Dynamic vs. fixed overdraft limits: And the winner is…?

In this corner… the Contender, Fixed Limits, challenging the formidable upstart, Dynamic Overdraft Limits…. Indeed it may seem like you're in a boxing match when deciding what type of overdraft limits you will offer in your automated discretionary overdraft program.

Both types of limit-setting strategies enable your institution to automatically allow or disallow overdrafts for those account holders who utilize your service.

The Contender:

FIXED LIMITS provide a "one-size-fits-all" approach that is determined at account opening. All account holders who qualify to be in the program, receive the same overdraft limit; OR the limit varies based on account type (i.e., $550 for Free Checking and $750 for Premier Checking).

The Challenger:

DYNAMIC LIMITS are calculated automatically based on a myriad of account holder data points, including specific deposit and overdraft activity, related balances and more. This data enables your institution to establish a risk profile for each account and assign individualized overdraft limits based on the account holder's ability to repay the overdraft and fees at any given time.

Both types of limits have been in use for many years, although community-sized banks utilize fixed overdraft limits more widely due to the previously high cost of developing or purchasing dynamic limit-setting matrices.

However, times have changed and so must financial institutions. Dynamic overdraft limits—the hallmark of a modern, automated discretionary overdraft program—are now affordable to implement and can help institutions provide a higher level of service, meet compliance demands and drive incremental income better than fixed overdraft limits can.

The blow-by-blow and how we score it:

1. Provide a higher level of service to account holders

Although fixed limits may sufficiently serve the broad base of account holders, they can be a disservice to two types of consumers: 1) Those who overdraw their account more than the fixed overdraft limit and have the ability to repay their overdrafts; and 2) Those whose economic circumstances prevent them from being able to repay the overdraft.

Data shows that in the first group, the majority of these consumers typically can afford to repay the overdrafts and fees. They are living a convenience-driven lifestyle and they rely on the service to help them when their funds fall short.

Setting a fixed overdraft limit for these account holders subjects them to potentially more denied transactions or returned items—resulting in greater dissatisfaction, especially since they have demonstrated their ability to repay the institution.

Conversely, allowing the second group of consumers to overdraft within the fixed limit while their transactional behavior suggests they do not have the ability to repay is also a disservice, but one that can have devastating consequences for the affected.

THE DECISION: With dynamic limits, your institution provides account holders a personalized overdraft service—one that pays more items for those account holders who appreciate and can afford the service, while pulling back on overdraft limits for those account holders whose ability to repay has diminished. Not only does this translate into better service to your account holders, it also manages risk by assigning limits based on an account holder’s ability to repay.

2. Meet compliance demands

Federal regulatory guidance requires that financial institutions monitor the credit risk of each account holder.

In the Federal Financial Institutions Examination Council (FFIEC) 2005 Joint Guidance on Overdraft Protection Programs, the FFIEC wrote: *“Institutions also should monitor these accounts on an ongoing basis and be able to identify consumers who may represent an undue credit risk to the institution. Overdraft protection programs should be administered and adjusted, as needed, to ensure that credit risk remains in line with expectations. This may include, where appropriate, disqualification of a consumer from future overdraft protection. Reports sufficient to enable management to identify, measure, and manage overdraft volume, profitability, and credit performance should be provided to management on a regular basis.”*

THE DECISION: This ongoing monitoring requires financial institutions to utilize advanced algorithms that analyze account holder data on a daily basis and alert you to take action such as adjusting overdraft limits, suspending the service, suggesting counseling, etc.

Outdated overdraft systems with fixed limits simply cannot provide this level of sophistication. However without it, your institution is at risk for higher charge-offs and at a loss when justifying overdraft limits to regulators.

3. Drive incremental revenue

Using fixed limits, your financial institution does not have the ability to increase an account holder’s limit when that person’s capacity to repay changes. As a result, your institution foregoes income while your account holder suffers.

Is your institution aware of the number of debit/ATM transactions denied for reason of non-sufficient funds (NSF)? A large percentage of these denials may happen to your account holders who have opted in to your overdraft service for one-time debit and ATM transactions (Reg E). These customers have proactively requested that you allow them to overdraft at these channels and they are willing to pay you a fee, but their transactions are being denied. Not only does this present a service dilemma, but it represents a missed opportunity for additional income.

THE DECISION: Dynamic overdraft limits allow your institution to generate additional revenue by honoring more overdrafts, including Reg E transactions, and helping more account holders meet their short-term funding needs.

In the battle to decide whether to implement fixed or dynamic limits, it is important to remember that both types of limits act only as guidelines for your account holders and your institution. You have the discretion to honor or dishonor any overdraft, regardless of the account holder's limit, based on the individual's circumstances and your own risk tolerance. Your overdraft program disclosures should clearly state that there is no guarantee of payment regardless of which type of limit you use.

If your institution encounters account holders who want such a guarantee, it may be best to educate them on other overdraft options, such as a line of credit or a deposit transfer.

And the winner—in a knock out—is… Dynamic Limits!

To learn more about our overdraft privilege solutions, please contact BSG Financial Group at (866) 274-8900 or go to http://www.BSGFinancial.com.

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