Research

From Free Checking to the Financial Fringe: A Tale of Two Regulations and Low-Income Families

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Summary

· Ensuring low-income individuals and families adequate access to transactions services is a perennial policy goal, whether that access is traditional banking (checking accounts) or newer innovations like prepaid cards.

· The Durbin Amendment to the Dodd-Frank Act raised the cost of checking accounts and associated debit cards which led to the unintended consequence of dramatically limiting free checking in the United States.

· Low-income individuals and families migrated away from now-expensive checking accounts toward prepaid cards and other services. Recently-proposed Consumer Financial Protection Bureau (CFPB) rules would likely eliminate these options as well.

The Durbin Amendment and the Demise of Free Checking Accounts

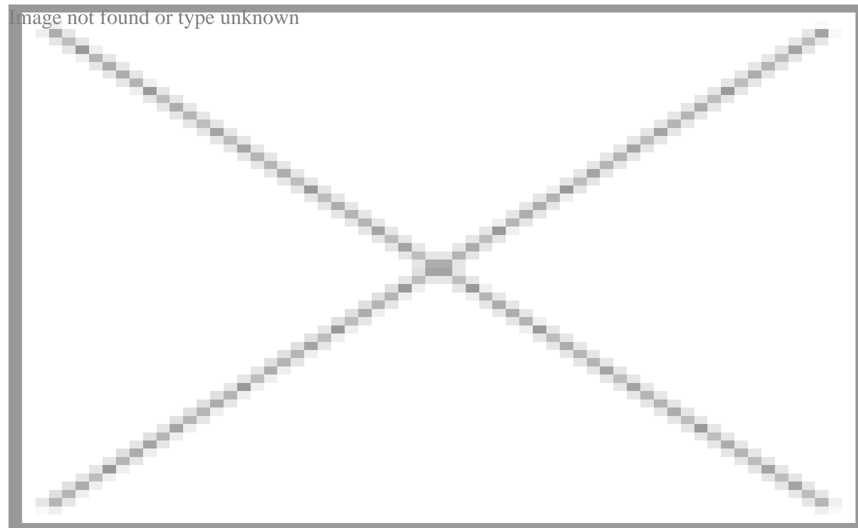
New technology, like Apple Pay and other forms of contactless payment, is reigniting old arguments over the Durbin Amendment. For anyone who may have forgotten about this small yet vastly consequential regulation, the Durbin Amendment to the Dodd-Frank financial reform law set a limit on interchange fees charged to retailers when a customer makes a purchase using a debit card. These so-called "Durbin fees" are generally less than two percent of the total purchase price, and the fee revenue is split between the card-issuing bank, the card company (Visa, MasterCard, etc.), and the retailer's merchant account provider. Durbin argued that limiting these fees would reduce retailers' costs and that those savings would be passed on to consumers.

In its wake, among other things, retailers promised to lower the costs of essentials, and hotels promised to charge lower rates to customers using debit cards. Not surprisingly, those promises never came to fruition. In fact, Dodd-Frank author Barney Frank, an unexpected opponent of the Durbin Amendment, warned that "[he] believe[d] that a free market approach in this area will be better for the economy and all concerned parties…"

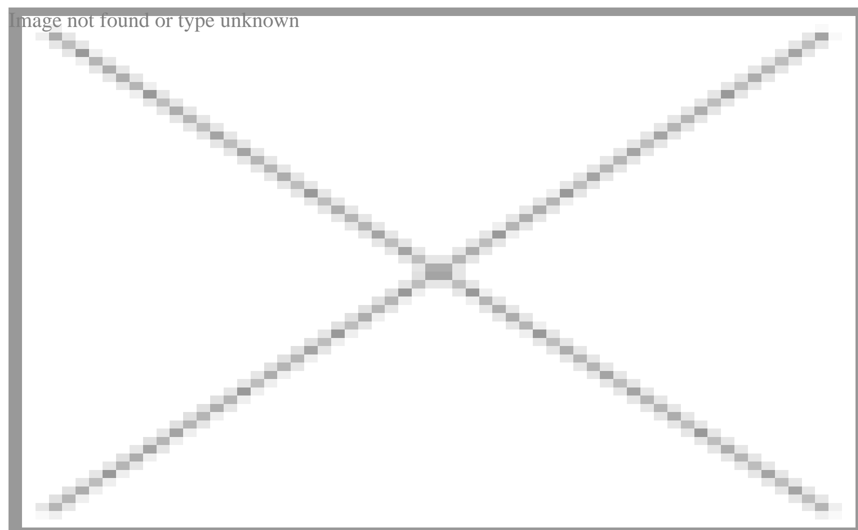
Frank called for the repeal of the Durbin amendment in 2011 citing "unintended consequences for consumers." The unintended consequences are costs being shifted from those customers who use bank cards to everyone with a bank account, thereby increasing costs for everyone and pricing many low and middle-income bank customers out of maintaining a bank account.

