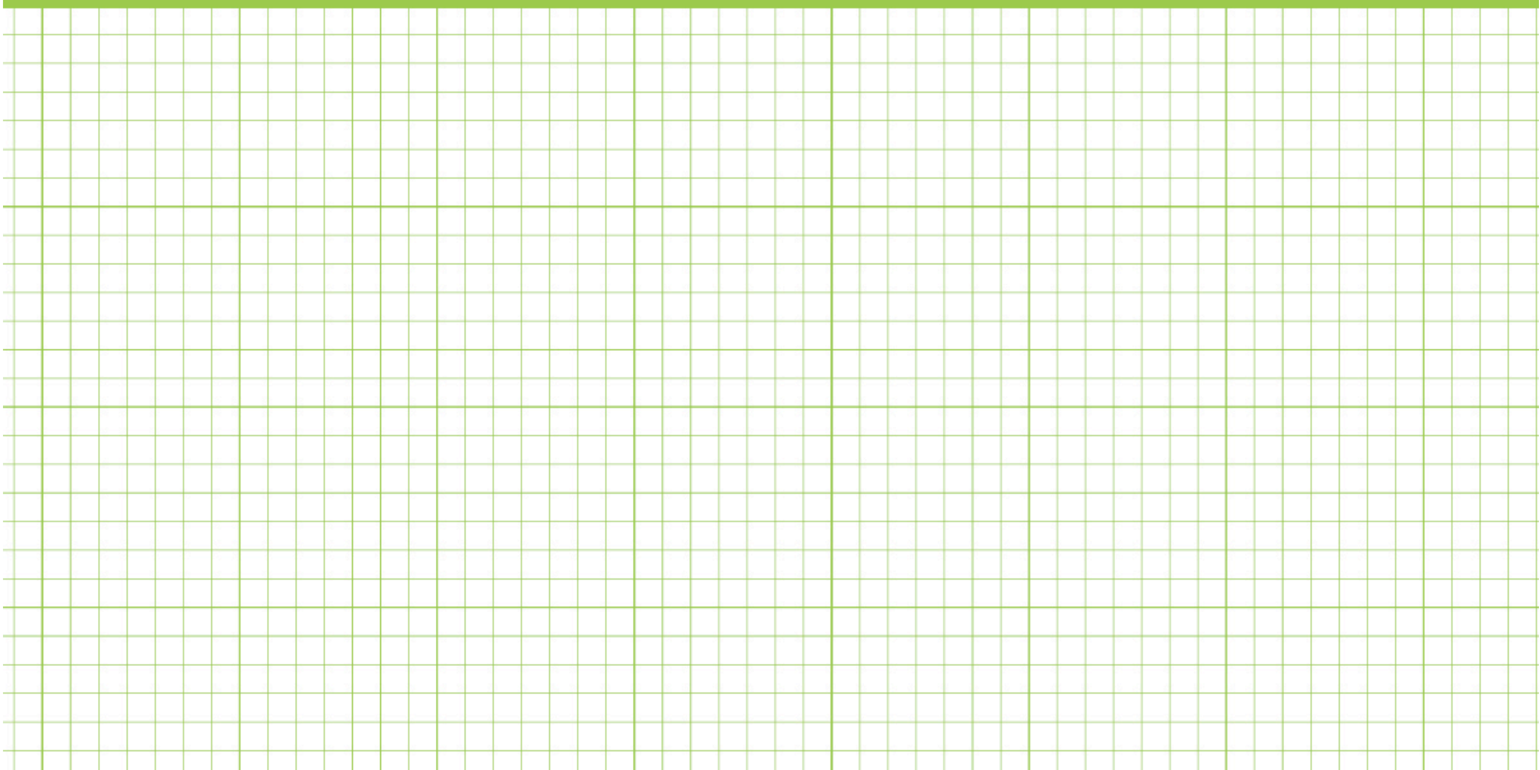
CONCEPT DOCUMENT



INTRODUCTION

Prior to today's economic conditions, consumers were struggling to pay down credit card debt. In a 2008 Javelin survey, 28 percent of cardholders said their ability to pay off their credit card balance had become more difficult ("Credit Card Issuer Profitability in a Difficult Economy," July 2008). This problem was likely exacerbated by recent changes in credit card regulations, which triggered a number of card issuers to increase interest rates and fees. An increased interest rate generally decreases the amount available to pay down the principal balance, resulting in longer repayment periods and increased credit costs.

In the fourth quarter of 2008, 13.9 percent of consumer disposable income went to service credit card debt (U.S. Congress' Joint Economic Committee, "Vicious Cycle: How Unfair Credit Card Company Practices Are Squeezing Consumers and Undermining the Recovery," May 2009). The average outstanding credit card debt for households with a credit card was $10,679 at the end of 2008 (Nilson Report, April 2009). Using this average, at an interest rate of 16.36% (average overall market rate per Credit Card Monitor, January 2010) and a monthly payment of 2% of the balance, it would take approximately 38 years to repay the total amount owed. And, the total interest repaid over that 38 year period would be $21,417 (Federal Reserve Credit Card Repayment Calculator).

