Testimony of Professor Todd Zywicki Presented to

The House of Representatives Committee on Financial Services

Subcommittee on Consumer Protection and Financial Institutions

"The End of Overdraft Fees? Examining the Movement to Eliminate the Fees Costing Consumers Billions"

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George Mason University Foundation Professor of Law

Antonin Scalia Law School

Research Fellow, Law & Economics Center

Tzywick2@gmu.edu

Chairman Perlmutter, Ranking Member Luetkemeyer, and Members of the Committee:

I am Todd Zywicki. I am George Mason University Foundation Professor at Antonin Scalia Law School and Research Fellow of the Law & Economics Center. From 2020-2021 I served as the Chair of the CFPB's Taskforce on Consumer Financial Law and from 2003-2004 I served as the Director of the Office of Policy Planning at the Federal Trade Commission. I am also co-author of *Consumer Credit and the American Economy* (Oxford 2014) and the author of four articles on the economics and regulation of bank overdraft protection, including *The Economics and Regulation of Bank Overdraft Protection*, 69 WASHINGTON & LEE L. REV. 1141 (2012) and *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Financial Protection Bureau*, 33 REV. BANKING & FIN. LAW 235 (2013), co-authored with former Comptroller of the Currency Robert Clarke. I appear voluntarily today in my personal capacity and do not speak on behalf or represent any other party.

I appear today to address the issue of bank overdraft protection, its usage by consumers, and the potential costs and benefits of new or additional regulations on its usage and access by consumers. Most regulatory and legislative attention has focused on the use of overdraft protection by more frequent and heavier users of the product, such as those who use overdraft protection ten or more times per year and those consumer will be the focus of my attention today. This has been an area of regulatory scrutiny for some time and the new CFPB Director Rohit Chopra has stated that fees charged for usage overdraft protection as an example of a "junk fee" on consumer financial products that financial institutions use to "feast on their customers."[1] Congress has also been considering legislation that would impose new limits on consumer use of overdraft protection and the fees that could be assessed in connection with those services.[2]

To be sure, all consumers—myself included—are often frustrated by dealing with banks and the various fees and complexities associated with modern consumer financial products. But exasperation is not a sound basis for policy and merely labeling these charges as "junk fees" obscures the more nuanced reality of the role they provide in efficiently pricing the risk of consumer financial services, increasing access to historically-underserved individuals and communities, and preventing inefficient and unfair cross-subsidies among various consumers.[3] Ill-considered new regulations on overdraft fees not only could harm consumers overall but by limiting the ability of banks accurately to price the risk of offering these services would have the greatest adverse effect on responsible lower-income, younger, higher-risk, and other marginal consumers who would likely find themselves facing higher bank fees, higher mandatory minimum balance requirements, and reduced access to banking services in general.

Reduced revenue from overdraft protection would also have direct safety and soundness implications for financial institutions, but would have a particularly large adverse effect on many smaller institutions, such as community banks and credit unions. Larger mega-banks offer a wider variety of products and services, thus they will have access to multiple revenue sources to offset any reduction is overdraft protection

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[1] *See* Rohit Chopra, *Prepared Remarks of CFPB Director Rohit Chopra on the Junk Fees RFI Press Call* (Jan. 26, 2022), https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-rohit-chopra-on-the-junk-fees-rfi-press-call/.

[2] *See* H.R. 4277 "Overdraft Protection Act of 2021," 117th Congress (June 30, 2021).

[3] *See* Howard Beales and Todd Zywicki, *Junk Fees or Junk Policy?*, THEHILL.COM (March 21, 2022), *available in* https://thehill.com/blogs/congress-blog/politics/599085-junk-fees-or-junk-policy?rl=1.

revenues. Smaller institutions, by contrast, are in general appear to be more dependent on fees generated from the provision of overdraft protection and will have more difficulty recovering lost fee revenues without significant harm to their competitive position (such as by reducing access to free checking).

Assessing the desirability of any new consumer protection regulation on overdraft protection or any other issue requires a three-step analysis that asks the following questions[4]:

(1) Is there a market failure?

(2) Is there a feasible solution to address the market failure?

(3) Will the benefit of the proposed intervention exceed the costs, including all unintended consequences associated with the intervention?

Applying this analysis to the question of new regulations on overdraft protection reveals the complexities and tradeoffs that are associated and suggest care to ensure that well-intentioned new regulatory interventions do not harm consumers, especially more vulnerable consumers.

Historically, overdraft protection was a courtesy that banks reserved only for its most elite customers, typically high-income professionals and others who had personal connections to bank managers.[5] Ordinary consumers, by contrast, were typically forced to deal with the inconvenience, embarrassment, and in some instances threat of criminal prosecution, of bounced checks, NSF fees, and declined payments. Over time, however, financial institutions developed automated overdraft protection programs that have

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[4] *See* CONSUMER FINANCIAL PROTECTION BUREAU, 1 TASKFORCE ON FEDERAL CONSUMER FINANCIAL LAW REPORT 285.

