



CRS Report for Congress

Overdraft/Bounced-Check Protection

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Summary

Overdraft protection programs are an option offered by financial institutions to consumers. These programs are often referred to as “bounced-check protection” or “courtesy overdraft protection” to distinguish them from the more traditional overdraft lines of credit. Participating institutions cover checks drawn on accounts with insufficient funds and charge a fee. Financial institution representatives state that these programs offer a beneficial service to their customers by covering checks that would otherwise be returned unpaid. Consumer advocates argue that these programs are high-cost credit products that are marketed to vulnerable consumers, and that their main purpose is to increase fee income for banks. In February 2005, federal regulators of the banking industry issued guidance concerning bounced-check/overdraft protection services offered by insured depository institutions. In May 2005, the Federal Reserve issued a final rule amending its Regulation DD to address concerns about the adequacy and uniformity of consumer disclosures relating to overdraft services offered by depository institutions, including the advertising of these services. Legislation in the 110th Congress (H.R. 946) would define these overdrafts as short-term extensions of credit and would provide enhanced consumer protections. On May 2, 2008, ongoing concerns with and interest in overdraft services prompted federal banking regulators to issue additional proposed rules to enhance consumer protections. This report will be updated as events and legislation warrant.

Background

Traditionally, when a bank customer writes a check on an account that does not have sufficient funds on deposit to cover the amount of the check, he or she is charged a nonsufficient-funds (NSF) fee as a penalty. The check would be returned unpaid to the merchant or other third party. The customer could be charged another fee by that third party. The management of a financial institution does have the discretion to cover the overdraft (not return the check) and charge an overdraft fee. Consumers can often make an arrangement with their bank for an overdraft to be covered by funds held in another account the consumer holds with the institution (for example a savings account).

Financial institutions have offered overdraft lines of credit for protection against account overdrafts. A customer must apply for this credit product and meet creditworthiness criteria set by the institution. The lines of credit are subject to the disclosure requirements of the Truth in Lending Act¹ implemented by Federal Reserve Regulation Z. Lines of credit usually charge an annual interest rate (generally around 18% to 20%) and allow repayment as the customer chooses within the terms of their agreement with the institution.

A more recent option for consumers is the bounced-check protection or courtesy overdraft protection service. These services vary among institutions but most share basic terms and conditions. Participating institutions offer this type of overdraft protection as a feature of their accounts, and customers do not have to apply and qualify for the service. An account normally qualifies if it has been open for a specified period and if there are regular deposits to the account. A ceiling is set for overdraft coverage, usually between \$100 and \$500. A flat fee (generally the bank's standard NSF fee) is charged each time an overdraft item is covered, and a daily fee may be charged for each day the account remains overdrawn. The service may extend beyond check transactions to other transactions including withdrawals at automated teller machines (ATMs), on-line banking, and debit card point of sale transactions. A specified time period may be set for overdraft repayment. Some institutions offer closed-end loans to customers who cannot meet the repayment deadline. Many programs are offered with the caveat that payment of an overdraft is discretionary on the part of the institution and, therefore, they may not pay all the overdrafts that customers incur. Some institutions employ automated systems to handle overdraft accommodations.

2005 Federal Regulatory Response

Guidance issued by federal regulators. In February 2005, guidance was issued by federal regulators addressing the risks presented by bounced-check or courtesy overdraft protection services. The guidance also incorporated a best practices list to assist financial institutions in developing responsible disclosure and program administration policies. The guidance was issued to assist depository institutions in the disclosure and administration of overdraft programs. In general, failure to comply with regulatory guidance may cause regulatory concern that a financial institution is not adequately protecting itself against risk. Two guidance documents were issued; the documents are similar but not identical. On February 14, 2005, the Office of Thrift Institutions issued guidance separately.² On February 18, 2005, joint guidance was issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration.³ The guidance documents reviewed the safety and soundness concerns raised by bounced-check or courtesy overdraft protection services, and stated that

¹ 15 U.S.C. 1601.

² The press release and access to the guidance document can be found at [<http://www.ots.treas.gov/docs/7/77503.html>].

³ The press release and access to the joint guidance can be found at [<http://www.fdic.gov/news/news/press/2005/fil1105.html>].

institutions should adopt written policies and procedures to address operational and other risks associated with overdraft programs. The joint agency guidance included an overview of legal risks. Both guidance documents informed institutions purchasing automated bounced-check protection programs from third-party vendors that a due diligence review should be conducted prior to entering into a contract.

