

TRANSACTION ACCOUNT FEES: DO THE POOR REALLY PAY MORE THAN THE RICH?

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During the Great Recession and its aftermath, customers became increasingly concerned about the fees banks charge for checking (transaction) accounts. Some believe that banks' fee structures are unfair. In particular, commentators often assert that high overdraft and other fees paid by poor consumers cross-subsidize free accounts for rich consumers or businesses. If true, this regressive cross-subsidization could be forcing some consumers to do without banking services or to use more costly fringe financial service providers. Moreover, if regressive cross-subsidization exists, it would provide a powerful argument for increased regulation of account fees.

Despite frequent claims that poor accountholders cross-subsidize rich accountholders, there is little scholarship examining or establishing such claims. This Article examines both theoretical and empirical evidence of cross-subsidization among transaction accountholders. Contrary to the assumptions made in much of the account fee literature, this Article concludes there is little evidence that the poor cross-subsidize the rich.

What the Article does find, however, is contradictory account fee regulation. Some regulations encourage fee structures with high overdrafts while other regulations simultaneously discourage overdraft fees. This Article recommends that instead of focusing on cross-subsidization, policymakers should work to establish a coherent theory of transaction account fee regulation. A coherent theory of fee regulation could correct this inconsistency and provide clear direction for banks.

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INTRODUCTION

In our modern economy, consumers rely on a variety of payment systems. They pay by cash, checks, credit cards, debit cards, prepaid cards, automated clearing house (ACH) transfers, and internet accounts. While there are numerous payment choices, many of the choices require a common ingredient—a transaction account. A transaction account, often called a checking account, is a bank account used to make payments to third parties.¹ Consumers withdraw money from their transaction accounts by writing checks, using debit cards, using automated teller machine (ATM) cards, or authorizing electronic withdrawals of money (such as providing an account number and bank routing number to a merchant or using a bank’s online bill pay service). Survey data indicate that 91.8% of consumers in the United States have at least one transaction account.²

Banks charge transaction account holders a variety of fees. While transaction accounts’ fee structures differ from bank to bank (and even account to account), common fees include overdraft fees,³ insufficient funds fees,⁴ return item fees,⁵ stop payment fees,⁶ and account maintenance fees.⁷ Some banks also assess teller fees,⁸ smart-phone banking fees,⁹

1. 12 U.S.C. § 461(b)(1)(C) (Supp. 2011); 12 C.F.R. § 204.2(e) (2012).

2. Kevin Foster et al., *2009 Survey of Consumer Payment Choice*, FED. RESERVE BANK OF BOSTON PUB. POL’Y DISCUSSION PAPER No. 11-1, at 47 (Apr. 2011), available at <http://www.bostonfed.org/economic/ppdp/2011/ppdp1101.pdf>.

3. A bank assesses an overdraft fee when it pays an item even though the customer’s account does not have sufficient funds to cover the transaction. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-08-281, BANK FEES: FEDERAL BANKING REGULATORS COULD BETTER ENSURE THAT CONSUMERS HAVE REQUIRED DISCLOSURE DOCUMENTS PRIOR TO OPENING CHECKING OR SAVINGS ACCOUNTS I (2008), <http://www.gao.gov/new.items/d08281.pdf> [hereinafter GAO, BANK FEES REPORT].

4. A bank assesses an insufficient funds fee when it returns an item that would have overdrawn the customer’s account. *Id.* at 4–5.

5. A bank assesses a return item fee when a customer deposits an item that is later returned unpaid. *Id.* at 12.

6. A bank assesses a stop payment fee for processing a customer’s order to stop payment on a previously written check. *Id.*

7. Banks typically assess maintenance fees “on a monthly basis for maintaining a checking . . . account. Depository institutions frequently waive routine service fees for customers who maintain a monthly minimum balance or meet other requirements, such as for direct deposits of paychecks.” *Id.*

8. See Jessica Silver-Greenberg, *Attack of the New Bank Fees*, WALL ST. J., Jan. 14, 2012, at B8 (“PNC . . . hits customers with a \$3 fee when they use a teller to transfer money. Bank of America already charges online customers for making deposits or withdrawals through a teller.”).

9. *Id.* (“U.S. Bancorp already hits customers with a 99-cent fee to make a mobile

paper statement fees,¹⁰ and a variety of other fees.

In recent years, banks have increased transaction account fees. A Government Accountability Office study found that between 2000 and 2007, banks' fees for insufficient funds, overdrafts, returns of deposited items, and stop payment orders all increased.¹¹ Fee increases continued as the country entered the Great Recession.¹² The typical overdraft fee increased by a dollar between 2007 and 2008.¹³ Monthly account maintenance charges increased even more.¹⁴ At the same time, the weak economy made it harder for some consumers to avoid overdraft and insufficient funds fees or maintain a balance high enough to avoid maintenance charges. A 2009 study by the Center for Responsible Lending, a consumer advocacy group, estimated that bank fees collected for overdrafts had increased 35% between 2006 and 2008.¹⁵ Today the

deposit. To see pending transactions on their phones, customers at Mercantile Bank of Michigan have to pay \$4 a month.”).

10. See Candice Choi, *A Richer 2012: A Monthly Guide to Maximizing Money*, HOUSTON CHRON., Dec. 26, 2011, at B6 (“The monthly service fee for a basic checking account at U.S. Bank, for example, is \$6.95 when customers opt for e-statements. If customers opt for paper statements, however, their monthly fee is \$8.95.”).

11. GAO, BANK FEES REPORT, *supra* note 3, at 68. Using different data that was not representative of the banking industry generally, the GAO concluded that account maintenance fees may have decreased during the same time period. *Id.* at 67, 69. At any rate, the study concluded that the percentage of bank income collected from fees rose from 2000 to 2006. *Id.* at 17–20. Others also noted an increase in bank fees during this time period. See, e.g., Thomas Watterson, *Beware of Soaring Bank Fees*, THE CHRISTIAN SCI. MONITOR, Nov. 17, 2008, at 15 (noting in 2008 that bank fees had been increasing for the last ten years).

12. “Great Recession” refers to the economic recession that “began in December 2007 and probably ended in June or July 2009.” David Wessel, *A Big, Bad . . . ‘Great’ Recession?*, WALL ST. J., Apr. 8, 2010, at A2. Bank fee increases during recessions were previously uncommon. Eric Dash, *How High Can They Go?: Banks Quietly Raise Fees in Penny-Pinching Times*, N.Y. TIMES, July 7, 2009, at B1 (reporting data collected by bank account fee researcher Michael Moebis).

13. See Dash, *supra* note 12, at B8 (noting that the typical overdraft charge increased from \$25 to \$26 and that it had been at only \$22 a few years earlier).

14. See *id.* (noting that in June 2009, Bank of America “raised the fees on its basic monthly checking account to \$8.95 from \$5.95”); *Obama’s A-Team; The Money Pit; Bailout Free-for-all; Read My Lips; Groups Claim Rise in Hate Crimes*, LOU DOBBS TONIGHT (CNN television broadcast Nov. 24, 2008), available at 2008 WLNR 22470689 (“ATM surcharges, bounced bank check fees and monthly service fees all jump[ed] in one year, from September 2007 to September [2008]. . . . Monthly service fees and interest bearing accounts [in 2008] averag[ed] almost \$12 and the minimum account balance needed to avoid those fees [rose] to close to \$3,500, four percent higher than [in 2007].”).

15. LESLIE PARRISH, OVERDRAFT EXPLOSION: BANK FEES FOR OVERDRAFTS INCREASE 35% IN TWO YEARS, CTR. FOR RESPONSIBLE LENDING (Oct. 6, 2009), available at <http://www.responsiblelending.org/overdraft-loans/research-analysis/crl-overdraft-explosion.pdf>.

median overdraft fee is \$30,¹⁶ and some experts predict rising transaction account fees in the future.¹⁷

Transaction account customers have not overlooked banks' fee increases. When Bank of America announced a monthly \$5 fee for customers who use a debit card to make purchases, customer Kristen Christian posted her complaints about the fee on Facebook and urged her friends to transfer their accounts elsewhere.¹⁸ Ms. Christian's complaint drew a nationwide following that eventually resulted in Bank of America's decision to rescind the fee.¹⁹ Despite this apparent victory for consumers, many believe that Bank of America and other large banks will simply increase other account fees.²⁰

While critics of current transaction account fees raise a variety of complaints, one of the most common complaints is that banks' pricing structures are unfair to the poor. One of Ms. Christian's objections to Bank of America's fee was that the bank would waive the fee for customers who maintained a balance of at least \$20,000.²¹ Ms. Christian concluded that the "fee clearly target[ed] the impoverished [and] working class."²²

16. Press Release, Moeb's Services, Overdraft Fee Revenue Falls as Banks Raise Overdraft Prices (Jan. 18, 2012), available at [http://www.moeb's.com/Portals/0/pdf/Press%20Releases/120111%20Moeb's%20PR%20OD%20Revenue%20%20Price%20Final%201-18-12%20\(2\).pdf](http://www.moeb's.com/Portals/0/pdf/Press%20Releases/120111%20Moeb's%20PR%20OD%20Revenue%20%20Price%20Final%201-18-12%20(2).pdf).

17. See Silver-Greenberg, *supra* note 8, at B8 (predicting that banks will increase fees to offset the costs associated with greater regulation); Elizabeth Reed Smith, *The US—To Fee or Not To Fee?*, THE BANKER, Feb. 1, 2012, at 88. But see Odysseas Papadimitriou, *The Rise in Bank Fees Is Over*, CHRISTIAN SCIENCE MONITOR BLOG (Nov. 21, 2011), <http://www.csmonitor.com/Business/Saving-Money/2011/1121/The-rise-in-bank-fees-is-over> (predicting that competition for customers will prevent banks from raising account fees).

18. Aaron Passman, *How Kristen Christian Came to Launch Bank Transfer Day*, CREDIT UNION J., Dec. 19, 2011, at 1, 23.

19. See, e.g., Pamela Yip, *People Power Vanquishes Debit Card Fee*, DALLAS MORNING NEWS, Nov. 7, 2011, at 1D.

20. See E. Scott Reckard, *Debit Cards Poised to Get Much Costlier*, L.A. TIMES, June 25, 2011, at B1.

21. Bank Transfer Day, http://www.facebook.com/note.php?note_id=298049023545172 (Oct. 8, 2011, 1:30 PM); see also Passman, *supra* note 18, at 1, 23 (quoting Ms. Christian, who stated: "It bothered me very deeply at a moral level, because it was clear to me that Bank of America was targeting those who couldn't afford to pay the fee."); Stuart Pfeifer & E. Scott Reckard, *Interest Grows in "Bank Transfer Day"*, L.A. TIMES, Nov. 5, 2011, at B1 ("Christian said BofA's planned fee bothered her because it exempted wealthy customers who met certain balance requirements, meaning it would hit people who could least afford it.").

22. Bank Transfer Day, http://www.facebook.com/note.php?note_id=298049023545172 (Oct. 9, 2011, 4:31 PM); see also Gary Rivlin, *Boycott Your Bank!*, THE DAILY BEAST (Nov. 3, 2011, 10:02 PM EDT), <http://www.thedailybeast.com/articles/2011/11/03/kristen-christian-s-bank-transfer-day-puts-withdrawal-squeeze-on-banks.html>.

Others take the essence of Ms. Christian's argument a step further. They assert that banks' transaction account pricing results in regressive cross-subsidization. They claim that high account fees paid by the poor cross-subsidize "free" transaction accounts for the wealthy. For example Professors John Campbell, Howell Jackson, Brigitte Madrian, and Peter Tufano assert that:

Bank customers who are attracted to initial low rates on checking accounts but fail to read the fine print on overdraft fees . . . tend to be very profitable. In a competitive market for financial services, these profits are typically passed on to other customers in the form of reduced bank charges and lower mortgage rates. Naive (often poor and uneducated) customers can end up subsidizing sophisticated customers.²³

Others use even more strident rhetoric. According to Reuters writer Felix Salmon, "[c]hecking is never free, but in recent years banks have been able to conjure the illusion of free through a system of regressive cross-subsidies, where the poor pay massive overdraft fees and thereby allow the rich to pay nothing."²⁴

23. John Y. Campbell et al., *Making Financial Markets Work For Consumers*, HARV. BUS. REV., July–Aug. 2011, at 47, 50; see also Peter A. Alces & Jason M. Hopkins, *Carrying a Good Joke Too Far*, 83 CHI.-KENT L. REV. 879, 890 (2008) (arguing that "myopic customers who unknowingly pay hidden fees and account charges" overpay for transaction account services thereby creating a "subsidy" for "sophisticated customers"); Stephanie J. Weber, Note, *Excessive Bank Fees—Theories of Liability and the Need for Legislative Action*, 25 U. MEM. L. REV. 1439, 1477 (1995) (arguing that banks give "good customers' preferential [fee] treatment" and pass "the cost of bank service . . . on to less-preferred customers"); *Bank Fees Carry Risks*, DETROIT FREE PRESS, Dec. 3, 2009, at B7 (arguing that because "one quarter of customers pay all [transaction account fees]," those customers are "essentially subsidizing the other three quarters" of accountholders that receive "free" checking); Reckard, *supra* note 20, at B1 ("For years, banks subsidized most debit card holders by levying heavy fees on . . . overdrawn consumers."). Even Wikipedia seems to have taken as truth that cross-subsidization occurs among transaction accountholders, although its description of cross-subsidization in this context is not fulsome. *Cross Subsidization*, WIKIPEDIA, http://en.wikipedia.org/wiki/Cross_subsidization (last updated Nov. 9, 2012) ("An example of cross subsidization often occurs in the banking industry. Fees associated with maintaining a low account balance (below \$1,000 for example) are charged to these customers to maintain their profitability.").

24. Felix Salmon, *Interchange and Free Checking*, REUTERS (June 17, 2010), <http://blogs.reuters.com/felix-salmon/2010/06/17/interchange-and-free-checking/>; see also G.D. Gearino, *Dealing with Collateral Damage*, BUS.-N.C., Feb. 1, 2011, at 37, 41 ("Basically, the poor fool who swiped his debit card for a Starbucks double latte when he was down to his last two dollars in the bank—and was subsequently dinged with a big overdraft fee—paid for his neighbor's checking account."); Kevin Drum, *Robbing the Poor to Give Air Miles to the Rich*, MOTHER JONES (June 17, 2010 10:23 AM PDT), <http://motherjones.com/kevin-drum/2010/06/robbing-poor-give-air-miles-rich> (stating that "overdraft and interchange fees [are] basically surreptitious ways for the poor to subsidize

If transaction account fees cross-subsidize wealthy customers, that pricing could contribute to social problems. In addition to placing an unfair burden on poor accountholders, high fees could price some poor consumers out of the transaction account market.²⁵ Without access to transaction accounts these “unbanked” and “underbanked”²⁶ consumers turn to a variety of costly and sometimes predatory financial products like check cashing services, money orders, and prepaid cards.²⁷ Such a result would be particularly intolerable if more efficient account fee pricing could lower the cost of transaction account services for poor consumers.

Unsurprisingly then, regressive cross-subsidization in transaction account pricing is often offered as a justification for regulatory transaction

the rich”); Ron Lieber & Andrew Martin, *Overspending on Debit Cards Is Painful, but Not for Banks*, N.Y. TIMES, Sept. 9, 2009, at A1 (“At the moment, people who pay overdraft fees help subsidize the free accounts of those who do not.”).

25. “[T]he most common reason persons cite for lacking a [transaction] account is not having enough money to be able to afford the costs of account ownership.” Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 131 (2004) (citing numerous sources); see also Rourke O’Brien, “*We Don’t Do Banks*”: *Financial Lives of Families on Public Assistance*, 19 GEO. J. ON POVERTY L. & POL’Y 485, 488 (2012) (discussing a former bank customer who discontinued his transaction account due to overdraft fees); Ebonya Washington, *The Impact of Banking and Fringe Banking Regulation on the Number of Unbanked Americans*, 41 J. HUM. RESOURCES 106, 110 (2006) (summarizing the results of three surveys of consumers who did not have bank accounts). Of course, there are other reasons that some consumers do not have bank accounts. For example, some may live far from a bank branch, may be uncomfortable entering banks, or may lack the needed documentation to open an account. See Barr, *supra*, at 184; 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 26–27 (2012), available at http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf [hereinafter FDIC, 2011 UNBANKED SURVEY].

26. “Unbanked” is usually defined to encompass those consumers who do not have a checking or savings account. See FDIC, 2011 UNBANKED SURVEY, *supra* note 25, at 4 n.2. “Underbanked” refers to those who have a checking or savings account, but still “rely on alternative financial services.” *Id.* This Article, however, focuses only on transaction (checking) accounts. It does not consider savings accounts because savings accounts typically allow only six transactions from the account per month. See Regulation D, 12 C.F.R. § 204.2(d)(2) (2012) (allowing an account to be classified as a savings account for reserve purposes only if “the depositor is permitted or authorized to make no more than six transfers and withdrawals, or a combination of such transfers and withdrawals, per calendar month or statement cycle”).

27. See Washington, *supra* note 25, at 109; see also Candice Choi, *Living Without a Bank: Fee, Not Free: Plethora of Charges and Inconvenience Price to Pay*, HOUS. CHRON., Oct. 4, 2010, at A8 (providing a first-person account of living without a transaction account). Because of the prevalence of transaction account-based payment systems and the lack of reasonably priced alternatives, former Treasury Secretary Lawrence Summers described transaction accounts as “the most basic link to the mainstream economy.” Press Release, Lawrence H. Summers, Sec’y Treas., Remarks at CFPI Coalition: Extending the Frontier of Capital (Jan. 27, 2000), available at <http://www.treasury.gov/press-center/press-releases/Pages/l350.aspx>.

account price reforms. Some proposals suggest that the government more heavily regulate transaction account pricing to eliminate regressive cross-subsidization.²⁸ Other proposals recommend that regulators require banks to provide low-income consumers free or low-cost transaction accounts²⁹—a policy that could result in progressive cross-subsidization. Unfortunately, little research has examined whether transaction account pricing structures actually result in regressive cross-subsidization.

Earlier scholarship has addressed the issue of cross-subsidization in financial service pricing, but none of this scholarship focuses directly on cross-subsidization among consumer transaction accounts. For example, some assert that consumers who make purchases with cash cross-subsidize consumers who pay with credit cards.³⁰ Other scholarship focuses on whether other bank customers subsidize (or are subsidized by) consumer transaction accounts. In particular, recent debate has focused on whether debit card interchange fees charged to merchants subsidize consumer

28. See Campbell et al., *supra* note 23, at 50 (suggesting that the Consumer Financial Protection Bureau address efficiency and fairness issues raised by transaction account cross-subsidization).

29. See, e.g., JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR 131–32 (1994) (advocating basic transaction accounts targeted to appeal to low-income consumers); Christopher Choe, *Bringing in the Unbanked off the Fringe: The Bank on San Francisco Model and the Need for Public and Private Partnership*, 8 SEATTLE J. FOR SOC. JUST. 365, 392 (2009) (suggesting that the federal government partner with banks to ensure that the poor have access to basic banking services); Felix Salmon, *How to Reform Overdraft Fees*, REUTERS, (July 7, 2009), <http://blogs.reuters.com/felix-salmon/2009/07/07/how-to-reform-overdraft-fees/> (suggesting that banks be “required by law to offer simple no-frills checking accounts for customers who can’t meet minimum-balance requirements and don’t want to pay monthly checking-account fees”). Cf. Michael A. Stegman et al., *Toward a More Performance-Driven Service Test: Strengthening Basic Banking Services Under the Community Reinvestment Act*, 9 GEO. J. ON POVERTY L. & POL’Y 405 (2002) (arguing that the regulators use the Community Reinvestment Act as a vehicle to encourage banks to provide deposit accounts to low-income consumers).

30. See, e.g., Adam J. Levitin, *Priceless? The Social Costs of Credit Card Merchant Restraints*, 45 HARV. J. ON LEGIS. 1, 1 (2008) (contending that “credit card rewards programs are funded in part by a highly regressive, sub rosa subsidization of affluent credit consumers by poor cash consumers”); Adam J. Levitin, *The Antitrust Super Bowl: America’s Payment Systems, No-Surcharge Rules, and the Hidden Costs of Credit*, 3 BERKELEY BUS. L.J. 265, 302–05 (2005) (summarizing an earlier study, John M. Barron et al., *Discounts for Cash in Retail Gasoline Marketing*, 10 CONTEM. ECON. ISSUES 89 (1992), as quantifying the cross-subsidization between cash and credit card consumers in the retail gasoline market); Scott Schuh et al., *Who Gains and Who Loses from Credit Card Payment? Theory and Calibrations*, FED. RESERVE BANK OF BOSTON PUB. POL’Y DISCUSSION PAPER NO. 10-3, at 44–45 (Aug. 31, 2010), available at <http://www.bos.frb.org/economic/ppdp/2010/ppdp1003.pdf> (quantifying “the transfer between cash buyers and credit card buyers” and the “the transfer between low-income and high-income households” in the U.S. payments market).

transaction accounts.³¹ Yet, there have not been any recent efforts to comprehensively analyze cross-subsidization among groups of consumer transaction accountholders.³² This Article fills that gap.

Contrary to common assumption, there is little reason to believe—either theoretically or empirically—that regressive cross-subsidization exists in the transaction account market. At the same time, however, existing account fee regulation is inconsistent and contradictory. Some regulations encourage fee structures with high overdrafts and other “penalty”-type fees while other regulations simultaneously discourage such fees. This Article recommends that instead of focusing on cross-subsidization, policymakers should work to establish a coherent theory of transaction account fee regulation. A coherent theory of fee regulation could correct this inconsistency and provide clear direction for banks. The Article proceeds in five parts.

Part I reviews the economic theory of cross-subsidization. It explains that cross-subsidization is more than charging different prices to different groups of consumers. A cross-subsidy exists only when one group of consumers pays less than the incremental cost of the service and another group pays more than the stand-alone cost of service.

Part II discusses the structure of transaction accounts. It explains that banks earn income from transaction accounts in two primary ways: by investing the deposits (often in the form of loans to other customers) and by charging account fees. High-balance accounts generate more investment income. Because, other things being equal, a bank earns more from a high-balance account than a low-balance account, banks may choose pricing structures that charge low-balance accounts more fees. Banks that price low-balance accounts differently than high-balance accounts are not necessarily creating a cross-subsidy.