[5] *See* Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, 69 WASH. & LEE. L. REV. 1141 (2012).

reduced the risk and cost of providing overdraft services and eliminated the traditional subjectivity and selectivity of discretionary overdraft protection programs, thereby expanding eligibility to virtually all bank customers regardless of income or status. Today, 92.9% of banks and 60.9% of credit unions operate overdraft programs and at those financial institutions that offer overdraft programs, decisions are largely automated.[6]

In this testimony I will briefly examine four issues: (1) Are there information problems with consumer understanding about overdraft protection that could be improved by new disclosure requirements and the like, (2) Why do consumers use overdraft protection, (3) What are the characteristics of consumers who use overdraft protection frequently, and (4) What would be the potential costs or harms to consumers from new regulations that would restrict their access to overdraft protection usage.

I. Do Consumers Understand Overdraft Fees and When They Incur Them?

Director Chopra has suggested a problem with overdraft fees and other comparable fees (such as late fees on credit cards) is that they are "back-end" fees that consumers cannot fully appreciate when they shop for financial services and cannot easily avoid incurring. Similarly, the Overdraft Protection Act of 2021 provides for new and revised disclosures by banks of fees related to overdraft transactions, including new required disclosures at the time of account opening and ongoing alerts and notifications with respect to ongoing usage of overdraft services and fees those services involve.

[6] *See* CONSUMER FINANCIAL PROTECTION BUREAU, DATA POINT: CHECKING ACCOUNT OVERDRAFT AT FINANCIAL INSTITUTIONS SERVED BY CORE PROCESSORS 3 (Dec. 2021) (Data Point No. 2021-11).

It is generally accepted that disclosure requirements today for consumer financial services are unfathomably bewildering and multitudinous.[7] *Ceteris paribus*, in making any decision about a consumer financial product or service, more information is generally preferable to less and information-based regulations that respect consumers' preferences and different circumstances are generally superior to prescriptive rules that ban products or dictate prices or other substantive terms.[8] But as with most good things in life, too much information can overload of our time and attention, bury important information in a sea of trivialities, or provide generally useful information at wrong time when it is not relevant to the particular decision at hand. These limits on consumer attention and interest raise the question of how much information consumers should receive specifically about overdraft protection at the time of account opening and how much information should be required to be provided to them on an ongoing basis.

When a consumer opens a new bank account, he or she is presented with an intimidating stack of papers to read and process, of which terms and conditions of overdraft programs is just one of those provisions. How important are those disclosures to the average consumer relative to other disclosures? To begin with the obvious point—the overwhelming majority of bank consumers never or rarely overdraft their accounts.[9] According to analysis by the CFPB in 2017, for example, 66.6% of accounts in their sample never overdrafted their account and another 14.5% overdrafted just 1-3 times during that time. In addition, inadvertent overdrafters are often granted fee waivers upon

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[7] *See* CFPB TASKFORCE REPORT, *supra* note 4, at Vol. 1, Ch. 7.
[8] *Id.* at 296.
[9] *See* Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5.

request.[10] This suggests that for roughly 80% of consumers, up-front disclosure about specific terms and conditions of a bank's overdraft program would provide little benefit but could run the risk of distracting them or making it more difficult for those consumers to focus on the terms and conditions they do care about, such as customer service, branch locations, security and fraud protection, monthly fees, interest rates, mandatory minimum balance requirements, debit card terms, mobile banking, or other attributes.[11] In addition to these factors, many consumers today also say they value information about environmental sustainability, diversity in bank leadership, and community involvement.[12]

According to one analysis, for example, most consumer can only focus on two or three criteria when shopping for a bank account information, and information about a bank's overdraft fee program ranked fifth on that list ("low or no overdraft fee" services ranked even lower for the typical consumer when shopping for a bank account).[13] Simply adding more required disclosures, especially one of minimal importance to most consumers, to the already-large stack of papers that consumers receive at account opening, therefore, is unlikely to benefit them.

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[10] *See* Jason Scott Johnston and Todd J. Zywicki, *The CFPB's Arbitration Study: A Summary and Critique*, 35(5) BANKING AND FIN. SERVS. POL'Y REPORT 9 (2016) (providing data from one regional bank on fee refunds for overdraft protection and other services); G. Michael Flores, *An Assessment of Usage of Overdraft Protection by American Consumers*, AMERICAN BANKERS ASSOCIATION 23 April 2017) (noting that 28% of all overdraft fees were waived or refunded). Flores further notes that once fee waivers and refunds are considered, even though the disclosed average fee is $35.50 per overdraft, the average *assessed* fee was $25.56. As noted below, he also finds that lower-income customers were more likely to have fees waived than higher-income consumers.

[11] *See* Lyle Daly, *Study: What Consumers Really Want from Banks*, THE ASCENT (Dec. 19, 2020), *available in* https://www.fool.com/the-ascent/research/study-what-consumers-really-want-from-banks/#:~:text=Competitive%20interest%20rates%20are%20important,giving%20back%20to%20the%20community.

[12] *Id.*

[13] *See* NOVANTAS, UNDERSTANDING CONSUMER CHOICE: A REVIEW OF CONSUMER OVERDRAFT BEHAVIORS 21 (2015). Notably, that list did not include many other relevant attributes such as quality of customer service, security and fraud protection, or environmental and social factors.

