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# REINVENTING CONSUMER LOANS

How Community-Based FIs Can Win the Millennial Lending Market

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# EXECUTIVE SUMMARY

Reports of the death of debt among Millennials have been greatly exaggerated. Credit card adoption, car ownership, and even home ownership are on the rise among Millennials. Despite market share gains by credit unions, community-based financial institutions (FIs) aren't winning their fair share of Millennials' borrowing needs. Competing by improving the digital application experience isn't likely to be a winning strategy for those FIs, as they are often reliant on third-party vendors for IT solutions and don't have the deep pockets to experiment with new digital solutions. Community-based FIs can compete, however, by reinventing the loan product itself.

# DEBUNKING THE MYTHS OF MILLENNIAL DEBT

**MYTH:** Back in 2013, an article on the financial website *Motley Fool* claimed:

> "Great news: Americans are giving up on one of the most ruthless destroyers of wealth the numerically challenged have ever known: credit cards. We're just much more interested in debit cards than credit cards these days. Which is great, frankly. Consumers are left with stronger finances. The old style of American consumerism, one built on debt, may be coming to an end. Total household debt as a share of GDP has been declining for five years. Is this a new trend? An enduring one that won't revert back to the old, unsustainable ways? Let's hope so. Good riddance, credit cards."

**REALITY:** Looking back, nothing could have been further from the truth. According to the Federal Reserve Board, consumers used credit cards for 37.3 billion transactions in 2016, up 10.2% from 2015, following 8.1% annual growth between 2012 and 2015. In contrast, growth in debit card use slowed in 2016. The number of debit card transactions increased 6% last year from the year before, compared with 7.2% growth between 2012 and 2015.

Even as this was happening in 2016, the press was running stories with titles like *Millennials Really Don't Like Debt, Aren't Into Credit Cards* and *Why Millennials Hate Credit Cards*.

**MYTH:** The supposed disdain for debt among Millennials wasn't limited to credit cards. The author of an article titled *Millennials: The Mobile and the Stuck* argued that the reasons why young people aren't buying houses came down to two factors:

> "Rich, urban, college-educated, and supermobile Millennials have elected to trade their 30s for their 20s when it comes to buying a home. Meanwhile, poorer, less-educated, and stuck minorities have often traded homes and apartments for their childhood bedroom."

**REALITY:** Again, perceptions didn't match reality. In May 2017, *Fox Business* reported:

> "After sitting on the sidelines for a decade, Millennials are buying homes *en masse*, promising to kick the already strong housing market into higher gear."

The share of first-time buyers rose to 35% in 2016, up three percentage points from 2015, when it was at its lowest level in nearly three decades, according to the National Association of Realtors.

**MYTH:** And then there's the issue of car ownership. One side of the view has it that Millennials don't want to own cars:

> "Owning a car is not necessarily the rite of passage it used to be. With environmental concerns, automation, and the advent of ride sharing services like Lyft and Uber, there have been concerns over the decline in car ownership."

**REALITY:** Nearly 80 percent of Millennials own cars and 75 percent of millennials who don't own a car aspire to own one now, according to the 2017 Accel + Qualtrics Millennial Study.

There's no doubt that today's young, urban consumers rely heavily on ride sharing services and have a lower rate of car ownership than older consumers. But it's hard to envision that today's young, single, urban woman waiting on the street corner for her Uber ride will be waiting for an Uber five years from now when she's got a baby, baby bag and stroller in tow. And when she's probably out in the suburbs by then, anyway.

## SO WHAT

Despite the pessimistic projections for Millennials' demand for debt, the past few years should have taught the banking industry two lessons: 1) Despite their claims of being so different from previous generations, when it comes to banking and borrowing needs, Millennials aren't that much different, and 2) Life stage changes rule—as Millennials have aged in their 30s, life stage changes likes marriage and family have driven the same needs as their parents before them.

