COMMENTARY ON CFPB REPORT: DATA POINT: CHECKING ACCOUNT OVERDRAFT

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Commentary:

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Data Point: Checking Account Overdraft

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Abstract

The Consumer Financial Protection Bureau (CFPB) released a data point update of its ongoing analyses of overdrafts. We review the report and provide commentary on its findings, methodology and the inferences of this update, specifically the potential to further restrict debit card overdrafts. We suggest metrics the CFPB should use in its future analyses to help provide a more thorough assessment of the costs and benefits of overdrafts. To this end, we cite findings from our previous and other third-party analyses. Finally, we recap the larger policy questions of access to credit, alternative sources of credit, and the economic benefit attained by the use of overdrafts. We hope to add positive feedback to the CFPB as they work toward potential regulations of overdrafts. As with the CFPB's prior efforts, this report provides no basis for additional regulation of bank overdraft protection. Further research, however, is warranted.

JEL codes: D14, D18, G21, G28

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Introduction

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

Pursuant to that mission, in April 2012 the CFPB announced a public inquiry and industry research study to gain insight into the impacts of overdraft (OD) protection on consumers.[2] In its Request for Information, the CFPB specifically sought public comment on how consumers use overdraft programs, the information they receive about various banking products, the impact of prior overdraft regulations, and, most important, the benefits of overdraft protection to consumers and the cost to consumers of alternatives.[3] In June, 2013, the CFPB published an initial White Paper describing its preliminary results.[4]

In November, 2013, we published a commentary on the findings of the CFPB's initial White Paper and its implications for additional regulation of overdraft protection.[5] We observed that although the paper provided a valuable addition to the evolving academic literature on the economics of overdraft protection it provided no basis for the imposition of new regulation of overdraft protection. In particular, we noted that the White Paper provided no information on the two considerations that the CFPB itself acknowledged were crucial to establish before imposing new regulations on overdraft protection: (1) the cost to consumers of alternatives to overdraft protection, particularly payday loans[6]; and (2) the likely impact to consumers of market adjustments in response to reduced consumer access to overdraft protection and the revenues it generates, particularly a further reduction in access to free checking for consumers and an increase in other bank fees, such as monthly maintenance fees and higher minimum balance requirements to be eligible for free checking, and the

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[1] CFPB, *Consumer Financial Protection Bureau Strategic Plan FY 2013–FY 2017* (Washington, DC, April 2013), Retrieved from http://www.consumerfinance.gov/strategic-plan/.

[2] See CFPB, "Impact of Overdraft Programs on Consumers," 77 Fed. Reg. 24687 (April 25, 2012), Retrieved from http://www.gpo.gov/fdsys/pkg/FR-2012-04-25/html/2012-9851.htm.

[3] Gary Stein, Deposits Markets Program Manager at Consumer Financial Protection Bureau, Comment Period on Overdrafts Extended to June 29 (April 25, 2012), Retrieved from http://www.consumerfinance.gov/blog/category/overdrafts/.

[4] CONSUMER FINANCIAL PROTECTION BUREAU, CFPB STUDY OF OVERDRAFT PROGRAMS: WHITE PAPER OF INITIAL DATA FINDINGS (June 2013). Although the White Paper provides some discussion of the cost of overdraft protection to consumers and its value to banks, it does not systematically attempt to determine what alternatives are available to consumers or whether consumers who reduce their usage of overdraft protection increase their use of other expensive alternatives or whether less-expensive alternatives (such as a bank of line of credit or linked savings account) are actually available to overdraft users

[5] G. Michael Flores and Todd J. Zywicki, *Commentary: CFPB Study of Overdraft Programs*, MERCATUS RESEARCH (Nov. 4, 2013), *Retrieved from* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2349819

[6] We noted that although the White Paper identifies several alternatives to overdraft protection, such as linked savings accounts or bank lines of credit, for consumers who rely most heavily on overdraft protection these alternatives are almost completely theoretical as they are unlikely to have sufficient funds or sufficiently high-quality credit to qualify. *See id.*

inevitable increase in the number of unbanked consumers that those adjustments would produce. Additionally, consider that further pressures on revenues will drive greater cost reduction initiatives, especially in rationalizing office locations. That is, this cost reduction will result in fewer branches, primarily those in LMI communities. In short, existing economic evidence overwhelmingly indicates that those who rely on overdraft protection most frequently do so with knowledge of not only its cost but the cost of realistic alternatives, but rely on overdraft protection because they have limited credit options available to them.