Moreover, while there has been much public and regulatory focus on the annoyance and unfairness of occasional surprise overdraft fees when someone unsuspectingly overdraws their account, surveys indicate that frequent users of overdraft protection are much more active in monitoring their accounts to check their balances and outstanding transactions than those who rarely use overdraft.[14] As a result, those who overdraft their accounts more frequently (more than 10 times per year) state that when they overdraft, they know their account balance is running low and either "hoped" an expected deposit would post to their account before a purchase they made or knew they were running low and used overdraft protection to make sure their payment cleared.[15] Few consumers who use overdraft protection frequently, therefore, seem to be doing so because they are unaware of either the risk or expected cost of overdrafting, but instead are doing so as a calculated gamble with respect to the timing of a credit and/or debit or as insurance to make sure a payment goes through without being declined. Enhanced real-time alerts (which many financial institutions offer already) could assist some consumers from incidentally overdrafting their accounts but they are unlikely to be of particular value to frequent users of overdraft protection for whom most overdrafts dod not come as a complete surprise.

Moreover, the observation that a disproportionately large amount of overdraft usage and fees are generated by a disproportionately small number of consumers is not unique to overdraft protection usage. Such patterns of consumer behavior are common across retail industries, including retail banking, and is known as the Pareto Principle or

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[14] *See* INDEP. CMTY. BANKERS OF AM., THE ICBA OVERDRAFT PAYMENT SERVICES STUDY (2012); NOVANTAS, *supra*, at 6.
[15] NOVANTAS, *supra*, at 6.

the "80-20 Rule."[16] For example, an analysis that I conducted with Michael Flores of one community bank found that 83 percent of checking account balances are provided by only 14 percent of customers.[17] Yet, at the typical bank the interest rate paid on deposits by high-balance customers are usually only slightly higher than for low-balance customers despite the higher profitability to the bank from high-balance customers and the resulting cross-subsidy from higher-balance customers to lower-balance.[18]

II. Why Consumers Use Overdraft Protection

Before taking any regulatory actions that could reduce the availability of overdraft protection to consumers, such as flat limits on the number of overdraft transactions a consumer could make in a given time period, it is crucial to understand why consumers use overdraft protection. As noted, available evidence suggests that consumers who use overdraft frequently do so knowing they have or may have insufficient funds to cover the payment. Consistent with that observation, available evidence also suggests that consumers use overdraft protection to purchase goods and services that are of high and urgent value and for which the inability to obtain necessary funds to make the transaction could impose significant hardship on the consumer and his or her family.

To test the proposition, Michael Flores and I obtained data from one mid-sized regional bank that provided Merchant Category Classification (MCC) codes for all customer transactions for which consumers used overdraft protection to make a purchase

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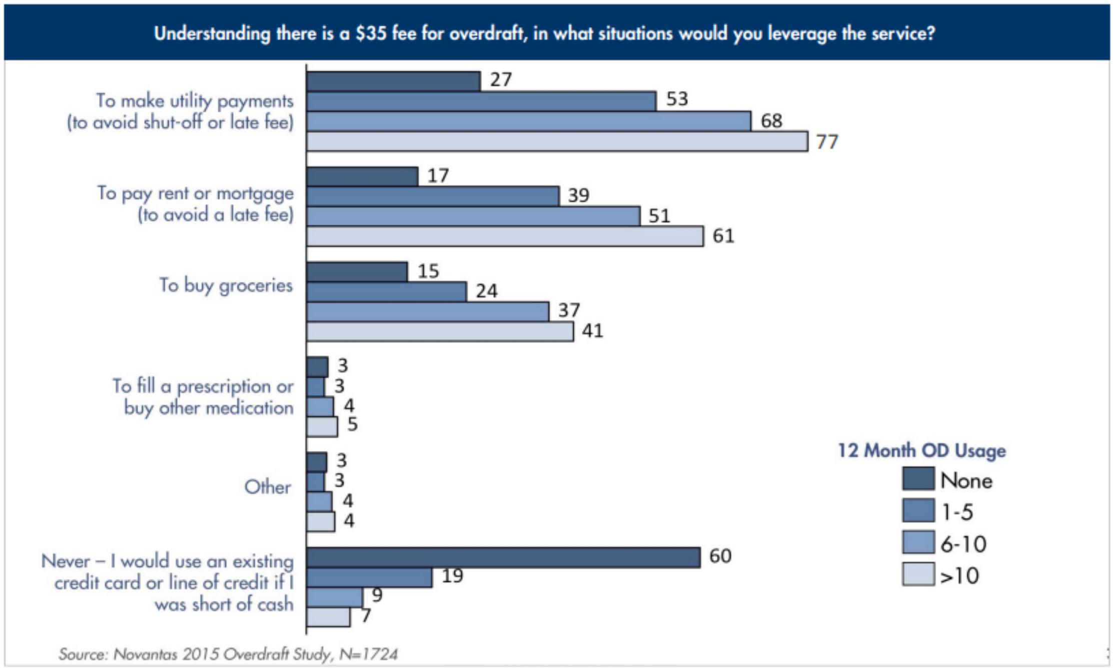
[16] G. Michael Flores and Todd J. Zywicki, *Commentary on CFPB Report: Data Point: Checking Account Overdraft* (working paper Sept. 2014), *available in* http://ssrn.com/abstract=2499716
[17] *Id.*
[18] As discussed below, leaving aside efficiency considerations, cross-subsidies could raise concerns about regressive distributional effects if they were seen to systematically disadvantage lower-income customers at the expense of higher-income. This does not seem to be the case with overdraft protection usage.