31. See generally Barbara Pacheco & Richard Sullivan, *Interchange Fees in Credit and Debit Card Markets: What Role for Public Authorities?*, 91 *ECON. REV.* 87, 93–100 (2006) (discussing current economic theory underpinning interchange fees).

32. Earlier scholarship examined the existence of cross-subsidization in transaction accounts during a period when regulations prohibited banks from paying interest on deposit accounts. See, e.g., Sherrill Shaffer, *Cross-Subsidization in Checking Accounts*, 15 *J. MONEY, CREDIT, & BANKING* 100, 103 (1984); see also *infra* Part III.B.2 (discussing this earlier scholarship). However, the deposit interest rates are now largely unregulated. See *Prohibition Against Payment of Interest on Demand Deposits*, 76 *Fed. Reg.* 42,015, at 42-015-20 (July 18, 2011). Thus, a re-examination of cross-subsidization in transaction accounts is warranted. While many sources have made claims of regressive-cross subsidization (see *supra* notes 23 and 24), none of these sources contain detailed analysis to support such claims. Their charges seem based primarily on the fact that low-balance accounts tend to incur overdraft fees while higher-balanced account do not. See *supra* notes 23–24, and 65. Yet, as explained, in Part I, this is not enough to substantiate the existence of regressive cross-subsidization.

Part III examines transaction account market inefficiencies that might explain cross-subsidization among transaction account holders. It examines information deficiencies, regulations, and agency problems in transaction accounts. It concludes that the current transaction account market provides theoretical explanations for both regressive and progressive cross-subsidization among transaction account holder groups. For example, the Community Reinvestment Act³³ might encourage banks to cross-subsidize some transaction accounts for poor consumers. At the same time, bank management may subsidize rich account holders in order to increase bank size, thereby maximizing management bonuses or creating financial institutions that are too big to fail.

Part III also examines the impact of current account fee regulations, concluding that these regulations provide conflicting instruction to banks. On the one hand, the Truth in Savings Act³⁴ and Office of the Comptroller of the Currency regulations³⁵ encourage banks to adopt high overdraft fees. On the other hand, recent Federal Reserve regulations make it more difficult for banks to charge overdraft fees on debit card transactions.³⁶ Because regulations conflict, it is difficult to determine the impact such regulations have on account pricing and cross-subsidization.

Part IV examines existing empirical evidence concerning transaction account prices and costs. It concludes that some consumers who pay numerous overdraft fees may pay more than the stand-alone cost of providing overdraft service to high overdraft accounts. However, it also concludes that most high-balance accounts generate enough investment income to cover the incremental cost of transaction account services. Thus, high-balance accounts are not receiving a subsidy from consumers who pay numerous overdraft fees. Using account balance as a proxy for wealth, there is insufficient evidence to conclude that poor account holders cross-subsidize rich account holders.

Given the lack of conclusive evidence of regressive cross-subsidization among transaction account holders, Part V recommends that those seeking transaction account fee regulation look beyond the cross-subsidization argument. In particular, fee regulation could benefit from a coherent governing philosophy. Laws and regulations adopted in the twentieth century encourage high overdraft fees. This regulation was driven by the theory that avoidable penalty-type fees are more consumer-friendly than unavoidable monthly maintenance fees. More recent

33. Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901-08 (Supp. 2011).

34. Truth in Savings Act, 12 U.S.C. §§ 4301-13 (Supp. 2011).

35. 12 C.F.R. § 7.4002 (2012).

36. *Id.* at § 205.17.

regulation discourages overdraft fees. This regulation is driven by a philosophy that upfront, but unavoidable, maintenance fees are more consumer friendly because they are more transparent than penalty-type fees. Allegations of cross-subsidization simply hide this fundamental disagreement in account pricing philosophy. A coherent theory of fee regulation could correct regulatory inconsistency and provide clear direction to banks. Clearer instruction to banks could encourage clearer account choices for consumers.

I. CROSS-SUBSIDIZATION

Cross-subsidization is “[t]he provision of a good or service at a loss, which is met by the supplier from profits made on other goods and services.”³⁷ When discussing implications of cross-subsidization in terms of social welfare, it is sometimes more useful to think about the groups of consumers who purchase bundles of goods or services.³⁸ Does one consumer group pay higher prices in order to facilitate lower prices paid by another consumer group?

In a perfectly efficient competitive market, cross-subsidization would not occur. Consider a handyman that provides both plumbing and electrical services. If the handyman charges those who need plumbing service a price that cross-subsidizes those who need electrical service, the consumers needing plumbing service will simply find another handyman who sells that service at a lower price.³⁹ A profit maximizing handyman will provide plumbing service up to the point where the marginal cost of providing the service equals the marginal revenue generated by the service.

A. Market Inefficiencies

Cross-subsidization potentially occurs in markets that are not perfectly efficient. Cross-subsidization can occur in at least three types of situations. First, cross-subsidization might occur because a service provider lacks

37. THE OXFORD DICTIONARY OF ECONOMICS 101 (3d ed. 2009); see also Gerald R. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AM. ECON. REV. 966, 966 (1975) (explaining that a cross-subsidy exists when the “price structure for the multicommodity enterprise ‘unduly’ favor[s] the consumers of one commodity at the expense of the purchasers of another commodity”).

38. Gerald R. Faulhaber & Stephen B. Levinson, *Subsidy-Free Prices and Anonymous Equity*, 71 AM. ECON. REV. 1083, 1083 (1981).

39. See Gerald R. Faulhaber, *Cross-Subsidy Analysis with More than Two Services*, 1 J. COMPETITION L. & ECON. 441, 442 (2005) (“Customers of any product or service who faced prices that forced them to pay too much (thereby subsidizing a more favored customer group) would soon find competitors willing to offer equivalent service at lower prices.”).

sufficient information to price its services according to the costs of providing that service.⁴⁰ For example, consider a simplified health insurance situation. A group of similarly situated healthy consumers wants to purchase health insurance. Because neither the consumers nor the insurance company can accurately predict who will become sick in the future, all the consumers pay the same price. Eventually some people in the pool will become sick, while others remain healthy. Thus, the healthy people subsidize the unhealthy people.⁴¹

Second, cross-subsidization might occur because regulatory constraints prevent the service provider from transferring costs to some customers.⁴² For example, regulators seeking to ensure that all consumers have access to electricity might require an electricity supplier to service some consumers at a loss. “This loss on some sales is financially feasible only when the [service provider] is permitted to make up for it by obtaining higher profits on its other sales.”⁴³ In order to preserve this type of cross-subsidization, the service provider must be “protected from price competition and free entry of new competitors in its other, more profitable markets (in which it charges the higher prices that subsidize the financing of the mandated low prices).”⁴⁴

Third, cross-subsidization might occur when agency problems arise.⁴⁵ Although directors and officers are often assumed to be maximizing

40. See Kenneth Fjell, *A Cross-Subsidy Classification Framework*, 21 J. PUB. POL’Y 265, 273 (2001) (“[C]ross-subsidization may also take place inadvertently, for instance due to weak management accounting systems, possibly because of managerial limitations or because they are not judged cost-effective. In other cases the cause of inadvertent cross-subsidization might be more fundamental, as in multiservice firms with high sunk costs and low variable costs such as telecommunications.”); Shaffer, *supra* note 32, at 103 (noting that a bank’s failure to adjust the price of checking accounts based on the cost of providing those accounts “may result either from lack of information . . . , from a regulatory constraint, or from a profit incentive not to use the information”).

41. See Mary Crossley, *Discrimination Against the Unhealthy in Health Insurance*, 54 U. KAN. L. REV. 73, 77 (2005) (describing health insurance as a system of “mutual aid” where “the majority of members who are fortunate enough to remain healthy subsidize the care of those members who become sick or suffer injuries”).

42. Shaffer, *supra* note 32, at 103.

43. WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS: PRINCIPLES AND POLICY* 275 (Alex von Rosenberg et al. eds., 11th ed. 2009).

44. *Id.*

45. Agency problems arise when an agent is employed to act on behalf of a principle, for example, when management is employed by a company to act on behalf of a firm’s shareholders. “If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.” Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

shareholder value,⁴⁶ in some instances management may instead act in its own self-interest. For example, if salaries of managers are positively correlated with firm size, managers may attempt to maximize their salaries by offering some products at a loss in order to increase the firm's size of operations.⁴⁷ On the other hand, management in some cases might also pursue "goals such as generating goodwill in personal relations unrelated to the business, [or] providing (unprofitable) services to charity."⁴⁸

B. Establishing Cross-Subsidization

Even when policymakers recognize conditions that might facilitate cross-subsidization, determining whether cross-subsidization occurs can be difficult.⁴⁹ Because cross-subsidization analysis involves comparing the price a consumer pays with the cost of providing the service, the first step is determining the cost of providing the service. While there are many possible ways to measure cost, the most widely accepted approach for measuring cross-subsidization is attributed to Gerald R. Faulhaber.⁵⁰ He

46. See, e.g., *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders."); Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 796 (2011) ("Both directors and officers are supposed to be working toward the goal of shareholder wealth maximization."); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423 (1993) ("Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers.").

47. See Fjell, *supra* note 40, at 274.

48. *Id.* at 272.

49. David Heald, *Contrasting Approaches to the 'Problem' of Cross Subsidy*, 7 MGMT. ACCT. RES. 53, 54 (1996) ("[C]ross subsidies are hard to measure because they are hard to define, and hard to define because they are hard to measure.").

50. See David L. Kaserman & John W. Mayo, *Cross-Subsidies in Telecommunications: Roadblocks on the Road to More Intelligent Telephone Pricing*, 11 YALE J. ON REG. 119, 132 (1994) (citing "Faulhaber's widely-accepted definition of a cross-subsidy"); Eric Ralph, *Cross-subsidy: A Novice's Guide to the Arcane* 3 (July 27, 1992), available at <http://www.ekonomicllc.com/Ralph1992Cross-subsidy.pdf> (noting that "the most widely accepted definition of cross-subsidy is commonly attributed to Faulhaber"); Mark Sievers & Brooks Albery, *Strategic Allocation of Overhead: The Application of Traditional Predation Tests to Multiproduct Firms*, 60 ANTITRUST L.J. 757, 769 n.28 (1992) ("The most widely accepted economic definition of 'subsidy-free' pricing is [attributable to] . . . Faulhaber . . ."). See generally Faulhaber, *supra* note 37 (explaining the Faulhaber approach). In spite of the wide academic acceptance of the Faulhaber approach, regulatory bodies have sometimes measured cross-subsidization by asking whether each consumer group covers its fully distributed costs. See Warren G. Lavey, *Innovative Telecommunications Services and the Benefit of the Doubt*, 27 CAL. W. L. REV. 51, 71 (1990) (noting that the FCC used the fully distributed costs standard to set telephone rates prior to 1985). The fully distributed costs approach has "been thoroughly discredited in

describes cross-subsidy as the absence of subsidy-free prices. Subsidy-free prices require two conditions. First, “revenues from the service must not exceed [the] stand alone cost” of providing that service.⁵¹ If one group pays more than the stand-alone cost of service, this group would be better off seeking an alternative arrangement from a provider that services only that group and prices according to costs.⁵² Second, “adding a service resulting in an incremental cost must also result in an increase in revenues that is at least as large [as the cost].”⁵³ Each group of consumers must generate at least enough income to cover the marginal cost of service for that group. If the two conditions are met, prices are considered subsidy-free and no cross-subsidization exists.

Faulhaber’s approach does not conceptualize a single subsidy-free price. Rather, it allows for a range of subsidy-free prices “bounded on the lower end by average incremental cost and on the upper end by the per-unit stand-alone costs.”⁵⁴

Applying the Faulhaber approach can be challenging. If two services have complementary or competing demands, it can be difficult to determine whether the revenue (including the net revenue changes attributable to the new service) exceeds the incremental cost of providing the new service.⁵⁵ In addition, it can sometimes be difficult to determine the hypothetical stand-alone cost of providing a service to a group of consumers.⁵⁶

C. Cross-Subsidization and Public Policy

Even when cross-subsidization clearly occurs, we are left with questions about the appropriateness of a particular pricing structure. In some circumstances, cross-subsidization may be viewed as socially desirable. For example, regulated cross-subsidization may help rural users have access to reasonably-priced mail service—a result that some could

legal, economic, and managerial accounting literature.” Steve G. Parsons, *The Economic Necessity of an Increased Subscriber Line Charge (SLC) in Telecommunications*, 48 ADMIN. L. REV. 227, 229 (1996).

51. Fjell, *supra* note 40, at 269 (citing Faulhaber, *supra* note 37).

52. Ralph, *supra* note 50, at 3–4.

53. Fjell, *supra* note 40, at 268 (citing Faulhaber, *supra* note 37).

54. Mark L. Burton et al., *Common Costs and Cross-Subsidies: Misestimation Versus Misallocation*, 27 CONTEMP. ECON. POL’Y 193, 194 (2009).

55. Fjell, *supra* note 40, at 268–69; *see also* ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 71–83 (1988) (discussing problems with defining and measuring marginal costs).

56. Heald, *supra* note 49, at 57–58 (describing problems with determining stand-alone costs).

view as socially desirable.⁵⁷ On the other hand, cross-subsidization is sometimes viewed as fundamentally unfair because some consumers pay more than the stand-alone cost of the product.⁵⁸ Absent some market flaw or restraint, competitors would enter the market and provide the overpaying group with service at a lower cost. When the cost burden of a cross-subsidy falls on a disadvantaged class, cross-subsidization is usually seen as undesirable.⁵⁹ Finally, some oppose cross-subsidization because it can distort consumers' decisions concerning the consumption of services. If some services are subsidized, consumers may over-use these services and cause resources to be distributed inefficiently.⁶⁰

Tolerance of an existing cross-subsidization might also depend on the reason or reasons that it exists. We might tolerate cross-subsidizations that occur due to lack of information because without sufficient information it would be difficult to correct the subsidy.⁶¹ In the case of regulation-produced cross-subsidization, we might ask whether an existing price structure is helping those whom it was designed to help. In the case of cross-subsidization caused by agency problems, we might ask whether the cross-subsidization is best corrected by efforts to eliminate the agency problem, or whether price regulation would be more effective.

Just as cross-subsidies are not necessarily unfair, subsidy-free prices are not necessarily fair.⁶² Pricing structures that are not cross-subsidizing may still often result in one group of consumers bearing a larger share of the fixed costs associated with a particular service. In these circumstances, price setters and policymakers might legitimately debate whether measures should be taken to encourage a different pricing structure.

57. See R. Richard Geddes, *Policy Watch: Reform of the U.S. Postal Service*, 19 J. ECON. PERSPS. 217, 224 (2005) (“The traditional argument is that a government monopoly over letter delivery will ensure that profits from dense, lucrative urban routes can cross-subsidize money-losing rural routes, whereas private competitors might not provide delivery to remote areas.”).

58. Ralph, *supra* note 50, at 4 (“[C]ommon sense suggests it is unjust that a group should have to pay more than its standalone costs.”).

59. For example, in evaluating whether law student tuition unfairly cross-subsidized professor research, Professor Edward Rubin observed that “[t]he term ‘cross-subsidy,’ is a sophisticated way to express that most corrosive but unsophisticated of political or economic complaints—that ‘somebody is doing something bad to somebody else.’” Edward Rubin, *Should Law Schools Support Faculty Research?*, 17 J. CONTEMP. LEGAL ISSUES 139, 140 (2008) (quoting Heald, *supra* note 49, at 54).

60. David B. Humphrey et al., *Cost Recovery and Pricing of Payment Services: Theory, Methods, and Experience* 3 (The World Bank, Working Paper No. 1833, 1997).

61. In that situation it might be impossible to gather enough information to confirm the existence of a cross-subsidy.

62. Faulhaber, *supra* note 37, at 967 (noting that “a subsidy-free price structure is not necessarily welfare maximizing; nor are we entitled to assume that such price structures are morally superior to their subsidy-prone fellows on grounds of social justice”).

II. TRANSACTION ACCOUNTS

Notwithstanding the ambiguous policy implications of cross-subsidization, the repeated claim that transaction account pricing results in regressive cross-subsidization⁶³ warrants closer inspection. Using Faulhaber's definition of cross-subsidy, transaction account pricing is subsidy-free if: (1) no group of consumers pays more than the stand-alone cost of providing account services to that group of consumers, and (2) each group of consumers paid a price equal or greater to the incremental cost to the bank of providing the transaction account service.⁶⁴ Both conditions require analysis of all costs incurred and the income earned by banks in providing transaction account services. Yet some who assert that cross-subsidization occurs in transaction account pricing focus primarily on a single source of income from transaction accounts: the fees.⁶⁵

This Section discusses the structure of transaction accounts and how that structure impacts both the cost of providing account services and the prices paid for account services. It explains that if banks priced transaction accounts according to the cost of providing those accounts, low-balance accounts (likely belonging to low-income consumers) would pay more fees because low-balance accounts generate little other income for the banks. However, the higher fees paid by low-balance accounts would not necessarily be cross-subsidizing high-balance accounts. High-balance accounts allow banks to generate investment income that offsets the cost of providing account services.

A. Banks' Cost

Banking laws define a "transaction account" as "a deposit or account on which the depositor or account holder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone transfers, or other similar items for the purpose of making payments or transfers to third persons or others."⁶⁶ The term transaction account "includes demand deposits, negotiable order of withdrawal accounts, savings deposits subject to automatic transfers, and share draft accounts."⁶⁷ In essence, a bank holds money for a customer and uses that

63. See *supra* notes 23–24 and accompanying text.

64. See *supra* Part I.B.

65. See, e.g., Lieber & Martin, *supra* note 24, at A1 ("[P]eople who pay overdraft fees help subsidize the free accounts of those who do not."); Salmon, *supra* note 24 (arguing that "the poor pay massive overdraft fees and thereby allow the rich to pay nothing").

66. 12 U.S.C. § 461(b)(1)(C) (Supp. 2011).

67. *Id.* Credit cards are not considered "transaction accounts" because credit cards

money to make payments at the customer's direction.

Banks incur a variety of costs in providing transaction account services. "These costs reflect the expense of processing transactions; providing monthly statements; investing in payment system technology and software; paying the cost of tellers, ATMs, and online banking; staffing call centers; complying with a myriad of regulations; ensuring privacy and data protection; and preventing fraud and covering fraud losses."⁶⁸ Some banks also offer transaction accounts that pay interest on account balances.⁶⁹ That interest must be considered a cost of the account.

Of non-interest costs, payment processing expenses may be the largest cost.⁷⁰ The payment processing costs associated with any given transaction account depend on the type of payments used and how many payments are made. Even though many paper checks are "electronified" at some point in the check processing process,⁷¹ checks are still more costly to process than debit card payments or electronic payments.⁷² Other things being equal, transaction accounts with more payments are more costly for banks than accounts with fewer payments.

Payment fraud and uncollected overdrafts also have the potential to be major expenses of transaction accounts. Payment fraud arises when someone makes an unauthorized transaction using a payment device. In some situations, banks can pass this loss back to either the customer who deposited the payment⁷³ or the customer who allowed the fraudulent

make payments using credit extended by the financial institution, rather than by debiting an account where a customer previously deposited money. See RONALD J. MANN, PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS: CASES, MATERIALS, AND PROBLEMS 200 (5th ed. 2011).

68. Am. Bankers Ass'n, The Cost of a Checking Account (June 2010) *available at* <http://www.aba.com/aba/documents/press/CostofCheckingAccountsJune2010.pdf>. Some banks also offer debit card reward programs for consumers who use their card frequently. However, these programs are becoming less common. Teresa Dixon Murray, *After a Year of Changes, Banks Brace for More Rules, Reforms and Hits to the Bottom Line: Consumers Starting to See the Effects of Financial Overhaul Law*, THE PLAIN DEALER, July 24, 2011, at D1.

69. TIMOTHY W. KOCH & S. SCOTT MACDONALD, BANK MANAGEMENT 401 (7th ed. 2010).

70. Cf. Shaffer, *supra* note 32, at 100 ("Check processing costs account for a substantial portion of the total checking account expenses for commercial banks.").

71. Stephen Quinn & William Roberds, *The Evolution of the Check as a Means of Payment: A Historical Survey*, 94(4) ECON. REV. 1, 23–24 (2008).

72. KOCH & MACDONALD, *supra* note 69, at 402–03; Amelia H. Boss, *Convergence in Electronic Banking: Technological Convergence, Systems Convergence, Legal Convergence*, 2 DREXEL L. REV. 63, 69 n.19 (2009).

73. For example, if a customer deposits a check that is later returned as unpaid, a depository bank that has already provisionally credited the customer's account may charge back the amount of the check to the customer. U.C.C. § 4-214(c) (2011).

payment to be made from his or her account.⁷⁴ Sometimes, however, legal rules or practical considerations require that the bank bears the loss. One study found that in 2006, banks incurred \$1.66 billion in fraud losses associated with payments by check, debit card, or ACH system.⁷⁵ Uncollected overdrafts arise when an account holder overdraws the account and fails to deposit sufficient money to cover the overdraft. If a bank is unable to collect the balance through some other means, the bank must charge-off the account.⁷⁶ An FDIC Survey found that in 2006, banks' charge-offs associated with deposit accounts amounted to "12.6 percent of total gross loan and lease charge-offs reported."⁷⁷

B. Banks' Income

While banks incur costs in providing transaction accounts, they also earn money from those accounts. There are three ways banks can earn money from transaction accounts.

First, banks can lend out the deposited money, thereby earning interest.⁷⁸ Indeed, this is often thought of as the quintessential business of banking: borrowing money from depositors at a low interest rate and then lending it out at a higher interest rate. The amount a bank can earn from lending deposits depends on a number of factors. Regulation requires that banks hold part of their deposits in reserve.⁷⁹ Banks must hold reserve amounts in cash or in accounts at the Federal Reserve or a correspondent bank.⁸⁰ Thus, banks are not free to lend all deposits. To the extent that a bank can lend deposits, the amount earned depends on the interest rate spread. The bank must lend at a rate higher than the rate it pays the depositor. Deposit availability, loan demand, and future interest rate

74. For example, a customer whose negligence results in a thief stealing his checkbook and cashing forged checks may be partly responsible for the loss. U.C.C. § 3-406(b).

