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Recent Trends in Consumer Retail Payment Services Delivered by Depository Institutions

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Summary

Congressional interest in the performance of the credit and debit card (checking account services) markets and how recent developments are affecting customers is growing. This report discusses these developments and examines the costs and availability of consumer retail payments services, particularly those provided by depository institutions, since the recent recession and subsequent legislative actions.

Consumer retail payment services include products such as credit cards, cash advances, checking accounts, debit cards, and prepayment cards. Some depository institutions have increased fees and decreased availability of these services; many others are considering the best way to cover rising costs to provide these services without alienating customers. Recent declines in the demand for loans, a historically and persistently low interest rate environment, higher capital requirements, and the existence of potential profit opportunities in non-traditional banking markets may have motivated these reactions. In addition, passage of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act; P.L. 111-24) and Section 920 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203), which is known as the Durbin Amendment, placed limitations on fee income for credit cards and debit cards, respectively.

Determining the extent to which one or all of these factors have influenced changes in the consumer retail payment services markets, however, is challenging. Market outcomes are often influenced by multiple simultaneous or overlapping events, thus making it difficult to attribute the reactions of financial service providers and their customers solely to any one particular factor. Any one or all of the factors listed above that occurred after 2007 may have driven changes in the costs or availability of consumer retail payment services, making it difficult to determine which one had the greatest influence on market outcomes.

Depository institutions reduced credit card loan limits during the recent recession, but those limits have since been rising. Customers with impaired credit, however, have seen increases in credit card rates and reduced access to this product. Many large depository institutions have also discontinued debit card rewards programs and “free” checking. Many small financial institutions have not increased checking account fees as aggressively, but many have increased fees on less frequently used financial services and are considering further fee increases to cover anticipated higher costs. The consumer retail payment services market may also be growing more bifurcated. For example, customers more likely to repay obligations or maintain high checking account balances may experience few changes in costs or availability of traditional payments services. At the same time, customers likely to face higher costs to use or limited access to traditional payment services may increase their usage of direct deposit cash advances and prepayment cards, as depository institutions make these options increasingly available to this market segment.

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Introduction

The consumer retail payments system facilitates transactions to purchase goods and services, pay bills, obtain cash through withdrawals and advances, and make person-to-person payments.[1] Consumers may use cash, checks, or traditional electronic banking products to facilitate these transactions. Traditional electronic banking products include credit cards and debit cards. Revolving credit or credit cards serve as unsecured (no collateral) short-term lending for some cardholders, if the outstanding balance is not repaid in full, and a convenient way to make transactions for others, if they fully repay balances upon receipt of the billing statement. Debit cards facilitate electronic access to checking account services discussed in more detail later in this report. Debit cards are provided primarily by depository institutions (banks and credit unions), but any institution that provides checking account services may provide debit cards.

According to the Federal Reserve Payments Study, the United States has seen continued growth of noncash or electronic payments.[2] Electronic payments are made by electronic payment (credit, debit, and prepayment) cards and by the automated clearing house (ACH), an electronic network used for direct deposit and electronic bill payment. In 2009, checking account holders were more than twice as likely to choose an electronic payment option over writing checks, indicating their preference for electronic financial services.[3] Debit cards and ACH payments were used in 35% and 18%, respectively, of noncash payments; paper checks accounted for another 22% of these transactions. The remaining noncash payments were conducted using credit cards and prepayment cards at percentages of 20% and 5%, respectively. In 2012, the percentages of noncash payment transactions using debit cards, credit cards, ACH payments, paper checks, and prepayment cards were 38%, 21%, 18%, 15%, and 7%, respectively.[4] In addition to the decline in paper check writing, checks increasingly were deposited with images (from 13% of deposits in 2009 to 17% in 2012). As the payments system continues to evolve, consumers using financial retail services provided by regulated depository institutions arguably enjoy benefits (e.g., stemming from various consumer protection laws designed to protect against unfair, discriminatory, or predatory practices) that may not be associated with non-covered financial service providers.[5]

Preliminary evidence suggests that, since 2009, some consumers experienced either higher charges or less availability of retail payment services provided by depository institutions. These developments may arguably be attributed to some of the following explanations.

[1] For a broader understanding of the U.S. payments system, see CRS Report R41529, *Supervision of U.S. Payment, Clearing, and Settlement Systems: Designation of Financial Market Utilities (FMUs)*, by Marc Labonte.

[2] The Federal Reserve Payments conducts a payment study every three years. See http://www.frbservices.org/fedfocus/archive_perspective/perspective_0313_01.html, which also includes links to the 2001, 2004, 2007, and 2010 Federal Reserve Payment Studies.

[3] See *The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006-2009* at http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf and Jeremy M. Simon, "Paper to Plastic: Checks and Cash Losing to Debit and Credit," at http://www.creditcards.com/credit-card-news/debit-credit-card-preferred-payment-1271.php.

[4] See *The 2013 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006-2009* at http://www.frbservices.org/files/communications/pdf/research/2013_payments_study_summary.pdf.

[5] See Maude Toussaint-Comeau and Sherrie L. W. Rhine, *Increasing Participation in Mainstream Financial Markets by Black Households*, Federal Reserve Bank of Chicago, Policy Studies: Consumer Issues Research Series, Chicago, IL, December 2000, http://www.chicagofed.org/digital_assets/others/region/cedric/papers/cca-2000-4.pdf.

- After the 2007-2009 recession, the demand for consumer loans declined, and U.S. interest rates dropped to historically low levels for an abnormally long period of time.[6] Declines in lending volumes and loan yields can squeeze profit margins, perhaps motivating depository institutions to increase fees on several products and services.
- Capital requirements for non-performing loans increased for the banking system.[7] Providing traditional retail services became more expensive for certain financial institutions with many customers unable or unwilling to repay obligations, triggering the need to hold greater amounts of capital in reserve against losses. Hence, depository institutions were inclined to show greater selectivity when making potentially costly financial products available.
- Rather than wait for the profitability to return to more traditional lines of business, depository institutions sought profits from emerging opportunities in new business lines, discussed later in this report.
- Congress passed legislation in 2009 and 2010 that placed limitations on fee pricing practices for credit and debit cards, discussed in greater detail below.[8] Disclosure requirements of remittances (electronic transfers of funds by a consumer to a person or business in a foreign country) may result in costs that some (small) depository institutions would not want to incur without sufficient volume to justify the expense.[9] Hence, the loss of fee income increases as well as other regulatory requirements may increase the difficulty of providing retail payment services at little or no cost to customers.