In this light, this paper offers our feedback to the CFPB's July 2014 update, *Data Point: Checking Account Overdraft*.[7] First, while the economic study itself is useful, we identify some methodological and data-related issues on which the report is silent, but should have been reported and analyzed here and that we urge future reports to consider. Second, and perhaps more important, while the report is appropriately restrained in the conclusions that it draws from its analysis, we wish to emphasize at the outset the limits of its findings in providing a basis for further regulation. As with the CFPB's White Paper, this Data Point again provides a useful academic contribution to understanding the usage of overdraft protection. But also as with the White Paper, this analysis provides no basis for new or additional regulation of overdraft protection as it fails to shed any new light on the core questions raised by the CFPB at the outset of its inquiry on this topic: why consumers use overdraft protection, what are the costs of realistic alternatives to overdraft protection (if overdraft protection were made less available), and what would be the net effect on consumers, especially low-income and traditionally unbanked consumers, from offsetting market adjustments by banks in order to offset the loss of access to overdraft protection and the revenues that it generates (such as further reduction in free checking, increased bank fees, fewer branch locations and a further increase in the number of unbanked consumers as a result of this loss of free checking and higher minimum balance requirements).

Analysis

In general, the data points presented and their economic interpretation seem reasonable on the surface. We do want to emphasize two methodological considerations, however, that are both relevant to recognizing the limited reach of this study for direct policy application as well as suggestions for future similar Data Point studies.

First, the Data Point study is the result of analysis of the largest banks on the country and does not consider usage patterns in community and regional banks. The CFPB Data Point report is based on data from "…a representative sample of account-level and transaction-level checking account histories from each of several large banks. These are large banks covered by the CFPB's supervisory authority and do not include

[7] See CFPB, "Data Point: Checking Account Overdraft", July, 2014. Retrieved from: http://files.consumerfinance.gov/f/201407_cfpb_report_data-point_overdrafts.pdf

credit unions, thrifts, or banks with total assets under $10 billion."[8] We are aware of no reason to believe that overdraft usage patterns by consumers differs for small and medium-sized banks and credit unions from the large banks that the CFPB studies, and thus there is no reason to believe that the CFPB's sample is unrepresentative of consumers. On the other hand, the data indicate that sampling only large banks subject to the CFPB's supervisory authority is an unrepresentative sample of banks on this issue—in particular, small and medium-sized banks are much more reliant on overdraft revenues as part of their bank operations, thus regulations that reduced access to overdraft protection by consumers would disproportionately affect small and medium-sized banks and their customers.

The following chart[9] analyzes the value of overdraft income to banks, highlighting the different patterns of overdraft protection for different-sized institutions:

	All Commercial Banks - Assets less than $100M 12/31/2013 $ in 000's	All Commercial Banks - Assets $100M to $1B 12/31/2013 $ in 000's	All Commercial Banks - Assets $1B to $10B 12/31/2013 $ in 000's	All Commercial Banks - Assets more than $10B 12/31/2013 $ in 000's
Number of institutions reporting	1814	3522	450	90
% of Total	31%	60%	8%	2%
	(Year-to-date)	*(Year-to-date)*	*(Year-to-date)*	*(Year-to-date)*
Service charges on deposit accounts	$278,740	$2,491,161	$3,285,941	$26,448,204
Overdraft Income/Service Charge Income @ 53% of Service Charge Income	74%	74%	74%	53%
Overdraft Income	$206,267.60	$1,843,459.14	$2,431,596.34	$14,017,548.12
Overdraft Income/Net Operating Income	**27%**	**20%**	**17%**	**12%**
Lost Debit Card Overdraft Fees @ 62% of Overdraft Fees	$127,886	$1,142,945	$1,507,590	$8,690,880
Average OD Fee - Moebs Services (2014)	$25	$30	$32	$35
Number of transactions at average OD Fee @ $35	5,115	38,098	47,112	248,311
Transaction amount @ $24/overdraft	$122,770	$914,356	$1,130,692	$5,959,460
Service Charges without Debit Cards	$150,854	$1,348,216	$1,778,351	$17,757,324
Net Operating Income	$773,377	$9,269,849	$13,945,558	$116,974,942
Income Reduction Potential	**17%**	**12%**	**11%**	**7%**

As can be readily observed, the contribution of overdraft income as a percentage of bank income is inversely correlated with bank size, declining from 27% of net operating income for the smallest banks to 12% of income for the largest. Thus, the smallest banks rely more than twice as heavily on overdraft income as the largest banks. In one of the author's experience, many community banks experience a significantly higher dependence on overdraft income as a percent of net operating income.

As of December 31, 2013, close to 5,900 banks reports service charge income of $32.5 billion. The CFPB reports that overdraft/NSF income account for 53 percent of service charge income although an FDIC report[10] in 2008 stated that overdraft income represented 74 percent of service charge income.

