



MEMBERS ONLY

## Loan Zone: Is it Time to add Credit Scoring to Your Bounce Protection Program?

*If so, this article provides six key steps for implementation*

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Credit scoring is commonly used for a variety of purposes in financial services, but often overlooked is its ability to enhance the deposit side of the business. A case in point is the application of credit scoring technology to share draft bounce protection programs. This article will take a look at the benefits for integrating credit scores into the bounce protection process, as well as the six key steps for implementation.

### Current Bounce Protection Programs

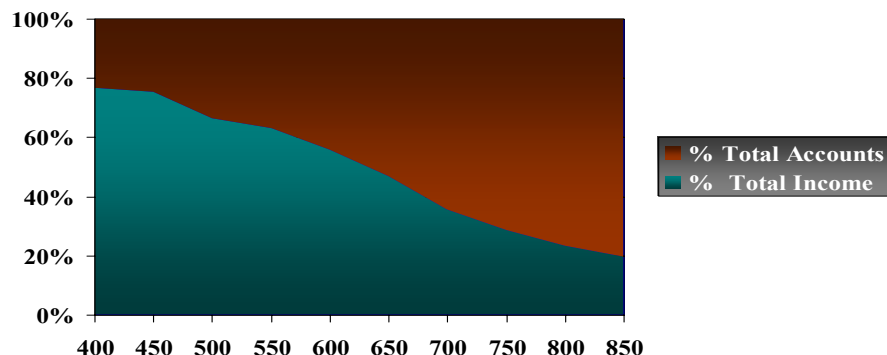
While operating under a variety of names such as Overdraft Privilege(SM) or Courtesy Pay, bounce protection programs all have the same basic purpose of allowing share draft accounts to go negative without the credit union bouncing members checks. Over the last few years these programs have resulted in significant fee income for credit unions and a level of comfort for their members.

Often the overdraft capability was given as a set amount, \$300 to \$500, to just about every share draft accountholder, resulting in large write-offs that went unnoticed when compared to the fee income earned. Now that many of the programs are becoming mature, credit unions are revisiting the fundamental steps involved and looking for ways to enhance revenue by reducing losses and increasing usage.

### Which Accountholders Use Bounce Protection Now?

There is an inverse credit score relationship between those who actually use the bounce protection feature and the make-up of the share draft or checking base.

**Checking Account Overdraft Income and Population by Score**



The chart above shows this relationship and reinforces the idea that fee income is heavy in the lower score area where the portfolio has the highest risk and the fewest number of accounts. An efficient program will better balance the income source.

The majority of the gross income (before losses) comes from those accounts below a score in the mid-600s, while the majority of the share draft population is above the mid-600s score range. From a risk standpoint, it is the higher-risk accounts that provide the most income. Clearly the way to increase income is through the balance of better managing losses from the higher-risk accounts and getting more usage from the lower-risk, high-score members. This also allows more flexibility for the lower-risk, high-score members by covering larger overdraft amounts.

## Enhancing Bounce Protection Revenue Through Credit Scores

A simple revenue enhancement solution is to apply credit scoring and risk management lessons learned from the loan side to share draft bounce protection programs. There are three main benefits in doing this:

**1. Losses are reduced.** Using a credit score as a key element in the overdraft program selection criteria will increase net income by better managing the high loss accounts. This is a case of taking the lessons learned from the lending side and applying them to overdrafts.

**2. Usage in the higher-score area is increased.** Many programs offer a flat \$300 or \$500 overdraft limit to all accountholders. There are some who deserve and can safely handle higher amounts. Experience shows higher amounts mean more usage. Using credit scores to set high limit tiers for better-risk members will increase usage fees and provide more balance to the high-score end of the share draft account spectrum.

**3. It meets the required regulatory guidelines released in 2005.** The 2005 Joint Guidance on Overdraft Protection Programs issued by bank, thrift and credit union regulators made it clear these programs are considered an extension of credit so credit risk management steps are required for safety and soundness purposes. Concerned over a lack of individual account underwriting, the regulators required the establishment of "express account eligibility standards" and "well-defined, well-documented dollar limit decision criteria." Using credit scores for cut-off points and dollar-limit tiering easily meets both standards.

This guidance also put to bed once and for all any past debate about the issue of pulling a credit report on a share draft account. You not only can but should use credit scoring for safety and soundness reasons as well as maximizing the risk/reward trade-off.

## Six Steps for Successful Implementation

The addition of credit scoring is fairly simple and can even be integrated into a credit union's share draft system. There are six key steps to follow when integrating credit scoring into the bounce protection process:

- 1. Recognize overdrafts are credit and need to be risk managed as such.** This includes housing this product in lending, not checking, and having formal policies and procedures in place that address the credit issues. The 2005 Joint Guidelines issued by the NCUA provide the best source to use when writing or updating your bounce protection policies.
- 2. Existing accounts need to be scored as well.** Authority for this is provided under the Fair Credit Reporting Act's permissible purposes rule. Since only a credit score is needed, the entire share draft account base can be run at one time with the digital results loaded back into the system at a much lower cost than getting individual reports. Your credit bureau rep will be glad to do most of this work for you and the cost will be easily offset by the reduced losses.
- 3. Cut-off scores and tiers are critical points in the risk and reward process.** Overdrafts and loans perform differently so normal lending cut-offs may not necessarily apply. Use your own history to help set the score ranges by doing a loss analysis based on the scores run in step 2 above.
- 4. Pulling a credit report is not a substitute for a check fraud verification report;** continue to use these reports as part of your selection process.

5. ***Treat new and existing accountholders differently when it comes to setting score limits and cut-offs.*** New accounts can carry higher risk, so adjust the overdraft amounts accordingly.
6. ***Use a modern score set, such as Next Gen V2;*** it will be more accurate in the program's critical lower-score ranges.

Applying credit score risk management techniques to your bounce protection program provides a simple, inexpensive solution that will be more than offset by lower overall losses and increased usage in the higher-tier accounts.

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