CFPB Overdraft Rule Could Mean Big Shift In Banking Biz

By **Stuart Richter, Eric Hail and Eric Werlinger** (February 16, 2024)

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Since 2022, the Consumer Financial Protection Bureau has threatened to regulate overdraft fees as part of its crusade against "junk fees."[1]

Last month, the CFPB finally made good on that threat by issuing a notice of proposed rulemaking that would change regulations under the Truth in Lending Act to "close a longstanding loophole that allowed many large banks to transform overdraft into a massive junk fee harvesting machine."[2]

So, what does the proposed rule mean for the industry and consumers? In a nutshell, a host of negative consequences may befall "very large financial institutions," or VLFIs — those with more than $10 billion in assets — and the customers they serve. That's not surprising, given that they're the direct target of the CFPB's contemplated action.

But underneath the headline-grabbing changes to Regulation Z is a foundational shift in how the CFPB views overdraft services. This shift may bring wider indirect consequences for everyone: both institutions regulated by the CFPB and those that aren't.

How would the proposed rule change the law?

We've already seen high-level analysis of the CFPB's announcement.[3] Regulation Z has long exempted "[c]harges imposed by a financial institution for paying items that overdraw an account" from the definition of "finance charge," meaning overdraft fees generally aren't subject to Regulation Z's disclosure requirements.[4]

The proposed rule would alter the definition of "finance charge" to eliminate this exemption for fees assessed on courtesy overdraft services, i.e., paying debits out of an overdrawn account, by VLFIs.[5] The proposed rule gives VLFIs two ways to continue charging overdraft fees and avoid the new definition of "finance charge": set their fees at or below the institution's "breakeven point" for overdraft services;[6] or charge a "benchmark" fee set by the CFPB, which will likely be somewhere between $3 and $14.[7]

Short of that, VLFIs may comply with the proposed rule by providing an associated credit account that provides the consumer with full, TILA-compliant disclosures about how the account will be used to cover overdrafts.

That's what the bureau says the proposed rule would do. But how would the law actually change? Currently, Title 12 of the Code of Federal Regulations, Section 1026.4(c)(3), says "The following charges are not finance charges: ... Charges imposed by a financial institution for paying items that overdraw an account, unless the payment of such items and the imposition of the charge were previously agreed upon in writing."

The proposed rule would narrow the exception by adding the following: "This paragraph (c)(3) also does not apply to above breakeven overdraft credit as defined in § 1026.62."

According to the proposal, "above breakeven overdraft credit" means:

overdraft credit extended by a very large financial institution to pay a transaction on which, as an incident to or a condition of the overdraft credit, the very large financial institution imposes a charge or combination of charges exceeding the average of its costs and charge-off losses for providing non-covered overdraft credit as described in § 1026.62(d).[8]

By limiting the definition of "above breakeven overdraft credit" to "very large financial institution[s]," the proposed rule cabins the changes to Section 1026.4(c)(3) to institutions with more than $10 billion in assets.[9]

VLFIs have two ways to demonstrate that their overdraft fees do not exceed the average costs and charge-offs associated with noncovered overdraft credit.

First, they can charge a set fee allowed by the CFPB, which will likely be between $3 and $14.[10] Second, VLFIs may calculate the "pro rata share" of the "total direct costs and charge-off losses for providing non-covered overdraft credit in the previous year," consistent with the limitations prescribed by the proposed rule.[11]

All of this is as-advertised by the CFPB's press releases to-date. But, buried in the web of proposed revisions to Regulation Z is a so-far unexamined change that may have a much broader impact on the banking industry.

The proposed rule introduces the new term "overdraft credit," which is "any consumer credit extended by a financial institution to pay a transaction from a checking or other transaction account," other than some prepaid accounts, "held at the financial institution when the consumer has insufficient or unavailable funds in that account."[12]

Unlike "above breakeven overdraft credit," the term "overdraft credit" is not explicitly limited to VLFIs. One can plausibly read this provision to reflect a fundamental shift in the CFPB's view of overdraft services and its interpretation of TILA: The agency sees overdraft services generally as an extension of "credit."[13]

Indeed, the proposed revisions to the official staff interpretation of Regulation Z's definition of "credit" seemingly confirm this suspicion.[14]

If this change is adopted in the final regulation, the CFPB would break with over five decades of law and policy. Since the Federal Reserve first promulgated Regulation Z in 1969, legal authorities have explicitly stated that overdraft services are not credit or debt services, and overdraft fees are not interest or loan-servicing fees.[15]

Case law on this point is legion: Overdraft fees compensate banks and credit unions for services directly connected to a deposit account, which is decidedly not a credit product.[16]

What are the possible consequences for regulated entities and the banking industry generally?