The FDIC Study of Bank Overdraft Programs sampled banks as follows:

- 12 banks with assets less than $250 million
- 3 banks with assets from$250 million to $1 billion

[8] Ibid, Page 6

[9] Since the FDIC report focused more on community banks, we chose to use the 74 percent overdraft income/service charge income for the banks in the strata below $10 billion in assets. For those banks above $10 billion, we use the CFPB metric of 53 percent. Additionally, we use the Moebs Services stratification of median overdraft pricing by bank assets size (http://www.moebs.com/Portals/0/pdf/Press%20Releases/140128%20PR%20OD%20Survey%20Final.pdf)

[10] See https://www.fdic.gov/bank/analytical/overdraft/FDIC138_ExecutiveSummary_v508.pdf

- 7 banks with assets from $1 billion to $5 billion
- 17 banks with assets greater than $5 billion

As noted, this difference in net operating income does not necessarily suggest that the customers of smaller banks use overdraft protection differently or in higher volume than those at large banks. Instead, as discussed in more detail below, it may reflect in part the possibility that larger banks derive their operating income from a more diverse set of revenue streams including monthly fees and the sale of other bank products. While the CPFB's sample of banks appears to be unrepresentative of all banks this does not necessarily imply that its sample of the customers of those banks is unrepresentative. Nevertheless, this question about the representativeness of the sample warrants caution to the Bureau in interpreting the results, and particularly in drawing conclusions from the results for policy.

Second, the report presents only the *median* values of the transaction data. That it does not present alternative ways of reporting the values of the transactions, most notably means, maximum and minimum values, and standard deviations leaves gaps in the ability to conduct a thorough assessment of the data. Thus, it may be that the authors of the Data Point chose to present the median value of transactions as the most useful way of presenting the data in that it helps to eliminate the effects of data outliers. But even if the authors of the Data Point chose to rely on the median values in their analysis, it would be useful to present these other standard measures as well, even if only in an appendix to the report, especially in light of the apparent purpose of the Data Point series to present new data not previously available to researchers.

Not only is the failure to present the data in alternative ways puzzling on its face, it limits the ability to evaluate the Data Points findings by comparison to other data sets and measurements of relevant variables. For example, The 2013 Federal Reserve Payments Study[11] analyzes the trend in various payments options and uses mean (average) values. Comparing the overdraft data to the Federal Reserve payments data would require having mean data from the CFPB.

Leaving aside these more general issues, we turn to a consideration of several of the key findings[12] (presented in italics) of the CFPB report and our view of these findings. Again, we wish to emphasize that our critiques rest not so much with any problems in the data or conclusions, but to express caution with respect to the CFPB relying on the Data Point's finding to take regulator or enforcement action.

[11] Federal Reserve Bank, *2013 Federal Reserve Payments Study*, December 2013. Retrieved from http://www.frbservices.org/files/communications/pdf/research/2013_payments_study_summary.pdf
[12] Ibid, page 3

"Overdraft and non-sufficient funds (NSF) fees constitute the majority of the total checking account fees that consumers incur. For opted-in consumers, overdraft and NSF fees account for about 75 percent of their total checking account fees and average over $250 per year."

This statement is accurate but it is crucial to recognize the limited implications of this statement. It is true that OD/NSF fees have been the primary driver of service charge income in most banks for many years.[13] But this is to be expected because of profound changes in the price structure of checking accounts over the past decade. In particular, beginning around 2001 there was a dramatic growth in free checking accounts: in fact, the percentage of customer accounts eligible for free checking grew from less than ten percent in 2001 to 76% of all accounts in 2008, resulting in a dramatic reduction in bank revenues generated by monthly maintenance fees. Moreover, there was a dramatic increase in the quality and services associated with bank accounts, such as the development of online banking, mobile banking and automatic bill payment, that eventually came to be offered free or almost completely free to bank customers.[14]

This context is important to appreciate because presenting this data as a *percentage* of bank fees may be misleading—for example, in theory banks could reduce the percentage of service fee income generated by customer overdrafts by simply adding on more fees, such as imposing monthly maintenance fees on top of overdraft fees or charging for services previously provided for free. While that would reduce the percentage of fees generated by overdraft protection, consumers clearly would be worse off. To the extent that reducing overdraft fees simply leads banks to substitute higher maintenance fees (as appears to have happened at large banks with respect to the imposition of price controls on debit card interchange fees[15]) it is theoretically ambiguous whether consumers would be better off or worse off.[16] But there is good reason to believe that consumers would be made worse off by forcing this new pricing scheme on consumers. Not only is this precisely the product structure that consumers and the market rejected over the past decade but it remains the case that the use of overdraft protection is entirely within the control of the consumer over whether to use or avoid its use, compared to monthly maintenance fees for which a consumer has no control.[17] Indeed, as we

