Is Your Overdraft Program a Black Box? Ask Yourself These 10 Questions

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Do you really understand how your overdraft management program calculates overdraft limits? It shouldn't be a mystery. Once data goes into your system, which then outputs an overdraft limit, you should be able to clearly explain what has happened in the system to your examiners. Further, if you understand the specific factors, trends and overrides that determine the overdraft limit, you'll be able to customize your overdraft program to provide superior service to your account holders.

Overdraft programs can benefit from the wealth of information you have, such as consumer metrics, overdraft habits and trends, and you should be able to easily access that data to make informed decisions regarding the management of your overdraft program. Unfortunately, many overdraft programs provide only pre-configured reports, and upcharge for special queries, restricting your knowledge and understanding of the overall program. They also often have pre-configured settings used to determine overdraft limits which are not visible to the financial institution, making your overdraft program a black box.

With today's focus on fairness in overdraft programs, banks and credit unions need a system that manages risk appropriately for both the financial institution and the account holder, while ensuring that overdraft limits are appropriate so consumers don't dig themselves into an overdraft hole from which they may not recover.

Is your overdraft program a black box? Ask yourself the following questions:

#1. Do you know how to turn data into actionable information?

If your answer is "no" to any of the following questions, then chances are that you're not effectively turning your overdraft data into actionable information.

- Are all of the factors used to determine the limit visible to you (along with their weighting)?
- Can you track each account's fees to deposit ratio? If an account holder is paying 25-30% of his or her deposits in fees, it's most likely not sustainable.
- How do deposit patterns (such as the dollar amounts of deposits and frequency of deposits) affect your risk?
- Does your overdraft program identify specific factors and behaviors to reduce charge off exposure to your institution?
- And most importantly, are you able to easily identify and mitigate risk with your current system? The best type of overdraft software evaluates every account, every day, for its risk. If the risk increases or decreases, the limit is adjusted accordingly.

#2. Do you have the real-world data to defend your overdraft program to an examiner?

The method your overdraft program uses to determine overdraft limits and account performance should be defendable, transparent and objectively determined across your financial institution. You should easily see how every limit is determined for every account over time. What is that account holder doing today vs. a month ago, or two months ago? Have there been fluctuations or changes in deposit habits?

#3. Can your system identify when the risk profile of an account has changed?

The right overdraft program identifies and mitigates the risk to your institution while simultaneously protecting the financial health of your account holders.

An effective overdraft program should work exactly like a hospital heart monitor – indicating good health with steady, consistent activity. The risk flag is waved when there's a fluctuation in that activity. Overdraft management systems should have a finger on the "pulse" of every account, every day, monitoring all changes in activity and adjusting the limit accordingly to keep your risk levels low.

In an April 2023 bulletin, the OCC specifically mentioned monitoring accounts this way, including this in its list of risk management practices: "Periodic account analyses that result in appropriate changes to overdraft limits, eligibility

for continued use, or recommendations to consumers for other appropriate deposit account services when overreliance, excessive costs, or options for more cost-effective credit usage are detected." [emphasis added]. Are you monitoring your accounts now and taking appropriate action, and do you have the ability to automatically adjust overdraft limits when the risk profile changes?

#4. Are refunds for overdraft fees granted equally and objectively across your institution?

In our experience, many financial institutions maintain a subjective policy when it comes to account holder requests for refunds of overdraft fees. Decisions for overdraft fee refunds often reside at the branch level or even at the front line. Many institutions that claim to have more structured, formalized policies still often leave decisions to the front line's discretion.

Here's a simple example illustrating the problem with this approach:

Branch A: Based in a wealthy, affluent town

Branch B: Based in a poor inner city

Without the right software, refunds are subject to discretion. And if Branch A's refunds are significantly higher than Branch B, expect your examiners to notice. A cursory review may lead an examiner to falsely conclude that your financial institution is treating these consumers differently, simply because of socio-economic status.

