

SPECTRUM

AN ELECTRONIC REPORT FROM THE CUNA LENDING COUNCIL

MITIGATING BANKRUPTCY LOSSES—IS IT POSSIBLE? PART II

Fawn Terwilliger, SVP Lending, USE Credit Union, San Diego, CA

**CLC FIFTH ANNUAL
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Personal bankruptcy has become the leading consumer credit problem accounting for nearly half of all charge-offs for many lending institutions. With consumer bankruptcy filings resulting in billions of dollars in losses to the credit industry, the bankruptcy problem is impossible to ignore. Compared with charge-offs or other types of losses, bankrupt consumers use higher rates of credit, resulting in a higher loss per account. Since most bankruptcy losses cannot be recovered without costly litigation, the net loss associated with bankrupt members is often higher than the net loss associated with other non-paying members. Unfortunately, the combination of relaxed consumer attitudes towards bankruptcies and the lack of significant changes in bankruptcy legislation almost assure that the problem will continue.

The March, 1999, issue of *Spectrum* featured an article on mitigating bankruptcy losses via tools available from various credit reporting agencies. This past issue featured Equifax's Bankruptcy Navigator Index 99 product. This issue features information provided by Experian on their Bankruptcy Model that protects lenders against bankruptcies and other high dollar losses.

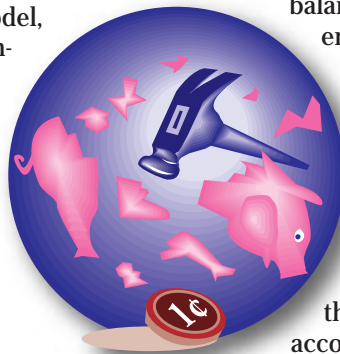
Building on the success of the original Bankruptcy Model, Experian introduced the recalibrated Experian Bankruptcy Model in 1998. The new Bankruptcy Model, developed with a more recent sample of data from the Experian database, uses advanced modeling techniques to significantly improve the identification of bankruptcies and other losses. This model can help you reduce your exposure to loss, stimulate revenue and allocate resources more effectively. The model indi-

cates the likelihood that a consumer will become bankrupt, seriously delinquent or a charge-off in the near future. Using this information, you can design policies that give your low-risk members preferential treatment while reducing exposure with high-risk members. In conjunction with the Experian Credit Profile report, the Bankruptcy Model score can help you make consistent and accurate risk evaluations.

The model was empirically derived by analyzing a sample of more than 7.5 million consumer credit files from the Experian database. Within this sample, Experian identified two groups of accounts based on their payment behavior; Goods - accounts that were never 60 days past due or more within the previous 12 months, and Bankrupts (or bads) - accounts that had filed for bankruptcy within the previous 12 months. These good and bad performing accounts were identified in June, 1997, and then evaluated, as they appeared 12 months earlier, in June 1996. This point in time is called the observation date.

Predictive Characteristics

More than 350 different predictive characteristics, or variables, were evaluated as they appeared at the observation date. These characteristics included items such as length of time in file, the number of recent inquiries, balance to limit ratios and the presence of delinquent or derogatory accounts. Since the future performance of these accounts was known, characteristics most predictive of future credit behavior could be isolated by comparing how these characteristics appeared in the Experian Credit Profile reports of the good accounts and bankrupt accounts.



Outcome Period

The *outcome period* is the amount of time between the observation date, when the Experian Credit Profile reports were analyzed, and the performance date, when the performance was measured. Because the Experian Bankruptcy Model was developed using a 12-month outcome period the model performs best when identifying losses likely to occur over the following 12 months. However, validations have shown that Experian Bankruptcy Model scores also perform well over longer time periods. Many creditors prefer a 12-month outcome period since it provides sufficient early warning to minimize or prevent loss and complements most portfolio review procedures that evaluate accounts annually or more frequently.

Multiple Scorecards

The Experian Bankruptcy Model uses *multiple scorecard technology* to improve predictive accuracy. This advanced technology segments the total consumer credit population based on credit history. Experian completed a sophisticated analysis of the development sample to determine the optimal number and type of sub-populations for grouping the Experian Credit Profile reports. Each account in the development sample could fall into only one group. As a result of this analysis, the following six specific *sub-populations* were isolated.