75. Richard J. Sullivan, *Can Smart Cards Reduce Payments Fraud and Identity Theft?*, 93 *ECON. REV.* 1, 38 (2008).

76. See *BLACK'S LAW DICTIONARY* 266 (9th ed. 2009) (defining "charge off" as "[t]o treat (an account receivable) as a loss or expense because payment is unlikely; to treat as a bad debt").

77. FDIC STUDY OF BANK OVERDRAFT PROGRAMS 62 (2008), available at http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_Final_v508.pdf [hereinafter FDIC, OVERDRAFT STUDY].

78. See KOCH & MACDONALD, *supra* note 69, at 403.

79. Regulation D, 12 C.F.R. §§ 204.1-.10 (2012). The amount of deposits each bank must reserve depends on the amount of deposits held by the bank and the type of account in which the deposit is held. *Id.* § 204.4.

80. See *id.* § 204.5. Banks earn relatively low rates of interest on deposits maintained at the Federal Reserve. *Id.* § 204.10.

forecasts all impact the interest rate spread.⁸¹ Assuming that neither the reserve requirement nor the interest rate spread makes lending unprofitable, the larger the average balance of a transaction account, the more a bank can earn by lending.

Second, banks generate income by charging fees on transaction accounts.⁸² As previously discussed, banks employ a wide variety of account fees.⁸³ A Government Accountability Office study found that in 2006, “consumers paid over \$36 billion in various fees associated with checking and savings accounts at depository institutions.”⁸⁴

Third, transaction accounts can increase the demand for other bank products and services.⁸⁵ In some instances, when a bank entices a customer to open a transaction account it may increase the likelihood that the bank will be able to sell that same customer other products and services.⁸⁶ For example, transaction accountholders often choose to purchase checks from their bank.⁸⁷ The more transaction accounts a bank maintains, the more checks the bank is likely to sell. Such cross-selling opportunities might extend to bank products that are not directly linked to the transaction account—like home mortgages, credit cards, and investment products. At least some banks pursue transaction accounts as an opportunity to cross-sell other products.⁸⁸ Banks may find cross-selling more fruitful when targeted toward wealthy accountholders.⁸⁹ Nevertheless, research suggests that

81. See Nathan Powell, *What the Yield Curve Does (and Doesn't) Tell Us*, FDIC FYI: AN UPDATE ON EMERGING ISSUES IN BANKING (Feb. 22, 2006), <http://www.fdic.gov/bank/analytical/fyi/2006/022206fyi.html>.

82. See KOCH & MACDONALD, *supra* note 69, at 403.

83. See *supra* notes 3–10 and accompanying text.

84. GAO, BANK FEES REPORT, *supra* note 3, at 1.

85. See Mike Branton, StrategyCorps, *What to Do with Unprofitable Retail Checking Accounts?* (Dec. 2010), available at <http://www.ababj.com/white-papers-2010/what-to-do-with-unprofitable-retail-checking-accounts.html>.

86. See KOCH & MACDONALD, *supra* note 69, at 22, 655 (noting banks' ability to cross-sell consumer products).

87. Cf. Lee Conrad, *Checks: Small Check Printer Goes Against Grain: Shrugs off Concerns of Shrinking Check Volume*, BANK TECH. NEWS, Oct. 3, 2005, at 1 (discussing bank profit margins on check sales).

88. See Steve Garmhausen, *Big Banks Gaining Retail Customers in Workplaces*, AM. BANKER, Dec. 29, 2010, at 2 (discussing Comerica Inc.'s efforts to target “select employee groups” for transaction accounts and then cross-sell other products); Rick Rothacker, *Bank of America's Plan: More Cross-Selling, Smaller Balance Sheet*, CHARLOTTE OBSERVER, Sept. 14, 2010 (discussing Bank of America's efforts to cross-sell investment products to bank customers).

89. See Shibo Li et al., *Cross-Selling the Right Product to the Right Customer at the Right Time*, 48 J. MARKETING RES. 683, 694 (2011) (“Higher income increases the purchase propensity [regardless of consumers' state of financial maturity.]”); Leonard J. Paas et al., *Acquisition Patterns of Financial Products: A Longitudinal Investigation*, 28 J. ECON. PSYCHOL. 229, 237 (2007) (finding that “households with high incomes and assets are over-

banks' cross-selling efforts are unlikely to be consistently successful.⁹⁰

In other instances, a transaction account might increase the demand for services that are not purchased directly by the accountholder. For example, when a transaction account customer uses his debit card to make a purchase, the merchant will pay an "interchange" fee that in part flows back to the accountholder's bank.⁹¹ The more customers want to use debit cards, the more merchants may be willing to pay for debit card processing.⁹² And the more merchants that accept the card, the more customers will want to use the card.⁹³ In this way, the "network effect" of having more consumers using debit cards produces value for the bank.⁹⁴ If banks are able to profit from interchange fees, then, other things being equal, transaction accounts with more debit card transactions will be more profitable than those with fewer debit card transactions.

Congress, however, recently limited banks' ability to use the network effect to generate income from consumer transaction accounts. Under a provision of the Dodd-Frank Act popularly known as the Durbin Amendment, the Federal Reserve gained power to regulate debit card interchange fees—the fees banks charge to merchants for debit card processing.⁹⁵ Under the Durbin Amendment, interchange fees must "be reasonable and proportional to the cost incurred by the issuer with respect to the transaction."⁹⁶ In particular the Federal Reserve must distinguish between "the incremental cost incurred by an issuer for the role of the

represented in segments with high [financial] product penetrations"); Michael S. Barr, *An Inclusive, Progressive National Savings and Financial Services Policy*, 1 HARV. L. & POL'Y REV. 161, 170–71 (2007) (noting that "lower-income households are unlikely to be the first place [financial institutions] look for assets and cross-selling opportunities").

90. See Rich Weissman, *Upscale Marketing: It's Not What You Think*, 89 HOOSIER BANKER 1, 2 (2005) (stating that "[m]ost traditionally defined upscale customers tend [to] be either among the most profitable or the most unprofitable customers in the banks (and not in the middle)"); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 432–33 (stating that "reports confirm that big banks have had very limited success in cross-selling different types of financial services to consumers").

91. Tim Mead et al., *The Role of Interchange Fees on Debit and Credit Card Transactions in the Payments System*, ECON. BRIEF NO. 11-05 (FED. RESERVE BANK OF RICHMOND) (2011).

92. Benjamin Klein et al., *Competition in Two-Sided Markets: The Antitrust Economics of Payment Card Interchange Fees*, 73 ANTITRUST L.J. 571, 580 (2006).

93. *Id.*

94. *Id.* at 577 (explaining that "network effects" occur when the supply and demand of one product impact the demand of another related product, for example, where a "newspaper publisher lowers reader prices and thereby increases readership, [thus] increas[ing] demand for advertising in the newspaper").

95. 15 U.S.C. § 1693o-2(a) (2011).

96. *Id.* § 1693o-2(a)(2).

issuer in the authorization, clearance, or settlement of a particular electronic debit transaction,” and “other costs incurred by an issuer which are not specific to a particular electronic debit transaction.”⁹⁷ The Federal Reserve can consider incremental costs in setting the fee, but cannot consider other costs.⁹⁸ The Federal Reserve’s rules implementing the Durbin Amendment limit debit interchange fees to no more than “21 cents” plus “5 basis points multiplied by the value of the transaction.”⁹⁹

Congress enacted the Durbin Amendment based on concerns that “retailers and consumers [were] bear[ing] a disproportionate amount of costs of the debit card system.”¹⁰⁰ Others challenge the conclusion that merchant fees were subsidizing consumer accounts, arguing that the interchange fees were likely the result of efficient pricing strategies.¹⁰¹ In any event, because future debit interchange fees must be focused on the incremental cost of providing the service, it seems unlikely that banks will be able to generate significant profits by encouraging transaction account holders to use debit cards thus boosting the demand for merchant processing. As Professor Richard Epstein states, “[t]he implicit subtext of [the Durbin Amendment] is that the banks can recoup the revenues they lose in debit interchange from their own customers, in the terms of higher rates for the various services they supply.”¹⁰² In other words, banks must

97. *Id.* § 1693o-2(a)(4).

98. *Id.*; see also Richard A. Epstein, *The Constitutional Paradox of the Durbin Amendment: How Monopolies are Offered Constitutional Protections Denied to Competitive Firms*, 63 FLA. L. REV. 1307, 1340 (2011) (noting that the Durbin Amendment is “[a] system of price controls that is keyed to variable (or incremental) costs . . . [and] does not afford the competitive firm any more opportunity to recover its fixed costs than [a] public utility”).

99. 12 C.F.R. § 235.3(b) (2012). The interchange regulations do not apply to financial institutions that have less than \$10 billion in assets. *Id.* § 235.5(a). However, many believe that market pressures and processing network policies will prevent smaller banks from charging higher interchange fees. See *Oversight of Dodd-Frank Implementation: A Progress Report by the Regulators at the Half-Year Mark: Hearing Before the Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 21 (2011) (testimony of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.) (“By the statute, the smaller institutions will be exempt from these restrictions, but there is the possibility that either because merchants would not accept the more expensive cards or because networks would not be willing to have a two-tiered pricing system, it is possible that in practice they would not be exempt from the lower interchange fee.”).

100. *TCF Nat’l Bank v. Bernanke*, 643 F.3d 1158, 1164–65 (8th Cir. 2011) (affirming the holding that the Durbin Amendment was rationally related to Congress’s concerns).

101. See Epstein, *supra* note 98, at 1314–24 (arguing that if debit cards were subsidized by cash and check customers, merchants would strive to eliminate the subsidies to increase their customer base, but the reverse is seen in practice).

102. Epstein, *supra* note 98, at 1326. Indeed, only politicians, including Senator Durbin, seemed shocked when banks did raise their fees after the Durbin Amendment. See Eryk J. Wachnik, “*The Durbin Tax*” and *How the Banks Tried to Insure Their Bottom Line*, 24

look to the traditional sources of account income: investment of deposits and fees.

C. The Natural Fee Difference

The fact that banks' primary sources of account income are investment and fees creates a situation where banks may efficiently price accounts differently based on the account balance. If a bank prices each transaction account to cover its costs, the bank may charge high-balance accounts fewer fees because these accounts are capable of producing investment income.¹⁰³ In contrast, banks may charge low-balance accounts more fees because investment income from these accounts will not cover the cost of providing transaction services.¹⁰⁴ Economics professors Timothy Koch and Scott MacDonald note that this type of pricing creates a "caste system of banking."¹⁰⁵ Under such a system:

Large depositors receive the highest rates, pay the lowest fees, and often get free checking. They do not wait in long teller lines and they receive more attention from their personal banker. When they call a bank representative, they often quickly get a live person on the line. Small depositors, by contrast, earn lower rates, if any, on their small balances and pay higher fees, with less personal service. When these customers call their bank—particularly at large, transactions-based organizations—they will be routinely routed from one electronic response to another and will wait long periods to visit with an actual person.¹⁰⁶

When banks charge fees for low-balance accounts, some consumers may turn to fringe financial service providers instead of banks.¹⁰⁷

While a pricing system that extracts fees from low-balance accountholders may seem unfair to some,¹⁰⁸ it does not necessarily imply

LOY. CONSUMER L. REV. 318, 323–25 (2011).

103. Of course, such a pricing structure would not be the only rational way for a bank to price a high-balance transaction account. A bank might instead choose to charge fees for high-balance accounts and then pay the same accounts a higher interest rate on the deposited balance.

104. This effect could be achieved with a variety of pricing structures. Customers could be charged monthly fees depending on the balance of their account. Alternatively, a bank could charge all accounts the same fees, but pay interest depending on the account balance. Alternatively still, a bank could charge fees that are likely to be paid only by those with low balances.

105. KOCH & MACDONALD, *supra* note 69, at 403.

106. *Id.*

107. See Barr, *supra* note 25, at 177–81 (noting that when accounts have high fees they may make little "economic sense" for some people).

108. See Tiffany S. Lee, *No More Abuse: The Dodd-Frank and Consumer Financial*

the existence of cross-subsidization among consumer groups. Under a transaction account pricing structure that charges fees according to costs, the poor may pay more fees because their accounts have lower balances and generate less investment income. On the other hand, a transaction account pricing structure that charges low-balance accounts more fees than high-balance accounts is not necessarily subsidy-free. In any event, a thorough examination of cross-subsidization among transaction account holders must evaluate not only account fees, but also income generated by banks' investment of deposits.

III. TRANSACTION ACCOUNT MARKET INEFFICIENCIES

Keeping in mind both fee and investment income from transaction accounts, this Part explores market inefficiencies that could theoretically explain cross-subsidization among transaction account holders. It focuses on the factors, identified in Part I.A, that have potential to produce cross-subsidization: information deficiencies, regulatory constraints, and agency problems.¹⁰⁹ It concludes that the transaction account market has features that could partially explain both regressive and progressive cross-subsidization. In particular, market entry restraints, interest rate regulation, fee regulation, and the Community Reinvestment Act all have potential to affect banks' transaction account pricing.

A. Information Deficiencies

First, cross-subsidization might occur because banks lack the information to price each transaction account strictly according to cost.¹¹⁰ At a minimum, banks do not know beforehand exactly which transaction accounts will result in overdraft charge-offs. While historical data can help banks predict the rate of charge-offs among various consumer groups, some high credit risk consumers will not result in charge-offs. Conversely, some low credit risk consumers will result in charge-offs. Thus, pricing according to credit risk will not eliminate cross-subsidization.

Protection Act's 'Abusive' Standard, 14 J. CONSUMER & COM. L. 118, 126 (2011) (stating that because "[t]he most frequent users of overdraft programs are lower-income individuals with less financial sophistication," account pricing exploits low-income individuals).

109. In analyzing potential market imperfections, this Part, like the Article more broadly, focuses on market imperfections that could produce cross-subsidization among transaction account consumers, rather than cross-subsidization involving transaction account consumers and other bank customers.

110. See Gregory F. Udell, *Pricing Returned Check Charges Under Asymmetric Information*, 18 J. OF MONEY, CREDIT & BANKING 495, 496 (1986) ("[I]t is not at all clear that bankers have more than a very imperfect knowledge of [deposit] costs themselves.").

Banks also lack advanced notice of the type and number of payments a transaction account consumer will make in any given month. Banks could cope with this lack of information by imposing a cost for each transaction.¹¹¹ However, such a pricing practice could be prohibitively expensive to administer.¹¹² In addition, because the full cost of each item could depend on the amount of fixed costs assigned to each item, such pricing would require an accurate projection of the total number of transactions processed.

Finally, banks lack advanced notice of the amount of money that will be in a transaction account at any given time. Banks can partially counteract this lack of information by paying interest calculated daily. However, for low-balance accounts, this mechanism will be ineffective in recouping costs. For those accounts, banks could charge monthly access fees depending on the account balance. This pricing mechanism is unlikely to be perfectly efficient because banks would have to divide accountholders into an administratively reasonable number of groups.

In sum, information deficiencies are likely to lead to some cross-subsidization among transaction accountholders. Determining whether this cross-subsidization is progressive or regressive would be difficult because the crux of the problem is a lack of knowledge. Furthermore, completely eliminating cross-subsidization caused by information deficiencies is likely to be cost-prohibitive or impossible.

B. Regulation

In contrast, any cross-subsidization caused by regulation should be more easily identified—especially to the extent that specific regulations are designed to impact banks’ transaction account pricing. This Part discusses the numerous regulatory constraints that could lead to cross-subsidization among transaction accountholders.

It begins by examining regulations that limit entry into the transaction account market. Such restrictions could allow banks to overprice some (or all) transaction accounts.

This Part then examines interest rate regulations. Although interest rate regulations likely caused cross-subsidization in the past, there are few current restrictions on the interest rates banks may pay on transaction accounts.

Next, this Part examines fee regulations. Here, examination of the

111. Shaffer, *supra* note 32, at 100–01.

112. *See id.* at 103 (noting that a per-check charge could “entail[] additional costs, such as record-keeping and tabulating expenses”).

regulations reveals a somewhat surprising conflict. The Truth in Savings Act and Office of the Comptroller of the Currency regulations encourage banks to adopt high penalty-type fees like overdraft and return check charges. These laws, coupled with the market entry restrictions and consumer choice inefficiencies could lead to over-pricing of overdraft fees. On the other hand, a new Federal Reserve regulation limits banks' ability to charge overdrafts on debit card transactions. This regulation seems aimed at discouraging debit overdraft fees, thereby ameliorating the harm caused by consumer tendencies to inefficiently choose transaction account products.

Finally, this Part examines regulations aimed at requiring or encouraging banks to provide transaction account services to low-income consumers. In the federal arena, the Community Reinvestment Act might encourage banks to provide progressive cross-subsidization of some transaction accounts. Yet its weak enforcement mechanism suggests its influence is likely limited.

In sum, while there are strong arguments that the transaction account market is inefficient, it is difficult to argue that these inefficiencies uniformly promote regressive cross-subsidization among transaction account holders.

i. Market Entry Restraints

As an initial matter, for regulation to require or encourage cross-subsidization, there must be a mechanism that allows banks to overprice some transaction accounts. If the market for transaction accounts was competitive, overpricing of some transaction accounts would lead competitors to offer the same service at a lower price. The overpaying customers would then move to the less costly alternatives. Overpricing is likely to occur only when consumers are limited in their options.¹¹³

There is reason to believe that regulatory barriers limit competition in the transaction account market. Transaction accounts offered by banks are particularly attractive to consumers because the accounts are insured by the Federal Deposit Insurance Corporation (FDIC).¹¹⁴ Non-banks cannot offer FDIC-insured accounts.¹¹⁵ The FDIC and other bank regulators tightly

113. *See supra* notes 39, 44, and accompanying text.

114. Single-owner interest bearing transaction accounts are insured up to \$250,000. 12 U.S.C. § 1821(a)(1)(E) (Supp. 2011). Most non-interest bearing transaction accounts are currently fully insured. 12 C.F.R. § 330.16 (2012) (providing unlimited coverage through December 31, 2012).

115. *See* 12 U.S.C. § 1815(a)(1) (Supp. 2011) (providing that "any depository institution which is engaged in the business of receiving deposits . . . upon application to and

control entry into the banking market.¹¹⁶ Capital requirements,¹¹⁷ activities restrictions,¹¹⁸ and other regulations also pose significant barriers to entry and expansion. Data show that a significant portion of deposits are held by a relatively small number of banks. In 2011, the ten largest U.S. banks held 44% of all domestic deposits.¹¹⁹ Large banks do tend to pay lower interest rates on transaction accounts¹²⁰ and charge higher fees¹²¹ than their smaller competitors.¹²² Studies suggest that larger banks may “have gained pricing power over deposit services in regional markets.”¹²³ Regulations

examination by the [FDIC] and approval by the Board of Directors, may become an insured depository institution”); *Id.* § 1813(c)(1) (2006) (defining a depository institution to include only “bank[s] or savings association[s]”).

116. See generally RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 73–76 (4th ed. 2009) (describing the process for receiving regulatory approval to charter a bank). In recent years, the FDIC has been particularly stingy with new (de novo) bank charters. See Barbara A. Rehm, *Editor at Large: FDIC Set to End De Novo Dry Spell*, AM. BANKER, Dec. 2, 2010, at 1.

117. See, e.g., 12 C.F.R. §§ 325.3, 325.103 (2012).

118. See, e.g., 12 U.S.C. § 1841–42 (Supp. 2011).

119. As of June 30, 2011, the ten largest banks as measured by total domestic deposits were: Bank of America, National Association; Wells Fargo Bank, National Association; JPMorgan Chase Bank, National Association; Citibank, National Association; U.S. Bank National Association; PNC Bank, National Association; TD Bank, National Association; SunTrust Bank; Branch Banking and Trust Company; and The Bank of New York Mellon. They held \$3.64 trillion of the \$8.25 trillion domestic deposits. See Summary of Deposits Data, FDIC, <http://www2.fdic.gov/sod/> (follow “Summary Tables” hyperlink; then follow “Top 50 Commercial Banks and Savings Institutions by Deposits” hyperlink; then select June 30, 2011 in “Data as of” dropdown menu; then select “Run Report” hyperlink) (last visited Nov. 20, 2012).

120. See Richard J. Rosen, *Banking Market Conditions and Deposit Interest Rates*, 31 J. OF BANKING & FIN. 3862, 3864 (2007) (concluding that between 1998 and 2004, “markets with a larger share of mega-banks [were] less competitive than markets with a larger share of mid-size banks, all else equal”).

121. See GAO, BANK FEES REPORT, *supra* note 3, at 16 (“Large institutions—those with more than \$1 billion in assets—on average charged more for the majority of fees than midsized or small institutions—those with assets of \$100 million to \$1 billion and less than \$100 million, respectively.”); BD. OF GOVERNORS OF THE FED. RESERVE SYS., ANNUAL REPORT TO THE CONGRESS ON RETAIL FEES AND SERVICES OF DEPOSITORY INSTITUTIONS 8 (2003), available at <http://www.federalreserve.gov/boarddocs/rptcongress/2003fees.pdf> (finding that “[o]f the fourteen fees for which comparisons are available . . . , multistate banks charged significantly higher fees in eight cases and in no case charged a significantly lower fee”).

122. There are several possible explanations for the pricing differences between small and large banks. See *infra* notes 274–78 and accompanying text.

123. Wilmarth, *supra* note 90, at 295; see also Maurice E. Stucke, *Lessons From the Financial Crisis*, 77 ANTITRUST L.J. 313, 335–36 (2010) (“[C]onsumers may be paying supracompetitive overdraft fees to large financial institutions, which in turn distribute the rents unequally (namely to the CEOs and other senior executives).” (citation omitted)).

that limit the entry and expansion in banking could potentially result in a market (or markets) where banks are able to charge supracompetitive prices to transaction accountholders.

General market power in transaction accounts would only explain why banks could overcharge all transaction accountholders. However, it may well be that the regulatory restraints in the transaction account market affect different transaction account services differently. Non-bank competition for transaction account-type services is partly determined by the account type. For those consumers capable of maintaining a high account balance, mutual funds are to some extent a competitive product to bank transaction accounts.¹²⁴ For those consumers who do not maintain a high account balance, check cashing services, money orders, and prepaid cards are to some extent competitive products for transaction accounts.¹²⁵ If mutual funds are a more effective competitor than fringe financial service providers, then regulatory restraints may allow banks to reap supracompetitive profits from low-balance accounts, but not high-balance accounts.

