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Editorial Perspective:
Making the Move to Variable Rate APRs: Why and How to Get Started NOW

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Credit card portfolio managers routinely ask our Advisors **Plus** Credit Consulting team whether to price their credit card APRs on a variable or non-variable basis, and over the past few years the question has always sparked an excellent deep-dive discussion of the vital importance of achieving a match between a credit union's portfolio funding and pricing approaches. Recently, however, there is a growing possibility that increases in market funding costs (driven by a rise in various interest rates) could threaten the earnings and capital generated by credit card portfolios that rely on non-variable APRs. This has given even greater urgency to the discussion.

Advisors **Plus** believes that many credit card portfolios are still vulnerable and **recommends that credit unions immediately begin to mitigate their risk and protect their profitability by marketing all new credit cards with variable APRs and consider taking steps to migrate existing portfolios toward variable APR pricing**.

In greater detail below we explain why variable rate APR pricing will help protect your credit union's pricing flexibility and profit potential and outline two potential action plans for re-pricing an existing portfolio.

Don't Ask If, Ask When

We are now five years into what has essentially been a record low interest rate environment, with the Fed Funds Rate and Prime Rate stuck at 0-0.25% and 3.25%, respectively, since the end of 2008. So while it might make for interesting water cooler conversation to debate if the Fed will begin to taper bond buying, if the U.S. is heading toward a currency crisis, if asset bubbles exist in multiple markets—or even if inflation will rear its head this time around—which of these exact scenarios comes true will not affect the eventual outcome: At some future point interest rates will rise because when "all roads lead to Rome" there is nowhere else for them to go but up.

In fact, Advisors **Plus** believes that only by moving past the question of *if* interest rates rise to focus on the more pertinent issues of *when* and *how much*, can credit unions begin to prepare for the impact of higher funding costs on their card portfolios.

The stakes are so high because regardless of the precise route to higher interest rates, one thing is certain: When interest rates do rise, the provisions of the CARD Act—in place since 2009—will quickly become more onerous for credit unions as they find their portfolio re-pricing options dramatically restricted in ways that were easy to dismiss when rates were low.

A CARD Act to Follow: How Did We Get Here?

Of the CARD Act's many provisions, one major change in particular reduced issuer re-pricing flexibility: Issuers no longer have the ability to change the APR on **existing** balances except in a limited number of situations, which has eliminated the de facto "insurance policy" of being able to change terms at any time, for any reason. This is especially troublesome for issuers who utilize non-variable APRs.

As a result of the CARD Act, the choice of utilizing a non-variable APR becomes a dicey proposition because an issuer has to estimate that the non-variable APR it adopts will be adequate to provide enough margin to cover a range of potential funding costs and still be profitable. The process of estimating a range of potential funding costs is essentially placing a bet that an issuer can predict the upper end of the range and still have a competitive, profitable price point. **Any possible move to recover from a rapid rise in market rates by stopping card plan issuance or re-pricing new transactions would be painfully slow.**

Building the Case for Variable APRs

With regulatory limitations in place and funding costs likely to increase over the next few years, Advisors **Plus** believes that variable APRs on credit cards offer the best balance of protection to your credit union and fairness to your members. Indeed, your credit card products provide a unique win-win scenario in the sense that they are simultaneously key contributors to your credit union's capital base and a very important means of returning value to your membership. **Time and again, Advisors Plus sees instances where credit card loans represent 5-10% of a credit union's assets but contribute 15-30% of the credit union's earnings.** Managing such a vital engine for both profit and member satisfaction, spotlights how extremely important it is to make the "right" decision on credit card pricing.

The Top 7 Reasons to Use Variable APRs

Here are seven reasons why Advisors **Plus** believes that variable APRs are a credit union's best choice:

1. Credit union members understand variable APRs and how they work.

2. Variable APRs allow issuers to offer the lowest possible rate to members because issuers do not have to cover a wide range of funding cost possibilities.
3. If the index portion of a variable APR changes—in either direction—no additional disclosure is required to change the APR on an account (assuming proper upfront disclosures were made originally).
4. Using variable APRs avoids the trap of lending long and funding short, i.e., mismatching asset and liability pricing and duration.
5. The NCUA is extremely concerned about interest rate risk in its exams and is looking at all areas that can be negatively impacted. (The NCUA is even exploring a proposal to allow the execution of simple interest rate swaps using derivatives.)
6. Variable APRs avoid the increased capital requirements that thinning interest margins from non-variable cards can bring about or accelerate. (As credit cards get shorter shrift in capital weighting formulas or even as capital requirements simply increase, variable APR cards are less vulnerable to decreased earnings.)
7. Due to CARD Act regulation, issuers can no longer count on the de facto insurance policy that allowed them to re-price at "any time, for any reason."

