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Editorial Perspective:
Move NOW to Variable Rate APRs: Here's Why and Here's How

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by Christopher D. Joy

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Credit unions often ask us at Advisors **Plus** if they should price their credit card APRs on a variable or non-variable basis. It's a conversation that our Credit Consulting team has always welcomed—even in tranquil economic times—because we believe strongly in the vital importance of matching a credit card portfolio's funding and pricing approaches.

Unstoppable Force (Interest Rates) Meets Immovable Object (CARD Act)?

Recently however, the discussion has taken on much greater urgency for us at Advisors **Plus**. We believe that projected rises in interest rates and funding costs (regardless of their precise timing) are on a trajectory to intersect the restrictive portfolio re-pricing provisions of the 2009 CARD Act with potentially negative results for credit unions whose card portfolios still contain non-variable APRs.

There's a lot at stake here because it is not uncommon for credit card loans to represent five to ten percent of a credit union's assets while contributing 15-30 percent of the credit union's earnings.

Don't Delay Your CU's Migration to Variable Rate APRs

That is why Advisors Plus is recommending that credit unions begin to protect their profitability and reduce their risk by marketing all new credit cards with variable APRs, while taking steps to migrate existing portfolios toward variable APR pricing as well. Strategically, now is the best time to take steps to mitigate this risk while there is interest margin stability and before funding costs start to creep upward.

We will explain in greater detail below:

- How variable rate APR pricing can guard your credit union's profit potential by maintaining pricing flexibility and,
- How to implement two potential action plans for re-pricing an existing portfolio.

Playing the Hand the CARD Act Has Dealt You

The CARD Act has dramatically restricted credit card portfolio re-pricing options in ways that can easily be accommodated now when rates are low but could become a dicey proposition for a portfolio with non-variable APRs in a rising rate climate.

Without the ability to change the APR on existing balances, card issuers have to gamble that the non-variable APR they adopt will provide enough margin to cover a range of potential funding costs while still remaining profitable.

7 Outstanding Reasons to Use Variable APRs

With regulatory limitations in place and funding costs likely to increase over the next few years, Advisors **Plus** believes that variable APR credit cards offer the best balance of protection to credit unions and fairness to their members for seven key reasons:

1. Credit union members understand variable APRs and how they work.
2. Variable APRs let credit union issuers offer members the lowest possible rates because they do not need 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).
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.
6. Variable APRs help avoid decreases to capital 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 contribution.
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.

Ready for Action? Choose from These Two Plans

Now that Advisors **Plus** has clarified the value behind the move to variable rate APR's let's focus on the logistics of rolling out changes to your card portfolios. There are two possibilities, each with its own pros and cons.

- ***New Card Program****:* The process is easy for a new program since variable APRs can be employed from the beginning and your credit union can be assured that it is building and growing a portfolio free from inherent interest rate risk. The emphasis rests entirely on matching the right product set with the right price points and margins.
- ***Mixed-rate Portfolio Phase-in****:* A more complex scenario is a currently successful card portfolio with non-variable APRs in its mix where 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.

Once your credit union is confident that it is not growing its risk pool, it now faces the decision of how to handle existing non-variable APR accounts. You can use:

1. An ***attrition approach,*** which leaves existing accounts at their current non-variable APRs and allows them to phase out over time,
   OR
2. A ***re-pricing approach****,* which re-prices new transactions on an existing account using variable APRs. This 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:

1. ***The Attrition Approach*:**
   - Slower but avoids potential cardholder confusion and complaints.
   - Interest rate risk will still be present in the existing portfolio; will transition only as fast as old accounts phase out and new accounts grow.
   - **Bottom line: Credit unions should consider this approach only if they value reducing negative cardholder feedback over risk mitigation.**

2. The Re-pricing Approach:

- To be used if interest rate risk is a credit union's primary concern or if management feels that funding costs are going to rise sharply.
- The immediate change to cardholders is negligible if the new variable APR is the same as or lower than their current non-variable APR. (Issuers can afford to do this since they will no longer have to cover the wide range of funding cost contingencies associated with a non-variable price point. They should also be willing to accept less margin income in exchange for more certainty.)
- While this scenario potentially risks short-term cardholder irritation, displeased cardholders will be unlikely to jump ship since low-rate, non-variable card product replacement options have all but vanished from the marketplace.
- **Bottom line: While substituting variable APRs for non-variable APRs should not be undertaken lightly, it is not a member services line that can never be crossed either.**

Protect Your Profitability Using Variable APRs

Credit unions have differentiated themselves versus the Big Banks by offering the right product at the right price to their members, but a landscape that includes the restrictions of the CARD Act has made it more difficult and expensive to switch gears.

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With the specter of rising interest rates on the horizon, Advisors **Plus** believes that credit unions need to protect their profits and minimize their risks by beginning the vital work of transitioning their portfolios to variable APRs. Some portion of the 15-30 percent that their credit card portfolio currently contributes to earnings hangs in the balance!

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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.**