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Point of View:

Transitioning Your Credit Card Portfolio to Variable Rate APRs: A Look at How…and Why Now?

Transitioning Your Credit Card Portfolio to Variable Rate APRs: A Look at How…and Why Now?

The CARD Act left credit unions with very little recourse available to re-price in the event of rising market interest rates, and although the Fed's monetary policy has so far kept rates at record lows, recent political events and management changes at the Federal Reserve could signal more volatility on the horizon.

With the possibility of funding cost increases and the reality of CARD Act portfolio re-pricing limitations, Advisors **Plus** recommends that credit unions immediately begin to market all new credit cards with variable APRs and consider migrating existing portfolios toward variable APR pricing.

The Time is Now for a Move to Variable APR Pricing

One of the questions our team at Advisors **Plus** Credit Card Consulting consistently encounters is whether to price credit card APRs on a variable or non-variable basis. This POV will explain not only our group's current recommendation on the issue but the economic factors and historical pricing context that have led to our position as well.

Since the enactment of the Credit Card Accountability Responsibility and Disclosure Act (CARD Act), credit unions have had very little re-pricing recourse available in the case of a spike in market interest rates or a turn toward unfavorable market conditions. This pricing vulnerability has been further exacerbated by the fact that credit unions haven't typically had the routine access that Big Banks do to the kind of sophisticated hedging techniques needed to help manage rising funding costs.

Now, with the possibility of funding cost increases on the horizon, coupled with the limitations on re-pricing written into the CARD Act, Advisors **Plus** is recommending that credit unions immediately begin to mitigate their risk and protect their profitability by marketing all new cards with variable APRs and consider taking steps to migrate existing portfolios toward variable APR pricing.

A Brief History of Credit Card APRs

To understand why variable rate APRs are not universal today—why many credit unions have so-called legacy cards subject to different rate schemes—it helps to have a bit of history on card pricing.

Market Volatility Leads to Variable APRs

A credit union member doesn't have to be *that* old to remember the mid-1980s when the vast majority of general purpose credit cards had fixed APRs with rates which ranged from 17.4% to 21.6%. The high APRs were the card issuers' response to Federal Reserve policies that were meant to thwart the rampant inflation of the period. The Fed's monetary tightening led to high cost of funds (COF) rates—an average of **9.88%** during the period from 1980 to 1985[1]—which, in turn, sustained the high APRs.

As market borrowing rates started to decrease in the early 1990s however, intense political pressure to lower credit card APRs began to mount toward lending institutions. In response, credit card lenders introduced variable APRs on their credit card products. Card issuers saw shifting to variable APRs as a way not only to satisfy lawmakers but to compete more aggressively for market share and eliminate the "boom and bust" cycles that affected card interest margins. Finally, the move to variable APRs also allowed lenders to put to work a valuable lesson learned from the Savings and Loan Crisis of the 1980s—avoiding mismatching on the pricing and duration of assets and liabilities.

The method used by issuers to calculate variable credit card APRs most often used an index of Prime Rate or LIBOR, which correlated to some degree with the lender's cost of funds (COF) rate. This index, when added to an issuer-defined margin, resulted in the cardholder's APR. Subsequently, whenever the index moved up or down, so did the effective cardholder APR.

According to the Federal Reserve's *Survey of Credit Card Plans*[2], by 1994 36% of credit card plans had variable APRs. And the growth continues to this day. By the end of 2010, the proportion of plans with variable APRs had grown to 68%. In the Consumer Financial Protection Bureau's latest survey, the percentage of variable APR credit card plans with cardholder agreements dated 2009 and later (i.e., complying with new CARD Act requirements) had risen to 81%.[3]

"Fixed" APRs Have Their Fans, Too

Yet, as popular as variable APRs have become, using non-variable or fixed APRs has remained a long-held credit union approach to pricing credit cards as well. Even though the majority of the card issuing industry long ago moved to variable APR pricing, many credit unions continue to market non-variable APR cards.

Historically, many of the credit unions which set their credit card APRs on a fixed or non-variable basis originated their programs in the 1980s or early 1990s when fixed rates were still in the majority among issuers. In particular, an up and coming monoline issuer at that time, Capital One®, made a splash in the marketplace by highly promoting a 9.9% fixed rate product, which likely served as an important benchmark.