If, however, restraints on entry and expansion in the banking market allow banks supracompetitive profits on all types of transaction accounts, then other factors must influence banks' decisions to engage in cross-subsidization.

ii. Interest Rate Regulation

Regulation of the amount of interest banks can pay to transaction accountholders could force or encourage banks to engage in cross-subsidization. Indeed, previous scholars have concluded that historic interest rate restrictions led to cross-subsidization. Today, however, banks are free to pay interest on transaction accounts. Thus, interest rate regulation can no longer be claimed as a source of cross-subsidization.

During the Great Depression, Congress enacted a law prohibiting all banks from paying interest on demand deposit accounts.¹²⁶ Because of this limitation, most consumers paid few transaction account fees.¹²⁷ In the

124. See *infra* notes 126–138 and accompanying text (discussing how the development of mutual funds led some bank customers to move their money from transaction accounts).

125. See *infra* notes 293–297 (discussing prepaid cards as a substitute for transaction accounts) and notes 313–328 (discussing payday loans as a substitute for transaction accounts).

126. Banking Act of 1933, Pub. L. No. 73-66, §10, 48 Stat. 162, 181 (1933). The law also limited banks' ability to pay interest on other types of deposits. *Id.*

127. In 1987, the General Accounting Office surveyed 1662 randomly selected banks and thrifts about the current and historic terms of their checking accounts. U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-87-70, BANKING SERVICES: CHANGES IN FEES AND DEPOSIT

1970s, however, the banking environment changed.¹²⁸ As interest rates rose, consumers became frustrated with the paltry rates of interest they earned on bank deposits.¹²⁹ Securities markets stepped up to fill the demand for better returns by offering mutual funds.¹³⁰ Rather than simply watch their deposit bases disappear,¹³¹ banks lobbied Congress to remove the interest rate caps that kept them from competing with mutual funds. Congress responded by passing the Depository Institutions Deregulation and Monetary Control Act.¹³² Among other things, this Act phased out many of the restrictions on the amount of interest that banks could pay depositors.¹³³ In 1982, the Garn-St Germain Act accelerated the phase-outs and allowed banks to offer insured money market deposit accounts without interest rate restrictions.¹³⁴ The result of interest rate deregulation was a sudden jump in the interest rates banks paid for transaction accounts. Banks that had been paying interest rates “of around 5 1/4% were suddenly paying in excess of 15% to attract or merely maintain deposits.”¹³⁵ Banks

ACCOUNT INTEREST RATES SINCE DEREGULATION 13 (1987), available at <http://www.legistorm.com/showFile/L2xzX3Njb3JlL2dhby9wZGYvMTk4Ny83/full15873.pdf> [hereinafter GAO, CHANGES IN FEES AND DEPOSIT ACCOUNT INTEREST RATES]. The survey found that in 1977 “about 35 percent of banks offered a free noninterest-bearing checking account. Another 59 percent carried no fees if a minimum balance was maintained.” *Id.* at 22. At that time, some banks did not even charge fees for services like printing checks, stopping payment on a check, or returning a check for insufficient funds. *Id.* at 32–34.

128. CARNELL, MACEY & MILLER, *supra* note 116, at 24–25.

129. *Id.*

130. *See id.* “The mutual fund became the most important financial innovation and money substitute by offering many of the deposit services of banks without imposing the costs of reserve requirements and federal deposit insurance.” Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 BROOK. L. REV. 1295, 1314 (1995).

131. *See* Laurie S. Goodman & Sherrill Shaffer, *The Economics of Deposit Insurance: A Critical Evaluation of Proposed Reforms*, 2 YALE J. ON REG. 145, 152 (1984) (“[A]s interest rates climbed in the late 1970’s, money market mutual funds, which had no interest rate limitations, grew from \$43 billion at the end of 1979 to \$242 billion in November 1982.”) (citation omitted).

132. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, tit. II, 94 Stat. 132, 142–45 (codified as amended in scattered sections of 12 U.S.C.).

133. *See id.* § 204.

134. Garn-St Germain Depository Institutions Act, Pub. L. No. 97-320, §§ 326–27, 96 Stat. 1469, 1500–01 (1982) (codified at 12 U.S.C. § 3503). The phase-outs were completed by 1985. *See* Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1143 (1990).

135. Alvin C. Harrell, *Deposit Insurance Issues and the Implications for the Structure of the American Financial System*, 18 OKLA. CITY U. L. REV. 179, 188 (1993); *see also* Eric J. Gouvin, *Truth in Savings and the Failure of Legislative Methodology*, 62 U. CIN. L. REV.

also increasingly turned to transaction account fees to generate income.¹³⁶

The adjustment in account pricing following interest rate deregulation led many scholars to conclude that the interest rate regulation had encouraged cross-subsidization among groups of transaction account holders.¹³⁷ “The popular view was that the 20 percent of bank customers with the largest deposit balances subsidized the 80 percent with lower balances.”¹³⁸

In an environment where banks could not pay interest on transaction accounts, large depositors could be overcharged (by not receiving interest for the use of their money) because there were few alternatives. Banks sought to evade the effects of the interest rate regulation by offering “implicit interest”—increased services to account holders.¹³⁹ Banks offered account holders “free bank-by-mail services, gifts ranging from teddy bears to toasters, and convenient neighborhood branch offices.”¹⁴⁰ This competition through increased service was inefficient.¹⁴¹ Empirical studies concluded that banks were not successful in fully compensating some high-balance accounts.¹⁴²

1281, 1292 (1994) (“When the artificial regulatory constraints on the price of deposits disappeared . . . deposit interest rates soared . . .”).

136. Gouvin, *supra* note 135, at 1292 (“In light of the shrinking interest rate spread, noninterest income, in the form of fees and charges, began to play an increasingly important role in the finances of banks.”). *See generally* GAO, CHANGES IN FEES AND DEPOSIT ACCOUNT INTEREST RATES, *supra* note 127 (reporting a survey of banks and thrifts regarding bank account fees between 1977 and 1985).

137. *See* Shaffer, *supra* note 32 (reporting an empirical investigation concluding that in an environment where interest rates were regulated, some transaction accounts subsidized other transaction accounts).

138. KOCH & MACDONALD, *supra* note 69, at 403; *see also* PETER S. ROSE & SYLVIA C. HUDGINS, BANK MANAGEMENT & FINANCIAL SERVICES 396–97 (7th ed. 2008) (describing how interest rate regulation led to non-price competition for transaction accounts).

139. STEPHEN H. AXILROD ET AL., STAFF OF THE BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE IMPACT OF THE PAYMENT OF INTEREST ON DEMAND DEPOSITS 1 (1977), *available at* http://fraser.stlouisfed.org/docs/publications/books/ipidd_bog_19770131.pdf (“Bank efforts to attract such deposits have mainly involved the payment of implicit interest in the form of charges below cost for services performed.”); Richard Startz, *Competition and Interest Rate Ceilings in Commercial Banking*, 98 Q. J. ECON. 255, 257 (1983) [hereinafter, Startz, *Competition and Interest Rate Ceilings*] (“Price controls are evaded fully or in part as agents substitute quality, advertising, or other forms of nonprice competition in place of forbidden, open price competition.”); Richard Startz, *Implicit Interest on Demand Deposits*, 5 J. MONETARY ECON. 515, 515 (1979) (finding that this “rate of implicit interest appears to be well below the competitive rate on deposits . . . [but] also well above zero”).

140. ROSE & HUDGINS, *supra* note 138, at 396.

141. *See id.* at 397 (noting the market distortion of service-based competition); KOCH & MACDONALD, *supra* note 69, at 403 (discussing the cross-subsidization).

142. Startz, *Competition and Interest Rate Ceilings in Commercial Banking*, *supra* note 139, at 259 (“[S]tudies all tend to show that banks return to depositors between one third

With the overpayment by high-balance accounts, banks could afford to provide account services to unprofitable low-balance accounts.¹⁴³ But over-payment by high-balance accountholders would not necessarily have flowed to low-balance accountholders. A bank seeking to maximize shareholder value would have preferred to retain the overpayments as monopolistic profits.¹⁴⁴ Nevertheless, in an environment where interest was prohibited, banks may have found it administratively difficult to simultaneously discourage small deposits and encourage large deposits.¹⁴⁵ Thus, high-balance accounts cross-subsidized low-balance accounts while interest was prohibited.

It seems reasonable to postulate that the cross-subsidization caused by the prohibition on interest was progressive—meaning that it benefitted low-income consumers (and perhaps even middle-income consumers) at the expense of high-income consumers. Of course, not all low-balance accounts were held by low-income consumers. For example, some relatively wealthy depositors may have maintained second or third accounts with low balances for special purposes.¹⁴⁶ At the same time, “large depositors [may have been] more sensitive to the costs of holding idle demand deposits” and aggressively sought alternatives.¹⁴⁷ Yet overall, it is reasonable to theorize that under interest rate regulation, wealthy depositors cross-subsidized low-income consumers.¹⁴⁸

and two thirds of the yield from investing deposit funds.”).

143. See CASKEY, *supra* note 29, at 88 (“The low competitive pressures in this [regulated] environment enabled banks to offer many services on which they lost money, making it up by paying below-market interest rates on large deposits. Among the money-losing services most banks offered was to permit depositors to maintain checking accounts with very small balances and low fees or no fees.”).

144. See William P. Kratzke, *Tax Subsidies, Third-Party-Payments, and Cross-Subsidization: America’s Distorted Health Care Markets*, 40 U. MEM. L. REV. 279, 352 (2009) (“Some providers are able to maintain a clientele that *pays* the rates necessary for cross-subsidization but, in fact, simply keep supracompetitive profits for themselves.”).

145. Cf. AXILROD ET AL., *supra* note 139, at 2 (stating that if banks were allowed to offer interest on transaction accounts “banks would be motivated to gauge more carefully their costs of demand deposit services”).

146. See Glenn B. Canner & Ellen Maland, *Basic Banking*, 73 FED. RESERVE BULL. 255, 255 (1987) (noting that some low-balance accounts were secondary, less-used accounts that the accountholder maintained simply because of the low cost).

147. AXILROD ET AL., *supra* note 139, at 25.

148. See Edward L. Rubin, *The Lifetime Banking Controversy: Putting Deregulation to Work for the Low-Income Consumer*, 67 IND. L.J. 213, 215 (1992) (noting that deregulation “worked to the disadvantage of low-income consumers [because] these consumers tended to have small account balances”). Elimination of the cross-subsidy likely led some consumers with small-balances to close their accounts. See CASKEY, *supra* note 29, at 90 (“Undoubtedly, in response to fee increases, some consumers with small bank accounts decided that it was no longer worthwhile to maintain bank accounts.”); GAO, *CHANGES IN FEES AND DEPOSIT ACCOUNT INTEREST RATES*, *supra* note 127, at 3 (noting that although

Any cross-subsidization that existed prior to the 1980s was reduced when mutual funds began to offer a viable alternative to transaction accounts and Congress began to allow banks to pay interest on transaction accounts.¹⁴⁹ However, the deregulation was limited. Regulations continued to prohibit banks from paying interest on corporate demand deposit accounts.¹⁵⁰ It is possible that this narrower restriction, like the broader interest rate regulation before it, led to some cross-subsidization. As before, banks and corporate transaction account holders attempted to minimize any cross-subsidization by employing transaction account alternatives to evade the interest rate regulation. For example, some corporations simply elected to keep funds that would otherwise have been deposited in bank transaction accounts in non-bank mutual funds.¹⁵¹ Banks offered corporate account holders “earnings credits” that could be used to offset bank fees.¹⁵² In addition, banks offered services to business customers that allowed them to temporarily sweep funds between transaction accounts and other accounts not covered by interest rate restrictions.¹⁵³ Notwithstanding these alternatives, it is possible that the corporate account interest rate regulation, like the broader interest rate regulation before the 1980s, resulted in banks’ overpricing some corporate transaction accounts.¹⁵⁴

“various efforts [had] been made to provide low cost alternatives [to bank accounts] for certain consumers, these services [were] not available to all”).

149. See KOCH & MACDONALD, *supra* note 69, at 403 (“Deregulation removed [the] subsidy [for low-balance accounts] and induced banks to modify their pricing policies.”).

150. 12 U.S.C. § 371a (2009) (repealed by Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 11-203, § 627(a)(1), 124 Stat. 1640).

151. See Sarah Johnson, *Any Interest in Interest?*, CFO MAG., July 21, 2011, at 2 (reporting survey results finding that companies keep 19% of their short-term investments in money-market mutual funds).

152. See Chris Moon, *New Rules on Corporate Checking Accounts a ‘Non-Event’—For Now*, WICHITA BUS. J., Aug. 5, 2011, available at 2011 WLNR 15561315.

153. See Financial Institutions Advisory & Financial Regulatory Client Publication, Shearman & Sterling LLP, *Dodd-Frank: Regulation Q Goes the Way of the Model T 2* (July 15, 2011), available at http://www.shearman.com/files/Publication/308b6f96-4aef-45f4-8177-a14e9defef2b/Presentation/PublicationAttachment/bee9d518-a03d-4643-8f57-25e566030422/FIA-071511-regulation_q_model_t.pdf (explaining that banks would sweep funds from corporate transaction accounts to interest-bearing offshore accounts and enter repurchase agreements with corporate transaction account holders allowing them to hold U.S. government securities overnight).

154. One commentator has noted that “[t]he earnings credit interest rate is typically less than that offered by a ‘hard’ investment-earning vehicle and any unused earning credits typically do not carry forward from month to month.” Dan Gill, *Repeal of Regulation Q to Impact Banking Relationships*, 31 ENTERPRISE 1, 6 (Dec. 31, 2001). If true, this suggests that business account holders may not have been effective in avoiding overpayment. Other commentary suggests that the implicit interest on commercial accounts was more effective. See *Prohibition Against Payment of Interest on Demand Deposits*, 76 Fed. Reg. 42,015,

It is difficult to determine who benefitted from any overpricing of corporate transaction accounts. Some suggest that banks kept the fruits of overpricing as profits.¹⁵⁵ This explanation is bolstered by the lobbying efforts many banks employed in an attempt to preserve the regulation.¹⁵⁶ Others suggest that the removal of the restriction will simply lead to more consumer account fees.¹⁵⁷ This prediction could be rooted in a belief that the interest-free commercial transaction accounts were cross-subsidizing consumer accounts.

At any rate, the Dodd-Frank Act repealed the restriction on paying interest on corporate demand deposit accounts.¹⁵⁸ Banks are now free to offer competitive interest rates on all transaction accounts.¹⁵⁹ Thus, direct interest rate regulation should no longer be a source of cross-subsidization in transaction account pricing.

42,016 (July 18, 2011) (noting that one bank supporting the repeal of the interest restriction argued that it “has been pretty much hollowed out and therefore rendered irrelevant through the years.”) (quoting an anonymous bank); Johnson, *supra* note 151, at 2 (“What [business accountholders are] making now from checking accounts through earnings credits (soft dollars used to offset banking fees) is currently higher than money market fund rates . . .”).

155. See John Hamby, Viewpoint, *Repeal of Reg Q a Great Opportunity*, AM. BANKER, Oct. 7, 2010, at 8 (“Many [banks] saw business checking accounts as merely ‘cost-free’ funds. Although most have some type of program for earnings credits to offset fees, they tend to favor minimal rates and a limited array of services, hoping that excess funds will be left in the bank without compensation.”); Tamarind Phinisee, *Dodd-Frank Creating Regulatory Burden for Community Banks*, SAN ANTONIO BUS. J., July 29, 2011, available at 2011 WLNR 15048338 (“Under Reg Q, banks, in essence, kept the interest earned on the money in these accounts as part of their profit margins.”).

156. See Kari Taylor, *Growing Interest in Interest*, BANK NEWS, July 1, 2011, at 50 (reporting that the Independent Community Bankers of America and the Independent Bankers Association of Texas opposed the move to lift the interest rate restriction).

157. See Letter from Christopher Cole, Senior Vice President & Reg’l Counsel, Indep. Cmty. Bankers of Am. to Jennifer J. Johnson, Sec’y, Bd. of Governors of the Fed. Reserve Sys. & Robert E. Feldman, Exec. Sec’y, FDIC (May 13, 2011), available at <http://www.icba.org/files/ICBASites/PDFs/cl051311.pdf> (stating that when banks can pay interest on business transaction accounts “[c]onsumers . . . will see new charges for bank services as banks seek to cover their increased funding costs”).

158. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 11-203, § 627(a)(1), 124 Stat. 1640; Prohibition Against Payment of Interest on Demand Deposits, 78 Fed. Reg. at 42,015–20. Since the repeal, there have been few pricing adjustments. See, e.g., Moon, *supra* note 152. It is difficult to know whether this should be attributed to the lack of a subsidy under the interest rate regulation or to the prevailing low interest rates at the time of the change. See Robert Barba, *Bankers Split on Impact of Reg. Q Move*, AM. BANKER, Mar. 18, 2011, at 1 (quoting a banker who believes that “[i]n this rate environment, [repeal of the interest rate restriction] doesn’t have an immediate effect because of how low rates are”).

159. Perhaps the only remaining significant restriction is that undercapitalized banks cannot solicit deposits “by offering rates of interest that are significantly higher than the prevailing rates of interest on insured deposits.” 12 U.S.C. § 1831f(h) (Supp. 2011).

iii. Fee Regulation

As policymakers relaxed the regulation of interest on transaction accounts, they simultaneously increased their scrutiny of bank fees. Like interest rate regulations, fee regulations can potentially lead to cross-subsidization. Due in part to contradictory attitudes about banks' fees, regulations provide conflicting incentives for banks regarding account pricing. Some regulations encourage pricing structures with high overdraft charges and other penalty-type fees, while other regulations discourage overdrafts on debit card transactions. This conflict, and the fact that fee regulations are largely aimed at disclosure, suggests that fee regulations themselves have had only a limited impact on transaction account pricing.

When interest rates were capped, neither the federal nor the state governments were particularly interested in regulating banks' fee income.¹⁶⁰ For this reason Uniform Commercial Code (U.C.C.) Article 4, which was originally completed in 1952¹⁶¹ and generally governs checking accounts, does not directly address fees.¹⁶² As currently drafted, the U.C.C. requires that banks act in "good faith" when dealing with account holders.¹⁶³ However, "good faith" is narrowly defined and requires only "honesty in fact and the observance of reasonable commercial standards of fair dealing."¹⁶⁴ This good faith standard gives banks wide discretion to charge transaction account fees.¹⁶⁵

States have also enacted laws that prohibit unfair or deceptive acts or practices.¹⁶⁶ For example, in Texas, the Deceptive Trade Practices Act

160. See *supra* note 127 and accompanying text.

161. The U.C.C. was drafted by the National Conference of Commissioners on Uniform State Laws and then enacted by state legislatures throughout the country. See STEPHEN C. VELTRI, *THE ABCS OF THE UCC, ARTICLE: 3 NEGOTIABLE INSTRUMENTS, ARTICLE 4: BANK DEPOSITS 4-5* (2d ed. 2004); Fairfax Leary, Jr. & Marc G. Tarlow, *Reflections on Articles 3 and 4 for a Review Committee*, 48 TEMP. L.Q. 919, 919 n.1 (1975).

162. See Gail K. Hillebrand, *Revised Articles 3 and 4 of the Uniform Commercial Code: A Consumer Perspective*, 42 ALA. L. REV. 679, 713 (1991) ("When the [U.C.C.] was first drafted and promulgated, the issue of ancillary fees was less pressing than it is today. It was not until the 1980s that banks began to look to multiple fees on individual accounts as a significant revenue source."); see also U.C.C. § 4-401 cmt. 3 (2011) ("This Act does not regulate fees that banks charge their customers for a notice of postdating or other services covered by the Act . . .").

163. U.C.C. § 1-304 (2011) ("Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.").

164. *Id.* § 1-201(b)(20).

165. Cf. Hillebrand, *supra* note 162, at 695 ("A good faith standard is not an adequate substitute for more specific consumer protections, because a good faith standard can be enforced only through cumbersome and expensive fact-based litigation.").

166. Jeff Sovern, *Private Actions Under the Deceptive Trade Practices Acts: Reconsidering the FTC Act as Rule Model*, 52 OHIO ST. L.J. 437, 446 (1991) ("[S]tate

protects consumers from “false, misleading, and deceptive business practices.”¹⁶⁷ Although these Acts generally protect only “consumers” of “goods and services,”¹⁶⁸ courts have held that a depositor is a “consumer” of “banking services.”¹⁶⁹ Most states grant aggrieved customers the right to sue for damages from violations of the statute.¹⁷⁰

As banks began to charge fees, customers upset with those fees brought suits against banks using the ill-suited U.C.C., deceptive trade practices acts, and other common law tools.¹⁷¹ Because these types of suits were largely ineffective,¹⁷² it is unlikely that these laws have had much impact on banks’ pricing of transaction accounts.

As account fees became more widespread, the Office of the Comptroller of the Currency (OCC) began to worry that state fee regulation could hurt the national banks that it supervised.¹⁷³ Some states began hinting that further fee regulation could be forthcoming.¹⁷⁴ To prevent

legislatures, beginning in the late 1950s, began enacting statutes designed to prohibit deceptive and, in some states, unfair practices. By 1981, every state in the country had enacted such a statute.” (citations omitted).

167. TEX. BUS. & COM. CODE ANN. § 17.44(a) (West 2011).

168. *Id.* § 17.45.

169. *Bank One, Tex., N.A. v. Taylor*, 970 F.2d 16, 28 n.12 (5th Cir. 1992); *see generally* RICHARD M. ALDERMAN, *THE LAWYER’S GUIDE TO THE TEXAS DECEPTIVE TRADE PRACTICES ACT* § 2.033[B] (2010).

170. *Sovern*, *supra* note 166, at 448.

171. *See, e.g., Saunders v. Mich. Ave. Nat’l Bank*, 662 N.E.2d 602, 607–11 (Ill. App. Ct. 1996) (holding that a bank’s overdraft fee did not amount to a deceptive practice, did not violate the bank’s duty of good faith, and was not unconscionable); *Daniels v. PNC Bank, N.A.*, 738 N.E.2d 447 (Ohio Ct. App. 2000) (holding that a bank did not violate its duty of good faith by sorting checks in a manner that maximized the overdraft fees charged to customers); *Wallace v. Nat’l Bank of Comm.*, 938 S.W.2d 684 (Tenn. 1996) (holding that a bank did not violate the duty of good faith by charging insufficient funds and return check fees even when those fees were increased after the account agreement was signed).