Both documents stated that clear disclosures and explanations to consumers of the operation, costs, and limitations of an institution's overdraft program are essential. The guidance highlighted examples of disclosure and marketing practices that raised concern. For instance, some institutions did not clearly illustrate all the types of transactions (ATM withdrawals, debit card purchases, telephone transfers) besides checks that may be covered by overdraft protections. Some marketing practices appeared to encourage consumers to overdraw their accounts by using the service to meet short-term credit needs. Some institutions did not clearly distinguish how the bounced-check or courtesy overdraft service differed from a traditional line of credit. Other institutions included overdraft protection amounts in the sum they disclosed as the consumer's account "balance" without clearly distinguishing the funds that are available for withdrawal without overdrawing the account.

The guidance provided a best practices list to be taken into consideration by institutions with (or those establishing) bounced-check/overdraft protection programs. The list was divided into two categories: (1) marketing and communications with consumers, and (2) program features and operation. Included were clear disclosure of program fees and an opt-out feature. The Office of Thrift Supervision added a best practice: to not manipulate transaction clearing rules to inflate fees.

Amendments to Regulation DD. The Board of Governors of the Federal Reserve System began to study bounced-check and courtesy overdraft services in 2002 to determine the need for regulatory guidance and/or revisions to Board Regulations. The Board solicited public comment and information on the issues. On May 19, 2005, the Federal Reserve issued a final rule amending its Regulation DD to provide consumers with uniform and adequate disclosure information concerning bounced-check or courtesy overdraft protection services.⁴ Regulation DD implements the Truth in Savings Act (TISA),⁵ which requires depository institutions to provide disclosures to enable consumers to make meaningful comparisons of deposit accounts. Regulation DD also contains rules for advertising deposit accounts. The Board stated that the revisions to Regulation DD are consistent with the joint guidance issued previously by Board and other regulators. Compliance with the amendments to Regulation DD became mandatory on July 1, 2006. Compliance is enforced by the appropriate federal banking agency; failure to comply can result in administrative sanctions.

The Board chose to amend Regulation DD because "an overdraft service is provided as a feature and term of a deposit account, and that the fees associated with the

⁴ The press release and access to the final rule can be found at [<http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050519/default.htm>].

⁵ 12 U.S.C. 4301.

service are assessed against the deposit account.”⁶ The Board stated that the adoption of these amendments did not rule out a possible future determination that Regulation Z (Truth in Lending) disclosures would be appropriate.

The amendments to Regulation DD addressed account-opening disclosures, periodic statement disclosures, and advertising rules. Institutions must now include in the account opening disclosures required by the TISA the categories of transactions for which an overdraft fee may be imposed. Examples of categories include checks, in person withdrawals, and electronic withdrawals.

New periodic account statement disclosures are required for institutions that promote the payment of overdrafts in an advertisement. The added information fields are the total amount of fees or charges imposed on the account for paying overdrafts and the total amount of fees charged for returning items unpaid. The added disclosures must be provided for both the statement period and for the calendar year to date. Communications that are defined as advertisements, as well as those that are excluded from the definition, are described in detail. The advertising requirement is also triggered if the periodic statement includes a message stating the overdraft limit for an account; or by disclosing an overdraft limit or including the amount of that limit in an account balance presented on an ATM receipt, an ATM screen, an institution’s Internet site, or telephone response system.

The Regulation DD revisions include changes to advertising rules. Bounced-check/overdraft protection advertisements must include the applicable fees or charges, the categories of transactions covered, the time period consumers have to repay or cover any overdraft, and the circumstances under which the institution would not pay an overdraft. Specific situations where some or all of the added disclosures are not required are covered. In addition, advertisements that are misleading or that misrepresent the overdraft service are prohibited. Specific examples of what is prohibited are provided.

Legislation and Ongoing Concerns

Bounced-Check/Overdraft Protection Legislation. The Consumer Overdraft Protection Fair Practices Act (H.R. 946), was introduced on February 8, 2007 by Representative Carolyn B. Maloney and others, and referred to the House Committee on Financial Services. The legislation would define overdrafts as short term extensions of credit, extend the protections of the Truth in Lending Act (TILA) to bounced-check/overdraft protection programs, and provide for other consumer protections. On July 11, 2007, hearings were held by the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services.⁷ The legislation would define overdraft protection programs or services as short-term extensions of credit. The legislation would amend TILA (implemented by Federal Reserve Regulation Z) to extend

⁶ Truth in Savings: Final Rule, issued May 19, 2005, p. 8, available at [<http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050519/default.htm>].