There is congressional interest in how the costs and availability of consumer retail payments services provided primarily by depository institutions have changed following the passage of recent legislative actions, namely the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act; P.L. 111-24) and Section 920 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203), which is known as the Durbin Amendment. Any one or all of the factors listed above that occurred after 2007 may have prompted changes in the consumer retail payment services market, making it difficult to determine which one had the greatest influence on market outcomes. This report recounts developments beginning in 2006 in the markets for credit cards and checking account services delivered primarily by depository institutions.

Preliminary evidence indicates some recent segmentation of the consumer retail payments market. Customers with the ability to repay short-term loans in a timely manner or maintain sufficient deposit balances may notice little change in cost or availability of traditional retail payment services. On the other hand, customers who generate fees, such as insufficient funds fees

[6] According to the National Bureau for Economic Research, the economy was in recession most recently between December 2007 and June 2009. See http://www.nber.org/cycles/recessions.html.

[7] On July 9, 2013, federal banking regulators required an increase in bank capital (150% risk weight) to the outstanding balance of non-performing consumer loans. See CRS Report R42744, *U.S. Implementation of the Basel Capital Regulatory Framework*, by Darryl E. Getter.

[8] See CRS Report RL34393, *The Credit Card Market: Recent Trends and Regulatory Actions*, by Darryl E. Getter; and CRS Report R41913, *Regulation of Debit Interchange Fees*, by Darryl E. Getter.

[9] See http://files.consumerfinance.gov/f/201305_cfpb_remittance-transfer-rule_summary.pdf and CRS Report R43217, *Remittances: Background and Issues for Congress*, by Martin A. Weiss.

that simultaneously trigger increased regulatory capital costs on their depository institutions, may find themselves paying more or experiencing limited access to conventional retail payment services. Some depository institutions, however, are offering this market segment greater payment services characterized by less credit or nonpayment risks, such as direct deposit cash advances and prepayment cards. These products and services, which are also part of the consumer retail payments system, are defined and discussed later in this report.

Recent Developments in the Credit Card Market

Congressional concerns about hidden and complex penalty fees and assessments on credit card holders led to passage of the CARD Act.[10] Various provisions of the CARD Act were implemented on August 20, 2009, and February 22, 2010, with full implementation accomplished by August 22, 2010.[11] Some notable provisions appear below.

Summary of Some Key CARD Act Regulations

- The CARD Act established circumstances when rate increases or fees on outstanding balances would be permissible.
- Advance notice (45 days) is required before any rate or fee increases.
- Accounts that experience rate increases must be reviewed every 6 months to determine if a rate reduction is warranted.
- A payment made by a cardholder with multiple accounts will be applied first to the balance with the highest rate, and then to each successive balance bearing the next highest rate until the payments are exhausted.
- A customer must receive a periodic statement within a reasonable amount of time (not less than 21 days) before payment is due.
- If a creditor changes terms, such as increasing the interest rate that would apply to future purchases, consumers must receive notice of their right to cancel the account before the effective date of the change. Cancellation of an existing account shall not trigger a demand for immediate repayment of the full amount owed or additional fees. Consumers must instead be offered a repayment option. The existing balance of a repayment option may be amortized on a schedule of not less than five years. A new repayment schedule may be established in which the percentage of the outstanding balance of the periodic repayment does not increase by more than twice the percentage required under the consumer's existing schedule.
- Enhanced consumer disclosures (e.g., the consequences of making only the minimum monthly payment, late payment deadlines and penalties, prominent disclosure of payment deadlines) are required.
- Credit card issuance to consumers under 21 years of age is limited.
- Total fees cannot exceed 25% of the initial credit limit, affecting the availability of subprime ("fee harvester") credit cards.
- Monetary penalties for violations of the Truth in Lending Act (TILA) as it relates to credit card lending were increased.

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[10] For example, see Martin H. Bosworth, "Credit Card Fees Rise, Disclosure Statements Inadequate," at http://www.consumeraffairs.com/news04/2006/10/gao_credit_cards.html and Anita Hamilton, "Exposing the Credit-Card Fine Print," at http://www.time.com/time/printout/0,8816,1715293,00.html#.

[11] See http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2010/first-quarter/regulation-z-rules.cfm, http://www.federalreserve.gov/newsevents/press/bcreg/20090715a.htm, and http://edocket.access.gpo.gov/2010/pdf/2010-624.pdf (final rule).

Risk-based pricing is the practice of charging riskier borrowers higher rates to reflect their additional credit or default risk.[12] Billing practices, such as double-cycle billing, served as a form of risk-based pricing of credit to cardholders immediately if their behavior indicated greater default risk. If cardholders switched from using their cards simply for transaction purposes to revolving loan purposes or missed a payment, fees and higher finance charges were imposed almost immediately, often without any grace period.

The CARD Act eliminated various billing practices and limited the ability to raise rates without providing advance notice to customers; however, there were no caps placed on credit card interest rates. Consequently, while risk-based pricing of cardholders may have been more difficult via the use of fees, credit card issuers have other available options to manage default risk. Card issuers could reduce lending risks by lowering credit limits and increasing credit card rates on all borrowers, both timely and delinquent.[13] Another response may be to increase rates and reduce limits for borrowers with greater delinquency and default risk. Issuers could also decide to limit the availability of this product to riskier customers.