This dovetails into the next question on most people's minds: What are the second-order effects of the proposed rule?

Let's start with direct legal consequences. The proposed rule may open a new litigation front against VLFIs that decide to charge overdraft fees. Private litigants may try to assert claims under Regulation Z against VLFIs that charge overdraft fees but do not use the "benchmark" fee.[17]

Even for entities that conduct a proper "breakeven" analysis to set their fees, a would-be plaintiff could still allege on information and belief that the analysis is improper. That would be a fact issue, which means such a case may well make it past a motion to dismiss and result in costly discovery. There's no set formula for this analysis, let alone a safe harbor, so the possibilities of expensive "battles of the experts" are real.

There may be broader indirect consequences for all entities under state law. In the early days of overdraft class actions, plaintiffs tried to assert claims under state consumer protection law — mainly usury and deceptive trade practice laws.

Defense lawyers snuffed many of these claims out by arguing: (1) an overdraft isn't a loan or extension of credit;[18] and (2) preemption under the National Bank Act, Federal Credit Union Act or the Truth in Savings Act barred these claims, because a private litigant can't use state tort law to regulate fees and disclosures by federally chartered or insured institutions that otherwise comply with federal law.[19]

The proposed definition of "overdraft credit" and official staff interpretation of "credit" may put this settled law back into flux. The proposed definition casts obvious doubt on the "overdrafts aren't credit" argument. Some courts and state regulators may also revisit whether usury laws ought to apply to overdraft fees.

As for preemption, the proposed rule may undermine the hard-fought case law on this front. One of the best counterarguments banks and credit unions had to "fees are really interest" claims is that federal law did not actively regulate overdrafts and overdraft fees on non-Regulation E transactions, which reflected the federal government's policy choice to let the free market shape these services and fees.

That would no longer be the case under the proposed rule. The plaintiffs bar may argue that, because Regulation Z addresses most overdraft services, any preemption analysis ought to focus on TILA's preemption provision — as opposed to those under the National Bank Act, Federal Credit Union Act or the Truth in Savings Act. And plaintiffs lawyers will likely try to claim the high ground on that argument, thanks to recent guidance by the CFPB stating the agency's view that TILA provides only a narrow form of conflict preemption.[20]

How might the industry react to the proposed rule?

What might banks and credit unions do in response to the proposed rule? The answer to that question will differ from institution to institution. Some banks and credit unions eliminated overdraft fees years ago.[21] For others, overdraft fees remain a source of revenue.[22]

Many institutions may question whether it's worth offering overdraft services in their present form — or at all — under the proposed rule. The banking industry views overdraft privilege as a valuable service to customers — one that is not without risks, e.g., delinquency or non-payment by unscrupulous or irresponsible individuals. Why undertake those risks if the law makes it untenably difficult to be rewarded?

Some institutions may limit overdraft privileges to lower-risk customers, particularly if the CFPB sets the "benchmark fee" too low. Or they may get rid of overdraft privilege entirely, and just reject all transactions when a customer has insufficient available funds to pay.

What about consumers?

In the eyes of the CFPB, the proposed rule will benefit consumers. They will get cheaper, or free, so-called loans from their financial institutions when they overdraft their checking accounts. But that supposition only holds true if one presumes financial institutions won't respond to the proposed rule, which is likely wrong. We foresee a host of potential negative consequences that may befall consumers as a result of the proposed rule.

As the CFPB acknowledges, the financially insecure — those living paycheck-to-paycheck, on fixed incomes, or without regular income — tend to be the heaviest users of overdraft services.[23] Money gets tight at the end of a pay period, but necessary expenses still have to get paid.

