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IN FOCUS

Updated March 28, 2022

Overdraft: Payment Service or Small-Dollar Credit?

Funding Gaps in Consumer Finances

One of the earliest documented cases of bank overdraft dates back to 1728, when a Royal Bank of Scotland customer requested a *cash credit* to allow him to withdraw more money from his account than it held. Three centuries later, technologies, such as electronic payments (e.g., debit cards) and automated teller machines (ATMs), changed the way consumers use funds for retail purchases, transacting more frequently and in smaller denominations. Accordingly, today's financial institutions commonly offer point-of-sale *overdraft services* or *overdraft protection* in exchange for a flat fee around $35. However, recently, a number of larger institutions have announced revisions to their overdraft programs, and some have even dropped the fees associated with such products.

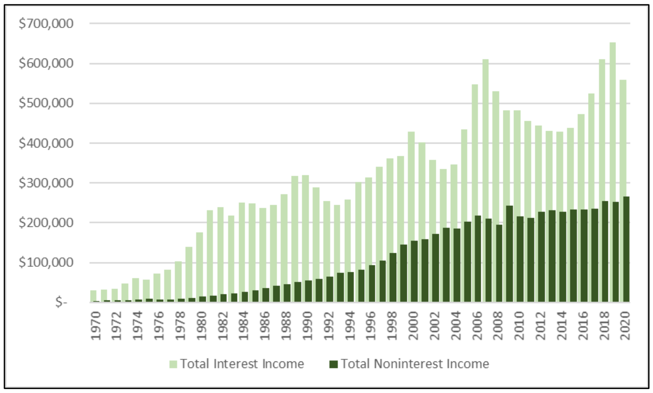
Although these fees can be large relative to the transaction, alternative sources of short-term small-dollar funding, such as payday loans, deposit advances, and installment loans, can be costly as well. Congress has taken an interest in the availability and cost of providing consumers funds to meet their budget shortfalls. Legislation introduced in the 117th Congress (H.R. 4277 and S. 2677) could impact consumer use of overdraft programs in various ways. The policy debate around this focuses on the trade-offs between access to funds and their associated costs. This In Focus examines the evolution of bank overdraft programs and potential outcomes associated with regulating them.

Evolution and Regulation of Overdraft

Core banking operations are built around two activities: accepting deposits and making loans. Banks make money from the interest earned on loans and from fees collected for providing certain services. In the mid-1980s, revenue from fees, known as noninterest income, generally began to grow faster than interest income. (See **Figure 1**.)

Figure 1. Annual Interest and Noninterest Income

U.S. Commercial Banks, 1970-2020 ($ millions)

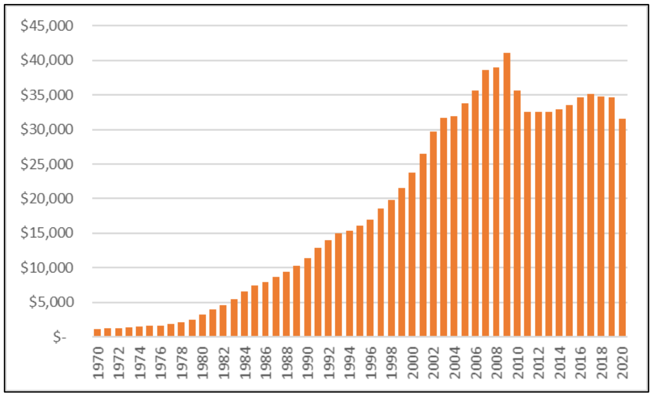


Source: Federal Deposit Insurance Corporation (FDIC).

Banks generate noninterest income in a number of ways. For example, a significant source of noninterest income comes from collecting fees for deposit accounts services, such as maintaining a checking account, ATM withdrawals, or covering an overdraft. Fees from checking accounts have grown considerably in the past two decades, peaking in the 2007-2009 financial crisis. (See **Figure 2**.)

Figure 2. Service Charges on Deposit Accounts

U.S. Commercial Banks, 1970-2020 ($ millions)



Source: FDIC.

Overdraft Opt-in Rule

Financial regulators began examining overdraft practices more closely following the financial crisis. In 2009, the Federal Reserve published a final rule to prohibit financial institutions from assessing overdraft fees on ATM and one-time (point-of-sale) debit card transactions without obtaining consumer consent (opt-in). Service charges on deposit accounts fell after 2010; however, it is unclear whether this was due to the rule or to improved economic and consumer financial conditions post crisis. In 2010, P.L. 111-203 (Dodd-Frank) created the Consumer Financial Protection Bureau (CFPB), granting it broad authority for consumer protections across the financial system, including the overdraft opt-in rule.

