

Five Myths of Overdraft Protection

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When bank customers gained access to funds through debit cards and Internet shopping, the velocity of payments skyrocketed. Suddenly, customers were presenting debit cards at fast food drive-through windows and e-commerce sites. Electronic transactions replaced the old practice of presenting a written check. Immediate payment replaced the “cushion” or float of waiting as a check or purchase order went through a distant clearing-house.

The new technology also presented an exponential increase in the volume of transactions presented against insufficient funds (NSF). Financial institutions having been paying accounts into overdraft for some time and more recently began covering debit card overdrafts as a convenience to their customers. Overdraft protection has become a distinct line of business that must be managed well to maintain compliance, provide exceptional customer service, operate efficiently and make a profit.

Above all, bankers need a solid understanding of the customers who use overdraft protection. That’s where a few key myths persist:

MYTH

Customers who regularly overdraw their accounts present a higher risk of charge-off.

TRUTH

Sheshunoff Consulting + Technology research demonstrates that the highest overdraft fee users have a lower charge off rate than light users. Heavy users of overdraft protection are fully aware of the fees and use the service as a convenience. These customers use their checking accounts actively, generating more

deposits, and creating more opportunities to recover overdraft amounts and fees.

MYTH

Average Collected Balance (ACB) is a good risk predictor.

TRUTH

Your speedometer is a good risk predictor as well, but only if you check it frequently. Many banks base overdraft limits on ACB, employing a 60- or 90-day average collected balance. This measure does not immediately reflect changes in the account. Using a software that maintains trends on an account’s deposit regularity and adjusts overdraft limits accordingly will allow you to get a better idea about your customer’s current conditions and ability to recover NSF balances.

MYTH

Account type is an effective risk predictor.

TRUTH

Financial institutions offer a number of checking account types, and some set overdraft limits referenced to account type. SMS research shows that account type has little to do with the amount of overdraft activity, and actually fails to accurately predict risk.

Banks can achieve a much more accurate measure with daily scoring that contrasts deposit frequency, NSF presentment frequency and NSF recovery spans for a better picture of the customer’s risk factors. Scoring software can provide constant account statistics that help the bank determine when it’s safe to exercise discretionary overdraft coverage.

MYTH

Age of account is the best risk measurement.

TRUTH

The older an account gets, the less risk on average. However, account age is not the best measure. Overdraft protection is a retention opportunity by providing a needed service at an opportune time. This convenience creates loyalty.

The best risk predictors for overdraft coverage is deposit regularity. Tracking customer deposit frequency and changes in deposit patterns is a much better predictor of risk and will help protect both the bank the customer.

MYTH

Overdraft services are predominantly used by poor people trapped in a cycle of debt.

TRUTH

SMS research has determined that customers presenting fewer than five NSF's per year average \$2,000 - \$2,500 in monthly deposits. Customers presenting more than 50 NSF's a year - up to five a month, average more than double the dollars deposited by the infrequent users and have dramatically fewer charge-offs.

Some banks have applied new procedures based on revised regulations and consultation to adjust their NSF practices, employing policies and software that identify NSF behaviors, clarify terms and establish targeted customer communications to those that remain overdrawn. With the right approach to overdrafts, a bank can provide better customer service while at the same time generating more revenue without increasing risk.

Clear customer communication is key to effective overdraft protection service and Federal regulators require it. With effective daily account tracking and automated communications, banks can employ accurate, timely overdraft limits and efficient processing, while providing excellent customer service.

Re-evaluate your bank's approach to overdraft management, and the standards you are using to make payment decisions. By properly monitoring your customers' transactional history, your system could be adjusted to cover more NSF's, thus increasing fee revenue while managing risk and providing a higher level of service. In short, shouldn't your program pay to a level where your customer can repay you? Not too much and not too little. Overdraft protection is more than a convenience for your customers— when managed well, it's a valuable service for both bank and customer. □



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