172. In two cases, courts determined that the plaintiff had presented issues of fact that could be presented to a jury. *See Perdue v. Crocker Nat’l Bank*, 702 P.2d 503 (Cal. 1985) (reversing the trial court’s dismissal of a claim that a \$6 overdraft charge was unconscionable); *Best v. U.S. Nat’l Bank of Or.*, 739 P.2d 554 (Or. 1987) (holding that issues of fact existed as to whether the bank had acted in good faith when setting fees). Both cases eventually settled. *See James J. White, NSF Fees*, 68 OHIO ST. L.J. 185, 188 (2007). Other plaintiffs were not so successful. *See White, supra*, at 192 (stating that “Perdue and Best were the high-water mark” for cases challenging bank fees and noting that “there are no reported opinions to document any plaintiff victories after 1987”).

173. *See Interpretive Ruling Concerning National Bank Service Charges*, 48 Fed. Reg. 54,319, 54,319 (Dec. 2, 1983) (citing “litigation . . . over deposit account service charges” as a motivating factor behind new preemption rules).

174. Vermont, for example, began conducting a quarterly survey of bank fees. VT. STAT. ANN. tit. 8, §§ 10,501–04 (2011). In addition, New York and New Jersey adopted laws requiring banks to offer basic transaction accounts with low monthly fees, but did not cap fees on regular bank accounts. *See infra* Part III.B.3 (discussing basic bank accounts in

states from regulating fees charged by national banks, the OCC promulgated a rule authorizing national banks to charge transaction account fees.¹⁷⁵ The rule further explained that any state regulation of fees was preempted by federal law, including the OCC's own regulation regarding fees.¹⁷⁶ Preemption freed nationally chartered banks, including nearly all of the large banks, from state fee regulation laws.¹⁷⁷ Nationally chartered banks need only follow the federal law including the OCC regulations.

OCC regulations give national banks the authority to charge transaction account fees.¹⁷⁸ The regulations state that "[t]he establishment of non-interest charges and fees, their amounts, and the method of calculating them are business decisions to be made by each bank, in its discretion, according to sound banking judgment and safe and sound banking principles."¹⁷⁹ A fee is "in accordance with safe and sound banking principles if the bank employs a decision-making process through which it considers" specifically identified factors including "[t]he cost incurred by the bank in providing the service."¹⁸⁰ While national banks are

greater detail).

175. See 12 C.F.R. § 7.8000(b) (1984) ("Establishment of deposit account service charges, and the amounts thereof, is a business decision made by each bank and the [OCC] will not substitute its judgment.").

176. See *id.* § 7.8000(c) ("A national bank may establish any deposit account service charge . . . notwithstanding any state laws which prohibit the charge assessed or limit or restrict the amount of that charge. Those laws impair the efficiency of national banks and conflict with the regulatory scheme governing the national banking system and are preempted by federal law.").

177. Over the years, the OCC softened the preemption language in its regulations. White, *supra* note 172, at 197. More recently, the Dodd-Frank Act adopted new preemption standards for state law consumer protection measures. See 12 U.S.C. § 25b(b) (Supp. 2011) (stating that "consumer financial laws are preempted" if they "prevent[] or significantly interfere[] with the exercise by the national bank of its powers"). The OCC regulation now provides that "[t]he OCC applies preemption principles derived from the United States Constitution, as interpreted through judicial precedent, when determining whether State laws apply that purport to limit or prohibit charges and fees." 12 C.F.R. § 7.4002(d) (2012). Under Dodd-Frank's new preemption standards, state laws that require national banks to provide transaction account services at prices lower than their marginal cost may still be preempted. Courts might reasonably conclude that a state law requiring below-cost service conflicts with the federal law's interest in maintaining a safe and sound banking system. See Office of Thrift Supervision Integration, 76 Fed. Reg. 43,549, 43,556 (July 21, 2011) (explaining that the OCC fee regulation could still preempt state law following Dodd-Frank); *Baptista v. JPMorgan Chase Bank, N.A.*, 640 F.3d 1194 (11th Cir. 2011) (holding that a state law regulating bank check cashing fees was preempted by OCC regulation after Dodd-Frank).

178. 12 C.F.R. § 7.4002(a).

179. *Id.* § 7.4002(b)(2); see also GAO, BANK FEES REPORT, *supra* note 3, at 25–28 (noting that as long as fees are properly disclosed, regulators will only interfere with a bank's fee structure if that structure poses a safety and soundness concern).

180. 12 C.F.R. § 7.4002(b)(2)(i).

to consider the cost of providing transaction account services in setting the fees, the regulation does not prohibit fees that exceed the cost of providing the service.¹⁸¹ A bank must also consider: “[t]he deterrence of misuse by customers of banking services; [t]he enhancement of the competitive position of the bank in accordance with the bank’s business plan and marketing strategy; and [t]he maintenance of the safety and soundness of the institution.”¹⁸²

The OCC regulations (and similar state regulations¹⁸³) do not on their face require cross-subsidization in transaction account pricing. They do not require banks to charge any group less than the incremental cost of providing the service. Nor do the regulations require that banks charge any group of consumers more than the stand-alone cost of providing service to that group. Indeed, by emphasizing the need to consider the cost of providing the service, the regulations may discourage cross-subsidization.

The regulations may, however, impact how banks structure their fees. In particular, the regulations suggest that banks should adopt pricing structures that deter customers from misusing banking services.¹⁸⁴ The OCC explained that this provision was intended to allow banks to charge relatively high fees for overdrafts and returned checks.¹⁸⁵ Writing bad checks was (and still is) a tactic of thieves and con-artists.¹⁸⁶ Bad checks often lead to losses for the banks involved in processing the check as well as for others who accepted the check before depositing it.¹⁸⁷ While the OCC was interested in preventing these losses, it may also have been motivated by a concern that a large volume of bad checks would undermine the credibility of banks or checks in general.¹⁸⁸ In any event, the OCC saw

181. *See* Video Trax, Inc. v. NationsBank, N.A., 33 F. Supp. 2d 1041, 1051 (S.D. Fla. 1998) (holding that it was reasonable for a bank to consider profit margin in setting fees).

182. 12 C.F.R. § 7.4002(b)(2)(ii)-(iv).

183. Some states have adopted fee laws substantially similar to the OCC regulation. *See, e.g.*, 205 ILL. COMP. STAT. 5/5e(b) (2011); MINN. STAT. § 48.512(7) (2011).

184. *See* 12 C.F.R. § 7.4002(b)(2)(ii).

185. *See* Interpretive Ruling Concerning National Bank Service Charges, 48 Fed. Reg. 54,319, 54,319 (Dec. 2, 1983) (opining that overdraft fees should be high enough to “discourage customers from frequently writing checks in amounts greater than their account balances”).

186. *See* Julie Andersen Hill, *Cashier’s Check Scam Targets Attorneys*, 14 J. CONSUMER & COM. L. 54 (2011) (discussing frauds perpetrated by check); White, *supra* note 172, at 185 (“In the early days, giving someone a bad check was so morally reprehensible that it sometimes landed one in jail.”).

187. *See supra* notes 73–77 and accompanying text.

188. *See* Wallace v. Bank of Bartlett, 55 F.3d 1166, 1169 n.4 (6th Cir. 1995) (quoting a bank’s claim that “overdrafts are detrimental to the banking system because at some level they will cause a loss of confidence in checks as a medium of payment.”); White, *supra* note 172, at 185 (“A bounced check might even draw a reproach from the banker on whose bank the check was drawn for fear that the checks from that bank would get a bad name.”).

penalty-type fees as a way to discourage bad behavior.

It is unclear what role OCC regulations play in banks' transaction account pricing. Some banks do cite deterrence as a reason for high overdraft charges. For example, the website of ACNB Bank in Gettysburg, Pennsylvania explains that its overdraft fee is "like a ticket or a fine you pay for speeding."¹⁸⁹ In addition, banks in litigation and administrative proceedings justify overdraft fees citing their desire to deter overdrafts.¹⁹⁰ It is possible that the OCC's fee regulations encourage some banks to adopt higher overdraft and insufficient funds fees than they otherwise would.

Similarly, laws aimed at improving the transparency of transaction account pricing might encourage banks to adopt penalty-type fees instead of monthly fees. Under the Truth in Savings Act and accompanying regulations, banks may advertise a transaction account as "free" or "no-cost" only if it does not have a minimum balance, does not have a limit on the number of transactions, and does not charge "any regular service or transaction fee."¹⁹¹ In other words, an account can be marketed as "free" even if it has large overdraft, insufficient funds, and other penalty fees.¹⁹² The apparent rationale behind this regulatory approach was that, unlike overdraft fees and other penalty fees, customers could not readily avoid regular service fees.¹⁹³

The Truth in Savings Act likely encourages banks to use fees that will

189. ACNB Bank, *Frequently Asked Questions About Overdraft Services*, http://www.acnb.com/home/fiFiles/static/documents/Opt_In_Project_FAQs_final_101311.pdf (last visited Nov. 20, 2012). Although the regulation was aimed at checks, ACNB's literature does not distinguish between check overdrafts and debit overdrafts when it offers the deterrence justification. *Id.* ACNB Bank also cites the risk of loss on unpaid overdrafts as a justification for the fee. *Id.*

190. *See, e.g., Wallace*, 55 F.3d at 1169 n.4; OCC, Interpretive Letter No. 1082 (May 17, 2007), available at <http://www.occ.gov/static/interpretations-and-precedents/jun07/int1082.pdf>.

191. 12 U.S.C. § 4302(d) (2011); *see also* 12 C.F.R. § 230.8 (2012) (listing fees that may not be applied to "free" accounts); FDIC, Advertisement for "No Fee" Checking Account Violates Truth in Savings Act if Fee is Imposed When Minimum Balance is Not Maintained, Interpretive Letter 95-31 (Nov. 21, 1995) (stating that a bank could not use an advertisement that used the words "no fee" followed by an asterisk explaining the minimum balance requirement).

192. *See* STEPHEN G. CECCHETTI, *MONEY, BANKING, & FINANCIAL MARKETS* 495 (2d ed. 2008) (claiming that "bankers joke that 'free checking' really means 'fee checking' because of all the fees customers end up paying."). Under current regulations, banks must disclose all fees, including overdraft fees. *See* Truth in Savings (Regulation DD), 12 C.F.R. §§ 1030.1-.11 (2012).

193. Regulators may be rethinking this historic rationale for the advertising rule. *See* Office of Thrift Supervision, Order to Cease and Desist, Woodforest Bank, Order No. WN-10-16 (Apr. 23, 2010) (suggesting that a transaction account should not be marketed as "free" if it charges high overdraft fees).

preserve the “free” status of their accounts—including large overdraft fees. For example, PNC Bank advertises a “free” checking account with no monthly service charge or minimum balance. However, the account also comes with overdraft charges of

- \$25 per item for the first occurrences in current and previous eleven service charge cycles (limit of 4 charges per day)
- \$36 per item for additional occurrences within the same period (limit of 4 charges per day) . . .
- [, and a continuous overdraft charge of] \$7 assessed each day your account remains overdrawn for a period of five (5) or more consecutive calendar days.¹⁹⁴

Of course, high overdraft fees alone, even if adopted due to regulatory pressure, do not necessarily provide evidence that some consumers overpay for transaction accounts. In a competitive market, customers faced with excessively high prices would simply take their business elsewhere. There are, however, at least two possible scenarios in which some customers might pay excessive overdraft fees. First, if accountholders who incur high overdraft fees have few alternatives, those accountholders could end up paying more than the stand-alone cost of providing transaction services to those accounts.¹⁹⁵ Second, consumers might suffer from cognitive biases that lead them to select accounts with suboptimal pricing.¹⁹⁶ Behavioral research shows that not all consumers faced with high overdraft charges will behave rationally.¹⁹⁷ Some consumers may systematically underestimate the likelihood that they will incur overdraft fees and discount fees that they will pay in the future.¹⁹⁸ In a competitive environment, banks

194. *Consumer Schedule of Service Charges and Fees*, PNC BANK, https://content.pnmc.com/live/pnc/personal/serviceCharges/PA_Pittsburgh_ServiceCharges.pdf (last visited Nov. 21, 2012).

195. See *supra* Part III.B.1 (discussing the possibility that market entry restraints might prevent meaningful competition in transaction account pricing).

196. See Jennifer Martin, *Debit Card Overdraft Services: Will the Federal Reserve's New Rules Enhance Transparency and Consumer Choice?*, 29 BANKING & FIN. SERVICES POL'Y REP. 1, 4 (2010) (“Effective private ordering of overdraft fees for debit card transactions is limited due to the disclosure issues and adhesive nature of account terms . . .”).

197. According to the Federal Reserve, “[b]ehavioral research suggests that consumers may choose the ‘free’ . . . account [with overdraft charges], even though the costs for overdrawing the account could end up being substantially higher than the monthly maintenance fee, because they may optimistically assume they will not overdraw the account and as a result, incur overdraft fees.” *Electronic Fund Transfers*, 74 Fed. Reg. 59,033, 59,044 (Nov. 17, 2009).

198. See Alces & Hopkins, *supra* note 23, at 890–91 (describing the difficulty some consumers face in understanding account terms); Jeff Sovern, *Toward a New Model of*

without high overdraft charges might attempt to educate customers about their more favorable account pricing.¹⁹⁹ But any gains from this educational effort could be easily lost if other banks change their pricing structures to match. This may encourage banks to persistently offer pricing that involves high overdraft charges.²⁰⁰

While all consumers are likely impacted by some cognitive biases,²⁰¹ unsophisticated consumers of limited means may be more prone to overpay for transaction account services. As Professor Gregory Mitchell explains: “[R]esearch tells us that cognitive biases do *not* affect us all with uncanny consistency. In particular, differences in education, training, cognitive capacity, thinking dispositions, sex, and cultural background across individuals appear to be reliably associated with different levels of cognitive performance.”²⁰² Perhaps this partially explains why, according to an FDIC study, only about 25% of transaction accountholders incur overdraft fees in any given year.²⁰³ As illustrated by the following table, consumers who lived in lower-income census tracts were more likely to incur overdrafts.

Consumer Protection: The Problem of Inflated Transaction Costs, 47 WM. & MARY L. REV. 1635, 1663 (2006) (stating that overpricing may occur when consumers “overlook or underestimate” transaction costs).

199. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 17–18 (2008).

200. *Id.*

201. See Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1183 (1997) (stating that “people in most social categories” exhibit the cognitive bias of over-optimism) (citing Shelly E. Taylor, *Positive Illusions: Creative Self-Deception and the Healthy Mind* 33 (1990)).

202. Gregory Mitchell, *Why Law and Economics’ Perfect Rationality Should Not Be Traded for Behavioral Law and Economics’ Equal Incompetence*, 91 GEO. L.J. 67, 87 (2002).

203. FDIC, OVERDRAFT STUDY, *supra* note 77, at 76. The FDIC study gathered one year worth of account-level data for overdrafts incurred by customers at a nonrandom sample of thirty-nine banks between January 2005 and September 2008. *Id.* at 3–4. These data were matched with census data regarding the average income of the area in which each accountholder lived. *Id.* at 72. While this methodology does not actually establish the income of the consumers incurring overdrafts, it is the best evidence available on this question to date.

CUSTOMER ACCOUNTS BY NUMBER OF OVERDRAFT TRANSACTIONS PER YEAR AND INCOME GROUP FOR SURVEYED BANKS WITH AUTOMATED OVERDRAFT PROGRAMS ²⁰⁴						
PERCENTAGE OF ROW TOTAL		BY NUMBER OF TRANSACTIONS ²⁰⁵				
CENSUS TRACT INCOME BRACKET	ALL	ZERO	1-4	5-9	10-19	20+
Low income	100	61.9	16.7	7.6	6.3	7.5
Moderate income	100	68.4	13.9	6.2	5.1	6.4
Middle income	100	74.3	11.8	5.0	4.0	4.9
Upper income	100	78.2	10.5	4.2	3.3	3.8
Income not classified	100	74.6	12.2	6.0	3.6	3.6
No tract	100	74.2	12.6	5.1	3.9	4.3
All income classes	100	74.3	11.9	5.0	4.0	4.9

Similarly, a telephone survey of consumers conducted by the Center for Responsible Lending found that consumers who incurred two or more overdrafts in six months were more likely to be low-income, single, and non-white.²⁰⁶ If low-income customers' cognitive biases lead them to inefficiently select transaction accounts with high overdraft fees or incur an inefficiently high number of overdrafts, it is possible that these customers will end up paying more than the stand-alone cost of transaction account services.

Not all scholars, however, believe that cognitive biases systematically lead low-income consumers to disproportionately overpay for transaction accounts. A Moebs Services study of over one million account users at both banks and credit unions found that only the accountholder's credit

204. *Id.* at 76.

205. "Excludes business accounts, savings accounts, other than checkable accounts, new accounts, and customers with more than 10 accounts." *Id.* at 76 tbl. IX-11.

206. See LISA JAMES & PETER SMITH, CENTER FOR RESPONSIBLE LENDING, OVERDRAFT LOANS: SURVEY FINDS GROWING PROBLEMS FOR CONSUMERS 3 (2006), available at http://www.responsiblelending.org/overdraft-loans/research-analysis/ip013-Overdraft_Survey-0406.pdf ("The average repeat [overdraft] user is 35-39 years old and has a household income of \$30,000 to \$35,000, and only 61 percent of repeat users own their own homes. Additionally, repeat overdraft loan users are more likely to be unmarried and to be non-white."). *But see* GAO, BANK FEES REPORT, *supra* note 3, at 24 ("[The Center for Responsible Lending Study] had limitations, including the inherent difficulty in contacting and obtaining cooperation from a representative sample of U.S. households with a telephone survey and because it relied on consumers' recall of and willingness to accurately report past events rather than on actual reviews of their transactions.").

score had a “high degree of correlation” with the accountholder’s likeliness to overdraft the account.²⁰⁷ “Gender, age, occupation, income, and wealth were found not to correlate to overdraft behavior.”²⁰⁸ In addition, Professor Marc Anthony Fusaro studied transaction account overdrafts at a small Midwestern bank and similarly found that “no discernable patterns emerged from these data indicating that people of all income levels overdraft equally often.”²⁰⁹

Professor Todd Zywicki offers two potential explanations as to why it is difficult to find a correlation between low-income and high overdrafts. First, the majority of consumers who incur overdrafts are not “poor” because “[b]y definition, overdraft borrowers have a bank account, which distinguishes them from many unbanked consumers and suggests that they have higher and more stable income than users of alternative financial products such as payday lending and pawnshops.”²¹⁰ Second, “access to overdraft protection is commonly linked to direct deposit of payroll checks, suggesting that many overdraft customers are also steadily employed” and not poor.²¹¹

While the jury may still be out as to whether cognitive biases impact the poor more than the rich, regulators have recently started to embrace the theory of cognitive biases as a justification for new regulation. As a result, regulators’ recent forays into transaction account supervision focus on consumer education and discourage overdraft and other penalty-type fees. For example, under Federal Reserve rules finalized in 2009, a consumer must give affirmative permission for his or her bank to pay debit card transactions that would result in an overdraft.²¹² Banks can continue to charge overdraft fees for debit card transactions, so long as the customer has given permission for debit card overdrafts.²¹³ If a customer elects not to opt for debit overdraft service, the bank must still offer the customer an

207. Press Release, Moebs Services, Who Uses Overdrafts? (Sept. 29, 2009), available at <http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/194/Default.aspx>.

208. *Id.*

209. Marc Anthony Fusaro, *Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks*, 29 J. OF FAM. & ECON. ISS. 251, 257 (2008).

210. Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, 69 WASH. & LEE L. REV. 1141, 1165 (2012).

211. *Id.*

212. Electronic Fund Transfers, 74 Fed. Reg. 59,033, 59,052–54 (Nov. 17, 2009) (codified at 12 C.F.R. §§ 205.12, 205.17). For a more fulsome discussion of the requirements for charging debit overdraft fees, see Peter J. Wilder, *The Brave New World of Regulated Overdraft Fees: How Can Banks Prepare?*, 127 BANKING L.J. 158 (2010).

213. 12 C.F.R. § 205.17(b) (2012). A bank may not condition its payment of overdrafts for checks on a customer’s decision with respect to debit card overdrafts. *Id.* § 201.17(b)(2).

account with the same features as accounts offered to those who opt in to debit overdraft service.²¹⁴ Consumers can enforce the opt-in provision and collect damages for unauthorized charges.²¹⁵ Sources estimate that as a result of the new regulations, bank overdraft revenue fell by \$3.6 billion in 2011,²¹⁶ as early estimates showed that only roughly one-third of customers elected to retain their overdraft coverage.²¹⁷

While banks are still able to assess overdraft charges on debit card transactions, this increased disclosure is aimed at discouraging banks from charging debit card overdraft fees. Indeed, the Federal Reserve acknowledged that the regulation could lead banks to adjust their transaction account pricing structures by adopting more monthly maintenance fees.²¹⁸ This move hints that regulators would prefer that banks charge monthly maintenance fees rather than large overdraft fees—at

214. *See id.* § 205.17(b)(3). This provision was “not intended to interfere with state basic banking laws or other limited-feature bank accounts marketed to consumers who have historically had difficulty entering or remaining in the banking system.” Electronic Fund Transfers, 74 Fed. Reg. at 59,045. The opt-in rule “does not prohibit institutions from offering deposit account products with limited features, provided that the consumer is not required to open such an account because the consumer did not opt in.” *Id.* For a discussion of basic bank account initiatives see *infra* notes 237–250 and accompanying text.

215. 15 U.S.C. § 1693m(a) (Supp. 2011).

