Testimony before the Subcommittee on

Financial Institutions and Consumer Credit

Committee on Financial Services

March 14, 2012

San Antonio City Council Chambers

9:30am

Ignacio Urrabazo

President – Commerce Bank

Laredo, Texas

Chairwoman Capito, Congressman Canseco, Congressman Green, and colleagues.

Thank you for letting me participate in this important forum.

My name is Ignacio Urrabazo, Jr and I am President of Commerce Bank in Laredo, Texas: a classic community bank. Commerce Bank is a $550 million bank established in 1982: we are a subsidiary of International Bancshares Corporation. IBC is the largest minority-owned bank in the continental United States with $11.7 billion in assets.

By way of background:

- I currently serve on the FDIC Advisory Committee on Community Banking,
- I am on the Executive Board and Treasurer of the Texas Bankers Association
- I serve on a variety of committees for the American Bankers Association
- I was a former Chairman of the Board for the National Bankers Association the largest minority banking trade association; and
- I have been in banking for over 42 years.

This morning, I would like to focus on three things---fairness, the current regulatory climate, and the impact to banks and consumers from these regulations.

They say a picture is worth a thousand words, so I have enclosed a page in my presentation to provide a visual of what compliance looks like today at IBC.

There is no need to rehash the causes of the unprecedented financial meltdown with near catastrophic results that occurred in 2008-2009. But I do want to say that the regulators were clearly part of the problem but got very little blame.

In my lifetime, the FDIC fund has been broken twice, several decades ago with the S&L crises and just recently with the sub-prime crises. Unfortunately, the industry received virtually all the blame and the regulatory agencies by in large received a pass. As an old banker, I have to tell you, the regulators failed every bit as badly as the industry, but they have never been called to judgment.

As seen in prior economic cycles and prior periods of crises, policymakers and the regulators overreact to these cyclical problems. Congress's holistic approach to fix everything in the financial sector has created unnecessary and inflexible rules. The Dodd-Frank Act in my view is a perfect example of horrible overreach. The Dodd-Frank bill which is 848 pages long, is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies—it can in fact become a multi-headed monster.

This action by Congress is unprecedented. I would like to remind the committee, the laws that set up America's banking System in 1864 ran to 29 pages, the Federal Reserve Act of 1913 went to 32 pages, The Banking Act that transformed American finance after the Wall Street crash, commonly known as the Glass-Steagall Act, spread out to 37 pages. I ask you how will our community banking system survive under the weight of Dodd Frank?

The community banks across the country will be destroyed as regulators create additional regulations on top of existing regulations. Community bankers are frustrated with the unknown and the additional costs required for compliance review and implementation. This has come when banks are trying to survive the worst economic crisis in the last 50 years and at a time when our interest margins are shrinking. Not to mention the elimination of fee income through the Durbin Amendment and limitations on overdraft fees.

These fees are critical to the survival of community banking: it is key noninterest income that helps provide many of our banking products and services for consumers.

The Dodd-Frank Bill has not been fully implemented, but we are already seeing its effects. While the Dodd-Frank bill has some necessary provisions that are required for systematic risk and certain complex financial products, we again see that good intentions for the short term will have unintended horrible consequences for the long term.

Let me talk about some issues that I see as having major consequences not only for our community banks, but more importantly for the consumer.

First, in the area of compliance and fair lending, we are seeing examiners becoming totally inflexible and rigid in the interpretation of fair lending laws—all in the name of fairness and equality. In order for a bank to avoid a violation of fair lending laws and a referral to DOJ, we have put in place very inflexible and rigid underwriting standards to avoid criticism.

On the surface, this sounds very appropriate, but in the trenches we are now rejecting many long time customers that pay well, but do not qualify under these new standards because of their credit scores, or their debt-to-income ratio. The same concept applies to pricing of these loans. Some of these customers have had a long term relationship with the bank, but now everybody has to fit into a box. If you don't fit and the bank makes the loan, you become an exception. If you make an exception and create an outlier, you must justify the reason for making the loan and then the examiner will ask for similar exceptions to other outliers that are in a protective class.

This applies to mortgage loans and consumer loans. The results, exceptions create enormous fair lending risks, so banks stop making exceptions. Furthermore, the FDIC has stated as a policy: the FDIC does not want loan officer's discretion in consumer lending. You must fit into the box. The bottom line, we are declining loans at record levels and worst of all, alienating our customers and damaging our reputation.

In addition to the above, the costs involved in monitoring and living with such regulatory tests as regression analysis has become burdensome and unclear. Banks provide data and the regulators will run regression analysis on (1) women vs. men; (2) Hispanic vs. white non Hispanic; (3) unsecure loans for women vs. men, or (4) unsecured loans for Hispanic vs. white non Hispanic; (6) vehicle loans for women vs. men; (7) vehicle loans for Hispanic vs. white non Hispanic; and (8) various other combinations.

If there are no significant variances or a disparate impact in the Underwriting Standards or the Pricing, then the regulator will continue to cut and slice the portfolio into other combinations such as one branch against another or even one loan officer against another loan officer of different branches until the regulators have exhausted every conceivable iteration—as they are clearly practicing "Gotcha" examination tactics. Smaller banks will be forced to outside consultants to gather and analyze the data at greater costs because they do not have the resources to handle these difficult and complicated tasks internally.

All banks are different and all customers are different: it is very difficult to place everybody in the same box. Rules are a poor substitute for good judgment. Policymakers are now attempting, in effect, to force good judgment out of the process by creating rules that embody their view of what is right—they want no discretion.

The <u>second</u> issue is the CFPB's review of Overdraft Programs and their impact on consumers. The CFPB has initiated new inquiries into overdraft practices and their impact on consumers and they are soliciting feedback on a prototype "Penalty fee Box" on the consumer's checking account statement. Last year the Fed, FDIC and the OCC all promulgated their own guidance and rules to supervise overdraft programs.

Many community banks incurred significant costs instituting new forms, new operating systems, new disclosures and training to comply with Reg E and Reg DD to establish full transparency and ensure customer consent to the Opt-in provisions, all based on customer choice. Now the CFPB's wants to review the same programs. What this means for banks is new rules and guidance. The Overdraft programs serve as a safety net to consumers, and it's a service that is widely demanded by our customers. It should be noted that the consumer has complete control and can revoke their Opt-in status at any time.

Overdraft protection satisfies a unique and important need in the consumer credit marketplace. Restricting access will not eliminate the need that consumers have for it—but it could limit their access to it as banks begin to realize it's too burdensome, too expensive to maintain and carries to much regulatory risk. I have included a recent study by Todd Zywicki for the record that thoroughly studies the overdraft product.

My bank has also done extensive research on overdraft programs. The bottom line, consumers want this important product.

The third issue is that consumer complaints will now play a larger role with the CFPB and will have a significant impact on my costs and many possible dangerous consequences. Of major concern to banks is the "Unfair, Deceptive, and Abusive Practices" (UDAAP) section. Banks will clearly need to formalize customer compliant programs, if for no other reason than to prove that the bank takes such concerns seriously. Banks will have to identify patterns of complaints and establish procedures to review such patterns as well as individual complaints. Management systems will have to be established and monitored.

Ridiculous and far-fetched allegations will surface driving the banks' crazy. The definition of "abusive" will be solely at the discretion of the CFPB, DOJ and consumer groups. At IBC, we recently spent several hundred thousand dollars to buy a consumer compliant system to help us manage these complaints. A huge burden on the bank.

Other issues that are of concern to community banks are:

- There will be higher capital requirements under different risk approaches at a time when a fair return on your investment are difficult to obtain. Additional capital for community banks is difficult to obtain with limited profitability, Stress Testing will require even higher levels of capital -- near impossible.

- There will be new costly record-keeping and reporting requirements. The Bureau will require banks to compile and report additional HMDA data and HMDA-like small business loan data. Banks will be required to provide customers with expanded access to account, transaction and fee information. If the CFPB moves into small business lending, that type of lending will disappear.

- There will be more difficulty for banks to tailor loans or deposit products to their customers, since the Bureau will favor standardized "Plain Vanilla" products as it pursues disclosure simplification. This is creating the large bank mentality and will drive all community banks to merge, consolidate, or abandon the market since all products will be basically the same and no room for flexibility or good judgment.

- Banks will now face changes to Mortgage Disclosures and new provisions to promote the accuracy and independent judgment for appraisals. There is pending new rulemaking to implement requirements for mortgage-related escrow accounts.

- <u>Mortgage Credit will be curtailed as the QRM is implemented</u> by the regulators that will require a minimum of 20 percent down and nearly spotless credit histories. Other new proposals are pending. Borrowers will now be able to raise ability-to-pay challenges when failing to pay their mortgage.

- Many banks in rural areas have decided not to make mortgage loans because of the costs and pitfalls. Their CRA ratings will be at risk as well as possible redlining as a consequence. Bottom line, many consumers will not get a mortgage loan.

- New rules from the SEC on the definition of a "<u>Municipal Advisor</u>" will require bank employees to register as municipal advisors and will have a fiduciary duty to the municipalities.

- <u>New rules on underwriting the bank's investment portfolio</u> will place bigger burden on community banks.

- Safety and soundness examinations are extremely difficult and menacing.

In summary, community banks are facing stiff challenges in the next few years. As interest margins shrink, and fee income becomes more difficult to obtain, the regulatory burden will overrun small community banks causing them to either merge or consolidate with a larger bank, or just go out of business.

Most large banks are not interested in small rural banks and rural banks do not want to become part of a larger holding company, they will be lost. In 1992 there were 1,193 banks in Texas; there are currently 594---a decrease of 50% or 599 banks. I venture to say, that another 50% or 300 banks will disappear from Texas in the next decade. At the national level, the trend is the same. As one who has worked in community banking for over 4 decades, I maintain, despite policymaker's good intentions in implementing regulations, they are ultimately detrimental to banks' ability to grow, to create capital in our communities and to build communities through job creation.

More importantly, consumers and small businesses are impacted in negative ways, such as higher costs for financial products or limited products or limited credit availability at a higher cost. At some banks, certain types of credit will be completely eliminated and access to credit will be denied.

Before I close, I want to personally thank Congresswoman Capito and Congressmen Canseco for being sponsors of HR 3461—Financial Institutions Examination Fairness and Reform Act. This bill is a critical piece of legislation for banking. More than ever, the regulators are out of control.

They are the judge, jury and executioner and without the important appeal provision in HR 3461, banking has no chance. As a community banker, I believe we will not survive under the weight of the current regulatory environment. We absolutely need independent appeal. It is the right thing to do.

Thank you for involving us at this important forum where we can share the experience of community banks. I hope our perspectives, which are based on our day to day interactions with consumers, help illuminate the need to lessen the burden on community banks and consumers who are directly and negatively impacted. Without community banking, we will no longer be the America that created the largest economy in the world. We have already lost over 11,000 community banks since 1985. How many more can we afford to lose?

Thank you.

Compliance Review Committee Mission Statement: To test, review, or evaluate the financial institution's conduct, transactions, or potential transactions for the purpose of monitoring and improving or enforcing compliance with:
(1) a statutory or regulatory requirement;
(2) financial reporting to a governmental agency;
(3) the policies and procedures of the financial institution or its affiliates; or
(4) safe, sound, and fair lending practices.

Objectives:
1. Coordinate all bank examinations.
2. Evaluate all regulatory manuals and determine applicability to IBC processes.
3. Redefine business processes as deemed appropriate and based on an enterprise compliance risk assessment.
4. Develop a working knowledge of all banking regulations for all lines of business.

Compliance Review Committee Organizational Chart-MEMBERS

CRC Co-Chair
Dalia Martinez

Board of Directors

CRC Co-Chair
William Cuellar

Audit Committee
Daniel B. Hastings, Jr.
Irving Greenblum
Larry A. Norton
Leonardo Salinas
Guillermo F. Trevino
Douglas B. Howland

External Consultants
Black, Mann & Graham
BKD
Compliance Coach

COMPLIANCE REVIEW COMMITTEE (CRC)
Dalia Martinez
Rene Avila
George Daves
David Guerra
William Cuellar
Julie Tarvin
Bob Barnes
Ignacio Urrabazo
Carlos Martinez
Gilbert Cruz
Gaby Holloway

External Legal Support
Karen Neeley
Joe Barloon
Cary Kavy
Carlos Castillon

COMPLIANCE DEPARTMENT OFFICERS
George Daves
Gaby Holloway

CRA Committee
Ignacio Urrabazo
Dalia Martinez
George Daves
Gaby Holloway
Marcela Davila
Ricky Ramirez
David Guerra
Bob Barnes
Julie Tarvin
Gilbert Cruz
~~Lee Reed~~

Retail Credit Committee
Tom Travis
Dalia Martinez
Kris Nicek
Nichole Patterson
David Moore
Bill Schonacher
Gilbert Cruz
~~George Daves~~

Fair Lending Committee
Dalia Martinez
David Guerra
Tom Travis
Bob Barnes
Ignacio Urrabazo

Revised 3/13/12

BSA/AML Committee
Jessica Mendiola
Dalia Martinez
Rene Avila
Becky Banda
Sonia Campa
Gilbert Cruz
Janie De La Garza
Lupita Garcia
Maggie Gonzales
Eliza Gonzalez
Ramiro Herrera
Kevin Mullins
Perla Nieto
Diana Ramirez
Javier Reyna
Julie Tarvin
Marlen Vasquez
Susan Wisdom
Carlos Castillon
Carol Witt
Gaby Holloway

Non Deposit Products
Gerald Schwebel
Mario Pena
CEO's & Executives

Accounting
Julie Tarvin
Judy Wawroski

Disclosure Committee
Imelda Navarro
Julie Tarvin
William Cuellar
Judy Wawroski
Carlos Martinez

Mortgage Lending Committee
Bob Barnes
David Guerra
Troy Martin
George Daves
Valerie Cardenas
Amancio Chapa
Gilbert Cruz
David Moore
Pam Phelps
Phyllis Thomas
Bob Almand
Lahoma Dade
Dalia Martinez
Gaby Holloway
Kris Nicek
Nichole Patterson
Joanne Perez
Jerri Rose
Mirta Salcedo
Jack Hoffman
~~Cody Hamshire~~

Small Business Lending Committee
Tom Travis
Kris Nicek
Dalia Martinez
George Daves
David Moore
Brannin Prideaux
Eddie Farias
Ignacio Urrabazo

Commercial Credit
Consumer Lending
Gilbert Cruz
Julie Tarvin
Jose Salinas
Ramiro Torres
Amancio Chapa
Veronica Aranda
Peggy Mayfield
Nick Fuhrman
Cesar Valdez
Polo Santos
Andrew Rice
Pam Phelps

HR
Rosie Ramirez
Julie Tarvin
Perla Nieto
Ana Ramos
Erin Monhollen
Sonia Casas
Yvonne Zepeda
Anness Bertrand
Debbie Salazar
Becky Banda

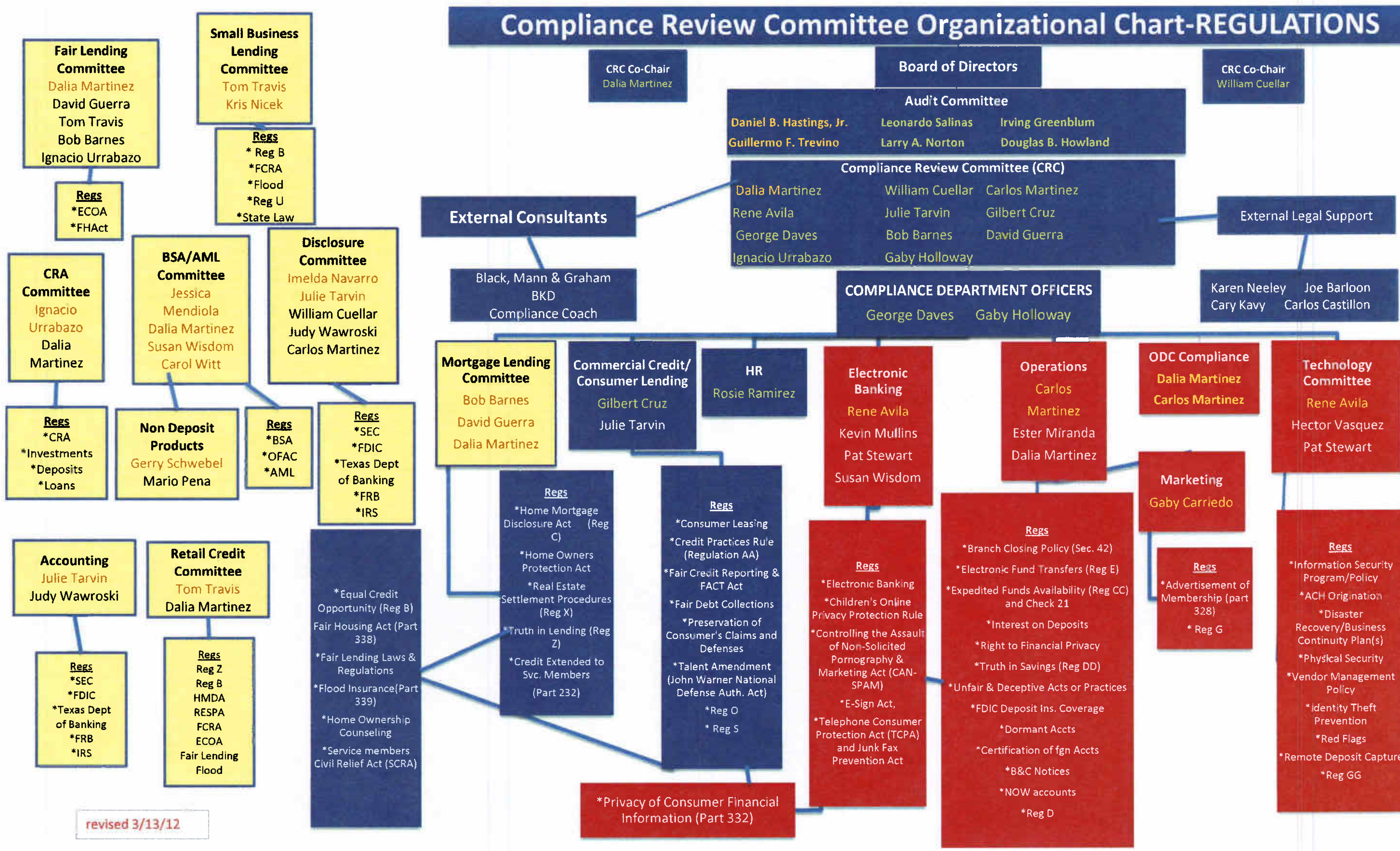
Electronic Banking
Rene Avila
Kevin Mullins
Pat Stewart
Susan Wisdom

