



Take These 6 Steps BEFORE New Card Pricing Rules Hit

Acting before proposed credit card pricing regulations take effect can help you comply—and compete

Number 14—March 2009

Regulators are quickly adapting to the immense changes in the economic markets affecting both institutional and consumer lending. In an effort to soften the impacts of interest rate changes on consumer credit cards, US regulators are poised to modify legislation regarding the timing and conditions required for APR adjustments. Additionally, the new regulations will impact payment assessment hierarchies and provide new limitations on subprime fee assessments.

The ability to re-price the terms of consumer credit products based on behavioral risk is a vital tool that many portfolio managers leverage in balancing risk and reward. With the landscape changing, many questions have surfaced regarding how revenue can be maintained while staying compliant with the newly proposed pricing regulations.

This white paper addresses:

- How the new regulations could impact customer pricing and profits
- What steps you should consider taking before these regulations are implemented
- Modifications that you should consider in account management strategies using FICO® TRIAD® Customer Manager

Your FICO consultant can be a valuable resource in preparing pricing strategies that will help you adapt and comply with regulatory changes.

» INSIGHTS**» Background**

On December 18th, The US Office of Thrift Supervision, National Credit Union Administration and the Federal Reserve jointly passed a new set of card-industry rules that are scheduled to take effect in July 2010. These changes can be broken down into the following areas:

1. Interest Rate Changes

Issuers are permitted to increase a rate at the expiration of a specified period, or if the consumer is more than 30 days delinquent. Once an account has been open a year, Issuers must provide 45-day written notice before implementing pricing changes on customers. This is an increase from the current requirement of 15 days. Increases apply only to balances related to new transactions unless the account is 30 days past due.

2. Reasonable Time to Pay

Customers must have at least 21 days to pay their bill before being considered late.

3. Payment Allocation

Issuers will be required to apply any customer payment beyond the minimum payment proportionately to all balances or to the balance with the highest interest rate on the account. They will no longer be permitted to pay down the balance with the lowest interest rate first.

4. Double-Cycle Billing

Issuers are no longer permitted to engage in double-cycle billing, in which they levy new finance charges based on balances associated with previous billing cycles.

5. High-Fee Subprime Cards

A cap will be placed on total fees permitted on sub-prime customers, particularly those with secured cards.

The new regulations can be found online on the US Department of Treasury website. To view an executive-level summary of the rules, go to: <http://files.ots.treas.gov/482006.pdf>

To view the entire content of the new regulations, go to: <http://files.ots.treas.gov/482007.pdf>

The moment these regulations are enacted, issuers will experience a significant loss in the pricing flexibility they enjoy today. They will not be able to act as quickly in response to changing customer status, nor will they be able to easily price to risk among non-delinquent customers. Furthermore, many issuers will see a significant reduction in interest revenue among those customers who carry balances month over month.

In the face of such revenue impacts, issuers may find themselves looking for new ways to increase revenue; perhaps with the introduction of new fees or fee structures. Decisions made early in the lifecycle will become even more critical in the overall profitability of an account.

It is recommended that issuers begin the process of reviewing these new regulations within their Legal, Risk and Finance departments. Now is the time to specifically assess the impact to business and develop a plan for ensuring compliance.

» INSIGHTS

» **Using Performance-Based Pricing Today**

For portfolio managers who are leveraging the Performance-Based Pricing module in FICO® TRIAD® Customer Manager or a similar account management framework, the underlying strategies will need some modification to reflect the new regulations. As with any business logic change, historical data should be examined. Predictive analytics often need to be monitored, adjusted and potentially updated or replaced. The execution of any adjustments will need to be rolled-out in a cautious and calculated manner with comprehensive data showing the effect of the proposed change on representative segments of the targeted population.

1. Analyze historical data and simulate the financial impact to understand the area of opportunity given the shift in pricing regulations.

From this information, new segments can be identified for potential treatment. A revised analytic approach that incorporates a prediction of future balance growth is essential to driving profit. Once treatment segments are identified, changes can be rolled out on a test population of accounts. Careful tracking of the new business logic is essential to quantify the impact upon the various behavior components that will influence profitability.

Performance measures in the area of delinquency, attrition and profit, among others, are essential to guiding a sound and profitable strategy. When redesigning and tracking new and existing pricing strategies, the pro forma and profit calculations for performance metrics will need to be updated. In short, certain accounts will no longer be as profitable as they were prior to July 2010, and analysis methodologies will need to reflect this. Internal analysis groups should be made aware of how customer profitability has changed for all future work.

