenders, a short-run 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 substitution to greater use of overdraft protection by consumers.⁶⁹

Research by Policis analysts also 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% of payday loan customers would make greater use of overdraft protection. Those who were most likely to shift to use of overdraft protection tended to be higher-income and have a greater number of alternative credit sources than payday loan customers on average.

A survey conducted by the Raddon Financial Group of customers of a large regional bank asked customers who used overdraft services where they would turn for emergency funds if they no longer had access to overdraft protection.⁷⁰ Fifty-three percent of “Elevated users” of overdraft protection reported that if overdraft protection was not available they would “Not be able to get money,” as opposed to only 16% of

⁶⁹ Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap* (Fed. Res. Bank of Philadelphia, Working Paper No. 08-32, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335438.

⁷⁰ Raddon survey, *supra* note 37.

non-users.⁷¹ And while 26% of non-users of overdraft protection said that they would “Use a credit card” if overdraft protection were unavailable, only 10% of elevated users said they would use a credit card (presumably reflecting their lack of access to credit cards or that using a credit card would cause them to exceed their credit lines and lead to penalties). Similarly, while only 6% of non-users said that they would seek a payday loan if overdraft protection was unavailable, 24% of elevated users reported that would be their option (the second-highest response after “Not able to get money” for elevated users). Moreover, while 56% of non-users said in such situations they would simply transfer the needed money from another account (presumably a savings account), only 13% of elevated users said that they would do so, presumably reflecting the simple truth that they have no other accounts available. Regular users of overdraft protection have low credit quality and limited credit alternatives.⁷² According to the Raddon survey, for example, only 7% of elevated users of overdraft protection describe their personal assessment of their credit rating as “excellent,” while 70% describe their credit rating as “fair” (38%) or “poor” (32%). By contrast, 74% of non-users of overdraft protection describe their credit rating as “excellent” or “good” and only 9% consider their credit rating to be “poor.” Thus, reducing access to overdraft protection would simply exacerbate the plight of those who rely upon it because of a lack of better alternatives.

Another survey conducted by Baselice & Associates, Inc., of one bank’s customers found similar results.⁷³ According to that study, 54% of those who self-identified as having “poor credit” thought that overdraft protection was “extremely important,” compared to only 18% of those who said that they had “excellent credit.”

⁷¹ 30% of low users and 39% of moderate users said that they would be unable to get money.

⁷² Raddon Survey, *supra* note 37.

⁷³ Baselice & Associates, Inc., Banking Survey (Aug. 29-31, 2011), on file with author.

When asked how upset they would be if overdraft protection was eliminated, 62% of those with poor credit said they'd be "extremely upset" compared to only 20% of those with excellent credit. In addition, while 41% of lower-income customers reported that they'd be "extremely upset," 29% of customers with annual incomes over \$60,000 also said that they would be extremely upset if overdraft protection were eliminated.

Overdraft protection may be used either to cover unintentional errors (an unknowing lack of funds in one's bank account) or intentionally as a short-term line of credit. Fusaro concludes that approximately 79% of overdraft use is of the first type: clearing payments that otherwise would result in bounced checks. The remaining 21%, he concludes, is conscious use by consumers of overdraft protection as a short-term line of credit.⁷⁴ Intentional overdrafters tend to borrow the money for longer durations, a rational strategy in light of the flat-fee pricing scheme in which the fees are front-end loaded. This suggests that many chronic overdrafters use overdraft protection intentionally as a short-term line of credit and becoming more sophisticated and knowledgeable about the most efficient ways to use overdraft protection as they become more experienced.⁷⁵

Overall, Fusaro concludes that, on average, consumers gain a consumer surplus of approximately \$50 per year from the availability of overdraft protection and the accompanying benefits of avoiding NSF fees and maintaining lower precautionary balances, or \$2 billion economy-wide.⁷⁶ Fusaro and Ericson conclude that overdraft protection is generally welfare improving for middle-class bank consumers and neutral

⁷⁴ Fusaro, *Are "Bounced Check Loans" Really Loans?*, *supra* note 57, at 499.

⁷⁵ Marc Anthony Fusaro, *Consumers' Bank Choice and Overdraft Volume: An Empirical Study of Bounce Protection Programs* (Working Paper, 2003).

⁷⁶ *Id.*

for low-income consumers.⁷⁷ They conclude that eliminating overdraft protection “through excess regulation would hurt the most vulnerable population most, as they have the fewest alternatives to maintain necessary liquidity.”⁷⁸

C. Do Consumers Understand the Cost of Overdraft Protection?

Evidence that consumers generally tradeoff usage of overdraft protection and payday loans in a manner consistent with the predictions of economic theory also suggests that consumers are generally aware of the costs of overdraft protection compared to various alternative forms of credit and tend to use those which are most efficient in light of the limited options that they have available to them.