Technology Committee
Rene Avila
Hector Vasquez
Pat Stewart

Operations
Carlos Martinez
Ester Miranda
Dalia Martinez

Marketing
Gaby Carriedo

ODC COMPLIANCE
Dalia Martinez
Carlos Martinez
Imelda Navarro
Hector Vasquez
Connie Vidal
Gaby Carriedo
Kevin Mullins
Amber Reese
Steve Lanciault
Gaby Holloway
Shannon Galloway
Brian Henry
Al Villarreal
Jorge Verduzco
Adrian Villarreal
Rene Avila
Lupita Garcia
Graciela Perez
Sue Richesin



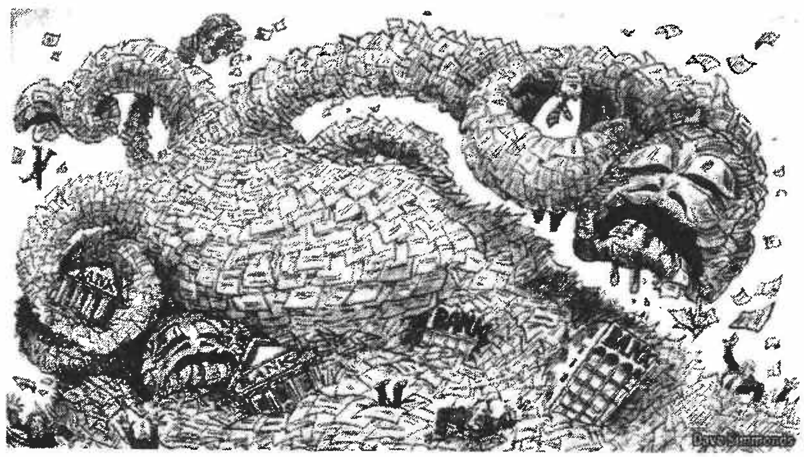
revised 3/13/12

The Dodd-Frank act

Too big not to fail

Flaws in the confused, bloated law passed in the aftermath of America's financial crisis become ever more apparent

Feb 18th 2012 | NEW YORK | The Economist



SECTIONS 404 and 406 of the Dodd-Frank law of July 2010 add up to just a couple of pages. On October 31st last year two of the agencies overseeing America's financial system turned those few pages into a form to be filled out by hedge funds and some other firms; that form ran to 192 pages. The cost of filling it out, according to an informal survey of hedge-fund managers, will be $100,000-150,000 for each firm the first time it does it. After having done it once, those costs might drop to $40,000 in every later year.

Hedge funds command little pity these days. But their bureaucratic task is but one example of the demands for fees and paperwork with which Dodd-Frank will blanket a vast segment of America's economy. After the crisis of 2008, finance plainly needed better regulation. Lots of institutions had turned out to enjoy the backing of the taxpayer because they were too big to fail. Huge derivatives exposures had gone unnoticed. Supervisory responsibilities were too fragmented. Dodd-Frank, named after its co-sponsors, Senator Chris Dodd and Congressman Barney Frank, attempted to address these issues (section 404 is one of those aimed at excessive risk exposure). But there is an ever-more-apparent risk that the harm done by the massive cost and complexity of its regulations, and the effects of its internal inconsistencies, will outweigh what good may yet come from it.

The law ~~that set up America~~'s banking system in 1864 ran to 29 pages; the Federal Reserve Act of 1913 went to 32 pages; the Banking Act that transformed American finance after the

Wall Street Crash, commonly known as the Glass-Steagall act, spread out to 37 pages. Dodd-Frank is 848 pages long. Voracious Chinese officials, who pay close attention to regulatory developments elsewhere, have remarked that the mammoth law, let alone its appended rules, seems to have been fully read by no one outside Beijing (your correspondent is a tired-eyed exception to this rule). And the size is only the beginning. The scope and structure of Dodd-Frank are fundamentally different to those of its precursor laws, notes Jonathan Macey of Yale Law School: "Laws classically provide people with rules. Dodd-Frank is not directed at people. It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies." Like the Hydra of Greek myth, Dodd-Frank can grow new heads as needed.

Take the transformation of 11 pages of Dodd-Frank into the so-called "Volcker rule", which is intended to reduce banks' ability to take excessive risks by restricting proprietary trading and investments in hedge funds and private equity (Paul Volcker, a former chairman of the Federal Reserve, has argued that such activity contributed to the crisis). In November four of the five federal agencies charged with enacting this rule jointly put forward a 298-page proposal which is, in the words of a banker publicly supportive of Dodd-Frank, "unintelligible any way you read it". It includes 383 explicit questions for firms which, if read closely, break down into 1,420 subquestions, according to Davis Polk, a law firm. The interactive Volcker "rule map" Davis Polk has produced has produced for its clients has 355 distinct steps.

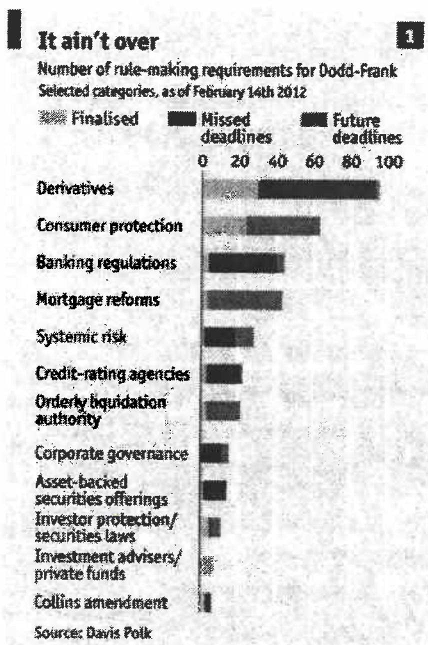
Boom time for lawyers

"I fear that the recently proposed regulation to implement the Volcker rule is extraordinarily complex and tries too hard," Sheila Bair, a former head of the Federal Deposit Insurance Company (FDIC), told Congress in December. A notable pre-crisis critic of regulatory gaps, she now believes that in this case "regulators should think hard about starting over again with a simple rule." Her comments were made before the Commodity Futures Trading Commission (CFTC), the fifth federal agency involved, issued its own proposal on proprietary trading on January 17th. That one is 489 pages long.

When Dodd-Frank was passed, its supporters suggested that tying up its loose ends would take 12-18 months. Eighteen months on, those predictions look hopelessly naive. Politicians and officials responsible for Dodd-Frank are upbeat about their progress and the system's prospects, at least when speaking publicly. But one banker immersed in the issue speaks for many when he predicts a decade of grind, with constant disputes in courts and legislatures, finally producing a regime riddled with exceptions and nuances that may, because of its complexity, exacerbate systemic risks rather than mitigate them.

This is Always the Case - We Never understand for a decade And Then it is to Late - 5000 Banks will be gone.

For the same reasons that bankers are worried, lawyers are rubbing their hands. For many of America's most prominent law firms helping companies to cope with Dodd-Frank is a vital service to clients, a lubricant for the American economy and a great new business. Daily updates on Dodd-Frank from Davis Polk and Morrison & Foerster have become as important to many on Wall Street as newspapers. Their popularity looks set to endure: according to Davis Polk only 93 of the 400 rule-making requirements mandated by Dodd-Frank have been finalised. Deadlines have been missed for 164 (see chart 1). And litigation is just beginning.

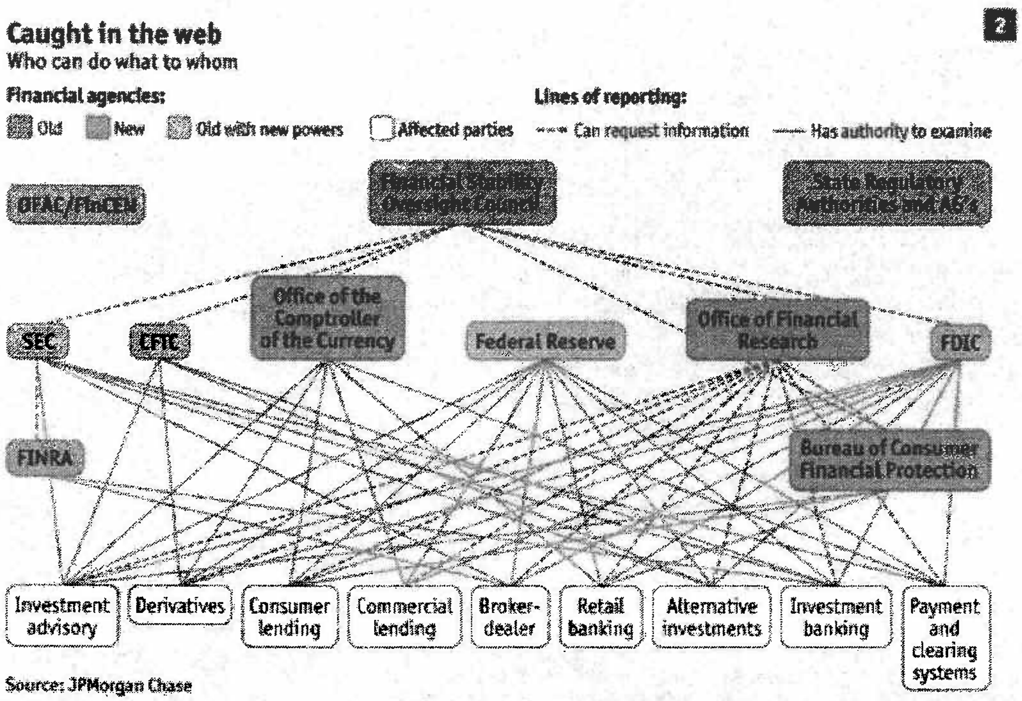


On July 22nd 2011 the United States Court of Appeals for the District of Columbia upheld a challenge by two trade groups to a Dodd-Frank-related rule on shareholder voting put forward by the Securities and Exchange Commission (SEC); the court found that the rule was backed by insufficient or faulty economic analysis of costs and benefits. On December 2nd, another case on similar grounds was filed in a Washington, DC, district court by two securities-industry trade groups, this time against the CFTC, concerning restrictions on derivative holdings. If that court, too, finds for the plaintiffs expect a deluge of further suits.

Along with requiring oodles of contestable rules, Dodd-Frank mandates 87 studies on big and small issues, ranging from the impact of drywall on mortgage defaults to the causes of the financial crisis. Once again, deadlines have been missed and progress is limited: 37 studies havé yet to be completed. The ones that have been finished have received little public attention; trying to drink from the rule-making fire hose leaves little time for absorbing the output of the reporting one. Some of the reports seem to reach odd conclusions. A report from the FDIC contends that had Dodd-Frank been in effect four years ago, Lehman Brothers' creditors would have received 97 cents on the dollar; one expert on the case calls this ludicrous. The problem is not that the reports are necessarily wrong, but that no one is scrutinising them.

Caught in the web

Who can do what to whom



Source: JPMorgan Chase

Another product of Dodd-Frank is a plethora of new government powers and agencies (see chart 2) with authority over areas of the American financial system and economy affecting veterans, students, the elderly, minorities, investor advocacy and education, whistle-blowers, credit-rating agencies, municipal securities, the entire commodity supply chain of industrial companies, and more. Quite a lot have tasks already done by others—frustrating the act's worthwhile objective of consolidating fragmented pre-crisis supervision. A new office within the Treasury department is intended to forecast and head off disasters—already a goal of research groups at the 12 regional Federal Reserve Banks, the Federal Reserve Board, the president's Council of Economic Advisers and numerous federal agencies, not to mention universities, think-tanks and private firms.

If the roles of many of these Dodd-Frank entities are overly familiar, their funding—which often skirts constitutional requirements for congressional approval—is more exotic. The new research bureau in the Treasury will be entitled to the proceeds of a new tax on banks. The new Consumer Financial Protection Bureau (CFPB) will be funded by the Fed.

But the really big issue that Dodd-Frank raises isn't about the institutions it creates, how they operate, how much they cost or how they are funded. It is the risk that they and other parts of the Dodd-Frank apparatus will smother financial institutions in so much red tape that innovation is stifled and America's economy suffers. Officials are being given the power to regulate more intrusively and to make arbitrary or capricious rulings. The lack of clarity which follows from the sheer complexity of the scheme will sometimes, perhaps often, provide cover for such capriciousness.

Already A Regulatory Method—

For example, the new CFPB will have latitude to determine what type of financial products can be provided to which consumers and at what cost, as well as the right to pursue institutions for acting in an "abusive" fashion (a term with no legal definition). Requirements for "living wills" that encompass hypothetical business plans have to be pored over by regulators; "stress tests" insert government assumptions deep into the decisions banks make about their capital. Such tests are not new to Dodd Frank. But the befuddling form the act gives such ideas unintentionally opens a path to much more state interference.

Allows regulators run the industry

Dodd-Frankenstein's monsters

Another problem with complexity is that it encourages efforts to game the system by exploiting the loopholes it inevitably creates. Take the simple matter of nomenclature. Anticipating the Volcker rule, bank departments previously using the word "proprietary" have been dropped, renamed or quietly shifted to sheltered corners. The shadow banking system existed before the crisis, but expect it to grow as some financiers decamp to companies that evade Dodd-Frank's definitions.

The fees banks can charge for debit cards are being sharply reduced, but other retailers with similar products have received a waiver, courtesy of the so-called Durbin amendment (named after a Democratic senator, Dick Durbin). Consequently the payment industry may be in the early stages of a rule-driven and otherwise unlooked-for transformation with no rationale in efficiency or safety. The bank-remittance business, which was also selectively hit with new rules, is facing a similar shake-up. The governments of Japan, Canada and the European Union have had their hackles raised by the fact that American federal and municipal bonds will be exempt from the Volcker rule, however it is put into practice, whereas their own bonds will not. Goldman Sachs's chief financial officer, David Viniar, has said that inefficiencies in the market resulting from Volcker could make trading more profitable—which was hardly the point.

very possible

Paying up

There could well be unintended consequences at the level of the employee, too. Last August the SEC opened an office mandated by Dodd-Frank that is dedicated to examining whistle-blower complaints. It collected 334 reports in its first seven weeks; no one will say how many have come forth since, but many more are expected the better known the office gets. This may sound welcome. But Dodd-Frank's provisions for massive payments to the whistle-blowers—of up to 30% of any monetary sanctions collected on the basis of their report—will make the SEC route more attractive than using companies' own processes, and may thus make corporate governance less effective.

For their part manufacturers seem largely unaware that a provision in Dodd-Frank concerning the extraction of minerals from in and around the Congo will mean that they will have to begin filing information on their entire supply chain to the SEC. This is officially estimated to affect 1,000-5,000 companies at a cost of $71m. The US Chamber of Commerce thinks it will affect hundreds of thousands. The National Association of

Manufacturers estimates it will cost $9 billion-16 billion. Conflict minerals are a disturbing issue. They were not one of the causes of the global financial crisis.

The overall cost of all this—both directly to public and private institutions and indirectly to the markets—is staggering. At the same time as banks are sacking employees in operating roles, they are adding swarms to cope with various requests from government agencies and other new filings, all to avoid violating rules that may never come into existence and temporary measures that may be rescinded. That is without looking at losses in terms of business not done. Loans that might not fit into a category favoured by regulators are being trimmed or withdrawn. VERY BIG ISSUE

BIG ISSUE *

Jamie Dimon, JPMorgan Chase's boss, reckons the direct costs to his bank, America's largest, will be $400m-600m annually. "Additional regulations resulting from the Dodd-Frank act may materially adversely affect BB&T's business, financial condition or results of operations," said one regional bank in its recent annual filing to the SEC. Other institutions are said to be in the process of drafting similar statements, or, at the least, planning to acknowledge the costs in the conference calls that surround quarterly earnings.

