Examining Overdraft Fees and Their Effects on Working Families
Testimony of Aaron Klein, Senior Fellow in Economic Studies, Brookings Institution[1]

Chairman Warnock, Ranking Member Tillis, thank you for holding this timely hearing examining the impacts of overdraft fees. Overdraft fees, developed as a convenience service for occasional instances when a consumer ran out of funds, morphed into a cottage industry with estimates of total fees paid by consumers ranging up to more than $30 billion a year.[2] By definition, every overdraft fee is paid by a person who has run out of money while trying to live their life. These fees, which are effectively short-term loans, can be extremely high-cost relative to the small amount of money received by the customer, short-lived in time borrowed, and carry small chance of default. As a result, overdraft fees result in nearly pure profit for the bank or credit union. No wonder one bank CEO named his yacht "Overdraft."[3]

After decades of racking up major profits off of American families living paycheck to paycheck, many banks, including most of America's largest banks, have announced sweeping changes to their overdraft policies. These changes will sharply reduce costs for their customers. Savings will go directly to people living on the financial edge and come directly out of bank profits. The result will be a more equal and just financial system and a significant dent in the high costs of being poor. By my calculations, the combined savings for consumers from overdraft changes already announced will be approximately $5 billion a year.[4] Even by Washington standards, that's real money.

Industry made these sweeping changes without any new legislation or new regulation. I commend these banks for their actions. They are doing the right thing for their customers, which will also reduce income inequality and, over time, reduce the number of unbanked households in America.

However, as my testimony will show, the difference in the actions taken by banks varies substantially, and some institutions' changes are more meaningful than others. Critically, a handful of banks have become dependent on overdraft for the majority—and in some instances totality—of their profit. These overdraft giants cannot structurally walk away from overdraft nor will they. Regulators have long been asleep at the switch in allowing these institutions to operate like this. New regulation is still needed on the basis of safety and soundness to address any bank or credit union that relies on overdraft for the majority of their profit.

My testimony will focus on three main points:

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[1] The views expressed are my own and do not necessarily reflect the views of other staff members, officers, or Trustees of the Brookings Institution.
[2] Bernard, Tara Siegel. "Banks Slowly Offer Alternatives to Overdraft Fees, a Bane of Struggling Spenders." New York Times, June 22, 2021. https://www.nytimes.com/2021/06/22/your-money/overdraft-fees-banks.html.
[3] Marte, Jonnelle. "A former bank CEO named his boat 'Overdraft.' Now that bank is in hot water over the fees." January 22, 2017. https://www.washingtonpost.com/news/get-there/wp/2017/01/20/a-former-bank-ceo-named-his-boat-overdraft-now-that-bank-is-in-hot-water-over-the-fees/.
[4] See footnote 24 for specifics on the author's calculations.

1. Understanding overdrafts and why some institutions are making changes.
2. Examining changes in overdraft policies to elucidate the problems and paths to solutions for families living paycheck to paycheck.
3. Additional policy solutions to address both remaining problems in overdraft and the broader root causes that have led America to be a nation where the less money you have, the more money it costs you to deal with your money.

Understanding overdraft

Overdraft fees are major profit centers for banks and credit unions, with estimates ranging from roughly $15 billion a year for banks alone[5] to over $30 billion a year for banks and credit unions.[6] Overdraft fee income peaked in 2019 as pandemic assistance and other Covid-related factors reduced overdraft revenue across the board for almost every institution.[7] While overdraft revenue rebounded in 2021 as pandemic assistance subsided, other changes have taken place that will likely make 2019 a highwater mark for overdraft revenue.

Among those other changes has been the entry of a growing number of financial technology firms (fintechs) partnering with banks to provide basic banking services to consumers. Many of these products do not allow for traditional overdraft fees. The lack of overdraft fees is often figured prominently in their marketing, a sign that consumers would be attracted to non-overdraft banking.[8] The growth of fintechs probably played a role in motivating some banks to change their overdraft policy.

The key to understanding overdraft is that a small number of customers account for the vast majority of overdrafts: 80 percent of overdraft fees come from 9 percent of account holders. The same data shows that one out of every twelve banked customers had ten or more overdrafts a year, paying on average $380 a year in overdraft fees.[9] For a person earning $38,000 a year, that is 1 percent of their annual income spent in overdraft fees alone!

Heavy overdrafters are highly profitable customers, often producing more profit than customers with more money in their account who manage to not overdraw. For some banks, this makes them a desirable customer set, so much so that a small number of banks have decided to specialize in attracting these customers and maximizing their overdrafts, a point I will get to later in my testimony.

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[5] Consumer Financial Protection Bureau. "CFPB Research Shows Banks' Deep Dependence on Overdraft Fees." December 1, 2021. https://www.consumerfinance.gov/about-us/newsroom/cfpb-research-shows-banks-deep-dependence-on-overdraft-fees/.
[6] Nova, Annie. "Banks will collect more than $30 billion in overdraft fees this year. Here's how to avoid them." CNBC, December 1, 2020. https://www.cnbc.com/2020/12/01/banks-will-get-30b-in-overdraft-fees-this-year-heres-how-to-avoid-them-.html.
[7] Fox, Zach and Ronamil Portes. "Overdraft fees jump 40% YOY but still headed lower from 2019 levels." S&P Global, August 25, 2021. https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/overdraft-fees-jump-40-yoy-but-still-headed-lower-from-2019-levels-66207671.
[8] Chime. "Overdraft with no fees." https://www.chime.com/spotme/.
[9] Bakker, Trevor, Nicole Kelly, Jesse Leary and Éva Nagypál. "Data Point: Checking account overdraft." Consumer Financial Protection Bureau, July 2014. https://files.consumerfinance.gov/f/201407_cfpb_report_data-point_overdrafts.pdf.