between August 1, 2012 to July 31, 2013.[19] We found of the 380 categories in the MCC code, the top 11 categories accounted for 60 percent of the transactions and 55 percent of the principal amount withdrawn. Based on these MCC codes, it appears that the majority of overdraft usage occurred in transactions arguably recognized as necessities, such as groceries, gasoline, utility bills, insurance payments, and the like. Grocery stores, the most commonly-used location, comprised over $2 million dollars and 14% of all transaction dollars. The category of Automated Fuel dispensers was the second most common location ($1.1 million and 7% of transaction dollars) and telephone services was third.

Consumer surveys confirm the inference that most overdraft usage is for more important purchases. According to Novantas consulting, consumers who use overdraft protection more frequently are more likely to indicate that they use overdraft protection to make important purchases such as utility payments, rent or mortgage, or to buy groceries.[20] By contrast, only 7 percent of frequent overdrafters said they would use a credit card to make these purchases compared to 60 percent of those who never overdraft, which reflects the limited options available to those who use overdraft protection frequently.

[19] *See* G. Michael Flores and Todd J. Zywicki, *Commentary: CFPB Study of Overdraft Programs*, SSRN.COM at *8 (Nov. 6, 2012), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2349819.
[20] *See* NOVANTAS, *supra* note, at 13.

Consumers — especially regular overdraft users — see value in overdrafts, even when knowledgeable of overdraft fees.



The fact that overdraft protection is often used for particularly important payments, such as utilities, rent, groceries, or gasoline, also highlights the flaw in a common criticism of overdraft protection, namely that the median size of transactions covered by overdraft protection are often relatively small compared to the value of the transaction to be covered. But it should be obvious that the dollar value of a particular transaction is at best an imperfect measure of the value of that transaction *to the consumer*. If, for example, a consumer would be unable to buy medicine, baby formula, groceries, or gasoline to get to work, the dollar value of the transaction hardly measures the true value of that service. Similarly, if overdraft protection is used to pay a utility bill, the cost of *not* paying the bill—late fees, possible termination of service, and other fees associated with reinstating ones' account—could far exceed the cost of the unpaid bill itself.

Frequent users of overdraft protection are also much more likely to report that the availability of overdraft protection is "extremely" or "somewhat" valuable than those who rarely or never use overdraft protection.[21]

In addition to survey evidence, consumer behavior also reveals the demand that frequent users of overdraft protection place on access to the product. In 2009, the Federal Reserve promulgated amendments to Regulation E, to require consumers to affirmatively "opt-in" to the usage of overdraft protection for ATM and point-of-sale debit transactions.[22] Reports following the issuance of the rule indicated consumers who used overdraft protection most regularly prior to the rule were much more likely to provide opt-in authorization than less-frequent users.[23] Combined with other data reported above that those who use overdraft protection most frequently monitor their account balances and pending transactions very closely, that they are more likely to use overdraft protection for especially urgent and important expenses, this finding that those who use overdraft protection more frequently opted-in to protection suggests that they do so with a high degree of knowledge of the cost of the service and the alternative options available to them at the time, and that they place a high value on access to overdraft protection.

III. What are the Characteristics of Those Who Use Overdraft Protection?

The foregoing suggests that consumers who use overdraft protection more frequently place a high value on access to the service and do so in order to make especially urgent and important payments, including the purchase of necessities such as

[21] *See* Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5, at 1173 (citing findings of 2011 Raddon Financial Group Survey).
[22] 12 C.F.R. §205.17.
[23] *See* Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5 (citing data from JP Morgan and Moebs).

groceries and gasoline and for other payments such as utility. Frequent users of overdraft protection also state that they would be much less likely to use a credit card to meet urgent liquidity needs than those who never or rarely use overdraft protection.

An analysis of the economic characteristics of heavy overdraft users illuminates why frequent users of overdraft place such a high value on the service and why they do not use less-expensive alternatives such as credit cards. Frequent users of overdraft protection share two important characteristics that differentiate them from those who rarely or never use overdraft protection: first, they typically have impaired credit and limited access to mainstream types of short-term credit (especially credit cards) and second, they appear to be relatively high-income but have a high need for short-term liquidity as a result of high and relatively unstable volatility in their household budget flows.

A. Impaired Credit and Limited Credit Options

Frequent users of overdraft protection are more likely to have impaired credit and reduced access to alternative forms of credit, such as credit cards. And where these consumers actually have credit cards they are much more credit-constrained and less likely to have available credit lines than others.[24] Finally, while many financial institutions offer the option of linking a consumer's debit account to a savings account or bank line of credit, both of which would be less expensive than usage of overdraft protection, for many heavier users of overdraft protection these options are unrealistic either because of a lack of adequate savings or an inability to be approved for a bank line of credit.

[24] *See* Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5, at 1172-74.

As noted, frequent users of overdraft protection are significantly less likely to state that they would use a credit card to meet short-term budget shortfalls than those who never or rarely use overdraft protection. This finding is explained by the relatively poor credit status of most frequent overdrafters and thus their lack of access to alternative short-term credit options.

