Checking Overdraft and the Voice of the Consumer

Not only would many of the proposed new regulations on overdraft run counter to consumer choices, but they also would likely reduce the availability of service options.

BY HANK ISRAEL, LEE KYRIACOU AND JIM BRAMLETT

Since the introduction of new regulatory requirements in 2010, overdraft fees on consumer checking have fallen by as much as 45% across the U.S. banking industry. Nevertheless, some overdraft critics are calling for new prescriptive controls on the use of overdraft, and regulatory action is being considered on additional disclosure requirements, further process controls and pricing restrictions.

Proponents of further regulation appear to base many of their arguments on the assertion that consumers are making ill-informed choices in the use of overdraft services. But despite all of the expressions of concern, commentators to date have provided limited direct consumer research on the reasons why consumers use overdraft, as opposed to simply describing their behaviors. To fill the gap, Novantas conducted a national survey to understand whether and why consumers choose to opt-in and use overdraft.

Contrary to popular perception, the survey found that most current overdraft usage is based on informed consumer choice. Not only would many of the proposed new prescriptive controls run counter to survey-revealed consumer choices, but they also would likely reduce the availability of overdraft options (Sidebar: Payment Coverage Available to Consumers) for the very consumers who rely on them most, causing many to embrace less-regulated alternatives.

A more productive regulatory agenda should begin by recognizing the right of consumers to make informed short-term funding choices, and then work with banks to provide effective information to consumers, along with more — not fewer — options to meet their short-term payment and liquidity needs. Consumers need three types of support:

Choice. Consumer flexibility will be preserved by maintaining current overdraft requirements on consent. This includes affirmative consent ("opt-in") for debit card overdraft, and negative consent ("opt-out") for transactions where consumers would otherwise pay transaction fees for processing overdrawn or returned checks.

Information. The most direct way of informing consumers is to simplify and streamline checking account disclosure. Regulatory bodies could make a huge contribution by consolidating overlapping requirements, and by encouraging consumer use of real-time alert options, which most accountholders can already access via their financial institutions.

Product options. Consumer choice is best supported by encouraging new product development, not by restricting or homogenizing current overdraft options by way of prescriptive pricing and controls.

With informed consumer choice as the basis of competition, banks will serve their consumers better and ensure a healthier and more competitive financial services industry.

IMPACT OF REGULATORY REFORM

From the 1990s to the late 2000s, annual financial institution fee revenues from overdrafts (both paid and returned checking account transactions) grew to an estimated $32.1 billion.

In response to growing pressure from consumer groups and others, regulators revised numerous rules, disclosures and guidelines for overdraft processing. Efforts began in 2005 and have continued past the financial crisis (Sidebar: Recent History of Overdraft).

Combined with 1) the adoption of best practices; 2) settlement of several high-profile class action and multi-state legal actions; 3) new product innovation; and 4) consumer responses to all these changes, these regulatory reforms have fundamentally changed the landscape of overdraft in the United States:

- *Consumers have made clear choices.* 32% have elected to opt-in for overdraft service on one-time debit card purchases, while 68% have exercised their choice not to (and therefore can no longer incur a debit card overdraft fee).
- *Annual fee outlays for consumer overdraft coverage have fallen dramatically.* Based on the early 2015 run rate versus the peak year of 2008, annual fees have been cut by roughly $14 billion. The largest source of this decline has been the debit card opt-in provision, in which 68% of accountholders have chosen to exclude themselves from debit card overdraft services. A second driver has been the implementation of best practices (e.g. date-driven posting orders, monitoring, and a wider range of overdraft choices, and fee structures and fee caps).
- *Consumers now receive timely information on their overdraft fees.* Checking account statements now include a monthly summary of overdraft instances and associated coverage fees, as well as year-to-date totals. Instant information is available at most banks for customers who enroll in bank text and e-mail alerts.
- *Consumers retain multiple product options to meet contingency liquidity needs.* Checking customers can choose from a host of overdraft service alternatives. They also can obtain services from alternative online providers with household brand names — some with especially low overdraft fees, and others that do not charge for overdrafts at all.

Notwithstanding these developments, overdraft critics are seeking further regulation, and the Consumer Financial Protection Bureau (CFPB) has begun to consider additional consumer overdraft policies. Calls for new regulation fall into three areas:

Disclosure. Further disclosure requirements are being proposed for verbal and written communication, both for debit opt-in and check/ACH opt-out. Specifics include stated fee costs for overdraft coverage, the annual percentage rate and available alternatives.

