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POV:
Rekindling Questions on Non-Variable/Fixed Credit Card APRs in a Rising Rate Environment

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On December 14, 2016, the Federal Reserve Open Market Committee (FOMC) announced a 0.25 percent increase in the fed funds rate. This is only the second rate hike since 2006 and will raise the target fed funds rate to 0.50-0.75 percent.

Stronger job numbers, lower unemployment, inflation signals and previous Fed statements are the drivers behind the increase. Additionally, analyst predictions for 2017 seem to center around 3 to 4 rate hikes. There are estimates that project a “neutral” fed funds rate of 2.5-3.0 percent by the end of 2019.

Rising Rates Raise Questions

All this comes as relatively new territory for credit card lenders in particular. Since 2008, the target fed funds rate has held steady at record lows (0-0.25 percent until December 2015, which increased to 0.25-0.50 percent). During that time, credit card lenders have experienced declining or unusually low cost of funds rates, which have resulted in notably high interest margins. For some lenders, interest margins have grown to double digits.

A rising rate environment should rekindle questions surrounding credit card portfolios that carry non-variable or fixed APRs. Regulators, boards of directors and senior management alike will be seeking information regarding the impacts of rising funding costs on margins and profitability.

Rising Funding Costs Lower Margins

In terms of profitability, over the last eight years most institutions have experienced declining or stable funding costs. Given a shift toward a rising rate environment, how many non-variable/fixed credit card lenders are projecting lower margins (and lower profitability) for 2017 and beyond?

This question, in turn, raises others: Is declining credit card profitability acceptable in the face of growing capital and loss reserve requirements? Can credit unions claim to be “overpriced” during the last eight years? And perhaps most important, what can be done to mitigate declining margins?

Pricing Using Variable APRs

Indeed, the only protection issuers have against funding cost volatility is to price open-end credit products, including credit cards, by using variable APRs. Variable APR products are usually indexed to the Prime Rate, so when fed funds rates (and rates paid on deposits) change, so does the Prime Rate.

Many issuers read the change in Prime Rate monthly and adjust their credit card APRs based on operational capability and disclosure language. Most credit card issuers have long understood this, as evidenced by a *CreditCards.com* study which reviewed over 1,600 cardholder agreements on file with the Consumer Financial Protection Bureau (CFPB).

The study found that only a "handful" of agreements were disclosing non-variable or fixed APRs. What's more, another form of open-end loan (though secured by real estate), Home Equity Lines of Credit, has had universal variable APR pricing.

A Game Plan for Card Issuers

The CARD Act of 2009 has eliminated the issuer protection of changing APRs on existing credit card balances "at any time, for any reason." That means that waiting and making wholesale changes on an entire portfolio when events reach a tipping point is no longer an option.

The CARD Act does allow for re-pricing the APR on new transactions for established accounts, but not on any existing balances. So what should non-variable/fixed rate credit card issuers do? Advisors **Plus** recommends that they:

1. Stress test their 2017 budgets (and longer-term forecasts) for varying degrees of funding cost increases to gauge the extent of any margin and profitability declines from the prior year.

2. Communicate those findings to key stakeholders and raise the issue. It's better to surface what could be a material issue early, as opposed to delivering a management "surprise" down the road.

3. Develop a short list of alternative actions that could address the reduction in interest margins and profitability. Quantify the impacts and resources affected. These options can include any of the following:

    a. Price all *new* credit card applications/accounts with variable APRs. This will stop the margin issue from growing larger and will reduce the concentration of non-variable/fixed APR loans over time.

    b. If the estimated decline in profitability is severe, consider executing a Change in Terms (CIT) and re-price new transactions on *existing* accounts to a variable nature. This would be in addition to option a. above.

    c. If your institution desires to maintain its non-variable/fixed APR pricing, adding an annual fee is an alternative. However, be aware that this kind of change carries a right to reject on the part of the cardholder once notified of the change.

    d. Other combinations of fee increases/additions and expense reductions, although these items alone are not likely to make enough of a difference to offset a substantial funding cost increase.

All of the above actions carry some degree of downside—from operational and servicing issues to cardholder irritation. However, for credit card issuers, the ability to deal successfully with a rising rate environment and create a path forward is largely tied to utilizing variable APRs to maintain stable interest margins and profitability.

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