To these consumers, the ability to overdraft is valuable.[24] If financial institutions were to curtail overdraft privileges, bank and credit union call centers would likely light up with outraged customers. Worse, if overdraft services dry up in response to the proposed rule, vulnerable consumers may be forced into undesirable or higher risk sources of funds.

Beyond these direct results, it is likely that consumer banking costs would increase generally. By the CFPB's own numbers, overdraft-fee revenue is around $10 billion per year.[25] Banks and credit unions have an obligation to their shareholders and members to replace that revenue. Free checking accounts may become a thing of the past. Low-balance fees may return. Consumer loans may become more expensive.

To be sure, these costs would be shifted onto a broader base of customers — not just a subset of financially insecure people. Either way, it is highly unlikely that financial institutions will sit back and take a potential hit to their revenue.

What's next?

Consumers and financial institutions have until April 1 to voice their comments and concerns to the CFPB. The rule will go into effect on the Oct. 1 that is at least six months after the publication of the final rule in the Federal Register. The CFPB expects the rule will be effective on Oct. 1, 2025, so expect a final rule sometime before March 2025.

We also expect legal challenges to the final rule once it is promulgated. As some of our colleagues in the defense bar recently highlighted, there's a cogent argument that the CFPB's determination that overdraft services are a form of "credit" is inconsistent with the statutory text of TILA.

And by the time a final rule is promulgated, Chevron deference may be modified or no longer exist, which means the CFPB's interpretation of TILA may not be entitled to the kind of deference the agency is used to getting.

The rulemaking process may also be subject to procedural attack. Title 15 of the U.S. Code, Section 1604(f), requires the enforcing agency to consider a list of factors in exempting transactions from TILA's regulatory scope.

Here, the CFPB is partially stripping away an exemption previously granted by the Federal Reserve over half a century ago. Does Section 1604(f) apply in these circumstances, and did the CFPB comply if so? Someone could argue it.

Finally, industry stakeholders will likely mount a frontal attack on the rule as arbitrary and capricious. It is not clear to us that the CFPB considered any of the consequences laid out here or by other industry commenters.

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[1] Consumer Financial Protection Bureau Launches Initiative to Save Americans Billions in Junk Fees, CFBP, Jan. 26, 2022, https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-launches-initiative-to-save-americans-billions-in-junk-fees/.

[2] CFPB Proposes Rule to Close Bank Overdraft Loophole that Costs Americans Billions Each Year in Junk Fees, CFPB, Jan. 17, 2024, https://www.consumerfinance.gov/about-us/newsroom/cfpb-proposes-rule-to-close-bank-overdraft-loophole-that-costs-americans-billions-each-year-in-junk-fees/.

[3] We did our own. Eric R. Hail et al., The Latest Chapter in the Government's War on Purported "Junk" Fees: The CFPB Moves to Define Overdraft Services as Credit and to Cap Fee Amounts, Katten, Jan. 19, 2024, https://katten.com/the-latest-chapter-in-the-governments-war-on-purported-junk-fees-the-cfpb-moves-to-define-overdraft-services-as-credit-and-to-cap-fee-amounts.

[4] 12 C.F.R. § 1026.4(c)(3).

[5] Proposed 12 C.F.R. § 1026.4(c)(3). For the proposed regulatory changes, we refer to the CFPB's Unofficial Redline of the Overdraft Lending: Very Large Financial Institutions Proposed Rule, available at https://files.consumerfinance.gov/f/documents/cfpb_unofficial-redline_overdraft-credit-very-large-financial-institutions_2024-01.pdf

[6] Proposed 12 C.F.R. § 1026.62(a)(1), (d).

[7] Proposed 12 C.F.R. § 1026.62(d). The regulation doesn't actually use the phrase "benchmark fee." That's from the CFPB's press release. See supra n.1. We use it here as a convenient shorthand to reflect the range for the proposed fee.

[8] Proposed 12 C.F.R. § 1026.62(a)(1).

[9] Proposed 12 C.F.R. § 1026.62(b)(8).

[10] Proposed 12 C.F.R. § 1026.62(d)(1)(ii).

[11] Proposed 12 C.F.R. § 1026.62(d)(1)(i), (d)(2).