Subprime credit card lending, or lending to borrowers with impaired credit, still exists; but identifying how the issuance of "fee harvester" cards has changed is difficult due to lack of available data.[14] One alternative to *unsecured* revolving credit to risky borrowers is *secured* revolving credit. Secured credit cards, which are offered to borrowers with missing or impaired credit histories, require either security deposits as collateral for the amount of the line of credit or links to checking or savings accounts, thereby allowing lenders to recover funds if payments are missed. The security deposit is refunded if borrowers do not miss payments.[15] Customer payment activity does get reported to credit bureaus. Hence, secured credit card lending can help

[12] For discussions about how the increased use of risk-based pricing strategies led to fewer credit denials and greater credit accessibility for higher risk borrowers, see Raphael W. Bostic, "Trends in Equal Access to Credit Products," in *The Impact of Public Policy on Consumer Credit*, eds. Thomas Durkin and Michael Staten, Massachusetts: Kluwer Academic Publishers, 2002, pp. 171-202; Wendy M. Edelberg, "Risk-based Pricing of Interest Rates in Household Loan Markets," *Finance and Economics Discussion Series 2003-62*. Washington: Board of Governors of the Federal Reserve System, 2003; Wendy M. Edelberg, "Risk-based Pricing of Interest Rates for Consumer Loans," *Journal of Monetary Economics*, vol. 53, November 2006, pp. 2283-2298; Mark Furletti and Christopher Ody, "Another Look at Credit Card Pricing and Its Disclosure: Is the Semi-Annual Pricing Data Reported by Credit Card Issuers to the Fed Helpful to Consumers or Researchers?", *Payment Cards Center Discussion Paper*, Federal Reserve Bank of Philadelphia, July 2006; Kathleen W. Johnson, "Recent Developments in the Credit Card Market and the Financial Obligations Ratio," *Federal Reserve Bulletin*, vol. 91, September 2005, pp. 473-486.

[13] Economic theory, specifically the law of supply, suggests that firms are less willing to supply products to the marketplace at lower prices. For studies on the regulatory effects of credit card rates and fees, see Diane Ellis, "The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-offs, and the Personal Bankruptcy Rate," *Bank Trends*, FDIC Division of Insurance, March 1998, at http://www.fdic.gov/bank/analytical/bank/bt_9805.html; and Jonathan M. Orszag and Susan H. Manning, *An Economic Assessment of Regulating Credit Card Fees and Interest Rates*, a study commissioned by the American Bankers Association, at http://www.aba.com/aba/documents/press/regulating_creditcard_fees_interest_rates92507.pdf.

[14] Fee harvester cards refer to a type of subprime credit card in which the total fees amount to a large proportion of the credit limit, making it similar in characteristics to a payday loan. On July 20, 2011, a lawsuit was filed, which challenged the application of fee limitation provisions of the CARD Act *prior* to opening the account. On April 12, 2012, the Consumer Financial Protection Bureau subsequently proposed a rule stating that credit card fee limitations will apply the first year *after* the account has been opened. The rule became effective on March 22, 2013. See http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-finalizes-credit-card-act-rule/, http://files.consumerfinance.gov/f/201303_cfpb_final-rule_regulation-z-amendment.pdf, and http://online.wsj.com/news/articles/SB10001424052702304356604577339851223075134.

[15] Unlike a prepayment card, which is defined later in the report, the customer must reload the card once the funds are spent in order to continue using it.

borrowers build or repair creditworthiness. Secured credit cards would still be subject to fee limitations and disclosure regulations stemming from the CARD Act. There is some evidence suggesting that the availability of secured credit card lending has subsequently risen in light of the regulation of subprime credit card lending, but locating official data sources that distinguish between unsecured and secured credit card lending is difficult.[16]

The Federal Reserve Bank of New York (FRBNY) collected a nationally representative sample of credit report data to estimate the availability of revolving credit for consumers.[17] Revolving credit availability and usage has declined, but estimates of the size of the decline vary depending upon the chosen time interval. Using the FRBNY data displayed in the first column of **Table 1**, household credit limits declined by 28.2% between 2008 and 2010; the decline is calculated to be 11.0% over the longer period 2006-2012.[18] The second column of **Table 1** shows the aggregate amount of revolving or credit card debt outstanding as reported by the Federal Reserve. Although the amount of credit card debt outstanding declined by 16.4% between 2008 and 2010, the decline was 8.6% between 2006 and 2012. The 2008-2010 period captures the year immediately before and after passage of the CARD Act as well as the trough of the 2007-2009 recession. The 2006-2012 period captures more of the recovery following the 2007-2009 recession, thus showing less of a decline in credit card usage.

Table 1. Credit Card Limits, Balances, Terms Before and After the CARD Act

Year	Average Amount Available Credit Limit (Trillions of Dollars, FRBNY)	Amount Consumer Credit Outstanding: Revolving (Billions of Dollars, G.19)	Credit Terms (Interest Rate) Commercial Banks, Credit Card Plans: All Accounts (Percent, G.19)	Credit Terms (Interest Rate) Commercial Banks, Credit Card Plans: Accounts Assessed Interest (Percent, G.19)	Estimates of Credit Terms (Interest Rate): "Cards for Bad Credit" (Percent, CreditCards.com)
2006	2.37	924.9	13.21	14.73	n.a.
2007	2.50	1002.9	13.30	14.68	13.27
2008	2.73	1005.2	12.08	13.57	11.86
2009	2.21	917.2	13.40	14.31	13.26
2010	1.96	840.7	13.78	14.26	21.09
2011	2.05	842.5	12.74	13.09	24.78
2012	2.11	845.8	12.06	12.96	23.64

[16] See http://www.nytimes.com/2010/12/13/business/13credit.html?pagewanted=all&_r=0 and http://www.americanbanker.com/issues/174_7/-370455-1.html?zkPrintable=1&nopagination=1. Lending institutions are reportedly making greater use of secured credit cards to help distinguish those defaulters that had a strong credit record prior to the 2007-2009 recession from those who are just poor risks, suggesting that secured credit card lending may be rising.

[17] See http://www.newyorkfed.org/research/national_economy/householdcredit/DistrictReport_Q32011.pdf.