The pricing of overdraft protection is simple and seemingly transparent. Attached as Appendix A is the form “Overdraft Courtesy Customer Disclosure” for one bank’s free checking account. As can be readily seen, the costs of overdraft protection are clearly disclosed, easily understood, and the criteria for available line of credit are plain (such as whether one has an overdraft account linked to a direct deposit account or not). The fees are clear: \$29 per overdraft, up to a maximum of six charged overdrafts per day (after which additional overdrafts within the credit limit are free), and an 18% APR for any overdraft loan. The bank will not charge any overdraft fees for *de minimis* balances of less than \$3. The bank also clearly discloses its clearing order from highest to lowest for various types of charges. Finally, it states that if the overdraft is not repaid within 45 days the account will be closed.

⁷⁷ Marc Anthony Fusaro & Richard E. Ericson, *The Welfare Economics of “Bounce Protection” Programs*, 33 J. CONSUM. POL’Y 55, 71 (2010).

⁷⁸ *Id.*

In short, the disclosure is clear, concise, and easy to understand. Moreover, although overdraft protection has been the source of criticism and regulatory scrutiny, it has not been claimed that consumers fail to understand the costs of or criteria for overdraft protection. Instead, criticism has focused on paternalistic rationales that even if consumers fully understand the costs of overdraft protection, they nonetheless should not be permitted to use it “chronically” or “excessively”—as those terms are defined by bank regulators.

In connection with the Federal Reserve’s amendments to Regulation E, Macro International Inc. conducted consumer surveys to see if 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 would be enrolled in the service automatically unless they opted-out.⁷⁹ They also understood what would happen when they overdrew their account through an ATM, debit card, recurring debit, or check transaction. Subsequent research confirmed these findings that consumers are able to understand overdraft programs.⁸⁰

Research on payday loans also confirms that payday-loan customers are generally aware of the cost of payday loans. According to Elliehausen, only two percent of payday-loan customers reported that they did not know the finance charge for their most recent new payday loan; 94.5 percent reported finance charges consistent with prevailing market

⁷⁹ See Macro International Inc., *supra* note 24.

⁸⁰ ICF Macro, *Design and Testing of Overdraft Disclosures: Phase Two*, submitted to Board of Governors of the Federal Reserve System (Oct. 12, 2009).

prices.⁸¹ Those who used payday loans most often were also most likely to know the reported APR on their loan.⁸² Whatever concerns have been expressed about payday loans, lack of transparency is not one: Payday-loan pricing is simple and easily understood.⁸³ Given the predominantly flat-fee nature of overdraft protection, it seems probable that those who use overdraft protection (especially those who use the product regularly) are aware of its cost as well as available alternatives. Moreover, to the extent that consumers are unclear about some terms of overdraft protection, their uncertainty relates to specific details, such as the fact that the bank is not required to pay an overdraft in some situations, not the price charged for an overdraft.⁸⁴

IV. Overdraft Protection and Free Checking

A. Overdraft Protection and the Economics of Retail Banking

The expansion in the availability of overdraft protection has also helped to transform the consumer banking system over the past decade, especially by spurring rapid growth in the availability of free checking and other bank services, increased innovation, and expanding access to bank services for previously-excluded consumers. The link between overdraft fees and free checking is a tight one: overdraft protection is essential for free checking to exist for low-balance consumers. Low-balance customers have little margin for error in managing their affairs—absent overdraft protection, these consumers might bounce checks and other payments with great regularity. For low-

⁸¹ Gregory Elliehausen, *An Analysis of Consumers' Use of Payday Loans* 35, 36-37 (Fin. Servs. Res. Program, Monograph No. 41, Jan. 2009).

⁸² *Id.* at 38.

⁸³ As one news story characterized payday lending terms, “[N]o surprises, no hidden fees.” McGray, *supra* note 11.

⁸⁴ ICF Macro, *supra* note 80.

income consumers, overdraft protection essentially serves as a substitute for higher required minimum balances or other fees that would be necessary to cover the cost and risk of serving these customers. Overdraft protection, which provides a line of credit to insure payment of obligations after the fact, is a substitute for requiring higher precautionary balances as insurance ahead of time that payments will be honored.