[12] Proposed 12 C.F.R. § 1026.62(a)(2).

[13] Indeed, the CFPB's press materials on the proposed rule casually refer to overdraft services as "overdraft loans" — an apparent change in public messaging to accompany its proposed change to the law. Supra n.2.

[14] "Funds extended by a financial institution" — not just VLFIs — "to a consumer to pay transactions that overdraw a checking or other transaction account held at the financial institution are credit whenever the consumer has a contractual obligation to repay the funds." Proposed Official Interpretation to 12 C.F.R. § 1026.2(a)(14).

[15] E.g., Truth in Lending, 34 Fed. Reg. 2002, 2004 (Feb. 11, 1969); Truth in Lending: Official Staff Interpretations, 42 Fed. Reg. 22,360, 22,362 (May 3 1977) (stating that fees charged for overdrafts on "regular demand deposit accounts [with] no credit features" do "not seem to be an element of [a] credit plan, but rather would seem to be related to the basic checking account agreement").

[16] Walker v. BOKF, Nat'l Ass'n, 30 F.4th 994, 1005-07 (10th Cir. 2022) (citing Office of the Comptroller of the Currency, Interpretive Letter #1082, at 6 (Jun. 2007)); see also, e.g., Video Trax, Inc. v. NationsBank, N.A., 33 F. Supp. 2d 1041, 1053, 1056 (S.D. Fla. 1998) ("[T]he payment of checks against an overdrawn account is not an extension of credit, and that the OD fee charged for such services is not interest."), aff'd, 205 F.3d 1358 (11th Cir. 2000); In re TD Bank, N.A. Debit Card Overdraft Fee Litig., 2018 WL 1101360, at *3-11 (D.S.C. Feb. 28, 2018) (collecting cases rejecting the proposition that overdrafting is tantamount to extending credit); Hernandez v. Wells Fargo Bank New Mexico, N.A., 128 P.3d 496, 499 (N.M. 2005); Freeman v. Hawthorn Bank, 516 S.W.3d 417, 425 (Mo. Ct. App. 2017).

[17] See 15 U.S.C. § 1640 (civil liability for failure of creditor to comply with any requirement under TILA).

[18] E.g., Video Trax, Inc., 33 F. Supp. 2d at 1053, 1056.

[19] E.g., Gutierrez v. Wells Fargo Bank, NA, 704 F.3d 712, 722-726 (9th Cir. 2012); Lambert v. Navy Fed. Credit Union, 2019 WL 3843064, at *2-3 (E.D. Va. Aug. 14, 2019).

[20] Truth in Lending; Determination of Effect on State Laws (California, New York, Utah, and Virginia), 88 Fed. Reg. 19,214, 19,214 (Mar. 31, 2023) ("Congress adopted a narrow standard for TILA preemption that displaces State law only in the case of 'inconsistency.' This means that States have broad authority to establish their own protections for their residents, both within and outside the scope of TILA.").

[21] E.g., You should never pay overdraft fees again, Alliant Credit Union, Aug. 12, 2021, https://www.alliantcreditunion.org/money-mentor/no-more-overdraft-fees; Capital One eliminates overdraft fees for customers, Capital One, Dec. 1, 2021, https://www.capitalone.com/about/newsroom/eliminating-overdraft-fees/.

[22] Banks' overdraft/NSF fee revenue declines significantly compared to pre-pandemic levels, CFPB, Feb. 7, 2023, https://www.consumerfinance.gov/data-research/research-

reports/banks-overdraft-nsf-fee-revenue-declines-significantly-compared-to-pre-pandemic-levels/.

[23] See generally CFPB, Overdraft and Nonsufficient Fund Fees: Insights from the Making Ends Meet Survey and Consumer Credit Panel (Dec. 19, 2023), available at https://files.consumerfinance.gov/f/documents/cfpb_overdraft-nsf-report_2023-12.pdf.

[24] National Survey: U.S. Consumers Remain Happy with Their Bank, Competitive Financial Services Marketplace, Am. Bankers Assoc., Oct. 9, 2023, https://www.aba.com/about-us/press-room/press-releases/consumer-survey-consumers-happy-and-competitive.

[25] Supra nn.1, 28.