[18] See Meta Brown, Andrew Haughwout, and Donghoon Lee et al., *The Financial Crisis at the Kitchen Table: Trends in Household Debt and Credit*, Federal Reserve Bank of New York, Staff Report No. 480, New York, NY, December 2010, p. 8, http://newyorkfed.org/research/staff_reports/sr480.pdf. A study using data from Visa, Inc. revealed that 70% of credit line downsizing took place on dormant/inactive accounts. See Susan Herbst-Murphy, *Trends and Preferences in Consumer Payments: Lessons from the Visa Payment Panel Study*, Federal Reserve Bank of Philadelphia, Payment Cards Center Discussion Paper, Philadelphia, PA, May 2010, p. 3, http://www.phil.frb.org/payment-cards-center/publications/discussion-papers/2010/D-2010-Visa-Payment-Panel-Study.pdf.

Source: The data come from the following data sources: Federal Reserve Bank of New York (FRBNY) Consumer Credit Panel (http://www.newyorkfed.org/householdcredit/2013-Q2/index.html), Board of Governors of the Federal Reserve System G.19 Statistical Release (http://www.federalreserve.gov/Releases/g19/current/default.htm), and various CreditCards.com's Weekly Rate Reports. The particular source is indicated in parentheses. The figures are not adjusted for inflation.

Notes: Averages of the Estimated Amount Available Credit Limits were computed by CRS.

Similarly, the change in credit costs or terms (interest rates) is sensitive to the chosen time interval. Revolving credit costs increased for all accounts and for those assessed interest (carrying balances) over the 2008 and 2010 period; however, the costs actually declined over the longer 2006-2012 period of time. In 2010, the credit terms for borrowers with impaired credit spiked after a period of rising credit card defaults and subsequent accounting recognition of losses from uncollectible obligations (charge-offs) that occurred during the 2007-2009 recession.[19] These findings may reflect greater bifurcation of the credit card market into high-quality and impaired borrowing groups. These findings are consistent with the anticipated reaction by lenders to both the recession and the CARD Act.

There have recently been conflicting reports of credit card market activity in terms of cost and availability. An academic study reports that the CARD Act reduced overall borrowing costs to consumers, with no offsetting increase in interest charges or reduction in credit access over the 2008 to 2011 period.[20] The results from the academic study, however, do not appear to be consistent with various industry reports. The American Bankers Association reported in a comment letter filed with the Consumer Financial Protection Bureau that new credit card users and impaired credit card users experienced higher costs and less availability of credit card credit.[21] Given the historically and persistently low (prime) interest rate environment coupled with a decline in demand for consumer loans, banks have been looking for lending opportunities that would allow them to charge higher interest rates.[22] Consequently, small and regional banks have reportedly renewed their interest in credit card lending after some retrenchment during the recession.[23] Furthermore, the decline in outstanding consumer credit, as reported in **Table 1** by the New York Federal Reserve Bank, has not returned to pre-recession (2006) levels. The relatively lower amount of credit card usage could reflect both lower credit card loan demand as well as higher lending standards reportedly imposed by (large bank) lenders.[24]

Generally speaking, it is difficult to attribute outcomes in the credit card market solely to either the 2007-2009 U.S. recession or to the CARD Act, which simultaneously affected both the

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[19] Data for credit card borrowers with impaired credit were provided by Creditcards.com at http://www.creditcard.com.

[20] See Sumit Agarwal, Souphala Chomsisengphet, and Neale Mahoney, et al., *Regulating Consumer Financial Products: Evidence from Credit Cards*, National Bureau of Economic Research, Working Paper 19484, Cambridge, MA, September 2013, http://www.nber.org/papers/w19484; and http://www.nytimes.com/2013/11/08/business/economy/a-credit-card-rule-that-worked-for-consumers.html?pagewanted=1&_r=2&pagewanted=all&. The study used panel data consisting of over 150 million credit card accounts and covers the second quarter of 2008 to the fourth quarter of 2011.

[21] See https://www.aba.com/Advocacy/commentletters/Documents/clCardAct2013Feb.pdf and http://www.creditcards.com/credit-card-news/aba-bankers-association-card-act-1282.php.

[22] See http://online.wsj.com/news/articles/SB10001424052748704094704575443402132987676 and http://www.creditcards.com/credit-card-news/interest-rate-report-041713-unchanged-2121.php.

[23] See http://www.americanbanker.com/issues/178_142/small-banks-squeezed-to-death-reembrace-cards-1060846-1.html and http://www.americanbanker.com/issues/178_179/regional-banks-eager-to-return-to-credit-card-issuance-1062090-1.html.

[24] See http://www.americanbanker.com/issues/178_31/credit_card_lenders_keep_getting_pickier-1056750-1.html.

demand for and supply of revolving credit.[25] The demand for revolving credit decreased over 2008-2010, and credit card defaults, some of which may have stemmed from the recession, increased.[26] In absence of the CARD Act, outstanding credit balances along with the cost of credit for most borrowers would be expected to decline as the uncertainty generated by a severe recession would likely reduce the demand for revolving credit. Furthermore, in absence of the CARD Act, rising credit card defaults would be expected to reduce lenders' willingness to supply revolving credit. Credit card limits and loans may decline, and credit card rates for riskier borrowers would be likely to increase (if they are able to obtain any credit). The observed outcomes would still be consistent with predicted reactions to requirements stemming from the CARD Act.

Recent Developments in the Market for Checking Account Services

Checking accounts are used by customers for deposits and to make payments. The full range of checking account services includes access to deposits via debit cards and access to ACH bill payment services, as well as any automated overdraft protection.[27] Depository institutions incur costs to provide checking account services. Interest is paid to depositors to use their funds to originate new loans.[28] Other costs associated with providing checking account services include maintenance and other regulatory requirements (e.g., monthly statements, deposit insurance, security). Recent developments in both the cost and availability of checking account services are examined in this section because overdraft and debit card fees are tied to the delivery of this financial product to customers.

The CARD Act also regulated overdraft fees.[29] An overdraft occurs when a customer's checking account does not have enough funds to cover the total amount of a purchase made with a check or debit card. Prior to the CARD Act, some depository institutions automatically enrolled its customers in an overdraft or "insufficient funds" protection program that would cover a shortage, and then charged the customer a fee. The CARD Act, however, required depository institutions to seek permission from customers before automatically enrolling them in automatic overdraft protection programs. Unless customers "opt in" or give their permission for overdraft protection, then financial institutions must reject transactions resulting in overdrafts.