Surveys of consumer use of overdraft reveal that consumers who use overdraft more frequently are more likely to describe themselves as having low credit quality and limited credit alternatives.[25] According to one survey, only 7% of elevated users of overdraft protection described their credit rating as "excellent" compared to 70% who described their credit rating as "fair" or "poor." By contrast, 74% of non-users of overdraft protection described their credit rating as "excellent" or "good" and only 9% considered their credit rating to be "poor."

More recent research by the CFPB confirms these findings that consumers who rely on overdraft protection more heavily do so in large part because of a lack of access to more attractive and less-expensive options, such as credit cards.[26] Drawing on data pulled from roughly 240,000 accounts, the CFPB found a strong correlation between a consumer's credit score and overdraft usage. For example, consumers with zero overdrafts or non-sufficient funds (NSF) transactions had an average credit score of 747, whereas consumers with 10-20 transactions had a credit score of 585 (borderline deep subprime) and those with 20 or more overdraft/NSF fees had an average credit score of 563 (very deep subprime).[27]

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[25] *Id.* (summarizing survey by Raddon Financial Group).
[26] CONSUMER FINANCIAL PROTECTION BUREAU, DATA POINT: FREQUENT OVERDRAFTERS (Aug. 2017).
[27] *Id.* at 16, Table 2.

The CFPB's findings confirm those of earlier studies that had found that the only accurate predictor of the propensity of a consumer to overdraft is their credit score and all other demographic income is non-predictive, including income.[28]

Consistent with this observation, another study found that 54% of those who self-identified as having "poor credit" said access to overdraft protection was "extremely important" and they would be "extremely upset" if overdraft protection was eliminated.[29] By contrast of those with "excellent credit," only 18% said that access to overdraft protection was "extremely important' and only 20% said they would be "extremely" upset if it were eliminated. Moreover, 41% of lower-income customers in the survey stated they would be "extremely upset" if access to overdraft protection was eliminated.

Frequent users of overdraft are also much less likely to have credit cards than those who never overdraft: only 49% of those who overdraft more than 20 times per year ("Very Frequent" users) have credit cards and only 57% of those who overdraft 10-20 times per year ("Moderately Frequent"), compared to 87% of those who say they never overdraft ("Non-Overdrafters") and 73% of those who overdraft 1-3 times annually ("Infrequent"). Credit lines are also much more constrained, as Very Frequent users state they have only $225 of available credit and Moderately Frequent users have $521. By contrast, Non-Overdrafters have $14,100 in available credit and Infrequent overdrafters

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[28] *See* Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5, *supra* note, at 1164. Notably, credit scores are only moderately correlated with income and uncorrelated with most other demographic factors. *See* THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY (2014); *see also* Rachael Beer, Felicia Ionescu, and Geng Li, *Are Income and Credit Scores Highly Correlated?*, FEDS NOTES (Aug. 13, 2018), *available in* https://www.federalreserve.gov/econres/notes/feds-notes/are-income-and-credit-scores-highly-correlated-20180813.htm; FEDERAL RESERVE BOARD, REPORT TO THE CONGRESS ON CREDIT SCORING AND ITS EFFECTS ON THE AVAILABILITY AND AFFORDABILITY OF CREDIT (Aug. 2007), *available in* https://www.federalreserve.gov/boarddocs/rptcongress/creditscore/differential.htm.

[29] *Id*. (discussing findings of 2011 survey by Baselice & Associates).

have $3000 in available credit. Very Frequent and Moderately Frequent users are twice as likely to as Non-Overdrafters to have "thin file" credit reports or no credit report at all.

Reducing access to overdraft protection would have a direct negative effect on those who use overdraft protection frequently. As noted, frequent users of overdraft protection use overdraft protection to cover important and urgent expenses for which they have limited alternatives. There is no indication that these are disproportionately lower-income consumers, but instead appear to be middle income consumers with high budgetary volatility and limited access to credit cards and other sources of credit.

Available evidence suggests that if these consumers were to lose access to overdraft protection, many of them would be forced to turn to payday loans to make ends meet.[30] According to one consumer survey, for example, when asked what they would do if they were unable to use overdraft protection, 24% of elevated users stated they would seek a payday loan.[31] Many other respondents reported they would be unable to get money, which presumably would mean they would be unable to make the desired purchase or would suffer late fees and other penalties associated with the failure to make payments in a timely manner. A survey by the Independent Community Bankers of America also found that although consumers in general would prefer to borrow from friends and family or use a bank line of credit to meet a short-term financial need, those consumers who used overdraft protection more than 4 times in the previous 12 months ranked it first as a preferred source of short-term funds.[32]

[30] *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).
[31] *See* Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5, *supra* note, at 1173.
[32] *See* ICBA, *supra* note 14, at 20, Fig. 24.

