

# Interest Refund Loan

*An auto loan to reward and build loyalty*

## **Team Participants:**

Lee Brice

Lori Hall

Karin Kovalovsky

Lisa Renner

# 1. Opportunity

Conventional wisdom holds that Baby Boomers, those born between 1946 and 1964, are moving from the borrowing stage to the saving stage of their lives. While this has traditionally been true of consumer behavior as the consumer ages, the Baby Boomer generation may very well be a contradiction to that. If not the entire group, certainly those not on the leading edge, may be finding themselves still enmeshed in debt as they face previously unrecognized challenges, from caring for aging parents, to boomerang children living at home after college and even to parenting young children of their own later in life.

According to a recent survey conducted by the Pew Research Center, "55% of baby boomers say it is likely that their incomes will not keep up with the cost of living over the next year."<sup>1</sup>

Supporting data is also found in the Risks and Process of Retirement Survey Report recently released by the Society of Actuaries. The reports cites that, due to increasing longevity and rising inflation, pre-retirees are deeply concerned about their ability to maintain a reasonable standard of living.<sup>2</sup>

In light of all the pressures which may be coming to bear on this diverse segment of the American population identified as Baby Boomers, it is reasonable to assume that they want to do the prudent thing financially. Even the youngest of the group are concerned about surviving today and into retirement. They worry about the uncertainty of Social Security, the rising cost of consumer goods and their potentially reduced lifestyle after they leave the work force.

While most of these are far larger issues than can be tackled through credit union innovation, one area ripe for reform is the vicious cycle of purchasing new cars every year or two. Among credit unions surveyed, the average length of time an auto loan stays on the books is 26 months. This is a situation that is rife with problems for the credit union and of significant impact to the personal finances of the borrower.

Bankrate.com reports that 40% of consumers are upside- down in their car loans; meaning that they owe more than the car is worth.<sup>3</sup> Survey results show that 26% of those who responded feel that refinancing the deficit from the previous car into the new car loan is "just part of buying a car."<sup>4</sup>

For the credit union, the concern is that as the car loan is paid off, the borrower is probably trading the vehicle in for a new one. How can the credit union be sure to get the new loan? Beyond that, how can the credit union be sure the loan meets the risk tolerance of standard lending guidelines and is actually a prudent financial decision for the member?

For the member, the trade-in cycle escalates a rising problem of upside-down equity in their vehicle. Each time they trade in a two year old car for a newer model, a little more of the negative equity is piled onto the loan for the new car. This means higher payments and even greater loss of value on the collateral. Additionally, these loans may be lost to less responsible lenders who care little for the loan to value proposition, mitigating the risk with significantly higher interest rates.

From the Baby Boomer perspective, this cycle creates an even greater risk as they creep closer to retirement and the almost inevitable reduction in income.

## **2. Solution**

The Interest Refund Loan is a vehicle loan designed to end the two year trade-in cycle, assure the loan stays on the credit union books, reward the borrower for loyalty to the credit union and set the borrower on the path of fiscal responsibility.

With an Interest Refund Loan, the borrower is promised a return of all the interest he or she pays in the final year of the term of the loan. For example, on a five year car loan, the borrower would be required to make every payment on time through the sixtieth payment. At that point the credit union would refund the total interest paid on the loan during the final twelve month period, payments 49 to 60. If the member ends the loan relationship early, the interest refund feature becomes void.

The member would have the option of receiving the rebate as cash or depositing the rebate along with additional funds into a special rate savings certificate. This allows the member to initiate a savings program adding value to the credit union relationship.

At this point, borrowers have bought into the spiraling cycle of ever increasing indebtedness related to over-financing new cars. This is a perfect opportunity for credit unions to invoke their responsibility to educate members regarding responsible handling of their personal finances. Member education is unique to the credit union philosophy and a good fit for materials produced to promote the Interest Refund Loan.

The Interest Refund Loan could be offered as a simple loyalty reward or several variations of the offer are possible, depending on the desires and needs of the individual credit union.

The member could be required to have

- i. automatic payments

- ii. eStatements
- iii. a checking account

When the loan is paid off, the credit union sends a congratulatory letter to the member stating that the total of the last year's interest has been deposited to their account. This could also include a pre-approval for another vehicle loan, since the member will now have a paid off vehicle to trade in, eliminating the need for over-financing the new vehicle.

### **3. Member Benefits**

- By rewarding the member for keeping the loan through its entire term, the Interest Refund Loan teaches more prudent borrowing habits.
- Having paid off the previous loan, the member has a trade-in to use as a down payment on the new car, eliminating the need to over-finance and, it is hoped, resulting in lower payments and interest.
- The Interest Refund Loan will help break the trade-in/upside-down cycle for the 40% of consumers caught in this revolving door.
- The interest refund at the end of the term is an obvious benefit. Better yet, by choosing the special rate certificate option, the member will earn a higher rate of return and initiate a responsible savings program.
- Encouraging members to keep the loan through its full term may afford some an opportunity to enjoy no payments for a period of time following the payoff, thereby increasing overall cash flow.