Indeed, the shorthand term “free checking” hardly captures the full value of a standard demand deposit account to consumers today. In fact, the typical “free checking” account today includes a bundle of valuable services: free debit card usage, free ATM access, free on-line bill payment, free mobile banking, and a host of other services. One bank estimates that the value of the products bundled in its “free checking” account is \$751 per year.⁸⁵ The bank makes up the cost of providing that bundled service in a variety of ways, one of which is through revenue generated by overdraft protection.

The past decade saw a revolutionary transformation in the pricing of bank services, away from the traditional pricing model of flat-fee monthly service fees to a combination of free checking and other bundled banking services, offset by growing debit card interchange and overdraft revenues.⁸⁶ There is a very close link between the spread of overdraft protection and 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% to 76% and the average minimum balance required for free checking fell from \$440 in 2001 to \$186 in

⁸⁵ Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 4. Obviously, this is an interested estimate, but “free checking” today includes multiple valuable services for which consumers otherwise would have to pay.

⁸⁶ See Stango & Zinman, *supra* note 49.

2009.⁸⁷ This growth in access to free checking appears to have arisen from two sources: the simultaneous growth in the availability of overdraft protection and the 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 also has brought with it greater risk that those consumers will bounce checks or otherwise miss payments. Absent 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 Evans, Litan, and 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 consumers. The number of accounts eligible for free checking fell 11 percentage points—from 76% in 2009 to 65% in 2010—a figure that translates to approximately 20 million accounts.⁸⁸ 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.

Market experience also suggests that overdraft protection is popular with consumers and that bank consumers prefer the combination of zero up-front maintenance

⁸⁷ David S. Evans, Robert E. Litan, & Richard Schmalensee, *Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses* (Feb. 22, 2011), available at 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% of bank accounts. See Claes Bell, *Abracadabra: Free Checking Disappears*, BANKRATE.COM (Sept. 26, 2011), available in <http://www.bankrate.com/finance/checking/abracadabra-free-checking-disappears.aspx>.

⁸⁸ See Evans, Litans, & Schmalensee, *supra* note 87.

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 lower required monthly fees), which has increased the market share of those banks and put competitive pressure on competitors to respond.⁸⁹ Access to overdraft protection allows consumers to hold smaller precautionary balances in low-interest demand deposit accounts, which also leads them to overdraft their accounts more often.⁹⁰ Moreover, an obvious but often-ignored point is that consumers can easily avoid paying overdraft fees simply by not spending more money than they have in their account, and can avoid overdraft charges by better financial management or by holding larger precautionary balances. Overdraft loans are created by the customer, not the bank—the customer decides whether to draw on his overdraft line of credit.⁹¹

For example, a Federal Reserve study published in 1999, when free checking was still somewhat uncommon, illuminates the tradeoff between various types of banking fees. The study found that checking accounts that did not require customers to consistently maintain a certain minimum balance through the month also imposed higher fees for various services.⁹² According to the study, for non-interest bearing accounts (the closest analog to free checking today) the average required minimum balance was \$348, and the average monthly fee was \$5.50 if the minimum balance was not maintained. Moreover, these accounts had additional fees for many other services and reduced

⁸⁹ Fusaro, *Consumers' Bank Choice*, *supra* note 75.

⁹⁰ Fusaro, *Are "Bounced Check Loans" Really Loans?*, *supra* note 57.

⁹¹ Recall, for example, that 71% of low-balance free checking accounts at one bank never incurred overdraft fees. *See supra* note 60.

⁹² Joanna Stavins, *Checking Accounts: What Do Banks Offer and What Do Consumers Value?*, *NEW ENGLAND ECON. REV.* 3, 6 (March/April 1999).

services generally. Although the monthly maintenance fee was slightly higher for interest-bearing accounts, once the additional fees were considered, bank customers with a no minimum-balance account paid \$12.30 each month in higher monthly fees (approximately \$250 per year) than those who maintained a certain minimum balance. Thus, as would be expected in a competitive market, there has always been a tradeoff between different bank fees and other requirements. The market response to Regulation E and the subsequent market responses to the imposition of the Durbin amendment are consistent with the predictions of the banking industry as a competitive market where sustainable economic rents are absent.

B. The “Fairness” of Overdraft Fees

Critics of overdraft might protection might argue that even though there are no demonstrable economic rents generated by overdraft fees, overdraft fees should nonetheless be regulated because they are “unfair.” “Fairness,” of course, is an entirely subjective and arbitrary concept. To the extent that the term has any meaning in this context, it appears to express a concern that the actual operation of overdraft fees results in a cross-subsidization by some consumers by others, as the minority of bank customers who pay overdraft fees sustain the system and provision of free services, innovation, and expanded service for the larger number of those who do not.