Another note on heavy overdrafters involves debit cards and regulation. Heavy overdrafters are likely to be heavy debit card users, as payment form and income are highly correlated.[10] As a result of the compromise worked out during debate and passage of the Durbin Amendment to the Dodd-Frank Act in 2010,[11] small banks were essentially given the ability to have a higher interchange fee on certain debit card transactions relative to larger banks.[12] When a fintech partners with a small bank, they are able to earn the higher interchange fee. This partnership is structurally able to generate more revenue off debit card users than larger banks for the same activity. Thus, fintechs can make more profit from the regular payments made by overdraft-prone customers than larger banks.

A final point on heavy overdrafters: for them, basic banking is expensive. The result is that many leave the banking system. As a recent Consumer Finance Protection Bureau (CFPB) note was titled: "Overdraft fees can price people out of banking."[13] While being unbanked is costly, there are times when non-bank services are actually cheaper than banks. In fact, the high costs of banking is the number one reason why people leave the banking system according to the Federal Deposit Insurance Corporation (FDIC).[14] Fixing the overdraft problem is one of the most important things that can be done to help address problems of the un- and under-banked.

Overdraft fees vary substantially between banks. Banks have structured their overdraft products very differently. As a result, overdraft revenue varies substantially among banks, including among the largest banks.[15] To compare banks by overdraft revenue, I analyze their overdraft revenue per consumer non-retirement deposit account.[16] This helps control for differences between banks by size while focusing on their consumer account footprint. It elucidates the substantial divergence in overdraft revenue, as some banks generate overdraft of more than seven times other banks. It is hard to imagine that among the nation's largest banks the variation in their share of heavy overdrafters is this drastic. Hence, there must be other practices and products offered by these banks that allow some to generate so much more overdraft revenue per customer than others. These include how reordering payments by size, posting debits before credits, and whether to allow overdrafts in certain instances like at ATMs.

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[10] Klein, Aaron. "How credit card companies reward the rich and punish the rest of us." LA Times, December 20, 2019. https://www.latimes.com/opinion/story/2019-12-20/opinion-how-credit-card-companies-reward-the-rich-and-punish-the-rest-of-us.

[11] 111th Congress. 15 U.S.C. § 1693o-2, "Reasonable fees and rules for payment card transactions."

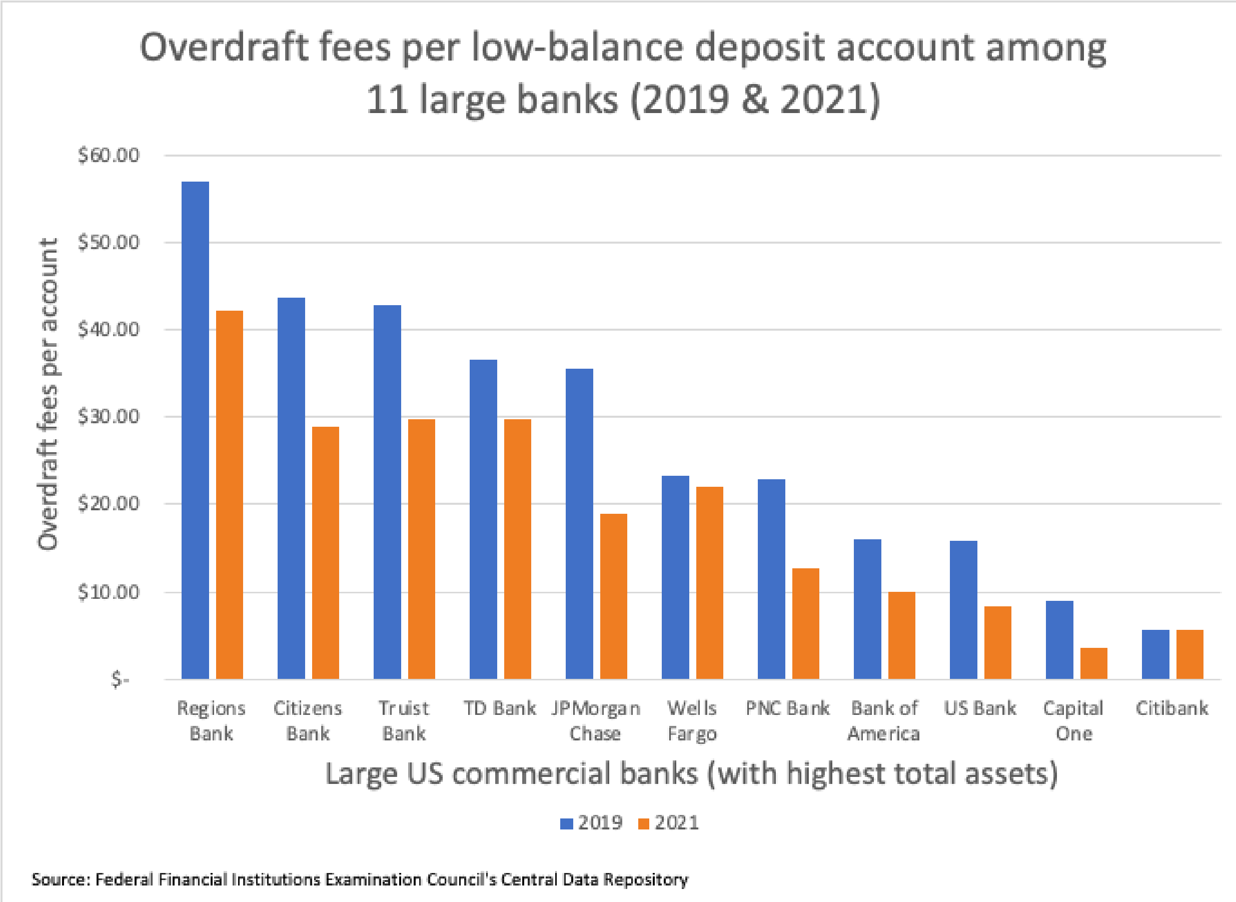
[12] Hopkins, Cheyenne. "Tester Touts Bill to Delay Interchange Fee Limits." American Banker, April 14, 2011. https://www.americanbanker.com/news/tester-touts-bill-to-delay-interchange-fee-limits.