Process controls. Under some proposals, credit underwriting would be required for all consumers using overdraft. Debit card overdrafts would be prohibited. Check/ACH overdraft coverage would either require opt-in or be prohibited, and there would be further stipulations on the processing order of transactions.

Pricing. Overdraft fee charges would be capped at six instances per year. Fee levels would be limited to amounts deemed "reasonable," or proportional to the transaction covered.

Underlying these new measures is a continuing assumption that financial services firms drive consumer overdraft behavior through their policies and practices, which in turn require management by regulators — as opposed to

Payment Coverage Available to Consumers

Consumers rely on access to overdraft services as a convenient way to ensure that their bank will honor payments, even when their account is short of funds.

When a charge posts to a checking account (whether from a debit card purchase, check, ACH electronic payment, ATM or other withdrawal) that exceeds the current account balance, one of several outcomes will occur:

Immediate bank coverage. If overdraft service is in place, the bank extends credit to cover the charge and assesses an overdraft fee, currently ranging from $15 to $38.

Immediate coverage via automatic transfer. Some banks and customers have overdraft protection, in which case the charge is covered by an automatic transfer from a linked savings account, credit card or other line of credit — also often with a fee.

Declined check or ACH payment coverage. If the charge is associated with a check or automated clearinghouse payment, the bank returns the item unpaid for non-sufficient funds and assesses an NSF fee of a similar amount — the intended payment recipient will likely impose a separate return fee as well.

Declined debit coverage. If the charge is associated with a debit or automated teller machine (ATM) card, it can be declined immediately, and the account holder must pay by a different means or not make the purchase.

Temporary no-fee coverage. Depending on the bank, the bank may temporarily cover the overdraft without a fee for small dollar amounts of short periods of time.

— Hank Israel

a scenario in which informed consumers use overdraft services as the best available choice, given their price and convenience preferences.

NATIONAL SURVEY

To help inform the public discourse on overdraft, Novantas designed a national online survey of 1,724 consumers (executed in December 2014), to understand key consumer overdraft behavior and decision-making. Adequate samples of survey participants were sought among four categories of checking customers based on their overdraft behavior in the past year: 1) those who never incur overdrafts; 2) occasional overdraft users with one to five instances in the past year; 2) frequent overdraft users with six to 10 instances; and regular overdraft users with more than 10 instances. Care was also taken to include a strong representation of new-to-bank customers, who have the most direct experience with revised arrangements for checking overdraft service.

The feedback from survey participants strongly supports a conclusion that most overdrafting consumers — frequent and regular overdraft users in particular — are making informed choices regarding overdraft: trading off the cost of obtaining short-term funds against other concerns such as the importance of the payment, speed, convenience and access.

While added restrictions on overdraft may further reduce overdraft fees, the service likely would become less available to current users, many of whom count on this particular form of contingency funding for occasional help in bridging monthly finances and making timely payments (e.g. rent, utilities, auto). Consumers with few alternatives other than overdraft for timely critical payments may well suffer rather than gain, facing increased exposure to late payment fees and concerns over payment status.

Going into the specifics, a core finding of the research is that overdraft transactions overwhelmingly are a reflection of consumer choice. In two-thirds of instances, survey respondents said they knew their checking account balance was "running low" when they made a payment that

Recent History of Overdraft

Significant regulatory reforms have been introduced across the industry, including:

Standards — February 2005. A multi-agency directive, the Joint Guidance on Overdraft set standards for disclosing fees and monitoring consumer behavior in an overdraft program. Issued by the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (Fed), the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA), this guidance additionally established a best practice that enables consumers to opt-out of the program. It further required financial service firms that advertise overdraft to provide customers with monthly statements and year-to-date totals on fees charged.

Disclosure — October 2009. Updating its interpretation of the 1991 Truth in Savings Act, the Fed amended disclosure requirements under Reg DD. Beginning in 2010, regardless of advertising status, financial services firms were required to disclose monthly and year-to-date overdraft fees to the consumer.