- **Building credit history:** This scorecard evaluates consumers who are just beginning to use credit. These consumers do not have an extensive payment history and have only a few credit accounts.
- **Active credit history:** Some consumers use a wide variety of credit very actively. This scorecard is specifically designed to evaluate these heavy credit users.
- **Finance company:** This industry-specific scorecard evaluates consumers who have credit primarily from consumer finance companies.
- **Department store:** This industry-specific scorecard evaluates consumers who have credit primarily from department stores.
- **Bankcard:** This industry-specific scorecard evaluates consumers who have credit primarily from bankcards.
- **Diverse credit backgrounds:** This scorecard evaluates consumers who use credit from many different industry sources.

By using six scorecards, the model better analyzes the characteristics that are most pre-

dictive for each sub-population. Although there are six scorecards, only one is used to score each Experian Credit Profile report. The content of the Profile report determines which scorecard is selected. Each Experian Bankruptcy Model score indicates the same level of risk, regardless of which of the six scorecards calculated the score.

Calculating the Bankruptcy Model Score

To calculate the score, the Model isolates the consumer's credit characteristics and compares them to the appropriate scorecard. Every characteristic receives a certain positive or negative point value. The sum of these points represents the model score. The score indicates the relative risk to the consumer as evaluated by the Experian Bankruptcy Model. The score ranks risk, meaning that a consumer with a score of 725 is riskier than a consumer with a score of 690. Remember, the higher the score, the higher the relative risk of the consumer.

Score Factor Codes

After the score is calculated, Experian identifies up to four characteristics that had the most negative impact on the score. Score factor codes are displayed in order of their affect on the score. A score factor may display if the consumer scores higher than the development sample average for that characteristic. When you take adverse action as a result of policies based on the model score, you must communicate the meaning of these score factor codes as reasons for adverse action to the consumer.

Score Ranges

The Model scores range from a low score of 108 to a high score of 1,200 + (with an absolute maximum of +1257). The lower the score the lower the credit risk; the higher the score, the higher the credit risk. In general, the amount of risk doubles with every 100 points.

Files That Do Not Receive a Score

The model requires certain minimum criteria to generate a score. An Experian Credit Profile report that contains any public records or inquiries will not receive a score. If a Profile report contains *tradelines* that have not been updated within the last 12 months, a Bankruptcy Model score will not be computed. ♦

A future issue of Spectrum will feature TransUnion's bankruptcy predictor product.

CUNA LENDING COUNCIL SCHOLARSHIP OFFER

The CUNA Lending Council is pleased to offer ten individual scholarships for up to \$500 each to worthy credit union lending staff to attend the CUNA Lending Council Conference or CUNA & Affiliates Center for Professional Development (CPD) Lending School. The program is intended to provide access to education for lending staff in credit unions that do not have the financial ability to send critical staff to the necessary schools. The requirements for eligibility as well as the process are summarized below.

Eligibility Requirements

Eligibility for a CUNA Lending Council Scholarship requires:

1. Assets for the credit union of \$50 million or less;
2. One scholarship per credit union per year;
3. Credit union must demonstrate a financial need;
4. Scholarship request must be for the CUNA Lending Council conference or a CUNA & Affiliates, Center for Professional Development, Lending School.

Selection Criteria

A scholarship committee will select the winners based on asset size, skills need, and financial need. All decisions are final.

Awards

A total of ten individual scholarships will be awarded for the 1999 calendar year. Each award will be for up to \$500, and can be used for combined expenses relating to the course or conference. Scholarships will be approved prior to attendance of the school, but reimbursed after proof of attendance is provided.

Application

Request the application from:
CUNA Lending Council Scholarship Committee
C/O Joe Brancucci
Boeing Employees' Credit Union
12770 Gateway Drive
Tukwila, WA 98168
(206) 439-5957
jbrancucci@becu.org

The instructions for completion of the application will accompany it. Entries must be postmarked at least 45 days prior to the starting date of the school you desire to attend. Scholarship winners will be notified no later than 30 days prior to the starting date of the school. ♦

DOES YOUR MARKETING DEPARTMENT UNDERSTAND REGULATION Z?