[13] Flores, G.M., Bretton Woods, Inc., "2008 Fee Analysis of Bank and Credit Union Non-Sufficient Funds and Overdraft Protection Programs", January 9, 2009. Retrieved from: http://bretton-woods.com/media/Bretton$20Woods$2C$20Inc.$202008$20NSF-ODP$20Fee$20Analysis$2C$2001-09-2009.pdf

[14] Zywicki, Todd, Washington and Lee Law Review, *The Economics of Regulation of Bank Overdraft Protection*, March, 2012, page 1147. Retrieved fromhttp://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=4284&context=wlulr

[15] See Todd J. Zywicki, Geoffrey Manne, and Julian Morris, "Price Controls on Payment Card Interchange Fees: The U.S. Experience," ICLE White Paper (2014), *Retrieved from* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080.

[16] Banks could also respond to reduced revenues by reducing the quality of service they offer, which would also not improve consumer welfare.

[17] Zywicki, Todd, Washington and Lee Law Review, *The Economics of Regulation of Bank Overdraft Protection*, March, 2012, page 1179. Retrieved from http://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=4284&context=wlulr

observed in our comment on the CFPB's White Paper, 63 percent of low balance free checking accounts at one large regional bank that we examined (average balance of under $250) paid *no* overdraft fees in 2012.[18] This means that for the overwhelming majority of low-balance (and presumably low-income) accounts, the full services of the bank's checking accounts were *entirely free.* An ABA study[19] states, "the cost of opening an account runs between $150 and $200[20] and the yearly cost of maintaining an account runs between $250 and $300[21]."

While this suggests that many low-income consumers are beneficiaries of free checking, there is no indication that usage of overdraft protection has regressive effects. For example, an analysis of a regional community bank in Texas indicates that after geocoding its accounts, approximately 70% of overdraft users are classified as either upper income (30%) or middle income (40%) and 30% of active users represent moderate income (27%) or low income users (3%)[22].

Research has found that there is no statistical relationship between usage of overdraft protection and income and any other demographic variable after controlling for credit riskiness.[23] The only discernible statistical relationship is between credit score (and thus presumably access to other types of credit) and overdraft usage.

We would hope that the CFPB add the income characteristics to its future analyses in order to provide a more complete profile of consumers who choose to use overdrafts.

If, however, forcibly reducing overdraft fee revenues by imposing new limits on consumer access to overdraft protection led to a reinstatement of monthly fees on these consumers, not only would many of them find themselves paying hundreds of dollars per year for services that they previously received for free, but many consumers would be forced out of the mainstream banking system entirely because of their inability to afford these new fees or the higher minimum balances necessary for eligibility for free checking. In turn, they would be forced to rely more heavily on expensive and less-preferred alternatives such as check cashers.

Alternatively, banks might respond by reducing the quality of their products and services offered. In short, CFPB should be extremely careful to ensure that if it imposes paternalistic regulations designed to protect

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[18] Flores and Zywicki at p. 21.
[19] Retrieved from https://www.aba.com/Press/Documents/e7a636cc2d244ec998d2ed16c23d1955CostofCheckingAccountsOnePageronJusttheCostsofAcco.pdf
[20] Robert C. Giltner, Velocity Solutions, Inc., Wilmington NC, BAI Retail Banking Solutions Live, May 19, 2010. Giltner estimates that it typically takes a year or so to break even on new accounts.
[21] Estimate by Celent, a unit of Marsh & McLennan Cos, May 2010, as reported in the Wall Street Journal, June 17, 2010, "The End is Near For Free Checking."
[22] IBC Bank, "Overdraft Data," on file with authors. See http://www.ffiec.gov/geocode/help3.aspx for income classification definitions.
[23] *See* Zywicki, *Economics and Regulation*, *supra* note 17, at 1164-65

a small group of consumers who use overdraft protection regularly—and voluntarily—the Bureau does not inadvertently and tragically disrupt the beneficial process of competition and financial inclusion that has brought millions of low-income consumers into the financial mainstream.

"Most overdraft fees are paid by a small fraction of bank customers: eight percent of customers incur nearly 75 percent of all overdraft fees."

This is an unsurprising metric. The Pareto Principle specifies an unequal relationship between inputs and outputs. The principle states that, for many phenomena, 20% of invested input is responsible for 80% of the results obtained. Put another way, 80% of consequences stem from 20% of the causes[24]. Any business manager can attest to the validity of this principle that a majority of the business's profitability is derived from a minority of its customers.

One of the authors has worked with banks for close to 40 years and time and again, stratifications of deposit account and loan portfolios affirm this finding – a minority of customers account for the majority of deposits and loan balances.