Banks are trading below book value. Low valuations make it hard for banks to raise the capital that would allow them to lend more, as politicians would like. This state of affairs is in part due to the condition of the economy. And the reasonable goal of restricting banks from taking private risks with socialised consequences may in some cases reduce their value. But it is hard to find a banker or analyst who doesn't privately attribute a lot of the low valuation to the unnecessarily harsh impact of current regulations.

Inevitably, banks themselves are adding to the costs with a vast lobbying effort. SIFMA, a financial industry trade association, says it has 5,490 people dealing with various subcommittees, almost all devoted to Dodd-Frankery. And there are quieter attempts to blunt the act's provisions or redirect them to the advantage of one set of financial institutions or another. The Occupy Wall Street crowd, with its emphasis on government-business collusion, would be enraged if it knew.

** Huge Problem

But most bankers are reluctant to discuss the law in public, and will do anything to avoid commenting on regulators. This is in part due to the risk that, given the industry's low public esteem, complaining would be inflammatory and counterproductive, perhaps also bringing with it regulatory retribution. A few also see the possibility of gaining an edge: some well established banks consider themselves better able to handle the costs than smaller or newer ones, particularly those that don't have cushy relationships with regulators. Others, according to the head of one large bank, are quiet only because they do not understand the scope of the changes. VERY TRUE FOR MOST –

Back to the drawing board

All of which leads to the question of what Dodd-Frank has actually achieved. More information on America's derivatives markets will be available to regulators than was previously the case, though how much will be useful is debatable. A new (untested) insolvency procedure is now in place for firms like AIG, which lacked an alternative to bankruptcy or bail-out before the crisis. But the heavy lifting on higher capital requirements for banks is being done internationally via the Basel 3 process. And Dodd-Frank has hardly touched Fannie Mae and Freddie Mac, the two big government-sponsored lending entities that received the largest bail-outs in 2008, and which are more important in the housing markets than ever.

The muddle stands in sharp contrast to the aftermath of earlier legislation. The banking-reform act of 1864 consolidated America's fragmented currency system and enabled Abraham Lincoln to finance the civil war. The period of reregulation between 1933 and 1940 reserved a safe harbour for commercial banks, which were backed by federal deposit insurance but didn't attract speculative capital because of caps on the rate of interest that could be paid. Risk was left to investment banks and asset-management firms, tempered by abundant requirements for disclosure and a shift in where the burden of proof lay in litigation, from plaintiffs to defendants.

Even Dodd-Frank's creators can bring no similar clarity to its intentions. In 2009 Mr Frank attempted to frame the new law's goals under four heads: securitisation, compensation, liquidation and systemic risk. But in a single speech his ambitions overflowed to consumer protection and the reform of ratings agencies, too. Ambition is often welcome; but in this case it is leaving the roots of the financial crisis under-addressed—and more or less everything else in finance overwhelmed.

http://www.economist.com/node/21547784

THE ECONOMICS AND REGULATION OF BANK OVERDRAFT PROTECTION

Todd J. Zywicki,
George Mason University School of Law

George Mason University Law and Economics Research Paper Series

11-43

THE ECONOMICS AND REGULATION OF BANK OVERDRAFT PROTECTION

TODD J. ZYWICKI
George Mason University Foundation Professor of Law
George Mason University School of Law
Arlington, VA 22201
Tzywick2@gmu.edu
703-993-9484

Abstract:

Consumer use of bank overdraft protection has risen rapidly over the past decade, leading to increased scrutiny and the imposition of new regulations. Public and political debate regarding overdraft protection has highlighted anecdotal stories about irresponsible college students who overdraw their accounts to buy a cup of coffee, thereby triggering substantial overdraft fees. But there has been little systematic examination of the safety and soundness or consumer protection issues implicated by the increased use of overdraft protection.

Available evidence indicates that those who rely on overdraft protection tend to have low credit ratings, use overdraft protection because it is sometimes less expensive, to maintain short-term liquidity needs, and more convenient than available alternatives. These alternatives include other credit options, such as payday lending, or options such as bounced checks or dishonored payments, which may result in eviction or termination of utilities or other services.

There is also no evidence that those who use overdraft protection are unaware of the cost or otherwise use overdraft protection foolishly or unknowingly. In addition, there is no evidence that banks are earning economic rents off the issuance of overdraft protection, as increases in overdraft revenues have been offset by dramatic increases in free checking, improved quality, and free services offered to bank customers. A serious reduction in overdraft revenues would reverse all of these trends and result in many consumers being driven out of the mainstream financial system, especially low-income consumers.

Absent a demonstrable market failure or demonstration of systematic consumer abuse, restriction on consumer choice of overdraft protection would likely impose substantial costs on consumers and banks with minimal gains.

The Economics and Regulation of Bank Overdraft Protection

Todd J. Zywicki[1]

Consumer use of bank overdraft protection has risen rapidly over the past decade. In 2010, 13 million consumers used overdraft protection and banks generated $35 billion in revenue, an important and growing part of total bank revenue. In turn, this growth has spawned increased media and regulatory attention focused on the product. Standard economic analysis recognizes that the increased demand for a product—including a financial product such as overdraft protection—as evidence of consumer satisfaction and demand for the product. Bank regulators, by contrast, have raised concerns about the increased use of overdraft protection by consumers and have issued regulatory guidance regarding the product under a safety and soundness rationale. In 2009, the Federal Reserve imposed new limits on overdraft protection that made it more difficult for banks to provide the service to consumers.[2] The Federal Deposit Insurance Corporation (FDIC)[3] and the Office of the Comptroller of the Currency have also issued guidance on overdraft protection and pricing.[4] In addition, the newly-created Federal Reserve Consumer Financial Protection Bureau (CFPB) created by the Dodd-Frank Financial

---

[1] George Mason University Foundation Professor of Law; Senior Scholar, Mercatus Center at George Mason University School of Law; Editor, *Supreme Court Economic Review*. Funding was provided by the Mercatus Center. Special thanks to International Bancshares Corp. (IBC), a major regional bank operating throughout Texas and the Southwest with approximately $12 billion, which generously agreed to provide data on the use of overdraft protection courtesy loans by its customers. In terms of assets and customer base, IBC appears to be generally representative of major banks.
[2] Federal Reserve System, Amendments to Regulation E, 74 FED. REG. 59,033 (Nov. 17, 2009) (to be codified at 12 C.F.R. pt. 205).
[3] Federal Deposit Insurance Corporation, Overdraft Payment Programs and Consumer Protection Final Overdraft Payment Supervisory Guidance, FIL-81-2010 (Nov. 24, 2010).
[4] Department of the Treasury, Office of the Comptroller of the Currency, "Guidance on Deposit-Related Consumer Credit Products," 76 FED. REG. No. 110, p. 33409 (June 8, 2011).

Regulatory Reform Legislation,[5] is also expected to consider additional restrictions on overdraft protection through regulation or enforcement actions.

Public and political debate regarding overdraft protection has highlighted anecdotal stories about irresponsible college students who overdraw their accounts to buy a cup of coffee, thereby triggering substantial overdraft fees.[6] Irresponsible college students who can't or won't balance their check books, however, are a small fraction of those who use overdraft protection in any given year. More important, although this subset of overdraft users might view the availability of overdraft as unnecessary or even a nuisance, for millions of others, overdraft can be a valuable tool to deal with short-term liquidity issues. The wisdom of imposing new guidance or regulations that could impair access to overdraft protection should be judged not by unrepresentative anecdotes but by seeking to understand the typical users of overdraft protection, why they use the product, and whether they understand its true cost relative to alternatives.

This paper seeks to take a first step toward answering those questions. To date, regulation has been promulgated despite an almost complete lack of knowledge about consumer demand for overdraft protection and any rigorous analysis of safety and soundness or consumer protection questions. Although the analysis presented here should also be understood as tentative, not comprehensive. But this first look at consumer use of overdraft protection suggests that those who use overdraft protection generally do so because the real-world alternatives that are available are more expensive or less flexible and convenient than overdraft protection, especially when the full cost of

---

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, PUB. L. NO. 111-203 (July 21, 2010).
[6] *See* Ron Lieber & Andrew Martin, *Overspending on Debit Cards is a Boon for Banks*, N.Y. TIMES (Sept. 8, 2009), *available at* http://www.nytimes.com/2009/09/09/your-money/credit-and-debit-cards/09debit.html?em.

alternatives is taken into account, including time, travel, and convenience. Moreover, those who use overdraft protection the most—and thus those about whom regulators appear to be most concerned—generally use the product rationally in light of available alternatives indicating that they are generally aware of the costs and benefits of overdraft protection and choose to use it anyway. In a free society, absent compelling evidence that consumers are ignorant or irremediably foolish—neither of which has been demonstrated with respect to overdraft protection—people are assumed to be the best judge of what is in their interests and should remain free to choose. If this is true, then restricting access to overdraft protection will harm most those supposedly sought to be helped.

To date, while regulators have imposed regulations and proposed still further interventions, they have provided no tangible evidence of safety and soundness risk, consumer harm, or other market failure from overdraft protection. Nor have they provided any evidence that consumers, especially high intensity users, are unaware of the cost of overdraft protection or other key terms of the contract or that they use overdraft protection irrationally in light of available alternatives. Most importantly, regulators have provided no evidence that curtailing access to overdraft protection would make better-off those consumers intended to be helped by the limitations. Those using overdraft protection generally do so because it is preferable to their available alternatives and forcibly reducing access will make many consumers significantly worse off by increasing the frequency of adverse events such as bounced checks, possible criminal prosecution, utility shut-offs, and evictions, or alternatively, forcing greater use of high-cost alternatives such as payday loans, pawn shops, rent-to-own, and even illegal lenders.

This article explores the economics of overdraft usage by consumers and banks to understand the economic logic of the product. It then examines the recent regulatory initiatives by the Federal Reserve, FDIC, and OCC governing overdraft protection issued under the rubric of safety and soundness protection as well as purported consumer protection rationales that might prompt regulatory action by the CFPB. The case for regulation in this area under traditional safety and soundness is exceedingly weak and the evidence of harm that would justify action under a consumer protection rationale, such as evidence of a lack of consumer understanding of the product's terms or prices, is nearly nonexistent. Moreover, although some of the regulations that have been issued to date have been troublesome but not crippling, the unintended consequences that followed in the wake of the Federal Reserve's 2009 rules illustrate the potential for more serious harm that could follow from intrusive regulation that dramatically limits access to or the usefulness of overdraft protection. In particular, although prudential safety and soundness regulators have taken a relatively cautious approach to the issue, it is foreseeable that an activist CFPB could dramatically reduce access to and the usefulness of overdraft protection, with far-reaching consequences for consumers, the banking system, and the national economy.

Sensible regulation of courtesy overdraft-protection services begins with a sound understanding of who uses overdraft protection and why. For most consumers, the primary purpose of overdraft protection is as liquidity insurance for which there are few real substitutes: convenient short-term credit to ensure the payment of current obligations (avoiding bounced checks and the like), paid back in a short period of time, and used as an alternative to maintaining low-interest precautionary balances in savings and checking accounts that can be accessed at the point of sale without a credit card. And even though some consumers use overdraft protection frequently, there is no evidence that they would be made better if their choices were restricted. Based on currently available evidence, the defining characteristic of frequent overdraft users is a low credit score and poor credit history, resulting in a paucity of attractive alternatives, not low income or other demographic characteristics.

Although overdraft protection is relatively more expensive than many mainstream financial products (such as credit cards), there is no evidence that overdraft protection is systematically more expensive relative to the real-world alternatives available to those who use it regularly.[7] More specifically, although overdraft protection may be more expensive than alternatives for some consumers, it may also be relatively superior for other consumers. This is especially so once the full costs of acquiring credit (including nonfinancial costs such as the time, travel, and convenience) are taken into account.

Overdraft protection also goes hand-in-hand with the availability of low minimum-balance, free checking accounts, which has provided access to the mainstream financial system for many low-income and young families. The rapid rise in the availability of free checking from 2001-2009 was aided by the spread of overdraft protection, and especially automated overdraft protection, as well as the increased use of debit cards.[8] Instead of the monthly-fee based model that dominated consumer banking

[7] It should be stressed at the outset that while the standard measure of lending cost—the "Annual Percentage Rate" or APR—might be a somewhat useful shorthand for describing the cost of loans, it is practically worthless in describing the real cost of a small-dollar short-term loan such as payday lending or overdraft protection, which is a loan for only a few weeks or even days. For example, the faster a consumer repays an overdraft loan the higher the APR, and the slower he repays it the lower the measured APR. This suggests the artificiality of APR as a measure of cost in the context of small-dollar short-term loans.

[8] Increased access to free checking began around 1998 but remained modest in numbers until access rose dramatically beginning in 2001.

for decades, the spread of overdraft protection opened the doors of the banking system to consumers who previously could not afford monthly maintenance fees and who were thus excluded from the banking system. And while substitution from use of fixed monthly fees to overdraft fees has produced a different pattern of cross-subsidization among bank consumers, reducing access to overdraft protection in the name of a subjective definition of fairness would reduce the availability of free checking accounts and impose new limits on bank access, such as higher mandatory minimum balances.

Finally, although overdraft fees and revenues have increased during the past decade, there is no evidence to date that banks are earning economic profits or "rents" from the growing use of overdraft protection. Instead, the market for overdraft protection is competitive both among banks offering overdraft services and with comparable products, such as payday lending. There is no evidence of super-normal returns to the banking industry generally from the growth of overdraft protection or from overdraft protection specifically. In fact, there is clear evidence to the contrary. Although overdraft revenues have risen, the costs of retail banking have increased as well, due to a range of quality improvements, including increased innovation (including on-line and mobile banking), an expansion of free services, and increased banking hours and banking days. These quality improvements and service improvements have made banking more convenient and accessible for consumers and brought many consumers into the mainstream banking system for the first time. These developments were spurred by the need to "keep up" in the highly competitive retail banking marketplace and reflect the high degree of competition in the banking market, a reality that makes it highly implausible that banks could earn sustainable economic profits that are not competed away. The decline in access to free checking in response to the Federal Reserve's imposition of regulations on overdraft protection in 2009 evidences the market's competitiveness and that where revenues fall and costs rise those costs are passed through to consumers. Absent any evidence of sustainable economic profits in this sector of the banking industry, regulations that limit revenues from overdraft protection or any other service will have to be made up elsewhere through new and increased banking fees or substantial reduction in retail banking services and quality. There is no reason to believe that this regulatory-induced equilibrium outcome would be economically superior to that chosen by voluntary choice in a competitive market, especially once these other offsetting price and quality adjustments occur.

Regulatory proposals offered in the name of consumer protection can be justified in two ways. Under a theory of information failure, it might be argued that consumers simply lack sufficient information about the products that they are using, such as cost or other elements of the contract. In that case, intervention might be justified to improve the flow of information in the market, such as be required standardized disclosure formats, to enable consumers to better match their preferences with the products available in the marketplace. Substantive regulation of terms, however, generally would not be justified under this theory. Alternatively, under a theory of paternalism, it might be argued that *even if* information is freely available to consumers, consumers should simply be prohibited from making certain choices. Regulation grounded in paternalism, however, is much more dangerous in the unintended consequences it can produce precisely because it overrides consumers' assessments of their own best interests in light of the options they have at any given time with the preferences of a bureaucratic agency unfamiliar with the particular context of consumer decision-making. Using overdraft protection is usually cheaper and more sensible than bouncing payments for utilities, rent, credit card accounts, or other bills. Crude and narrow measures of cost, such as APR, exclude many of the important total costs of obtaining and using credit—time, flexibility, and convenience—as well as these other costs of eviction and termination of utility service. Taking away overdraft protection or making it less useful and flexible for consumers and financial institutions will likely result in consumer harm in terms of more dishonored payments, utility service shut-offs, evictions, and other hardship, as well as more time and travel wasted in order to borrow relatively small sums of money.

I. Overdraft Protection: Background

A. The History of Overdraft Protection

Traditionally, American consumers had three primary forms of payment available to them: cash, checks, and more recently, credit cards. The advent and rapid spread of debit cards has added an additional payment system, one which has highlighted the question of overdraft fees because of the perception that debit cards and ATM machines are unusually prone to triggering "unfair" overdraft charges.

When using cash, a consumer bears no risk of overdrawing his account because he is limited to the cash he has on hand. On the other hand, cash is inconvenient and time-consuming to obtain and the consumer bears the risk associated with its loss or theft. Many consumers are reluctant to carry large amounts of cash with them or to make frequent trips to the bank to obtain cash. This in turn creates a liquidity constraint for consumers who use cash because they lack sufficient cash on hand, thus they may be unable to take advantage of a retailer's sale or to purchase goods or services in an emergency. Cash generally is not used to make larger purchases and some merchants will not accept large-denomination bills. Moreover, cash can only be used for face-to-face transactions and cannot be used to pay bills by mail. Accessing large amounts of cash may also arouse suspicion with law enforcement authorities. And while ATMs make it easier to obtain and use cash than in prior eras, there is still a substantial cost in terms of time and inconvenience from ATM visits. Consumers can reduce those costs by making more infrequent ATM visits, but that requires withdrawing and carrying a larger amount of cash per transaction, which raises problems of loss or theft. Using out-of-network ATMs reduce the transaction costs of obtaining cash but usually incurs fees. In addition, using ATMs to withdraw cash can create a risk of overdrafting one's account.