The vast majority of bank consumers pay zero or few overdraft fees, meaning that they gain access to bank accounts at very low cost. Moreover, the FDIC estimates that for those customers who conducted 1 to 4 NSF transactions during the prior year on average were charged \$64 in NSF fees—or approximately \$5 per month—less than that

person would have been expected to pay in monthly bank fees prior to the spread of overdraft protection. Even a consumer with 5 to 9 NSF transactions paid on average \$215 year, or about \$15 per month. In addition, of course, the consumer avoided ancillary costs of bounced checks, late fees on other bills, etc. On the other hand, the bulk of overdraft fees are accumulated by heavy users of the product, but presumably they are most aware of the cost and the alternatives available to them and find it most necessary to use overdraft protection in light of available alternatives.

Is it “unfair” that most bank customers benefit from this system by receiving valuable bank services at low or zero costs, while bank customers who pay substantial overdraft fees appear to pay fees in excess of what they receive in exchange? As an initial matter, economics establishes that because those who use overdraft protection do so voluntarily their behavior establishes that in fact 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.

The claim of unfairness 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. For example, customers who purchase items on sale or with a coupon pay less than those who do not. Some consumers pay more to buy a book in hardback when it is first released while others are more patient and buy it at much-cheaper paperback prices. Those paying full price for movies subsidize those who attend matinee showings. Indeed, those who buy on sale or with coupons are typically commended for being thrifty and responsible shoppers although this means that they are being effectively subsidized by those who pay full price. That some bank

consumers subsidize free checking for others through overdraft fees seems no more unfair than consumers who pay full price or attend full-priced movies, thereby subsidizing others who are patient and buy 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.

Banking services are no exception to this rule. Today, banks offer a wide variety of services (many of them provided for free), but all of those are funded by a relatively small number of revenue streams. Different customers use different services supported by these streams and few consumers would prefer that every service be priced on an a la carte manner.⁹³ 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 of which I am aware 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 than walk or take public transportation. Similarly, some customers use online bill pay or other services that are offered for free as part of a bundle of products and others do not. Banks offer all of these “free” services as a bundle—debit cards, tellers, heat, free parking, drive-through windows, online banking, and a myriad of other services—even though they result in cross-subsidies because of competition and customer demand. 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*

⁹³ Similarly, few consumers seem to prefer paying separate baggage fees for checked bags on every flight rather than having those fees bundled into the price of their ticket.

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 is arbitrarily condemned on this ground.

In fact, like all of 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, the number of services offered, and banking hours generally have been extended.⁹⁴ The number of bank branches nationwide grew from 64,900 in 2000 to over 83,000 by the end of the decade.⁹⁵ Local banks have opened branches inside supermarkets and other retailers, thereby expanding the number of branches and the hours during which a teller is available to assist with banking services.⁹⁶ Rarely are consumers charged on a piecemeal basis for this increased choice and customer service, but rather all of these efforts are funded out of a handful of revenue streams.

Once the trade-off between free checking and overdraft protection is recognized, however, 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, innovation, and expanded access to the mainstream banking system to many consumers who traditionally

⁹⁴ The number of branches of commercial banks rose 39% between 1988-2006. See Timothy H. Hannan & Gerald A. Nanweck, *Recent Trends in the Number and Size of Bank Branches: An Examination of Likely Determinants*, 23 J. OF FIN. TRANSFORMATION 155 (2008) (Capco Institute).

⁹⁵ FDIC, Table CB01, available in www.fdic.gov/hsob/hsobRpt.asp.

⁹⁶ Between 2003 and 2008 the number of retail-based bank branches increased from 5,581 to 6,162. See Kevein Dobbs, *In-Store Branches Could Boost Growth for Some Banks in the West* (Sept. 1, 2009), available in <http://branchlocation.com/showArticle.php?id=68>.

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 of 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 promotes 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.

V. Competition and Overdraft Protection

If overdraft fees were simply a novel tool for banks to rip-off consumers then the growth of revenue from overdraft protection would be correlated with an increase in bank's bottom line profitability overall. Or, in economics jargon, the growth in interchange fee revenues would evidence "economic rents" or "economic profits" for those banks that have adopted overdraft protection. But, in fact, there is no evidence that

risk-adjusted bank profitability has increased substantially during the period that overdraft protection has spread and overdraft revenues have risen. Instead, profitability of depository institutions has remained relatively constant over time, even though overdraft revenues have risen substantially. Indeed, the crisis in bank solvency that began in 2008 developed just as revenues from overdraft fees reached their peak. Nor is there any obvious difference in the overall profitability of those institutions that offer overdraft protection versus those that do not. This absence of any systematic evidence of major economic profits linked to the provision of overdraft protection suggests that the increased use of overdraft fees has been driven by the competitive need to meet growing consumer demand not oppressive or unfair behavior by banks.

