Reexamining Overdraft Programs

A Guide for Financial Institutions

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Introduction

Overdraft programs have received growing attention in recent months. A number of depository institutions – including national, regional, and community banks, along with some credit unions – have made significant changes in the terms of their overdraft programs. Others have introduced new products to supplement overdraft as a form of liquidity. Some have even gone so far as to eliminate overdraft altogether.

Various factors are driving these trends. Fintech challengers, including neobanks, have sought to position themselves as industry disruptors by using low or no fees as a differentiator or offering personal financial management solutions designed to obviate overdraft and non-sufficient funds (NSF) fees.

At the same time, the economic downturn caused by the pandemic has increased the salience of low-income workers' financial health challenges, increasing both the impact of overdraft fees on these consumers as well as the reputation risk to depository institutions associated with overdraft and other fees. **Because financial services charges, such as**

overdraft fees, are disproportionately borne by Black and Latinx consumers, high institutional reliance on overdraft fees risks undermining the commitments many institutions have made to racial equity in recent months.[1] Partly due to these reasons, banking regulators and consumer advocates have shown increased interest in consumer protection issues associated with overdraft.

In response to these developments, many depository institutions are reconsidering their approach to overdraft. These institutions are evaluating the extent to which their consumer (and small business) deposit business lines depend on overdraft and NSF fee revenue and the sustainability of such business models for their institutions. They are likewise evaluating the extent to which their overdraft and NSF revenue is derived from a small segment of customers and the sustainability of such costs for these customers. And they are reconsidering their overdraft practices and their other credit offerings to find new ways to cost-effectively meet the needs of their customers and guide them toward improved financial health.

This paper is intended to aid depository institutions in **identifying key considerations and options for changing overdraft policies and outcomes in a way that meets the needs of both the institution and its customers**. There is no silver bullet or one-size-fits-all recommendation for these institutions. Each organization will need to weigh the feasibility of implementation and the revenue and policy implications, including the potential for acquiring new customers, increasing the loyalty of existing ones, and reducing inequities and negative outcomes for consumers.

Given the groundswell of movement in the market, some of the options outlined below may quickly become table stakes, raising the bar for what customers expect and demand of their financial institutions.

[1] Stephen Arves, Necati Celik, Hannah Gdalman, Elaine Golden, & Meghan Greene, "The FinHealth Spend Report 2021," Financial Health Network, June 2021.

Understanding Consumer Needs

The starting point for reassessing overdraft and related offerings is understanding who uses overdraft and why.[2] As the Financial Health Network explains in our report on small-dollar credit, frequent use of short-term credit products like overdraft is often a symptom of a customer in poor financial health.[3] Although the use of overdraft and the reasons behind it vary from institution to institution and customer to customer, research by the Consumer Financial Protection Bureau (CFPB), supplemented by industry research, provides some general insights:

- **Most overdraft fees are paid by a small number of customers.** In any given year, about one-third of banking customers overdraw their accounts. Among those who overdraw, more than 40% are infrequent overdrafters, with one to three incidents per year. At the other end of the spectrum, however, more than 25% of overdrafters are frequent users, with at least 10 overdrafts or NSFs in the course of this year. Half of this group are very frequent users, with 20 or more overdrafts per year. Indeed, 8% of customers incur nearly 75% of overdraft fees.[4] For these customers, overdraft can be a substantial cost and a significant drag on their financial health.[5] As discussed below, the experience of frequent overdraft can even result in customers leaving or being forced to leave the banking sector altogether.

- **Frequent overdrafters face numerous financial health challenges.** Frequent and very frequent overdrafters almost by definition maintain low average daily balances. They are heavy users of debit cards, with a median of over 25 transactions per month. They also have low credit scores, with a median under 600; little, if any, savings; and little or no available credit from credit cards.[6]

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[2] Stephen Arves & Meghan Greene, "Amid Resurgence of Interest in Overdraft, New Data Reveal How Inequitable It Can Be," Financial Health Network, September 2021.
[3] "Industry Insights: How Financial Institutions Can Structure Small-Dollar Credit for Financial Health," Financial Health Network, 2020.
[4] Trevor Bakker, Nicole Kelly, Jesse Leary, & Éva Nagypál, "CFPB Data Point: Checking account overdraft," Consumer Financial Protection Bureau, July 2014.
[5] Ibid.
[6] David Low, Éva Nagypál, Leslie Parrish, Akaki Skhirtladze, & Corey Stone, "CFPB Data Point: Frequent Overdrafters," Consumer Financial Protection Bureau, August 2017.