Research by Federal Reserve economists Brian Melzer and Donald Morgan identified that for many consumers, overdraft protection and payday loans are close substitutes and that payday loan bans spur consumers to make greater use of overdraft protection.[33] Similarly, Morgan, Strain, and Seblani found that when a state bans payday lending, overdraft revenues (and NSF fees) increase at banks, whereas legalizing payday loans results in a decline bank overdraft fee revenues.[34]

B. Frequent Users of Overdraft Protection Have High Budgetary Volatility

A second characteristic of frequent overdraft users is that they have high budget volutility in terms of the predictability and timing of their debit and credit flows from month-to-month. When combined with their lack of access to readily0available sources of short-term credit such as credit cards, this characteristic suggests that they use overdraft protection as a short-term source of liquidity to ensure that important payments clear rather than being declined for lack of adequate liquidity. More important, there is little evidence that overdraft protection usage is related to income levels generally or that low-income consumers are more likely to use overdraft protection more heavily than higher-income. The findings of several studies generally support these findings.

The CFPB's 2017 Data Point on Frequent Overdrafters revealed findings that when taken as a composite suggest this portrayal of frequent overdrafters is accurate.[35] First, the CFPB report found that Very Frequent overdrafters made more than 4 times as many POS debit card transactions (29) then Non-Overdrafters (4.6) and twice as many as Infrequent users (14.1). But Very Frequent users actually had a *higher* level of average

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[33] *See* Brian T. Melzer and Donald P. Morgan, *Competition in a Consumer Loan Market: Payday Loans and Overdraft Credit*, 24(1) J. FIN. INTERMEDIATION 25 (2015).
[34] *See* Donald P. Morgan, Michael R. Strain, and Ihab Seblani, *How Payday Credit Access Affects Overdraft and Other Outcomes*, 44 J. Money, Credit & Banking 519 (2012).
[35] CFPB DATAPOINT: FREQUENT OVERDRAFTERS at 16, Table 2.

monthly deposits ($2,554) than Non-Overdrafters ($2,093) and Infrequent users ($1,726).[36] Despite having higher levels of monthly deposits, however, Very Frequent users had an average end-of-day balance of only $276, compared to $1,585 for Non-overdrafters and $518 for Infrequent users. The CFPB also found little evidence of correlation between neighborhood income and overdraft usage; for example, the average neighborhood income of Infrequent overdrafters ($55,936) was similar to that of Moderately Frequent overdrafters ($54,953) and Very Frequent users ($54,265).[37]

This high level of transaction activity, high level of deposits, and low average end-of-day balance suggests that those who overdraft most frequently do not do so because they are low-income but because they have a comparatively high level of activity occurring in their accounts, perhaps giving rise to recurrent short-term and unpredictable timing asynchronies between debits and credits for which overdraft protection is the best-available option to cover these short-term needs.

Research by Michael Flores confirms the findings of the CFPB's Data Point report.[38] Flores found, contingent on an account having at least one overdraft transaction during the period under investigation, that overdraft usage was highest among those accounts with (1) *higher* levels of monthly deposit amounts but also (2) the *lowest* average monthly balances. For example, households with more than $5000 in monthly deposits had more than 2-1/2 times as many overdrafts per month (1.5 items versus 0.6) than those with $500 or less per month and the average number of items rose linearly with increasing income. Accounts with low average monthly balances, however, had a larger number of overdrafts than those with higher average balances. Flores suggests that

[36] Moderately Frequent users had an average of $2,050 per month in deposits.
[37] CFPB DATAPOINT: FREQUENT OVERDRAFTERS, *supra* note.
[38] *See* Flores, *Assessment of Overdraft Protection*, *supra* note.

this relationship between high monthly deposits, low average monthly balances, and high usage of overdraft protection might reflect rational usage of overdraft protection by middle-income households to deal with budgetary volatility and resulting short-term misalignments of income and expenses from month to month. Like the CFPB, Flores finds no evidence that lower-income households (as proxied by size of average monthly deposits) incur a disproportionate percentage of overdrafts and also finds that lower-income households were more likely to have overdraft fees waived than higher-income households. Finally, Flores found that, on average, lower income accounts are less likely to opt-in to POS and ATM overdraft protection than higher-income accounts and more likely to have more POS and ATM transactions declined paid into overdraft protection than higher-income households, which suggests that banks are not disproportionately approving transactions by lower-income consumers to exploit or "feast" on their lower-income circumstances.

C. Frequent Users of Overdraft Protection Have Limited Alternative Sources of Short-Term Liquidity

As noted, frequent users of overdraft protection have limited access to credit cards and even where they have credit cards, they have less credit available on them. Frequent users of overdraft protection are also less likely to have access to other sources of liquidity, such as linked savings accounts or lines of credit than consumers that do not use overdraft.

For example, according to a consumer survey by the Raddon Financial Group, when bank customers were asked where they would get access to short-term credit if needed, 56% of non-users of overdraft protection said they would simply transfer the money from another account, presumably a savings account. By contrast, only 13% of elevated users of overdraft protection said they would do so, presumably reflecting the fact that they have no other accounts available.[39] Moreover, while in theory bank consumers who are unable to get a credit card could apply for a tied bank line of credit, many elevated users of overdraft protection would be unable to be approved.[40]

D. Summary: Characteristics of Frequent Users of Overdraft Protection

This composite picture of frequent users of overdraft protection suggests that they use the product because they have a high demand for short-term liquidity because of budgetary volatility and a high demand for overdraft protection because of highly-constrained access to alternative sources of short-term liquidity. Indeed, as will be discussed below, if frequent overdrafters were to face reduced access to the product they would likely incur more NSF fees (which could be more expensive in total cost than overdraft protection once late and penalty fees are included) and declined payments or be forced to increase their use of payday loans. By contrast, there is little evidence that overdraft protection is designed to exploit lower-income consumers.