The apparent absence of risk-adjusted economic profits can be explained by several different, overlapping explanations. First, although overdraft revenues have increased, bank risk and loss has increased as well by bringing into the banking system lower-income consumers with lower average balances, narrower profit margins for banks and lower credit ratings. Moreover, as noted, the average loss on a non-paid overdraft loan is approximately \$300, roughly ten times the amount of the standard overdraft fee (\$30)—suggesting that approximately 10 or more successfully repaid overdraft loans are necessary to offset the losses from one defaulting overdraft customer.

Further evidence that overdraft protection does not generate economic rents is the rapid spread of the product and general satisfaction with those who use overdraft protection regularly. The banking industry is highly competitive.⁹⁷ This high degree of competition in the banking industry suggests that if any economic profits are earned from overdraft protection they are dissipated in the competitive process of extending banking

⁹⁷ Evans, Litan, & Schmalensee, *supra* note 87.

services to more consumers or reducing other banking fees, such as monthly account maintenance fees. Banks offering overdraft protection also compete with non-bank products such as payday lending and evidence suggests that if the cost of overdraft protection became unduly high relative to those alternatives, then consumers could and would shift to those alternatives. Circumstantial evidence is provided by the absence of economic rents in the payday lending industry once risk and cost are considered⁹⁸ and the beneficial effect of competition on payday loan prices.⁹⁹

Finally, the cost of retail banking has risen during the past decade as banks have increased the quality of bank services through innovation and expanded services, thereby competing away increased revenues from overdraft protection and debit card fees. Of course, the opposite is true as well: if revenues from these are forcibly reduced, then banks will be forced to cut costs and services, closing branches and charging for services that were formerly free. This economic reality is already appearing in the market place as regulations are causing many banks to abandon free checking and to adopt “a la carte” charges on products and services previously offered without charge. Rather than imposing new fees, other banks have chosen to trim costs by closing branches or otherwise reducing services.¹⁰⁰ Again, there appears to be no coherent regulatory principle that would support the principle that the combination of lower revenues and a lower level of consumer services is preferable to the alternative from a safety and soundness perspective and thus should be encouraged by law.

⁹⁸ See Paige Skiba & Jeremy Tobacman, *The Profitability of Payday Loans* (Working Paper, 2006).

⁹⁹ Donald P. Morgan, *Defining and Detecting Predatory Lending* (Fed. Res. Bank of New York, Staff Report No. 273, 2007); Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing* (Fed. Res. Bank of Kansas City, Working Paper No. 09-07, 2009); see also Philip Bond, David K. Musto, & Bilge Yilmaz, *Predatory Lending in a Rational World* (Fed. Res. Bank of Philadelphia, Working Paper No. 06-2, 2006).

¹⁰⁰ See Nelson D. Schwartz, *Branch Closings Tilt Toward Poor Areas*, N.Y. TIMES (Feb. 22, 2011), available in <http://www.nytimes.com/2011/02/23/business/23banks.html?pagewanted=all>.

VI. Unintended Effects of Regulation of Overdraft Protection

Regulation of the terms of overdraft loans may also have negative unintended consequences. As noted, the Federal Reserve's amendments to Regulation E, which adopted an opt-in regime for debit card overdraft protection, had the severe effect of reversing a decade-long increase in the percentage of free checking accounts at banks and subsequent regulation has accelerated this trend.¹⁰¹ Moreover, most of the regulations are patently absurd from a safety and soundness perspective: banking regulators have singled out for special concern the most profitable customers and terms of overdraft protection products without any empirical evidence or even plausible economic theory about how reducing revenues could improve safety and soundness.¹⁰² Moreover, overdraft programs have grown over the past decade, increasing their scope and volume, without any tangible evidence of heightened safety and soundness risk. In fact, most of these purported safety and soundness concerns are actually consumer protection concerns in disguise. An awareness of the incoherent nature of the safety and soundness concerns expressed by bank regulators may explain the tentative nature of many of these regulations.

Leaving aside these incongruities in safety and soundness issues, regulations could have unintended consequences for consumers and the banking system if interpreted in an unduly prescriptive manner. In addition, even if the FDIC's approach is characterized by some degree of restraint, there remains a looming threat that the newly-formed Bureau of Consumer Financial Protection might seize the authority to regulate

¹⁰¹ See discussion at *supra* note 88, and accompanying text.

