*Testimony of*

**Nessa Feddis**

*On Behalf of the*

AMERICAN **BANKERS** ASSOCIATION

*Before the*

Committee on Financial Services

United States House of Representatives

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**October 30, 2009**

Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Nessa Feddis, vice president and senior counsel of the American Bankers Association (ABA). The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

I appreciate the opportunity to testify today on overdraft protection and H.R. 3904 which was recently introduced by Representative Maloney (D-NY) and Chairman Frank (D-MA). The bill will regulate and limit overdraft services, services which government consumer testing has found bank customers value and expect. In addition, the bill would have significant business and technological challenges that will mean a complete retooling and redesign of checking account features and particularly its pricing. The result will be more hassle and costs for consumers who find their payments returned or rejected, and the bill will likely have significant unintended consequences on the availability of services and cost to all checking account customers.

In my testimony today, I would like to make several points:

- Consumers value depository institutions paying their overdrafts – and have come to expect it – as it helps to avoid the embarrassment, inconvenience, fees imposed by merchants and others, and other adverse consequences of having a check bounce or a transaction denied.

- Overdrafts fees are very easy to avoid and most consumers avoid them. The banking industry has been responsive to consumer concerns and will continue to work to improve overdraft protection practices. Even prior to some recent announcements by some banks about limiting and reducing overdraft fees, many institutions had already adjusted policies so that fees are not imposed for small overdrafts and the number of overdrafts is limited.

- H.R. 3904 would require significant changes in the business model for transaction accounts and a retooling of technology necessary to support them, all of which will have significant unintended consequences.

I would like to discuss each of these in turn.

## I. Consumers Value Depository Institutions Paying Their Overdrafts

American consumers enjoy the most affordable, efficient, and accessible banking system of any country in the world. Today, consumers can open a checking account with a minimal deposit and have access to the entire menu of payment services – ***at little or no cost***. They can write checks, use debit cards to withdraw cash or make purchases, pay bills, and make fund transfers online 24/7 from virtually anywhere in the world – all for free. Indeed, a 2008 Government Accountability Office report found that most banks offer free checking accounts. For consumers, such an easy and convenient service, however, comes with important responsibilities.

Bank response to consumer demand drove this expansion of payment services, access, capabilities, and pricing (including free checking). In the memories of many of us, bank accounts typically had minimum balance requirements and maintenance fees. Today, those minimum balance requirements and maintenance fees are not the common experience. With the elimination of the minimum balance requirement, there is no longer the incentive to keep a cushion which helps customers to avoid inadvertent overdrafts. This means customers must manage their accounts more carefully and keep them from going below zero.

In the best of all worlds, people would only write a check or make an electronic payment when there are sufficient funds in their bank accounts to cover the transaction. Of course, this is not a perfect world. There are also many different ways for consumers to make payments today, which, while convenient for consumers, increases the challenge for them to know what payments they have made and what resources are available to them in their bank accounts to cover them.

Today's modernized version of bank's traditional practice of paying overdrafts helps customers manage these challenges. Bank overdraft accommodations are successful because they provide desirable back-up for customer payment decisions. People want the bank to recognize that when they inadvertently overdraw their account they can be trusted to make it right and understand what they will pay for the bank's accommodation.

Most consumers generally want banks to pay their overdrafts even if it means paying a fee so they can avoid the inconvenience, embarrassment and potential cost of having a payment or transaction rejected. In fact, 96 percent of customers who had the overdraft covered by their bank were glad the payment was covered. Similar studies by the Federal Reserve also documented that most participants expect and want coverage to ensure their transactions went through and felt it was a positive feature.[1] This is because consumers understand there are costs and consequences of having a payment rejected or returned. Return or rejection of a check or electronic payment, for example, means not only paying an additional fee to the person who received the check or electronic payment, such as the mortgage lender, landlord, or merchant, but not having checks or automated payments accepted in the future and instead being required to purchase a money order or pay by cash. It may also mean an important bill is not paid on time which causes negative information to be put into a credit report. Customers also often want their debit card transactions to go through, whether it is for groceries already selected and bagged or for a meal that has already been eaten – or a bill they want paid though their debit card.

Consumers have also shown a keen understanding of the timing of transactions and how to manage within the overdraft accommodations provided by the bank. For example, some customers are aware of and avail themselves of the fact that even with debit card transactions, there is some window of opportunity to deposit funds ***after*** a transaction is made. For example, someone can make a purchase in the morning with their debit card – uncertain about their available funds at that time – and transfer or deposit money into their account before the books are closed for that day to cover the shortfall. Indeed, banks have reported that over half of debit card transactions for which there were insufficient funds at the time the transaction was made settle into good funds. This means that even though there was not enough money in the account at the time of the transactions, there is money in the account when it settles later that night. Some customers have obviously figured out that they can use their card during the day even though there are insufficient funds so long as they make a deposit before the end of the day -- and avoid an overdraft fee.

Today's "bounce protection" or overdraft accommodation programs are basically the latest, customer-driven innovation of this traditional practice. The primary difference is that many of the more recent overdraft protection practices rely on automated systems. The advantage of the automation of the historical practice of paying overdrafts on a discretionary basis is that it reduces costs associated with case-by-case assessment and manual intervention and promotes consistent treatment of customers.

