



Unpacking the CFPB's Proposed Overdraft Rule

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When my kids were much younger, we started a New Years' Eve tradition of writing down our predictions for the upcoming year. Our practice of forecasting the year in sports, world events, and the anticipated life milestones of family and friends continues to this day. Each New Years' Eve we scribble down our notes for the year ahead, seal them away in a mason jar, and then forget about them until they are resurrected a year later. Revisiting these forecasts is always humorous. They are wildly inaccurate and eerily prescient in equal measure.

In the first quarter of last year, I penned several articles for this publication discussing CFPB's actions involving "junk fees" and overdraft income. In those articles I posited that a key element to the CFPB's approach was for fees to have cost justification. In reviewing CFPB's proposed rule governing overdraft lending (the "Proposed Overdraft Rule"), it appears that my prognostication skills have not entirely deserted me.

The heart of the Proposed Overdraft Rule is found in a new section that would be added to CFPB Reg Z (proposed Reg Z § 1026.62). This new section establishes a baseline definition of "overdraft credit," defining it to mean consumer credit extended by a financial institution to pay transactions drawn on a checking or other form of transaction account when the consumer has insufficient available funds. The definition includes (but is not limited to) credit extended by a transfer from a credit card or overdraft line. Amendments proposed to the Official Staff Commentary to the definition of "credit" clarify that "overdraft credit" is "credit" if a consumer has a contractual obligation to repay the overdraft, which is common.

The Proposed Overdraft Rule divides the universe of "overdraft credit" into two camps:

- Covered Overdraft Credit: overdraft credit that is either subject to a finance charge and/or is payable by an agreement in more than four installments.
- Non-Covered Overdraft Credit: the mirror image of "covered overdraft credit" - meaning that it is overdraft credit that is not subject to a finance charge and is not payable by a written agreement in more than four installments.

The nomenclature used here is to signify overdraft credit subject to Reg Z (covered overdraft credit) and overdraft credit that remains outside the coverage of Reg Z (non-covered overdraft credit).

The Proposed Overdraft Rule would amend the Official Staff Commentary to the definition of "open-end credit" to clarify that "covered overdraft credit" would generally be considered open-end credit, meaning that it would be subject to the Reg Z requirements governing such credit.

Moreover, the CFPB proposal would require “covered overdraft credit” to be structured as a separate credit account (referred to as a “covered overdraft credit account”), and not as a negative balance on the deposit account tied to the covered overdraft credit account.

Given these definitions, and the fact that deposit account agreements generally require the immediate repayment of overdrawn amounts, the key to unlocking the proposed rule is to determine whether a “finance charge” will be assessed. The proposed revisions to the Official Staff Commentary’s definition of “open-end credit” state that “[r]egardless of whether the financial institution assesses such charges on the deposit account itself or a separate credit account, any service, transaction, activity, or carrying charges imposed by a financial institution for paying a transaction that overdraws a consumer’s deposit account held at the financial institution are finance charges unless they are excluded from the definition of finance charge by § 1026.4(c).” Section 1026.4(c) of Reg Z excludes from the definition of “finance charge” charges imposed for overdrawing an account unless there is a written agreement between the depositor and the financial institution to pay, for a fee, overdraft amounts. This overdraft finance charge exception is what drives deposit account agreements to state that the payment of items to create an overdraft on the deposit account is at the sole discretion of the financial institution. If this act is discretionary, there is no agreement to honor the item and create an overdraft. The Proposed Overdraft Rule tacks an exclusion to the end of this statement, noting that the finance charge exclusion does not apply to “above breakeven overdraft credit.” What does that mean?

Under the proposal “above breakeven overdraft credit” is defined to mean overdraft credit with charge(s) that exceed the average of the financial institution’s costs and charge-off losses for providing non-covered overdraft credit. Such charge(s) surpass this threshold if they exceed the greater of the pro rata share of the financial institution’s total direct costs and charge-off losses for providing non-covered overdraft credit in the prior year, or an amount (somewhere between \$ 3 and \$ 14 in the proposal) to be set by rule.

In short, whether “overdraft credit” graduates to become “covered overdraft credit” – subject to the panoply of Reg Z requirements – depends on whether the overdraft charge exceeds a breakeven point. If the financial institution is simply recouping its average costs and losses, the assessment is not a finance charge and the “non-covered overdraft credit” avoids the requirements of Reg Z. While one can find other cost-limiting measures in CFPB regulations (for example: the limitation on credit card penalty fees), application of a regulation entirely dependent on a cost-justified fee amount appears unique.

The other elephant in the room with the Proposed Overdraft Rule is that it would apply only to “very large financial institutions”: meaning insured depository institutions with total assets of more than \$ 10 Billion, which is the threshold amount for CFPB regulation. Such an approach result in two sets of rules within Reg Z (one for large institutions, another for everyone else), and it seems aimed at a group of institutions that, by the CFPB’s own tracking, appear to be moving away from overdraft as a revenue stream. (For more on this, please see our article [Is Overdraft and NSF Income at a Tipping Point?](#))

There is much more to the Proposed Overdraft Rule than this concept of pricing and cost-justification. However, it seems to confirm the tea leaves we saw last year in terms of where the CFPB might be headed with its fee initiatives. Will this approach spread to other regulations and other fee-related concerns? I do not know, but I could venture a guess. Perhaps I will write it down in, place that prediction in a mason jar, and return in early 2025 to see how I did.