⁷ Testimony presented at the hearings can be found on the committee’s website [http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr0705072.shtml].

its coverage to these programs. Fees associated with overdraft protection programs (if imposed more than three times a year) would be considered finance charges and must be disclosed as both a dollar amount and in terms of an annual percentage rate (APR). The legislation would provide for additional restrictions specific to overdraft protection programs and services. Before a depository institution could initiate a bounced-check/overdraft service, an account holder would have to provide written consent to an agreement detailing the terms and conditions of the service (an opt-in feature as opposed to an opt-out). The legislation addresses restrictions on the advertising of overdraft programs. The restrictions would include a prohibition on advertisements that are misleading or that misrepresent the overdraft protections or services.

H.R. 946 would also require depository financial institutions to warn customers at electronic terminals that a requested electronic fund transfer would trigger an overdraft protection fee and permit the customer to cancel the transaction. Additionally, the bill would prohibit institutions from manipulating the process of posting checks and debits against an account to increase the account holder's overdraft fees.

Industry Response to H.R. 946. At the hearings, industry representatives expressed general opposition to H.R. 946. It was stated that the recent actions taken by federal banking regulators concerning bounced-check/overdraft programs were providing consumers with adequate disclosure and protection. It was argued that the additional TILA disclosure requirements and program restrictions required by the legislation would impose considerable costs and would likely result in the discontinuance of this beneficial service for many consumers. Transmitting the notifications required by the legislation at electronic terminals would necessitate potentially prohibitive technical changes to the terminals and software. Financial institutions have worked to make it easier for a consumer to check an account balance online or by telephone but providing "real time" account balance information presents difficult challenges. Industry representatives argue that the consumer is in the best position to know if authorized but possibly not yet processed (cleared) transactions would change the balance provided by the bank. If an account holder carefully keeps track of all their transactions (including checks, debit card purchases, and preauthorized automated payments), they have the best information to avoid overdrafts.

Consumer Advocate Response to H.R. 946. The hearings' testimony from consumer advocates was supportive of H.R. 946 stating that the legislation would provide many of the protections they have sought. The general belief is that financial institutions have transformed a beneficial, occasionally employed back-up system for consumer checking accounts into an automated system that triggers high cost bank overdraft loans. Direct deposit, electronic payments, and advances in technology have made it more difficult for consumers to track their account balance to avoid overdrafts. Consumer advocates have urged the Federal Reserve to revise its Regulation Z, which implements the Truth in Lending Act, to require institutions to treat courtesy overdrafts as loans. The TILA disclosures required by H.R. 946 would enable consumers to make more informed decisions and would require consumers to actively choose to participate in bounced-check/overdraft protection programs by signing up (opting-in). Warning notifications at electronic terminals would prevent unintentional overdrafts.

Proposed Enhanced Protections. On May 2, 2008, the Board of Governors of the Federal Reserve System, the National Credit Union Administration, and the Office

of Thrift Institutions (working jointly) proposed rules to address ongoing concerns with aspects of the marketing, disclosure, and implementation of overdraft services. The banking regulators stated that concerns with overdraft services continue despite the issuance of the 2005 guidance and Regulation DD amendments. The banking regulators used their statutory authority to address unfair or deceptive practices provided by the Federal Trade Commission Act.⁸ The Federal Reserve also proposed complementary additional amendments to Regulation DD.⁹

The enhanced protections include a substantive opt-out notice requirement for bounced-check/overdraft services. The proposal would require that consumers receive an opt-out notice before a financial institution assesses any fees in connection with paying an overdraft, the proposal sets forth content and timing requirements. In addition, consumers would be able to choose the option of a partial opt-out, for example, by directing their institution to pay overdrafts resulting from checks but opting out of overdraft services for ATM and debit card transactions.

The proposal would require all institutions to provide aggregate cost information for overdraft services on periodic statements to facilitate the consumer's ability to make informed judgements about using these services. Currently, periodic account statement disclosures are required for institutions that promote the payment of overdrafts in an advertisement.

When account balance information is provided in response to a consumer inquiry (including those made at electronic terminals) this proposal would prohibit financial institutions from including in the disclosed balance any additional amounts of funds that may be provided to cover an overdraft. Generally institutions would disclose only the amount of funds available for immediate use. The institution would not be required to provide "real-time" balance disclosures.

Finally, financial institutions would be prohibited from charging an overdraft fee if the overdraft results solely from a "debit hold" amount placed on an account which exceeds the actual cost of the purchase.

⁸ 15 U.S.C. 41-58.

⁹ Detailed information on the statutory authority provided by the FTC Act, the proposed rules, and proposed Regulation DD changes can be found at [<http://www.federalreserve.gov/newsevents/press/bcreg/20080502a.htm>].