[1] "Review and Testing of Overdraft Notices," Federal Reserve, December, 2008

## II. Overdraft Fees are Easy to Avoid and Most Consumers Avoid Them

Keeping track of transactions and the balance is critical to avoiding overdrawing an account. This is, of course, never a pleasant task and most of us would like to avoid it altogether. But doing so is part of good financial management and an important responsibility of using any transaction account. Writing transactions in the checkbook or ledger is, of course, the best way to track transactions. This is even more important today with the variety of ways that customers have available to make transactions.

Another reason for customers to keep track of their transactions is that there are occasions when the bank's record of the balance will not reflect transactions the customer has authorized, but which have not yet reached the bank. This includes not only checks written and scheduled automatic payments, but also some debit card transactions. For example, some merchants will forego transaction processing, especially for small dollar transactions which tend to draw the most attention. To save time or money the merchants verify that the card is valid, but choose not to get authorization. Thus, while the customer knows about the transaction, the bank has no knowledge of the transaction until it arrives at the bank that night or even later. The bottom line is that customers are in the best position to know what their actual balance is – only they know what checks they have written, automatic payments they have authorized, and debit card transactions they have approved.

Customers can – and should – check their balances and transactions often by phone, at the ATM, online, or using the Internet browser on their phone or other handheld devises. Knowing the balance – but also what transactions have been authorized by the customer but have yet to be processed and are not reflected in that balance – are very important to avoid overdrafts. Simply put, consumers are in control of their finances and can avoid overdraft fees.

Even with careful tracking, however, inadvertent overdrafts can occur. This is why banks have traditionally paid overdrafts on a discretionary basis, based on the historical activity of the account and the likelihood that the accountholder will cover the overdraft. However, customers who find it challenging to manage their accounts and avoid overdrafts have other options available to them. Many consumers avoid overdrafts by maintaining a cushion in the account to cover transactions they may have forgotten about or not written down in the checkbook. Others, for example, link their account to a savings account, credit card, or line of credit to cover overdrafts. In contrast to simple overdraft accommodation provided as a courtesy by banks, overdraft lines of credit are legal agreements where the bank is obligated to pay overdrafts and customers must complete applications and be subject to the bank's underwriting standards to qualify. What works best for one customer may not work as well for another.

Depository institutions will also often waive the fee for an initial or occasional overdraft. After the first incident, the consumer is then aware that debit card transactions may cause an overdraft and can take appropriate steps to avoid them. Of course, customers dissatisfied with their bank's services have many other banks to choose from in our very competitive industry.

In addition, most depository institutions permit customers to opt out of having overdrafts authorized or paid. The FDIC found the fast majority (86 percent) gave customers a choice: 75.1 percent allowed opt out and 11 percent provided opt in.

While anyone's bank account can fall short from time to time, overdraft fees are 100 percent avoidable. Just like a parking ticket or speeding ticket, they are meant to be a deterrent. Like any penalty, they are designed to get the person's attention in a way that nominal fees simply do not. In fact, most consumers manage their accounts and avoid any overdraft fees. In an annual survey of 1,000 consumers conducted by Ipsos-Reid for the ABA in 2009, 82 percent of bank customers said they did not pay an overdraft fee in the previous 12 months (up by two percent from the year before). Clearly, consumers who pay overdraft fees are the minority, and that number is shrinking.

Simply put, overdraft protection is an important service for our customers. We believe customers should understand the process, the responsibilities to track deposits and withdrawals, and any fees associated with overdrafts and options to avoid them. Banks can and do provide convenient access to account information today to help customers manage their financial flows, but ultimately it is consumers who are in the best position to track and manage their accounts.

## III. H.R. 3904 Would Require Significant Changes Which Will Have Many Unintended Consequences

The ABA is very concerned about the potential unintended consequences that would result from H.R. 3904. Below we highlight some, but not all, of the specific concerns that we have:

***Limits on overdraft fee amounts:*** Overdraft fees are set to create incentives for good management of accounts and discourage overdrawing of the account. This is very similar to the incentives provided for parking illegally or speeding tickets. These fees are designed to get people's attention in a way that nominal fees simply do not. If parking fees or speeding tickets were set according to the cost of enforcement, there clearly would be many more cars parked illegally and many drivers would ignore speed limits altogether.

The bill limits the amount of overdraft fees to those that are "reasonable and proportional to the cost of processing the transaction." First, the cost of "processing" ignores the deterrent value of overdrafts. Second, the cost of "processing" the overdraft does not possibly reflect the risk of loss that the bank assumes in providing the overdraft coverage. This risk varies by the type of account and how well the customer has managed the account and how often the account is overdrawn.[2] Third, the cost of processing does not reflect the consequences of a negative balance on the account. Because the bank has to cover this deficit, it is not able to use those funds for other interest earning purposes, such as loans. This lost income makes it more difficult to provide checking account services for all depositors and means that those who manage their accounts well must absorb those costs in the form of higher or additional fees and/or fewer services.