[13] Valenti, Joe. "Overdraft fees can price people out of banking." Consumer Finance, March 30, 2022. https://www.consumerfinance.gov/about-us/blog/overdraft-fees-can-price-people-out-of-banking/.

[14] Kutzbach, Mark, Alicia Lloro, Jeffrey Weinstein and Karyen Chu. "How America Banks: Household Use of Banking and Financial Services." Federal Deposit Insurance Corporation, October 2020. https://www.fdic.gov/analysis/household-survey/2019execsum.pdf.

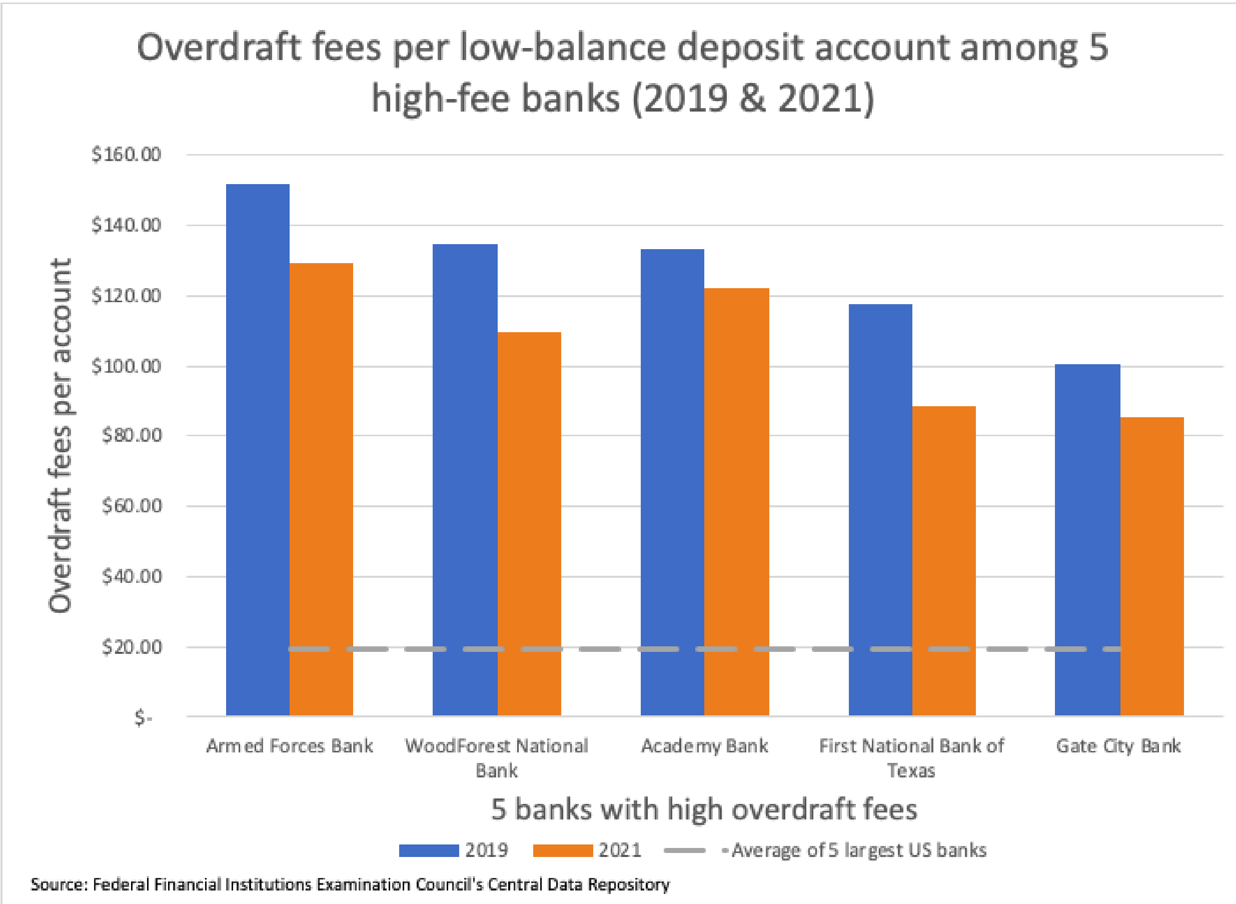
[15] Baker, Todd H. and Corey Stone. "Making Outcomes Matter: An Immodest Proposal for a New Consumer Financial Regulatory Paradigm." SSRN, May 21, 2020. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3607308.

[16] Author's calculation using FFEIC data. While FFEIC data is governmental data filed by banks there may be some banks that have certain types of consumer non-retirement deposit accounts that are structurally different and less likely to overdraft. Note that Truist's merger in late 2019 required some additional calculations.