Assumptions may also be challenged in future analysis. For example: credit losses in some segments may be positively impacted by the regulations. Some customers will be better able to pay without the burden of higher interest rates. Some organizations may be more willing to negotiate lower rates for clients who are experiencing financial difficulties when they are not driven by aggressive punitive pricing policies. Total delinquency amounts may be lower as a result of less interest accumulating.

2. Review existing pricing decision trees to confirm they are in compliance with the new regulations.

The areas of focus here will be on any portion of the decision tree that increases APR for accounts that are less than 30 days delinquent¹. Issuers may need to either stop increasing interest rates for this population or find other solutions, such as issuing a change in terms that stipulates an increase in APR after a set number of days have passed, as is currently done with introductory and backend pricing. Furthermore, timing parameters will need to be reviewed to ensure pricing actions are communicated at least 45 days in advance.

3. Evaluate how to use additional data elements in your account management business logic to ensure compliance with the new regulations.

For example, issuers may want to consider leveraging elements like "Cycles Delinquent" in a pricing decision tree to ensure that no customer less than 30 days delinquent receives an interest rate increase. Other data elements could be used to assist with measuring the revised customer profitability. These would include: interest income in the past 12 months, times overlimit in the past 12 months and finance charges in the past six months.

¹In this case "30 Days Delinquent" means 30 days after the customer has missed a first payment obligation

» INSIGHTS

- 4. Consider implementing a portfolio-wide risk assessment and re-price the entire portfolio for risk prior to July 2010.** This would represent a final opportunity to price specific segments of the customer population for risk.
- 5. Discuss with your Legal department whether a change in terms is required for new and existing customers, to ensure that pricing practices are in compliance with the new regulations.**
- 6. Analyze how these changes will impact interest revenue and have a clear understanding of how much money will be lost once these regulations are implemented.** This will be the first step in developing new strategies that may compensate.

» **Making Up for Profits Elsewhere in the Lifecycle**

The removal of incremental interest income on existing balances will undoubtedly reduce portfolio profitability as it relates to performance-based pricing programs. However, other portfolio management tools can be employed to help manage risk and increase profitability.

As accounts are approved, through the origination process, initial account terms are set. Since pricing adjustments downstream will not impact prior spending, decisions about the initial APR will require methodical and extensive testing using a high degree of analytical sophistication. Analytical predictions at the point of origination will become increasingly important. There are many factors (balance growth, acceptance, usage, delinquency and attrition) that will impact a radical change in the underwriting and product design strategy. However, with the use of strong and targeted analytics focusing on the performance of these factors, overall interest income can be managed better upfront to help offset the lost opportunity of downstream pricing adjustments.

Delinquent balance growth and charge-off losses can also be mitigated through the effective use of credit line reduction programs. A multi-dimension strategy will need to be applied that looks not only at the risk or loss, but also at the impact of potential attrition. Attrition dynamics are expected to change among the impacted population. Good customers who can transfer their balances elsewhere will likely not transfer their entire old balance. Instead, they may gradually pay down their "old" balances since the interest rate cannot be changed. Of course, despite this payment behavior, these customers would be unlikely to use their cards for future purchases. This may prove an advantage to issuers because it is likely to slow balance attrition for good customers.

A comprehensive approach to an account's pricing strategy must be analyzed across the lifecycle. Decisions made earlier in the lifecycle, when balances are lower, will become increasingly important throughout the life of the account. While these new regulations will force lenders to pay closer attention and apply more analytic rigor around the initial account terms, the effort to collect delinquent balances may be eased due to lower balances as a result of the fixed interest rate.

» **INSIGHTS**

» **Jumping in the Game**

Many portfolio managers may not be applying performance-based pricing treatments. With the new regulations aiming to change the game, now may be the best time to leverage pricing adjustments as a tool for increasing interest income to offset risk. Insights from an untreated portfolio data set will be immensely valuable in determining the right segments of customers to apply APR increases or decreases.

» **Conclusion**

As the regulatory and economic landscape changes, issuers must be prepared to face these challenges and the impacts they will have on business. FICO can assist your business in meeting those challenges. With decades of experience and up-to-date information on current industry trends, FICO consultants can provide more detailed guidance and analysis specific to your business. Contact your FICO strategy consultant today to get started.

The Insights white paper series provides briefings on research findings and product development directions from FICO. To subscribe, go to www.fico.com/insights.

For more information

US toll-free
+1 888 342 6336

International
+44 (0) 207 940 8718

email
info@fico.com

web
www.fico.com