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[1] Office of Thrift Supervision National Monthly Median Cost of Funds Index (COFI)

[2] Federal Reserve Board Semi-Annual Survey of Credit Card Plans

[3] Consumer Financial Protection Bureau Survey of Credit Card Plans

Most of the credit unions which employed fixed rate APRs did so for one or more of the following reasons:

- They started offering credit cards in the era of industry-wide fixed APRs.
- Prior to CARD Act, they could always change the APR, if needed, with 15 days prior notice.
- Fixed rate cards gave them a perceived marketing advantage vs. issuers who used variable APRs.
- Fixed rate cards encouraged the belief among cardholders that banks used variable APRs to "trick" cardholders.
- There was a "set it and forget it" inertia mentality inherent in getting a credit card program up and running and then moving on to other priorities. The lack of reporting on both product interest margins and the marketplace in general also added to the complacency.

A CARD Act to Follow

In 2009, the CARD Act became law, with most of the provisions going into effect in February of 2010. Although it addressed many practices that related to open-end revolving credit card lending, one major change stood out: issuers would no longer be able to change the APR on **existing** balances except in a limited number of situations.

As a result, issuers have lost their "insurance policy" of being able to change terms at any time, for any reason. What happens if interest rates and funding costs reach 1982 levels again and an issuer is using fixed or non-variable APRs? With no re-pricing mechanism permitted for existing balances, the only available exceptions to re-price an existing balance now include:

- Expiration of a previously disclosed introductory (temporary) rate
- Variable rate exception if a publicly available index changes
- Delinquency of 60 days past due with 45 days advance notice
- Completion or failure of a loan workout program
- End of Servicemembers Civil Relief Act qualification

CARD Act Provisions and Non-variable APRs

The one permissible way to change an account's APR—or type of APR—is the advance notice exception. If an issuer provides 45 days notice, **new transactions** (i.e., starting 14 days into the 45-day notice period) **can be re-priced**. This assumes the APR in effect is not disclosed as "fixed"—more on this in the next section—but instead is considered non-variable. Keep in mind that due to additional rules regarding payment application, the highest APR balances are usually the first paid[4]. This additionally prolongs the positive impact of corrective actions available to issuers. Also, any balances on an account up to the 14-day period will have to be "protected" and allowed to pay out at their current APR.

The CARD Act makes the choice of utilizing a non-variable APR a dicey proposition. 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.

New and Confusing Terms

Prior to implementation of the CARD Act, APRs were described as "fixed" or variable. Intuitively, most consumers understood those terms. Fixed meant that the rate would not vary based on an index. The advent of the CARD Act introduced consumers to a world in which there were actually **three types** of contract APRs that could apply to a credit card account and can now be found on applications and account opening materials:

1. **Variable APR:** States the current APR and the fact that it will vary with the market based on an index, most commonly the Prime Rate. The index used must be out of the issuer's control, which also eliminates the concept of floor rates.
2. **Non-variable APR:** Simply stated APR with no further language. The issuer can change this APR with 45 days notice for *new* transactions.
3. **Fixed APR:** States the APR and the time period it will be in effect. If no time period is specified, then not even APR changes to new transactions can apply to the account.

The reason the new definitions exist was based on consumer testing. The evidence suggested that the term "fixed" was understood by cardholders to mean that their rate would never change. That was not true prior to CARD Act. So the new rules established were to include three definitions under the implementation of CARD Act with the intent of balancing consumer interest with some issuer flexibility. **The bottom line is that issuers who choose not to use variable APRs should elect to use "non-variable" APRs as opposed to "fixed." This will allow them some leeway to re-price new transactions if the need arises.**

[4] Payment amounts up to the minimum due may be allocated at issuer's discretion; payment amounts in excess of the minimum due must be applied to balances with the highest APR.