A small number of small banks are overdraft giants. On a per customer basis, a handful of smaller banks generate overdraft revenue dwarfing the largest banks. These banks target heavy overdraft customers and seek to maximize revenue from them. For example, Woodforest branch in Atlanta is located in the Walmart Supercenter on Gresham Road, SE while Armed Services Bank targets customers located primarily on military bases such as its operations on Moody Air Force Base in Georgia. Compare the overdraft revenue per customer these banks generate: often more than $100 per account each year, more than five times the average of America's five largest banks.[17] Because their overdraft revenue per customer is higher they account for a disproportionate amount of total overdraft. Woodforest National Bank actually generates more overdraft revenue per year than Citibank.

[17] Based on each bank's filings using the same methodology described above.



These banks have no business model besides overdraft. First National Bank of Texas has made more than 100 percent of its profit on overdraft in each of the last seven years (that's as long as overdraft data have been separately reported).[18] For Woodforest and Gate City, that has been true in six of the last seven. Armed Forces Bank has made more than 75 percent of its profit on overdraft for each of the last seven years (and over 100 percent for three of the seven). Academy Bank made more than 100 percent of its profit in overdraft fees for four straight years from 2017-2020. I group Armed Forces and Academy Bank together because they are part of the same holding company: Dickenson Financial Company. This holding company's strategy appears to be based on overdraft. The Federal Reserve regulates that holding company, while the Office of the Comptroller of the Currency (OCC) regulates these banks, which are nationally chartered banks. There may be more overdraft giants among the banks regulated by the FDIC and National Credit Union Administration (NCUA), as banks under $1 billion and all credit unions are exempt from publicly disclosing their overdraft revenue. Regulators have been asleep at the switch in allowing these banks to operate in what are clearly unsafe and unsound business models, as they have been losing money every year on all other aspects of banking other than overdraft.

Shining the spotlight. The divergence in bank practices has gotten the attention of policymakers, media, and bank executives. Members of Congress, including several on this Committee,

[18] Figures relating overdraft revenues to a bank's profits are based on the author's own calculations from FFEIC call reports available at: https://cdr.ffiec.gov/public/.

publicly engaged with bank CEOs,[19] regulators,[20] and the media,[21] raising questions about outlier banks. Academics, consumer advocacy groups, and reporters began digging in. This public pressure is part of the reason, I believe, why some banks have decided the overdraft business is simply not worth it. As some institutions began making pro-consumer changes, the pressure increased for others. The industry started to move. As Acting Comptroller Hsu put it in a speech a few months ago before the American Bankers Association, "You don't want to be the last bank that still has a traditional overdraft program."[22] Words like that from regulators have meaning, even if they do not yet have a regulation behind them.

Overdraft changes

Most of the nation's largest banks and many smaller ones have announced changes in their overdraft policy. Several eliminated the product altogether. Others instituted a set of changes designed to reduce the number of overdrafts their customers experience. How banks are reducing overdrafts shed significant light on the factors that drove overdraft in the first place. The changes taken can be categorized into four buckets. Each bucket is a type of change that highlights a different aspect of the overdraft problem and how it can be solved. The four buckets are:

1. Reducing fees
2. Changing time
3. Providing small dollar liquidity in different forms
4. Consumer empowerment

Before turning to each bucket, several top line observations. Generally speaking, the less a bank relied on overdraft for revenue the more likely they were to eliminate the product or cut fees by the largest amount. Citibank and Capital One eliminated the product entirely. While Bank of America did not eliminate overdraft, it pledged to cut total overdraft revenue by 97 percent (although from a different baseline).[23] On the other end the changes announced by Regions and

[19] Bloomberg. "JPMorgan's Dimon Clashes With Warren Over Overdraft Fees." May 26, 2021. https://www.bloomberg.com/news/videos/2021-05-26/jpmorgan-s-dimon-clashes-with-warren-over-overdraft-fees-video.

[20] Office of the Comptroller of the Currency. "Acting Comptroller Michael J. Hsu Remarks before the Consumer Federation of America's 34th Annual Financial Services Conference." December 8, 2021. https://www.occ.gov/news-issuances/speeches/2021/pub-speech-2021-129.pdf.

[21] CNBC Television. "Sen. Elizabeth Warren on JPMorgan CEO Jamie Dimon's testimony." YouTube, May 26, 2021. https://www.youtube.com/watch?v=DT4ojj-spoY&ab_channel=CNBCTelevision.

[22] American Banking Journal. "OCC's Hsu: 'You Don't Want to Be Last' to Offer Traditional Overdraft Programs." March 9, 2022. https://bankingjournal.aba.com/2022/03/occs-hsu-you-dont-want-to-be-last-to-offer-traditional-overdraft-programs/.

[23] Bank of America. "Bank of America Announces Sweeping Changes to Overdraft Services in 2022, Including Eliminating Non-Sufficient Funds Fees and Reducing Overdraft Fees." January 11, 2022. https://newsroom.bankofamerica.com/content/newsroom/press-releases/2022/01/bank-of-america-announces-sweeping-changes-to-overdraft-services.html.

Citizens Banks will reduce their overdraft revenue by only 23 and 28 percent respectively, despite each starting from a higher base.[24,25]

Overall savings from this subset of fourteen banks that have made changed overdraft policies is around $5 billion a year.[26] If these savings were distributed evenly across the country, on a per capita basis, a state like Georgia would expect savings of $162 million a year. This estimate is derived from various bank public statements regarding their expectations of reduced overdraft fees coupled with estimates based on announced policy changes for banks where I was unable to find public statements regarding expected revenue lost. It includes the largest banks plus several others who made announcements and for which I was able to find data.[27]

The savings are estimated from the 2019 base-year, given the pandemic-related changes in overdraft revenue described earlier that began in 2020, coupled with the reality that some banks who were early announcers of overdraft policies have already seen revenue changes. This estimate is more inclusive of than the CFPB's estimate of the savings from banks eliminating non-sufficient funds fees (NSF) which they estimated will save consumers $1 billion alone.[28] It also includes institutions that have made announcements since an earlier estimate by Pew which found potential savings of $2 billion a year based on changes from only the five largest banks.[29] This estimate does not include the potential offsetting costs borne by consumers who end up in small dollar loans instead of being charged overdrafts. Those interest costs will offset some of these savings and should be monitored as these new small dollar loan alternatives are rolled out.