Such artificial limitations – which do not reflect either the value of the product to consumers, the incentives it creates, the risks involved, or the opportunity cost that ultimately impacts the cost of transaction accounts for depositors – will lead to significant unintended consequences. As history has shown time and time again, government price fixing does not work and ends up hurting the very people it is intended to help.

***Limitations requiring not more than one overdraft charge per month and six per year:*** In effect, this provision limits consumer choice by prohibiting overdrafts they want paid from being paid. Under the bill, banks would return or reject overdraft transactions once the maximum fee limits have been met. Some banks might simply not offer overdraft protection at all, given the limits on the amount of fees as they will not cover the actual costs and risks associated with paying an overdraft. This means consumers will suffer the consequences as discussed earlier: the hassle, inconvenience, costs, and embarrassment of rejected or returned items – the very reasons that consumer testing has found people value and want the service.

There are also negative consequences for those accepting the payments. For example, a landlord might not have the funds to meet her or his own obligations or the merchant might end up providing merchandise for free. A restaurant might not get paid for a meal or a grocer might have to spend resources to re-stock the shelves for items left un-bought or discard them. To protect against the risk, banks may re-institute minimum balance requirements to encourage customers to have a cushion

[2] Some overdrafts cannot be avoided. For example, as discussed, some merchants do not obtain authorization and as a practical matter, the bank cannot return the item when the actual transaction is presented to the bank. In addition, there are numerous other circumstances when transactions cannot be returned or rejected, e.g., when transactions go to a back-up system.

or re-institute monthly fees for checking accounts. Thus, such a provision ends up hurting customers that have managed their accounts well and rarely if ever overdraw their account.

***Effective APR Calculation.*** H.R. 3904 classifies overdraft coverage fees as "finance charges" – and hence include them in disclosed calculations of interest rates. This means that banks would have to calculate an effective annual APR for those fees. Given that the number, amount, and duration of overdrafts are unknowable in advance (and are entirely within the control of the customer), it is obviously not possible to incorporate them into a nominal or forward-looking APR calculation.

The alternative is to use a historical or effective APR. However, consumers do not understand effective APRs, raising questions over whether this cumbersome process for calculating interest rates in the bill makes any sense. Given the nature of overdraft fees, the APR will be greatly inflated to the point of distortion. Any time an ***annual*** percentage rate is calculated for a term ***less than a year***, the inclusion of a fixed fee, even a modest one, will distort and overstate the APR. In the instance of overdrafts, the fee is fixed, the overdraft often small, and the term of repayment short (as the banking agencies encourage banks to request prompt repayment). It is easy to see how triple digit APRs would result. However, it is not at all clear how this would be meaningful to or assist consumers.

First, the shorter the repayment period, the greater the APR will appear in instances where there is a fixed fee. **This means that the *sooner* the consumer repays, the *greater* the calculated APR – a difficult concept to explain to consumers, as it appears that paying *earlier* actually *increases* the cost of credit and that it is better to delay repaying the overdraft.**

Second, the larger the amount overdrawn, the lower the APR will appear in instances where there is a fixed fee. This means that the more customers exceed their available funds, the lower the APR, implying it is better to overdraw one's account by more rather than less. Such a lesson is contrary to sound personal account management.

Third, the inflated and distorted APR will confuse consumers as they attempt to reconcile this APR with other APRs with which they are familiar, such as the nominal APRs for credit card, home, auto, and personal loans. The result will be to dilute the effectiveness of the APR generally, rather than enlighten them with regard to overdrafts. In the overdraft fee context, consumers understand a dollar amount far better than an inflated and meaningless APR.

Indeed, in a recent study, the Federal Reserve noted, "The quantitative consumer research conducted by the Board validated the results of the qualitative testing conducted both before and after the June 2007 proposal; it indicates that most consumers do not understand the effective APR, [as applied to open-end credit such as credit cards] and that for some consumers, the effective APR is confusing and detracts from the effectiveness of other disclosures." For this reason, the Federal Reserve has rejected the effective APR for open-end credit and in its stead will soon require disclosure of total interest and fees (by period and year to date) to be disclosed on periodic statements – because this is what customers understand.

**Technological and other issues:** There are also a number of other issues the legislation poses for which we are happy to provide additional information. They include technical operating issues as well as inconsistency in the legislative language that creates ambiguity and uncertainty, and thus potential liability for inadvertent violations. Other issues involve serious technological difficulties related to ATMs not owned by the bank and debit card holds that will impact all institutions, but particularly small and medium size banks.

## Conclusion

Mr. Chairman and members of the committee, ABA believes that overdraft protection services provide a valuable service to bank customers and small businesses. Taken together, the provisions of H.R. 3904 will mean a complete retooling and redesign of checking account features. The result will be more hassle and costs for customers who find their payment returned or rejected; less access to checking account services for some people; and higher prices due to the higher cost of providing bank accounts. It will also mean that those who manage their accounts well will pay for those who do not. Because of these and other significant unintended consequences, ABA has to oppose H.R. 3904 in its current form. We are ready to work with this committee to address ways to improve how overdraft accommodation programs serve bank customers.

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