Checks are an ancient response to all of these limits on the usefulness of cash. Checks solve many of the problems inherent in cash by enabling parties to transfer funds among themselves through bank drafts, rather than physically. But checks create new problems of their own because the payment order is separated in time from the actual payment. Even if there were sufficient funds in the account at the time the check was written, there might not be at the time the check clears. This gives rise to the well-known danger that a check might "bounce" and be returned for insufficient funds. In fact, because of bounced check risk, delay in settlement, and the slowness of checks in the checkout line, many merchants today no longer accept checks or do so only under limited, lower-risk circumstances, and instead prefer payment by electronic payment systems such as debit cards.[9]

Bounced checks can be very costly to consumers. Direct fees imposed for checks returned for insufficient funds are substantial. For example, a bounced check may lead to fees imposed by both the payee as well as the financial institution that may exceed $60 total per transaction, an implied APR far higher than for high-cost loans such as payday loans.[10] Moreover, bounced check fees are cumulative—bouncing several checks can result in the imposition of substantial fees each time from both the bank and injured merchants. Dishonored checks also impose indirect costs. If a check is for payment of insurance, the policy will be terminated, and if for utilities (such as telephone or electricity) the bounced check may lead to termination of service, penalties, and a substantial security deposit to reconnect service. Retailers may refuse future service to customers who bounce checks. Bounced checks may also result in termination of a bank account[11] and even a risk of criminal prosecution[12]. In all, these various penalties may exceed hundreds of dollars. Most bounced check occurrences also require physical redemption of the check with payment of cash, which is time-consuming and embarrassing. Bouncing a check is also very damaging to one's credit score, making subsequent access to credit even more difficult.

---

[9] According to one recent study 40% of national retail merchants will not accept checks for the purchase of goods and services. *See* Ed Roberts, *Average Account Overdraft Is $40, but Total Cost is $58, Study Finds*, CREDIT CARD MANAGEMENT (Aug. 22, 2011).

[10] Michael W. Lynch, *Legal Loan Sharking or Essential Service? The Great "Payday Loan" Controversy*, REASON (2002); Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 155 (2004).

[11] According to one news story, at most banks "if you've bounced too many checks you're banned for five to seven years." Douglas McGray, *Check Cashers, Redeemed*, N.Y. TIMES MAGAZINE (Nov. 9, 2008).

[12] Every state provides for criminal penalties for passing bad checks under some circumstances. *See, e.g.*, National Check Fraud Center, *Bad Check Laws by State*, http://www.ckfraud.org/penalties.html.

B. The Growth of Overdraft Protection Programs

Instead of bouncing checks, many banks have instead offered overdraft protection, in which a bank advances funds to clear the check so that it is not returned. Historically, banks occasionally cleared some checks on an *ad hoc* basis that otherwise would bounce. But this courtesy service was highly limited and discretionary, reserved for high income customers with short-term liquidity problems.[13] That overdraft protection traditionally was a benefit for high-income customer is relevant for understanding the current demographics of overdraft usage: the practice originated as an ad hoc courtesy service for high-income customers, not low income. Thus, although overdraft protection now has been made available to middle-class and lower-income bank customers as well, its origin was as a short-term liquidity source for high-income customers. Most customers were denied this *ad hoc* courtesy and thus were forced to deal with the cost, inconvenience, and potential criminal penalties of bounced checks.

Over time, access to overdraft protection has grown as automated overdraft protection has reduced its cost and risk and increased its scale. Automated overdraft protection removed much of the subjectivity and selectivity of discretionary overdraft protection, mainstreaming access to overdraft protection by using automated underwriting and processing systems to control risk and cost and increasing the scale of the program to mitigate risk. The FDIC found in its 2006 survey of 1,171 FDIC-supervised banks that 86% of banks "operated at least one formal overdraft program" and that 40.5% of all banks offered automated overdraft programs.[14] Among larger banks with over $1 billion in assets, 76.0% offered automated overdraft programs.

[13] *See* Regulation E, *supra* note 2.
[14] *See* FDIC STUDY OF BANK OVERDRAFT PROGRAMS 2-3 (Nov. 2008), *available at* http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_Final_v508.pdf.

Approximately 70 percent of banks with overdraft programs implemented their automated programs after 2001.[15] As the use of ATMs and point-of-sale debit cards increased, banks have also extended overdraft protection to those products.[16] As of 2007, the average fee for an overdraft was $26 and larger banking institutions charge higher rates on average than smaller institutions.[17]

Bank revenues from overdraft fees rose from $30 billion in 2005 to $37 billion in 2009 before slipping back to $35 billion in 2010 as a result of new Federal Reserve regulations that reduced the number of consumers using overdraft protection.[18] Overdraft fees constitute a substantial portion of bank revenues, and an even larger percentage for credit unions.[19] According to the FDIC's 2006 survey, overdraft fees on average represent 6% of total net operating revenues of FDIC-insured banks.[20] It is estimated that 90% of overdraft revenues are generated by a relatively small percentage of heavy users.[21]

---

[15] *See id.* at 8.

[16] According to the FDIC study, 81% of banks that operated automated overdraft programs allow overdrafts to be paid at ATMs and POS debit card terminals. *Id.* at 6.

[17] *See* U.S. Government Accounting Office, *Bank Fees: Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts*, GAO REPORT 08-281 at 14 (Jan. 2008). According to Moebs, banks with over $50 billion in assets charge an average of $35 per overdrawn check compared to $26 for all institutions. Press Release, Moebs Services, Consumer Overdraft Fees Increase During Recession: First-Time Phenomenon (Jul. 15, 2009), *available at* http://www.moebs.com/AboutUs/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/65/Default.aspx.

[18] *Overdrafts Pile Up as Opt-In Pays Off, But Were Consumers Misled?*, PAYMENTS JOURNAL (May 5, 2011), *available at* http://www.paymentsjournal.com/Featured_Stories/Overdrafts_Pile_Up_as_Opt-In_Pays_Off,_But_Were_Consumers_Misled_/.

[19] Brian T. Melzer & Donald P. Morgan, *Competition and Adverse Selection in a Consumer Loan Market: The Curious Case of Overdraft vs. Payday Credit* (Working Paper, 2009) *available at* http://www.clevelandfed.org/research/conferences/2010/9-9-2010_household-finance/Melzer_Morgan_2_16_2010.pdf.

[20] FDIC Study, *supra* note 14, at iv.

[21] Press Release, Moebs Services, Overdraft Fee Revenue Drops to 2008 Levels for Banks and Credit Unions (Sept. 15, 2010), *available at* http://www.moebs.com/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/193/Default.aspx.

This growth in the availability and usage of overdraft protection is consistent with consumer preferences. According to a 2009 survey by the American Bankers Association, of those consumers who had paid an overdraft fee in the past 12 months, 96% wanted the payment covered.[22] A 2010 survey found that 69% of those who paid overdraft fees were happy that the payment was covered.[23] Four of six respondents in a small focus group research by ICF Macro conducted in connection with the Federal Reserve's promulgation of its amendments to Regulation E said that they were glad that their debit and ATM transactions were paid even though they triggered overdraft fees.[24] The vast majority of overdraft customers, therefore, self-report that they are happy that overdraft protection was available to cover their payments.

C. Risk of Overdraft Protection to Banks

The risk to banks of offering overdraft protection is nontrivial but reasonable. The historical chargeoff rate for overdraft loans is between 3-5%, comparable to the rate on many other unsecured bank loans such as credit cards.[25] Between 2001-2005 banks closed 30 million bank accounts for recidivist check bouncing.[26] And the average loss per bad account was $310.[27] In the one year period between October 2009 and October 2010, for example, according to data provided, one bank charged-off 53,588 overdraft

---

[22] Press Release, American Bankers Association, ABA Survey: More Consumers Avoid Overdraft Fees (Sept. 9, 2009), *available at* http://www.aba.com/Press+Room/090909ConsumerSurveyOverdraftFees.htm.
[23] Press Release, American Bankers Association, ABA Survey: Most Consumers Avoid Overdraft Fees (Sept. 15, 2010), *available at* http://www.aba.com/Press+Room/091510ConsumerOverdraftSurvey.htm.
[24] Macro International Inc., *Review and Testing of Overdraft Notices* at ii, submitted to Board of Governors of the Federal Reserve System (Dec. 8, 2008).
[25] American Bankers Association, Letter to John Walsh, et al., at 4 (Aug. 24, 2011).
[26] Dennis Campbell, Asis Martinez-Jerez, & Peter Tufano, *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures* (Working Paper, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335873.
[27] FDIC Study, *supra* note 14, at 62.

accounts for a total of $18,733,457.[28] Even if every overdraft or non-sufficient funds charge generated $30 in pure profit with no cost of provision, therefore, it would be necessary to process 10 repaid overdrafts for every account that went bad.

According to data provided by one regional bank, the largest loss risk for financial institutions from overdraft programs is not those customers who overdraft repeatedly although this seems to be a particular concern of the FDIC.[29] Instead, the largest risk arises from low-use or "hit-and-run" customers who open an account with the minimum required balance, conduct several overdrafts in short succession, and then abandon the account. The bank's largest losses on its overdraft program are from new accounts less than three months old. Although frequent overdraft customers may eventually default on an overdraft loan, the fact that they have paid prior overdraft fees typically renders them profitable on average. For this bank, for example, the average chargeoff for free checking customers who default on one overdraft in a year is $188.78. But the aggregate loss on all customers who default on one overdraft is $838,733.80. Moreover, the bank reports that despite its best efforts to ascertain risk of new customers, accurate risk assessment on overdraft accounts remains elusive. Precisely because free checking makes banking available to nontraditional customers, it is difficult to predict who among those customers eventually will default on overdraft loans. Although the bank uses ChexSystem reports (a central reporting service for bounced checks and closed bank accounts) to try to predict risk, it provides little predictive weight for subsequent default on overdraft loans. The size of the first deposit made by a new customer also has no predictive value. Nor is account seniority very predictive: As noted, accounts of 1-3

---

[28] Data on file with author.
[29] Data on file with author.

months old are the riskiest ones for overdraft default losses but older accounts over 24 months old also present substantial risk of loss. It is actually those who overdraft infrequently who present the safety and soundness risk, not those who use the product regularly.

II. The Regulatory Framework

A. Federal Reserve Regulation

In 2009, the Federal Reserve promulgated amendments to Regulation E, governing electronic transfers, to place new regulations on overdraft fees.[30] Under those rules, consumers must affirmatively choose to opt-in to overdraft protection for ATM and point-of-sale debit transactions. The Federal Reserve's justification for its action was its conclusion that based on the responses of participants in a survey of just six people, "participants generally indicated that they would want their checks paid into overdraft" but that the "majority of participants [4 of 6] also indicated that they would prefer an opt-in over an opt-out even if they would choose to have ATM and one-time debit card transactions paid."[31] Even if the responses of this six-person study are generalizable, however, the Fed made no determination of the relative cost of opt-in versus opt-out options on the system as a whole. Thus, if opt-in is substantially more expensive to obtain than opt-out would be, it might still be more efficient to have an opt-out regime even if many consumers would actually choose to opt-out.[32] In the context of securing

[30] 12 C.F.R. §205.17 (Nov. 17, 2009).
[31] Regulation E, *supra* note 2, at 59,036.
[32] For example, even though a majority of consumers arguably would choose to opt-out of telemarketing calls through the National- Do-Not-Call Registry created by the Federal Trade Commission, it might nonetheless be efficient for the rule to be set as an opt-out rather than opt-in rule in light of the relative ease by which consumers could opt out (by adding their phone numbers to the list) versus the high cost and difficulty that telemarketers would have to incur to contact and persuade consumers to opt-in. *See* Posting

consent for banking services such as overdraft protection, it is much easier for consumers to contact the bank than for the bank to track down consumers, especially those who have to be contacted at home. For example, when one large regional bank sought to contact its customers to give them the option to opt-in to overdraft protection for debit cards and ATM transactions, it was unable to contact almost 10% of its customers even after repeated efforts.[33] I have located no authoritative estimate of the impact of adopting an opt-in regime on participation rates in overdraft protection programs, but news reports indicated that participation has declined. About 20% of banks increased the fee that they charged on overdrafts to offset lost revenues from those who opt-out.[34] Because of the cost and difficulty of contacting consumers, many banks chose to not even try to contact customers to solicit their opt in, which included both community banks for whom it was too expensive relative to their somewhat smaller customer base as well as very large banks with such a large and transient customer base that it was financially infeasible to contact them.

On the other hand, for those who have made the effort to contact consumers, a high percentage of consumers chose to opt in and the heaviest users were those most likely to choose to opt in. For example, one regional bank solicited opt-in for overdraft protection for debit card transactions from its largest overdraft users.[35] The bank sought permission from 499 customers that had 25 or more overdraft transactions in 2010. Of the 499 customers, 466 (93%) opted in for debit card transactions and 33 (7%) opted

---

of Todd J. Zywicki to the Volokh Conspiracy, Two New FTC Commissioners and the National Do-Not-Call Registry, *available at* http://www.volokh.com/posts/1092515307.shtml.

[33] Comment of International Bancshares Corporation to the Federal Deposit Insurance Corporation at 6 (Sept. 24, 2010), *available at* http://www.fdic.gov/regulations/laws/publiccomments/overdraft_comments/2010-09-24-ibc.pdf.

[34] In addition, opt-in may create an adverse selection problem as low-risk users who use the product rarely may be more likely not to opt-in.

[35] Data on file with author.

out.[36] This willingness of the heaviest users to opt-in to overdraft protection suggests that they value access to overdraft protection notwithstanding its seemingly high cumulative cost. Overall, 73% of the bank's customers chose to opt-in to debit card overdraft protection. A subsequent survey of the bank's customers by the Raddon Financial Group in June 2011 found that when asked to rank the value of overdraft courtesy protection from "Extremely valuable" to "Not at all valuable," 86% of elevated users stated that the availability of overdraft protection was extremely valuable (only 2% said it was "Not at all valuable").[37] Moreover, the percentage of those stating that overdraft protection is "extremely valuable" rose consistently with the intensity of use, from 57% for non-users of overdraft protection to 86% for elevated users. Overall, of 2,009 respondents to the online survey, 71% said that access to overdraft protection is "Extremely valuable" and another 21% said it was "Somewhat valuable." Only 4% said it was "Not at all valuable."

Market surveys have suggested similar results. According to a survey by Moebs, at various large banks 60%-80% of customers opted-in to debit card overdraft protection, with a median opt-in rate of 75%.[38] According to analysis by the American Bankers Association, 46% of consumers opted-in to one-time debit card and ATM transactions.[39] A study by the Center for Responsible Lending, by contrast, concluded that 33% opted-in.[40]

---

[36] Information provided by International Bancshares Corporation to author.
[37] Raddon Financial Group, Inc., *Custom Survey Research Findings* (June 2011), on file with author.
[38] Overdrafts Pile Up, *supra* note 18.
[39] Press Release, American Bankers Associations, Half of Bank Customers Choose Overdraft Protection (Aug. 31, 2010), *available at* http://www.aba.com/Press+Room/083110OverdraftProtection.htm .
[40] Center for Responsible Lending, Banks Collect Overdraft Opt-Ins Through Misleading Marketing (Apr. 26, 2011), *available at* http://www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/banks-misleading-marketing.html.

Perhaps more significant, Moebs found that almost all of those who use overdraft protection regularly—more than 10 times per year—opted-in to coverage[41] and JP Morgan reported that 53% of those who regularly use overdraft protection opted-in[42]. Similarly, a survey by *Consumer Reports* found that a majority of those who had overdrawn their account in the past six months opted-in to overdraft protection.[43] Although these surveys and studies are not rigorously scientific, they suggest that the most-frequent (and thus presumably the most knowledgeable) users of the product also are those who are most likely to opt-in to overdraft protection when given the choice. As the analysts at Moebs Services put it, "The consumer no longer views overdrafts as a penalty like a parking ticket, but as a safety net."[44]

The recent experience of one bank is also illustrative with respect to overdraft fees at ATMs.[45] Between April 7 and April 30 this year, the bank had 41,273 customers who were alerted when they sought to make an ATM withdrawal that doing so would overdraw their account and asked whether to cancel the transaction or continue with an overdraft charge. Of that group, only 3,380 (8%) initially declined to have the transaction processed with an overdraft fee. Of that group of 3,380 who initially declined to have the transaction go forward, however, 1,470 (44%) came back within 24 hours and opted-in to overdraft protection for ATM transactions. Within 24 hours, therefore, 95%

---

[41] Moebs Services Inc., Press Release, Banks Lower Overdraft Fees as Consumers Choose to Opt-In (Dec. 8, 2010), *available at* http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/197/Default.aspx.
[42] David Benoit, *Customers Opt for Overdraft Protection*, WALL ST. J. (Nov. 26, 2010), *available in* http://online.wsj.com/article/SB10001424052748703678404575636884207120508.html.
[43] Consumer Reports Poll (Nov. 16, 2010), *available at* http://www.consumersunion.org/pub/core_financial_services/017109.html.
[44] Moebs, Banks Lower Overdraft Fees, *supra* note 41.
[45] Data provided by IBC bank and on file with author.

of those who were originally given the opportunity to accept overdraft protection for an ATM withdrawal chose to do so.