For the banks examined, policy changes already announced average out to a reduction of just below 60 percent of total 2019 overdraft revenue, although they vary significantly between financial institutions. Several institutions that have made relatively small changes to reduce overdraft fees will appear even larger outliers relative to their peer group in coming years. Policymakers, regulators, and the media should continue to carefully analyze overdraft policies as not all changes will have the same impact.

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[24] Author's calculation between bank reported revenue and reported reductions due to overdraft policies.

[25] Bennet, Karen. "Banks that have cut or eliminated overdraft fees." Bankrate, April 29, 2022. https://www.bankrate.com/banking/checking/banks-eliminated-overdraft-fees/.

[26] The banks included in this analysis are: JPMC, BoA, Wells Fargo, Citibank, USBank, Truist, PNC, Capital One, USAA, TD Bank, Regions, Citizens, Ally, and Frost.

[27] Sources for the overdraft revenue reductions include conversations with individual banks and the following publications: https://www.americanbanker.com/news/truist-joins-industrys-pivot-away-from-overdraft-fees https://www.capitalone.com/about/newsroom/eliminating-overdraft-fees/ https://seekingalpha.com/news/3789183-regions-bank-is-the-latest-to-cut-overdraft-fees-to-keep-attract-customers

[28] Borné, Rebecca and Ashwin Vasan. "Consumers on course to save $1 billion in NSF fees annually, but some banks continue to charge these fees." Consumer Financial Protection Bureau, April 13, 2022. https://www.consumerfinance.gov/about-us/blog/consumers-on-course-to-save-one-billion-in-nsf-fees-annually-but-some-banks-continue-to-charge-them/#:~:text=In%20recent%20months%2C%20a%20number,savings%20of%20about%20%241%20billion.

[29] Horowitz, Alex and Linlin Liang. "America's Largest Banks Make Major Overdraft Changes That Will Help Consumers." Pew Research, February 8, 2022. https://www.pewtrusts.org/en/research-and-analysis/articles/2022/02/08/americas-largest-banks-make-major-overdraft-changes-that-will-help-consumers.

If every bank and credit union made changes along this industry average, savings for consumers would exceed $17 billion, based on the Moebs estimate cited above of $30 billion in total overdraft charges in 2019. However, as noted above, that is unlikely absent regulatory or legal changes given how dependent some institutions are on overdraft for their business. Thus, while industry actions to date constitute a major win for many working families—after all, the majority of people in America have an account with a bank that has changed its policies—much more can be done.

Reducing fees

Among actions banks and credit unions can take to benefit consumers, lowering the costs of overdraft is the most straightforward and impactful. Overdrafts had generally been priced at about $35 each, with institutions setting a maximum number of daily overdrafts (often between four and eight). Many institutions charged a non-sufficient funds fee (NSF) when certain payments could not be covered by the funds in a consumer's account. NSF fees tended to be around the same size as overdraft fees.

Changes observed: Most of the largest financial institutions have eliminated NSF fees entirely.[30] Some institutions have reduced the $35 fee; notably Bank of America lowered it to $10, M&T to $15. This has eliminated part of the punitive penalty aspect of the fee and is one reason why Bank of America expects such a substantial decline in total overdraft revenue. Some have also reduced the maximum number of overdraft fees charged per day.

These changes are straightforward and will reduce the cost borne by consumers. Elimination of NSF fees is particularly important as these were sometimes a double whammy, hitting a consumer on top of the overdraft fee, making the true cost of a negative balance event greater than $35.

Insight revealed: Overdraft fees do not reflect the cost to the financial institution of providing overdraft coverage. The fee was often designed to have a punitive element to discourage consumers from going negative.[31] Charging penalty fees for overdrafts may have been designed at one point to reduce frequency, but given the illiquid nature of the customer at the moment they run out of money, it became a way to generate more profit for a financial institution. Given the high cost of alternative small dollar credit and the consumers' frequent lack of awareness that they were even overdrafting, the fee was able to stay quite high.

Changing time

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[30] Horowitz, Alex and Linlin Liang. "America's Largest Banks Make Major Overdraft Changes That Will Help Consumers." Pew Research, February 8, 2022. https://www.pewtrusts.org/en/research-and-analysis/articles/2022/02/08/americas-largest-banks-make-major-overdraft-changes-that-will-help-consumers.

[31] United States Senate Committee on Banking, Housing and Urban Affairs. "Testimony of Michael Calhoun, Center for Responsible Lending." November 17, 2009. https://www.banking.senate.gov/imo/media/doc/CalhounTestimony111709.pdf.

Overdraft is as much or more about running out of time than out of money. The reason people go negative in their bank account temporarily has a lot to do with the mismatch in time between when they have access to their money and when their payments are debited from their account. They are often minutes, hours, or days away from having the money necessary to cover the overage. In addition, some customers have positive balances able to cover the cost when they make a purchase, but because of the time delay in settlement, other payments have been processed before this purchase. This results in a 'positive when made, negative when settled' scenario in which a consumer was shown that they had the money in their account when the payment began but ended up being charged an overdraft.

