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THE CARD GAME

Overspending on Debit Cards Is a Boon for Banks

By RON LIEBER and ANDREW MARTIN

When Peter Means returned to graduate school after a career as a civil servant, he turned to a debit card to help him spend his money more carefully.

So he was stunned when his bank charged him seven $34 fees to cover seven purchases when there was not enough cash in his account, notifying him only afterward. He paid $4.14 for a coffee at Starbucks — and a $34 fee. He got the $6.50 student discount at the movie theater — but no discount on the $34 fee. He paid $6.76 at Lowe's for screws — and yet another $34 fee. All told, he owed $238 in extra charges for just a day's worth of activity.

Mr. Means, who is 59 and lives in Colorado, figured employees at his bank, Wells Fargo, would show some mercy since each purchase was less than $12. In addition, a deposit from a few days earlier would have covered everything had it not taken days to clear. But they would not budge.

Banks and credit unions have long pitched debit cards as a convenient and prudent way to buy. But a growing number are now allowing consumers to exceed their balances — for a price.

Banks market it as overdraft protection, and the fees it generates have become an important source of income for the banking industry at a time of big losses in other operations. This year alone, banks are expected to bring in $27 billion by covering overdrafts on checking accounts, typically on debit card purchases or checks that exceed a customer's balance.

In fact, banks now make more covering overdrafts than they do on penalty fees from credit cards.

But because consumers use debit cards far more often than credit cards, a cascade of fees can be set off quickly, often for people who are least able to afford it. Some banks further increase their revenue by manipulating the order of a customer's transactions in a way that causes more of them to incur overdraft fees.

"Banks will let you overspend on your debit card in a way that is much, much more expensive than almost any credit card," said Eric Halperin, director of the Washington office of the Center for Responsible Lending.

Debit has essentially changed into a stealth form of credit, according to critics like him, and three quarters of the nation's largest banks, except for a few like Citigroup and INGDirect, automatically cover debit and A.T.M. overdrafts.

Although regulators have warned of abuses since at least 2001, they have done little to curb the explosive growth of overdraft fees. But as a consumer outcry grows, the practice is under attack, and regulators plan to introduce new protections before year's end. The proposals do not seek to ban overdraft fees altogether. Rather, regulators and lawmakers say they hope to curb abuses and make the fees more fair.

The Federal Reserve is considering requiring banks to get permission from consumers before enrolling them in overdraft programs, so that consumers like Mr. Means are not caught unaware at the cash register.

Representative Carolyn Maloney, Democrat of New York, would go even further by requiring warnings when a debit card purchase will overdraw an account and by barring banks from running the most expensive purchases through accounts first.

The proposals carry considerable momentum given the popularity of credit card legislation signed into law in May. They also have a certain inevitable logic, since the credit card legislation requires a similar "opt in" decision from consumers who want to spend more than their credit limits and pay the corresponding over-the-limit fees. Overdrafts are simply the reverse, where the limit is zero, and the bank charges a fee for going under it.

But with so much at stake, the banking industry is intent on holding its ground.

Bankers say they are merely charging a fee for a convenience that protects consumers from embarrassment, like having a debit card rejected on a dinner date. Ultimately, they add, consumers have responsibility for their own finances.

"Everyone should know how much they have in their account and manage their funds well to avoid those fees," said Scott Talbott, chief lobbyist at the Financial Services Roundtable, an advocacy group for large financial institutions.

Some experts warn that a sharp reduction in overdraft fees could put weakened financial institutions out of business.

Michael Moebs, an economist who advises banks and credit unions, said Ms. Maloney's legislation would effectively kill overdraft services, causing an estimated 1,000 banks and 2,000 credit unions to fold within two years. That is because 45 percent of the nation's banks and credit unions collect more from overdraft services than they make in profits, he said.

"Will they be able to replace it with another fee?" Mr. Moebs said. "Not immediately and not soon enough."

They will certainly try. For instance, some banks have said they might slap a monthly fee of between $10 to $20 on every free checking account. At the moment, people who pay overdraft fees help subsidize the free accounts of those who do not.

