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Overdraft Best Practices for Financial Institutions

Introduction

Almost one in five consumers incurs overdraft fees each year, amounting to as much as $15 billion annually. Low-income people and people of color are disproportionately impacted. For example, an analysis by the Financial Health Network found that low- to moderate-income (LMI) households are nearly twice as likely as higher income households to overdraft. Black and Latino households are also about twice as likely as Whites to be charged overdraft fees. The knock-on effects for consumers of excessive overdraft fees can be serious. Individuals who overdraft frequently sometimes use high-cost loans from payday lenders and loan sharks to cure their overdraft fee, trapping them in a cycle of debt.

Furthermore, a 2013 Consumer Financial Protection Bureau (CFPB) study showed that, among consumers with overdraft protection, the number of involuntary account closures tripled when compared to those who lacked the service. Overdraft fees reinforce broader banking system inequities as such account closures can push consumers out of the financial mainstream and add to the number of people who are unbanked. Federal Deposit Insurance Corporation (FDIC) data from 2019 show that 12% of Latinos are unbanked compared to 2.5% of Whites, and that 23% of those who earn less than $15,000 a year are unbanked compared to 0.6% of those who earn at least $75,000. Another study by the Center for Responsible Lending found that about 1 million people no longer have a bank account, primarily as a result of high or unpredictable bank fees. Further, the FDIC's biannual survey of the unbanked found that more than a third of respondents do not have an account because fees are too high.

An equitable overdraft policy should reduce the excessive elements of overdraft, but some basic aspects of overdraft may be necessary to meet consumer needs. For example, evidence shows that a subset of consumers, especially those who cannot easily access a credit card or small dollar loans, would pay an overdraft fee to cover their rent or mortgage payments. Others would tolerate an overdraft fee to make utility payments and buy groceries. Financial institutions should therefore reform overdraft policies that harm their customers while maintaining a basic and safe level of access to overdraft services where it is truly needed.

The following best practices are tools to measure the transparency and affordability of a financial institution's overdraft policies. The model for this approach comes from the Bank On account standards, which are used to measure the affordability and quality of deposit accounts. By adopting the practices listed below, financial institutions can offer substantial advantages to consumers, such as reducing overdraft fees, making overdraft policies more transparent, and helping to make financial institution products more equitable and accessible for low-income people and people of color.

The practices are listed in order of priority, from most impactful to least. They are grounded in several current practices and proposals including policies currently adopted by the biggest banks, proposals such as the Overdraft Protection Act, H.R. 4277, sponsored by Representative Maloney (D-NY), published research by Aaron Klein of the Brookings Institute, and published research by Pew Charitable Trusts.

Recommendations for Reducing Fees

FEATURE	RECOMMENDATION
Opt-in process	Consumer should provide consent in writing, in electronic form, or in such other form as is permitted under regulations of the Consumer Financial Protection Bureau.
Non-sufficient fund fees	None
Overdraft fees on debit card purchases	None
Overdraft fees on automated teller machine withdrawals	None
Extended/sustained overdraft fees	None
Limits on frequency and amount of overdraft fees	**Recommendation 1:** • Size of overdraft fee **$35 OR LESS** • Daily limit on number of overdraft fees **ONE** • Yearly limit on number of overdraft fees **SIX** **Recommendation 2:** • Yearly total overdraft fees **$210** • Flexibility in size and number of overdraft fees with a $210 yearly limit
Cushion before overdraft fee is charged	$50
Length of grace period to cure overdraft	Three business days

Payment Systems and Transaction Processes

- [Process all transactions either chronologically or from low to high by dollar amount](#).
- No reordering of transactions from high to low by dollar amount, which maximizes overdraft fees.
- Upgrade payment systems so that credits are posted immediately.

Small Dollar Liquidity

- Provide small dollar loans as an alternative to overdraft fees that meet the standards of the [Military Lending Act](#):

    - **APR cap of 36% which must include:**
        - Finance charges
        - Credit insurance premiums
        - Add-on credit-related products sold in connection with the credit
        - Fees such as application fees, participation fees, or fees for debt cancellation contracts, with some exceptions
        - No prepayment penalty from a creditor if the customer pays back part—or all—of the loan early

    - **Small dollar loans should meet [these additional standards](#):**
        - Affordable installment payments of no more than 5% of each paycheck or 6% of deposits in a checking account
        - Online or mobile application, with automated loan approval, so that loan funds can be quickly deposited into a borrower's checking account
        - Credit bureau reporting of loan terms and positive repayments

Consumer Information and Empowerment

- **Disclosures:**
    - Provide information about account terms, conditions, and fees in a uniform, concise, easy-to-read format available online and in physical branches.
    - Provide account holders with clear, comprehensive terms and pricing information for all available options to ensure that consumers can make the best choice for their personal situations, including choosing not to opt in to any coverage.
    - Provide information about alternative overdraft products (such as linked accounts, credit, and alerts) and a clear explanation of the terms and fees of these products.
    - Use Pew's Model Disclosure Box for Checking Accounts (see Appendix), or a similar model, that clearly explains the overdraft service terms and conditions.

- **Prompt notification:**
  - Promptly notify consumers via email and text message when overdraft fees are charged no later than 24 hours after the financial institution charges the fee.
  - Include pertinent information about the overdraft, including, where appropriate, whether participation in overdraft coverage will be terminated.

- **Notice and opportunity to cancel:**
  - Warn consumers who opted into overdraft coverage via email and text message if a transaction will trigger an overdraft fee or fee of any kind, including the reason for and amount of the fee.
  - Provide the consumer with the opportunity to cancel the transaction.

- **Account statements:**
  - In every account statement, clearly disclose the dollar amount of all overdraft coverage fees charged for the relevant period and year to date.

APPENDIX

PEW'S MODEL DISCLOSURE BOX FOR CHECKING ACCOUNTS

BASIC TERMS AND CONDITIONS			
Overdraft Options for Consumers	Option A: (Default)	No Overdraft Service	**If you choose not to opt in to any kind of overdraft service, transactions that would cause an overdraft will be declined at no cost to you.**
	Option B: Overdraft Transfer Plan	Overdraft Transfer Fee **$**	**per overdraft covered by a transfer from a linked savings account, line of credit, or credit card**
	Option C: Overdraft Penalty Plan	Overdraft Penalty Fee **$**	**per overdraft covered by an advance from your financial institution**
		Maximum Number of Overdraft Penalty Fees per Day	**You will only be charged this number of overdraft penalty fees per day, even if we elect to cover additional overdrafts.**
		Minimum Amount Required to Trigger an Overdraft Penalty Fee **$**	**If you are overdrawn by this amount or less, you will not incur an overdraft penalty fee.**
		Extended Overdraft Penalty Fee **$**	**charged every X day the account is overdrawn, starting Y days after the account is first overdrawn**