These problems are exacerbated by America's antiquated payment system, which still runs on technology that is decades old. In this system, payments are often credited and debited in batches rather than individually when they occur. A batch system is analogous to a washing machine in which all the clothes go in together, regardless of when they were soiled, and come out clean at the same time. The person doing the laundry then decides when to fold and return the clean clothes, much like the bank has some discretion on which order to post the various debits and credits that come through the payment cycle.

Changes observed: Many banks have created grace periods where consumers who cure an overdraft within 24 to 48 hours or more are not charged a fee (PNC, Wells Fargo). In addition, many banks have moved up consumers' payday, crediting accounts with direct deposit up to two days earlier (Capital One, Regions). This is a valuable service to customers because direct deposit is not instant. Typically, a direct deposit that is withdrawn from a business on Tuesday does not become available to the worker until Friday. Banks with direct deposit relationships often know the amount of money their customer will receive and are able to provide access to those funds earlier. Some banks have also eliminated any overdraft fees incurred if a charge was made when the account had funds but settled negative (JPMC).

Insight revealed: Time is money. The provision of extra time has had a substantial impact. PNC, which was among the first banks to change overdraft fees, has been able to collect some data from their changes which they term "Low Cash Mode." 63 percent of PNC customers who end the day with a negative balance are able to fix the problem and avoid an overdraft.[32] The average time to cure is only 13 hours, evidence that the majority of their customers' problems are very short-term mismatches. From PNC's experience, 75 percent of reduction in fees was the result of extra time and the change on the limit on total overdrafts. The remaining 25 percent of savings came from the elimination of NSF fees.

Overdraft fees are driven in large part by short temporal mismatches in income flows. The provision of short time windows to cure is very impactful. This helps explain the popularity of early wage access and other faster payment options spreading through the banking and fintech systems. It also makes clear the incredibly high cost of our nation's slow payment system born by American families living paycheck to paycheck. The failure of the Federal Reserve to speed up our payment system has taken billions out of the pockets of working families and stuffed it in

[32] Data provided to the author, available upon request

the bottom line of banks, credit unions, check cashers, and payday lenders.[33] Faster payments ought to be among our top priorities.

Small dollar liquidity in different forms

Economically, overdraft is a form of small dollar credit. Charging a fixed price instead of an interest rate does not change that basic fact. Legal and regulatory structures deemed overdraft a fee instead of a loan, avoiding a set of legal requirements like Truth in Lending that requires disclosures, including the annual percentage interest rate (APR). APR's for overdrafts may or may not be useful concepts, but they would appear astronomical for covering a tiny overdraft, as one story reports $100 in overdraft fees for covering an overdraft of two cents.[34]

The differentiation between a fee and a loan is important for legal purposes, but economically the concept of a financial institution providing money to a consumer and in exchange being repaid in the future is the same. This is the provision of credit. How that credit is priced can be spliced in different forms. In the case of overdraft, which is almost always relatively small dollar amounts paid back quickly, a representation of costs over the time horizon of a year will would be equivalent to mammoth APR rates.

Changes Observed: Most banks making changes in policies have increased the amount a consumer can go negative without incurring a fee. Many have raised their limits from $5 to $50 (US Bank, Huntington, TD, and JPMC) while some have gone as high as $100 (Truist and Frost Bank).

Another common change has been automatically converting negative balances into installment loans rather than charging a fee. These loans typically have a fixed charge for the amount borrowed. US Bank started a similar product (Simple Loan) earlier that now charges $6 per $100 borrowed. The loans typically last a few months and are paid back in even, amortizing payments. Institutions typically make repayment automatic but say they will not take such payment if it then causes a new overdraft.

Insight Revealed: Heavy overdrafters go negative many times throughout the year. Solutions require standing facilities of small dollar credit that meet their needs. Increasing the 'grace zone' of negative balances without any costs is a major win for consumers. It also recognizes the reality that for people living near the zero lower balance of their bank account it can be impossible to know exactly how much money you have in your account and when your debits and credits will clear.

Changing from a fee-per-transaction when a customer's balance is negative into one loan where costs are based on amount borrowed, not number of transactions, is another win for consumers.

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[33] Klein, Aaron. "Why don't checks clear instantly? Ask the Fed." Politico, September 28, 2016. https://www.politico.com/agenda/story/2016/09/financial-technology-payment-transactions-federal-reserve-000209/.

[34] Lieber, Dave. "Why are some big banks getting rid of bounced-and-check and overdraft fees?" The Dallas Morning News, February 17, 2022. https://www.dallasnews.com/news/watchdog/2022/02/17/why-are-some-big-banks-getting-rid-of-bounced-check-and-overdraft-fees/.

Frankly, it may be a more fair product for the lender as well, as the costs/risks of default are related to the total amount, not the number of transactions.

Simple fees based on amount borrowed are easier to understand and consider for consumers. Separating the cost from the time horizon of the loan is also different from traditional loans with fixed interest rates on outstanding balances. Fees on the order of 5 percent of amount borrowed are substantially lower than most alternatives available to heavy overdrafters for small dollar credit. However, fees on the order of 10% or higher can reach high costs if the funds are repaid quickly. For example, $10 to borrow $100 that is paid back over six weeks approaches a 100% APR.

Total savings to consumers from changes to overdraft fees may be somewhat offset by interest and other costs of small dollar lending. No-cost temporary negative balances are different than interest-bearing loans. Both can be beneficial for consumers, but a full accounting of total savings from overdraft fee changes should include the corresponding costs associated with small dollar credit products that are being rolled out as alternatives to overdraft.

Consumer empowerment

People do not know how much money is in their bank account or when exactly payments are being made, and even if they do they may lack the ability to stop automatic payments. Providing consumers increased knowledge of their situation and the ability to decide whether to stop or delay an automatic payment would empower consumers to decide whether the "overdraft was worth it."