Banks may also have to answer a question that many consumers ask and that Ms. Maloney has raised in her proposal: Why can't banks simply alert a consumer at the cash register if they are about to spend more than they have in their account, and allow them to say right then and there whether they want to pay a fee to continue?

The banking industry says that simply is not possible without new equipment and software, costs that would be borne by consumers.

"If you think about when you swipe your card at, let's say, Starbucks or at the Safeway or the Giant, there is no real sort of interaction there," said Mr. Talbott. "It's just approved or disapproved. So how logically would that work? Would a screen come up? Would someone at the bank call the checkout clerk and say, 'That customer is overdrawn?' Logistically that would be very difficult to implement."

No one could have imagined this controversy decades ago, when the A.T.M. card was born. Back then, it was simple: when money ran out, the card was usually rejected by the banks.

But then A.T.M. cards started acquiring Visa or MasterCard logos, allowing users to "debit" their bank accounts for purchases. A thorny issue soon sprang up. What if there wasn't enough money in a cardholder's account to cover a purchase?

For years, banks had covered good customers who bounced occasional checks, and for a while they did so with debit cards, too. William H. Strunk, a banking consultant, devised a program in 1994 that would let banks and credit unions provide overdraft coverage for every customer — and charge consumers for each transgression.

"You are doing them a favor here," said Mr. Strunk, adding that overdraft services saved consumers from paying merchant fees on bounced checks.

Some institutions do not see it that way, and either do not offer overdraft services or allow their clients to decline the service. "We've never subscribed to the notion that individuals who overdraw or attempt to should be allowed to do so without the opportunity to opt in," said Gary J. Perez, the president and chief executive of the University of Southern California Credit Union.

A Source of Easy Money

But many of the nation's banks have found that overdraft fees are easy money. According to a 2008 F.D.I.C. study, 41 percent of United States banks have automated overdraft programs; among large banks, the figure was 77 percent. Banks now cover two overdrafts for every one they reject.

In all, $27 billion in fee income flows from covering overdrafts from debit card purchases, A.T.M. transactions, checks and automatic payments for bills like utilities; an additional $11.5 billion arrives from bounced checks and other instances in which banks refuse to pay overdrafts, Mr. Moebs said.

By contrast, penalty fees from credit cards will add up to about $20.5 billion this year, according to R. K. Hammer, a consultant to the credit card industry. For instance, customers incur penalties for paying their bills late or by spending beyond the credit limit the bank has set for them. Banks also make billions in interest from credit cards.

Most of the overdraft fees are drawn from a small pool of consumers. Ninety-three percent of all overdraft charges come from 14 percent of bank customers who exceeded their balances five times or more in a year, the F.D.I.C. found in its survey. Recurrent overdrafts are also more common among lower-income consumers, the study said.

Advocacy groups say banks are making a fortune because consumers are unaware of the exorbitant costs of overdraft services. And banks, they argue, have an incentive to keep it that way.

That is what Mr. Means found when he approached his Wells Fargo branch in Fort Collins, Colo., to redress the $238 in fees he was billed. An employee explained that her ability to waive fees had been revoked by the bank because she had refunded fees for too many customers, Mr. Means said she told him.

Rory Foster, a former branch manager in Illinois, said that Wells Fargo based its compensation for managers in part on overall branch profitability. Fee income, including that from overdrafts, is part of the calculation.

A spokeswoman for Wells Fargo, Richele J. Messick, said the bank did not tie branch manager pay directly to fee collection.

‘I Can’t Afford That’

Yet fees, and how they are generated, remain a mystery to many consumers. Because regulators do not treat overdraft charges as loans, banks do not have to disclose their annualized cost to consumers.

And often, the price is enormous. According to the F.D.I.C. study, a $27 overdraft fee that a customer repays in two weeks on a $20 debit purchase would incur an annual percentage rate of 3,520 percent. By contrast, penalty interest rates on credit cards generally run about 30 percent.

“People would be shocked at how brutally high those fees are relative to the costs of a credit card,” said Edmund Mierzwinski, the consumer program director for the United States Public Interest Research Group.

Ruth Holton-Hodson discovered that the hard way. She keeps close tabs on the welfare of her brother, who lives in a halfway house in Maryland and uses what little he has in his account at Bank of America to pay rent and buy an occasional pack of cigarettes or a sandwich.