To put it in practical terms, banks previously relied on revenues from interchange fees to cover the costs related to debit card operations. Since the Durbin Amendment took effect, banks are experiencing losses between $6.6 billion and $8 billion annually

and are no longer able to cover the costs of debit card operations through interchange fees. As a result, banks are increasing fees to consumers and drastically cutting down on services, like checking accounts, that were previously free. One study shows that in 2009, before Durbin, 76 percent of all bank accounts were free, charging no usage fee to the consumer. However, in 2013, a mere 38 percent of bank accounts are offered free of charge.

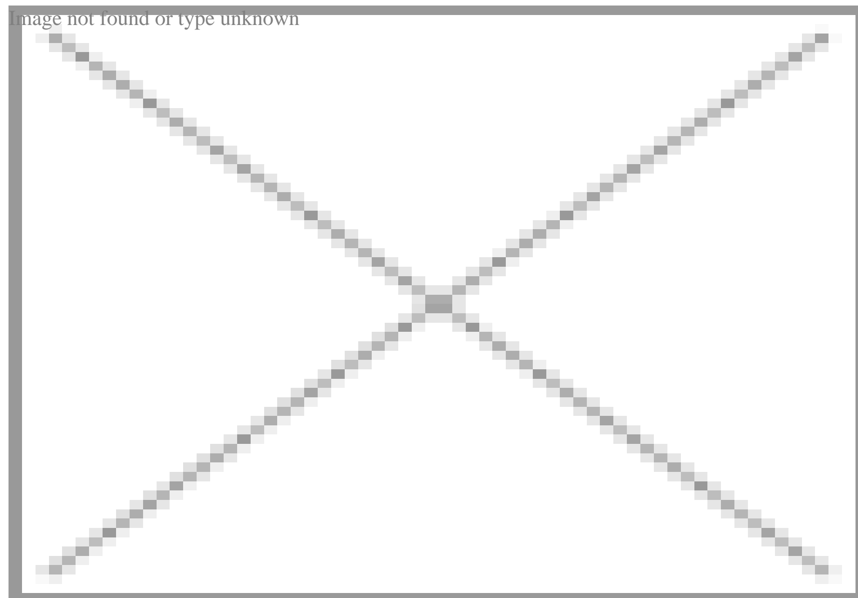


Banks also began requiring higher minimum balances on their free or low-fee accounts as well as charging higher card replacement and other administrative fees. JPMorgan Chase estimated that these increased minimum balances and ensuing fees would result in as many as five percent of its banking customers getting pushed out of the banking system. This five percent drop is reasonable considering that Durbin has mainly impacted individuals and families at the lowest end of the income spectrum.



Low-Income Families and Loss of Access to Free Checking

Even by taking a conservative approach to JPMorgan's five percent estimate, the Federal Reserve in a 2011 consumer impact study said, "We would expect that a significant portion of the customers that would abandon checking accounts would be lower-income households since those are the ones most likely not to be able to want to pay for the more expensive accounts. To get an understanding of the potential significance of these closures we note that a one percent decline in checking accounts would result in the loss of checking access for roughly 1 million households; an increase in the number of households by 1 million would increase the percent of unbanked individuals by 12 percent."



The Growing Use of Alternative Financial Services

As a result, these unbanked and underbanked households are forced to turn to alternative financial services (AFS) to carry out their day to day transactions. AFS may be divided between transactional AFS and credit AFS, the former representing non-bank money orders, non-bank check cashing, and non-bank remittances and the latter representing pay day loans, pawn shops, rent-to-own stores, and refund anticipation loans. According to a 2012 Federal Deposit Insurance Corporation (FDIC) study on unbanked and underbanked households, nearly two-thirds (64.9 percent) of unbanked households have used at least one AFS product in the last year and close to half (45.5 percent) have used AFS in the last 30 days. Over 60 percent (62.1 percent) have used a transactional AFS product in the last year while 16.8 percent have used an AFS credit product. Only 29.5 percent of unbanked and underbanked households have not used any AFS in the past year which points to their reliance on cash usage and other informal transactions. Among unbanked and underbanked households that have used AFS, 61.2 percent have used it within the past 30 days which suggests that these households rely on AFS regularly and often.