- **Overdrafts tend to be for relatively small amounts of money and tend to be repaid fairly quickly.** The median overdraft is for a $50 transaction, with the median debit card overdraft half that amount. The median overdraft is repaid within three days. A large share of debit card overdrafts occur because available funds in the account run out in the relatively short period – typically two days – between the time the transaction was authorized and the time it settled.[7]

- **Overdrafts can be unintentional or intentional.** In a survey conducted for the Consumer Bankers Association, approximately one-quarter of frequent overdrafters reported that their most recent overdraft was a mistake on their part. Another 30% indicated that it was a gamble – that they made a transaction hoping that a recent deposit would clear before the transaction settled. Just over 40% indicated that they knew they were running low on funds and wanted to ensure that a particular transaction went through.[8]

These data suggest that there are several drivers of overdraft behavior, especially among frequent and very frequent overdrafters, and a number of discrete consumer needs at work. This, in turn, implies that depository institutions seeking to reform their overdraft programs in ways that serve their customers must be attentive to myriad considerations.

Although reforming policies to improve customers' financial health can be viewed as an end in and of itself, such reforms also should yield benefits in customer engagement. Financial Health Pulse® research finds that the overwhelming majority of customers (80%) expect their primary financial institutions (PFIs) to help them improve their financial health, yet only 14% "strongly agree" that their PFIs actually do this.[9] The research shows that those who believe that their PFI is working to improve their financial health are deeply loyal, committed customers. PFIs thus have an opportunity to fill this gap in expectations and build long-term, sustainable customer relationships, particularly among Black and Latinx customers, women, younger people, and low-income people, all of whom are more likely to

[7] Trevor Bakker, Nicole Kelly, Jesse Leary, & Éva Nagypál, "CFPB Data Point: Checking account overdraft," Consumer Financial Protection Bureau, July 2014.
[8] "A Novantas Study Reveals Most Overdrafts are the Result of Informed Consumer Choice," Novantas, October 2015.
[9] Stephen Arves, Nadia van de Walle, & Marisa Walster, "Building Valuable Customer Relationships Through Financial Health," Financial Health Network, August 2020.

list caring about customer financial well-being as a top reason for doing business with a financial institution.[10]

A Framework for Rethinking Overdraft

There are a number of steps that depository institutions can take – indeed, that some banks and credit unions already have taken – to reform their overdraft programs. The Financial Health Network believes that these are best evaluated in the context of an overall financial health framework, with the ultimate aim of helping consumers manage their day-to-day expenses, build resilience, and thrive.

To evaluate the impact of existing overdraft programs and possible reforms on customer financial health, we recommend that depository institutions ask the following questions:

- How can we reform our overdraft practices to ensure that the fees we charge are reasonable and proportionate to the benefit our customers are deriving?
- Which of our customers need help tracking their inflows and outflows, managing their expenses, and building emergency savings to avoid overdrafts and NSFs? How can we ensure more consistent and impactful uptake of tools, such as cash flow monitoring and automatic savings? Are the right tools getting to the right people? Are there common moments or situations that tend to trigger overdraft, and can we predict those triggers to better serve customers?
- How can we help customers understand the choices available to them when it comes to overdraft and ensure that customers are not subject to repeated, costly charges for inadvertent overdrafts?
- Which of our customers need alternative forms of credit to cope with financial shocks or cash shortfalls, and how can we best serve them?

[10] Stephen Arves, Nadia van de Walle, & Marisa Walster, "Building Valuable Customer Relationships Through Financial Health," Financial Health Network, August 2020.

- Which of our customers need a "safe" checking account, and how can we serve them?

In response to these questions, banks, credit unions, and fintechs have pioneered various options outlined below that are worthy of consideration. The list below is not an exhaustive survey of overdraft reforms, but it provides an overview of the current state of the field.