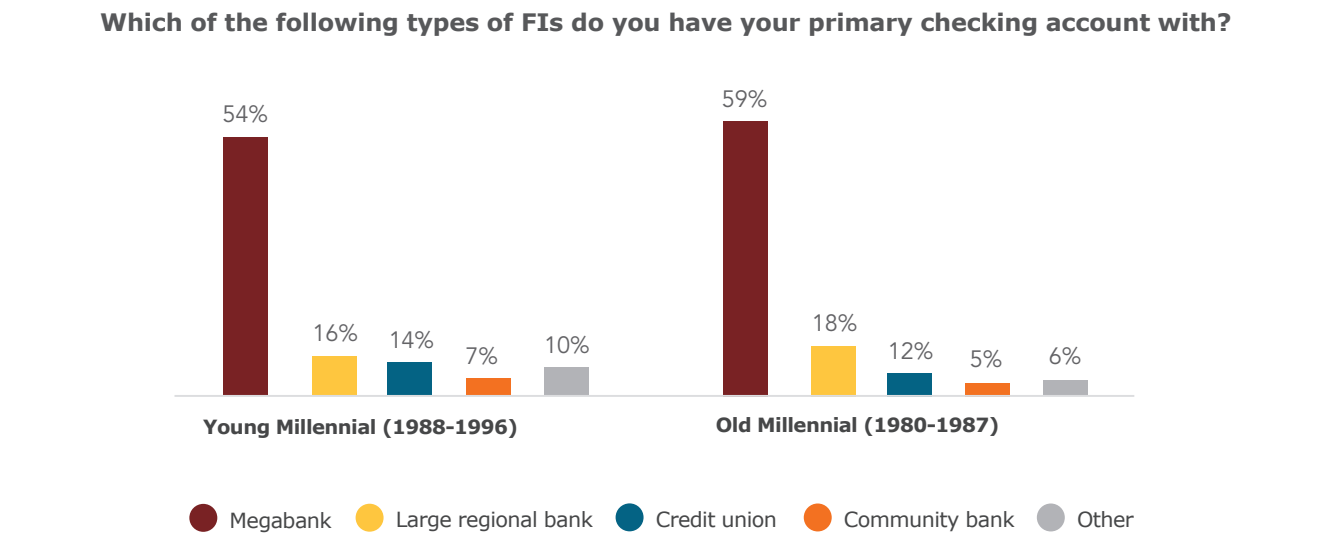
Another point to consider: Even if the rates of adoption of credit cards, mortgages and auto loans among Millennials are lower than among older generations, the sheer size of the Millennial population will help to ensure a steady demand for credit for some years to come.

# CHALLENGES FOR COMMUNITY-BASED FIS

The overstated reports of the death of credit is good news for banks and credit unions of all sizes. But community-based institutions (generally speaking, FIs with $500 million to $40 billion in assets) face a couple of challenges in capturing their fair share of the demand.

First, many Millennials are banking with megabanks—not smaller FIs. Among Millennials in their 20s ("Young Millennials"), 54% call a megabank their primary FI. Just 14% say a credit union holds their primary checking account, and only 7% bank with a community bank. Among Older Millennials (i.e., consumers 30 to 37 years old), the pattern is similar, with 59% banking with a megabank (Figure 1).

FIGURE 1: **Primary FI by Generational Segment**




Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

Second, community FIs have underperformed megabanks in cross-selling their checking account customers/members credit products like (Table A):

- **Credit cards.** Among Young Millennials who bank with a megabank, 42% have opened a credit card with that FI. In contrast, just 31% of the consumers in the age group who bank with a credit union have a credit card from the credit union, and that percentage drops to a mere 4% among community bank customers. Among Old Millennials, the discrepancy is even wider. Half of the 30-somethings who bank with a megabank own a credit card from that FI; among credit union members that percentage drops to 19%.

- **Mortgages.** Megabanks have done a superior job of putting mortgages in the hands of their Old Millennial customers (who are more likely to have, and be in the market for, a mortgage) than credit unions and community banks, 16% versus 10% and 7%.

- **Home equity loans.** Megabanks have attracted a higher percentage of both Millennial segments to open home equity loans or lines of credit than other FIs. Among the Millennials who participated in the survey and that bank with a community bank (vs and that banks with a community bank)

Credit unions have fared better in cross-selling other personal loans (typically auto loans) with Young Millennials, but large regional banks have done better with Old Millennials.

TABLE A: **Percentage of Consumers Who Have Opened or Purchased Product with Primary FI**

| | | Credit card | Mortgage | Home equity loan | Other personal loan |
|---|---|---|---|---|---|
| **Young Millennial** (1988-1996) | Megabank | 42% | 9% | 6% | 6% |
| | Large regional bank | 20% | 2% | 2% | 6% |
| | Credit union | 31% | 4% | 2% | 13% |
| | Community bank | 4% | 0% | 0% | 9% |
| **Old Millennial** (1980-1987) | Megabank | 50% | 16% | 9% | 4% |
| | Large regional bank | 24% | 10% | 7% | 11% |
| | Credit union | 19% | 7% | 4% | 9% |
| | Community bank | 18% | 0% | 0% | 5% |

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

# MILLENNIALS AND BORROWING

To understand the opportunities for community-based FIs to compete in the lending markets, we assessed how consumers—and Millennials (who represent a disproportionate share of the demand for loans) in particular—select providers, make payments, and manage their debt.

## SELECTING PROVIDERS

We asked consumers: If you were in the market for an auto loan, what three factors would be most important in determining your choice of provider? It's probably no surprise that, across each generational segment, lowest interest rate and lowest monthly payment are two of the three factors.

It might be surprising to learn, however, that for Millennials and Gen Xers, "transparency, flexibility, and assistance paying off the loan faster" was the third most-frequently selected decision factor—ahead of customer service quality and speed of the application and decision process (Table B).