This real-world experience rebuts one of the proffered rationales offered by Federal Reserve—but one for which it offers no evidence or even serious theoretical support—that opt-in would paternalistically protect frequent users of overdraft protection from overusing the product.[46] According to Federal Reserve, requiring opt-in would make it more difficult for these consumers to access overdraft protection, which "could therefore best prevent these consumers from entering into a harmful cycle of repeated overdrafts."[47] But experience shows that heavier users of overdraft protection are those who are most likely to opt in to overdraft protection. Standard economic analysis provides a straightforward explanation for this observation: regular users of overdraft protection are those who are most likely to be aware of its costs and to choose to use overdraft protection because they believe it to be superior to their available alternatives. Consistent with standard economic analysis, and contrary to the Federal Reserve's paternalistic approach, making overdraft protection more expensive and less available to the heaviest users is almost certainly likely to reduce their welfare and to impose unnecessary costs on the financial institution in order to reach the desired end by consumers and banks. Restriction has proven to just add cost to those that are supposedly being protected with no obvious benefits.

B. FDIC Guidance

[46] Regulation E, *supra* note 2, at 59,038.
[47] *Id.* On March 1, 2010, the Federal Reserve promulgated additional amendments to Regulation E clarifying some questions raised by the prior rulemaking. 75 Fed. Reg. 9120 (March 1, 2010).

On November 24, 2010, the FDIC issued guidance regarding overdraft fees.[48] Under the FDIC Guidance, financial institutions must take several steps regarding their overdraft accounts. Among its requirements, banks must "monitor [customer] accounts" and "take meaningful and effective action to limit use by customers" of overdraft protection. For example, the guidance provides that with respect to "excessive or chronic" users of overdraft protection—defined as those who overdraw their accounts on more than six occasions in a rolling twelve-month period—the bank must take affirmative steps to provide the customer with reasonable opportunity to choose a less costly alternative, such as linked savings account overdraft protection or a line of credit.[49] Banks are required to institute "appropriate daily limits" on overdraft fees and consider eliminating overdraft fees for transactions that overdraw an account by a "de minimis" amount. Finally, banks are required to "not process transactions in a manner designed to maximize the cost to consumers," which has been interpreted to prohibit posting larger items first.

C. OCC Guidance

In June 2011, the Office of the Comptroller of the Currency also issued proposed "Guidance on Deposit-Related Credit Products."[50] The OCC guidance describes several principles that the OCC expects national banks to follow in connection with any deposit-

---

[48] Overdraft Payment Programs, *supra* note 3.

[49] Since the initial announcement of the Guidance the FDIC has clarified that this requirement can be satisfied by a statement on a customer's monthly statement. *See* FDIC Overdraft Payment Program Supervisory Guidance Frequently Asked Questions, *available at* http://www.fdic.gov/news/conferences/overdraft/FAQ.html. Research suggests that this simple statement may be sufficient to persuade consumers to avoid use of overdraft fees by raising the salience of the issue even if it does not directly lead to a shift to substitute products. *See* Victor Stango & Jonathan Zinman, *Limited and Varying Consumer Attention: Evidence from Shocks to the Salience of Bank Overdraft Fees* (Nat'l Bureau of Econ. Research, Working Paper No. w17028, 2011).

[50] Office of the Comptroller, Guidance, *supra* note 4.

related consumer credit product, and specifically automated overdraft protection programs and deposit advance products. The OCC contends that the purpose of its program is to provide "a high degree of flexibility" for banks to "structure and operate their programs in a prudent and safe and sound manner" that also "provides for fair treatment of customers without dictating specific product terms." Although the rules purport to be only guidance and not to impose specific prescriptive requirements, it is likely to be interpreted as dictating specific requirements.

The OCC's guidance imposes several different requirements. First, it requires disclosure not only of the terms of the overdraft protection program offered but also of any alternative deposit-related credit products offered by the bank (such as tied savings protection). The OCC guidance also requires banks to provide customers with clear disclosure about the order of processing transactions as well as to inform consumers that the order in which they are processed can affect the total amount of fees incurred. Second, the OCC rules urge banks to adopt an opt-in approach for all overdraft protection products, including checks, ACH, and recurring debit card transactions.[51] Unlike overdraft protection for one-time debit transactions and ATM transactions (for which consumer testing by the Federal Reserve suggested about half of consumers preferred to be opt-in), available evidence clearly indicates that an overwhelming majority of consumers want overdraft protection for these larger and more important transactions, so requiring opt-in seems like an unnecessary logistical hurdle. Third, pursuant to safety and soundness requirements, the OCC guidance requires the bank to conduct sufficient analysis to ensure that the customer will be able to manage and repay the credit obligations arising from the product. Fourth, the OCC requires banks to adopt "prudent

[51] For check, ACH and recurring debit transactions the opt-in requirement is prospective only.

programmatic limitations" on the usage of overdraft protection in terms of the number of overdrafts and the total amount of fees that may be imposed per day and per month and any *de minimis* levels.

D. Rationales for Regulation

To date, regulation of overdraft protection has been grounded in purported safety and soundness concerns. But safety and soundness concerns are obviously misplaced. The provision of overdraft protection is a net financial asset to banks that provide it—there is no evidence that banks lose money from it. Individual overdraft loans are quite small, just a few hundred dollars or up to $1,000. In addition, regulators have claimed that there is an undefined "reputation risk" from overdraft protection, a completely unsubstantiated assertion and hard to square with the market trend toward greater availability of overdraft protection for customers. Those who use overdraft protection most regularly—who regularly borrow and repay overdraft loans—provide the *smallest* safety and soundness risk, as they are the customers most likely to generate revenues from overdraft loans that exceed the costs or risk of loss to the bank. Thus, although safety and soundness regulation has focused on heavier users of overdraft protection as presenting particular risk, this focus is obviously nonsensical from a traditional safety and soundness perspective. Overdraft programs are highly effective from a risk-mitigation perspective because of their large scale and small dollar exposure per account, i.e., a large number of accounts with small average balance. On the other hand, safety and soundness can become a real concern if regulators continue to carve away at the revenues generated from overdraft programs, thereby subjecting banks to greater and greater exposure from declining revenues, a reduction in the scale of the program that would spread the risk across a smaller number of customers, and heightened risk of adverse selection. When combined with the negative impact of the Durbin Amendment on interchange fee revenue, excessive interference with overdraft protection could imperil the solvency of the retail banking system as it exists today, producing its own safety and soundness concerns and eventually leading to a major restructuring and retrenchment in retail banking.

On the other hand, purported safety and soundness concerns actually appear to be poorly disguised consumer protection concerns. One suspects that the concern of bank regulators is not that banks will *lose* too much money from the issuance of overdraft protection thereby imperiling safety and soundness, but rather that banks will *make* too much money on the product which many activists believe to be an undesirable product for consumers, notwithstanding their decision to use it. It is precisely because overdraft protection is profitable that it is criticized.

Unlike purported safety and soundness rationales which are completely backward, consumer protection at least provides a coherent (although questionable) rationale for heightened regulation of overdraft protection. But without understanding who uses overdraft protection and why, regulation runs a serious threat of imposing greater cost in the form of unintended consequences than benefits.

III. Consumer Protection and Overdraft Regulation

A. Who Uses Overdraft Protection?

The overwhelming majority of bank customers in the United States never use overdraft protection. According to the FDIC, in 2006, 75% of bank customers never overdrew their bank accounts and 12% overdrew only one to four times. A 2009 survey by the American Bankers Association found that 83% of consumers did not overdraft their account during the past year and that of the 17% who did overdraw, 64% used overdraft protection four or fewer times.[52] A 2010 survey by the American Bankers Association found that 77% of consumers paid no overdraft fees and of those who did, 64% paid four or fewer.[53] Melzer and Morgan found that 86% of bank customers take out fewer than 4 overdrafts per year.[54] On the other hand, some bank customers use overdraft protection dozens of times over the span of a year or two and incur hundreds of dollars in overdraft fees as a result.

Overdraft protection traditionally was used by high-income consumers to address short term liquidity problems. Even though the customer base eligible for overdraft protection has broadened most still use overdraft protection to meet short-tem liquidity needs—even if sometimes recurrent liquidity issues—rather than as a source of long term borrowing. According to data provided by a major regional bank, approximately one-third of all overdraft loans are repaid within 10 days and approximately 90 percent are paid off within a month of the initial credit extension.

It is often asserted without evidence that overdraft protection is used predominantly by low-income consumers. A study by Moebs research firm, however, concludes that the only accurate predictor of the propensity to overdraft is credit score—

[52] Sept. 9, 2009 ABA Survey, *supra* note 22.
[53] Sept. 15, 2009 ABA Survey, *supra* note 23.
[54] Melzer & Morgan, *supra* note 19.

those with lower credit scores are more likely to use overdraft protection.[55] All other demographic information—including income—is non-predictive of the likelihood of using overdraft protection and building a reliable risk model has proven elusive.[56]

Economist Marc Fusaro also finds that among frequent users of overdraft protection there is little correlation between income and overdraft usage: high-income individuals are just as likely as lower income individuals to overdraft, but that higher-income customers' overdrafts typically are larger.[57] Frequent users of overdraft protection also tend to be younger than less-frequent users.[58]

The FDIC study found that accounts held by customers in low-income geographic areas are more likely to incur overdraft charges and that use of overdraft protection is more common among younger bank customers than others. For example, according to the FDIC, 46.4% of those in the 18-25 age range overdrew their account in the 2006 study, while only 12.2% of seniors did. But the FDIC study did not control for credit score, which tends to be correlated with income and age, thus it cannot be determined whether the driving factor was creditworthiness or demographic variables.

There are other reasons to think that overdraft customers are not particularly poor. By definition, overdraft borrowers have a bank account, which distinguishes them from many unbanked consumers and suggests that they have higher and more stable income than users of alternative financial products such as payday lending and pawnshops. Moreover, access to overdraft protection is commonly linked to direct deposit of payroll

---

[55] Press Release, Moebs Services, Who Uses Overdrafts? (Sept. 29, 2009), *available at* http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/194/Default.aspx.
[56] *See supra* note 29 and accompanying text.
[57] Marc Anthony Fusaro, *Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks*, 29 J. FAM. ECON. ISS. 251, 257, 260 (2008); Marc Anthony Fusaro, *Are "Bounced Check Loans" Really Loans? Theory, Evidence and Policy*, 50 Q. REV. OF ECON. & FIN 492, 499 (2010).
[58] Fusaro, *Are Bounced Checks*, *supra* note 57, at 499.

checks, suggesting that many overdraft customers are also steadily employed. Finally, recall that overdraft protection was originally a benefit offered to high-income customers, thus there is no reason to presume that it is a product exclusively or even primarily for low-income customers.

Thus, according to available research, the significant distinguishing feature of heavy overdraft users appears to be their credit score, not their income or other demographic status. After all, overdraft fees can be entirely avoided through responsible financial management: one regional bank found, for example, that 71% of its free checking accounts with average balances of less than $250 incurred no overdraft fees in the one year period between October 2009 and October 2010 (a total of 105,000 accounts).[59] Moreover, the percentage of low-balance accounts that incurred zero overdraft fees during that period (71% of all accounts) was actually *higher* than the overall percentage of *all* accounts at the bank that incurred no overdraft fees (62%).[60] Those who are financially responsible can and do manage even low balance accounts without triggering overdraft fees. Because of their paternalistic focus on protecting irresponsible consumers from overdraft fees, however, regulators have implicitly assumed that overdraft fees are a function of income and have overlooked the important role of consumer responsibility in avoiding overdraft fees.

Infrequent users of overdraft protection exhibit distinct patterns of behavior. Fusaro finds those who overdraft only occasionally (1-10 times in his study) generally make overdrafts that are much larger in size than those who overdraft frequently. He

[59] Data on file with author.
[60] This figure may not be entirely representative as some of those with low-balance free checking accounts may not be actively using those accounts and thus may not be incurring overdraft fees. But it does illustrate the point that whether overdraft fees are incurred is within the control of the consumer and cannot be simply assumed to be a low-income product.

finds that the average overdraft size for those who overdraft occasionally is $306, as compared with $90 for those who overdraft chronically (over 100 overdrafts).[61] This might be explained in several ways. It is consistent with the hypothesis that infrequent overdraft users use overdraft protection to ensure payment of large and important checks, such as for utilities, mortgage payments, rent, or the like. If this is so, it seems unlikely that these occasional users are simply being tripped up by inadvertent use of their debit cards, rather than choosing to use overdraft to clear large and important payment obligations.[62] Alternatively, it might reflect usage by "hit and run" scammers who open a bank account and exploit overdraft protection in several short-term transactions that they never intend to repay.

B. *Why Consumers Use Overdraft Protection*

Overdraft protection usually serves as a short-term source of small-dollar credit in order to meet a pressing need for funds and to prevent important payments such as utilities, rent, or other bills from being denied for insufficient funds. Moreover, those who use overdraft protection do so because it is better than available alternatives. For many, the closest real-world alternative to overdraft protection is payday lending. Other sources of credit are either unavailable (such as credit cards), clearly inferior (such as pawnbrokers), or unwanted because they are longer term or require borrowing larger amounts of money than desired (such as personal finance company installment loans). According to research by Moebs Services, about 19 million Americans use payday

[61] Fusaro, *Hidden Consumer Loans*, *supra* note 57, at 259.
[62] Note that this feature also makes the requirement of opt-in for checks, ACH transactions, and recurrent debit card payments extremely cumbersome and counterproductive for infrequent users, as those most likely to use it for that purpose may be the least likely to anticipate their subsequent need for it and thus to op-in.

lenders and 13 million use overdraft protection every year.[63] Thus, both are popular products with significant market demand. How then do consumers choose between payday loans and overdraft protection—and do they do so rationally?[64]

For most consumers, both payday lending and overdraft protection are fairly expensive compared to mainstream credit offerings such as credit cards.[65] This is to be expected: fundamentally it is and always has been the case that the cost of making small loans to consumers is high relative to the size of the loan. And these costs are reflected in a variety of forms—fees, interest rate, time, search costs, convenience and many others. For example, even if a consumer could shop around and find a slightly lower rate for a payday loan than an overdraft loan, doing so would incur time and shoe leather costs of searching around, the risk of being rejected for the loan, or having to process paperwork and wait for the money. Many of these costs (such as the time spent traveling from store to store, paperwork time, and approval delays) are incurred regardless of the size of the loan and thus are especially costly in relation to the small size of these loans. Similarly, many of the costs of making small loans such as store rent, employee time, paperwork, and credit checks are expensive to amortize over small, risky loans of a few hundred dollars. In light of these basic economics, there simply is no foundation for thinking that the total cost of overdraft loans is exorbitant when compared to alternatives. High price relative to the size of the loan is simply inherent in small loans. But even then, many of the real costs of a small loan are not directly financial at all but include a variety of

---

[63] Press Release, Moebs Services, Payday Loans are a Better Deal for Consumers than Overdraft Fees (Jul. 7, 2010), *available at* http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/169/Default.aspx.

[64] Available evidence indicates that consumers generally use payday loans rationally. *See* Todd J. Zywicki, The Case Against New Restrictions on Payday Lending (George Mason University Mercatus Ctr., Working Paper No. 09-28, 2009).

[65] Credit cards are not always a less-expensive alternative than payday lending and overdraft protection for those whose usage tends to trigger substantial behavior-based fees.

transaction costs in terms of time, effort, and convenience, none of which is captured in a crude and limited measure of cost such as APR and which generally are invariant of loan size.

Payday and overdraft loans share these fundamental economic characteristics that explain why their prices seem high. But payday loans and overdraft protection also differ in several significant ways. First, payday loans are less convenient and flexible than traditional overdraft loans, including the time and "shoe leather" costs of going to a payday lender, waiting in line, and then delivering the cash to a bank or to pay a bill. In fact, payday loans might not even be realistically available in some situations, such as when traveling or in an emergency. Overdraft protection, by contrast, is processed automatically and immediately, 24 hours a day from anywhere in the world, and can be directly triggered by retail or online transactions rather than having to make a special trip to acquire the funds from a payday lender. Consumers who place a higher value on their time or convenience might therefore prefer using overdraft protection rather than going to a payday lender even if payday lending is less expensive. Second, there is a possible psychological cost of payday loans for some consumers in that they might feel embarrassed to be seen patronizing a payday lending storefront or otherwise uncomfortable with going to a payday lending store. By contrast, overdraft protection is done privately, instantaneously, and electronically so there is no concern about outsiders becoming aware of their borrowing.[66] Third, although the fees may be high relative to the amount borrowed, overdraft protection in fact permits the consumer to borrow exactly the amount needed (plus the fee), no more and no less. Moreover, overdraft loans must

[66] For example, the upper-income professionals for whom overdraft protection originally was created might be unwilling to patronize payday lenders or other storefront small-loan lenders.

be paid back within 45 days or the account will be terminated. For payday loans, by contrast, consumers may be tempted to borrow more than they need for immediate purposes and while the overwhelming majority of payday loan customers benefit from and value the option to revolve their payday loan at the end of the loan period, this can lead some borrowers to fall into a "debt trap" of rolling over payday loans or credit card balances. Thus, if consumers fear their inability to precommit to timely repayment, then they might prefer overdraft protection. Finally, consumers who have defaulted on a payday loan simply may find themselves unable to acquire payday loan credit in the future—so payday loans may no longer be an available option. For those consumers, overdraft protection may be the best alternative available in a group of options limited to pawnshops, auto title loans, rent-to-own and other options.