### **4. Credit Union Benefits**

- Keeping the loan on the books through its full term increases interest income and lowers loan regeneration costs.
- Each time members shop for a new vehicle, it opens the door for the credit union to lose that relationship. Keeping a loan increases the likelihood that the credit union will retain the member's auto business.
- As loans mature on the books, it should result in fewer upside-down loans in collections.
- Loans going to full term rather than ending at 26 months reduced the risk of a deficit balance if the auto were repossessed due to delinquency. The longer into the amortization cycle before the loan goes bad, the less risk of a deficit balance.
- Cash back is a proven member loyalty reward.
- By providing the Interest Refund Loan, credit unions are also providing valuable member financial education and encouraging the right borrowing

habits, which have positive image impact in the community as for well as the industry.

- As noted in the solution section above, the Interest Refund Loan has potential for increasing the number of services and products per member, depending on how the credit union builds its offer.

## 5. Target Market

Some may think that Baby Boomers are not good targets for vehicle loans. However, according to cars.com, in 2007 “The average age of new-vehicle buyers ended the year at 48 years old; in January 2007 it was 43.”<sup>5</sup> This clearly indicates that a significant percentage of those purchasing new cars would be classified as Boomers. Additionally, CNW Marketing research reports that only 12 percent of new car purchases are cash deals, leaving 88 percent to be financed.<sup>6</sup>

While targeted to the leading-edge of the baby boomers who are about to enter retirement (ages 55-62), given the significant majority of new car purchases that are financed, the Interest Refund Loan can easily apply to any age group.

## 6. Operation and Other Considerations (Risk)

Several operational, compliance and legal issues were discussed with credit union experts. The opinions are outlined below. However, prior to implementation, each credit union is encouraged to obtain its own legal counsel with regard to these items.

- This refund does not affect the APR. The loan would advertise at the stated APR and the refund would only be given if the car loan was paid as agreed to the full term of the loan.
- The name “Interest Refund Loan” was deemed to present no legal or compliance concerns.
- A 1099-MISC does need to be filed if \$600 or more is received by the member based on this promotion added in with any other promotion where something of value or money is given to a member. However, amortization calculations on a variety of loan scenarios show that the final year’s interest on the majority of vehicle loans does not exceed this amount.

As with any loan, there is a certain degree of interest rate risk. In a rising rate environment, fixed rate loans that remain on the books will not produce income at the same level as new loans written at the current, higher rate. Conversely, in a declining rate environment, these loans would create more income than new loans written at a lower rate.

A credit union would also have to develop the means for tracking the Interest Refund Loan. Methods could include setting up a new loan type or assigning a purpose code. Tracking would be dependent on a credit union's systems capability.

## **7. Proof of Concept**

The Interest Refund Loan is currently in the test pilot phase at Air Academy Federal Credit Union in Colorado Springs, Colorado under the direction of Vice President of Marketing, Karin Kovalovsky. The progress of the test is documented as follows:

- Presented concept to senior management team and received go-ahead to test.
- Interest Refund Loan details finalized.
  - Loan will be 60-month term at current posted rates for new and used vehicle loans. These rates range from 4.99% APR to 9.94% APR depending on member's credit worthiness, percent of retail price financed and if they choose to have automatic transfer of loan payment and direct deposit.
  - Loan will be assigned a purpose code rather than a new loan type.
  - When the Interest Refund Loan requirements are met, member can choose to either receive the interest from payments 49 to 60 or open a one-year term-share certificate (up to \$20,000) that pays 1% APY above current posted rate.
- Contacted compliance for approval of required disclosures.
- Created advertising to distribute to target market. (see below)
- Staff informed of Interest Refund Loan details.
- Advertising placed September 2008.
- Currently waiting on target market response.

Because of the timeline associated with the Interest Refund Loan pilot, initial data will be based on response to offer. Members who respond to this offer will be tracked by the purpose code. If member chooses to pay off loan early, there is no prepayment penalty; rather the member forfeits the interest refund or special term-share certificate. Upon meeting the loan requirements, members will be contacted to determine which incentive they would like to receive. At this point, the credit union has the opportunity to further educate members on how to build their savings.

**Remember When?** **Get it Now!**



and ReCHARGE your savings with our **Interest Refund Loan!**

**AIR ACADEMY**  
FEDERAL CREDIT UNION

**Get your dream car now**  
with our **Interest Refund Loan**, and we'll help you ReCHARGE your savings in the process.



Keep your loan with us for 60 months and we'll **refund you the last year's interest\*** or you can choose to open a one-year certificate that pays 1% APY\*\* over our regular advertised rate. **You Choose!**  
Call **719.593.8600** or **800.223.1983** for details.