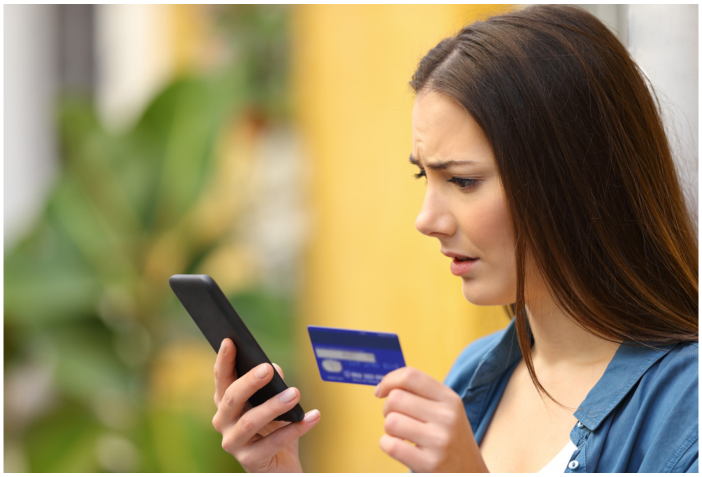
An effective overdraft program looks at all factors in determining refund amounts. It uses the same metrics and the same algorithm for every account, applying it to deposit behavior, overdraft behavior, and historic patterns. It's entirely machine-driven, providing an objective, fair and equitable decision, removing all human subjectivity.

#5. Can your overdraft program provide a debit decline opportunity analysis?

Debit declines play a significant role in the service your institution provides, and the strategy you choose has enormous potential to impact your institution's financial performance. The right software identifies actionable events on each account: Is this account holder an overdrafter? Is this account holder experiencing debit declines? Did this account holder fail to respond to Reg. E, opting out by default?

This is where your opportunity lies. Debit declines are a double hit for your institution. Your customer or member is receiving poor service, and your institution is losing potential overdraft revenue. Consumers may not understand why their debit card was declined, and a simple conversation explaining Reg. E may turn a negative event into a positive event.

As for the analysis element, the right overdraft program should clearly show you where debit declines are occurring and the magnitude at which they're occurring. Reporting should indicate the total amount of transactions that were declined, and the corresponding interchange revenue you've lost with each one.



The right overdraft software can automatically send a letter for opt-in, queue up a call or initiate a conversation. Further, the right overdraft software will help you analyze the root cause of debit declines. "We declined $2 million in transactions yesterday due to default opt-outs, and 80% of those came from Branch 9. So, what's going on at Branch 9?"

#6. Does your pay ratio indicate your true service level?

Most financial institutions calculate their pay ratio with a simple formula: number of items paid divided by total number of items. So, if a consumer writes 10 checks, and the financial institution pays 8 of those, then the FI is satisfied that it has provided an 80% pay ratio to that account holder. But what if that account holder had 10 debit card declines in that same period?

In our experience, most financial institutions do not factor debit declines into their pay ratio, which results in a metric that does not truly reflect the level of service provided to that account holder because the debit declines reduce the true effective pay ratio.

When a check is processed and sent to the FI, there is usually a system with which to approve it if the account holder does not have sufficient funds in his or her account. Even if the FI does not have an overdraft software program in place, there is often the opportunity to review the check, make a judgment call and approve it with the appropriate fee.

But a debit card decline happens immediately. Not only does this prevent the transaction from occurring, but it's likely to create an embarrassing situation for the card holder if the debit decline occurs in a public retail setting. Whatever the reason for the decline, that card holder may be very unhappy! So, your institution has taken a double hit: you've lost revenue from a debit transaction (both overdraft as well as interchange income), and you've delivered poor service to your valuable customer or member.

The right overdraft program will provide true pay ratios that factor in the debit declines, providing a more realistic picture of your service level. This information allows you to proactively manage your service levels, while retaining debit transaction revenue.

#7. Do you know the risk level of each account's mobile deposits?

With every consumer deposit comes a certain level of risk. FIs assume a level of risk by giving account holders access to a portion of their deposited funds before they can confirm that the check has cleared. But mobile deposits are inherently more risky, due to the greater potential for fraud in this channel.