Overdraft Reporting

After Dodd-Frank, the CFPB began examining fees associated with insufficient funds in bank accounts. (Generally, this includes overdraft fees, when the purchase is covered by the bank, or fees for a bounced check.) In 2015, the banking regulators required financial institutions with more than $1 billion in assets to itemize revenues earned from deposit accounts on their call reports, including a separate line item for overdraft and insufficient funds fees. Roughly 600 banks have met the threshold each year, reporting $11 billion-$12 billion in fees for insufficient funds, though that number dropped in the 2021 call report to around $9 billion. This likely underreports the amount of overdraft revenue in the banking system, because credit unions and smaller community banks are not subject to the reporting requirement. In 2019, the CFPB estimated that revenue from overdraft and insufficient funds fees could be closer to $15.5 billion for banks and credit unions.

Overdraft Policy Debate

Bank regulators are responsible for ensuring the safety and soundness of the banking system. Diversified revenue streams from interest and noninterest income support the profitability of the banking system. In addition, noninterest income has proved to be a stable source of income during periods of economic volatility. However, there is evidence that some consumers are not aware that they can opt-in to overdraft (or not) and that a small number of consumers bear a disproportionately high percentage of total overdraft fees. How policymakers approach overdraft may depend on whether they view it as a service or as a form of credit.

Payment Service Versus Small-Dollar Credit

A 2017 Pew Charitable Trusts (Pew) survey suggests that almost 40 million Americans incurred an overdraft fee in the previous 12 months. Most of those consumers experience fewer than three overdrafts per year. CFPB data show a small number of consumers pay the overwhelming majority of overdraft fees—roughly 9% of accounts comprise 79% of overdraft and insufficient funds fees—these consumers overdraft more than 10 times a year. Overdraft frequency is correlated with negative financial conditions: for instance, those who overdraft more than 10 times a year generally have lower incomes, credit scores, and available credit. However, while there are similarities among accounts with more frequent overdrafts, consumers use overdraft programs for different purposes:

- **Payment Service.** Industry representatives like the American Bankers Association posit that overdraft programs serve as a payment service for cash-strapped consumers. For instance, a consumer can cover an unplanned budget gap for a $35 fee, rather than have a payment denied. Banks have also begun offering overdraft transfer services, linking a savings account or credit card for free or a smaller fee.

- **Small-Dollar Credit.** Some consumers may use overdraft as a form of credit. The 2017 Pew survey also showed that 32% of consumers with an overdraft said they viewed the program as a way to borrow funds when short on cash. When paired with the previously mentioned data correlating frequent overdraft accounts with lower credit profiles, one could posit that overdraft is used as a form of credit in some circumstances.

Policy Tools and Potential Outcomes

Consumers have a number of options to cover a gap in their budget. Overdraft is a product that consumers with a bank account typically have access to. In addition, products like payday loans and deposit advances have been offered at different times in the past as ways to provide funds to consumers outside of the traditional bank loans. Although overdraft can be an expensive way to make small purchases, many of the alternatives also carry relatively high costs. Regulators must balance their mandates for safety and soundness with their interest in maintaining consumer protections. Currently, legislation introduced in the House and Senate would address the use of overdraft through different policy tools, including limiting the fees and frequency of overdraft charges and increasing disclosure requirements for overdraft programs.

Limiting Overdraft Fees

Some have argued that overdraft fees should be limited to a price that is reasonable and proportional to the cost of providing the overdraft. Others have argued that because overdraft acts as a form of credit, its fee structure should fall in line with fee and interest rate provisions in lending laws such as the Military Lending Act (P.L. 109-364), which caps interest and fees at an Annual Percentage Rate (APR) of 36%. If overdraft were priced as credit, it would typically carry an APR of much higher than 36%. Although this type of limit would bring overdraft costs down, it could limit the options available to consumers as well. To the extent banks were not willing to offer overdraft at the new price point, consumers may look for funding in markets where APRs can exceed 36% by wide margins, such as state-regulated payday loans.

Limiting Overdraft Frequency

Limiting the number of overdrafts for which an institution can charge a consumer could help the small percentage of bank customers who pay the majority of overdraft fees by overdrafting several times a year. However, to the extent customers still need funds after the limit is reached, they may consider other products, such as payday loans, outside the banking system, or they could use installment loans or deposit advances if their bank offers them.

Enhanced Disclosures

Previous regulation sought to improve the disclosures around overdraft to help consumers understand the programs they opted into. Consumer advocates have raised concerns about whether overdraft programs are sufficiently transparent and how financial institution practices influence the opt-in decision. Current legislative proposals would build on the existing disclosure framework by requiring banks to disclose coverage fees and provide notification of an account’s overdraft status. This could help consumers compare rates as they choose a financial institution.

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