Contrasting Payday Loans to Bounced-Check Fees

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Introduction

Payday loans and bounced-check fees are increasingly penetrating America's economic landscape. Both of these financial-service vehicles have recently drawn the attention of federal regulators. This paper examines and contrasts these financial services and their real costs to consumers. Although actual data regarding individual consumer usage of overdraft services require refinement, inferential data suggest that payday loans hold a cost advantage over overdraft services for the average consumer.

Overdraft Protection Programs

On February 18, 2005, the Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corp. and National Credit Union Administration issued final "Joint Guidance on Overdraft Protection Programs" designed to ensure the responsible disclosure and administration of overdraft protection programs offered by entities they regulate.[1]

FDIC and NCUA data suggest that more than 18,000 financial institutions and credit unions collect $32.6 billion annually in service charges from the 56 million checking accounts they service.[2] Thus these institutions annually derive $582 in service charges from an average checking account.

Bank service fees have virtually doubled in the eight years from 1995 and 2003, from $16.4 to $32.6 billion.[3] Interestingly, fees from overdraft protection programs (also called "nonsufficient funds" or "NSF" fees) have risen so dramatically that they may now represent the preponderance of all such fee income for banks and credit unions.[4] NSF income for banks and/or credit unions can amount to up to 50% of total consumer checking account revenue.[5] One recent analysis estimates that such NSF fees account for more than half — roughly $18.8 billion — of the service-fee income derived by America's banks and credit unions.[6] An independent consultant estimates that banks collected $22 billion in overdraft fees in 2003.[7] Virtually all banks now impose NSF fees.[8]

1 http://www.federalreserve.gov/boarddocs/srletters/2005/SR0503a1.pdf.
2 Bretton Woods, Inc., Management Advisory Service presentation to CFSA, March 4, 2005.
3 Bretton Woods, Inc.
4 Bretton Woods, Inc.
5 https://www.bai.org/bankingstrategies/2005-jan-feb/sizing/index.asp.
6 Bretton Woods, Inc.
7 Ibid.
8 http://www.bankrate.com/brm/news/chk/20020619b.asp.

Overdraft Protection and the Cost to Consumers

Typically, whenever a consumer bounces a check — or possibly overdraws from an automated teller machine (ATM), debit card, automated-debit feature, phone-initiated transfer or on-line banking transaction — the possibility exists that an overdraft fee could be levied. NSF fees were reported to average $25.81 per occurrence in 2004.[9] These fees were 20% higher in 2004 than the average of $21.57 in the fall of 1998.[10] Another analysis by the State of Washington Department of Financial Institutions found that the average fee per occurrence in that state was $28.75 in late 2004.[11] Simple division of the NSF fee against the aggregate estimated NSF fee of $18.8 billion suggests that more than 725 million NSF charges were processed nationally. This represents more than two bounced-check fees for every man, woman and child living in the country, every year. However, NSF fees are not derived from everyone; NSF fees are collected only from those 56 million Americans with checking accounts. Specifically, NSF fees are drawn exclusively from the substantially smaller pool of customers who bounce checks.

If such a customer experiences one NSF fee, he or she is likely to encounter additional NSF fees:

> *"Suppose you had $300 in your checking account and wrote six checks totaling $375. The six checks are for $200, $12, $50, $60, $23 and $30.*
>
> *"If they all come back to the bank at the same time, the bank could clear the last five checks and just bounce the one for $200. You'd pay one NSF fee. But, more than likely, the bank will clear the biggest ones first; so, the $200 check clears and so does the $60 check. But with the $50 check you're overdrawn. So, you pay four NSF fees."*[12]

9 http://moneycentral.msn.com/content/Banking/Betterbanking/P110012.asp.

10 Ibid.

11 *Pay Day Lending Report, Statistics & Trends, 2003*, Washington State Department of Financial Institutions, p. 5 (figure cited reflects typical practices of four largest financial institutions on Dec. 29, 2004).

12 http://www.bankrate.com/brm/news/chk/20010508a.asp. Since the publication of the cited article, primarily in response to numerous class actions alleging unfair and deceptive practices related to the "posting order" of NSF checks, most major banks have adopted "low to high" posting policies. See, http://www.bankrate.com/brm/news/chk/19991110.asp.

Possible experiences such as the one described immediately above suggest that NSF costs are likely to multiply rapidly for consumers who encounter them. A December 2004 Federal Reserve payment study suggests that 183.5 million NSF checks were issued in 2003.[13] One analysis of NSF fees suggests that the average checking account will yield 13 NSF fees in a typical year.[14] Again, use of an average is likely to obscure the harsher reality: most NSF fees are assessed against a smaller segment of consumers who pay substantially higher aggregate fees due to the multiplying effect of numerous NSF charges. The recent initiative by federal regulators was not motivated entirely by a desire to protect consumers from themselves; instead, it was designed to check financial institutions from literally "piling on." The Federal Reserve estimates the average bounced check was valued at $756 in 2003.[15] This average incorporates checks written by business, commercial and individual consumer interests. However, it seems reasonable to assume that checks written by individuals and families are very likely for smaller amounts.[16]

The agencies' new overdraft protection guidelines candidly addressed their concern. For example, they state:

"While both the availability and customer acceptance of these overdraft protection services have increased, aspects of the marketing, disclosure, and implementation of some of these programs have raised concerns with the Agencies...