Overdraft protection also benefits consumers by reducing their need to maintain precautionary bank account balances, and in fact those who have bounce protection generally hold smaller precautionary balances. This is valuable for many consumers because checking accounts, especially free checking accounts, often pay no interest. Thus, the ability to reduce precautionary balances enables consumers to keep more of their funds in less-liquid but higher earning accounts.

Overdraft loans also provide a degree of flexibility that many other products lack. For example, when overdraft protection is combined with a debit card it can be used functionally like a credit card, allowing purchases to be made immediately with payment to come later (albeit an expensive credit card). Because overdraft can be used to pay bills, it can also be used to protect access to other types of credit, such as utilities, medical treatment, credit cards, or even payday lending, as overdraft can be used to make sure those payments are honored and thus to avoid costly penalties and termination of service. For example, the effective APR on a bounced check is many times higher than for overdraft or payday loans once all fees are assessed and this doesn't even include the threat of criminal prosecution and bank account termination. A simple financial measure of cost such as APR does not include the value of maintaining access to other types of credit or avoiding the costs associated with not performing on them.

In addition, although payday loans often are less expensive than overdraft fees, this is not always the case. Leaving aside the benefits of overdraft protection in terms of convenience, privacy, and time and shoe-leather costs, there are important differences in the pricing scheme that are relevant to understanding consumer behavior. Payday loans typically charge $15 for every $100 borrowed. Overdraft loans, by contrast, typically charge a fee of $26-$35 *regardless* of the amount advanced. For loans to cover a single small expense of $100 or less, therefore, payday loans are typically less expensive than overdraft loans.[67] For loans of about $200, the price is about equal, and for loans of $300 or above, a single overdraft loan typically will be less expensive. This calculation will vary, of course, depending on whether the consumer is making one overdraft or more. But that is precisely the point—freedom of contract is most likely to more efficient than regulation when consumer preferences are heterogeneous and knowledge of one's needs is highly personal.

In fact, evidence indicates that consumers generally act rationally when choosing between payday and overdraft credit. Federal Reserve economists Brian T. Melzer and Donald P. Morgan have studied consumer decision-making with respect to the choice

[67] Moebs Services, Payday Loans, *supra* note 63.

between payday lending and overdraft protection.[68] They note that the key difference in the way the two products are priced generates predictions about rational consumer behavior. Because the primary price component of overdraft protection is a flat fee (irrespective of the size of the overdraft) rather than a periodic interest rate, rational consumers would tend to use overdraft protection to cover *larger* transactions that otherwise would be declined for insufficient funds. The price of payday loans, by contrast, is tied to the size of the loan (e.g., $15 per $100 borrowed), thus consumers would be predicted to use them to cover *smaller* transactions. This pricing difference also creates a potential adverse selection problem as consumers select the option that gives them the lowest price for any given-sized transaction.

Melzer and Morgan's analysis confirms that consumers generally use overdraft and payday lending in the manner predicted by economic theory. Moreover, they find that in markets where payday loans are available, the number of overdraft attempts and bounced checks *fall* in number (as consumers use payday loans to cover some transactions that otherwise might bounce) but *rise* in average dollar amounts as payday loans continue to be used to cover larger transactions. They find further that in markets where payday credit is available banks reduce the availability of "free" checking for those accounts *without* direct deposit, but not those *with* direct deposit. This is because the presence of direct deposit is a sort of insurance for the bank against "hit and run" customers who open an account without direct deposit anticipating large overdrafts that will never be repaid and then switch to using payday loans to meet short-term credit needs.

[68] Melzer & Morgan, *supra* note 19.

Economist Jonathan Zinman also found evidence of substitution between payday lending and overdraft protection. He found that when Oregon imposed a cap on the finance charge that could be assessed on payday loans, there was a dramatic drop in the number of licensed payday lenders, a short-run deterioration in the overall financial condition of Oregon households, and some evidence that the ban led to an increase in late bill payments and a substitution to greater use of overdraft protection by consumers.[69]

Research by Policis analysts also found a significant substitution effect between payday lending and overdraft protection. In a survey of Australian payday loan customers, they found that if payday loans were not available, approximately 20% of payday loan customers would make greater use of overdraft protection. Those who were most likely to shift to use of overdraft protection tended to be higher-income and have a greater number of alternative credit sources than payday loan customers on average.

A survey conducted by the Raddon Financial Group of customers of a large regional bank asked customers who used overdraft services where they would turn for emergency funds if they no longer had access to overdraft protection.[70] Fifty-three percent of "Elevated users" of overdraft protection reported that if overdraft protection was not available they would "Not be able to get money," as opposed to only 16% of non-users.[71] And while 26% of non-users of overdraft protection said that they would "Use a credit card" if overdraft protection were unavailable, only 10% of elevated users said they would use a credit card (presumably reflecting their lack of access to credit cards or that using a credit card would cause them to exceed their credit lines and lead to

[69] Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap* (Fed. Res. Bank of Philadelphia, Working Paper No. 08-32, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335438.
[70] Raddon survey, *supra* note 37.
[71] 30% of low users and 39% of moderate users said that they would be unable to get money.

penalties). Similarly, while only 6% of non-users said that they would seek a payday loan if overdraft protection was unavailable, 24% of elevated users reported that would be their option (the second-highest response after "Not able to get money" for elevated users). Moreover, while 56% of non-users said in such situations they would simply transfer the needed money from another account (presumably a savings account), only 13% of elevated users said that they would do so, presumably reflecting the simple truth that they have no other accounts available. Regular users of overdraft protection have low credit quality and limited credit alternatives.[72] According to the Raddon survey, for example, only 7% of elevated users of overdraft protection describe their personal assessment of their credit rating as "excellent," while 70% describe their credit rating as "fair" (38%) or "poor" (32%). By contrast, 74% of non-users of overdraft protection describe their credit rating as "excellent" or "good" and only 9% consider their credit rating to be "poor." Thus, reducing access to overdraft protection would simply exacerbate the plight of those who rely upon it because of a lack of better alternatives.

Another survey conducted by Baselice & Associates, Inc., of one bank's customers found similar results.[73] According to that study, 54% of those who self-identified as having "poor credit" thought that overdraft protection was "extremely important," compared to only 18% of those who said that they had "excellent credit." When asked how upset they would be if overdraft protection was eliminated, 62% of those with poor credit said they'd be "extremely upset" compared to only 20% of those with excellent credit. In addition, while 41% of lower-income customers reported that

[72] Raddon Survey, *supra* note 37.
[73] Baselice & Associates, Inc., Banking Survey (Aug. 29-31, 2011), on file with author.

they'd be "extremely upset," 29% of customers with annual incomes over $60,000 also said that they would be extremely upset if overdraft protection were eliminated.

Overdraft protection may be used either to cover unintentional errors (an unknowing lack of funds in one's bank account) or intentionally as a short-term line of credit. Fusaro concludes that approximately 79% of overdraft use is of the first type: clearing payments that otherwise would result in bounced checks. The remaining 21%, he concludes, is conscious use by consumers of overdraft protection as a short-term line of credit.[74] Intentional overdrafters tend to borrow the money for longer durations, a rational strategy in light of the flat-fee pricing scheme in which the fees are front-end loaded. This suggests that many chronic overdrafters use overdraft protection intentionally as a short-term line of credit and becoming more sophisticated and knowledgeable about the most efficient ways to use overdraft protection as they become more experienced.[75]

Overall, Fusaro concludes that on average consumers gain a consumer surplus of approximately $50 per year from the availability of overdraft protection and the accompanying benefits of avoiding NSF fees and maintaining lower precautionary balances, or $2 billion economy wide.[76] Fusaro and Ericson conclude that overdraft protection is generally welfare improving for middle-class bank consumers and neutral for low-income consumers.[77] They conclude that eliminating overdraft protection

---

[74] Fusaro, *Are "Bounced Check Loans" Really Loans?*, *supra* note 57, at 499.
[75] Marc Anthony Fusaro, *Consumers' Bank Choice and Overdraft Volume: An Empirical Study of Bounce Protection Programs* (Working Paper , 2003).
[76] *Id.*
[77] Marc Anthony Fusaro & Richard E. Ericson, *The Welfare Economics of "Bounce Protection" Programs*, 33 J. CONSUM. POL'Y 55, 71 (2010).

"through excess regulation would hurt the most vulnerable population most, as they have the fewest alternatives to maintain necessary liquidity."[78]

C. Do Consumers Understand the Cost of Overdraft Protection?

Evidence that consumers generally tradeoff usage of overdraft protection and payday loans in a manner consistent with the predictions of economic theory also suggests that consumers are generally aware of the costs of overdraft protection compared to various alternative forms of credit and tend to use those which are most efficient in light of the limited options that they have available to them.

The pricing of overdraft protection is simple and seemingly transparent. Attached as Appendix A is the form "Overdraft Courtesy Customer Disclosure" for one bank's free checking account. As can be readily seen, the costs of overdraft protection are clearly disclosed, easily understood, and the criteria for available line of credit are plain (such as whether one has an overdraft account linked to a direct deposit account or not). The fees are clear: $29 per overdraft, up to a maximum of six charged overdrafts per day (after which additional overdrafts within the credit limit are free), and an 18% APR for any overdraft loan. The bank will not charge any overdraft fees for *de minimis* balances of less than $3. The bank also clearly discloses its clearing order from highest to lowest for various types of charges. Finally, it states that if the overdraft is not repaid within 45 days the account will be closed.

In short, the disclosure is clear, concise, and easy to understand. Moreover, although overdraft protection has been the source of criticism and regulatory scrutiny, it has not been claimed that consumers fail to understand the costs of or criteria for

[78] *Id.*

overdraft protection. Instead, criticism has focused on paternalistic rationales that even if consumers fully understand the costs of overdraft protection, they nonetheless should not be permitted to use it "chronically" or "excessively"—as those terms are defined by bank regulators.

In connection with the Federal Reserve's amendments to Regulation E, Macro International Inc. conducted consumer surveys to see if consumers understood standard disclosure forms regarding overdraft protection. They found that consumers understand the concept of overdraft protection—that the institution will cover its customers' overdrafts for a fee—and that they would be enrolled in the service automatically unless they opted-out.[79] They also understood what would happen when they overdrew their account through an ATM, debit card, recurring debit, or check transaction. Subsequent research confirmed these findings that consumers are able to understand overdraft programs.[80]

Research on payday loans also confirms that payday-loan customers are generally aware of the cost of payday loans. According to Elliehausen, only two percent of payday-loan customers reported that they did not know the finance charge for their most recent new payday loan; 94.5 percent reported finance charges consistent with prevailing market prices.[81] Those who used payday loans most often were also most likely to know the reported APR on their loan.[82] Whatever concerns have been expressed about payday loans, lack of transparency is not one: Payday-loan pricing is simple and easily

---

[79] *See* Macro International Inc., *supra* note 24.

[80] ICF Macro, *Design and Testing of Overdraft Disclosures: Phase Two*, submitted to Board of Governors of the Federal Reserve System (Oct. 12, 2009).

[81] Gregory Elliehausen, An Analysis of Consumers' Use of Payday Loans 35, 36-37 (Fin. Servs. Res. Program, Monograph No. 41, Jan. 2009).

[82] *Id.* at 38.

understood.[83] Given the predominantly flat-fee nature of overdraft protection, it seems probable that those who use overdraft protection (especially those who use the product regularly) are aware of its cost as well as available alternatives. Moreover, to the extent that consumers are unclear about some terms of overdraft protection, their uncertainty relates to specific details, such as the fact that the bank is not required to pay an overdraft in some situations, not the price charged for an overdraft.[84]

IV. Overdraft Protection and Free Checking

A. Overdraft Protection and the Economics of Retail Banking

The expansion in the availability of overdraft protection has also helped to transform the consumer banking system over the past decade, especially by spurring rapid growth in the availability of free checking and other bank services, increased innovation, and expanding access to bank services for previously-excluded consumers. The link between overdraft fees and free checking is a tight one: overdraft protection is essential for free checking to exist for low-balance consumers. Low-balance customers have little margin for error in managing their affairs—absent overdraft protection, these consumers might bounce checks and other payments with great regularity. For low-income consumers, overdraft protection essentially serves as a substitute for higher required minimum balances or other fees that would be necessary to cover the cost and risk of serving these customers. Overdraft protection, which provides a line of credit to insure payment of obligations after the fact, is a substitute for requiring higher precautionary balances as insurance ahead of time that payments will be honored.

---

83 As one news story characterized payday lending terms, "[N]o surprises, no hidden fees." McGray, *supra* note 11.
84 ICF Macro, *supra* note 80.

Indeed, the shorthand term "free checking" hardly captures the full value of a standard demand deposit account to consumers today. In fact, the typical "free checking" account today includes a bundle of valuable services: free debit card usage, free ATM access, free on-line bill payment, free mobile banking, and a host of other services. One bank estimates that the value of the products bundled in its "free checking" account is $751 per year.[85] The bank makes up the cost of providing that bundled service in a variety of ways, one of which is through revenue generated by overdraft protection.

The past decade saw a revolutionary transformation in the pricing of bank services, away from the traditional pricing model of flat-fee monthly service fees to a combination of free checking and other bundled banking services, offset by growing debit card interchange and overdraft revenues.[86] There is a very close link between the spread of overdraft protection and free checking. Although banks began mainstreaming free checking in the late-1990s, between 2001 and 2009 the percentage of accounts at large banks that qualified for free checking rose dramatically from 7.5% to 76% and the average minimum balance required for free checking fell from $440 in 2001 to $186 in 2009.[87] This growth in access to free checking appears to have arisen from two sources: the simultaneous growth in the availability of overdraft protection and the rapid increase in the use of debit cards and the interchange fee revenues that they generate. Bringing

---

[85] Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 4. Obviously this is an interested estimate, but "free checking" today includes multiple valuable services for which consumers otherwise would have to pay.

[86] *See* Stango & Zinman, *supra* note 49.

[87] David S. Evans, Robert E. Litan, & Richard Schmalensee, *Economic Analysis of the Effects of the Federal Reserve Board's Proposed Deb it Card Interchange Fee Regulations on Consumers and Small Businesses* (Feb. 22, 2011), *available at* http://www.federalreserve.gov/SECRS/2011/March/20110308/R-1404/R-1404_030811_69120_621655419027_1.pdf. With the onset of the Durbin Amendment's price controls on interchange fees for large bank customers, by 2011 free checking had plummeted to only 45% of bank accounts. *See* Claes Bell, *Abracadabra: Free Checking Disappears*, BANKRATE.COM (Sept. 26, 2011), *available in* http://www.bankrate.com/finance/checking/abracadabra-free-checking-disappears.aspx.

lower-income consumers with lower average balances into the banking system also has brought with it greater risk that those consumers will bounce checks or otherwise miss payments. Absent universal access to overdraft protection, it is likely that average minimum balances would be raised and monthly fees reimposed. To reduce risk exposure many financial institutions also link the availability of free checking or the size of the available overdraft line of credit to a commitment to paycheck direct deposit.

The reduction in the availability of free checking in the immediate period after the Federal Reserve's amendments to Regulation E took effect, illustrates the competitive nature of the market. According to Evans, Litan, and Schmalensee, "within days" of the Fed's announcement of its new rules banks starting scaling back access to free checking, imposing new fees, and eliminating services for consumers. The number of accounts eligible for free checking fell 11 percentage points—from 76% in 2009 to 65% in 2010—a figure that translates to approximately 20 million accounts.[88] Although some of these adjustments may be attributable to other factors, such as the ongoing banking crisis, much of this change is attributable to the new restrictions on overdraft protection.