More important, simply reducing access to overdraft protection will not magically alleviate the underlying economic factors that lead consumers to use overdraft protection nor will it magically increase their access to other types of short-term liquidity such as credit cards. This point is especially salient in light of other regulatory and other issues that in recent years have actually resulted in reduced access and higher prices on credit cards for subprime consumers, thereby leading to increased reliance on products such as

[39] Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5, at 1173 (summarizing findings of Raddon Financial Group survey).
[40] *Id.*

overdraft protection, payday loans, and installment loans from personal finance companies.[41]

IV. Impact of New Restrictions on Overdraft Protection for Small Banks

Available evidence suggests that community banks are much more dependent on the revenues generated by overdraft protection than larger banks. As a result, any initiative that dramatically reduces revenues from overdraft programs, such as strict limits on the number of overdraft transactions per year or price caps on the permissible amounts that can be charged for overdraft protection services, will likely harm smaller banks disproportionately relative to larger banks and force them to seek out new sources of revenue that could erode their already-tenuous competitive position versus larger banks. In turn, by further tilt the competitive playing field against smaller banks consumers will suffer from reduced choice and competition.

Large, diversified consumer mega-banks offer multiple lines of products and services from which they can generate revenues, such as wealth and investment advisors, monthly maintenance fees, and an array of product offerings such as credit cards, car loans, insurance, and mortgages. But offering such a wide array of products and services requires certain scale economies in expertise, regulatory compliance, and other up-front investments in personnel and process. As a result, community banks typically offer a smaller array of products and services and lack the scale and expertise to diversity their revenue streams by easily adding new product lines.[42] As a result, regional and

[41] *See* CFPB TASKFORCE REPORT, *supra* note 4, at Chapter 10.
[42] *See* Justin Ho, *As Big Banks Lower Overdraft Fees, Smaller Banks Mull Their Options*, MARKETPLACE.ORG (Jan. 12, 2022), *available in* https://www.marketplace.org/2022/01/12/big-banks-lower-overdraft-fees-small-banks-mull-their-options/.

community banks are generally more reliant on revenue generated by overdraft fees than large banks.[43] Moreover, in the wake of Dodd-Frank, many smaller banks actually discontinued some revenue-generating product lines, notably mortgages, in response to the elevated regulatory cost, complexity, and potential liability associated with offering those products.[44]

Examining FDIC data in 2013, Michael Flores and I confirmed this conventional understanding, finding that smaller banks were more than twice as dependent on overdraft protection revenues as a share of their net operating income than larger banks.[45] As noted, this seems to still be the case today.[46]

Moreover, even if smaller banks could defray reduced revenues from operating overdraft programs by imposing new fees, such as monthly maintenance fees, they could do so only by putting at risk their competitive position, which rests on continuing to offer free checking. For example, following the enactment of the Durbin Amendment as part of Dodd-Frank, large banks responded by substantially curtailing access to free checking and raising bank fees substantially.[47] Community banks and credit unions below the Durbin Amendment's $10 billion asset threshold, by contrast, have seen some erosion in debit card fee revenue, but much less so than larger banks. As a result, smaller banks have been able to continue offering free checking accounts at a much higher rate than

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[43] *See* Max Reyes, *Dimon Took Heat by Regional Banks Rely More on Overdraft*, BLOOMBERG.COM (June 1, 2021), *available in* https://www.bloomberg.com/news/articles/2021-06-01/dimon-took-heat-but-regional-banks-rely-most-on-overdraft-fees; Aaron Klein, *A Few Small Banks Have Become Overdraft Giants*, BROOKINGS (Mar. 1, 2021), *available in* https://www.brookings.edu/opinions/a-few-small-banks-have-become-overdraft-giants/.

[44] *See* Todd Zywicki, *Dodd-Frank at Five Years: Implications for Consumers and the Economy*, 34(11) BANKING AND FIN. SERVS. POL'Y REPORT 1 (2015).

[45] *See* Flores and Zywicki, *Commentary on CFPB Report*, *supra* note 16.

[46] *See supra* note 43 and accompanying text.

[47] *See* Todd Zywicki, Julian Morris, and Ben Sperry, *Credit Cards and the Reverse Robin-Hood Fallacy: Do Credit Cards Rewards Really Steal from the Poor and Give to the Rich?*, 41(3) BANKING AND FIN. SERVS. POL'Y REPORT 1 (2022).

larger banks.[48] Any erosion to other revenue streams, however, would dramatically increase the pressure on small banks to reduce access to free checking and increase account fees generally, thereby dramatically reducing the value of this competitive advantage. Thus, contrary to conventional wisdom, new restrictions on overdraft protection would likely have a much larger negative impact on smaller financial institutions and their customers than larger ones, which are less reliant on overdraft fee revenues generally and which can turn to a larger source of alternative revenue lines to offset lost overdraft fee income.