Changes observed: Many banks have developed sophisticated systems designed to alert consumers of low balances and provide the ability to delay or stop payments (PNC, TD). Some of these systems provide proactive alerts to customers when their balance reaches a threshold ("$50 left in your account") while others indicate an automatic payment is coming that would create an overdraft. Consumers can then use this information to decide how to manage their finances and potentially avoid an overdraft.

Insight revealed: Knowledge is power. Consumers should know their bank balance and have the ability to decide whether an overdraft fee is worth the consequences of not making the automatic payment. However, cancelling an automatic payment may itself result in fees and charges from the other entity (late fees, NSF fees for attempting to get paid, delinquency notifications for credit reports, etc.). Banks making changes to their policies cannot be responsible for how the other party will respond. Consumers may not know that either.

While consumer empowerment sounds good, it is not as impactful. PNC estimates that only about 1 percent of payments were cancelled or delayed by customers receiving this alert.[35] This may be evidence that customers want these payments to move forward regardless of overdraft consequences or that they know they will have enough money to cover the payment given that PNC's new product allows extra time to cure the overdraft. It is hard to know how many of the

[35] Data provided to the author.

consumer alerts sent resulted in changed behavior without a complicated control group-style experiment.

It is hard to argue against providing consumers more information. However, information without the ability to fix a problem is often insufficient. The problem people living on the financial edge face with overdraft is more likely a combination of temporal mismatches of money and the high cost of small dollar credit than it is about knowing that they are near the edge. Data from the Financial Diaries Project and others indicate that people living paycheck to paycheck may be more likely to budget and be aware of their finances than those who are comfortably upper middle class.[36] However, when you do not know the exact moment your paycheck will hit your bank account or when a payment will be taken out it is impossible to budget or plan in a way to avoid fees.

Policy solutions

Many banks have made great strides to reduce overdraft fees, some more impactful than others. These banks' excellent decisions do not eliminate the need for structural policy changes. Here are five policy changes still needed to address ongoing overdraft problems that harm working families.

1. **Stopping overdraft giants with safety and soundness regulation**. A small number of banks and credit unions depend on overdrafts for a majority, or in a few instances, totality of their profits. That regulators consider it safe and sound for banks and credit unions to base their business model on overdraft, a product charged only to their most financially vulnerable customers, is a dereliction of duty. Regulators should immediately revise their rules. Any institution that relies on overdraft fees for a majority of their profits for multiple consecutive years should be given failing regulatory grades, a position the Washington Post editorial board has echoed.

2. **Credit unions should disclose overdraft data just like banks**. Currently all banks over $1 billion in size must file information in their call reports listing various consumer fees, including overdraft fees.[37] These items in Schedule RI, line 15, form the basis of the data I and others have used to highlight trends in industry, identify troubling practices and overdraft dependent institutions, and encourage the banking industry to reform. Credit unions are exempt from this requirement. As such, even the nation's largest credit unions with tens of billions in assets do not file this information publicly. No one knows which credit unions are overdraft giants or are engaged in practices harming their customers, although the data described above and a few lawsuits have revealed there are problems.[38] Credit unions should report this data publicly, just like banks of similar size.

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[36] Morduch, Jonathan and Rachel Schneider. *The Financial Diaries: How American Families Cope in a World of Uncertainty*. Princeton University Press, 2019.
[37] Federal Financial Institutions Examination Council. "FFIEC 031 and FFIEC 041 Call Report." December 29, 2014. https://www.ffiec.gov/pdf/ffiec_forms/FFIEC031_FFIEC041_20141229_fi_draft.pdf.
[38] Tompor, Susan. "2 big Michigan credit unions hit with lawsuits regarding overdraft policies." Detroit Free Press, September 17, 2017. https://www.freep.com/story/money/personal-finance/susan-tompor/2017/09/17/overdraft-fees-class-action-credit-unions/401149001/.

3. **Real-time payments**. As Treasury Secretary Yellen recently stated, America's slow payment system "contributes to the use of high-cost check cashers or 'pay day' lenders to get their money in time to pay their bills. Some are forced to draw against already low balances and are charged overdraft fees."[39] She was right to draw this link. My research, using FDIC data, makes clear that 70 percent of people using check cashers have bank accounts.[40] The problem Americans face is that the check takes too darn long to clear!

Voluntary decisions by some institutions to offer new programs—including faster access to certain types of payments (generally direct deposit wages) and 24 to 48 hours to cure negative balances—and a growing industry providing early wage access have all helped millions of American families avoid expensive overdrafts and other fees. That some banks and fintechs help their customers with these services only underscores the importance and power of broader payments reform. If a subset of banks moving a subset of payments faster can result in billions of dollars saved by families living paycheck to paycheck, consider the impact of a full transition to real-time payments.

The solution is real-time payments. The Federal Reserve could solve this problem today using the regulatory authority given to it under the Expedited Funds Availability Act.[41] But the Fed has not moved even though Congress was explicit in requiring that the Fed "shall, by regulation, reduce the time periods established under subsections (b), (c), and (e) to as short a time as possible." Absent Fed action, legislation is needed. Previously proposed legislation introduced in the Senate by two leading members of this Committee, Senators Van Hollen and Warren would solve this problem.[42]

If Congress wants to address inequality, the most impactful change I can think of that does not raise taxes or government spending would be to require immediate posting of all deposits under $5,000 by all banks. Make this happen and save American families billions in overdrafts, check cashing fees, payday lending fees, late fees, and other problems caused by our slow payment system.