Does your overdraft program provide a mobile deposit risk ratio? It should. Based on an account's past behavior, deposit patterns, etc., your system should provide you with a level of mobile deposit risk – similar to how overdraft limits are calculated.

That mobile deposit risk score will provide your FI with a more secure method for determining what percentage of the funds you should release, and when you should release them.

#8. Does your program allow for customizable criteria to initiate communication with the account holder?

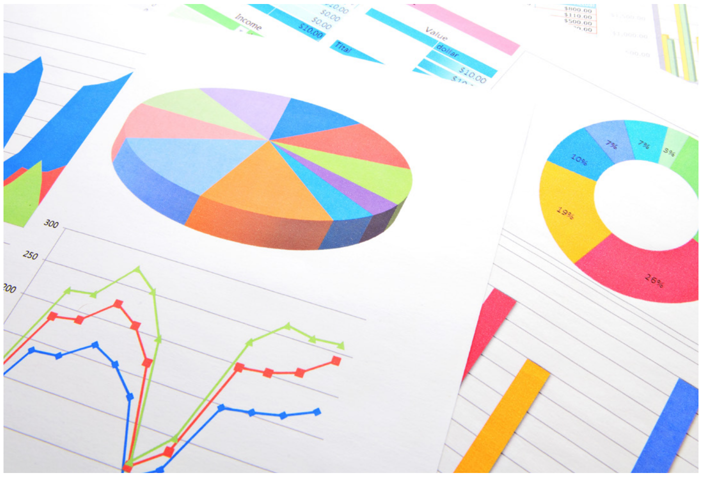
When patterns of account behavior change, indicating an increase in the risk level for that account, an effective overdraft program will flag that behavior change and automatically initiate a response based on your criteria. For instance, if an account holder regularly makes deposits 4 times per month, and suddenly that number of deposits reduces to 2, can your overdraft system identify that as a trigger event, and respond by queueing up a phone call, email or letter to that account holder?

The right overdraft program will automatically review every account, every day, for specific trigger events you've identified. The system will then queue up the appropriate response based on your customized input, resulting in a communication strategy that is efficient, timely, and provides excellent service to your account holders.

Without this feature, your staff would have to manually run reports and contact account holders directly. Further, you should always be prepared for the possibility that your examiners will require account holder communication for specific behavior changes. Is your software configurable to send out custom communications at a moment's notice?

#9. Do you have the capability to customize reports with any and all data in the system?

Are you able to identify all the various types of data stored in your software? Do you have the capability and the knowledge to create and run any type of custom report without needing your technical team to write queries? The #1, most critical feature of any overdraft program is the ability to easily build and customize reports using any data in the system, with an interface that is simple and intuitive enough for anybody in your institution to use. You should have the ability to save reports, and schedule them to run automatically or manually as needed.



If your program requires you to rely on a technical staff to write custom queries for basic reports, you're wasting time and money. You cannot effectively manage an overdraft line of business if you don't have quick and easy access to the information that facilitates intelligent and timely business decisions.

#10. Can your software identify exactly where your charge offs are coming from?

Every financial institution wants to reduce the amount of charge offs on its general ledger. One of the obvious ways to reduce charge offs is to reduce overdraft limits. The problem with this approach is that when you reduce limits, you also reduce potential revenue and service to your account holders. Your goal is to limit your charge offs while minimizing impact to your revenue and service levels. The right overdraft program will achieve this balance for you.

Using the information in the software, the FI can analyze the key risk variables of your accounts and identify the accounts that have the highest probability of charge off. Armed with this knowledge, you can pinpoint the riskiest accounts with surgical precision and adjust limits accordingly.

The right overdraft program should be transparent, intuitive and simple to manage for all stakeholders. It will give you the ability to make more informed business decisions, resulting in greater efficiencies, maximum service levels, and increased revenue.

The right overdraft program – an effective overdraft program – will be illuminating.

Are you afraid that your bank or credit union's overdraft program is a black box? [Contact Velocity Solutions](#) to help.

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