"...some institutions have promoted this credit service in a manner that leads consumers to believe that it is a line of credit…without clearly disclosing the terms and conditions of the service...

"...some institutions have adopted marketing practices that appear to encourage consumers to overdraw their accounts, such as by informing consumers that the service may be used to ***take an advance of their next paycheck****...*

"Some institutions may advertise accounts with overdraft protection coverage as 'free' accounts, and thereby lead consumers to believe that there are no fees associated with the account or the overdraft protection program."

13 http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf.
14 Bretton Woods, Inc., Management Advisory Service presentation to CFSA, March 4, 2005.
15 http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf
16 Unfortunately, at this writing, additional data on this premise are not available from the Federal Reserve.

Payday or Cash-Advance Loans

The payday-lending industry has experienced tremendous growth in recent years. During the 1990s, the number of payday-loan retail outlets grew from virtually none to more than 10,000 by the end of the decade. Estimates suggest that there are currently about 22,000 payday-lending outlets in the United States.

Borrowers include educated, middle-income Americans who often take out a payday loan because it is a better alternative to bounced-check fees, utility shut-offs or other costs. In such circumstances, payday loans may provide a practical option to consumers who either lack access to alternative forms of credit or who choose the convenience and simplicity of a payday loan.[17]

The Federal Deposit Insurance Corporation issued new guidance for banks under its supervision on March 2, 2005. The regulations describe the FDIC's expectations for prudent risk-management practices for payday-lending activities, particularly with regard to asset concentration, capital, allowances for loan losses, classification and consumer protection. The guidelines also address recovery practices, income recognition and managing risks associated with third-party relationships.[18] The FDIC's new guidelines affect payday loans made by state-chartered, federally insured banks, which are generally originated and serviced by non-bank marketers, as discussed in the next section.[19]

[17] *Payday Lending, A Practical Overview of a Growing Component of America's Economy*, William O. Brown, Jr., Ph.D., David W. Findlay, Ph.D., Thomas E. Lehman, Ph.D., Michael T. Maloney, Ph.D., and James W. Meehan, Jr., Ph.D. (available at http://www.consumercreditresearchfoundation.com).

[18] http://www.fdic.gov/regulations/safety/payday.

[19] http://www.chicagotribune.com/business/chi-0503030311mar03,1,4987310.story?coll=chi-business-hed&ctrack=1&cset=true.

Comparing Payday Loans to NSF Fees

Payday-loan providers are required by law to comply with federal disclosure requirements for the interest and other charges on the short-term loans they provide. Those costs are prominently described on an annual percentage rate (APR) basis, and are often expressed in interest rates of, for example, 391% (derived from an annualized fee of $15 per hundred dollars borrowed over a loan duration of 14 days). NSF fees are not recognized by bank regulators to be "interest," even though they are interest in an economic sense. Because of this regulatory anomaly, NSF charges are not subject to the disclosure requirements of the Truth In Lending Act; and borrowers are deprived of an APR disclosure with respect to the true cost of NSF credit.

While some groups have maligned payday lenders for the relatively high interest rates they charge, the cost of a payday loan can be significantly less than the cost of a bounced check. Indeed, bank and credit union NSF fees are similarly expensive — or in the case of repeated fees accrued from multiple bounced checks — substantially more expensive. If, on average, 13 checks are overdrawn in a year, and the consumer were to incur a $28.51 fee for each, then the annual cost of this service would be $370.63. Alternatively, if the typical payday-loan borrower opts for as many as seven loans (at a per-loan cost of $45 per $300 borrowed), over the course of a year the total interest paid would be $315. The State of Washington, for example, imputed a 499.7% APR from just two $300 checks.[20] If overdraft fees are incurred from NSF checks written for smaller amounts, then the imputed APR would be substantially higher than in Washington State's example.[21] Because overdraft protections are not subject to Truth In Lending Act disclosure requirements, NSF fees may represent a significantly larger economic cost than generally understood.

[20] *Pay Day Lending Report, Statistics & Trends, 2003*, Washington State Department of Financial Institutions, p. 6.

[21] The above-referenced report does not offer a basis for selecting the $300 example NSF checks, although the Department may have used this amount because it reflects the average face value of a payday loan.

Deducing the average size of a "bounced" consumer check is a critical task which requires some judicious reasoning from banking, retail and academic sources. The cited Federal Reserve 2004 Payment Study reports the average returned check from all sources (businesses and individual consumer accounts combined) was $756.[22] This number artificially inflates the actual size of the average consumer's bounced check.