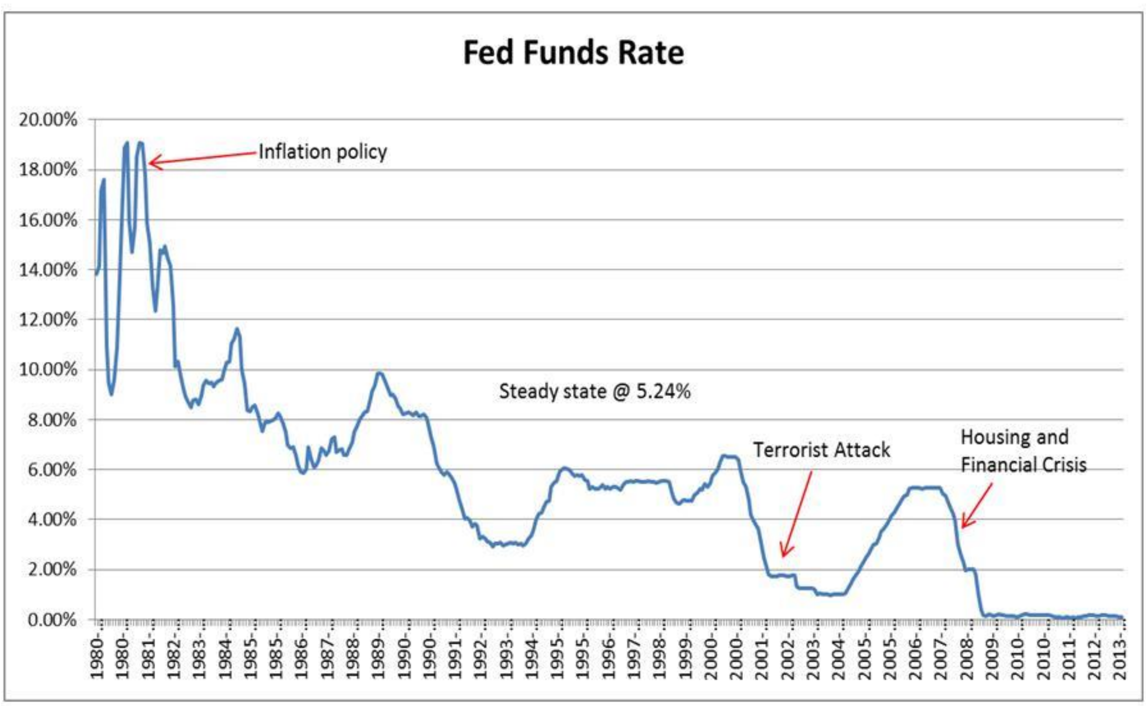
Interest Rate History and Stress Testing

One outcome of the recent U.S. economic crisis has been record low interest rates—for depositors as well as borrowers. This has been due in large part to the monetary intervention on the part of the Federal Reserve's zero interest rate policy and bond buying programs. As a result, interest rates on most deposits and loans have plummeted to record lows.

To be sure, for non-variable APR credit card programs, these have been salad days. Interest margins have probably never been higher and if credit losses are in check, things have never looked better. But these are unusual times. What will happen if (or when) funding costs go back to the steady state period of the mid-1990s? And what if funding costs approach the level of the early 1980s? It has been noted that almost $2 trillion in excess bank reserves are on deposit at the Federal Reserve. What will happen to inflation (and deposit rates) when those funds—now effectively out of circulation—are loaned out and rapid economic expansion occurs? And what happens to rates when the Fed pulls back on bond buying programs?

The following two charts illustrate that in a relatively short period of time, the level of interest rates can swing wildly. The first is the Fed Funds Rate which is often used as a proxy for short-term funding costs. The second is the National Median Monthly Cost of Funds Index which is an aggregate average cost for all sources of funding for lending institutions.

Figure 1: Fed Funds Rate 1980-2013



Source: Federal Reserve Bank—NY

Figure 2:
National Monthly Median Cost of Funds Index Starting from May of 1979

	1979	1980	1981	1982	1983	1984	1985	1986	1987
January		8.09	9.50	11.44	10.14	9.89	9.75	8.50	7.22
February		8.29	9.82	11.26	9.75	9.73	9.40	8.29	7.02
March		7.95	10.24	11.37	9.72	9.73	9.36	8.35	6.99
April		8.79	10.40	11.35	9.62	9.64	9.29	8.22	6.93
May	7.35	9.50	10.59	11.39	9.62	9.74	9.19	8.12	6.92
June	7.27	9.41	10.79	11.38	9.54	9.67	8.95	7.95	6.90
July	7.44	9.18	10.92	11.54	9.65	9.90	8.87	7.94	6.96
August	7.49	8.98	10.76	11.50	9.81	10.01	8.77	7.80	6.95
September	7.38	8.78	11.02	11.17	9.74	9.93	8.63	7.59	6.93
October	7.47	8.60	11.53	10.91	9.85	10.15	8.59	7.50	7.03
November	7.77	8.68	11.68	10.62	9.82	10.04	8.50	7.33	7.04
December	7.87	8.84	11.58	10.43	9.90	9. 92	8.48	7.28	7.11