¹⁰² Note the obvious point which actually must be stated in this context: simply because a customer or term is highly profitable (and, thus, beneficial from a safety and soundness perspective) does not mean that it is adverse to the interests of consumers. Profits in a free-market economy generally are earned by providing a service that consumers desire and value.

overdraft protection in a less-measured and less-informed manner, thereby potentially harming consumers and the economy.

A. *Regulating the Posting Order of Transactions*

The FDIC Guidance requires that banks not process transactions in a manner designed to maximize overdraft fees. As an example, the FDIC has suggested clearing items in the order received or by check number. Although the formal guidance does not speak further to the issue, the FDIC has stated that the practice of many banks of re-ordering transactions to clear payments from the largest to smallest value items as many banks is impermissible under the FDIC’s guidance because this will “tend to increase the number of overdraft fees.”¹⁰³ The FDIC’s justification for the rule is 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 incurring 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 consumer. Requiring clearance from lowest to highest dollar value is contrary to the

¹⁰³ 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. Moebs Services, Consumer Overdraft Fees, *supra* note 17.

practice of many institutions which has been to clear larger items first—usually checks and ACH payments—under the assumption that larger items tend to be more important items such as payments for mortgage, rent, utilities, or other high-priority payments that consumers would want to be sure would be paid. Although a requirement that smaller payments to be cleared first would likely reduce the cost of overdraft fees, it ignores 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 available credit balance available for overdraft protection, leading large and more important payments to be rejected because honoring them would exceed the available credit line.

In fact, a report by the Raddon Financial Group of one bank’s overdraft program found that 58% of its customers preferred that larger items be posted *first*, even though that might result in more overdraft charges in total.¹⁰⁴ Among “elevated users” of overdraft protection the percentage that preferred larger items to be posted first rose to 60%. Thus, the FDIC guidance contradicts the expressed preferences of a majority of the bank’s customers, especially those who use overdraft protection most frequently, making consumers worse off. Put more mildly, 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 suggests that more hard data is necessary before concluding that the contracted-for clearing order reflects a market failure rather

¹⁰⁴ Raddon survey, *supra* note 37.

than a term best left to be established by competition and free choice, especially with respect to 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.¹⁰⁵ 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 4%, but the dollar value of the rejected payments returned increased 16%. Moreover, many of those returned payments were for important items like payments of mortgages, utilities, medical bills, student loans, rent, taxes, and even payday loans. Thus, while the rule might reduce the amount of overdraft fees paid, it comes at a heightened risk of rejecting larger, more important payments. It is far from obvious that this tradeoff improves consumer welfare. It is even less obvious that this is an appropriate issue to be resolved by a one-size-fits-all FDIC mandate that overrides consumer choice rather than voluntary agreement between banks and their customers.

B. Special Rules for “Excessive or Chronic” Overdraft Customers

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, of course, is entirely

¹⁰⁵ The information discussed in this paragraph was provided to the Mercatus Center by IBC.

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 those goals. The basis for this belief or this arbitrary number, however, is unclear. Indeed, actual consumer behavior and revealed consumer preferences suggest that the basis for this opinion is 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 available alternatives. Therefore, it seems unlikely that these admonitions will cause many consumers to change their behavior. 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, including even traditional mortgages.

As with virtually every other aspect of overdraft protection, this paternalistic regulation is least popular with the most-frequent users of overdraft protection. According to the Raddon survey, although 89% of non-users of overdraft protection would want to be contacted after six overdrafts occur within a year, only 60% of elevated users would like to be contacted. Elevated users were also those most likely to opt-out of these notices if they could (33%). 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) would want to be alerted when they reached six occurrences. On the other hand, providing such notice would incur some cost—had the survey asked whether customers would be willing to *pay* in order to receive such notice (even a nominal fee such as

processing and mailing costs), one suspects that the percentage of those who responded affirmatively would drop substantially, especially among elevated users.