Opt-in — November 2009. Strict conditions were set on the circumstances in which fees could be charged on overdrafts associated with debit card and automated teller machine transactions. Per the Fed's amendment of Regulation E (Electronic Funds Transfers), effective in 2010, financial institutions were prohibited from assessing ATM/debit overdraft fees unless the consumer "opts in" to the bank's overdraft coverage program under following conditions:

- The customer receives formal notice, segregated from all other information, listing the important features and fees of the overdraft protection program;
- The customer is given a reasonable opportunity to consider whether to affirmatively consent (opt-in) to the ATM/debit overdraft program;
- The customer formally opts in to the overdraft program;
- The customer receives written (or electronic) confirmation of consent, including a statement informing them of the right to revoke such consent; and
- The customer retains the ability to revoke the arrangement at any time.

Specified best practices — November 2010. The FDIC issued final supervisory guidance regarding best practices for overdraft programs, with specifics that went considerably beyond the requirements of the Fed's opt-in rules. Directed at FDIC-regulated institutions but adopted more broadly, these best practices included:

- Overdraft monitoring programs;
- Posting order reforms on same-day transactions subject to overdraft fees;
- De minimis limits, eliminating overdraft fees for small dollar amounts; and
- Daily caps on the number of overdraft fees a consumer could receive.

— Hank Israel

ended up requiring overdraft coverage (Figure 1: Consumer Awareness and Control of Overdraft). This finding is in line with 2014 research by the Federal Reserve Bank of Kansas on overdrafts with prepaid cards.

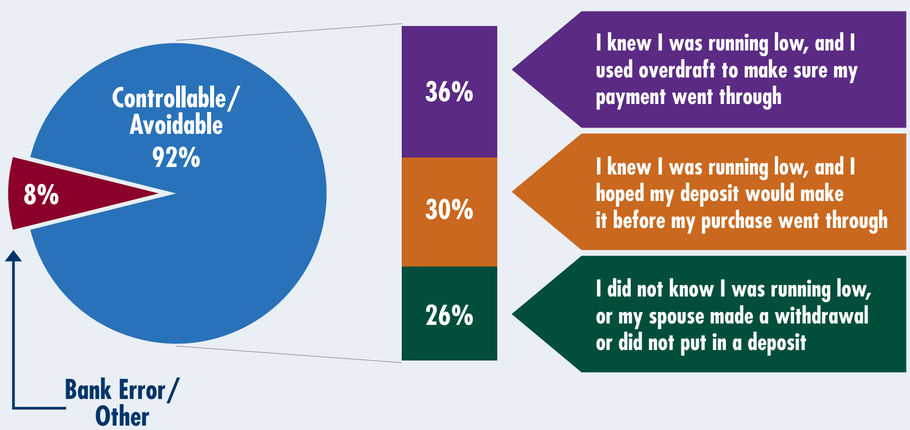
Further supporting the context of choice, the majority of overdraft volume is associated with customers who use bank-supplied digital account management tools each month (Figure 2: Availability and Usage of Account Management Tools). Based on published regulatory statistics and Novantas survey findings, 83% of overdraft volume is associated with consumers who make monthly use of online tools to monitor their checking account balances. The corresponding figure for mobile tool usage is 63%.

These findings do not support public commentary to the effect that overdraft users lack sufficient information to make informed decisions about specific account situations. Calls for action have been based on claims that it takes three to four days until the average consumer becomes aware of an overdraft, and further that overdraft users do not have access to online or mobile tools to manage their accounts.

Novantas survey respondents report otherwise. The majority of overdraft users report regular use of account management tools and said they often know of potential overdraft exposure before initiating the transaction, further suggesting informed choices.

Figure 1: Consumer Awareness and Control of Overdraft

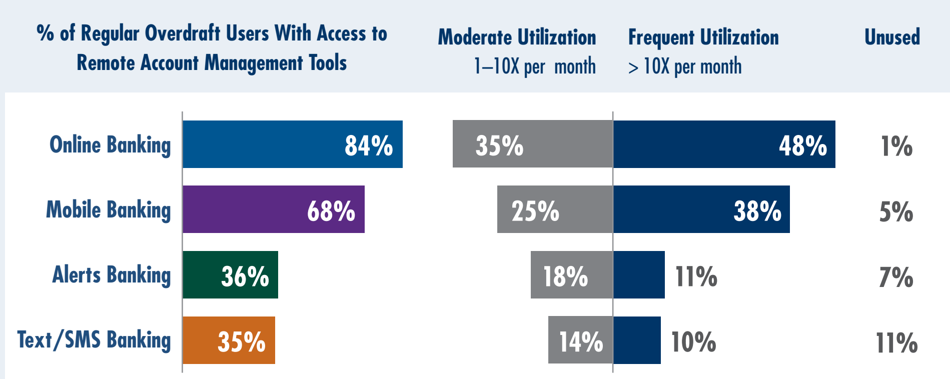
Consumers, especially those who overdraft more often, are largely aware of their overdraft usage. In a majority of cases they intentionally choose it, most other instances are controllable/avoidable.