John Zasada, Consultant, National Financial Institutions Consulting Group of McGladrey & Pullen.

One of the more misunderstood areas of regulatory compliance involves loan advertisements. Hardly a day goes by when we are not asked by a credit union whether their loan advertisement is "in compliance". The most common questions we receive are:

- * What is a "trigger term"? If we state an APR in an advertisement, does it trigger further disclosures?
- * If we state that there are no annual fees in an advertisement, does it trigger further disclosures?

The answer to these questions can be found in Regulation Z and the accompanying commentary. Let's make some sense of the requirements and provide framework for credit unions to use in applying the regulation.

WHAT IS AN AD?

Regulation Z defines "advertisement" as a commercial message in any medium that promotes, directly or indirectly, a credit transaction.

Examples of advertisements include messages in a newspaper or magazine and messages on share draft account statements. Regulation Z specifically excludes direct personal contacts, such as follow up letters, from the definition of advertisement. Unlike Truth in Savings (NCUA Rules and Regulations Part 707), Regulation Z contains no exceptions for lobby boards from the advertising requirements.

THREE REG. Z RULES

Regulation Z contains three general rules.

These rules are applicable to all open-end loan plans.

Clear and Conspicuous—Disclosures must be legible and clearly understandable. However, Regulation Z does not require that credit terms be printed in a certain type size or in any particular place in the advertisement.

Available Credit—A credit union can only advertise products and services, which are actually available. “Bait and switch” tactics are not allowed. For example, you cannot advertise a rate of 8%, if it would not be available to members.

Misleading Advertisements—Advertisements must fairly represent the products and services available.

A “trigger term” simply means a term, which, if included in an advertisement, triggers the disclosure of more terms. An important aspect of Regulation Z’s advertising requirements is determining what is a trigger term. Whenever a trigger term is stated, it must be accompanied by certain disclosures.

We break the advertising requirements in to three groups: open-end credit, home equity lines of credit (HELOC) and closed-end credit.

For open-end credit, the following terms are considered trigger terms:

1. The periodic rate used to compute the finance charge or the Annual Percentage Rate (APR). An example is “9% APR.”
2. A statement of when the finance charge begins to accrue, including the grace period, if any. An example is “25 day grace period.”
3. The method of determining the balance on which finance charge may be imposed. The statement “Interest will be calculated using the daily balance method” is a trigger term.
4. The method of determining the finance charge, including a description of how any finance charge other than the periodic rate, will be determined. Statements such as “\$2 cash advance fee” and “2% origination fee” are trigger terms.
5. The amounts of any charge other than a finance charge. Examples include “\$25 membership fee” and “\$10 annual fee.”

Required Disclosures

If an advertisement of open-end credit contains a trigger term, it must also state the following disclosures:

1. Any minimum, fixed, transaction, activity or similar charges.

2. The periodic rate expressed, as an annual percentage rate (APR), and if the rate is variable, that fact.

3. Any membership or participation fees.

One of the biggest differences between home equity lines of credit and other open-end credit plans is the treatment of negative terms. Unlike other open-end plans, triggering terms apply if they are stated affirmatively or negatively for home equity lines of credit.

The following terms are considered trigger terms in advertisements for home equity lines of credit:

1. The periodic rate used to compute the finance charge or the APR. Examples include “Home equity loans at 9% APR” and “Pay only 1% per month.”
2. A statement of when the finance charges begins to accrue, including the “grace” period, if any. Statements such as “There is no free ride period” and “25 day grace period” are trigger terms.
3. The method of determining the balance on which finance charge may be imposed. An example is “Interest will be calculated using the average daily balance method.”
4. The method of determining the finance charge, including a description of how any finance charge other than the periodic rate will be determined. Examples include “No points,” “No fees,” “No closing costs,” “\$1.50 cash advance fee” and “2% origination fee.”
5. The amount of any charges other than a finance charge. Examples include “\$25 membership fee” and “\$10 annual fee.”

If an advertisement for a home equity line of credit plan contains a trigger term, it must also state the following disclosures:

1. Any minimum, fixed, transaction, activity or similar charges.
2. The periodic rate expressed, as an annual percentage rate (APR), and if the rate is variable, that fact.
3. Any membership or participation fees.