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The average income of the more than 90 million underbanked Americans is $25,500, less than half of the median income in the United States. Of that $25,500, the underbanked population spends about 10 percent each year – approximately the same amount they spend on food – simply gaining access to their funds through AFS. In recent years in an effort to avoid both the fees and minimum balances from traditional bank accounts as well as the high fees and services charges related to AFS, unbanked and underbanked households have increasingly been turning to prepaid debit cards and payroll cards. In fact, the Federal Reserve found that they are the fastest growing form of non-cash payment.

Regulating – and Limiting Access to – Alternative Financial Services

Unfortunately for those households who rely on prepaid cards as an alternative to bank accounts, the Consumer Financial Protection Bureau (CFPB) is proposing new regulations that would have a significant impact on the availability of prepaid cards as well as the benefits they bring. In the 870 page proposal on prepaid cards, including 156 pages of actual proposed rules, the CFPB seeks to mandate new disclosures on behalf of the card companies, new error resolution procedures, consumer liability limits for unauthorized transactions, fee limits, and added requirements for cards with overdraft or credit features.

The proposed rule covers "prepaid accounts" which is defined as "a card, code, or any other device that is capable of being loaded with funds, is not otherwise an account under [the proposed] Regulation E (such as a deposit account), and is redeemable upon presentation at multiple unaffiliated merchants for goods or services, or usable at either ATMs or for person to person transfers." For those accounts, the proposed rule would require a short-form and long-form fee disclosure along with other information at the time a consumer acquires a prepaid account. Issuers also would be required to deliver statements and both electronic and paper account histories dating back at least 18 months. Additionally, the rule proposes to require overdraft and credit extension features on prepaid cards, thus subjecting these prepaid accounts to the Credit Card Accountability Responsibility and Disclosure (CARD) Act requirements, as well as CFPB's vast authority over any cards with credit features as it applies to their reporting, marketing, and disclosure rules. The rule also sets standards for error resolution and limits consumer liability.

Costs of Regulation and the Impact of Cost-Shifting

Buried 700 pages into the proposed rule, CFPB admits the hefty time and dollar burden it believes will come as a result of the new requirements. For Regulation E alone, CFPB estimates a one-time burden of 35,398 hours and an ongoing or annual burden of 10,376 hours to the prepaid card providers. Even at a conservative $33 per hour, that's a one-time compliance cost of $1,168,134 and an annual compliance cost of $342,408 to these prepaid card companies. And that's just one regulation. The proposal also estimates costs of $17 million simply to dispose of and replace the prepaid cards currently in stores in order to comply with the pre-acquisition disclosure requirements. If we've learned anything about government-mandated costs to providers of financial services, it's that they will, in one way or another, get passed onto the consumers. It's hard to imagine that these would be any different.

In its 46 page comment letter submitted in response to CFPB's proposal, the American Bankers Association (ABA) raises several concerns, most of which center around the way the proposal's treatment of overdrafts on prepaid cards. Among other problems, the proposal would treat overdrafts as an extension of credit, which categorically violates the Truth in Lending Act (TILA). In short, TILA conveys a right to defer payment to credit account holders, but anyone who overdrafts on a prepaid card is not afforded such a right even though CFPB seeks to equate those overdraft allowances with credit extensions. CFPB is attempting to paint prepaid cards with a broad brushstroke, and instead should be defining these prepaid accounts more narrowly. Without a more narrow definition, the proposal would effectively ban overdraft services or credit extension on the cards because the card issuers will be faced with unsurmountable compliance costs and risks.

ABA's summary closing paragraph is a compelling argument – one supported by both numbers and precedent: "In short, the cumulative operation and compliance costs and risks of the proposal will significantly hinder banks' ability to offer prepaid cards. The result will be the suppression of a promising option to move people without bank accounts into financial products offered by insured depository institutions. Thus, rather than creating guardrails, the proposed overdraft services treatment, coupled with other onerous provisions, will create regulatory potholes and barriers to needed and valuable financial products."

Conclusion

It's bad enough that millions of Americans are left unbanked or underbanked as a direct result of government action through the Durbin Amendment, but now CFPB wants pull the last rug out from under their feet and impose high regulatory costs that will result in higher fees for consumers or constrict their options. Prepaid card companies and their users were doing just fine (apart from being forced to use prepaid cards as a bank alternative) without CFPB's intervention. CFPB should be reminded that if it ain't broke, don't fix it.