Source: Novantas 2015 Overdraft Study

Figure 2: Availability and Usage of Account Management Tools

Regular overdraft users have similar access to remote account management tools as other checking customers, and use these tools at significantly higher rates.



Source: Novantas 2015 Overdraft Study

DEBIT DYNAMICS

Overall, Novantas research indicates a roughly 32% consumer opt-in rate for debit overdraft coverage. This is in line with widely-cited findings published by The Pew Charitable Trusts in June 2014.

For a tight reading of consumer motivations and intentions, the Novantas survey queried overdraft users who said they had opted in and also

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recalled the details of the process. This encompassed two of every three overdraft users, a clear majority.

Within this universe, 86% cited contingency payment coverage as the motivation for opt-in to debit overdraft service (Figure 3: Motivations for Opt-in to Debit Overdraft Service). Along with emergency standby, respondents said they wanted a safety net to cover key transactions as needed (which seems logical given that a growing majority of consumers use debit cards to pay for utilities at provider websites).

Drilling down further within the 86%, 13% said they went into the arrangement with the conscious intent to invoke debit overdraft coverage from time to time. The remaining 73% wanted the coverage "just in case" (and ended up using it).

Going back to the top level, banker recommendation was cited as the opt-in motivation by 13% of overdraft users who requested debit overdraft service and recalled the details of the process. Importantly, only 1% of respondents said they were confused by the opt-in process, again suggesting that consumers make informed choices about the option.

Turning to fee incidence, commentators raise the issue that debit card usage results in a disproportionate share of overdrafts relative to other checking account payment methods. These payment methods include automated teller machines, paper checks, debit cards, tellers and automated clearinghouse (ACH, including electronic payments for items such as direct deposit, payroll and various types of vendor payments).

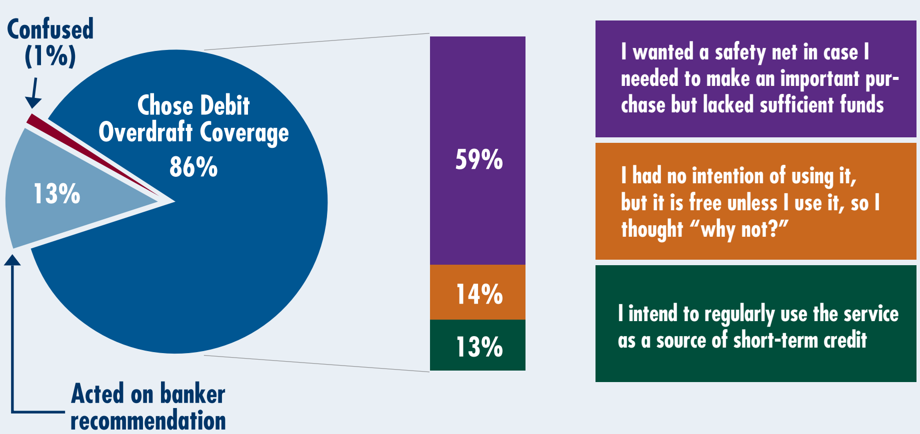
For guidance, the Novantas project assessed exception incidence (i.e. overdraft or NSF returns) for each payment method relative to its proportion of checking account transactions, based on figures published by the Consumer Financial Protection Board:

- By this measure ACH payments have the highest exception incidence, carrying 12% of checking account transaction volume but accounting for 17% of OD/NSF volume.
- Sharing the top ranking for overdraft overweight are paper checks, which account for 13% of checking account volume but 18% of OD/NSF volume.
- By contrast, debit cards account for a lower proportion of overall exception incidence relative to transaction volume, carrying 60% of checking volume but associated with a lesser 56% of OD/NSF volume (note that debit cards can only create an overdraft, and not a Not Sufficient Funds return).

Additionally, the CFPB estimates that a substantial portion of debit-related overdraft fees is rebated to customers, reflecting instances where the bank covered payments for its customers but did not charge a fee — although this was not deducted from the CFPB's published totals. Including an estimated adjustment for rebates, the probability that checking customers will incur a debit overdraft fee is likely more than 25% lower than the proportionate use of debit card for total payment transactions.