When a consumer makes a purchase using a debit card, the merchant pays a "swipe" fee, of which a portion is called the *interchange fee*. The interchange fee is paid to the consumer's bank

[25] See http://blogs.reuters.com/reuters-money/2011/03/02/dont-blame-card-act-for-higher-rates-study/.

[26] See CRS Report R41623, *U.S. Household Debt Reduction*, by Darryl E. Getter.

[27] The FDIC reports that overdraft protection services were more likely to be offered by larger banking firms. Overdraft coverage limits also tended to be larger for larger banks relative to smaller banks. The median credit limit for automated overdraft coverage was approximately $500. See *FDIC Study of Bank Overdraft Programs* at http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_Final_v508.pdf.

[28] The report refers to checking accounts, but the product may actually be a Negotiable Order of Withdrawal (NOW) account, which came about as a result of the regulation of interest rates on Demand Deposit Accounts (DDA). See http://www.consumerfinance.gov/askcfpb/953/what-difference-between-checking-account-demand-deposit-account-and-now-negotiable-order-withdrawal-account.html.

[29] Regulation E (Electronic Fund Transfers) Section 226.5 overdraft line of credit accessed by a debit card. See http://www.gpo.gov/fdsys/pkg/FR-2010-02-22/pdf/2010-624.pdf.

that issued the debit card to cover the costs to process the transaction, prevent fraud, and other service fees. Section 920 of the Dodd-Frank Act, known as the Durbin Amendment, required the Federal Reserve Board to issue regulations to ensure that any interchange transaction fee received by a bank (with $10 billion or more in assets that issues a debit card) is "reasonable and proportional" to the cost.[30] The Federal Reserve could consider the authorization, clearance, and settlement costs of each transaction when setting the interchange fee. The statute allows the interchange fee to be adjusted for costs incurred by debit-card issuers to prevent fraud, but the Federal Reserve may not consider other costs associated with the transaction.[31] The legislation does not regulate the interchange fees associated with reloadable prepayment cards or debit cards provided pursuant to a federal, state, or local government administered program. On June 29, 2011, the Federal Reserve issued a final rule to implement the Durbin Amendment.[32] A summary of notable requirements affecting checking account services appear below.

Summary of Some Key Fee Regulations Affecting Checking Account Services

- As required by the CARD Act, Regulation E was amended to require customers to opt-in and provide affirmative consent for overdraft coverage of ATM withdrawals and non-recurring debit card transactions. The new rules do not cover checks or automatic bill payments.[33]
- The final rule implementing the Durbin Amendment does not regulate the interchange fee that a network provider may charge; it only restricts the amount of interchange fee revenue that large-issuing banks may receive. After conducting a survey to obtain transaction cost information,[34] the Federal Reserve issued a rule that caps the interchange fee received by large issuers (with $10 billion or more in assets) to 21 cents plus 0.05% of the transaction. The Federal Reserve also allows for a 1 cent adjustment if the issuer implements fraud-prevention standards that satisfy the requirements set out in an interim final rule.[35]

Free or low-cost checking at depository institutions has reportedly diminished, primarily at large depository institutions, which may reflect substitution into new fee generating strategies since

[30] Bank debit card issuers with less than $10 billion in assets were exempt from the regulation, allowing smaller financial institutions to receive larger interchange fees for transactions.

[31] See http://www.crs.gov/LegalSidebar/details.aspx?ID=624&Source=search.

[32] The legislation also prohibited network providers (Visa, MasterCard, etc.) and debit card issuers from imposing restrictions that would override a merchant's choice of the network provider through which to route transactions. Every issuer regardless of size is also required to link with at least two unaffiliated network providers, thus allowing merchants to choose the network provider with the lowest fees to process their debit card transactions.

[33] See http://www.federalreserve.gov/consumerinfo/wyntk_overdraft.htm and http://www.federalreserve.gov/newsevents/press/bcreg/20091112a.htm.

[34] See http://www.federalreserve.gov/newsevents/press/bcreg/20101216a.htm and http://edocket.access.gpo.gov/2010/pdf/2010-32061.pdf. The Federal Reserve reported an *average interchange fee* of 44 cents per transaction and a *median total processing cost* of 11.9 cents per transaction for all debit transactions in the proposed rule. On December 16, 2010, the Federal Reserve proposed a cap of 12 cents per transaction, which only considered authorization, clearing, and settlement costs. Fraud prevention expense had not been incorporated in the proposed rule.

[35] See http://www.federalreserve.gov/newsevents/press/bcreg/20110629a.htm and http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110629b1.pdf. For example, suppose a customer makes a $38 purchase, which is the average debit card transaction in 2009 reported by the Federal Reserve. Under the rule, the interchange fee received by the bank would be 21 cents plus 0.05% (approximately 2 cents) for a total of 23 cents. If the bank's fraud protection measures are deemed sufficient by regulators, the bank may receive an additional 1 cent for a total of 24 cents. The equivalent interchange fee for a $100 transaction would be 27 cents, or 21 cents plus 0.05% (5 cents) and 1 additional cent. The interim final rule concerning the fraud-prevention standards may be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110629a1.pdf. Whether the cap was set "too high," meaning that the Federal Reserve incorporated some fixed costs to provide debit card services that were not permitted by statute, is currently being challenged. See http://online.wsj.com/news/articles/SB10001424127887324619504579027072910241080 and http://paymentsjournal.com/Content/Featured_Stories/18202/.

previous strategies became less viable after 2007.[36] For example, fee income, which was generated by the sale of mortgage loans to the private-label mortgage securitization market, declined after investors deserted the market at the beginning of the financial crisis.[37] The difficulty to generate fees increased following the decline in overall customer demand for loans and other traditional banking services after 2007. New regulations limiting credit card fees, overdraft fees, and the amount of fees that large institutions could collect from debit transactions were also in place by 2011. Previous fee generating activities may have been used to cross-subsidize or reduce the total costs of providing financial services to customers, allowing many services to be offered for a nominal charge or free.[38] Given the fading away of these revenue generating options, more financial institutions may be pursuing new fee pricing strategies, which includes customers covering more of the costs of checking account services.[39]