Moreover, very few customers are likely to even be able to establish an alternative payment source for overdrafts. For example, in a filing with the FDIC on the proposed rules, one bank stated that of its 327,865 free checking accounts only 49,616—approximately 15%—have savings accounts at the bank.¹⁰⁶ Moreover, that figure includes *all* free checking customers: The number of customers with free checking who have a savings account and have used overdraft protection is probably even smaller in light of the fact that those with sufficient funds to have a savings account are probably also less likely to overdraft.¹⁰⁷ This small percentage of free checking customers is consistent with the findings of the Raddon survey, which found that only 13% of elevated users of overdraft would “transfer funds from another account” if overdraft protection was unavailable. The reason why repeat users of overdraft protection do not use linked savings accounts or other similar options is not because they do not realize that those options would be less expensive, they do so because those options simply are not available to frequent users and to do without overdraft would force them to either do without the money (and suffer the resulting consequences) or use a payday lender.¹⁰⁸

¹⁰⁶ Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 12 n.8. Overall, the bank has 446,288 checking accounts with overdraft protection. Of those customers, only 62,310 have a related savings account but only 19,105 have chosen to sign up for its overdraft transfer protection that automatically transfers funds from the customer’s savings account to his checking account to cover payments when necessary.

¹⁰⁷ According to the Raddon survey, almost half of elevated users of overdraft protection at one bank reported that they did not have sufficient funds to maintain a separate account from which overdrafts could be drawn. Raddon Survey, *supra* note 37.

¹⁰⁸ These findings on the reasons for using overdraft protection in light of available alternatives are consistent with the usage of other alternative credit products, such as payday lending. Zywicki, Payday Lending, *supra* note 64.

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 in excess of that of most of the bank’s overdraft users. As noted, regular users of overdraft have low credit quality and limited credit alternatives. In addition, a line of credit typically requires a minimum line of credit of approximately \$2,500, far exceeding the \$300-\$800 available for overdraft protection. In fact, the spread of overdraft protection was hastened by the regulatory and economic difficulties of offering a line of credit to consumers.¹⁰⁹ Few of those who use overdraft protection are likely to be approved for such a large line of credit. But if the bank were to offer a smaller line of credit then the cost would rise substantially. In the end, therefore, the FDIC Guidance is almost completely irrelevant to the typical elevated user of overdraft protection, although the need to comply with the guidance will impose unnecessary administrative costs on banks and will have negative consequences for consumers.

VII. Conclusion

Regulation by anecdote is always dangerous and regulation of overdraft protection based on unrepresentative anecdote presents the risk of injuring consumers and the safety and soundness of the banking system. Safety and soundness regulators are targeting those borrowers who provide no safety and soundness risk (regular users who generate a net profit for banks). Moreover, it is these very same heavy users who report that they are the least likely to have easy, low-cost alternatives to overdraft protection and

¹⁰⁹ Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 4.

thus are the most likely to be diligent in maintaining their access to overdraft loans in good standing. Lacking any identifiable safety and soundness threat or identifiable market failure or evidence of consumer ignorance, regulation can be supported by only bald paternalism. And as the lessons of history indicate, paternalistic regulation of consumer credit products tends to injure precisely those it is intended to help, by driving them to use less-preferred credit or reducing their access to credit generally, with all of the ancillary consequences.

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. The OCC has raised concerns in its guidance as well. 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, or 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.

Regulators cannot wish away consumers' need for credit. Eliminating access to overdraft protection will not eliminate the need that consumers have for it. History teaches the hard but undeniable lesson that well-intentioned paternalistic regulations that make it more difficult for consumers to obtain certain products cannot magically make

them more financially responsible or make other less-expensive products magically appear. Everyone makes errors when it comes to many things, including personal finances. Yet it remains the case that most of us most of the time know better than central planners what is right for ourselves and our families. Access to overdraft protection is no exception. According to the Raddon survey, 94% of one bank's customers reported that use of overdraft protection should be their personal choice (including 92% of non-users and 96% of elevated users) and 89% reported their view that government should have *no* voice in how many overdrafts are allowed on your account.¹¹⁰ 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 regulation typically does is reduce access to one type of credit and, thereby, force consumers to make greater use of other, less-preferred products. Overdraft protection fills a unique need in the consumer credit marketplace—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. If access to overdraft protection is taken away, where will consumers who count on it turn?

¹¹⁰ Raddon Survey, *supra* note 37.

APPENDIX A

FORM OVERDRAFT COURTESY CUSTOMER DISCLOSURE

The Deposit Account Agreement controls the duties, obligations and rights of the Depositor, the Authorized Signatories and Bank with regard to your checking account. The Deposit Account Agreement (and all amendments thereto) is incorporated herein for all purposes as if it were set forth verbatim, and its terms shall control any possible conflict, if any, between any provision of this Overdraft Courtesy Policy and the Deposit Account Agreement. This discretionary service is offered to our customers who are United States residents or Resident Aliens.