Figure 3: Motivations for Opt-in to Debit Overdraft Service

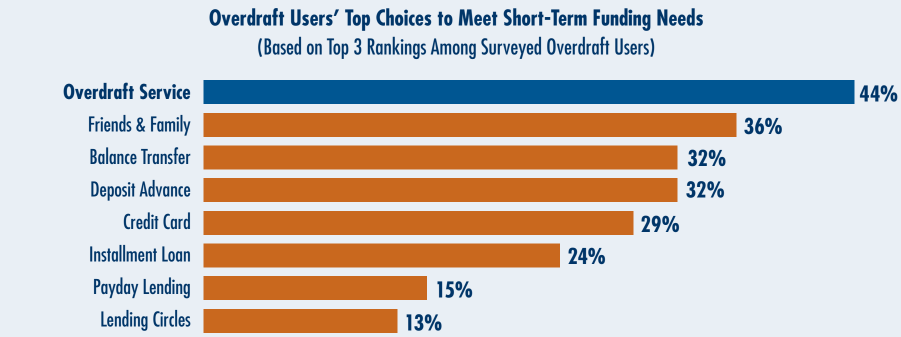
Among survey respondents who said they had opted in for debit overdraft coverage, the majority indicated they did so of their own volition.



Source: Novantas 2015 Overdraft Study

Figure 4: Alternatives for Short-Term Funding Needs

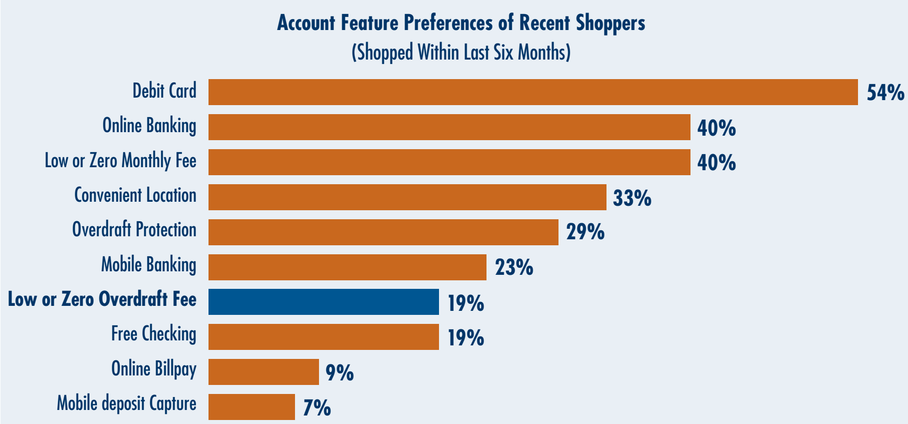
Even when fully informed on the alternatives and their comparative cost, overdraft users still prefer that service to meet cash contingencies.



Source: Novantas 2015 Overdraft Study

Figure 5: How Shoppers Rank Checking Features

When shopping for a checking account, consumers focus on easy payment access, free checking and convenience - not on overdraft fees.



Source: Novantas 2015 Overdraft Study

This favorable ratio of debit overdraft fee incidence is quite different from the portrayal of several commentators, whose statistics on debit overdraft incidence have been presented without mentioning that debit cards now represent the lion's share of checking account payments, or that a substantial portion of debit-related overdrafts are waived.

CONSUMER PREFERENCES

The Novantas project examined the consumer preference for overdraft service compared with other methods of meeting short-term cash needs (Figure 4: Alternatives for Short-Term Funding Needs).

Again for a tight reading, questions on liquidity alternatives were directed only to those survey respondents who reported having used overdraft services. To start with, participants were presented with a side-by-side comparison of products, features and pricing for various short term funding options. Although overdraft fees were high compared with other listed alternatives, survey respondents who use overdraft said they still preferred it to other sources of contingency funds, even given the fresh presentation of differences in cost (both in absolute and APR terms). In a compilation of the top-ranked liquidity alternatives listed by each respondent, overdraft service came out as the top preference, ranked either first, second or third by 44% of participants.

The study also queried respondents on the three most important features when shopping for a checking account. Overdraft pricing ranked seventh overall. Interestingly, maintenance fees ranked much higher, even for regular overdraft users. (Figure 5: How Shoppers Rank Checking Features). The results support the conclusion that for consumers in this segment, the cost of overdraft is not the primary concern; rather, the more likely usage drivers are convenience and access to the product.