216. Victoria Finkle, *Overdraft Rev Fell \$3.6B in 2011*, AM. BANKER Jan. 27, 2012, at 10.

217. Kyle Mills & Timothy J. Yeager, *New Opt-In Overdraft Rules Cost Arkansas Banks \$39 Million Annually 1-4 (2012)*, available at http://waltoncollege.uark.edu/faculty/papers/FINN/Costs_Opt_Overdraft_Regulation.pdf (finding an opt-in rate of 31% at survey-responding Arkansas banks); CENTER FOR RESPONSIBLE LENDING, *BANK COLLECTS OVERDRAFT OPT-INS THROUGH MISLEADING MARKETING 2* (Apr. 2011), available at <http://www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/CRL-OD-Survey-Brief-final-2-4-25-11.pdf> (finding that “33 percent of accountholders opted-in to overdraft coverage”). These early estimates may be low. A later survey found that 77% of consumers at surveyed community banks opted for debit card overdraft coverage. *See Community Banks Explore New Areas of Business to Raise Revenue*, ABA BANK MARKETING, Jan. 1, 2012, at 3 (reporting on a survey conducted by HEIT, a company that provides bank compliance services).

218. *See* Electronic Fund Transfers, 74 Fed. Reg. at 59,039. According to the Federal Reserve:

To the extent institutions adjust their pricing policies to respond to the potential loss of income from overdraft fees, some consumers may experience increases in certain upfront costs as a result of the final opt-in rule. Nonetheless, the Board believes that giving consumers the choice to avoid the high cost of overdraft fees, and the increased transparency in overdraft pricing that would result from an opt-in rule, outweigh the potential increases in upfront costs. In addition, some consumers will continue to be able to avoid monthly maintenance or other account fees as a result of meeting minimum balance requirements or having other product relationships with the bank.

Id.

least for debit card overdrafts. In adopting the opt-in rule, the Federal Reserve concluded that banks should not be allowed to offer customers the choice of either a maintenance charge-“free” account with debit card overdrafts or a monthly maintenance charge account without debit card overdrafts. The Federal Reserve believed that if customers were given the choice, many would mistakenly opt for the “free” account with overdraft charges.²¹⁹ This reasoning is directly at odds with the theory codified in the Truth in Savings Act, that customers are best served when banks charge avoidable penalty-type fees.²²⁰

As the Federal Reserve suspected, many banks’ first reaction to the opt-in rule was to announce new maintenance fees for low-balance accounts. Initial efforts at large banks were focused on accountholders who used debit cards for purchases.²²¹ Bad publicity, public outrage, and a threatened loss of deposits led the largest banks to back away from their plans to enact fees based on debit card use.²²² Banks, however, were more successful in raising standard maintenance fees and increasing the account balance necessary to avoid these fees. According to Bankrate, only 45% of banks now offer “free” checking, down from 76% in 2009.²²³ Commentators also believe that many banks are raising other “under the radar” account fees to compensate for lost overdraft revenue.²²⁴ Ironically, data suggest that many banks increased overdraft charges to compensate

219. *Id.* at 59,044–45.

220. *See supra* notes 191–193 and accompanying text.

221. *See, e.g.,* Kathleen Pender, *New Banking Rules Making Free Checking More Elusive*, S.F. CHRON., Oct. 4, 2011, at D1 (discussing Bank of America’s decision to “begin charging most customers \$5 a month for debit card usage”); Jennifer Saranow Schultz, *Debit Cards: A Hint of Fees*, N.Y. TIMES, Jan. 22, 2011, at B5 (raising the possibility that U.S. Bankcorp would adopt a debit card fee in the wake of the new interchange rule).

222. Jennifer Bjorhus, *Consumer Fury Forcing Banks to Kill Debit Fees*, STAR TRIB. (Minneapolis, Minn.), Nov. 2, 2011, at 1A.

223. *See* Dave Carpenter, *For Frustrated Consumer, There Are Ways to Avoid or Reduce Pesky Bank Fees*, BOS. GLOBE, Nov. 5, 2011, at 7. While fee structure changes were partly motivated by debit card overdraft rules, they were also motivated by new limits on debit card interchange fees. *Cf. supra* notes 95–99 and accompanying text.

224. *See* Candice Choi, *At Biggest Banks, Even a \$5 Overdraft Can Trigger a Steep Fee, Survey Shows*, BOS. GLOBE, Aug. 5, 2011, at 10 (explaining that some banks either changed the order of overdraft processing to increase fees or increased the number of overdraft fees one customer could incur in a day); Eric Dash, *Banks Quietly Ramp Up Costs to Consumers*, N.Y. TIMES, Nov. 14, 2011, at A1 (“Banks tried the in-your-face fee with debit cards, and consumers said enough,” said Alex Matjanec, a co-founder of MyBankTracker.com. “What most people don’t realize is that they have been adding new charges or taking fees that have always existed and increased them, or are making them harder to avoid.”); *see also* Candice Choi, *Profit-Hungry Banks Are Apt to Levy New Fees, But They Can Often Be Avoided*, BOS. GLOBE, Dec. 16, 2011, at 9 (highlighting fees that “don’t get as much attention” like TD Bank’s increase in fees for wire transfers and stop payment orders).

for the fewer overdrafts incurred. According to Moeb's Services, the median overdraft fee increased from \$27.50 in June 2011 to \$30.00 in November 2011.²²⁵ Moeb's Services explained: "In almost 30 years of collecting [overdraft] data we have never seen an increase as high as \$2.50 at one time, especially in a five month period."²²⁶ They attributed the increase directly to the debit overdraft opt-in regulation.²²⁷

It is difficult to determine what this account re-pricing means in terms of cross-subsidization. As previously discussed, consumers who repeatedly overdraw their transaction accounts with small debit card purchases may have been overpaying due to difficulty understanding the overdraft terms and over-optimism about how successful they would be in avoiding overdrafts.²²⁸ To the extent this was the case, the opt-in rule should at least partly eliminate this overpayment by bringing the fee to consumers' attention. If, however, the debit opt-in rule is not successful in correcting any consumer cognitive biases, resulting higher overdraft and other hidden fees may simply lead to continued customer overpayment. Again though, overpayment alone does not equate to cross-subsidization.

Another example of recent regulatory action disfavoring overdraft fees and encouraging consumer education is FDIC guidance regarding overdraft fees incurred in a single day. The FDIC guidance provides that banks must "[i]nstitute appropriate daily limits on customer costs by, for example, limiting the number of transactions that will be subject to a fee or providing a dollar limit on the total fees that will be imposed per day."²²⁹ The guidance further provides that the banks should identify customers who are repeated overdraft users and offer them alternatives that might better meet the customers' needs.²³⁰

Other regulators may follow the FDIC lead. The OCC recently proposed guidance that would similarly require banks to adopt "prudent

225. Press Release, Moeb's Services, Overdraft Fee Revenue Falls as Banks Raise Overdraft Prices (Jan. 18, 2012), *available at* [http://www.moeb's.com/Portals/0/pdf/Press%20Releases/120111%20Moeb's%20PR%20OD%20Revenue%20%20Price%20Final%201-18-12%20\(2\).pdf](http://www.moeb's.com/Portals/0/pdf/Press%20Releases/120111%20Moeb's%20PR%20OD%20Revenue%20%20Price%20Final%201-18-12%20(2).pdf).

226. *Id.*

227. *Id.*

228. *See supra* notes 195–200 and accompanying text.

229. FDIC, Overdraft Payment Programs and Consumer Protection, Final Overdraft Payment Supervisory Guidance, Fin. Inst. Letter FIL-81-2010, 4 (Nov. 24, 2010), *available at* <http://www.fdic.gov/news/news/financial/2010/fil10081.pdf>.

230. *Id.* The FDIC, nevertheless, made it clear that no bank was required to offer new products as a substitute for transaction account overdrafts. *See* FDIC OVERDRAFT PAYMENT PROGRAM SUPERVISORY GUIDANCE FREQUENTLY ASKED QUESTIONS 4 (Apr. 1, 2011), *available at* <http://www.fdic.gov/news/conferences/overdraft/FAQ.pdf> ("Is an institution required to provide new alternatives to automated overdraft payment programs? No. Banks are not required to develop new products in response to the Guidance.").

programmatic limitations on . . . the number of overdrafts and the total amount of fees that may be imposed per day and per month.”²³¹ Under the proposed guidance, banks are also encouraged to provide customers “clear and conspicuous disclosures” of account terms, including fees.²³² Furthermore, the newly created Consumer Financial Protection Bureau has launched an inquiry into transaction account overdraft fees.²³³ Among the reforms the Bureau is considering is a “penalty fee box” that would display overdraft and similar charges in a prominent location on consumers’ account statements.²³⁴ All of these proposals seem driven by the philosophy that customers’ cognitive biases are causing some to overpay for transaction account services.

In sum, existing fee regulations are contradictory. On the one hand, OCC regulations and the Truth in Savings Act encourage high overdraft and other penalty-type fees on the theory that banks should encourage accountholders to engage in responsible behavior to avoid these fees. More recent regulation discourages overdraft fees and encourages broad account disclosures on the theory that consumer cognitive biases may lead some to overpay for transaction accounts with large penalty fees. Given the conflicting messages to banks, it is difficult to assess the extent to which regulations impact banks’ account pricing. To the extent that overdraft and penalty-type fees provide a breeding ground for consumers’ decisions to be hampered by cognitive biases, earlier regulations may have led to some consumers overpaying for transaction account services. The evidence conflicts as to whether those most prone to the cognitive biases would have been low-income customers. More recent efforts to encourage robust disclosure, facilitate consumer choice, and limit large penalty charges could potentially ameliorate harm from consumer cognitive bias. Finally, even if some consumers overpay due in part to cognitive biases or fee regulations, fee regulations do not offer any reason why banks would pass these supracompetitive profits along to wealthy consumers.²³⁵

231. OCC, Proposed Guidance on Deposit-Related Consumer Credit Products, 76 Fed. Reg. 33,409, 33,411 (June 8, 2011).

232. *Id.* at 33,410.

233. Edward Wyatt, *Consumer Inquiry Focuses on Bank Overdraft Fees*, N.Y. TIMES, Feb. 22, 2012, at B7.

234. Press Release, Consumer Financial Protection Bureau, Consumer Financial Protection Bureau Launches Inquiry into Overdraft Practices (Feb. 22, 2012), available at <http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-launches-inquiry-into-overdraft-practices/>.

235. See Stucke, *supra* note 123, at 335–36.

iv. Encouragement to Cross-Subsidize

In spite of growing concern about bank fees, policymakers have made few attempts aimed at requiring or encouraging banks to cross-subsidize transaction accounts for low-income consumers. This Part discusses policymakers' efforts to require or encourage banks to provide low-cost transaction accounts, sometimes called "basic" accounts.²³⁶ Like transaction account fee regulations, basic bank account policies have sometimes suffered from conflicting theories about the fairest types of account fees. Yet, there is little reason to believe that these regulatory efforts have resulted in widespread cross-subsidization in the transaction account market.

In the aftermath of transaction account interest rate deregulation, some states adopted laws requiring banks to provide basic bank accounts.²³⁷ If these laws require banks to provide transaction account services for less than the incremental cost of the services, cross-subsidization might occur. New Jersey seems to have contemplated this possibility. The New Jersey statute specifically provides that "[n]o depository institution shall be required to offer a New Jersey Consumer Checking Account at a cost which is below its actual cost to provide such an account."²³⁸ Thus, under

236. "Lifeline banking was the term originally used by those advocating the provision of financial services at reduced prices." Canner & Maland, *supra* note 146, at 256. However, critics suggested that it was not fair to use a term that carried such "life-or-death connotations." *Id.* "Over time, then [the term] *lifeline* has largely given way to [the term] *basic*." *Id.*

237. New Jersey and New York require that banks make basic checking accounts available for all consumers. *See, e.g.*, N.J. STAT. ANN. §§ 17:16N-1, :16N-3 (West 2000) (stating that in order to ensure banks "meet the basic banking needs of the communities in which they are authorized to operate" those banks "that maintain[] regular checking accounts in [New Jersey] shall make available to consumers a [basic checking account] at all offices of that depository institution where regular checking accounts are offered or available."); N.Y. BANKING LAW § 14-f (McKinney 2008) ("It is the policy of this state that, consistent with safe and sound banking practices, banking institutions make available lower cost banking services to consumers."). Illinois and Massachusetts require that banks make basic checking accounts available to some consumers. 205 ILL. COMP. STAT. 605/4 (2011) ("Every financial institution shall offer a Basic Checking Account to any natural person 65 years of age or older who requests such an account."); MASS. GEN. LAWS ch. 167D, § 2 (2011) (providing basic checking accounts for consumers 18 or younger and 65 and older). In addition, a Vermont statute authorizes its banking regulator to adopt rules requiring a lifeline account if the regulator "finds a material deterioration in the availability and cost of basic checking and savings account services in the results of any two consecutive surveys." VT. STAT. ANN. tit. 8, § 10504 (West 2011). To the extent that these laws would require national banks to provide basic accounts without regard to the cost of providing the accounts, the state laws may be preempted by federal law governing national banks. *See supra* note 177 and accompanying text.

238. N.J. STAT. ANN. § 17:16N-3(a).

the New Jersey law, banks could still charge basic account customers at least the incremental cost of providing the basic account. Assuming that banks charged at least this incremental cost to low-income customers, cross-subsidization would not occur.

Even outside of New Jersey, basic account laws are unlikely to lead to cross-subsidization. Basic bank account laws typically allow banks to charge some fees for the account—including overdraft fees—provided that the fees do not exceed those for other accounts.²³⁹ Perhaps because these fees can be substantial, New York has concluded that its law does not result in the cross-subsidization of its basic account.²⁴⁰

It is possible that in the future, federal banking regulators will join the basic bank account states in requiring low maintenance fee accounts for some consumers. Depending on their construction, mandatory basic accounts could force banks to price some transaction accounts below the incremental cost of the service and lead to cross-subsidization. Federal regulators have repeatedly experimented with basic banking projects but have so far been unwilling to make such accounts mandatory.

In 2001, the Department of the Treasury (hereinafter “Treasury”) began a program known as “First Accounts.”²⁴¹ Under the program, Treasury awarded grants to community-based non-profit organizations and financial institutions in order to “provide low-cost checking or savings accounts to ‘unbanked’ low- and moderate-income individuals.”²⁴² This created a direct subsidy to low-income consumers. Under the First Accounts program, “85 percent of the accounts opened were savings accounts” rather than transaction accounts.²⁴³ Of the two grant recipients who focused primarily on transaction accounts, one experienced problems like large overdrafts with nearly half of the new accounts opened.²⁴⁴ The

239. See 205 ILL. COMP. STAT. 605/4(c); N.J. ADMIN. CODE § 3:1-19.2(a)(9) (2011); Grace Sterrett, *Basic Banking: New York’s Attempt to Democratize Banking Services*, 49 CONSUMER FIN. L.Q. REP. 13, 14 (1995) (discussing the basic bank account regulation in New York).

240. See Letter from Richard H. Neiman Superintendent of Banks, N.Y. State Banking Dep’t, to Fed. Deposit Ins. Corp. (June 4, 2010), available at <http://www.banking.state.ny.us/prft100604.htm> (“Based on data from the past 15 years since the basic banking account was introduced by the New York Legislature, we find that the account is not a ‘loss-leader’ for banking institutions.”).

241. See generally U.S. DEP’T OF THE TREASURY, FINDINGS FROM THE FIRST ACCOUNTS PROGRAM (Jan. 2009).

242. *Id.* at iii.

243. *Id.* at 4-5 (“Thus for the most part, the First Accounts program helped participants gain access to accounts that would support savings, but were not designed to encourage the use of accounts for transactions.”).

244. See *id.* at 4-7, 12-11. That program, operated by Mission of Peace in conjunction with Fifth Third Bank, offered checking accounts with no monthly fees or minimum

First Accounts program did not attempt to determine whether the accounts had been profitable for the financial institutions that participated.

More recently, the FDIC created a “Model Safe Accounts Template” to provide banks “with guidelines for offering cost-effective transactional . . . accounts that are safe and affordable for consumers.”²⁴⁵ The account template allows customers to maintain a minimum balance of \$1.²⁴⁶ While it does allow a monthly fee of up to \$3, it does not allow any overdraft or insufficient funds fees.²⁴⁷ The account is card-based and does not allow customers to write checks.²⁴⁸

To help determine whether the Model Safe Accounts Template is feasible, the FDIC conducted a pilot program.²⁴⁹ For one year beginning on January 1, 2011, the FDIC collected information from nine banks that volunteered to participate.²⁵⁰ While the nine participating banks were not a representative group of financial institutions,²⁵¹ the FDIC concluded that “[t]he pilot showed that safe, low-cost accounts are valuable to consumers and feasible for banks.”²⁵² The FDIC was especially encouraged that only about “20 percent of the transaction accounts were closed by the end of the pilot.”²⁵³ By disallowing checks and overdraft transactions, banks were able to limit the “instances of fraud or intentional mismanagement.”²⁵⁴ This suggests that currently unbanked consumers become stable customers when offered transaction accounts with transparent and attractive terms.

The FDIC pilot, however, had a more difficult time determining whether the accounts were economically feasible for the banks. The participating banks “did not uniformly define and allocate fixed and

balances. *Id.* at 12-12. However, the accounts were subject a \$30 charge per overdraft item. *Id.* Under the Mission of Peace program, a grant of \$425,316 translated into 660 checking accounts. *Id.* at 12-1. To minimize losses, Fifth Third “monitored [the accounts] very closely and closed [them] quickly if serious problems occurred.” *Id.* at 12-11.

245. FDIC Model Safe Accounts Template (Aug. 4, 2011), <http://www.fdic.gov/consumers/template/template.pdf>.

246. *Id.* Under the template, banks can require a \$10 deposit to open an account. *Id.*

247. *Id.*

248. *Id.*

249. FDIC MODEL SAFE ACCOUNTS PILOT: FINAL REPORT (Apr. 2012), available at <http://www.fdic.gov/consumers/template/SafeAccountsFinalReport.pdf>.

250. *Id.* at 1, 3.

251. *Id.* at 3, 5 (noting that the banks were Bath Savings Institution (Bath, ME), Citibank (New York, NY), Cross County Savings Bank (Middle Village, NY), First State Bank (Union City, TN), ING Direct (Wilmington, DE), Liberty Bank and Trust Company (New Orleans, LA), Pinnacle Bank (Lincoln, NE), South Central Bank (Glasgow, KY), and Webster Five Cents Saving Bank (Webster, MA)).

252. *Id.* at 3.

253. *Id.* at 5 (noting that this rate was lower than the industry-reported closure rate of 30% for regular transaction accounts).

254. *Id.* at 8.

variable costs,” and “[i]nformation technology infrastructure limitations . . . made it difficult [for banks] to monitor and track costs and revenues.”²⁵⁵ Some banks noted that the marginal costs of the accounts were low because the accounts did not have check-related costs and because the accounts generated income in the form of interchange fees.²⁵⁶ While this information seems promising, it is still far from certain that such accounts will generate income for banks—especially if banks are limited in their ability to assess interchange fees.²⁵⁷

Although neither the First Accounts Program nor the FDIC Model Safe Accounts Pilot provided detailed data on basic bank account costs, further federal experimentation will occur. The Dodd-Frank Act authorized Treasury to implement a program of grants to “enable low- and moderate-income individuals to establish one or more accounts in a federally insured depository institution.”²⁵⁸ Regulators may eventually decide to require that banks provide basic bank accounts. For now though, no federal law requires banks to offer such accounts.

Regulators do, however, broadly encourage banks to consider providing transaction accounts for underserved consumers. Under the Community Reinvestment Act (CRA), banks are required to “serve the convenience and needs of the communities in which they are chartered to do business.”²⁵⁹ The “convenience and needs of the communities” includes the need for “deposit services.”²⁶⁰

In spite of this ambitious language, the CRA’s enforcement mechanisms are rather weak. Regulators evaluate a bank’s transaction account offerings, along with its credit offerings, and assign the bank a rating of outstanding, satisfactory, needs to improve, or substantial non-compliance.²⁶¹ Regulators must then consider this rating when evaluating the bank’s applications for new branches, mergers, and acquisitions.²⁶² “While regulators only rarely deny such applications based on CRA concerns, community groups can slow down the approval process

255. *Id.* at 7.

256. *Id.*

257. *See supra* notes 91-102 and accompanying text (discussing the Durbin Amendment and the impact it may have on transaction account pricing).

258. 12 U.S.C. § 5623 (Supp. 2011); *see also* Financial Access Activities; Comment Request, 76 Fed. Reg. 56,499, 56,500 (Sept. 13, 2011) (requesting comments “on how [Treasury] can encourage activities that enable low- and moderate-income individuals to establish one or more accounts in a federally insured depository institution and to improve access to the provision of such accounts”).

259. 12 U.S.C. § 2901(a)(1) (Supp. 2011).

260. *Id.* § 2901(a)(2).

261. *Id.* § 2906(b)(2).

262. *Id.* §§ 2902(2), 2903.

significantly with CRA protests.”²⁶³ Thus, it is possible that some banks looking to expand or merge might offer below-cost transaction accounts to low-income consumers to assuage any CRA-related concerns.

For example, when Washington Mutual acquired Great Western Bank in 1997, Washington Mutual, among other things, promised two community-based organizations that it would introduce a checking account without a monthly fee or minimum balance requirement in a low-income area.²⁶⁴ In exchange, the community-based organizations promised not to oppose the acquisition.²⁶⁵ It is difficult to determine how often community-based organizations successfully influence banks’ transaction account fees.²⁶⁶ However, to the extent that the CRA is influential, it should encourage progressive, rather than regressive, cross-subsidization because community-based groups should be most concerned about low-income individuals.²⁶⁷

It appears, then, that although current regulations do not require banks to provide any service at a loss, the CRA might encourage some banks to voluntarily do so. Low-income consumers are those most likely to be helped or subsidized by the CRA.

C. Agency Problems

Agency problems, like regulations, could lead to cross-subsidization in transaction account pricing. Banks, like other corporations, are run by bank managers whose interests might not always align with the profit-maximizing interests of shareholders. Some community-minded financial institutions may choose pricing structures that cross-subsidize transaction accounts for low-income consumers. Other banks, motivated by discriminatory intent or a desire to grow, may choose pricing structures that cross-subsidize a preferred group of consumers.

263. Stegman et al., *supra* note 29, at 409 n.15.

264. KENNETH H. THOMAS, *THE CRA HANDBOOK* 118-20 (1998).

265. *Id.*

266. See NATIONAL COMMUNITY REINVESTMENT COALITION, *CRA COMMITMENTS* 53-54 (Sept. 2007), available at http://www.community-wealth.org/_pdfs/articles-publications/cdfis/report-silver-brown.pdf (identifying several CRA agreements that include provisions for basic transaction accounts); Canner & Maland, *supra* note 146, at 258 n.8 (“In 16 out of 22 [CRA] agreements recently reviewed by Federal Reserve staff, basic banking was a negotiated issue.”).