	1988	1989	1990	1991	1992	1993	1994	1995	1996
January	7.12	7.52	7.90	7.48	6.01	4.44	3.87	4.44	5.01
February	7.11	7.59	7.80	7.33	5.78	4.34	3.76	4.49	4.90
March	7.13	7.71	7.82	7.30	5.63	4.31	3.81	4.69	4.92
April	7.12	7.84	7.75	7.16	5.48	4.24	3.81	4.79	4.87
May	7.11	7.99	7.58	7.07	5.38	4.18	3.85	4.91	4.87
June	7.11	8.01	7.66	6.94	5.25	4.10	3.86	4.93	4.82
July	7.14	8.07	7.68	6.85	5.13	4.09	3.91	4.98	4.87
August	7.21	8.08	7.66	6.76	4.98	4.04	3.97	5.01	4.87
September	7.21	8.02	7.59	6.61	4.84	3.96	4.01	4.98	4.84
October	7.29	8.01	7.63	6.53	4.74	3.95	4.11	5.03	4.89
November	7.35	7.99	7.59	6.40	4.59	3.90	4.17	4.92	4.76
December	7.40	7.92	7.54	6.25	4.51	3.90	4.32	5.01	4.87

	1997	1998	1999	2000	2001	2002	2003	2004	2005
January	4.92	4.96	4.63	4.63	5.22	3.79	2.83	2.22	2.27
February	4.79	4.85	4.57	4.67	5.17	3.65	2.73	2.15	2.30
March	4.90	4.92	4.54	4.68	5.09	3.55	2.70	2.14	2.34
April	4.89	4.91	4.53	4.73	5.01	3.48	2.62	2.12	2.39
May	4.94	4.91	4.48	4.83	4.90	3.38	2.57	2.08	2.43
June	4.90	4.87	4.48	4.88	4.78	3.32	2.50	2.09	2.48
July	4.96	4.90	4.47	4.96	4.68	3.28	2.41	2.09	2.54
August	4.97	4.90	4.46	5.05	4.59	3.21	2.36	2.11	2.61
September	4.92	4.85	4.49	5.09	4.45	3.13	2.32	2.15	2.67
October	4.98	4.84	4.52	5.13	4.27	3.10	2.28	2.16	2.74
November	4.93	4.77	4.57	5.20	4.09	3.00	2.25	2.18	2.82
December	4.97	4.74	4.60	5.21	3.90	2.90	2.22	2.22	2.86

	2006	2007	2008	2009	2010	2011			
January	2.94	3.71	3.74	2.78	1.98	1.48			
February	3.00	3.71	3.59	2.68	1.94	1.44			
March	3.06	3.74	3.45	2.62	1.90	1.43			
April	3.11	3.76	3.32	2.54	1.83	1.39			
May	3.21	3.79	3.22	2.48	1.80	1.37			
June	3.28	3.79	3.10	2.43	1.78	1.34			
July	3.35	3.81	3.06	2.36	1.74	1.31			
August	3.45	3.84	3.02	2.33	1.70	1.28			
September	3.52	3.85	2.99	2.26	1.66	1.25			
October	3.57	3.83	2.95	2.17	1.62	1.22			
November	3.63	3.81	2.89	2.13	1.57	1.20			
December	3.67	3.77	2.86	2.05	1.53	1.16			

Source: OTS—Monthly Cost Survey, 2011

If funding costs approach the steady state period of the mid 1990s—around 4-5 percent—what would happen to the margins and profitability of a non-variably priced credit card portfolio? A simple stress test is shown in Figure 3. Assume a non-variable 9.9% card portfolio is in place. If today's cost of funds rate is about 0.50% and jumps to 4.0% over some period of time (with everything else holding steady), the resulting 3.50% increase in funding costs drops straight to the bottom line. This could leave little profitability or even a loss for a product that the credit union counts on to return value to the member.