Discretionary service. Bank is not obligated to pay any item presented for payment if your account does not contain sufficient available funds, and any discretionary courtesy payment (or other negotiation or processing) by Bank of any non-sufficient fund check or other item as identified below does not obligate Bank to pay any additional non-sufficient fund check or item or to provide prior notice of its decision to refuse to pay any additional non-sufficient fund check or item. Approval of payment of reasonable overdrafts by Bank on consumer accounts in good standing (as described below) is only a courtesy, and not a right or an obligation, is within Bank's sole and absolute discretion, and can cease at any time without prior notice or reason or cause.

"Good standing" requirement. Pursuant to Bank's commitment to always "Do More," now and in the future, if your consumer account (primarily used for personal and household purposes) or your sole proprietor account has been opened for at least 30 days and is maintained in good standing, which includes at least: A) Making regular deposits consistent with your past practices; B) Depositing \$300.00 or more in your account within each thirty (30) day period and bringing your account balance to a positive balance within every thirty-five (35) day period; C) You are not in default on any loan or other obligation to Bank; and D) You are not subject to any legal or administrative order or levy, Bank will consider, as a discretionary courtesy and not a right or obligation, approving your reasonable overdrafts.

Limits. This courtesy will generally be limited to a maximum of (i) a \$300.00 overdraft (negative) balance for "Free Checking Accounts," (ii) a \$500.00 overdraft (negative) balance for "Free Checking Accounts" that have been open and in good standing for at least one year, OR which have direct deposit, where there have been two or more direct deposits totaling at least \$600.00 within the past sixty (60) day period, (iii) a \$700.00 overdraft (negative) balance for "Free Checking Accounts" that have been open and in good standing for at least one year, AND which have direct deposit, where there have been two or more direct deposits totaling at least \$600.00 within the past sixty (60) day period, (iv) a \$500.00 overdraft (negative) balance for "Other Personal Checking Accounts / Free Biz Rite Accounts," (v) a \$700.00 overdraft (negative) balance for "Other Personal Checking Accounts / Free Biz Rite Accounts" that have been open and in good standing for at least one year, OR which have direct deposit, where there have been two or more direct deposits totaling at least \$600.00 within the past sixty (60) day period, and (vi) a \$900.00 overdraft (negative) balance for "Other Personal Checking

Accounts / Free Biz Rite Accounts” that have been open and in good standing for at least one year, AND which have direct deposit, where there have been two or more direct deposits totaling at least \$600.00 within the past sixty (60) day period. Customers are highly encouraged to balance their checkbook and use their overdraft courtesy in a responsible manner that avoids excessive fees.

Covered Transactions. Overdraft Courtesy Program covers checks, in person withdrawals, ATM withdrawals, and electronic transactions. “Electronic transactions” includes automatic payments, online bill pay, and debit cards used at point of sale. Authorization and payment of overdrafts for ATM and everyday debit card transactions by Bank are subject to your “opt-in” decision to such coverage.

Order of payment. It is the bank’s policy to clear items in the following order: (1) First any wire transfers from highest to lowest dollar amount; (2) items we have already paid out or committed to pay from lowest to highest dollar amount such as ATM withdrawals, teller cash withdrawals, transfers, and debit card or point of sale withdrawals (3) checks and ACH withdrawals from highest to lowest dollar amount. Transactions may not be processed in the order in which they occur. The order in which transactions are processed can affect the total amount of overdraft/non-sufficient funds fees incurred. Bank reserves the right to clear in any order, as permitted by state law.

One account per household. Generally, Bank will limit this discretionary courtesy to only one account per household.

Repayment of overdrafts. The total of the courtesy overdraft (negative) balance, including any and all bank fees and charges, including all non-sufficient funds/overdraft fees and OD interest charges is due and payable upon demand, and Depositor and each Authorized Signatory will continue to be liable, jointly and severally, for all such amounts, as described in the Deposit Account Agreement.

Closing of account. If your account is not returned to a positive balance within 45 days of the date it first become overdrawn, your account will be closed.

Fees. The Bank will charge an overdraft fee of \$29.00 for each item that is paid as an overdraft. Multiple overdraft fee charges up to 6 may be incurred on the same day. You will not be charged an overdraft fee if your ending account balance is overdrawn by \$3.00 or less. Fees are subject to change. You will receive advance notice of any fee increase in accordance with state and federal law. In addition, overdraft amounts will accrue an OD interest charge at the rate of 18% per annum. OD interest accrues from the date of the overdraft until the date of receipt by Bank of repayment of such overdraft. The amount of your overdraft courtesy will be reduced by the imposition of the fee(s).