267. However, in at least some cases, the community-based organizations have sought transaction accounts that could be classified as “free” under current bank advertising regulations. See Thomas, *supra* note 264, at 120 (noting that WAMU promised to provide “its widely-heralded Free Checking Account”). To the extent that these agreements simply encourage banks to adopt pricing structures with high penalty fees, the CRA may have an effect similar to that of the Truth in Savings Act’s advertising requirements.

Some banks, especially community banks and credit unions, may lack shareholder pressure to maximize profits.²⁶⁸ Credit unions, at least according to law, are non-profit cooperative associations owned by “members” who deposit money, rather than shareholders.²⁶⁹ While some credit unions have now grown so large it is reasonable to believe they behave like profit-maximizing large banks,²⁷⁰ smaller credit unions may be more motivated by the will of their depositors. Similarly, closely held banks may have shareholder constituencies made up largely of bank depositors who live in the community serviced by the bank.²⁷¹

Without shareholder pressure, some community banks and credit unions may be willing to offer low-balance transaction accounts below cost due to charitable or community-oriented non-profit goals.²⁷² If there is little competition in the transaction account market (or if large depositors are also charitable), banks with such goals may finance these accounts by paying less than market interest on high-balance transaction accounts.

As discussed earlier, small banks have different pricing structures than large banks.²⁷³ In general, large banks charge higher fees.²⁷⁴ Unfortunately, it is difficult to determine why this difference in fee structures exists. Perhaps it is because community banks and credit unions are less profit-driven. Perhaps larger financial institutions are better able to determine the costs of transaction account services and are therefore more

268. See Marc Schneiberg, *Toward an Organizationally Diverse American Capitalism? Cooperative, Mutual, and Local, State-Owned Enterprise*, 34 SEATTLE U. L. REV. 1409, 1433 (2011) (“Community banks and credit unions are less subject to pressures to maximize shareholder value than commercial banks.”).

269. See 12 U.S.C. § 1752(1) (Supp. 2011) (explaining that credit unions are organized as cooperatives); 26 U.S.C. § 501(c)(14)(A) (2011) (providing that credit unions, as non-profit, mutual organizations, are exempt from federal income taxation).

270. See Wendy Cassity, Note, *The Case for a Credit Union Community Reinvestment Act*, 100 COLUM. L. REV. 331, 361 (2000) (stating that a relaxed “common bond membership policy has given credit unions bank-like incentives and powers”).

271. See Schneiberg, *supra* note 268, at 1425–26.

272. See James F. Bauerle, *Regional Banking Outlook: Capital*, 128 BANKING L.J. 180, 180 (2011) (stating that “[m]ost [community banks] have shareholder constituencies that own shares out of loyalty to the communities where the banks are located rather than out of desire for maximum return on equity”); Choe, *supra* note 29, at 367–68 (suggesting that non-profit credit unions would be more likely to serve low-income consumers); Tony S. Guo, *Tenants at Foreclosure: Mitigating Harm to Innocent Victims of the Foreclosure Crisis*, 4 DEPAUL J. FOR SOC. JUST. 215, 252 n.201 (2011) (stating that “[c]ommunity banks are ‘mission driven’ instead of ‘profit driven’”); Schneiberg, *supra* note 268, at 1433 (noting that community banks and credit unions are “much more oriented to serving members and clients than making a business of subjecting them to an endless stream of fees and charges”).

273. See *supra* note 121 and accompanying text.

274. *Id.*

efficient in their pricing decisions.²⁷⁵ Perhaps larger banks are more able to exercise market power.²⁷⁶ Perhaps larger banks have higher costs due to their more extensive networks of ATMs and branches.²⁷⁷ Or perhaps small banks have a greater need for deposits as a funding source and thus offer more competitive prices.²⁷⁸

While some banks may be partly benevolent, other banks may be partly malevolent. Some banks may engage in discriminatory behavior manifested by pricing structures designed to discourage some consumers from opening transaction accounts—even when those accounts might be profitable for the bank. If this occurs, some consumers might pay higher prices while other consumers pay lower prices.

The question of whether banks engage in economically inefficient discrimination in lending has been widely studied. The results are mixed. Some believe that banks often make discriminatory lending decisions,²⁷⁹ while others discount such claims.²⁸⁰ Even assuming significant credit discrimination exists, that does not necessarily suggest that transaction account discrimination also exists. Banks may have a greater opportunity to discriminate in credit decisions because of the detailed customer information they typically collect to evaluate borrowers' credit risk.²⁸¹ In addition, anti-discrimination laws may provide strong disincentives for banks to discriminate against protected classes in the provision of transaction accounts. For these reasons, widespread discriminatory intent in the provision of transaction accounts is probably unlikely.

Some managers might have incentives that lead them to maximize bank size rather than bank profits. Managers of larger firms tend to have

275. See *supra* Part III.A (discussing information deficiencies).

276. See *supra* notes 121-123 and accompanying text.

277. See Victoria Finkle, *Free Checking Isn't Cheap for Banks*, AM. BANKER, Dec. 12, 2011, at 2 (reporting that “[o]verhead, or the institutional costs not associated with a specific division or service” is higher at the largest banks). But see *Legislative Highlights*, AM. BANKR. INST. J., Apr. 2011, at 8 (stating that small banks have higher per-transaction operating costs).

278. Cf. KOCH & MACDONALD, *supra* note 69, at 391-92 (noting small banks' limited access to international capital markets and reliance on deposits as a source of funding).

279. See, e.g., William C. Apgar & Allegra Calder, Joint Center for Housing Studies at Harvard University, *The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Lending*, in THE GEOGRAPHY OF OPPORTUNITY: RACE AND HOUSING CHOICE IN METROPOLITAN AMERICA (Xavier de Souza Briggs ed. 2005), available at <http://jchs.unix.fas.harvard.edu/sites/jchs.harvard.edu/files/w05-11.pdf>.

280. See, e.g., Peter P. Swire, *Equality of Opportunity and Investment in Creditworthiness*, 143 U. PA. L. REV. 1533 (1995) (concluding that creditworthiness, rather than redlining, is responsible for minorities' lack of credit).

281. James T. Lindley et al., *Racial Discrimination in the Provision of Financial Service*, 74 AM. ECON. REV. 735, 736 (1984).

higher salaries.²⁸² They may also have “increased prestige[] and other perquisites.”²⁸³ A bank manager seeking to maximize the size of the bank’s deposit base may choose a cross-subsidizing transaction account pricing structure if the bank has market power sufficient to retain the accounts that are over-paying.

A disconnect between the FDIC’s interest as deposit insurer and banks’ interest in maximizing shareholder value may provide an even stronger incentive for banks to grow large. When one of the largest banks gets into financial trouble, the government often provides bailout funds. In contrast, when a small bank encounters financial difficulty, regulators close the bank. Although the Dodd-Frank Act aimed to reduce the risk posed by large financial institutions,²⁸⁴ most commentators believe the too-big-to-fail problem still exists.²⁸⁵ In such an environment, banks—particularly those within striking distance of “systemically important” status—may have an incentive to cross-subsidize some transaction accounts. To these banks, increasing the deposit base may be more beneficial than the costs incurred in providing transaction accounts.

It is unclear whether the unprofitable accounts added by this type of

282. See, e.g., Aigbe Akhigbe et al., *CEO Compensation and Performance of Commercial Banks*, 23 *MANAGERIAL FIN.* 40, 40 (1997) (finding that bank size is “positively related to the total compensation (including salary, bonus, and stock options) levels of bank CEOs”); Henry L. Tosi et al., *How Much Does Performance Matter? A Meta-Analysis of CEO Pay Studies*, 26 *J. MGMT.* 301, 329 (concluding that “organizational size [is] an important determinant of total CEO pay”).

283. Wilmarth, *supra* note 90, at 288.

284. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 11-203, 124 Stat. at 1376 (stating that the purpose of the Act was “[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes”).

285. See, e.g., Lissa Lamkin Broome, *The Dodd-Frank Act: TARP Bailout Backlash and Too Big to Fail*, 15 *N.C. BANKING INST.* 69, 81 (2011) (noting that “Dodd-Frank provides a framework for ending too big to fail if the regulators have the will”); Adam J. Levitin, *In Defense of Bailouts*, 99 *GEO. L.J.* 435, 439 (2011) (concluding that large bank bailouts are “an inevitable feature of modern economies, in which the interconnectedness of firms means that the entire economy bears the risk of an individual firm’s failure”); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 *OR. L. REV.* 951, 954 (2011) (concluding that “Dodd-Frank’s provisions fall far short of the changes that would be needed to prevent future taxpayer-financed bailouts and to remove other public subsidies for [too-big-to-fail] institutions”). Even Senator Dodd, for whom the Act is named, seems skeptical of the Act’s chances of success. He now claims the Act was “not meant to prevent another bank from being too big to fail.” Rather it was meant to “prevent [failures] from metastasizing so that they we [sic] can avoid another Lehman style bankruptcy.” Laura Goldman, *Dodd Backs Away from Namesake Bill*, *NAKED PHILADELPHIAN*, (July 8, 2011, 12:07 PM), <http://nakedphiladelphian.blogspot.com/2011/07/dodd-backs-away-from-namesake-bill.html>.

expansion would belong to low-income or upper-income consumers. On one hand, in theory a bank could grow its deposit base most quickly by adding high-balance accounts. On the other hand, the cross-subsidization experienced when banks could not pay interest on deposit accounts²⁸⁶ suggests that banks might not be that efficient in attracting one particular type of account, while excluding other types of accounts.

D. Theoretical Explanations of Cross-Subsidization

It appears, then, that several theories suggest that some groups of accountholders might pay more than the stand-alone cost of providing services to that group. Banks may not be able to accurately assess the cost and attach an appropriate price to some transaction accounts. Laws limiting new bank charters and expansion of existing banks might lead some banks to exercise market power. In addition, OCC regulations and the Truth in Savings Act might encourage banks to set high overdraft and penalty fees. To the extent that consumers have few alternatives to these high fee accounts or are unable to accurately assess the costs they will incur, these accountholders may pay more than the stand-alone cost for transaction account services.

At the same time, several theories could explain why some accountholders might pay less than the incremental cost to the bank of providing the account. Again, information deficiencies might cause some banks to adopt pricing structures where some accountholders underpay for the services they receive. The CRA might motivate banks to agree to provide some low-income consumers account services at a loss in order to facilitate regulatory approval of bank expansion or mergers. To the extent that other accountholders pay more than their stand-alone costs, the CRA could result in progressive cross-subsidization. Finally, agency problems might lead some banks to cross-subsidize some accounts. In particular, management's desire for growth might lead banks to adopt pricing structures that cross-subsidize some accounts. It is unclear whether this subsidy would flow to low-income or high-income consumers.

At best, a theoretical examination of transaction accounts yields mixed results. While explanations for regressive cross-subsidization exist, explanations for progressive cross-subsidization also exist.

IV. OVERDRAFT FEES AND CROSS-SUBSIDIZATION

In an effort to better understand whether regressive cross-

286. *See supra* Part III.B.3.

subsidization occurs, this Part explores existing empirical evidence concerning the prices and costs of transaction accounts. Its structure tracks Gerald Faulhaber's definition of subsidy-free prices.²⁸⁷ First, is the revenue from each group of accounts less than the stand-alone costs of providing service to that group? If the poor are paying more than the stand-alone cost of service, they would be better off seeking an alternative arrangement. Second, do all transaction accounts cover at least the incremental cost of providing those accounts? If the rich are paying less than the incremental cost of service, cross-subsidization could be present. As acknowledged in Part I.B, establishing or refuting cross-subsidization can be data intensive and difficult. This Part concludes that existing data are not sufficient to clearly establish the existence of regressive cross-subsidization in transaction accounts. In particular, high-balance accounts likely generate at least enough revenue to cover the incremental cost of service.

A. Are the Poor Over Paying?

Under Faulhaber's approach, subsidy-free prices exist only when no group of consumers pays more than the stand-alone cost of service. Regressive cross-subsidization could exist if high overdraft accounts would be better off (would pay lower prices) by seeking an alternative arrangement.

It is undeniable that some consumers rack up huge overdraft fees on their transaction accounts. A single overdraft fee can range between \$10 and \$38, depending on the bank.²⁸⁸ Some consumers can incur multiple overdraft charges in a single day.²⁸⁹ Given the large nature of these charges it is difficult not to agree with a conclusion reached by the Pew Health Group: "Overdraft fees far exceed the *incremental* cost to the bank of providing this service since these transactions, designed to be paid back with the customer's next deposit, pose minimal credit risk."²⁹⁰

But would low-income consumers who pay high overdraft fees be

287. See *supra* Part I.B.

288. See FDIC, OVERDRAFT STUDY, *supra* note 77, at 16, 18, 24 (finding a range of overdraft fees from \$10 to \$38, with a median of \$27, for overdrafts at banks with automated overdraft protection); PEW HEALTH GROUP, HIDDEN RISKS: THE CASE FOR SAFE AND TRANSPARENT CHECKING ACCOUNTS 12 (Apr. 2011), available at http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Safe_Banking_Opportunities_Project/Pew_Report_HiddenRisks.pdf [hereinafter PEW, CHECKING ACCOUNT STUDY] (finding a range of \$10 to \$36, with a median of \$35 at the ten largest banks in the U.S.).

289. See PEW, CHECKING ACCOUNT STUDY, *supra* note 288, at 12 (reporting that the ten largest banks all allow multiple overdraft charges per day).

290. *Id.* at 14 (emphasis added).

better off seeking an alternative arrangement? What would it cost to set up a stand-alone system that only provided transaction accounts to low-income consumers who repeatedly overdraw their accounts? It is difficult to determine the answers to these questions because no such system exists. Nevertheless, comparing similar products sheds some light on this question.

First, it might be reasonable to assume that the cost of a hypothetical arrangement for low-income consumers would cost roughly the same as a system for all consumers. To provide transaction account services to low-income consumers, a service provider would still need a physical location, staff, and technology. As discussed below, the cost of providing the average checking account when considering fixed costs ranges from \$250 to \$300 per year.²⁹¹ Using these figures, a low-balance account without a monthly fee with a \$25 overdraft charge, would need between ten and twelve overdrafts a year. An account with twenty overdrafts per year could potentially be profitable with a charge of only \$12.50 per overdraft, assuming no higher risk of charge-off.²⁹² But even this amount is higher than the overdraft charge at some banks, suggesting that perhaps not many low-income consumers would benefit from an alternative arrangement.

Another potential reference point for the hypothetical cost of providing low-income transaction accounts is the prepaid card industry. Prepaid cards, also called stored-value cards, are “device[s] that provide[] access to a specified amount of funds for making payments to others.”²⁹³ While there are many different types of prepaid cards, general purpose reloadable prepaid cards are the products that most closely approximate transaction accounts.²⁹⁴ Consumers using these prepaid cards can receive automatic deposits, use the card to pay bills and make purchases, and withdraw money from ATM machines. Unlike most transaction accounts, many prepaid cards do not allow the consumer to overdraw the card; the

291. See *infra* notes 338–339.

292. In considering the hypothetical stand-alone cost, annual average cost of mid-sized or small banks are probably a better proxy than the average annual cost of the largest banks. However, when using the average annual cost of \$350 to \$450 for the largest banks (see Kapner, *infra* note 339, at C1) and the \$35 average overdraft fee at the largest banks (see PEW, CHECKING ACCOUNT STUDY, *supra* note 288, at 12), an account could recover its stand-alone cost at ten overdrafts per year.

293. BLACK’S LAW DICTIONARY 1301, 1556 (9th ed. 2009).

294. See Anisha Sekar, *The AmEx Prepaid Debit Card’s Dirty Little Secret*, NERDWALLET (June 22, 2011), <http://www.nerdwallet.com/blog/2011/amex-prepaid-debit-dirty-little-secret/> (“The primary reason to get a prepaid debit card is to avoid having a checking account to begin with, whether because you can’t make the minimum balance requirements to avoid paying fees, or because you simply don’t want to keep your cash with a bank.”).

consumer can only spend money that has already been loaded on the card.²⁹⁵ For this reason, prepaid cards do not typically charge an overdraft fee. They do, however, charge other fees. These fees vary widely by card provider, but often include a fee to load money on the card.

Some research suggests that current prepaid cards are a cost-efficient alternative to transaction accounts for those consumers who would typically maintain a low transaction account balance.²⁹⁶ If this is correct, it could suggest that at least some transaction account consumers would be better served by making alternative arrangements. However, the prepaid product is not perfectly akin to the transaction account. Prepaid card networks might be less costly for service providers to offer because they do not extend credit in the form of paid overdrafts and do not offer check-writing services.²⁹⁷ In addition, some research concludes that current prepaid cards are actually more expensive than transaction accounts.²⁹⁸ At any rate, the current evidence from the prepaid card market is insufficient to conclude that transaction account holders with overdraft charges are paying more than the stand-alone cost of the service they receive.

Credit products might also be partial substitutes for transaction account holders with repeated overdrafts. Credit cards are the credit products that are functionally closest to transaction account overdrafts.²⁹⁹

295. See Gail Hillebrand, *Before the Grand Rethinking: Five Things to Do Today With Payments Law and Ten Principles to Guide New Payments Products and New Payments Law*, 83 CHI.-KENT L. REV. 769, 784 n.36 (2008) (noting that some cards, for example the Wal-Mart money card, are not set up to allow overdrafts). *But see* Will Hernandez, *Prepaid Benefit Cards Draw Fire*, AM. BANKER, May 17, 2011, at 6 (noting that U.S. Bank “charges \$10 to \$20 in overdraft fees on prepaid cards it issues in Arkansas, Idaho, Nebraska, Ohio, and Oregon”).

296. See G. MICHAEL FLORES, BRETTON WOODS, INC., ANALYSIS OF RELOADABLE PREPAID CARDS IN AN ENVIRONMENT OF RISING CONSUMER BANKING FEES 12-13 (Mar. 2011), available at <http://bretton-woods.com/media/51f57d9869e66aa1ffff8159fffd502.pdf>. (finding that average prepaid card users incurred fees between \$76 and \$380 annually and the transaction account users with the same basic use pattern would spend \$218 to \$314 annually).

297. The prepaid card also offers some conveniences the typical transaction account does not. For example, prepaid cards can be purchased and loaded in a variety of locations. Many of these locations have more convenient hours than bank branches.

298. See CONSUMERS UNION, ADDING IT ALL UP: HOW PREPAID CARD FEES COMPARE TO CHECKING ACCOUNT FEES (Apr. 4, 2011), available at <http://www.defendyourdollars.org/pdf/Adding-It-All-Up.pdf>. The major difference between the Bretton Woods study and the Consumers Union study appears to be the way overdraft charges were included for transaction accounts. The Bretton Woods study assumed five overdraft fees a year, while the Consumers Unions study does not explicitly consider overdraft fees. See Phyllis Furman, *Prepaid Debit Cards No Bargain, Consumer Group Sez*, N.Y. DAILY NEWS, Apr. 7, 2011, at 35. Thus, a debit card may be more expensive than a prepaid card for the consumer who does not use overdrafts, but less expensive for the consumer who does use overdrafts.

299. See L. Ali Khan, *A Theoretical Analysis of Payment Systems*, 60 S.C. L. REV. 425,

With both debit cards and credit cards, the consumer can make a purchase using a card and repay the loan later.³⁰⁰ Most observers agree that credit cards are generally a cheaper form of credit than overdrafts.³⁰¹ The FDIC Study of Bank Overdraft Programs (FDIC Overdraft Study) explained that when viewed as credit products, overdrafts can be costly.

Assuming a \$27 overdraft fee (the survey median), a customer repaying a \$20 [point-of-sale] debit overdraft in two weeks would incur an APR of 3,520 percent; a customer repaying a \$60 ATM overdraft in two weeks would incur an APR of 1,173 percent; and a customer repaying a \$66 check overdraft in two weeks would incur an APR of 1,067 percent. More rapid repayment of the overdraft amount results in higher APRs, and slower repayment results in lower APRs.³⁰²

In comparison, average credit card rates are around 15%.³⁰³ While some credit card customers pay above average interest rates or incur fees that push their cost of borrowing higher,³⁰⁴ credit cards are often cheaper than overdrafts.

481 (2008) (“When a bank extends a line of credit to an account holder, whether in the form of overdraft facility in a checking account or revolving credit in a credit card account, the bank obligates itself to comply with the account holder’s authorized payment orders. Thus, no meaningful distinction separates an overdraft account from a credit account.”); Joseph U. Schorer, *The Credit Card Act of 2009: Credit Card Reform and the Uneasy Case for Disclosure*, 127 *BANKING L.J.* 924, 956 n.1 (2010) (noting that credit cards and overdrafts of transaction accounts are both revolving lines of credit).

300. See Martin, *supra* note 196, at 1 (noting the similar appearance of debit and credit cards). In the case of a transaction account, the consumer can also write a check or perhaps use an electronic transfer.

301. In 2004, federal banking regulators issued a brochure to educate consumers about overdraft charges. The brochure suggested that linking a transaction account with a cash advance on a credit card could provide a less costly alternative to overdrafts. BD. OF GOVERNORS OF THE FED. RESERVE ET AL., *PROTECTING YOURSELF FROM OVERDRAFT AND BOUNCED-CHECK FEES* (2004), available at <http://www.federalreserve.gov/pubs/bounce/bounce.pdf>. But see Zywicki, *supra* note 210, at 1167 n.81 (noting that “[c]redit cards are not always a less expensive alternative than payday lending or overdraft protection for those whose usage tends to trigger substantial behavior-based fees”).

302. See FDIC, *OVERDRAFT STUDY*, *supra* note 77, at v n.8 (“These examples assume that the credit extended as a result of the overdraft occurrence equaled the total transaction, that the consumer repaid the credit extended in two weeks, and that no additional fees are imposed on the consumer as a result of the [overdraft]. The APRs were calculated as follows: ((Fee Charged/Amount financed)*365)/Term (14 days).”).

303. Tim Devaney, *Credit Card Interest Remains High While Other Rates Stay Low: Average at 15.14 Percent Nationally*, *WASH. TIMES*, Jan. 9, 2012, at A10.