EXECUTIVE SUMMARY

THE BIG PAYOFF LOAN helps members responsibly "chip away" at their credit card debt by structuring repayment using the debt snowball concept and a low fixed interest rate. The concept is to encourage overall debt reduction versus simply consolidating debt, and the small loan commitment should help credit unions avoid excessive losses while offering the program.

OPPORTUNITY

Today, lenders are far less willing to help someone consolidate credit card debt given increased credit losses (OCC Survey of credit Underwriting Practices 2009). That door has closed, so to speak, for a number of borrowers. Additionally, the prospect of trying to repay a significant amount of credit card debt can be daunting for some consumers, especially if they do not possess the knowledge of how to best apply excess funds when making payments (lowest balance, highest rate, equal amounts across the board, etc.). In some cases, this simple decision about how to repay debt can be the difference between success and failure.

What if a credit union could offer an unsecured consolidation loan product that mitigates credit risk, while creating a debt repayment plan that includes a low-fixed interest rate, budgeting, and an incentive for overall debt reduction? That product now exists and it is called THE BIG PAYOFF LOAN.

ENVIRONMENTAL SCAN

A number of programs currently exist to help borrowers with high unsecured credit. The benefits and drawbacks of each program are listed below.

Traditional Balance Transfer Programs

A lender advances funds from the consumer's credit card to payoff another credit card(s) or consumer debt. The typical fee for this service is approximately 3% of the amount borrowed. The interest rates vary from lender to lender, but in many cases, the rate is not fixed for life and may be a teaser rate. Minimum payment amounts generally range from 2% to 3% of the balance. While the borrower may receive a lower interest rate when compared to their prior obligation(s), the small minimum payment allows for slow repayment of the balance.

Debt Consolidation Loans

A lender, through either an unsecured or secured loan, pays off a consumer's credit card and/or consumer debt. Lenders offering large unsecured debt consolidation loans are rare, but they do exist. However, these lenders commonly charge high interest rates and fees. A more common approach is for the consumer to pledge collateral, such as a home. Home equity loans and first mortgages were once very popular options for debt consolidation. The borrower could consolidate his or her debt and obtain a much lower interest rate and monthly payment. However, the lower payment is mostly the result of an extended repayment period. While the borrower may have improved his or her monthly cash flow, they have also extended the life of their debt and will pay a significant amount of interest over time if they make only the minimum monthly payment.

Debt Management Programs (i.e. CCCS)

A Debt Management Plan (DMP) is another option for paying unsecured debt, where a third party organization reviews a consumer's obligations and cash flow, and then re-negotiates a lower interest rate and payment amount with the issuer of the debt. Once the plan begins, the borrower generally makes one payment to the third party, who then distributes the funds to the lenders. When lenders agree to the plan, it is with the assumption that a reduced payment amount/interest rate will increase the likelihood of repayment. Third parties who assist with a DMP typically charge the consumer an upfront and/or an ongoing administrative fee for their service and will also take a percentage of the negotiated payment amount, known as a "fair share" (essentially paid for by the lender). While it is rarely disclosed in advertisements, someone's credit rating can be impacted by a DMP, as the borrower is not fulfilling their contractual obligations with the lender. Additionally, the common complaints about a DMP include unscrupulous third parties who take an exorbitant amount of the monthly payment as a fee, along with companies who fail to send payments to creditors on time, which can result in a negative credit rating.

Debt Settlement Services

A debt settlement company negotiates with a lender on a borrower's behalf to reduce the amount owed in exchange for immediate payment. Generally speaking, a borrower must be in default before a lender will consider a settlement offer. Typically, to qualify for a debt settlement, the consumer must have a lump sum of cash, which is approximately 30% to 50% of the amount owed. If the borrower does not have this amount, a debt negotiation company may offer a long-term savings plan (trust account). Once the amount is sufficient, an offer to the creditor is made (however, by then, the consumer may have already been sued by the creditor). Fees for debt settlement services can be very costly and a number of states outlaw debt settlement services altogether. Additionally, debt settlement can be very damaging to a consumer credit file, as the account is typically in default when the negotiations begin, and if a reduced amount is agreed to, the creditor can report this as a settled account. Lastly, settled debt is the same as forgiven debt, and in most cases, must be reported to the IRS as taxable income (1099-C).