A recent analysis[25] of a community bank by one of the authors indicated:

1. 85.7 percent of consumer checking accounts represented only 17.2 percent of the dollar balances
2. 85.1 percent of commercial checking accounts provided only 10.8 percent of the balances
3. 87.1 percent of commercial loans accounted for only 27.4 percent of the loan commitments

In the first example, almost 83 percent of the checking account balances are provided by only 14 percent of the customers. When one considers the bank's ability to arbitrage these balances with interest earning assets (loans), the value (revenue) is provided by a minority of the customers. In the third example, 73 percent of loans (revenue) reside with only 13 percent of loan customers. Cross subsidization within business lines and product lines is a reality in many industries and has been a factor in bank product pricing for years.[26]

It is our hope that this one metric does not influence restrictive regulation of overdrafts because if you eliminate the most active strata and then perform another stratification analysis, the long tail distribution will still appear.

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[24] See http://www.investopedia.com/terms/p/paretoprinciple.asp
[25] Data on file with authors.
[26] *See* Dymski, Gary, *The Bank Merger Wave, The Economic Causes and Social Consequences or Financial Consolidation* at Chapter 3, Page 48 (1999)

"The propensity to overdraft generally declines with account holder age, with 10.7 percent of the 18-25 age group having more than 10 overdrafts per year, but only 2.8 percent of the 62 and over age group falling into this category."

One area that is not explored in this report is the relationship of the monthly number of debit transactions for the opt-in group (35) compared to the non-opt-in group (27). This is a 30 percent differential between the groups. The debit card usage shows a more extreme difference of 46 percent (24 versus 16 POS transaction between the opt-in and non-opt-in groups). Only further analysis would determine any correlation with the age, debit card usage and use of overdrafts. The CFPB report is a snapshot and which must be placed into historical context.

One of this paper's authors recently co-authored, *"Consumer Credit and the American Economy"* a book that tracks consumer credit usage over the years and ties various demographic markers to the usage.[27] In particular, it is well-established in economic literature that use of credit, and particularly nontraditional and higher-cost consumer credit, follows a predictable lifecycle pattern.

Demand for consumer credit is highest early in a person's life, when they are beginning their adult lives, forming households, and starting families. At the same time, however, younger borrowers typically have fewer assets, lower incomes, and less-established credit histories than later in life, thus the *supply* of consumer credit is typically lower at the same time demand is highest. As consumers age and households mature, consumers begin to transform from net borrowers to net savers.

As a result, consumers frequently find themselves in a period of their lives of having their access to credit rationed at the same time that their demand for credit is highest. Thus, these same consumers are also more likely to exhaust available sources for standard credit (such as credit cards) and are more likely to rely on alternative credit products such as payday lending, pawn shops, and overdraft protection which does not require traditional credit qualification in most programs. Therefore, there is nothing unusual about the life-cycle pattern of usage that the CFPB identifies for overdraft protection; indeed, this usage pattern of higher usage at younger ages that declines over time is a mirror image of the patterns for similarly-situated products such as payday loans and pawn shops and is not unique to overdraft protection.[28]

[27] *See* Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy* at Chapter 8 (2014).

[28] *See* Durkin, et al., at 374 ("The economic model of consumer credit predicts that users of high-price credit products would be consumers in early family life cycle stages who have limited discretionary income for servicing debt and face constraints to additional credit use. An examination of demographic characteristics of high-price credit users suggests they generally have the characteristics that economic theory predicts.").

Moreover, the likely unintended consequences of restricting access to overdraft protection is again entirely clear and predictable: in the first instance these same consumers will likely increase their usage of alternative high-cost and frequently less-convenient products, particularly payday lending, or in some instances, expensive cash advances on credit cards.[29]

"The number of overdraft transactions and fees varies substantially with opt-in status. Opted-in accounts are three times as likely to have more than 10 overdrafts per year as accounts that are not opted in. Opted-in accounts have seven times as many overdrafts that result in fees as accounts that are not opted in. Disentangling the causal nature of the relationship between opt-in status and overdrafting would require further analysis."

We agree that further analysis is required to better understand why consumers see value in the overdraft service and would suggest that OD protection is an ex post substitute for higher ex ante required minimum balances and monthly fees. Future analysis should delve into the other characteristics of those who use OD, such as their age, income, average balances, or whether they are more likely to have free checking than other similarly-situated consumers who do not use OD.