Two Suggested Action Plans for Making the Change to Variable APRs

Most of the discussion here so far has been on comparing the theoretical virtues of variable versus non-variable APRs, but now it's time to turn our attention to the logistics of rolling out an actual variable APR program to your credit union's members.

- **New Card Programs:** For new programs just starting out, this process is easy because there are no legacy price points or member issues to deal with, and no change-in-terms or account mapping comes into play. The emphasis rests entirely on choosing the "right" product set with the "right" price points and margins.

  In clear-cut cases like these, variable APRs can be employed from the beginning of a new program and your credit union can be assured that it is building and growing a portfolio free from inherent interest rate risk.

- **Mixed-rate Portfolio Phase-ins:** What about a currently successful card portfolio that still has non-variable APRs—and management has growing concerns about future rate rises and/or margin compression? If your credit union is facing this scenario, **Advisors Plus recommends that your credit union immediately switch to variable rate pricing on credit cards for new card accounts.** This will stop the build-up of balances at non-variable rates and start your portfolio on the path to reduced risk.

Armed with the peace of mind that comes with the knowledge that your credit union is not making its risk pool any larger, you are now faced with a choice of what to do with your non-variable APR accounts that have already been established. You can use:

- An **attrition approach** which leaves existing accounts at their current non-variable APRs and allows them to phase out over time,

  OR

- A **re-pricing approach** which re-prices new transactions on existing accounts to use variable APRs (which may involve change-in-terms, adverse action/risk-based pricing notices and/or a six month review requirement depending on the nature of the actions taken.)

Let's look at the pros and cons of each approach in turn:

1. **The Attrition Approach**: This approach is the slower of the two transitional approaches but spares the credit union from potential cardholder confusion and complaints. Interest rate risk will still be present in the existing portfolio and will transition only as fast as old accounts phase out and new accounts grow.

   Depending on the strength of the portfolio and the anticipated magnitude of any funding cost increases, **a credit union should consider this approach only if it values reducing negative cardholder feedback over risk mitigation.** That's because this approach, while minimizing member complaints, will have costs associated with the need to maintain multiple disclosures and service multiple rate type accounts.

2. **The Re-pricing Approach**: If interest rate risk is a credit union's primary concern or if management feels that funding costs are going to rise sharply, it can opt to re-price new transactions for existing accounts in addition to actions taken for new accounts. (The change to cardholders can even be softened if the new variable APR is lower than their current non-variable APR.) The issuer can do this since it no longer has to cover a wide range of funding cost contingencies with a non-variable price point and should be able to accept less margin income in exchange for more certainty.

   Note that while this scenario might risk short-term cardholder irritation, displeased cardholders may be far less likely to "jump ship" than one might think for the simple reason that options for replacement low-rate, non-variable card products have all but vanished from the marketplace. In the final analysis then, substituting variable

APRs for non-variable APRs should not be undertaken lightly but should not be viewed as a member services line that can never be crossed either.

Protect Your Profitability Using Variable APRs

Such member services dilemmas underscore how important it is for credit unions to offer the right product at the right price to their members now that the CARD Act has made it more difficult and expensive to switch gears.

With the specter of increasing interest rates on the horizon—whatever the eventual timing—Advisors **Plus** believes that credit unions need to begin the vital work of transitioning their portfolios to variable APRs sooner rather than later or run the risk of sacrificing some portion of the 15-30% earnings contribution!

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About Advisors Plus Consulting Services Credit Card Consulting

Advisors **Plus** Consulting Services provides comprehensive credit card portfolio services to credit unions including portfolio reviews, and evaluations of products, marketing practices and financial performance.

Credit Card Consulting is designed to provide a credit union's management team with an in-depth view of its portfolio profitability, credit risk and member usage to help it identify and capitalize upon untapped potential in its credit card product line.

An Advisors **Plus** engagement typically begins with a customized portfolio review which normally includes a P&L analysis, credit card products review, comprehensive scan, and assessment of how the credit card products are positioned and marketed through the client credit union. A comprehensive report is delivered in writing and onsite with analysis, recommendations and proposed actions to improve credit card portfolio performance**.**

Our average Net Promoter Score in 2012 was 79 as measured by client surveys.

About Advisors Plus

Advisors **Plus** was established in 2005 to provide consulting and marketing services to credit unions. Our range of services covers the key areas of strategy, credit cards, debit and checking, marketing, contact center, operations, and branch sales.

The experienced consultants at Advisors **Plus** work with a credit union's staff through the entire process from project analysis to implementation and management. Our goal is to ensure that each credit union client achieves sustainable business growth, exceptional member experiences and operational efficiencies.

As of December 31, 2012, Advisors **Plus** has superior NPS Scores of: 79 – Credit; 84 – Debit and Checking; 91 – Contact Center. For more information, please visit **AdvisorsPlus.com.**