When the brother, who has a mental illness that she says requires her to assist with his finances, started falling behind on rent, Ms. Holton-Hodson found he had racked up more than $300 in debit card overdraft fees in three months, including a $35 one for exceeding his balance by 79 cents.

Ms. Holton-Hodson said she spent two years asking bank employees if her brother could get a card that would not allow him to spend more than he had. Though Bank of America does not typically allow customers to opt out of overdraft protection, it finally granted an exemption.

“I’ve been angered and outraged for many years,” she said. “When there is no money in his account, he shouldn’t be able to pay.”

Anne Pace, a spokeswoman for Bank of America, said the case was “complicated issue without any simple solutions,” but declined to elaborate, citing privacy concerns. She added the bank allowed customers to opt out of overdraft services on a “case-by-case basis.”

And when a consumer does overdraw an account, banks have found a way to multiply the fees they collect by rearranging the sequence of transactions, critics say.

Ralph Tornes, who lives in Florida, is pursuing a lawsuit against Bank of America for charging him nearly $500 in overdraft fees in 2008 after it rearranged his purchases from largest to smallest. In May 2008, for instance, Mr. Tornes had $195 in his account when he made two debit purchases for $8 and $13; the bank also processed a bill payment of $256.

He claims that Bank of America took his purchases out of chronological order and ran the biggest one through first. So instead of paying $35 for one overdraft fee, he was stuck with three, for a total of $105.

Mr. Talbott, of the Financial Services Roundtable, said some banks reordered purchases based on surveys showing that consumers want their most vital bills, like rent and car payments, which tend to be for larger amounts, paid before items like a $3 coffee.

Consumers who have been slapped with large fees as a result of this practice have a different perspective. “There is no reason they should get the little guy because he’s only got a few bucks in his account,” said Ryan Pena, 24, a recent college graduate who has filed suit against Wachovia, now part of Wells Fargo, for what he says are abusive practices, including reordering his purchases. “I can’t afford that.”

Officials at Bank of America and Wachovia declined to talk about specific complaints, but echoed Mr. Talbott’s remarks on processing payments.

The Debate in Washington

These lawsuits open a window onto the questions that government officials and banks are now trying to answer. Do consumers actually want overdraft service? Can they use it responsibly? If so, what is the best way to deliver it?

Federal regulators have acknowledged problems with overdraft fees since at least 2001 but have done little aside from improving disclosure and issue voluntary guidelines they hoped the industry would follow. That year, Daniel P. Stipano, deputy chief counsel for the Office of the Comptroller of the Currency, wrote that a company that markets overdraft programs to banks showed a “complete lack of consumer safeguards.”

In 2005, after intense industry pressure, the Federal Reserve ruled that overdraft charges should not be covered by the Truth in Lending Act. That meant bankers did not have to seek consumers’ permission to sign them up, nor did they have to disclose the equivalent interest rate for the fees.

That same year, the Federal Reserve said that some banks had “adopted marketing practices that appear to encourage consumers to overdraw their accounts.” It issued a list of “best practices” that asked banks to more clearly disclose overdraft fees, let customers opt out of overdraft programs and provide an alert when a purchase occurs that would put the account below zero. But critics said the recommendations had no teeth.

“No regulator has made any of their bank examiners adhere to best practices,” said Mr. Halperin, of the Center for Responsible Lending. “The result is over that time period consumers have paid probably upwards of $80 billion in overdraft fees while the Federal Reserve considers and considers and considers whether or not they are going to do anything."

Officials at the Federal Reserve dispute that they have not taken sufficient action on overdraft fees, noting that they imposed tougher disclosure requirements in 2004 and are now considering additional regulations to address abusive practices. They will disclose their intent before the end of the year.

What no one disputes is that the stakes in the coming battle on overdraft fees are enormous. Ms. Maloney said she did not push her overdraft legislation this spring because the uproar from the banking industry could have jeopardized the credit card bill.

"It was very important to provide more tools to consumers to better manage their credit cards," she said. "And now I think they deserve the same treatment with debit cards."