Industry reports indicate that checking account services have become more expensive for those depositors unable to maintain balances above specified minimums or who fail to incur fees via use of multiple financial services. Rather than charge higher monthly maintenance fees to all customers, many pricing strategies allow depositors the option to maintain relatively larger account balances or use multiple financial services to avoid fees.[40] Small depository institutions, which are more dependent upon deposits to carry out their functions, reportedly have not been as aggressive as large banks to increase checking account fees.[41] Nevertheless, both large and small depository institutions are considering pricing strategies to replace revenue streams that may have disappeared in a manner that does not alienate their more profitable customers.[42]

In addition to higher fees, various checking account services reportedly became less available to customers as they become more costly to service. Overdraft protection service is analogous to a cash advance or payday loan that lacks any underwriting.[43] Similarly, when an overdraft is not covered by the customer within 60 days, banks are required to treat those balances as charge-offs, meaning that the obligations must be recognized as uncollectible and charged against allowances for loan and lease losses (ALLL) reserves.[44] Thus, the severe economic downturn incentivized depository institutions to reduce overdraft limits for the same reason credit card limits were

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[36] See http://www.americanbanker.com/issues/178_161/free-checking-accounts-dwindle-at-brick-and-mortar-banks-survey-1061458-1.html and http://www.money-rates.com/research-center/bank-fees/.

[37] For information on securitization markets issues, see U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance and Investment, *Securitization of Assets: Problems and Solutions*, Testimony of George P. Miller, American Securitization Forum, 111th Cong., 1st sess., October 7, 2009.

[38] In 2011, a survey found that small banks incur between $175 and $200 to offer checking account services; large banks with more than $5 billion in deposits incur between $350 and $450 in costs. See http://www.americanbanker.com/bankthink/bank-of-america-debit-interchange-durbin-1042689-1.html.

[39] See http://online.wsj.com/news/articles/SB10001424052748704076804576181563561540554.

[40] See http://www.americanbanker.com/bulletins/-1031145-1.html.

[41] See http://www.americanbanker.com/issues/178_216/small-banks-taking-serious-look-at-adding-fees-1063484-1.html?ET=americanbanker:e17626:805795a:&st=email&utm_source=editorial&utm_medium=email&utm_campaign=AB_Daily_Briefing_110713; and http://online.wsj.com/news/articles/SB10001424052702304672404579182183365345064.

[42] See http://www.americanbanker.com/issues/178_25/service-charges-starting-to-rebound-at-community-banks-1056475-1.html.

[43] See http://www.federalreserve.gov/boarddocs/SRLETTERS/2005/SR0503a1.pdf.

[44] Ibid. The ALLL is a component of regulatory capital that is funded with current income and must be adjusted quarterly when loan default risks increase. For more information, see CRS Report R43002, *Financial Condition of Depository Banks*, by Darryl E. Getter; and CFPB Study of Overdraft Programs at http://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf.

reduced. Institutions had to set aside greater amounts of current income to absorb losses, which reduced profits even more at a time when interest rates were historically low and fee restrictions were implemented. Hence, *involuntary* checking account closures have allegedly increased, prompting increased reporting to banking history bureaus of overdraft and insufficient funds activity.[45] If involuntary closures reflect activity associated with a disproportionate amount of low-income individuals, then this group may encounter difficulties gaining access to traditional checking account services for several years.[46]

Many banks covered by the Durbin Amendment eliminated their debit card rewards programs after implementation, but this simultaneously eliminated a mode for attracting (checking account) deposits to fund loans.[47] Offering checking accounts with direct deposit, automated bill paying, and debit card services helps depository institutions attract customers that are likely to use other financial products, including loan products. Furthermore, when customers use a variety of financial products and services, the ability of a depository institution to cross-subsidize its costs and financial risks is enhanced. Given that financial institutions are still interested in attracting deposits, many of them have entered into partnerships with merchants who are sponsoring more customer reward programs.[48] The customer gets rewards for shopping with a particular merchant and paying for their purchases using an electronic payment card (i.e., credit, debit, or prepayment card) associated with a particular bank.[49]

In addition to Durbin Amendment fee restrictions, capital buffers for non-performing loans increased for the banking system as a result of enhanced capital requirements.[50] Both factors would prompt less willingness to tolerate less profitable or more expensive customers. Depository institutions would be incentivized to separate customers into two categories: those who generate fee income using a variety of financial products, and those who primarily generate overdraft and insufficient funds fees, which trigger higher regulatory capital costs.

Alternatives to Traditional Retail Payment Services

Financial products commonly used by unbanked populations have experienced recent popularity among people no longer able to qualify for traditional banking products, particularly if they have

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[45] See http://dealbook.nytimes.com/2013/07/30/over-a-million-are-denied-bank-accounts-for-past-errors/?_r=0. Defaulted borrowers can be reported to credit history firms; similarly, frequent checking account holders that do not pay overdraft and insufficient funds fees are reported to banking history repositories, such as ChexSystems. See https://www.consumerdebit.com/consumerinfo/us/en/chexsystems/faqs.htm#FAQ_01.

[46] A report regarding the mishandling of a checking account may remain on file for five years. See https://www.consumerdebit.com/consumerinfo/us/en/chexsystems/faqs.htm#FAQ_03.

[47] See http://www.creditcards.com/credit-card-news/debit-card-rewards-program-cutback-tips-1277.php, and http://www.accountingweb.com/topic/accounting-auditing/debit-cards-rewards-may-be-gone-more-changes-coming Unlike deposits, customer funds loaded on prepayment cards cannot be used by depository institutions to fund loans.

[48] See http://www.firstdata.com/downloads/thought-leadership/FI_Loyalty_WP.pdf.

[49] Advocates favoring the Durbin Amendment argued that capping interchange fees would translate into lower costs to merchants that could be passed on to consumers. The extent to which consumers see any greater benefit when merchants rather than banks have more control over customer rewards programs is ambiguous. The benefits to patrons depend more upon the generosity of the loyalty programs they use more frequently.