Here the authors of the Data Point identify the most crucial cautionary warning in the report in terms of using the Data Point study as a foundation for new regulation, and one that we fully endorse: "Disentangling the causal nature of the relationship between opt-in status and overdrafting would *require further analysis*." As the report indicates, establishing the direction of causation would require further analysis—but this further analysis is precisely that which much be conducted before the CFPB can establish whether further restricting access to overdraft protection will benefit or harm consumers, including the more-frequent users of overdraft protection about whom the CFPB appears to be most concerned. We are aware that banks have reported wide variance in the opt-in rates for their customers, which suggests that it matters how the opt-in decision is marketed to consumers and presented to them matters. Still, analyses of opt-in rates, including by the CFPB, have consistently found a linear relationship between the frequency of overdraft usage and the likelihood of opting-in. Prior research also suggests that heavier users of overdraft protection opted-in to overdraft protection because available alternatives are more expensive or less convenient and useful than overdraft protection.

In fact, while we agree with the authors of the Data Point that establishing causation requires further careful study, Table 8 of the Data Point study suggests that heavier users of overdraft protection opt-in to coverage, rather than the alternative. As the study states, *"When breaking out Opted-In and Non-Opted-In*

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[29] *See* Robert L. Clarke and Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 REV. OF BANKING AND FIN LAW 235 (2013-2014).

accounts, an interesting result emerges: among Opted-In accounts, the probability of overdrafting is significantly higher across all transaction types, not just those covered by the Regulation E opt-in requirement (ATM and non-recurring debit card transactions)." This finding—that use of overdraft across *all transaction types* (including check and ACH) is higher for those who opt-in to POS and ATM protection—strongly suggests they have a need for overdraft protection generally (presumably because they have limited alternative credit options generally). If, by contrast, it were the case that those who opt-in to POS and ATM are then more likely to use it--i.e., the causal direction were reversed--then their usage of non-opt-in products (check and ACH) would be expected to have the same distribution as the non-opt-in group. But this is not the case. In short, this finding implies that heavier users opt-in to overdraft protection because they need and value the product and that limiting access to its use would simply push them to greater use of expensive alternatives such as payday lending.

"Transactions that lead to overdrafts are often quite small. In the case of debit card transactions, the median amount that leads to an overdraft fee is $24 and the median amount of a transaction that leads to an overdraft fee for all types of debits is $50."

This is a metric that would benefit from a full statistical assessment with mean, maximum, minimum and standard deviation added to the analysis. In particular, understanding the distribution of the size of the transactions that trigger overdraft protection is essential to understand the welfare effects of access to overdraft protection and the possible welfare effects of restricting access. For example, research has found that consumers generally appear to choose rationally in deciding whether to use overdraft protection or payday lending to cover a particular payment.[30] Because of the distinct pricing schemes of overdraft protection versus payday lending, there is a discrete dollar value for a transaction at which it may become less expensive to use overdraft protection versus payday lending. Knowing the distribution of transaction size is useful to determine how consumers are choosing between those two products. Moreover, focusing only on the median transaction size to the exclusion of the mean and distribution of transaction size also does not take account of the full costs of alternatives, such as the time cost of delaying purchases (i.e., making multiple trips to the store or ATM because of an inability to complete the transaction originally), shifting to other socially more expensive transaction devices for which the consumer does not have opt-in (such as checks), or the "shoe leather" costs of payday lending and other credit sources as compared to the convenience of overdraft protection.

This comparison of overdraft protection with alternatives such as payday loans reinforces the importance of the CFPB considering *all* costs, not just fees, of the alternatives available to consumers. While overdraft protection may appear more expensive in some circumstances than available alternatives (such as

[30] Donald P. Morgan, Michael R. Strain, and Ihab Seblani, "How Payday Credit Access Affects Overdrafts and Other Outcomes," *Journal of Money, Credit, & Banking* 44 (2012): 519–31.

payday loans or pawn shops) that may not be the case once *all* costs are taken into account. For example, a consumer can trigger an overdraft advance at any time day and night, anywhere in the world, for any reason without needing any preapproval or advance planning. By contrast, payday lending may be less expensive financially for some transactions, but can only be accessed if a consumer plans ahead to acquire the money, which may be of little help in an emergency or at the moment the consumer is at the checkout counter at the grocery store. Similarly, pawn shops by definition require the borrower to part with valuable personal goods and to bear the time and inconvenience of transporting those goods to the store. Understanding the role played by these *non-financial* elements of the full cost of alternative sources of credit is essential to understanding how consumers use different types of consumer credit and to understand the implications of reducing access to overdraft protection

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"Most consumers who overdraft bring their accounts positive quickly, with more than half becoming positive within three days and 76 percent within one week"

When discussing how overdrafts are used, one should place overdrafts in the context of the consumer credit continuum. That is, it is apparent that the need for overdrafts is relatively short-term. If the overdraft facility was not available or severely restricted, what is the next best option for the consumer - a payday loan, perhaps?

