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Lines of Credit and Overdraft Banking

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In the United States it is customary for a household or a firm to have a deposit before it writes a check. This is true even if the bank lends to the check drawer, for the process by which a loan takes place typically involves the crediting of the borrowers account with the amount of a loan, wpon which checks are then drawn. The borrower gives to the bank a note, an I.O.U. which is legal evidence than the loan took place. This is not the only way in whcih a commercial bank can carry on lending operations. An important and interesting alternatives to such lending banking is overdraft banking. Overdraft banking is of particular interest at this time because some recent developments can be interpreted as movements in the diredtion of overdraft banking.

Overdraft banking differs from deposit banking in that checks are written against non-existent deposits. In deposit banking if checks are written against non-existent deposits the bank will refuse to honor the check. The writer of the check will have passed a bad check which is a criminal offense. However in overdraft banking the bank will honor, i.e. pay the check written against the non-existent account. The receiver of the check will deposit it to his account--presumably in some other bank in a banking system with many banks such as exists in the

United States and hence an increase in deposits occurs. In depoit banking, the existence of a deposit preceeds the writing of checks whereas in overdraft banking the check is written before a deposit exists.

Of course a bank will not honor a check written on a non-existent account independently of who the writer of the check is. A bank will only honor such checks that have been written by customers who have entered into an overdraft agreement with the bank. In an overdraft agreement a bank grants a customer a limited right to have checks honored even if his account does not have a positive balance. The right is limited in that the bank sets a maximum to the negative balance that the customer may have. The customer is charged at an agreed upon interest rate on the outstanding negative balance.

This type of overdraft agreement is common in Britain but it was well nigh unheard of in the United States a few years ago. At present it seems as if the commercial banks are moving to smething like overdraft banking in their effort to get both the cream of the consumer installment credit business and to compete with credit cards.

As yet there is no standard scheme for such overdraft arrangements. A typical scheme is based upon a speial checking account and an agreement by the customer to pay up to a specified sum each month to the bank to be credited against the negative balance once the special checking account is used. The bank also adds to the balance due let us say 1% of the unpaid balance each month as an interest charge.

An example of such overdraft banking may take the following form:

A household will agree to pay up to $100 per month against its negative balance and in return the bank will agree to honor all checks drawn against this account as long as the total negative balance remains less than $1200. The customer agrees to pay at least 1/12th of each debit against this account each month as long as a negative balance exists. It is obvious that to those households who qualify for this type of credit arrangement, a more convenient and perhaps even a cheaper substitute for consumer installment credit has been created.

Bank credit cards combine the payment ease and the free credit that a credit card represents with the possibility of transforming such credit card debits into a short term debt to the bank. A typical bank credit card plan involves a maximum outstanding credit to each card holder, a right to pay the entire debt to the bank by a particular date in each month without incurring any interest charges and a charge at say 1% per month on any balance not payed by a specified date. Of course a credit card does have the property of being acceptable in places and for purchases where a personal check is not often used, and as such the bank credit card does not quite correspond to the credit implicit in an overdraft agreement. However the other feature, that the holder of a Bank Credit Card does have a right to "fund" an agreed upon amount of payments into a debt to the bank does make it like the overdraft agreement.

The significant difference between loan and deposit banking and overdraft banking is that in the former the deposit set up by the credit operations of the bank are the result of some positive action by the bank. That is the bank makes a loan. Even though a bank may hesitate to turn down a loan application from a good customer, nevertheless at least the possibility exists that the bank can, if its money position requires it to, turn down or decrease any loan a customer may request. In overdraft banking however once the bank enters into an overdraft agreement with its customer, the amount of credit it actually extends on the basis of the overdraft agreement depends upon the desire of the customers: the bank becomes passive. In deposit banking the bank has much more initiative than in overdraft banking.

In particular in a banking system where overdrafts make up a large portion of the total bank credit, the volume of bank credit outstanding may change independently of what the control bank does to commercial bank reserves. In such a situation, the commercial banks will be forced by the behavior of their customers to find the reserves needed to pay for the clearing losses that result from their customer's utilization of their overdraft privileges.

A further step in the evolution of these revolving credit systems toward a complete overdraft arrangement would involve the integration of the system into the ordinary checking accounts.

Note that these credit agreements do not entail any leins on the item purchased. The credit is not "mortgage" credit in that the collateral for the loan~~s~~ is the item ~~is~~ that is purchased; the credit is personal, it is based upon the net worth, income and reputation of the person or business firm to whom the overdraft arrangement has been extended. The development of such lines of credit to the extent that "big ticket" consumer durables can be financed by their uses also makes controls over consumer installment credit more difficult.

Also to the extent that these standing overdraft agreements become the standard way for those households that can qualify for these agreements to purchase the big ticket items, the quality of the paper that the consumer installment credit houses will acquire will decrease. This either will mean an increa e in the riskiness of the portfolios of the consumer installment credit houses or a stiffening of the terms that they will offer to users of their credit. This in turn can decrease the demand for those items typically financed by sales finance houses.