[50] On July 9, 2013, federal banking regulators required banks to apply a risk weight of 150% to the outstanding balance of non-performing consumer loans, which is a new requirement stemming from Basel III implementation in the United States. See CRS Report R42744, *U.S. Implementation of the Basel Capital Regulatory Framework*, by Darryl E. Getter.

recently defaulted on loans.[51] Depository institutions have reportedly demonstrated a willingness to serve this market segment by offering a different set of financial services.[52] Unlike traditional relationship banking, which generally refers to a business strategy in which close familiarity or long-term relationships are developed with customer bases, depository institutions can provide a limited range of retail services with less information about how these customers manage their financial affairs.[53] The financial services associated with serving this market segment may have one or more of the following characteristics:

- the fees are required to be paid up front;
- the costs of a financial product, such as a short-term cash advance, are expensive relative to a loan arrangement expected to last for a year or longer;[54]
- any information pertaining to customer payment history is unlikely to be reported to any credit bureau;
- a formal or long-term relationship with a traditional depository institution is not required to obtain alternative financial services.

Direct Deposit Cash Advances

Depository institutions periodically change the delivery or format of their payday loan (cash advance) products.[55] Subprime credit cards and overdraft coverage for checking accounts have features analogous to payday loans, and are considered substitutes. Direct deposit or salary cash advances, a more recent version of the payday loan service, is arguably a close substitute for fee harvester credit cards and overdraft coverage products.[56] Direct deposit cash advances, similar to payday loans, are not underwritten. Customers must be employed and must set up direct deposit with their checking accounts. The fees charged for this financial product would not be considered overdraft fees, and they are not associated with a credit card. Regulations for the credit card and checking account products, therefore, are not directly applicable to the direct deposit cash advance product. The design of this cash advance product allows depository institutions to serve

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[51] See *2011 FDIC National Survey of Unbanked and Underbanked Households* at http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf.

[52] See http://www.forbes.com/sites/halahtouryalai/2012/12/14/walmart-vs-big-banks-the-battle-for-poor-customers/.

[53] See http://www.americanbanker.com/bankthink/there-will-be-blood-the-era-of-engagement-banking-1060723-1.html.

[54] Between December 2007 and December 2009, the FDIC conducted a small-dollar loan pilot program with 31 banks to observe the feasibility of offering lower credit cost alternatives to payday loans and fee-based overdraft programs. (See http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf.) A lesson learned was that small-dollar lending programs may be successful when associated with and fostering long-term relationship lending, but it is expensive when not targeted to existing customers. See http://www.americanbanker.com/issues/178_146/five-reasons-why-small-dollar-credit-is-so-expensive-1060965-1.html?zkPrintable=1&nopagination=1.

[55] The Federal Trade Commission defines payday lending as a cash advance by a personal check or electronic transfer. See http://www.consumer.ftc.gov/articles/0097-payday-loans. The Consumer Financial Protection Bureau defines payday lending as a cash advance in which the lender has access to the customer checking account. See http://www.consumerfinance.gov/askcfpb/search?selected_facets=category_exact:payday-loans.

[56] For more information on deposit advance products, see *Payday Loans and Deposit Advance Products* at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

the 'overdraft' market segment while generating new revenue streams in lieu of defunct fee-income streams.[57]

Payment of a direct deposit cash advance is due in approximately 30 days, in contrast to a credit card loan that is typically underwritten based upon a one-year period.[58] Thus, the annual percentage rate (APR) computation for a direct deposit cash advance is likely to be significantly greater than for a loan designed to be repaid over a period of years.[59] Also, customer payment histories are not reported to any credit bureaus. Hence, customers could use this product if they are unable to qualify for a traditional credit card.[60]

Publicly available data on payday lending are scarce, and data on the various forms of payday lending conducted by financial institutions are scarcer. Various reports indicate that large institutions are offering deposit advance products, and that federal regulators have heightened scrutiny of this activity.[61] For example, the Consumer Financial Protection Bureau (CFPB) conducted a 12-month study over 2012 that included a small number of depository institutions that offered direct deposit account advances, with a common loan limit of $500.[62] In addition, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), which are federal banking regulatory agencies that focus on activities posing bank solvency risks issued final supervisory guidance regarding the delivery of these products.[63]

Federal banking regulators have expressed concerns about payday lending by banking institutions. According to the CFPB, consumers that use deposit advance products were more likely to have had overdraft transactions or incurred insufficient funds fees. Offering deposit advances, however, allows financial institutions to serve this market segment without necessarily having to increase ALLL. Consequently, the federal banking regulators expressed concern that this service, via its high costs and repeated extensions of credit, could add to borrower credit (default) risks. In addition to reminding banks of their vulnerability to various risks (e.g., credit, reputational, legal) and potential compliance violations (e.g., Truth in Lending Act, Truth in Savings Act, Equal Credit Opportunity Act, Electronic Funds Transfer Act), the agencies listed

[57] See http://www.consumerfinance.gov/askcfpb/1103/my-bank-offers-direct-deposit-advance-or-checking-account-advance-what.html.

[58] See http://www.federalreserve.gov/creditcard/#.

[59] The computation of an APR for a payday loan is arguably misleading given that the APR is an annual measurement of the interest costs. The APR is arguably a more meaningful measure for loans typically expected to be outstanding for at least one year, allowing the fixed costs to borrowers to be diffused over longer periods of time. See http://aprexplained.com/what-is-apr/ and http://www.federalreserve.gov/boarddocs/caletters/2008/0805/08-05_attachment1.pdf.

[60] See letter written by the American Bankers Association to the Consumer Financial Protection Board at https://www.aba.com/Advocacy/commentletters/Documents/clCardAct2013Feb.pdf.

[61] Six banks, four large and two regional, reportedly have offered direct deposit advances. See http://www.americanbanker.com/issues/178_80/new-regs-could-wipe-out-bank-payday-loans-1058655-1.html, http://www.npr.org/2013/04/25/179052559/regulators-warn-banks-on-direct-deposit-loans, and http://www.creditcards.com/credit-card-news/bank-advance-direct-deposit-loan-cfpb-1282.php.