Given the recent guidance by the OCC that has led most major banks to terminate their direct-deposit advance products, consumers who rely on overdraft protection are facing increasingly limited alternative options.

While it is true that most overdrafts are repaid within a few days, that analysis is incomplete. Many overdraft loans are never repaid at all when the consumer defaults on the amount borrowed, forcing the bank to write-off potentially hundreds of dollars per account. Thus, if the average overdraft fee runs approximately $30 per overdraft, a bank must have a ratio of some 10 or more paid overdrafts to compensate for each defaulted overdraft account. A large number of overdraft defaults occur very early in the lifecycle of an account (so-called "hit and run" schemes) where the customer opens an account with a nominal balance and then immediately overdrafts the account to the full and never repays any of the amount overdrafted.[31]

Finally, banks could redesign the product so that it had a longer effective loan period (say two weeks, like a payday loan) or change the fee structure or repayment period. But there is no evidence that encouraging such a redesign of the product would make consumers better off. Indeed, economic analysis indicates that consumers generally act rationally in choosing between the use of overdraft protection or payday loans based on their existing fee structure, so it is unlikely that forcing a redesign of the typical fees or expected maturity of overdraft

[31] See Zywicki, Washington and Lee at page 1155.

advances would make consumers better off (i.e., choose the less-expensive option).[32]

Conclusion

Since the CFPB report seems to focus on consumers who opt-in for ATM and POS overdrafts, we explore two areas of potential unintended consequences of further restrictive regulation of overdrafts.

First, as noted above, if debit card overdrafts were restricted or eliminated, then the smallest community banks would experience the greatest negative impact to earnings. Given that many community banks remain somewhat weak in light of the financial crisis and subsequent regulatory compliance costs, any substantial erosion in overdraft protection revenues would be especially destabilizing. A recent survey by the American Bankers Association[33] indicates that most consumers pay nothing for checking accounts:

- 62 percent said they pay nothing (55 percent in 2013)
- 12 percent said $3 or less (10 percent in 2013)
- 7 percent said $4 to $6 (8 percent in 2013)
- 3 percent said $6 to $9 (4 percent in 2013)
- 7 percent said $10 or more (14 percent in 2013)
- 9 percent were unsure (9 percent in 2013)

Should further restrictions impact overdraft fees, community banks likely would have to scale back their free checking programs and raise other fees, just as larger banks have done in response to regulation-induced reductions in revenue streams.

According to Moebs Survey[34] in January 2014, community banks have the highest concentration (up to 65 percent) of free checking products. The same Moebs survey highlights that the percent of banks offering free checking has declined from a high of 81.5 percent in 2009 to 59.1 percent in 2014. Much of this reduction can be attributed to the Reg E reduction of overdraft fess and the impact of the Durbin Amendment on interchange fees in banks with assets greater than $10 billion. Additionally, while the largest banks have reduced access to free checking substantially since Dodd-Frank's enactment, community banks to date have shown no corresponding tendency to reduce access to free checking.[35] Given the much heavier reliance of smaller banks on overdraft revenues, any significant reduction in overdraft revenues, however, would likely force smaller banks to follow larger banks and to reduce access to free checking for consumers.

[32] *See* Morgan, Strain, and Seblani, *supra* note.
[33] Retrieved from http://www.aba.com/Press/Pages/090914BankFeesSurvey.aspx
[34] Retrieved from http://www.moebs.com/Portals/0/pdf/Press%20Releases/140128%20PR%20OD%20Survey%20Final.pdf
[35] Indeed, by some measures access to free checking at smaller banks may have actually increased. *See* Richard J. Sullivan, The Impact of Debit Card Regulation on Checking Account Fees, in FEDERAL RESERVE BANK OF KANSAS CITY ECONOMIC REVIEW FOURTH QUARTER 65-66; *see also* Zywicki, Manne, and Morris, *supra* note, (comparing trends in availability of free checking for large versus small banks since the enactment of the Durbin Amendment as part of the Dodd-Frank financial reform legislation).

From the consumers' perspective, if debit card overdrafts account for 41 percent of all overdrafts[36] at a median $24 overdraft (as indicated in a previous chart), the lost purchasing power would be $5.4 billion.

Before any further limiting regulation is proposed, we suggest that a full cost/benefit analysis be conducted by the CFPB team. The next review should consider the economic benefit to the consumer, the cost of alternative credit as well as the cost to the consumer if many of the overdraft transactions were significantly restricted. When considering these costs, we suggest an analysis of the *"all-in"* costs including the time and expense to apply for alternative credit (payday, pawn), travel to stores in the case of some payday loans and all pawn loans and the inability of the consumer to access these products in a *"just in time"* scenario for those purchases of necessities such as gasoline or groceries. Furthermore, we believe that there is a convenience factor related to overdrafts in that there is only a one time application (opt-in) if a customer qualifies for a checking account and the service is available all the time and at all places by simply using the debit card.