\* Offer good on new, used and refinanced vehicles. With approved credit. Requires direct deposit and automatic payment. When account requirements are met, members can choose to receive a refund of interest from payments 49-60. To meet account requirements must make all payments and must receive e-statement. Interest will be refunded into savings account upon meeting requirements. Other restrictions apply. Limited time offer. Call for details. Rates subject to change. No prepayment if account is paid off early, but interest refund is forfeited.

\*\* Annual Percentage Yield. Member can choose to open a one-year certificate account that pays 1% annual percentage yield above current advertised rates on certificate amounts up to \$20,000 in lieu of interest refund. Other restrictions apply. Limited time offer. Call for details. Rates subject to change.

**AIR ACADEMY**  
FEDERAL CREDIT UNION  
www.aafcu.com

**NCUA**

## 8. How to Get Started –

1. Define target audience.
2. Define product parameters, i.e. rate and term.
3. Establish tracking mechanism i.e. different loan type.
4. Identify product enhancements, i.e special rate certificate.
5. Create marketing plan.
6. Track results.
7. Establish follow-up plan with members.

## 9. Appendices

### a. Marketing Tactics

#### Messaging/Value Proposition

Baby boomers (ages 44-62) are the target market. Messaging for the marketing pieces emphasizes the loan refund, i.e., "getting something for free." This is a proven motivator for this segment.

The subtle message is that we are changing the embedded habits of the group—the consumptive nation—tending to trade cars every couple of years. We are encouraging a smarter financial choice for the consumer.

#### Media Used in the Pilot

- Direct mail to target market based on age and geographic area
- Electronic marketing to target market
- Lobby and drive-up advertising including fliers and posters

#### Other Marketing Tactic Suggestions

- Ask Financial Service Representatives to identify potential prospects during member interaction by phone or face-to-face.
- Partner this product with an auto loan promotion or a car sale.
- Have a one-day sale on repossessed vehicles. Feature this product. Bring in a radio station for a remote to advertise.
- Create a promotional contest where one member who gets an Interest Refund Loan during the promotional period will be selected at random and receive double the interest back.
- Partner this product with a gas give-away promotion.
- Consider other media: radio, TV, billboard, lobby video posters, teller envelopes, ATM screens, receipt messages, telephone on-hold messages, employee e-mail footers, outside banners.
- Make presentations to select employer groups.
- Consider using member testimonials about program.
- Direct mail:
  - Postcard mailings to the targeted age group
  - Pre-approve a select group for the offer

- On-going monthly direct mailings to auto loans that are reaching 24 months maturity

Direct mail should also be directed to borrowers nearing the end of the term to encourage them to purchase the next vehicle through the credit union. This may include a pre-approved loan for ease.

## **b. Financial Pro Forma**

### **Financial Analysis**

For analysis, a \$20,000 vehicle loan for 60 months at 7% interest was used. Comparison of two loans, one using the assumption of a typical 26 month payoff cycle and the other an Interest Refund Loan going to full term, the credit union can recognize a net income increase of 45%.

<b>26 Month Payoff</b>	
Loan Amount	\$20,000.00
Interest Rate	7%
Term	60 months
Interest Income over 26 Months	\$2,478.15
<b>Net Interest Income</b>	<b>\$2,478.15</b>

<b>Interest Refund Loan - Full Term</b>	
Loan Amount	\$20,000.00
Interest Rate	7%
Term	60 months
Interest Income	\$3,761.44
Refund to Member	\$175.39
<b>Net Interest Income</b>	<b>\$3,586.05</b>

The analysis does not attempt to take into account any additional loan income earned from credit insurance or other ancillary products.

From a financial perspective, the interest refund auto loan offers a unique win-win opportunity for both the member and the credit union. It points the member on the path of fiscal responsibility and it increases interest income for the credit union. In fact, if a credit union funded 100 auto loans a month under the Interest Refund Loan program and all 100 were carried to full term, the loans would generate an additional \$110,790.00 in interest income.

## Footnotes

1. D'Vera Chohn, Senior Writer, *Pew Social and Demographic Trends Project*, June 26, 2008 ([www.pewresearch.org](http://www.pewresearch.org)).
2. Kim McKeown and Mike Nowak, Society of Actuaries, *Inflation Ranks Top Retirement Concern*, May, 19, 2008, ([www.soa.org](http://www.soa.org)).
3. Lucy Lazarony, *In a Hole with an Upside-down Car Loan*, ([www.bankrate.com](http://www.bankrate.com)).
4. Philip Reed, Senior Consumer Advice Editor, ([www.edmunds.com](http://www.edmunds.com)).
5. Jim Mateja, *Kicking the Tires*, January 18, 2008, ([www.cars.com](http://www.cars.com)).
6. Terry Jackson, *Driving for Dollars*, August 18, 2007, ([www.bankrate.com](http://www.bankrate.com)).