SOLUTION

A creative way to repay credit card debt is using a debt snowball plan. In a debt snow plan, a borrower puts all excess funds towards their smallest balance debt until it is fully repaid, while making minimum payments on other balances. After the smallest balance is repaid, the full amount that was being paid towards that balance is then paid towards the next lowest balance, in addition to the current minimum payment. This cycle is repeated until all debt is repaid. In theory, the debt snowball concept works because the consumer quickly reduces the number of accounts outstanding and feels as though progress is being made. This is why current interest rates are not a consideration.

Using the debt snowball concept, THE BIG PAYOFF LOAN was designed for consumers who have a desire to reduce their unsecured debt, but lack the financial discipline or know-how to do so. In the program, the borrower transfers a percentage of their unsecured debt to a 12-18 month personal loan at a low fixed interest rate. If the borrower succeeds at paying down this portion of the debt, the credit union would then advance additional funds to pay down another portion of their debt (up to the original amount approved). This cycle repeats itself until all debt is repaid. If during the course of the program the borrower fails to pay as agreed or fails to reduce their overall unsecured debt, the borrower would not be eligible for future advances.

MEMBER BENEFITS

- Inexpensive and easy to understand method of repaying credit card debt, using the debt snowball concept.
- Quick reduction in the total amount owed, creating a greater sense of accomplishment.
- Low-fixed interest rate – no gimmicks or surprises.

CREDIT UNION BENEFITS

- Help members pay down credit card debt without significantly increasing credit risk.
- Increase member loyalty.
- Quick and simple implementation.
- Generate interest income.
- Marketing materials, budget spreadsheet, interview guide, and generic loan documents provided by i3.

TARGET MARKET

Borrowers who have at least $2,500 or more in credit card debt (but no more than $15,000), a desire to payoff their debt in its entirety, sufficient cash flow to service their existing debt, and stable credit (positive history of repaying like amounts).

OPERATIONAL AND OTHER CONSIDERATIONS

Credit Risk

Being unsecured, this product creates credit risk. However, that risk is somewhat mitigated as the credit union does not take on all of the consumer's debt, as is the case with a debt consolidation loan or a traditional balance transfer. Instead, the credit union assumes only a small portion of the debt, and therefore has less exposure should the borrower default on his or her obligation. Additionally, part of the approval process requires a budget be completed to validate whether or not the borrower can repay the amount borrowed. While budgets are never perfect, this additional step, along with financial coaching, should result in reduced losses. In exchange for this reduced risk, the credit union would grant a lower, fixed interest rate.

Loan Terms

A credit union offering the program must decide on several variables before implementing. Items to be considered include:

- Max term (12 to 18 months recommended);
- Maximum/minimum loan amounts ($2,500/$1,000 is recommended);
- Application fee (if any);
- Interest rate (s/b fixed; can be risk based priced);
- Credit score minimum (if any);

- Initial or ongoing credit counseling/coaching;
- Budget required (recommended to confirm sufficient cash flow)
- Requirements for additional advances; and
- Additional underwriting criteria as required by the credit union.

Policy requirements such as portfolio limits and allowance for loan loss allocation should also be considered.

PROOF OF CONCEPT

- Unitus Community Credit Union
  - Beta launched to employees in late March
  - Member pilot launches in April
- Land of Lincoln Credit Union
  - Employee/member pilot launches in April
- Wright-Patt Credit Union
  - Pilot launches in April

GETTING STARTED

1. Select program guidelines (see above).
2. Create policies and procedures.
3. Create/update loan documents, as required.
4. Create new loan type in application/host system, as applicable.
5. Train frontline staff to recognize candidates for the program.
6. Market the program.

MARKETING TACTICS

A simple and inexpensive method to generate leads is to train front-line staff to pre-screen potential applicants (in addition to or in place of the product the member originally applied for). Depending on the interest rate set by the credit union, the most likely candidate will be someone with an acceptable debt-to-income ratio (by the credit union's standards), a credit score between 650 and 740, and credit card debt in excess of $2,500, but not more than $15,000.

Another option is to order a pre-screen through a credit bureau in order to identify candidates meeting the credit union's criteria. However, a pre-screen requires a firm offer of credit be extended to the borrower, so credit unions choosing this method should carefully consider their credit-based qualifications before finalizing their program (to ensure adequate risk mitigation).

Lastly, a credit union could use traditional marketing channels, such as statements stuffers, branch signage, websites, and mass media, such as radio and television. It is recommended that a credit union apply some level of segmentation to reduce overall marketing costs, as the program is unlikely to generate significant income (more goodwill and loyalty than profitability).

Free turn-key marketing materials have been designed and provided by i3. Participating credit unions are required to use program trademarks and logos. A website was also designed to promote the program and provides consumers a list of credit unions who offer the product: www.bigpayoffloan.com.

PROJECT TEAM

Filene i^3 is a creative group of insightful and energetic credit unions professional who develop new ideas, innovate, and implement for the benefit of the credit union system. Please visit filene.org/home/innovation or email innovation@filene.org to learn more. The team members who developed this idea are:

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