[62] See http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf. The $500 limit offered with the direct deposit cash advance is similar to the median credit limit for overdraft protection as reported in the *FDIC Study of Bank Overdraft Programs*.

[63] Both agencies issued guidances on April 25, 2012. See http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-69.html and http://www.fdic.gov/news/news/press/2013/pr13031.html. The FDIC released a final rule on direct deposit advances on November 21, 2013. See http://www.fdic.gov/news/news/press/2013/pr13105a.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery.

their expectations with respect to loan classification policies, underwriting and administration policies, the length of customer relationships, and customer credit histories. The guidances recommended the following: customers with impaired credit should not be eligible for this product, each deposit advance should be repaid in full before extension of a subsequent advance loan, and no more than one loan may be offered per monthly statement cycle. In light of these guidances, banks may decide to discontinue offering this financial service.[64]

Prepayment Cards

Usage of non-cash prepayment cards, which may be considered an alternative to a traditional checking account, has reportedly increased since 2009.[65] Some prepayment cards are closed-loop, meaning that they can be used only with a specific merchant or merchants; others are open-loop, meaning that a customer can them use anywhere that accepts payment from a network provider such as Visa or MasterCard. Prepayment cards may be obtained online or in retail stores, and cash may also be loaded onto the cards at these locations. Thus, there is no need to go to a traditional bank or credit union in order to gain access to this financial product. Nevertheless, some prepayment cards can be issued with an account and routing numbers, making it possible to have payroll checks deposited directly onto the card.

Prepayment cards, however, are not perfect substitutes for checking accounts because they have relatively limited functionality. General use prepayment cards are issued to the cardholder prior to funds being loaded on the card and, unlike checking accounts, there is typically a charge for customers to "reload" cards (replenish fund balances).[66] More importantly, a prepayment card is exempted from Durbin Amendment rules as long as it is "the only means of access to the underlying funds, except when all remaining funds are provided to the cardholder in a single transaction."[67] In other words, prepayment cards cannot be attached to checking accounts, meaning that funds may not be provided by check, ACH payments, or wire transfers. Furthermore, the funds on prepayment cards generally are not federally insured like checking account deposits, and financial institutions would not have access to funds stored on those cards to make new loans.[68]

The limited functionality of prepayment cards means that they also lack some of the benefits associated with more traditional banking products. For example, prepayment cards cannot be used to repair credit given that historical records regarding usage are not maintained or reported to credit bureaus.[69] Customers also do not depend upon one primary institution to obtain prepayment cards, meaning that development of a long-term relationship with a financial firm is not necessary

[64] See http://www.americanbanker.com/issues/178_225/banks-deposit-advance-guidelines-will-help-payday-lenders-hurt-consumers-1063840-1.html?zkPrintable=1&nopagination=1.

[65] See The Pew Charitable Trusts, *Loaded With Uncertainty: Are Prepaid Cards a Smart Alternative to Checking Accounts?*, Washington, DC, September 2012, at http://www.pewstates.org/research/reports/loaded-with-uncertainty-85899415043.

[66] As more customers experience increases in fees for their checking account services, the ability to distinguish between prepayment cards and checking accounts on the basis of whether fees are charged is arguably becoming more difficult.

[67] See http://www.federalreserve.gov/paymentsystems/regii-faqs.htm.

[68] See http://www.fdic.gov/consumers/consumer/information/ncpw/cardstopten.html.

[69] See http://www.creditcards.com/credit-card-news/help/9-things-you-need-to-know-about-prepaid-cards-6000.php and http://www.netbanker.com/2013/08/new_online_banking_report_published_new_opportunities_with_prepaid_gift_cards.html.

to make effective use of the product. Anyone unable (e.g., due to poor banking history) or unwilling to establish a relationship with a mainstream bank or credit union may use prepayment cards, which can still generate a revenue stream for issuers even if the product does not attract new long-term deposits.

Prepayment cards, therefore, enable depository institutions to provide financial services to people that prefer not to have a formal relationship with mainstream financial institutions.[70] According to a study conducted by the FDIC and the U.S. Census Bureau, 68.8% of U.S. households were "fully banked" in 2011.[71] Households in the survey were considered fully banked if they had a bank account and had not relied upon any alternative financial services (AFS) providers for a year or more.[72] People that are not fully banked, however, still need electronic payment cards for various transactions (e.g., to purchase airplane tickets, make hotel reservations). In light of consumer demand for electronic payment cards, some depository institutions appear to be aggressively seeking to enter this market. Entry into this non-traditional banking market may allow depository institutions to serve customers no longer eligible for traditional banking products. Revenues generated from expansion into the market for prepayment card services may also help offset losses stemming from fee limitations.

Federal regulators have reported on the rapid growth of banks in the prepayment card industry. On June 28, 2011, the OCC issued guidance pertaining to risk management and sound practice for national banks.[73] The OCC reminded banks to carefully monitor the risks (e.g., electronic funds transfer, fraud, reputation), especially with respect to the behavior of third party providers, as well as to ensure proper implementation of consumer disclosure policies. Similarly, the CFPB also reported that prepayment cards were the fastest growing payment instrument in the United States.[74] On May 23, 2012, the CFPB requested comments after announcing that it intends to extend consumer protections associated with electronic funds transfer activities (Regulation E) to prepayment cards.[75]

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[70] Mainstream institutions may also be hesitant to enter into formal relationships with people with past payment problems or who have in the past incurred frequent overdrafts.

[71] See http://www.fdic.gov/householdsurvey/2012_unbankedreport_execsumm.pdf.

[72] AFS include non-bank money orders, non-bank check cashing, non-bank remittances, payday loans, pawn shops, rent-to-own stores, and refund anticipation loans.

[73] See http://www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-27.html.

[74] See http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-considers-rules-on-prepaid-cards/ and http://files.consumerfinance.gov/f/201205_cfpb_GPRcards_ANPR.pdf.

[75] P.L. 90-321 Electronic Fund Transfer Act of 1978. (P.L. 95-630; 92 Stat. 3728).