On the question of further regulation on overdraft usage and pricing, the Novantas survey asked self-reported overdraft users and found weak support for pricing regulation, especially if it would restrict the availability of overdraft services:

- Roughly half of respondents made no mention of price regulation, either limits on total overdraft fees or limits on charges for a single instance of coverage.
- Among respondents who mentioned price regulation, most of that support was conditioned on continued access to overdraft services (Figure 6: How Overdraft Users View

Potential Price Regulation). On the pointed question of whether fee caps would be supported regardless of impact on access, only 17%–19% of overdraft users said yes.

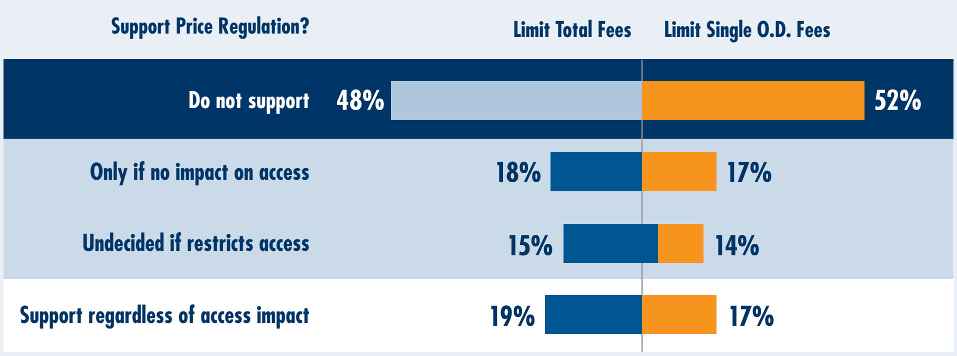
These findings provide important clarifications on findings by regulatory advocates, which suggest broad, unconditional support for overdraft price regulation. Actually, continued access is a concern for the majority of consumers who would consider price controls. (Prior research only asked if the consumer thought overdraft should be regulated, not what the regulation should be, nor about the impact regulation may have on users of overdraft).

POLICY IMPLICATIONS

Consumers are best served when they can make well-informed choices in a competitive market with multiple options and varied pricing. Prescriptive usage and pricing regulations will likely work against regular overdraft users, both by reducing coverage options and the availability of alternatives.

Figure 6: How Overdraft Users View Potential Price Regulation

Among all surveyed overdraft users, roughly half do not support price regulation, and only 17%–19% support price regulation regardless of impact.



Source: Novantas 2015 Overdraft Study

Based on Novantas research findings — that a majority of regular users of overdraft are informed on their options — a more constructive regulatory agenda should emphasize: 1) preserving consumer choice; 2) improving disclosure; and 3) fostering product innovation to expand the range of solutions for contingency liquidity.

Maintain current consumer consent procedures.

- Debit card opt-in — consumers cannot receive an overdraft fee unless they opt-in to an overdraft program in advance; and
- Check and electronic debit opt-out — whether paid or returned, the consumer will receive a fee for overdrawn checks and ACH debits. However, consumers will be advantaged by ongoing bank coverage, which helps overdraft users to avoid merchant and/or biller return fees, the potential for service disconnects, and potential blemishes on their credit scores.

Promote streamlined disclosure. Rather than independently examining overdraft disclosure, regulatory bodies should collaborate on a streamlined disclosure framework for checking accounts, integrated across multiple regulatory requirements.

Foster — not stifle — product innovation. Stiff criteria for credit underwriting and pricing will undoubtedly have the counter-effect of narrowing the accessibility of overdraft services to those customers who need it the least — highly qualified credit users who already have access to lower cost forms of credit — and restricting access to those who have fewer alternatives and still need short-term liquidity. By allowing the development of small-dollar loans, with appropriate underwriting and pricing criteria for emergency lines of credit, financial institutions will be incented to expand the range of options for regular overdraft users, as opposed to retreating from the market.

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This study was initiated at the request of the Consumer Bankers Association to better understand consumer sentiment and fill a gap in current research. CBA provided funds to cover market research survey costs. Novantas independently conducted the design, analysis, and synthesis of report results.

SPECIAL REPORT

Novantas Consumer Research Reveals that 92% of Overdraft Cases Are Consumer Avoidable

Access the full report at novantas.com/understanding-consumer-choice

Understanding Consumer Choice:
A Review of Customer Overdraft Behaviors

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