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Federal Reserve Says Banks Can Continue Overdraft Plans

By ALEX BERENSON

The Federal Reserve said yesterday that banks could continue controversial programs that consumer groups say function as high-cost loans used mainly by poor and middle-income people.

The programs enable, and in some cases encourage, customers with low balances to overdraw their checking accounts, allowing the banks to skirt credit laws and collect billions of dollars in fees. They are generally marketed as "overdraft privilege" or "bounce protection" and have grown very rapidly in the last five years, with at least 1,500 banks now offering them.

After studying the programs for more than a year, the Federal Reserve said in a statement that they should not be covered under truth-in-lending laws and did not propose any substantive restrictions on them. The Fed did propose some minor changes in the way the programs were marketed.

The Fed's stance was a defeat for consumer protection groups, which have campaigned against the programs.

The public now has 60 days to comment on the proposed changes, and then the Federal Reserve will consider issuing a final rule, a spokeswoman said.

Under the programs, the banks cover checks that would otherwise bounce, permitting people to overdraw their accounts with A.T.M. and debit cards. Although banks have always offered lines of credit to higher-income depositors with large balances, these programs are aimed at depositors with smaller balances and usually will not cover overdrafts of more than \$500.

Each time a person overdraws his account, he is charged a fee of \$15 to \$35, and the overdraft must be paid back in a matter of days or weeks. Some programs also add a daily fee if the overdraft remains outstanding for more than a few days.

When the overdraft occurs as a result of a debit card or A.T.M. transaction, banks generally do not immediately inform their customers or give them the option to reverse a transaction. Instead, they mail a

notice out. So a person who uses a debit card may incur several overdrafts before realizing what has happened.

The effective interest rates on the programs are enormous; someone who pays a \$20 fee for a \$100 overdraft that is outstanding for two weeks is paying the equivalent of an annual interest rate of 520 percent. Industry consultants who help banks create and market the programs have said that the fees are paid disproportionately by low- and moderate-income people.

One consultant has advised banks to maximize the fees by opening branches "in supermarkets, particularly supermarkets with a middle to down market and a family target market."

Banks and consultants say that they are offering a service that lets people avoid paying bounced-check fees to retailers. But many inside and outside the banking business say the programs, while extremely profitable for the banks, are a bad deal for consumers and amount to high-interest loans.

For the banking industry, the move to encourage overdrafts is a major shift. In the past, when consumer groups complained that bounced-check fees were excessive, banks generally responded that high fees motivated people to use their checking accounts responsibly. Now, with banks increasingly dependent on fees from consumers, overdrafts have become a source of profit.

Groups like the Consumer Federation of America, based in Washington, had encouraged the Federal Reserve to regulate the programs under truth-in-lending laws, which would have forced banks to disclose the effective interest rates they are charging and might have subjected them to usury laws. Banks said that the programs should not be considered lines of credit or subject to lending laws.

In its statement, the Federal Reserve agreed with the banks and said it had chosen to regulate the programs under "truth in savings" laws, which regulate the way that banks market and provide accounts.

The Fed said it found that in general the programs were not a problem as long as they were adequately disclosed.

Robert R. Davis, executive vice president of America's [Community Banks](#), a lobbying group for 1,200 mainly smaller banks, said his group was pleased with the Fed's decision.

"Generally, what they are doing is consistent with the policy positions we've maintained," Mr. Davis said. "These programs administered as we feel they should be administered are not credit extensions, they're a service."

A spokesman for Washington Mutual, the largest financial institution to promote bounce protection programs, said the company was studying the Fed's proposal and had no comment. Washington Mutual charged customers more than \$1 billion in overdraft fees last year, industry analysts estimate.

Consumer groups have proposed limiting the programs in several ways, like capping fees, barring banks from charging more than a certain number of fees each month or quarter, or forbidding the fees on very small overdrafts.

These groups have said that the programs can be especially pernicious when someone has a series of small overdrafts, like a \$20 A.T.M. withdrawal followed by a \$10 purchase at a convenience store, and is charged an overdraft fee each time. Consumers would not use their accounts that way if they knew they were being charged, the groups have argued.

The Federal Reserve proposal also does not bar banks from programming their A.T.M.'s to display a balance that includes both the amount available under the overdraft program and the consumer's own balance without distinguishing between the two. For example, some banks tell a person with \$100 in his account that he has an "available balance" of \$400, including a \$300 overdraft program. They then charge an overdraft fee for any withdrawal of more than \$100.

While the Fed found that the programs were not loans and should not be covered under credit laws, it also said in its statement that fees charged for the programs "relate to the institution's own provision of credit." A spokeswoman for the Federal Reserve said she could not explain why the Fed had referred to the fees that way.