A more accurate gauge of a typical consumer's average bounced check can be gleaned from those who provide goods and services directly to end-use consumers, and those who provide banking services directly to those consumers. The National Automated Clearing House Association represents more than 12,000 financial institutions through direct memberships and a network of regional payments associations and 650 organizations through its industry councils. NACHA develops operating rules and business practices for the automated clearinghouse network and for electronic payments in the areas of Internet commerce, electronic bill and invoice presentment and payment, e-checks, financial electronic data interchange, international payments and electronic benefits transfer.

NACHA reported that the average dollar amount of a represented check was $155 in 2003.[23] A represented check is a consumer NSF check that is represented for payment electronically rather than through the traditional and increasingly outdated paper check collection system.

NACHA's data, common sense and a review of consumer economic literature suggest that $155 offers a realistic estimate of the average size of a NSF check. Applying the average NSF fee of $28.51 to a $155 overdrawn check yields an APR of 478%, assuming that repayment is made in two weeks.[24]

22 http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf.
23 http://svcfirst.com/download/resource_032204.pdf.
24 Payday lenders typically limit customers to one payday loan in a two week period. Banks often, on the other hand, charge for up to four bounced check fees (likely totaling $115 or more) in a single business day.

Comparing Payday Loans to NSF Fees

	Payday Loan	Overdraft Protection for One Paid Overdraft Paid in 14 Days	Overdraft Protection for One Paid Overdraft In Five Days
Amount	$300	$155	$155
Duration	14 days	14 days	5 days
Actual Fee	$45.00	$28.75	$28.75
Hypothetical APR	**391%**	**478%**	**1,353%**
	$45 per loan based on $15 fee per $100 borrowed.	Overdraft fees range from $25 to $33. Average is $28.75. Example assumes average fee with one overdraft paid. *Source:* Four large financial institutions in Washington on 12/29/04. APR equivalent for comparison purposes only; overdraft protection not subject to Truth in Lending Act.	Example assumes the average overdraft fee of $28.75 is applied to a $155 average NSF represented check, which is required by bank policy to be paid within five days. If expressed as an APR equivalent for comparison purposes only this would be 1,353% ($28.75 x 73 five-day cycles in a year = 1,353%). Overdraft protection not subject to Truth in Lending.

The State of Washington Department of Financial Institutions recently studied payday loans and compared them to bank NSF fees. In that analysis, the APR cost of two NSF checks exceeded the imputed APR cost of one payday loan of the same ($300) face value.[25] It is interesting to note that, in separately issued guidance to state-regulated banks, the Department noted "a number of institutions have established reasonable limits on the amount of overdraft fees assessed per day (e.g., one institution has a daily limit of four fees at $18 per overdraft item). If the customer has six overdrafts on the same day, the institution will charge $72 in total fees ($18 x 4 items)."[26] Clearly the Department and at least some of the banks under its purview have acknowledged the potential for extraordinary NSF fees. As the above chart

[25] www.dfi.wa.gov/news/DFI_PaydayReport.pdf
[26] http://www.dfi.wa.gov/news/Final%20Guidance%20Overdraft%20Protection.pdf.

demonstrates, if repayment is made promptly, the effective APR through an NSF fee becomes nothing short of breathtaking.

From this analysis, it appears likely that a typical overdraft customer will sustain higher costs of credit than a payday-loan customer for credit of comparable amount and duration.

While payday-loan borrowers can clearly discern the costs they are incurring, a consumer encountering a NSF fee or other charges for overdraft protection may not be able to determine the true cost of credit. This is particularly the case when additional (perhaps unseen) costs are considered. When comparing NSF fees and bank overdraft protections with payday loans, a number of additional questions arise, some of which have not been considered in the research to date. For example, which consumers can obtain overdraft protection? Not all consumers have access to overdraft protection, and therefore a payday loan may be the only viable option for short-term credit for certain borrowers. Also, what is required to obtain overdraft protection? Are there indirect costs (such as inconvenience, delay or additional disclosures of personal information) that borrowers would prefer to avoid while obtaining this service?

This paper demonstrates that the typical payday loan holds a cost advantage over traditional check overdraft services for the average consumer.

It remains true that consumers will endeavor to do what is in their best interests, provided they have the necessary information on all the alternatives and can properly gauge the costs and benefits that are appropriate to their unique situations.

Competition in the marketplace benefits consumers, and payday loans offer a cost-effective alternative to overdraft protection. Consumers will continue to benefit from access to short-term credit in a variety of forms.

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Dr. Lehman's teaching and research interests include: principles of microeconomics and macroeconomics, public policy and administration, public finance and budgeting, urban economics and government, urban housing markets, urban economic growth, inequality, and statistics and social science research methods. Dr. Lehman has written and published widely on local economic development issues in Indiana, and has coauthored several studies on the determinants of rental prices in urban housing markets.

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