4. **Smarter payments regulation**. A series of tricks allow some banks and credit unions to increase overdraft revenue in part by taking advantage of the slow payment system. Two of these can be ended through joint regulation: posting debits before credits and reordering payment flows from largest to smallest. When payments come in a batch, which is common in our current payment system, the financial institution working with its core processor has some discretion in how it posts payments. The best practice for the consumer would be to post all of their credits first and then start debiting their account. A recent study by the CFPB found that almost ninety

[39] United States Department of the Treasury. "Remarks from Secretary of the Treasury Janet L. Yellen on Digital Assets." April 7, 2022. https://home.treasury.gov/news/press-releases/jy0706.
[40] Klein, Aaron. "Can Fintech Improve Health?" The Brookings Institution, September, 2021. https://www.brookings.edu/research/can-fintech-improve-health/.
[41] Klein, Aaron. *Open letter to Ann Misback, Secretary of the Board of Governors of the Federal Reserve System*. The Federal Reserve, December 14, 2018. https://www.federalreserve.gov/SECRS/2018/December/20181221/OP-1625/OP-1625_121418_133277_428769914666_1.pdf.
[42] 116th Congress. *Payment Modernization Act of 2019*.

percent of banks and two-thirds of credit unions did this.[43] However, that left one-third of credit unions and ten percent of banks posting some debits before credits, a practice that would result in more consumers overdrafting. This should be stopped.

The same study found that while nearly two-thirds of credit unions ordered the credits chronologically, only 22 percent of banks did. However, larger banks were more likely to order chronologically, with 46 percent banks over $2 billion in size doing so. The study found a concerning 40 percent of banks in the sample reordered from largest payment to smallest, a trick that would result in more overdrafts. Less than 1 percent of credit unions did this trick. To be fair, 44 percent of banks and almost 10 percent of credit unions reordered from smallest to largest, which should minimize overdrafts. Many financial institutions are doing the right things and should be acknowledged as such. Regulation is still needed as there are also many institutions doing the wrong thing. Hopefully institutions who are doing the right thing by their customers would be supportive of their best practices being mandated across the industry.

5. **Universal Bank-On-style accounts**. All financial institutions should be required to offer a no overdraft, low-cost, basic bank account.[44] These accounts have proven to be popular when properly offered and marketed (see Citibank reporting one in five new customers opening one) and can be done in a way that is profitable for the financial institution. The American Bankers Association calls it a best practice for all banks to offer this type of account.[45] This best practice should be mandated for all banks and credit unions. Draft legislation proposed in the House would do so for all banks and credit unions above $10 billion and this legislation would make a major positive difference in addressing the problems of un- and under-banked Americans.[46] It does so with no additional government spending or costs imposed on financial institutions, many of which already offer these accounts. Given the importance of small banks and credit unions in reaching all Americans, I think all financial institutions should be required to offer these accounts. After all, all banks and credit unions are chartered by the government and have a duty to serve their communities. Providing a basic, low-cost account that is accessible to all community members should be a part of that obligation.

Universal accounts expand access to the financial system. The number one reason why people are unbanked is the high cost of basic bank accounts. Approximately half of people without bank accounts report having had an account in the past, highlighting that people leaving the banking system are driven by the high cost of accounts. Requiring no-overdraft accounts will help better meet the needs of lower-income consumers.

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[43] Kelly, Nicole and Éva Nagypál. “Data Point: Checking Account Overdraft at Financial Institutions Served by Core Processors.” Consumer Financial Protection Bureau, December 2021. https://files.consumerfinance.gov/f/documents/cfpb_overdraft-core-processors_report_2021-12.pdf.

[44] Klein, Aaron and Myrto Karaflos. “Universal bank accounts necessary for families to bank on Child Tax Credit.” The Brookings Institution. April 29, 2021. https://www.brookings.edu/opinions/universal-bank-accounts-necessary-for-families-to-bank-on-child-tax-credit/.

[45] American Bankers Association. “ABA Urges America's Banks to Offer Bank On-Certified Accounts.” October 19, 2020. https://www.aba.com/about-us/press-room/press-releases/aba-urges-americas-banks-to-offer-bank-on-certified-accounts.

[46] United States House of Representatives. “Expanding Access to Affordable Bank Accounts Act.” March 28, 2022. https://financialservices.house.gov/uploadedfiles/033022_bills-117pih-expandingaccesstoaffordable-u1.pdf.

Conclusion

America's largest banks and others around the world have made many sweeping changes to their products that will substantially reduce usage of overdrafts and overall cost of banking for consumers. These changes will likely save American consumers $5 billion a year, putting money directly in the hands of people who are living on the financial edge. The banks and credit unions who have made these changes should be commended and more should follow suit. It is not easy for a company to change in a way that reduces its immediate profits but improves the lives of its customers. This behavior should be rewarded.

The less a bank depends on overdraft revenue the more likely it is to give it up. A handful of banks and credit unions operate on business models entirely dependent on overdraft revenue for their viability. Financial regulators must no longer tolerate this. They should never have tolerated it in the first place. The market has moved; regulators need to adapt.

The explosive growth and popularity of overdraft as a product reveals deeper structural problems with America's basic banking system. Slow payments, limited options for small dollar liquidity, and fees designed to be punitive rather than in accordance with actual costs are core reasons why overdraft became so widely used. These problems drive people out of the banking system and take billions from working families living paycheck to paycheck.

The positive changes by banks on overdraft fees are a step in the right direction. But they do not address the underlying problems. Congress has the ability to fix many of these problems and deliver a financial system that works better for working people. Critically, many of these solutions, like real time payments, do not require raising taxes or new government spending or new programs. That a person ought to have access to their own money immediately should be a bipartisan ideal.

I appreciate the opportunity to testify before the Committee and look forward to answering your questions.