Market experience also suggests that overdraft protection is popular with consumers and that bank consumers prefer the combination of zero up-front maintenance fees and lower required balances with overdraft protection to the traditional model of monthly maintenance fees and higher minimum required balances. Consumers have tended to migrate to banks that offer overdraft protection (and thus lower required monthly fees), which has increased the market share of those banks and put competitive pressure on competitors to respond.[89] Access to overdraft protection allows consumers to

[88] *See* Evans, Litans, & Schmalensee, *supra* note 87.
[89] Fusaro, *Consumers' Bank Choice*, *supra* note 75.

hold smaller precautionary balances in low-interest demand deposit accounts, which also leads them to overdraft their accounts more often.[90] Moreover, an obvious but often-ignored point is that consumers can easily avoid paying overdraft fees simply by not spending more money than they have in their account, and can avoid overdraft charges by better financial management or by holding larger precautionary balances. Overdraft loans are created by the customer, not the bank—the customer decides whether to draw on his overdraft line of credit.[91]

For example, a Federal Reserve study published in 1999, when free checking was still somewhat uncommon, illuminates the tradeoff between various types of banking fees. The study found that checking accounts that did not require customers to consistently maintain a certain minimum balance through the month also imposed higher fees for various services.[92] According to the study, for non-interest bearing accounts (the closest analog to free checking today) the average required minimum balance was $348, and the average monthly fee was $5.50 if the minimum balance was not maintained. Moreover, these accounts had additional fees for many other services and reduced services generally. Although the monthly maintenance fee was slightly higher for interest-bearing accounts, once the additional fees were considered, bank customers with a no minimum-balance account paid $12.30 each month in higher monthly fees (approximately $250 per year) than those who maintained a certain minimum balance. Thus, as would be expected in a competitive market, there has always been a tradeoff between different bank fees and other requirements. The market response to Regulation

[90] Fusaro, *Are "Bounced Check Loans" Really Loans?*, *supra* note 57.
[91] Recall, for example, that 71% of low-balance free checking accounts at one bank never incurred overdraft fees. *See supra* note 60.
[92] Joanna Stavins, *Checking Accounts: What Do Banks Offer and What Do Consumers Value?*, NEW ENGLAND ECON. REV. 3, 6 (March/April 1999).

E and the subsequent market responses to the imposition of the Durbin amendment are consistent with the predictions of the banking industry as a competitive market where sustainable economic rents are absent.

B. The "Fairness" of Overdraft Fees

Critics of overdraft might protection might argue that even though there are no demonstrable economic rents generated by overdraft fees, overdraft fees should nonetheless be regulated because they are "unfair." "Fairness," of course, is an entirely subjective and arbitrary concept. To the extent that the term has any meaning in this context, it appears to express a concern that the actual operation of overdraft fees results in a cross-subsidization by some consumers by others, as the minority of bank customers who pay overdraft fees sustain the system and provision of free services, innovation, and expanded service for the larger number of those who do not.

The vast majority of bank consumers pay zero or few overdraft fees, meaning that they gain access to bank accounts at very low cost. Moreover, the FDIC estimates that for those customers who conducted 1 to 4 NSF transactions during the prior year on average were charged $64 in NSF fees—or approximately $5 per month—less than that person would have been expected to pay in monthly bank fees prior to the spread of overdraft protection. Even a consumer with 5 to 9 NSF transactions paid on average $215 year, or about $15 per month. In addition, of course, the consumer avoided ancillary costs of bounced checks, late fees on other bills, etc. On the other hand, the bulk of overdraft fees are accumulated by heavy users of the product, but presumably they are most aware of the cost and the alternatives available to them and find it most necessary to use overdraft protection in light of available alternatives.

Is it "unfair" that most bank customers benefit from this system by receiving valuable bank services at low or zero costs, while bank customers who pay substantial overdraft fees appear to pay fees in excess of what they receive in exchange? As an initial matter, economics establishes that because those who use overdraft protection do so voluntarily their behavior establishes that in fact they do receive value in excess of what they pay, albeit value not entirely in direct banking services but in convenience and avoidance of higher alternative costs.

The claim of unfairness founders on another conceptual problem: consumer cross-subsidies are ubiquitous in the modern economy, yet few people consider most of these cross-subsidies to be "unfair" in some way. For example, customers who purchase items on sale or with a coupon pay less than those who do not. Some consumers pay more to buy a book in hardback when it is first released while others are more patient and buy it at much-cheaper paperback prices. Those pay full price for movies subsidize those who attend matinee showings. Indeed, those who buy on sale or with coupons are typically commended for being thrifty and responsible shoppers although this means that they are being effectively subsidized by those who pay full price. That some bank consumers subsidize free checking for others through overdraft fees seems no more unfair than consumers who pay full price or attend full-priced movies, thereby subsidizing others who are patient and buy on sale. It cannot be contended that the simple existence of consumer cross-subsidies in the retail economy is inherently unfair, yet it is difficult to understand what the "fairness" critique of overdraft fees could mean.

Banking services are no exception to this rule. Today, banks offer a wide variety of services (many of them provided for free), but all of those are funded by a relatively small number of revenue streams. Different customers use different services supported by these streams and few consumers would prefer that every service be priced on an a la carte manner.[93] For example, some consumers physically go into branches to conduct transactions, thereby using the rent, heat, and employee time that others do not. Yet no banks of which I am aware charge a fee for those who use a teller window, even though those who do not use tellers are forced to subsidize those who do. Nor have bank regulators sought to prohibit this "unfair" cross-subsidization of those who use tellers. Similarly, banks that offer free parking or drive-through banking subsidize those who drive rather that walk or take public transportation. Similarly, some customers use online bill pay or other services that are offered for free as part of a bundle of products and others do not. Banks offer all of these "free" services as a bundle—debit cards, tellers, heat, free parking, drive-through windows, online banking, and a myriad of other services—even though they result in cross-subsidies because of competition and customer demand. There is simply no sound policy justification for the arbitrary assertion that the only appropriate pricing scheme for banking services is one that is *a la carte* and that bundling services or cross-subsidizing consumers as competitive circumstances demand is a fundamentally flawed pricing scheme. Even more unsustainable is the notion that every one of these other cross-subsidies is "fair" and permissible and that overdraft protection alone is arbitrarily condemned on this ground.

[93] Similarly, few consumers seem to prefer paying separate baggage fees for checked bags on every flight rather than having those fees bundled into the price of their ticket.

In fact, like all of these other market-driven cross-subsidies, the expansion of overdraft and the accompanying increase in access to free checking and other innovations is the product of competition among banks that has benefited consumers overall. For example, as free checking has expanded over the past decade so has the number of bank branches nationwide, the number of services offered, and banking hours generally have been extended.[94] The number of bank branches nationwide grew from 64,900 in 2000 to over 83,000 by the end of the decade.[95] Local banks have opened branches inside supermarkets and other retailers, thereby expanding the number of branches and the hours during which a teller is available to assist with banking services.[96] Rarely are consumers charged on a piecemeal basis for this increased choice and customer service, but rather all of these efforts are funded out of a handful of revenue streams.

Once the trade-off between free checking and overdraft protection is recognized, however, the concern about whether the current allocation of banking fees is consistent with some arbitrary definition of "fairness" is overwhelmed by a more significant point: the development of the current pricing model has promoted competition, innovation, and expanded access to the mainstream banking system to many consumers who traditionally were excluded and the return to older fee structures. Replacing the outcomes of market competition and consumer free choice with those preferred by bureaucratic design of prices and products will reverse all of these beneficial trends. Regulatory policies that result in the elimination of free checking and the imposition of higher fees will drive

[94] The number of branches of commercial banks rose 39% between 1988-2006. *See* Timothy H. Hannan & Gerald A. Nanweck, *Recent Trends in the Number and Size of Bank Branches: An Examination of Likely Determinants*, 23 J. OF FIN. TRANSFORMATION 155 (2008) (Capco Institute).

[95] FDIC, Table CB01, *available in* www.fidc.gov/hsob/hsobRpt.asp.

[96] Between 2003 and 2008 the number of retail-based bank branches increased from 5,581 to 6,162. *See* Kevein Dobbs, *In-Store Branches Could Boost Growth for Some Banks in the West* (Sept. 1, 2009), *available in* http://branchlocation.com/showArticle.php?id=68.

many consumers out of mainstream financial services and force them to rely on alternative financial products, such as check cashers, prepaid card issuers, and rent-to-own companies. While those credit providers play a crucial and valuable role in serving certain members of the economy, especially unbanked consumers, it is difficult to conceive of a justification for government policies that promotes reduced access to mainstream banks and greater reliance on those products. Yet this is the predictable unintended consequence of the cascade of government regulation since the financial crisis. In fact, as restrictions on overdraft fees and the Durbin Amendment's price controls on debit card interchange fees have bitten deeper, these trends have been reversing. Fewer customers are now eligible for free checking, new fees have been imposed on existing services, quality and convenience have declined, and banks have begun closing branches. It is hard to see how these trends will benefit consumers.

V. Competition and Overdraft Protection

If overdraft fees were simply a novel tool for banks to rip-off consumers then the growth of revenue from overdraft protection would be correlated with an increase in bank's bottom line profitability overall. Or, in economics jargon, the growth in interchange fee revenues would evidence "economic rents" or "economic profits" for those banks that have adopted overdraft protection. But, in fact, there is no evidence that risk-adjusted bank profitability has increased substantially during the period that overdraft protection has spread and overdraft revenues have risen. Instead, profitability of depository institutions has remained relatively constant over time, even though overdraft revenues have risen substantially. Indeed, the crisis in bank solvency that began in 2008 developed just as revenues from overdraft fees reached their peak. Nor is there any obvious difference in the overall profitability of those institutions that offer overdraft protection versus those that do not. This absence of any systematic evidence of major economic profits linked to the provision of overdraft protection suggests that the increased use of overdraft fees has been driven by the competitive need to meet growing consumer demand not oppressive or unfair behavior by banks.

The apparent absence of risk-adjusted economic profits can be explained by several different, overlapping explanations. First, although overdraft revenues have increased, bank risk and loss has increased as well by bringing into the banking system lower-income consumers with lower average balances, narrower profit margins for banks and lower credit ratings. Moreover, as noted, the average loss on a non-paid overdraft loan is approximately \$300, roughly ten times the amount of the standard overdraft fee (\$30)—suggesting that approximately 10 or more successfully repaid overdraft loans are necessary to offset the losses from one defaulting overdraft customer.

Further evidence that overdraft protection does not generate economic rents is the rapid spread of the product and general satisfaction with those who use overdraft protection regularly. The banking industry is highly competitive.[97] This high degree of competition in the banking industry suggests that if any economic profits are earned from overdraft protection they are dissipated in the competitive process of extending banking services to more consumers or reducing other banking fees, such as monthly account maintenance fees. Banks offering overdraft protection also compete with non-bank products such as payday lending and evidence suggests that if the cost of overdraft protection became unduly high relative to those alternatives, then consumers could and

[97] Evans, Litan, & Schmalensee, *supra* note 87.

would shift to those alternatives. Circumstantial evidence is provided by the absence of economic rents in the payday lending industry once risk and cost are considered [98] and the beneficial effect of competition on payday loan prices.[99]

Finally, the cost of retail banking has risen during the past decade as banks have increased the quality of bank services through innovation and expanded services, thereby competing away increased revenues from overdraft protection and debit card fees. Of course, the opposite is true as well: if revenues from these are forcibly reduced, then banks will be forced to cut costs and services, closing branches and charging for services that were formerly free. This economic reality is already appearing in the market place as regulations are causing many banks to abandon free checking and to adopt "a la carte" charges on products and services previously offered without charge. Rather than imposing new fees, other banks have chosen to trim costs by closing branches or otherwise reducing services.[100] Again, there appears to be no coherent regulatory principle that would support the principle that the combination of lower revenues and a lower level of consumer services is preferable to the alternative from a safety and soundness perspective and thus should be encouraged by law.

VI. Unintended Effects of Regulation of Overdraft Protection

Regulation of the terms of overdraft loans may also have negative unintended consequences. As noted, the Federal Reserve's amendments to Regulation E, which

---

[98] *See* Paige Skiba & Jeremy Tobacman, *The Profitability of Payday Loans* (Working Paper, 2006).

[99] Donald P. Morgan, *Defining and Detecting Predatory Lending* (Fed. Res. Bank of New York, Staff Report No. 273, 2007); Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing* (Fed. Res. Bank of Kansas City, Working Paper No. 09-07, 2009); *see also* Philip Bond, David K. Musto, & Bilge Yilmaz, *Predatory Lending in a Rational World* (Fed. Res. Bank of Philadelphia, Working Paper No. 06-2, 2006).

[100] *See* Nelson D. Schwartz, *Branch Closings Tilt Toward Poor Areas*, N.Y. TIMES (Feb. 22, 2011), *available in* http://www.nytimes.com/2011/02/23/business/23banks.html?pagewanted=all.

adopted an opt-in regime for debit card overdraft protection, had the severe effect of reversing a decade-long increase in the percentage of free checking accounts at banks and subsequent regulation has accelerated this trend.[101] Moreover, most of the regulations are patently absurd from a safety and soundness perspective: banking regulators have singled out for special concern the most profitable customers and terms of overdraft protection products without any empirical evidence or even plausible economic theory about how reducing revenues could improve safety and soundness.[102] Moreover, overdraft programs have grown over the past decade, increasing their scope and volume, without any tangible evidence of heightened safety and soundness risk. In fact, most of these purported safety and soundness concerns are actually consumer protection concerns in disguise. An awareness of the incoherent nature of the safety and soundness concerns expressed by bank regulators may explain the tentative nature of many of these regulations.

Leaving aside these incongruities in safety and soundness issues, regulations could have unintended consequences for consumers and the banking system if interpreted in an unduly prescriptive manner. In addition, even if the FDIC's approach is characterized by some degree of restraint, there remains a looming threat that the newly-formed Bureau of Consumer Financial Protection which might seize the authority to regulate overdraft protection in a less-measured and less-informed manner, thereby potentially harming consumers and the economy.

A. Regulating the Posting Order of Transactions

[101] *See* discussion at *supra* note 88, and accompanying text.

[102] Note the obvious point which actually must be stated in this context: simply because a customer or term is highly profitable (and thus beneficial from a safety and soundness perspective) does not mean that it is adverse to the interests of consumers. Profits in a free market economy generally are earned by providing a service that consumers desire and value.

The FDIC Guidance requires that banks not process transactions in a manner designed to maximize overdraft fees. As an example, the FDIC has suggested clearing items in the order received or by check number. Although the formal guidance does not speak further to the issue, the FDIC has stated that the practice of many banks of re-ordering transactions to clear payments from the largest to smallest value items as many banks is impermissible under the FDIC's guidance because this will "tend to increase the number of overdraft fees."[103] The FDIC's justification for the rule is belief that it will improve consumer welfare by reducing the number of payments that bounce—by clearing multiple small payments first, the absolute number of payments that bounce will be reduced. The traditional convention of clearing larger payments first, by contrast, results in a more rapid depletion of funds which then leads to a larger number of smaller payments being rejected later thereby incurring a larger number of overdraft or bounced check fees.

Although it is plausible that requiring smaller payments to be posted first will reduce the total amount of overdraft fees, the FDIC's narrow focus on minimizing the total *cost* of overdraft protection ignores the potential *benefit* of overdraft protection to consumer. Requiring clearance from lowest to highest dollar value is contrary to the practice of many institutions which has been to clear larger items first—usually checks and ACH payments—under the assumption that larger items tend to be more important items such as payments for mortgage, rent, utilities, or other high-priority payments that consumers would want to be sure would be paid. Although a requirement that smaller

[103] *See* FDIC Overdraft Payment Program Supervisory Guidance Frequently Asked Questions, No. III.4. According to a 2009 survey, approximately 20 percent of financial institutions reportedly used the practice of clearing transactions from larger to smaller obligations. Moebs Services, Consumer Overdraft Fees, *supra* note 17.

payments to be cleared first would likely reduce the cost of overdraft fees, it ignores that the *benefit* of paying larger items is usually greater because the consequences of dishonoring larger payments are more severe. Overdraft protection programs limit the amount of overdraft credit that can be extended, from $300 for low-balance free checking accounts up to $500 or $800 for more stable accounts. As a result, one large check added on top of several previously-paid small debit card payments might exceed the available credit balance available for overdraft protection, leading large and more important payments to be rejected because honoring them would exceed the available credit line.

In fact, a report by the Raddon Financial Group of one bank's overdraft program found that 58% of its customers preferred that larger items be posted *first*, even though that might result in more overdraft charges in total.[104] Among "elevated users" of overdraft protection the percentage that preferred larger items to be posted first rose to 60%. Thus, the FDIC guidance contradicts the expressed preferences of a majority of the bank's customers, especially those who use overdraft protection most frequently, making consumers worse off. Put more mildly, government interference in contract terms typically is justified only if there is manifest evidence of a failure of market terms to reflect consumer preferences. The findings of the Raddon Report, while subject to qualification about its methodology, strongly suggests that more hard data is necessary before concluding that the contracted-for clearing order reflects a market failure rather than a term best left to be established by competition and free choice, especially with respect to more frequent users.