1. Reforming Overdraft Policies and Practices

Before adopting new practices, products, or tools, depository institutions can and should evaluate their existing practices and policies. Such an examination should ensure that the cost of an overdraft to a consumer is proportional to the benefit of having a given purchase or set of purchases go through while the account is overdrawn. A number of depository institutions have recently taken steps in this direction.

Examples of significant reforms to existing overdraft practices include:

- **Increasing the cushion before charging a fee.** Chase and Huntington Bank now offer a $50 cushion, and Frost Bank is offering $100. Chime's cushion goes up to $200, albeit with a requested "tip" for covering these transactions.
- **Not charging fees on transactions for which there were sufficient funds at the time of the transaction.** Chase has instituted this practice.
- **Not charging NSF fees on check and automated clearing house (ACH) transactions that are returned unpaid.** Chase, Capital One, and PNC have eliminated their NSF fees.
- **Providing a 24-hour (or longer) grace period.** Huntington Bank offers a grace period if a sufficient deposit is made by midnight of the next business day. Wells Fargo will "rewind" overdrafts if a deposit is made by 9:00 AM the next business day. Capital One is now offering a grace period to all of its customers who opt-in to overdraft coverage that would extend through 11:59 PM ET of the following business day.
- **Limiting the number of overdraft fees per day or per negative balance episode.** PNC and Capital One have reduced their fees to one per day.

- **Ensuring that transaction-clearing order practices avoid maximizing customer overdrafts.**
- **Tiering fees to the size of the overdraft**, so that for customers of banks with a small cushion, a $5 purchase does not incur a $35 fee.

The above examples represent meaningful changes to the customer experience and do not rely upon customer behavior change or adoption of alternative products or tools.

2. Helping Customers Manage Their Monthly Expenses

For some customers, improved access to savings and budget tools could eliminate the intentional or unintentional use of overdraft as a short-term liquidity tool. As the Financial Health Network has explained, various "retronovations" – financial health solutions that mine the experience of paper banking to produce digital solutions – show great promise in fostering and maintaining financial health.[11]

Depository institutions can support customers in building savings and budgeting effectively by offering tools such as earmarking income, automating savings, surfacing opportunities to reduce debt (e.g., when cash flow permits, nudging customers to exceed the minimum payment on a credit card with the same institution), and providing budgeting and cash flow analysis tools in mobile applications.

Fintech provider Digit, for example, uses machine learning to analyze inflows and outflows and calculate an amount that users can save or put toward debt, without causing them to skip bill payments or feel an appreciable difference in their balance. Chime and Acorns both enable customers to round up their purchases and automatically direct the change to a savings account (Chime) or investment account (Acorns). Bank of America's Keep the Change® savings program offers this feature as well.

While some banks offer these money management solutions, they may still have room to improve the integration and adoption of their budgeting, savings, and debt repayment tools. Depository institutions that aim to increase customers' control over their accounts

[11] Corey Stone, "Financial Health Can Be So…Retro," Financial Health Network, July 2020.

and costs should consider how well they have integrated their money management offerings into their product suites. How are they promoting these offerings, and are they directing them to the customers who might benefit most? Are the offerings structured to promote customer choice so that inertia does not prevent adoption? Are customers engaging with the tools, and is engagement correlated with reduced overdraft?

As with many of these solutions, providing customers with tools to help them manage their monthly expenses can also improve their lifetime value to an institution by putting them on the path to other financial products, such as mortgages.

3. Positioning Customers To Avoid Inadvertent Overdrafts

As noted above, overdrafts tend to be for relatively small amounts of money and tend to be repaid relatively quickly. This suggests that institutions could undertake measures to help customers avoid inadvertent overdrafts, especially at the point of sale, with minimal disruption to the customer experience while helping customers to avoid fees that are high relative to the amount overdrawn.

Banks that offer overdraft on an opt-in basis – whether only for debit card and ATM transactions or for checks and ACH – may want to carefully review how well they communicate the consequences of opting in and the ability to revoke an opt-in so that consumers clearly understand their opt-in decisions. One bank, PNC, has given customers the no-penalty option (i.e., no NSF fee) to direct PNC to pay or return checks and ACH debits that would overdraw an account on a transaction-by-transaction basis.

