CFA Consumer Federation of America

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Q and A on Overdraft Loans and H.R. 3904, the Overdraft Protection Act of 2009

What is an overdraft loan?

Overdraft loans are high cost, very short-term credit extended to consumers at the discretion of the bank. Banks with automated programs permit most customers to borrow money from the bank by writing a check, withdrawing funds at an ATM, initiating a debit card purchase or preauthorizing an electronic payment even when the checking account lacks sufficient funds, all without consumer consent or approval. Most banks will cover the overdraft up to a preset limit and impose a high overdraft fee on consumers.

Do consumers have other options besides fee-based overdraft loans?

Under traditional programs that link checking accounts to a savings account, a credit card, or a line of credit, funds are transferred in increments when the checking account is temporarily overdrawn. Financial institutions have offered these programs for decades. The largest banks charge a median $10 fee to transfer consumers' funds from savings accounts to cover overdrafts in checking accounts. The median charge for a line of credit transfer is $5 according to the FDIC report on overdraft loans. Banks with overdraft lines of credit generally charge around 18 percent per year and provide installment payment plans. With these options, banks do not collect payment by "set-off" from the next deposit to the account.

What is the most common trigger of overdraft fees?

By far, the most common triggers of overdraft fees are small debit card transactions, which could easily be denied at the point of sale at no cost to the consumer. Forty-four percent of overdrafts are triggered by using a debit card to make a purchase or to withdraw cash at an ATM, followed by 27% triggered by checks, and 28% by electronic fund transfer, according to a study by the Center for Responsible Lending.

Do consumers apply to get fee-based overdraft coverage?

No. Without asking for their consent, banks and credit unions unilaterally permit most customers to borrow money from the banks by writing a check, withdrawing funds at an ATM, using a debit card at point of sale, or preauthorizing an electronic payment that exceeds the funds available in a checking account. Instead of rejecting the debit card purchase or ATM withdrawal at no cost to the consumer, or returning the check unpaid with a bounced check fee, most institutions will now cover the overdraft and impose an expensive fee for each transaction.

How widespread are overdraft loans?

The FDIC reports that over three-fourths of the banks it surveyed automatically pay overdrafts for a fee and seventy-five percent of those banks automatically enroll their customers in overdraft programs without their permission. Fifty-one million Americans' accounts become overdrawn each year, and overdraft fees alone cost consumers $24 billion in 2008.

How does the order in which withdrawals are paid affect overdrafts?
Large banking institutions usually clear the largest transaction first, causing more transactions to overdraw the account. This practice generates more in overdraft revenues because the institution can charge an overdraft for each transaction once the account is below zero. Unfortunately, consumers do not know the order in which items drawn on their account will be presented to their bank and are not likely to know the order in which the bank pays items.

How much do banks charge for overdraft loans?
CFA's 2009 survey of the nation's largest banks shows that the maximum overdraft fee at this sample of banks is now $39, while the median fee is $35. Five of the largest banks use tiered fee schedules, with fees rapidly escalating when consumers incur more than a few overdrafts over a one-year period. Ten of the sixteen largest banks add sustained overdraft fees when consumers are unable to pay the overdraft and fee within a few days.

Won't the changes that some banks recently made to their overdraft loan programs help consumers?
Recently announced changes in overdraft programs by some large banks are unlikely to significantly reduce costs to customers. Some banks have changed the threshold that triggers overdraft fees to a total of $5 to $10 in total overdrafts per day before fees are charged and some have lowered the total number of overdraft fees a consumer can be charged in one day. But none of the banks are lowering the fees charged for initial or sustained overdrafts.

How will H.R. 3904, the Overdraft Protection Act, give consumers more control over these overdraft loans?
The Overdraft Protection Act will prevent abuses by requiring financial institutions to obtain account holders' specific written consent in order for financial institutions to enroll them in fee-based overdraft programs. The bill requires banks and credit unions to warn account holders before making them a high-cost loan at the ATM or from a teller and permits them to terminate the withdrawal to avoid the fee. The bill also clarifies that an overdraft fee is a finance charge subject to the Truth in Lending Act, giving consumers protection and requiring cost-to-borrow disclosures as determined by the Fed.

Will the Overdraft Protection Act rein in overdraft fees?
The bill requires banks to provide information on their less expensive and more appropriate products available to address overdrafts or extend small dollar loans. The bill limits banks to one overdraft fee per month up to a total of six per year. The bill permits banks to cover more overdrafts without charging additional fees. The bill also requires that overdraft fees be "reasonable and proportional" to the cost to banks to process these loans; it requires further guidance on this standard from the Federal Reserve Board.

Will the Overdraft Protection Act stop bank manipulation of account activity?
The bill prohibits manipulation of account activity if the result is to increase overdrafts. Banks will no longer be able to debit accounts with the highest dollar charge first in order to increase the number of overdraft fees an account holder is charged and no holding deposits before crediting accounts in order to create a negative balance and charge an overdraft fee.