The problems that the FDIC's guidance can cause in practice is illustrated by the experience of one bank after it changed its policy in October 2010 to comply with

[104] Raddon survey, *supra* note 37.

regulatory guidance to clear debit card payments before checks on the assumption that in general debit transactions are smaller in value than checks.[105] As a result, the bank has returned unpaid many more large payments than in the past. Comparing the two-month period before the rules went into effect with the two months following, the bank reports that the total number of checks and ACH items returned increased 4%, but the dollar value of the rejected payments returned increased 16%. Moreover, many of those returned payments were for important items like payments of mortgages, utilities, medical bills, student loans, rent, taxes, and even payday loans. Thus, while the rule might reduce the amount of overdraft fees paid, it comes at a heightened risk of rejecting larger, more important payments. It is far from obvious that this tradeoff improves consumer welfare. It is even less obvious that this is an appropriate issue to be resolved by a one-size-fits-all FDIC mandate that overrides consumer choice rather than voluntary agreement between banks and their customers.

B. Special Rules for "Excessive or Chronic" Overdraft Customers

The FDIC Guidance also requires banks to make special efforts to educate consumers who engage in "excessive or chronic use" of overdrafts, defined as making use of overdraft protection more than six times in a twelve month period. Defining "excessive or chronic" use as six instances in a twelve month period, of course, is entirely arbitrary. The rationale for this regulation appears to be that there is some arbitrary number of overdraft transactions that regulators consider to be simply "too many" transactions and for which consumers would be better served by choosing some other means to meet those goals. The basis for this belief or this arbitrary number, however, is

[105] The information discussed in this paragraph was provided to the Mercatus Center by IBC.

unclear. Indeed, actual consumer behavior and revealed consumer preferences suggest that the basis for this opinion is paternalism by FDIC officials and is based on little or no investigation of the habits of those who use overdraft protection regularly. There is no reason to believe that the most regular users of overdraft protection are unaware of its cost or available alternatives. Therefore, it seems unlikely that these admonitions will cause many consumers to change their behavior. To be sure, some minority of bank customers may misuse overdraft protection and incur substantial fees. But if the events of recent years have taught anything, it is that virtually every type of consumer credit product can be misused or overused, including even traditional mortgages.

As with virtually every other aspect of overdraft protection, this paternalistic regulation is least popular with the most-frequent users of overdraft protection. According to the Raddon survey, although 89% of non-users of overdraft protection would want to be contacted after six overdrafts occur within a year, only 60% of elevated users would like to be contacted. Elevated users were also those most likely to opt-out of these notices if they could (33%). Thus, according to the survey, a majority of elevated users (those who are most likely to actually incur six overdrafts in a 12 month period) would want to be alerted when they reached six occurrences. On the other hand, providing such notice would incur some cost—had the survey asked whether customers would be willing to *pay* in order to receive such notice (even a nominal fee such as processing and mailing costs), one suspects that the percentage of those who responded affirmatively would drop substantially, especially among elevated users.

Moreover, very few customers are likely to even be able to establish an alternative payment source for overdrafts. For example, in a filing with the FDIC on the proposed rules, one bank stated that of its 327,865 free checking accounts only 49,616—approximately 15%—have savings accounts at the bank.[106] Moreover, that figure includes *all* free checking customers: The number of customers with free checking who have a savings account and have used overdraft protection is probably even smaller in light of the fact that those with sufficient funds to have a savings account are probably also less likely to overdraft.[107] This small percentage of free checking customers is consistent with the findings of the Raddon survey, which found that only 13% of elevated users of overdraft would "transfer funds from another account" if overdraft protection was unavailable. The reason why repeat users of overdraft protection do not use linked savings accounts or other similar options is not because the do not realize that those options would be less expensive, they do so because those options simply are not available to frequent users and to do without overdraft would force them to either do without the money (and suffer the resulting consequences) or use a payday lender.[108]

The FDIC Guidance also suggests that some customers may find it less expensive to open a bank line of credit. This is true—but almost certainly irrelevant for most overdraft users because acquiring a discretionary line of credit requires a standard loan application and approval, which requires a credit score far in excess of that of most of the bank's overdraft users. As noted, regular users of overdraft have low credit quality and

---

[106] Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 12 n.8. Overall, the bank has 446,288 checking accounts with overdraft protection. Of those customers, only 62,310 have a related savings account but only 19,105 have chosen to sign up for its overdraft transfer protection that automatically transfers funds from the customer's savings account to his checking account to cover payments when necessary.

[107] According to the Raddon survey, almost half of elevated users of overdraft protection at one bank reported that they did not have sufficient funds to maintain a separate account from which overdrafts could be drawn. Raddon Survey, *supra* note 37.

[108] These findings on the reasons for using overdraft protection in light of available alternatives are consistent with the usage of other alternative credit products, such as payday lending. Zywicki, Payday Lending, *supra* note 64.

limited credit alternatives. In addition, a line of credit typically requires a minimum line of credit of approximately $2,500, far exceeding the $300-$800 available for overdraft protection. In fact, the spread of overdraft protection was hastened by the regulatory and economic difficulties of offering a line of credit to consumers.[109] Few of those who use overdraft protection are likely to be approved for such a large line of credit. But if the bank were to offer a smaller line of credit then the cost would rise substantially. In the end, therefore, the FDIC Guidance is almost completely irrelevant to the typical elevated user of overdraft protection, although the need to comply with the guidance will impose unnecessary administrative costs on banks and will have negative consequences for consumers.

VII. Conclusion

Regulation by anecdote is always dangerous and regulation of overdraft protection based on unrepresentative anecdote presents the risk of injuring consumers and the safety and soundness of the banking system. Safety and soundness regulators are targeting those borrowers who provide no safety and soundness risk (regular users who generate a net profit for banks). Moreover, it is these very same heavy users who report that they are the least likely to have easy, low-cost alternatives to overdraft protection and thus are the most likely to be diligent in maintaining their access to overdraft loans in good standing. Lacking any identifiable safety and soundness threat or identifiable market failure or evidence of consumer ignorance, regulation can be supported by only bald paternalism. And as the lessons of history indicate, paternalistic regulation of consumer credit products tends to injure precisely those it is intended to help, by driving

[109] Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 4.

them to use less-preferred credit or reducing their access to credit generally, with all of the ancillary consequences.

The Federal Reserve's amendments to Regulation E implemented last year dealt a major blow to the availability and usefulness of overdraft protection for many consumers. The FDIC's regulatory guidance threatens overdraft protection further. The OCC has raised concerns in its guidance as well. Undoubtedly, some consumers misuse overdraft protection. But as recent years have amply demonstrated, every type of consumer credit is potentially subject to misuse—even traditional mortgages. For millions of consumers, overdraft protection provides a short-term lifeline that enables them to avoid more expensive problems, such as bounced checks, eviction, late fees on credit cards, or utility shutoffs. Lacking overdraft protection, many of these consumers could turn to less-preferred alternatives such as payday lending. Regulators should be careful to ensure that in trying to prevent abuse or misuse of overdraft protection, they do not go too far in the direction of making it too difficult to use or obtain.

Regulators cannot wish away consumers' need for credit. Eliminating access to overdraft protection will not eliminate the need that consumers have for it. History teaches the hard but undeniable lesson that well-intentioned paternalistic regulations that make it more difficult for consumers to obtain certain products cannot magically make them more financially responsible or make other less-expensive products magically appear. Everyone makes errors when it comes to many things, including personal finances. Yet it remains the case that most of us most of the time know better than central planners what is right for ourselves and our families. Access to overdraft protection is no exception. According to the Raddon survey, 94% of one bank's customers reported that use of overdraft protection should be their personal choice (including 92% of non-users and 96% of elevated users) and 89% reported their view that government should have *no* voice in how many overdrafts are allowed on your account.[110] Government intervention into a competitive market is typically justified only by demonstrable evidence of a market failure and confidence that interventions will ameliorate, not exacerbate, market failures. To date, such evidence is lacking for overdraft protection. All that regulation typically does is reduce access to one type of credit and thereby force consumers to make greater use of other, less-preferred products. Overdraft protection fills a unique need in the consumer credit marketplace—for a convenient, flexible, line of credit accessible 24 hours a day on demand, anywhere in the world, at an ATM, point-of-sale purchase, or for a check to clear. If access to overdraft protection is taken away, where will consumers who count on it turn?

[110] Raddon Survey, *supra* note 37.

APPENDIX A

FORM OVERDRAFT COURTESY CUSTOMER DISCLOSURE

The Deposit Account Agreement controls the duties, obligations and rights of the Depositor, the Authorized Signatories and Bank with regard to your checking account. The Deposit Account Agreement (and all amendments thereto) is incorporated herein for all purposes as if it were set forth verbatim, and its terms shall control any possible conflict, if any, between any provision of this Overdraft Courtesy Policy and the Deposit Account Agreement. This discretionary service is offered to our customers who are United States residents or Resident Aliens.

Discretionary service. Bank is not obligated to pay any item presented for payment if your account does not contain sufficient available funds, and any discretionary courtesy payment (or other negotiation or processing) by Bank of any non-sufficient fund check or other item as identified below does not obligate Bank to pay any additional non-sufficient fund check or item or to provide prior notice of its decision to refuse to pay any additional non-sufficient fund check or item. Approval of payment of reasonable overdrafts by Bank on consumer accounts in good standing (as described below) is only a courtesy, and not a right or an obligation, is within Bank's sole and absolute discretion, and can cease at any time without prior notice or reason or cause.

"Good standing" requirement. Pursuant to Banks commitment to always "Do More," now and in the future, if your consumer account (primarily used for personal and household purposes) or your sole proprietor account has been opened for at least 30 days and is maintained in good standing, which includes at least: A) Making regular deposits consistent with your past practices; B) Depositing $300.00 or more in your account within each thirty (30) day period and bringing your account balance to a positive balance within every thirty-five (35) day period; C) You are not in default on any loan or other obligation to Bank; and D) You are not subject to any legal or administrative order or levy, Bank will consider, as a discretionary courtesy and not a right or obligation, approving your reasonable overdrafts.

Limits. This courtesy will generally be limited to a maximum of (i) a $300.00 overdraft (negative) balance for "Free Checking Accounts," (ii) a $500.00 overdraft (negative) balance for "Free Checking Accounts" that have been open and in good standing for at least one year, OR which have direct deposit, where there have been two or more direct deposits totaling at least $600.00 within the past sixty (60) day period, (iii) a $700.00 overdraft (negative) balance for "Free Checking Accounts" that have been open and in good standing for at least one year, AND which have direct deposit, where there have been two or more direct deposits totaling at least $600.00 within the past sixty (60) day period, (iv) a $500.00 overdraft (negative) balance for "Other Personal Checking Accounts / Free Biz Rite Accounts," (v) a $700.00 overdraft (negative) balance for "Other Personal Checking Accounts / Free Biz Rite Accounts" that have been open and in good standing for at least one year, OR which have direct deposit, where there have been two or more direct deposits totaling at least $600.00 within the past sixty (60) day period, and (vi) a $900.00 overdraft (negative) balance for "Other Personal Checking

Accounts / Free Biz Rite Accounts" that have been open and in good standing for at least one year, AND which have direct deposit, where there have been two or more direct deposits totaling at least $600.00 within the past sixty (60) day period. Customers are highly encouraged to balance their checkbook and use their overdraft courtesy in a responsible manner that avoids excessive fees.

Covered Transactions. Overdraft Courtesy Program covers checks, in person withdrawals, ATM withdrawals, and electronic transactions. "Electronic transactions" includes automatic payments, online bill pay, and debit cards used at point of sale. Authorization and payment of overdrafts for ATM and everyday debit card transactions by Bank are subject to your "opt-in" decision to such coverage.

Order of payment. It is the bank's policy to clear items in the following order: (1) First any wire transfers from highest to lowest dollar amount; (2) items we have already paid out or committed to pay from lowest to highest dollar amount such as ATM withdrawals, teller cash withdrawals, transfers, and debit card or point of sale withdrawals (3) checks and ACH withdrawals from highest to lowest dollar amount. Transactions may not be processed in the order in which they occur. The order in which transactions are processed can affect the total amount of overdraft/non-sufficient funds fees incurred. Bank reserves the right to clear in any order, as permitted by state law.

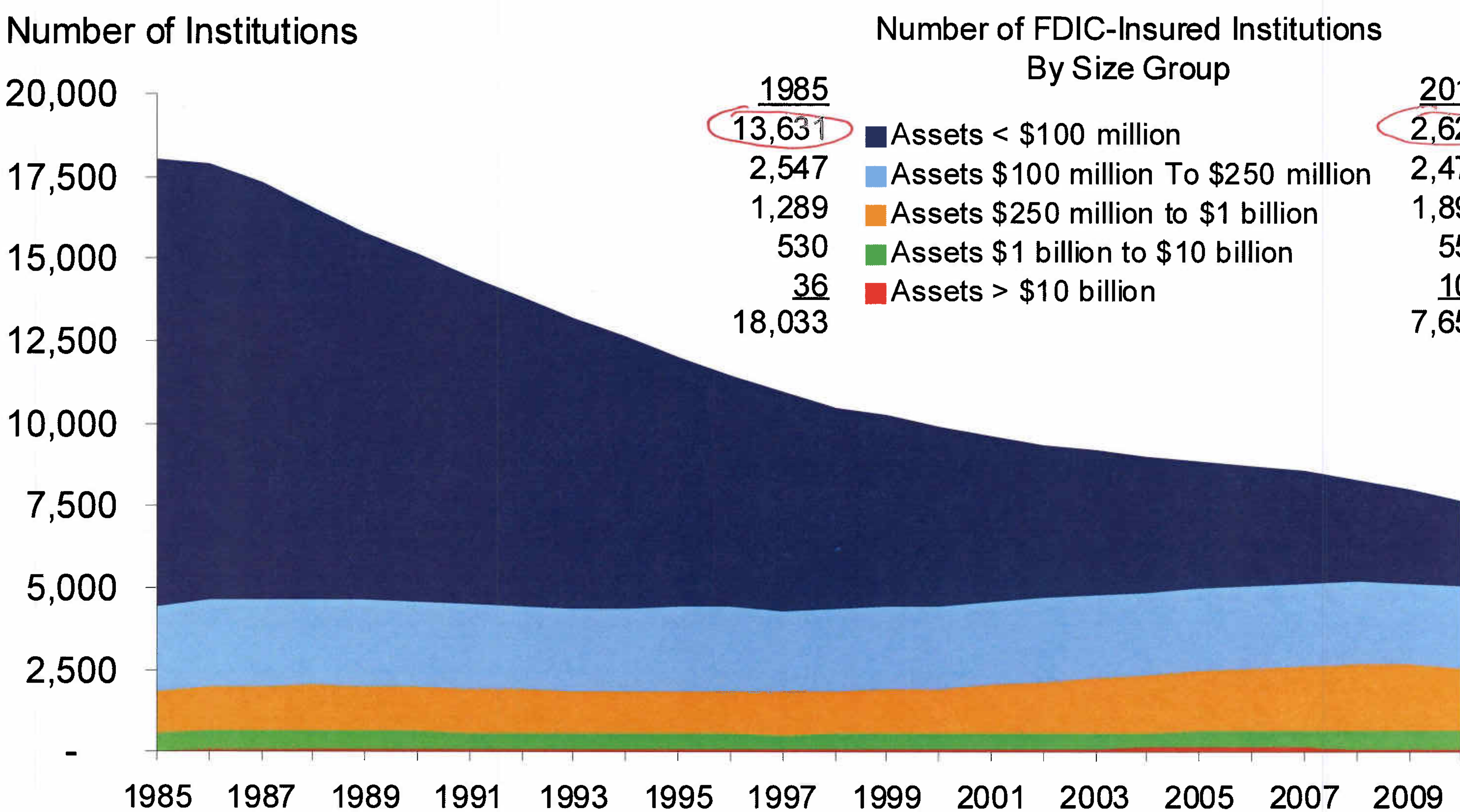
One account per household. Generally, Bank will limit this discretionary courtesy to only one account per household.

Repayment of overdrafts. The total of the courtesy overdraft (negative) balance, including any and all bank fees and charges, including all non-sufficient funds/overdraft fees and OD interest charges is due and payable upon demand, and Depositor and each Authorized Signatory will continue to be liable, jointly and severally, for all such amounts, as described in the Deposit Account Agreement.

Closing of account. If your account is not returned to a positive balance within 45 days of the date it first become overdrawn, your account will be closed.

Fees. The Bank will charge an overdraft fee of $29.00 for each item that is paid as an overdraft. Multiple overdraft fee charges up to 6 may be incurred on the same day. You will not be charged an overdraft fee if your ending account balance is overdrawn by $3.00 or less. Fees are subject to change. You will receive advance notice of any fee increase in accordance with state and federal law. In addition, overdraft amounts will accrue an OD interest charge at the rate of 18% per annum. OD interest accrues from the date of the overdraft until the date of receipt by Bank of repayment of such overdraft. The amount of your overdraft courtesy will be reduced by the imposition of the fee(s).

All of the net decline in FDIC-insured institutions since 1985 has come from banks under $100 million.



Number of FDIC-Insured Institutions
By Size Group

1985		2010
13,631	Assets < $100 million	2,625
2,547	Assets $100 million To $250 million	2,474
1,289	Assets $250 million to $1 billion	1,893
530	Assets $1 billion to $10 billion	559
36	Assets > $10 billion	107
18,033		7,658

Source: FDIC

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Ignacio Urrabazo, Jr.	Commerce Bank
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: [signature]	

Please attach a copy of this form to your written testimony.