Further, there are several ways depository institutions can help consumers avoid inadvertent overdrafts. Such measures could include “safe to spend” calculations that analyze customers’ recurring payments and deposits to estimate and alert customers of an amount that is safe to spend on discretionary items without overdrawing the account. Similarly, reminding customers of recurring debits before they hit the customer’s checking account, issuing low balance alerts, and alerting customers when a requested or authorized transaction (either at point of sale, through an ATM, or via a push ACH) will result in an overdraft could all help customers avoid unintentional overdrafts.

Although many banks offer some or all of these tools, there are opportunities to increase uptake and engagement.

Finally, for customers who receive direct deposit, providing early access to electronic deposits can be another way to avoid inadvertent overdrafts and to ensure that mismatches in the timing of purchases and deposits do not result in burdensome fees.

4. Offering Alternative Forms of Credit

Some institutions may find that the best way to help customers avoid the harmful financial health impacts of overdraft, and to increase customer satisfaction and loyalty, is by offering alternative, non-overdraft forms of credit. Because overdraft is, in effect, a costly short-term loan, some depository institutions are replacing overdraft with more predictable and lower-cost forms of short-term credit. Examples include Huntington Bank's Standby Cash line of credit option, U.S. Bank's Simple Loan, and Brigit's subscription fee model, all of which provide coverage for immediate cash flow needs without charging overdraft fees. Indeed, Huntington Bank is not charging any fee for its line of credit product.

Importantly, any small-dollar credit program that an institution adds to its offerings needs to be designed as a substitute for, rather than an addition to, overdraft as a means of dealing with liquidity challenges. For example, Bank of America will not offer its Balance Assist installment loan to a consumer with a negative balance. This can help ensure that customers do not find themselves overwhelmed by repayment obligations, including principal repayments, finance charges, and overdraft fees.

5. Providing Safe Checking Accounts

Some consumers prefer accounts that do not provide any risk of overdrafting; surveys show that frequent overdrafters will sometimes close their checking accounts or exit the mainstream banking sector to avoid fees.[12] Other consumers simply cannot qualify for a

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[12] "Overdraft America: Confusion and Concerns about Bank Practices," Pew Center on the States, May 2012.

checking account with overdraft either because they do not have regular incoming deposits or because of their credit history.

For both of these groups, accounts compliant with the national Bank On account standards meet an important need.[13] These standards include no overdraft or NSF fees, and low or waivable monthly maintenance fees. However, providing a Bank On option as part of a menu of products cannot and should not be viewed as a substitute for assuring that *all* of a bank's checking account products advance the financial health of the customers using those products.

Evaluating the Impact of Overdraft Changes

Depository institutions that choose to implement any of the above measures should assess and monitor their impact on customers' financial health to determine how well they are addressing customer needs. Finhealth impact can be indicated by metrics such as overdraft incidence, average daily balances, account closures (both voluntary and involuntary), and per-customer overdraft fees. Averages, however, can often be misleading, so it will be important to examine the impact of the changes on customers most at risk of overdrawing their accounts.

While overdraft revenue may decrease – or disappear altogether – depending on the reforms undertaken, institutions should consider the revenue impact of overdraft reforms not by product margin alone but also in terms of customer lifetime value and reputational metrics, such as net promoter score. Institutions can also evaluate where they rank compared with their peers by metrics such as overdraft revenue in relation to debit card income or in relation to deposit service charges as a way to gauge their relative standing.

The ideas listed above can help institutions acquire new customers who are wary of overdraft and increase customer loyalty by showing responsiveness to customers' financial health needs. Results of any impact analysis can serve as a further tool for enhancing the institution's reputation and appeal to customers, as such analysis can be marketed and serve as thought leadership in the financial services field.

[13] "Bank On National Account Standards," Cities for Financial Empowerment Fund.

The Financial Health Network Can Help

This paper is designed to aid depository institutions in their thinking around timely changes to overdraft practices and policies. The market is rapidly changing, and the Financial Health Network offers expert advice and peer support to help companies design, implement, and evaluate the impact of best-in-class financial health strategies. For more information on how to engage with us, visit our consulting page or contact consulting@finhealthnetwork.org.