Figure 3: Sample Portfolio Stress Test Scenarios		
Line Item	COF @ 0.50%	COF @ 4.00%
APR (non-variable)	9.90%	9.90%
Finance Charge Yield (90% revolve)	8.91%	8.91%
COF %	(-0.50%)	(-4.00%)
Net Interest Margin	8.41%	4.91%
Other (net losses, operating income/expense)	(-4.41%)	(-4.41%)
ROA	**4.00%**	**0.50%**

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 the credit union and fairness to the member. Indeed, credit card products provide a unique win-win scenario in the sense that they are simultaneously key contributors to a credit union's capital base and a very important means of returning value to the member.

Time and again, Advisors Plus sees instances where credit card loans represent 5-10 percent of a credit union's assets but contribute 15-30 percent of the credit union's earnings. When managing such a vital engine for both profit and member satisfaction, it spotlights how extremely important it is to make the "right" decision on credit card pricing.

Seven Reasons Why Variable APRs Make Sense for Your Credit Union

Advisors **Plus** believes that variable contract APRs are a credit union's best choice because:

1. Credit union members—and consumers in general—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—either an increase or decrease—no additional disclosure is required to change the APR on an account (assuming, of course, that proper upfront disclosures have occurred.)

4. Using variable APRs avoids the trap of lending long and funding short, i.e., a mismatch of asset and liability pricing and duration.
5. The NCUA is highly focused on interest rate risk in its exams and is looking at all areas that can be negatively impacted. (The NCUA has become so concerned about interest rate risk in fact, that it 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."

Making the Change to Variable APRs—Two Possible Scenarios

Most of the discussion to this point has been on the simple choice of variable vs. non-variable APRs on credit cards. But what about the logistics of making such changes in real-world situations?

New Card Programs: For new programs just starting out, the decision 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 is solely 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 credit unions can be assured that they are building and growing a portfolio free from inherent interest rate risk.

Mixed-rate Portfolio Phase-ins: But what about the case of a currently successful card portfolio with non-variable APRs where management has growing concerns about future margin compression? **Here, Advisors Plus recommends that such a 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 the credit union on the path to reduced risk.

It may take time but the issuer will have peace of mind knowing that it is not making the risk pool any larger. Once this has been done, the credit union then has a choice of what to do with the non-variable APR accounts that have already been established:

- Leave existing accounts at their current non-variable APRs and manage them through attrition *OR*
- Re-price new transactions on existing accounts to use variable APRs[5]

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

The Attrition Approach: Note that the first choice 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 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 is because this strategy has several drawbacks beyond slower risk mitigation, namely, the need to maintain multiple disclosures and to train and service for multiple rate types.

The Re-pricing Approach: If the credit union feels that interest rate risk is its primary concern or if management feels that funding costs are going to rise sharply, it can opt for the second choice and 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 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.

While this scenario carries more chance of short-term cardholder irritation, reducing the immediate financial risks to the credit union will most likely outweigh the member services benefits of maintaining a legacy pricing approach. While displeased cardholders may react negatively to losing a "too good to be true card product," they may be less likely to "jump ship" than one might think. One simple reason for this is that their options for replacement low-rate, non-variable card products have all but vanished from the marketplace.

Where such offering do still exist, they require a new application, an unknown outcome and an uncertain impact on the applicant's credit score. In the final analysis then, changing to variable APRs in

[5] May involve change-in-terms, adverse action/risk-based pricing notices and six month review requirement depending on nature of actions taken

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

Decide to Protect Your Assets Using Variable APRs

Such dilemmas underscore that it is more important than ever for credit unions to offer the right product, at the right price to their members. The CARD Act has made it more difficult and expensive to switch gears. With the economy slowly turning and the specter of increasing interest rates on the horizon, however distantly, Advisors **Plus** believes that credit unions need to strongly consider variable contract APRs on their credit card portfolios and begin the work of transitioning their portfolios sooner rather than later. Remember that 15-30 percent of your credit union's earnings depend on you making a correct and timely decision!

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POV: Transitioning to Variable Rate APRs: A Look at How…and Why Now?

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.**