Data from the International Bank of Commerce (IBC Bank), a regional bank in the southwest, indicate that over a period of one year (August 1, 2012–July 31, 2013) overdrafts (spending) totaling $437.6 million cost consumers $58.8 million.[37] That is, there was an economic benefit multiplier of 7.4 times the cost of the overdrafts. For point-of-sale (POS) and ATM overdrafts, the multiplier was 4.9 times. An economic disadvantage (additional costs) would accrue to consumers if overdrafts or other credit options were unavailable or the purchase was deferred. Possible disadvantages include late fees, utility disconnections, and forgoing necessary purchases (food, pharmaceuticals, auto repairs, etc.).

Our analysis of IBC Bank data shows that the majority of POS overdrafts were for necessities.[38] The transactions were tracked by the Merchant Category Classification (MCC) code. Of the 380 categories in the MCC code, the top 11 codes (3 percent) accounted for 60 percent of the transactions and 55 percent of the principal overdrawn. As shown in the following table, these 11 categories are primarily for food, fuel, utilities, and financial services that one could reasonably consider necessities.

[36] Blair, Sheila, FDIC, *Bank Can Help You Avoid Debit Card Overdraft*, May 6, 2010. Retrieved from https://www.fdic.gov/news/letters/bank_overdrafts.html

[37] IBC Bank, "Overdraft Data," on file with authors.

[38] As a result of technological advancement and consumer demand, acceptance of debit cards has grown over time. Thus, many transactions traditionally made by check can today be made by debit cards. Thus, the distinction between checks and POS debit cards which is at the heart of the opt-in rule seems increasingly artificial. For example, the Federal Reserve notes that debit cards or ACH increasingly are used for bill payments and invoices. FEDERAL RESERVE BOARD, THE 2013 FEDERAL RESERVE PAYMENTS STUDY 27 (Dec. 2013), *available in* http://www.frbservices.org/files/communications/pdf/research/2013_payments_study_summary.pdf.

Cumm %	MCC CODE	MCC DESCRIPTION	Transaction Amt	%	Cumm %	Volume Count	%	Cumm %
0.3%	5411	Grocery Stores	2,162,275.77	14.09%	14.09%	27,045	11.62%	11.62%
0.5%	5542	Automated Fuel Dispensers	1,121,739.17	7.31%	21.40%	25,493	10.95%	22.57%
0.8%	4814	Telephone services	910,065.21	5.93%	27.33%	7,029	3.02%	25.59%
1.0%	4899	Cable and other pay television (previously Cable Services)	747,709.03	4.87%	32.21%	7,081	3.04%	28.63%
1.3%	5814	Fast Food Restaurants	740,628.08	4.83%	37.03%	27,831	11.96%	40.58%
1.6%	4900	Electric, Gas, Sanitary and Water Utilities	641,218.88	4.18%	41.21%	4,526	1.94%	42.53%
1.8%	5812	Eating places and Restaurants	631,693.06	4.12%	45.33%	16,206	6.96%	49.49%
2.1%	5541	Service Stations (with or without ancillary services)	516,822.52	3.37%	48.70%	20,131	8.65%	58.14%
2.4%	6300	Insurance Sales, Underwriting, and Premiums	488,207.68	3.18%	51.88%	3,611	1.55%	59.69%
2.6%	6012	Financial Institutions – Merchandise and Services	246,607.62	1.61%	53.49%	703	0.30%	59.99%
2.9%	4829	Money Orders – Wire Transfer	208,566.64	1.36%	54.85%	572	0.25%	60.24%

The value of these overdraft programs for overdraft users is also revealed in a June 2011 survey by Raddon Financial Group of customers of one large regional bank. The survey found that, when asked to rank the value of overdraft protection from "extremely valuable" to "not at all valuable," 86 percent of elevated users stated that the availability of overdraft protection was extremely valuable; only 2 percent said it was not at all valuable.[39] Moreover, the percentage of those stating that overdraft protection was extremely valuable rose consistently with the intensity of use, from 57 percent for nonusers of overdraft protection to 86 percent for elevated users. Overall, of 2,009 respondents to the online survey, 71 percent said that access to overdraft protection was "extremely valuable" and another 21 percent said it was "somewhat valuable". Only 4 percent said it was "not at all valuable".

We look forward to CFPB's continuing analysis of overdrafts and appreciate their willingness to hear comments about their work.

[39] See Zywicki, "Economics and Regulation of Bank Overdraft Protection," 1173.