304. Some credit cards assess annual fees. Many collect fees for extras like cash advances and balance transfers. Many also assess late charges if a payment is not made on time. See Jason Ashley Wright, *Credit: A Fact of Life*, *TULSA WORLD*, Aug. 13, 2012, at D1.

Credit cards, however, have features that may make them a sub-optimal substitute for overdrafts.³⁰⁵ As Professor Ronald J. Mann explains, credit cards can lead some consumers to spend and borrow more than they otherwise would.³⁰⁶ Racking up credit card debt can contribute to financial distress and even bankruptcy.³⁰⁷ Thus, some consumers might rationally avoid credit cards, on the theory that their cost is far more than the interest rate and fees credit cards assess.³⁰⁸ It is, therefore, difficult to conclude that transaction account fees exceed the stand-alone cost of account service based solely on a comparison of credit card prices.

Beyond this difficulty, credit cards may not be comparable to transaction accounts. Some consumers may use overdrafts because they do not have access to credit cards. Overdraft users tend to have lower credit scores than those who do not use overdrafts. A Moebs Services study found that “the lower the [credit] score the higher the incidence of overdraft behavior and the more overdrafts.”³⁰⁹ Similarly a survey conducted by the Raddon Financial Group found that of the consumers surveyed who were frequent users of overdrafts, 38% self-described their credit rating as “fair” and 32% described their credit rating as “poor.”³¹⁰ Consumers with low credit scores may not be able to secure a credit card, especially in financial environments where credit is tight.³¹¹ Lack of credit

305. See Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 890 (2007) (“If forcing customers to overdrafts is bad because they are expensive and opaque, shifting consumers to credit cards is much worse.”).

306. See RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 45–72 (2006).

307. See *id.*; see also Jim Hawkins, *Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress*, 86 IND. L.J. 1361, 1373–75 (explaining that credit cards cause financial distress because they allow consumers to accumulate a large amount of debt in a relatively painless way).

308. For example, Professor Katherine Porter notes that consumers are often reluctant to engage in significant credit card borrowing after a bankruptcy. Katherine Porter, *Life After Debt: Understanding the Credit Restraint of Bankruptcy Debtors*, 18 AM. BANKR. INST. L. REV. 1, 37 (2010).

309. See Press Release, Moebs Services, Who Uses Overdrafts (Sept. 29, 2009), available at <http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/194/Default.aspx> (finding that only credit score was significantly correlated with overdraft use).

310. See Raddon Financial Group, Inc., Custom Survey Research Findings 33 (June 2011) (unpublished survey results on file with author) (reporting a survey conducted by the Raddon Financial Group of customers at a single financial institution) [hereinafter Raddon Survey]. By comparison, 17% of the consumers who did not use overdraft credit reported “fair” credit. *Id.* Only 9% of non-overdraft users reported “poor” credit. *Id.*

311. When banks experienced difficulty in the fall of 2008, approximately 60% of banks responded by tightening their lending standards for new credit cards and lowering credit limits on existing accounts. BD. OF GOVERNORS OF THE FED. RESERVE SYS., OCTOBER 2008 SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES 5, available at <http://www.federalreserve.gov/boarddocs/snloansurvey/200811/fullreport.pdf>. “After years

card availability may explain why when asked what they would do if they did not have access to overdraft credit, only 10% of one bank's customers reported they would use a credit card.³¹² For consumers without access to credit cards, the cost of credit card borrowing is not a reasonable proxy for the stand-alone cost of transaction account services.

Instead, it may be more reasonable to consider the cost of payday loans as an approximation of the stand-alone cost of overdraft credit. If a transaction account holder cannot secure (or has already reached the credit limit on) a credit card, then the account holder might seek to substitute overdrafts with other high cost borrowing like payday loans.³¹³ While payday loans are not generally regarded as a consumer-friendly option,³¹⁴ in some cases payday loans can be more cost-effective than overdraft fees.³¹⁵

Whether or not this is true in any given circumstance probably depends at least partly on the size and duration of the loan. As previously discussed, most banks charge a flat overdraft fee of around \$30, which is not dependant on the size of the overdraft.³¹⁶ This means that low dollar overdrafts that are repaid quickly end up with a high annual percentage rate, which measures the cost of borrowing over a year.³¹⁷ In contrast, payday loans are typically priced according to the amount borrowed. On average, payday loan customers pay between \$15 and \$20 per \$100

of mailing cards out to just about anybody, banks [were] suddenly freezing out all but the most credit worthy customers.” Jane J. Kim, *Banks Get Picky In Doling Out Credit Cards*, WALL ST. J., Aug. 5, 2009, at D1. In such conditions, even previous overdrafts may disqualify consumers from some credit card offers. See Drew K. Kifner, *Alien to Financial Services: Should Social Security Numbers be Required for Banking Services Provided to Immigrants?*, 12 N.C. BANKING INST. 303, 308–09 (2008) (describing a Bank of America credit card that required customers hold a checking account with no overdrafts for three months).

312. Raddon Survey, *supra* note 310, at 30. Another 6% of survey respondents reported that they would apply for a credit card. *Id.*

313. See Mann & Hawkins, *supra* note 305, at 889 (“[I]t seems fairly clear that overdraft products are more expensive than payday lending products.”); Donald P. Morgan et al., *How Payday Credit Access Affects Overdrafts and Other Outcomes*, 44 J. MONEY, CREDIT & BANKING 519, 521 (2012) (“Payday credit is closely akin to the overdraft credit (“protection”) supplied by depository institutions. Both financial intermediaries supply credit by postponing depositing a check or debiting an account for a time, providing float in the interim.”).

314. See generally CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET (2004).

315. See Mann & Hawkins, *supra* note 305, at 889; William M. Webster, IV, *Payday Loan Prohibitions: Protecting Financially Challenged Consumers or Pushing Them over the Edge?*, 69 WASH. & LEE L. REV. 1051, 1062 (2012) (“While . . . overdraft programs generally are quite profitable for depositories, they frequently are far more costly to consumers than payday advances.”).

316. See *supra* note 16 and accompanying text.

317. See *supra* note 302 and accompanying text.

borrowed.³¹⁸ Payday loans are typically outstanding until the borrower's next payday—usually in two to four weeks.³¹⁹ “For loans of about \$200, the price is about equal, and for loans of \$300 or above, a single overdraft loan typically will be less expensive. This calculation will vary, of course, depending on whether the consumer is making one overdraft or more.”³²⁰

Some empirical evidence suggests that consumers do consider payday loans a substitute for transaction account overdrafts. Brian Melzer and Donald Morgan studied how overdraft fees varied based on the availability of payday loans.³²¹ They found that “overdraft fees are roughly 5% lower when payday lenders are absent.”³²² Banks also varied their overdraft credit offerings depending on the availability of payday loans. In the absence of payday lenders, banks were “less likely to offer [overdraft protection] programs, and those still offering [overdraft protection] lower their credit limits.”³²³ Thus, Professor Melzer and Federal Reserve Economist Morgan conclude that there is “competition between payday lenders and overdraft credit providers.”³²⁴

Melzer and Morgan's conclusions are curious because we might have expected a lack of competition from payday lenders to increase overdraft fees, but Melzer and Morgan found the opposite. They hypothesize that “overdraft prices decline when payday loans are prohibited because overdraft providers sustain lower credit losses as they reduce credit limits.”³²⁵ Explaining the change in overdraft offerings is trickier. Melzer and Morgan offer two hypotheses, but both rely on the idea that in the presence of payday lenders some consumers use payday lenders as a substitute for overdraft credit, and banks then react to changing consumer

318. See Press Release, Moebs Services, PayDay Loans Are a Better Deal for Consumers Than Overdraft Fees (Jul. 12, 2010), available at <http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/169/Default.aspx> (“Consumers who use a payday advance loan for \$100 or less will pay an average of \$17.97”); Mann & Hawkins, *supra* note 305, at 861–62 (“In financial terms, [a payday loan] is a very short-term, single-payment loan, in which the lender extends a loan on one date in return for a promise (usually evidenced by a postdated check or by automated clearinghouse (ACH) authorization) to repay the amount of the loan plus a standard fee, typically in the range of \$15 to \$20 per \$100 borrowed.”) (citations omitted); Webster, *supra* note 315, at 1051–52 (stating that the “typical” fee for a payday loan is “\$15 per \$100 borrowed”).

319. See Mann & Hawkins, *supra* note 305, at 862–63.

320. Zywicki, *supra* note 210, at 1170.

321. Brian Melzer & Donald P. Morgan, *Competition in a Consumer Loan Market: Payday Loans and Overdraft Credit* (July 5, 2012) (Working Paper), available at http://www.kellogg.northwestern.edu/faculty/melzer/Papers/Melzer_Morgan_7_12_2012.pdf.

322. *Id.* at 2.

323. *Id.* at 2–3.

324. *Id.* at 3.

325. *Id.*

behavior.³²⁶ At a minimum, Melzer and Morgan's work suggests that when presented with a choice between overdraft and payday credit, some consumers make an economically rational choice.

Yet evidence still suggests that some consumers repeatedly incur large overdraft fees to gain only a small amount of credit. For example, the FDIC Overdraft Study found that "[t]he median dollar amount [of overdraft loans was] \$36."³²⁷ Consumers who incur low-dollar overdrafts are not necessarily irrational. Payday loans and overdraft credit are not perfect substitutes for each other. Some consumers might rationally prefer the overdraft because of functionally different ways these two forms of credit operate. As Professor Zywicki explains, "payday loans are less convenient and flexible than traditional overdraft loans, including the time and 'shoe leather' costs of going to a payday lender, waiting in line, and then delivering the cash to a bank or to pay a bill."³²⁸ In other circumstances, a payday loan might not be a reasonable alternative—for example, when the consumer had an emergency³²⁹ or lives in an area where regulation has limited payday lending.³³⁰ Yet even accounting for the convenience and other factors associated with overdraft credit, it seems possible that at least some consumers overpay for overdraft credit.

In sum, there is simply not enough evidence to conclude that the poor are systematically overpaying for transaction account services. It is difficult to determine what it might cost to provide stand-alone transaction account services for the poor. Comparing transaction account fees to other potentially comparable services like prepaid cards, credit cards, and payday loans is far from conclusive. None of the comparable products closely approximate all of the services provided by a transaction account. Yet in each of these cases, there is at least some evidence that the alternative product can be less costly than the equivalent transaction account. This leaves open the possibility that some consumers are paying more than the stand-alone cost of their transaction accounts. Further research would be

326. *Id.* at 3–4.

327. FDIC, OVERDRAFT STUDY, *supra* note 77, at 79. The study further found: [Debit card] transactions were not only the most frequent, but also the smallest, with a median value of \$20. The median transaction size of an ATM withdrawal and a check that resulted in an [overdraft] transaction were \$60 and \$66, respectively. [Automated Clearinghouse overdraft] transactions showed the largest median at \$78.

Id.

328. Zywicki, *supra* note 210, at 1168.

329. *See id.* (noting that "payday loans might not even be realistically available in some situations, such as when traveling or in an emergency").

330. *See* Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap*, 34 J. BANKING & FIN. 546, 547 (2010).

necessary to determine the extent of the overpayment and the demographics of those who are overpaying.

B. Are the Rich Under Paying?

Under Faulhaber's second condition, subsidy-free prices exist only if each group of consumers pays at least the incremental cost to the bank of providing the accounts. Regressive cross-subsidization could exist if revenues from transaction accounts held by upper-income consumers do not cover the bank's incremental costs of providing the transaction accounts.

It is difficult to establish that upper-income consumers pay more than the marginal cost of service. Critics of current account fees point to the previously discussed FDIC Overdraft Study,³³¹ suggesting that upper-income accountholders pay few overdraft fees.³³² The study found that "[a]bout 62 percent of accounts in low-income areas had zero [overdraft] charges, while 78.2 percent of accounts in upper-income areas had zero [overdraft] charges."³³³ It further found that accounts in upper-income areas were much less likely to incur multiple overdraft charges in a year.³³⁴

However, this information alone is insufficient to conclude that upper-income consumers do not cover the *marginal* cost of service. As previously discussed, other studies have not found a link between low-income state and overdrafts incurred.³³⁵ In addition, simply comparing the overdrafts incurred by various accounts does not take into account the income that a high-balance account would generate for a bank. The FDIC Overdraft Study found that accounts in middle- and upper-income locations were more likely to have higher average balances.³³⁶ For that reason, it is difficult to tell whether differences in fees paid by low-income consumers when compared with middle- and upper-income consumers are attributable to cross-subsidization or to efficient pricing structures.

331. FDIC, OVERDRAFT STUDY, *supra* note 77.

332. See, e.g., *Protecting Consumers from Abusive Overdraft Fees: The Fairness and Accountability in Receiving Overdraft Coverage Act: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. 34-36 (2009) (written statement of Jean Ann Fox, Dir., Consumer Fed'n of Am.) (using the FDIC Overdraft Study to advocate new overdraft legislation).

333. FDIC, OVERDRAFT STUDY, *supra* note 77, at 77.

334. *Id.*

335. See *supra* notes 207-209 and accompanying text.

336. "Middle- and upper-income areas had approximately one-third of accounts with less than \$100 and about one quarter of accounts with an average balance of \$3,000 or more." FDIC, OVERDRAFT STUDY, *supra* note 77, at 76. In contrast, "more than half (56.7 percent) of the micro-data accounts in low-income areas held less than \$100, on average." *Id.*

Reports often claim that many transaction accounts are “unprofitable” for banks. “Unprofitable” accounts could indicate the presence of cross-subsidization. The estimated percentage of “unprofitable” accounts varies widely, but is often reported to be more than 50% of all accounts.³³⁷ These estimates, however, are largely unhelpful for cross-subsidization analysis because they likely include fixed costs. The estimates that disclose cost calculations put the annual cost of providing a transaction account between \$250 and \$300.³³⁸ These cost data are consistent with average annual cost data (including fixed costs) from other sources.³³⁹

However, the incremental cost of a new transaction account is likely much lower than the \$250 to \$300 “average” annual cost of providing a transaction account. A 2005 article placed the annual “incremental front and back office costs on a checking account . . . between \$50 and \$60.”³⁴⁰

337. See Mike Branton, StrategyCorps, What to Do with Unprofitable Retail Checking Accounts (Dec. 2010), available at <http://www.ababj.com/white-papers-2010/what-to-do-with-unprofitable-retail-checking-accounts.html> (“A recent survey by Strategy Corps of 150 retail banking executives shows that 96% said at least 30% of their retail checking accounts were unprofitable.”); Sandra Block, *Building a Bridge to the ‘Unbanked:’ FDIC Votes Today on Plan to Set up No-Frills, Low-Cost Checking, Savings Accounts*, USA TODAY, Aug. 10, 2010, at 6A (“A 2009 analysis by Novantas, a consulting firm, estimated that even in a ‘good’ year, about half of checking accounts are unprofitable, and that regulatory and economic changes could raise that figure to 75%.”); Robin Sidel & Dan Fitzpatrick, *The End Is Near for Free Checking*, WALL ST. J., June 16, 2010, at A1 (“More than half of all checking accounts are currently unprofitable, according to a report issued last month by Celent, a unit of Marsh & McLennan Cos.”); Hank Israel & Sherief Meleis, *Repositioning the Checking Account*, BAI BANKING STRATEGIES (Jan. 1, 2010), available at <http://www.bai.org/bankingstrategies/product-management/deposit-products/repositioning-the-checking-account> (stating that “perhaps 40% of the customer base” of checking accounts are “marginal” profit producers); Bob O’Meara, *Is it Time to Take a New Look at Your Checking Strategy*, THE RADDON REPORT (July 16, 2009, 1:52 PM), <http://www.theraddonreport.com/?p=1573> (stating that for any given bank the segment of transaction account holders who do not generate enough income to cover their operating costs can be “more than 60 percent”).

338. Branton, *supra* note 337; Sidel & Fitzpatrick, *supra* note 337, at A1.

339. See Eric Dash & Nelson D. Schwartz, *Cut Back, Banks See a Chance to Grow*, N.Y. TIMES, July 16, 2010, at B1 (“‘The rule of thumb is that it costs a bank between \$150 and \$350 a year’ to maintain a checking account, said Aaron Fine, a partner at Oliver Wyman, a financial consultancy.”); Rob Garver, *Free Checking Has A Future, Mainly At Small Banks*, AM. BANKER, Mar. 15, 2011, at 4 (“‘It costs a lot of money to open and maintain a checking account,’ said Jim Chessen, the ABA’s chief economist. ‘It costs between \$150 and \$200 to open an account and the annual cost of providing a checking account is between \$250 and \$300.’”). Of course, different banks will have different transaction account costs. Moebs Service, a bank research firm, estimates that an average transaction account costs the largest banks between \$350 and \$450 per year while it costs the smallest banks only \$175 to \$250 per year. Suzanne Kapner, *Credit Unions Poach Clients*, WALL ST. J., Nov. 7, 2011, at C1.

340. Janet Bigham Bernstal, *Checking Free-For-All*, ABA BANK MKTG., Mar. 1, 2005, at 14.

A more recent white paper prepared by bank consulting firm Haberfeld Associates puts the marginal annual cost of a transaction account at about \$30.³⁴¹ This marginal cost number includes only marginal data processing, statement expenses, the cost to issue a debit card and keep it active on the card processing networks, and the loss of principle on charged off accounts. When considering only marginal costs, the Haberfeld Report concludes that less than 10% of transaction accounts do not generate sufficient income from fees and interest to be profitable.³⁴²

This, of course, leaves open the possibility that some consumer transaction accounts do not cover their marginal costs. However, it is not clear that these accounts belong to upper-income consumers. The Haberfeld Report describes one group of marginally unprofitable accounts as “single-product customers that are active, but have no overdrafts, do not use a debit card, do not buy checks from the bank and have less than \$400 average balance.”³⁴³ It is difficult to believe that the bulk of such customers would be wealthy consumers.³⁴⁴

C. *Empirical Evidence of Cross-Subsidization*

Although it is easy to conclude that many low-income consumers pay a significant amount in fees associated with their transaction accounts, there is not enough information to establish that the poor systematically pay more than the stand-alone cost of their transaction accounts. Furthermore, even if banks’ revenue from some subset of low-income consumers exceeds the stand-alone cost of providing transaction account service, there is still insufficient information to conclude that regressive cross-subsidization exists under the Faulhaber definition. Incremental costs for transaction accounts are likely very low, meaning that most accounts will generate enough revenue to cover the marginal cost of account service. Using currently available data, it is impossible to conclude that the bulk of account holders who pay less than the marginal cost of service would be wealthy. Neither theoretical nor empirical evidence conclusively supports claims of regressive cross-subsidization amount transaction account

341. Jeff Platter, Haberfeld Associates, Cost Models and Checking Profitability (Jan. 2011) (unpublished white paper) (on file with author). The \$30 was the average marginal cost of Haberfeld clients “derived directly from customer data extracts [collected] . . . on a monthly basis[.]” *Id.* Their sample includes “over 2 million checking households from community banks with offices in 46 states.” *Id.*

342. *Id.*

343. *Id.*

344. Indeed, the FDIC study suggests that consumers living in low-income areas would be more likely to maintain an account with an average balance below \$500. FDIC, OVERDRAFT STUDY, *supra* note 77, at 75.

holders.

V. BEYOND THE CROSS-SUBSIDIZATION ARGUMENT

The dearth of evidence of regressive cross-subsidization does not necessarily mean that further transaction account fee regulation is not appropriate. Indeed, Part III.B's discussion of transaction account regulation reveals one particularly fertile area for reform: Fee regulation could benefit from a coherent theory. Fee regulations adopted soon after interest rate deregulation encourage banks to charge high penalty fees. The OCC's regulations encourage high penalty-type fees to discourage customers from misusing transaction account services.³⁴⁵ The Truth in Savings Act encourages high overdraft and other non-maintenance fees by allowing banks to advertise accounts without maintenance fees as "free."³⁴⁶ Even state basic bank account laws allow high overdraft fees, but require low maintenance fees.³⁴⁷ Some CRA agreements between banks and community-based groups similarly allow high penalty fee, low maintenance fee accounts.³⁴⁸ These laws embody an underlying philosophy that avoidable fees are more consumer-friendly than standard maintenance fees.

In contrast, more recent regulation is aimed at discouraging overdraft fees. The Federal Reserve's recent opt-in regulation allows banks to charge debit card overdraft fees only when a consumer has authorized such overdrafts.³⁴⁹ In addition, the FDIC's Model Safe Accounts Template recommends that banks adopt basic accounts that have a \$3 monthly maintenance charge, but do not have overdraft or insufficient funds fees.³⁵⁰ These regulatory efforts are premised on the underlying philosophy that transparent maintenance fees are more consumer-friendly than avoidable penalty fees.

This Article takes no position about the consumer-friendliness of any particular fee structure. Rather, it offers the more modest claim that policymakers would be more successful in influencing banks' account pricing decisions if they adopted a coherent regulatory philosophy. Regulations should not simultaneously encourage and discourage banks from charging high overdraft fees.

As policymakers consider competing regulatory philosophies, they

345. *See supra* notes 173-188 and accompanying text.

346. *See supra* notes 191-193 and accompanying text.

347. *See supra* notes 237-240 and accompanying text.

348. *See supra* note 267.

349. *See supra* notes 212-219 and accompanying text.

350. *See supra* notes 245-248 and accompanying text.

should keep in mind that any adjustments to fee regulations are likely to impact low-balance accounts more than high-balance accounts. Unless new regulation explicitly requires regressive cross-subsidization, banks will look to fee income from low-balance accounts to cover the cost of services to those accounts. New fee regulation will be less likely to impact high-balance accounts because investment income earned from high-balance accounts offsets at least part of the cost of those accounts.

CONCLUSION

Professor David Heald observed that “the topic of cross subsidy is an excellent example of a context where language is used both imprecisely and persuasively. Some consumers are said to be paying ‘too little for some goods, at the expense of other consumers who are paying ‘too much.’”³⁵¹ This accurately describes assertions of regressive cross-subsidization among transaction account holders. Although it is often claimed that fees paid by poor consumers subsidize free accounts for the rich, this assertion is not substantiated with currently available theoretical or empirical evidence. Those championing additional transaction account fee regulation should look beyond cross-subsidization to substantiate their arguments.

351. Heald, *supra* note 49, at 54.