The following are special rules that only apply to home equity lines of credit. These rules apply regardless of whether a trigger term is stated in an advertisement.

1. **Balloon payments.** If the home equity line of credit advertisement mentions a minimum periodic payment, then the balloon payment must be disclosed, if applicable. For example, if the advertisement state

“payments of only \$100 required,” then it must also state “a balloon payment may result.”

2. *Tax Implications.* Statements regarding tax deductibility must include a statement similar to “Consult your tax advisor for additional information regarding the deductibility of interest.”
3. *Discounted Rates.* If an advertisement for a home equity line of credit plan with a variable rate states discounted rate, the ad must also state the period of time the initial rate will be in effect and a reasonably current APR that would have been in effect using the index and margin.

Truth in lending

There are some subtle and not so subtle differences between the Truth in Lending requirements of open-end and closed-end loan advertisements. One of the big differences between the two is that the APR is a trigger term for open-end loan advertisements. Be careful not to apply the closed-end advertising requirements to open-end ads and vice-versa.

The following terms are considered trigger terms of closed-end credit:

1. The number of payments or total period of repayment. Examples include “up to five years to pay,” “take three years to repay,” and “15 year mortgages available.”
2. The dollar amount of any payment. This includes statements such as “Monthly payments less than \$150” and “\$150 per month”.
3. The dollar amount of any finance charge or the percentage amount is readily determined from other information in the ad.

Examples include “\$1,000 total cost of credit,” “\$50,000 mortgage, two points to the borrower,” and “\$25 documentation fee”. Statements such as “6% APR” and “no closing costs” are not trigger terms for closed-end loans.

4. Amount or percentage of any down payment in credit sale transactions only.

If an advertisement for a closed-end credit plan contains a trigger term, it must also state the following disclosures:

1. *Repayment terms*—the number, timing and amount of payments. Your credit union can provide an exact repayment schedule, an example of a typical extension of credit and all applicable terms (must be labeled an example), or a unit-cost approach such as “48 monthly payments of \$27.83 per \$1,000 borrowed.”
2. *The annual percentage rate.* The APR must reflect any prepaid finance charges.
3. If the advertised rate is variable, the fact that it is subject to increase after consummation of the loan.
4. The amount or percentage of any down payment. Don’t skip a step. The key to complying with Regulation Z advertising requirements is to use three steps. First, determine what type of credit is being advertised (open-end, closed-end). Next, identify any trigger terms. Third, if trigger terms are present, include the required disclosures. Following these three steps should make compliance with Regulation Z a little easier for your marketing department. ♦

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REALTOR AFFINITY REBATE PROGRAMS

*Bill Steele, VP WESCOM Credit Union,
Chairman, CUNA Lending*

A realtor/credit union affinity agreement is becoming more common and directly benefits a member who takes advantage of the agreement. The affinity program has the primary benefit of a partial rebate of the commission charged by the real estate firm on either the purchasing side or the selling side of the transaction. In addition to the



partial commission rebate, many times there are associated benefits such as reduced moving company charges (negotiated by the realty firm) and reduced charges for other services required in the moving activity.

So how does the “typical” affinity program work? Obviously the most significant benefit to the member is the “rebate” of a por-

tion of the commission. Note: The rebate of the commission is not a violation of RESPA as the funds are paid directly to the consumer.

The "typical" agreement is between the real estate firm and the credit union. The credit union commits to advertise the agreement conditions to its members. The usual way is that the member must make contact through a controlled access point, such as a dedicated phone number. When dealing with a local real estate firm it must be stressed to the members that only contracts through the dedicated number are eligible for the rebate. When contact is made, the member is registered and assigned a specific real estate agent to assist the member in either listing their home, or acting as a buyer's agent. These real estate agents are usually a member of the relocation department for the realty firm and are generally most professional and experienced.

As a reward for the contact, the member will receive a rebate of 20% of the realtor's commission. For example, say a house is

listed/sold for \$200,000. The usual commission is 6% (\$12,000). The usual split of the commission is 3% to the listing agent and 3% to the selling agent. Assume the member is purchasing the home, and the realtor's commission split is 3% (\$6,000), then the member will get a 20% rebate (\$1,200) at or following closing.

