ARE BANKS THE 'BAD GUYS'? OVERDRAFT FEES ARE CRUSHING LOW-INCOME CUSTOMERS

DJUMAYEVA GULNORA AMIRQULOVNA

Prepare: teacher of the "Special sciences" department of special school № 2 of Chilonzor district of Tashkent city.

Annotation: *Payday lenders have been accused of exploiting poor consumers, but traditional banks exact a similar toll through overdraft fees. Research by Marco Di Maggio and Emily Williams shows how seemingly innocuous checking accounts can become vehicles for financial distress.*

Key words: *bank, financial crisis, credit markets, red-zone*

Payday lenders have long been cast as villains for charging consumers sky-high interest rates, leaving borrowers who live paycheck to paycheck struggling to repay loans. But conventional banks are just as guilty of using fees to penalize consumers, hurting low-income customers the most, research shows.

Despite scrutiny of overdraft fees during the financial crisis more than a decade ago, some banks still reorder checking account debits so that the largest amounts, rather than the earliest debits posted, are withdrawn first. Harvard Business School researchers found that this practice can result in banks charging consumers multiple overdraft fees rather than just one, draining significant cash from people living at the edge of their means at a time when inflation is further reducing their buying power.

"The misconception is that checking accounts are vanilla products that don't screw people," says Marco Di Maggio, the Ogunlesi Family Associate Professor of Business Administration at HBS. "Well, overdraft fees are a form of credit. The bank is lending you money for a very, very short amount of time. That, I think, escaped the regulatory net."

Imagine a checking account with $400. A bunch of debits post, and the bank first puts through the largest, a $500 rent check. That triggers a $35 overdraft fee. Two checks for $50, which technically came in before the larger check, go through next, bouncing and charging the account another $70 in overdraft fees.

Failing to pay those multiplying fees can lead the bank to close accounts—a stain on a consumer's record that can have lasting ramifications. The main consumer reporting agency that banks use, records when a bank shuts down accounts, which often happens if a customer fails to repay overdraft fees and other outstanding balances for two months. That black mark can prevent a consumer from opening a bank account elsewhere for up to five years, the authors write, limiting a customer's ability to obtain credit, write checks, or use convenient banking products and services, like debit cards and direct deposit.

This possibility induces some low-income customers to pay back the bank with high-interest loans from payday lenders, the researchers suggest. But that can mean getting trapped in a downward spiral of debt.

Di Maggio examines the practice, known as "high-to-low ordering," with HBS Assistant Professor Emily Williams and doctoral student Angela Ma in a working paper entitled in the red: Overdrafts, payday lending, and the lending.

"Overdraft fees can be much more expensive than even payday loans. We always thought of banks as being the good guys and payday lenders as being the bad guys," says Williams. "We're saying it's not as simple as that. The banks do look a bit like the bad guys here."

The bank's rationale for high-to-low ordering is that the bigger bills, which are often more important, get paid first under the system.

But banks also reap the rewards. In 2018, overdraft fees were $33 billion of bank revenue and two-thirds of deposit account fees earned by banks, say the researchers, citing Moebs Services data. About half of the 50 largest banks organized deposits by high-to-low ordering as of 2016, according to a report by the Pew Charitable Trusts.

The researchers looked at the link between high-to-low ordering and payday lenders and found a direct relationship between the two.

They compiled data from alternative credit bureau Clarity Services, which covers 1 million people who use lenders like payday services, and data from Equifax, a major consumer credit bureau that offers insights into installment loans for low-income borrowers. They complemented that data with hand-collected information about lawsuits against high-to-low reordering that ultimately spurred a ban of the practice at 23 banks.

The researchers found that when lawsuits forced banks to stop the high-to-low practice, consumers benefitted. Following the bans, payday loans dropped 16 percent, or by about $84 per borrower per quarter. Installment loans dipped 6 percent, or by about $200 per borrower, the researchers found.

Consumers' overall financial health improved, as well. Two years after high-to-low reordering bans, borrowers' balances in good standing increased by about $431, credit card limits increased by $190, and their FICO score increased significantly. These findings suggest that the overdraft practices implemented by the banks might have severe consequences on consumers living paycheck to paycheck.

About 14 percent of bank customers incur five or more overdraft fees a year, according to the FDIC. The researchers estimate that 4.2 million customers have benefitted from the bans. Sued banks that had to stop high-to-low reordering saw overdraft revenue decline by $1.3 billion per year, which has translated into $330 in savings per customer, the researchers estimate.

One unintended consequence of the ban is that, once traditional banks are ordered to stop using the high-to-low practice, they often shut down branches in neighborhoods where people with low incomes live, the research shows. This finding suggests that these fees are somewhat necessary to make it worthwhile for the banks to serve this less affluent segment of the market.

How consumers can protect themselves. For consumers, the message is clear: Make sure you know your bank's policy on how—and when—overdraft fees are charged. "Community-based banks also do this," says Di Maggio. "If anything, the overdraft fees might be a bigger chunk of their overall revenue. So the message is not, 'You should go to your credit union rather than Wells Fargo.' The message is, 'Check your individual bank and look at the fees, and make sure you know what you're getting into.'"

Banks should find other ways to earn profits rather than charging exorbitant fees on low-income checking accounts, the researchers say. They should "focus instead on lowering their costs," Williams says. In addition, policymakers should take a closer look at which financial services best meet low-income consumers' needs, rather than push hard to get everyone into the mainstream banking system, the authors suggest. "A blanket push for people to become banked is maybe not the policy response that is going to be the most effective for helping these consumers," Williams says.

REFERENCES:

1. Making Public in a Privatized World David A. McDonald London, United Kingdom ZED-BOOKS-LTD 2016 Paperback.

2. https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Banks

3. https://hbswk.hbs.edu/item/are-banks-the-bad-guys-overdraft-fees-are-crushing-low-income-customers