V. Reducing Access to Overdraft Protection Would Increase the Cost of Bank Accounts for Many Consumers, Force Many Consumers to Rely on More-Expensive Alternatives, and Reduce Access to Bank Accounts

As noted, reduced access to overdraft protection, such as by fee limits or caps on the number of overdrafts a consumer could use, will impose direct harm on many of those consumers who rely on overdraft protection to cover payments. But available evidence indicates that many other consumers would also be harmed by new restrictions on overdraft protection programs, most notably lower-income consumers and those traditionally excluded from the financial system.

As with any other consumer financial product, payments made through overdraft protection run some risk of subsequent non-payment and eventual chargeoff.[49] Moreover, predicting which consumers will default on their overdraft advances can be very difficult; indeed, many chargeoffs occur from "hit-and-run" consumers who open a new bank

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[48] *Id.*
[49] *See* CFPB DATAPOINT: FREQUENT OVERDRAFTERS, *supra* note.

account (perhaps fraudulently) and max out their overdraft protection limit and then close the account while making no effort to repay the amount advanced.[50] Financial institutions will then be forced to cover those advances through fees generated by other consumers.

As a result, if regulators place price ceilings on the maximum permissible fee that can be assessed for an overdraft advance (such as $10), financial institutions will be likely to respond either by reducing access to overdraft protection services to a more limited subset of consumers (perhaps returning to the era where overdraft protection was largely a privilege of more elite customers) or reducing the allowable amount of the size of the line available to consumers to access through overdraft protection.

Indeed, a recent paper by Dlugosz, Melzer, and Morgan, confirms this prediction.[51] They found that federal preemption of state price ceilings on the size of the permissible fees that could be charged for overdraft protection transactions led to higher average fees on overdraft transactions but also a willingness to cover a larger number of payments (prior to which they were more likely to dishonor payments) and returned check rates fell by 10%, resulting in fewer bounced checks and accompanying NSF and related fees.

But limits on overdraft protection would be likely to have adverse effects not just for those who use overdraft protection but for other consumers as well, including those who never use overdraft protection.[52] This is for several reasons. First, as noted above, fees generated by overdraft protection programs provides a revenue line for financial institutions, especially smaller ones. Eliminating or substantially reducing revenues from

[50] *See* Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5.
[51] Jennifer L. Dlugosz, Brian T. Melzer, and Donald P. Morgan, *Who Pays the Price? Overdraft Fee Ceilings and the Unbanked*, working paper (Apr. 15, 2021).
[52] *See* Zywicki, *Economics and Regulation of Bank Overdraft Protection*, *supra* note 5, at 1179.

overdraft protection will require those institutions to look elsewhere for operating revenue, such as by charging higher monthly maintenance fees or fees for other services, which will be expected to harm lower-income households more than higher-income households. Second, overdraft protection serves a type of insurance that consumer payments will clear, rather than resulting in bounced checks or other dishonored payments. Thus, absent access to overdraft protection, consumers will need to maintain larger precautionary balances to ensure that payments do not bounce. This too will be likely to negatively impact lower-income consumers as well. Empirical evidence tends to confirm both of these concerns.

For example, consider the market response to Fed's rulemaking in 2009 to require consumers to opt in to overdraft protection for ATM and POS debit card transactions. According to one economic analysis, "within days" of the Fed's announcement of the new rule, banks started scaling back access to free checking, imposing new fees and eliminating services for consumers.[53] The percentage of consumer accounts eligible for free checking fell eleven percentage points—from 76% in 2009 to 65% in 2010—which amounts to approximately twenty million accounts.

Dlugosz, Melzer, and Morgan found that when price controls on overdraft fees for national banks were relaxed following preemption, checking account ownership by low-income households (defined as the bottom quintile of households) rose by 4 percentage points in affected states relative to others, which they note corresponds to a 10% increase

[53] *See* 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*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE (Feb. 22, 2011), *available in* https://www.federalreserve.gov/SECRS/2011/March/20110308/R-1404/R-1404_030811_69120_621655419027_1.pdf.

in the probability that a low-income household would have a bank account.[54] They further note, "By contrast, bank account ownership by higher income households does not change after preemption, implying the rationing of overdraft credit under fee caps affects only low-income households." Moreover, not only are low-income households more likely to obtain accounts, they are more likely to persist in account ownership and less likely to lose accounts following preemption.[55] Moreover, they when price controls on overdraft fees were preempted, national banks lowered the minimum balance necessary for eligibility for interest checking by 28%-40%, or approximately $3760$538 less that customers need to keep in interest bearing accounts in order to avoid a monthly fee.

This suggests that new limits on overdraft protection programs would be likely to reduce access to the service for those consumers who current rely on it, resulting in a larger number of dishonored payments and bounced checks and potentially greater reliance on alternative products such as payday loans. Moreover, these offsetting effects would also be likely to adversely impact even those consumers who never or rarely use overdraft protection as banks would be likely to respond by reducing access to free checking, raising mandatory minimum balances to be eligible for free accounts, and reduction of access to bank accounts generally, especially among lower income households.

Thank you for your time and the opportunity to appear before you today and I am happy to take any questions you may have.

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[54] *See* Dlugosz, Melzer, and Morgan, *supra* note 51.

[55] One possible reason for this finding might be that greater access to overdraft protection might result in fewer bounced checks and dishonored payments, which are a leading cause of bank account closures.