The same example will apply if our member is the seller of the property. A member who sells property within the guidelines of the program, will get the 20% rebate, and, assume the purchaser is also a member and they comply with the requirements, they will also get the 20% rebate.

One of the additional benefits of the agreement is the credit union building a relationship with the real estate firm. And, as a result, the credit union will hopefully acquire a new mortgage loan. One of the most effective ways to do this is provide the member a pre-approval at the time the initial contact is made. ♦

BULLETIN BOARD

- Have you made plans to attend the Fifth Annual CLC Lending Conference in Orlando, FL, Nov. 14 - 17, 1999? If not, you'll want to do so as soon as possible because this conference will be HOT! The conference will serve up a plethora of great sessions on mortgage and consumer lending, collections and even business lending. Information is out on the Web site now at www.cuna.org, select COUNCILS, then the CLC.
- Career ExCELLSM is the exciting new professional development tool that you'll want to learn more about. Examine technical/functional skill sets not only for lending, but finance, human resources, technology, operations and marketing.
- PLUS, Career ExCELL identifies the competencies for CEOs as well. Get the full scoop at our Web site at www.cuna.org, select COUNCILS, then Career ExCELL.
- Memberships in the CLC are half price! New members that sign-up July 1 - Dec. 31 can take advantage of CLC's 1/2 price membership dues and receive benefits from the time they join through December 31, 1999. (All memberships expire 12/31/99). Have your peers hit the Web site to join at www.cuna.org, select COUNCILS, then the CLC, or call CLC's fax-on-demand at (800) 643-6080 and request document #4300.
- Jack Houseknecht's white paper, "The Gods of Lending Speak," has been mailed to all CUNA Lending Council 1999 members. If you did not receive a copy, please call us at (800) 356-9655, ext. 4018.

THANKS, JOE!

Since the beginning, success of the CLC can be attributed to the dedication of strong leaders who have volunteered endless hours to build this organization. Joe Brancucci, Director of Consumer Lending, Boeing

Employees' Credit Union, is one of those leaders. In 1997, Joe volunteered to chair the newly formed Education Subcommittee. In December, 1997, Joe held the first committee meeting. Since that time, he and his volunteer team have accomplished several major initiatives:

- Established the mission and objectives of the committee.
- Participated on a project for developing the curriculum for CUNA & Affiliates-Center for Professional Development lending schools.
- Developed a comprehensive assessment of the employee skill sets needed for the various types of lending.
- Developed the application for the Scholarship program.

The committee is currently also defining the necessary skill sets for loan management, loan administration and collections, and managing loan vendor relations. They are also putting the final touches on a communication plan for the Scholarship program.

Current members of the Education Subcommittee include:

- Nancy Jo Mitchell, *Chevron Credit Union, San Ramon, CA;*

- Sue Cutchall, *Barksdale Federal Credit Union, Bossier City, LA;*
- Deborah Sparrow, *Maine State Employees' Credit Union, Augusta, GA;*
- Mary Estes, *Florida Commerce Credit Union, Tallahassee, FL;*
- Tracy Ashfield, *CUNA Mutual, Madison, WI;*
- Lyndora Taylor, *NW Community Federal Credit Union, Ridgecrest, CA;*
- Chuck Taylor, *CUNA & Affiliates-Center for Professional Development, Madison, WI;*
- Richard Smith, *Peoples Credit Union, Middletown, RI;*
- Rae Ann Rose, *Boeing Employees' Credit Union, Tukwila, WA.*

Thanks to Joe and the team for their hard work and dedication in getting this committee off to a great start! ♦



CUNA Lending Council SPECTRUM is a web-based newsletter published quarterly by the CUNA Lending Council at www.cuna.org, selecting COUNCILS, then the CUNA Lending Council. Send news and Lending Council information to: Fawn Terwilliger, SVP Lending, USE Credit Union, Phone: 619-641-7575, ext.104, fax: 619-641-7784, e-mail: fterwilliger@usecu.org. For Council information, contact Dan Hoover, manager council administration, phone: 800-356-9655, ext. 4141 or fax: 608-231-4061, e-mail: dhoover@cuna.com.

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