TABLE B: **Top Three Factors Influencing Choice of Auto Loan Provider**

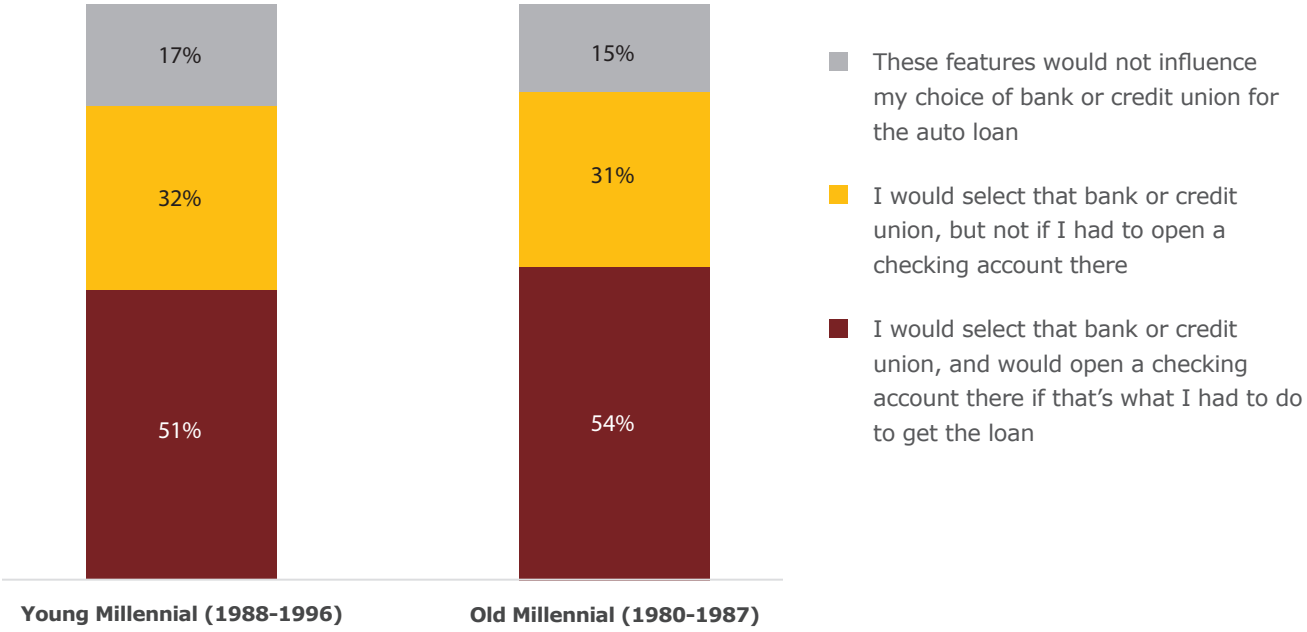
| | Young Millennial (1988-1996) | Old Millennial (1980-1987) | Gen X (1964-1979) | Boomer (1945-1963) |
|---|---|---|---|---|
| Lowest interest rate | 66% | 64% | 70% | 76% |
| Lowest monthly payment amount | 56% | 53% | 54% | 49% |
| Loan features that provide transparency, flexibility, and assistance paying off loan faster | 37% | 34% | 31% | 22% |
| Online/mobile banking tools that assist in tracking and paying the loan | 29% | 26% | 21% | 14% |
| Quality of customer service | 26% | 29% | 22% | 21% |
| Previous experience or relationship with a financial institution | 20% | 21% | 23% | 28% |
| An institution referred by the dealer so I could get a lower price on the car | 19% | 20% | 15% | 20% |
| Speed of the application and decision process | 16% | 23% | 20% | 23% |

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

To underscore the importance of loan flexibility and faster payback capabilities, roughly 85% of Millennials said they would select a bank or credit union that offered those features on an auto loan, assuming the interest rate was comparable to other loans. More than half said they would open a checking account at that institution if that's what they had to do to get the loan (Figure 2).

FIGURE 2: **Impact of Additional Loan Features on Choice of Auto Loan Provider**

Imagine that an FI offered an auto loan that had a comparable rate to other loans, but gave you: 1) Flexibility on monthly payments; 2) Assistance paying back the loan faster; and 3) Insight into how payments affect balances and interest payments. Which statement best describes how these features would impact your choice of FI?




Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

## PAYMENTS

But can Millennials afford to take advantage of a loan feature like faster payback? Many can. Granted, almost four in 10 Millennials are struggling to make the minimum payments on some or all of their loans. But among Young Millennials, roughly four in 10 have no problem making their minimum payments, and 14% sometimes or often pay more than the minimum. Among Old Millennials, just shy of half have no problem with payments, and about a quarter pay more than the minimum (Table C).

TABLE C: **Loan Payments by Millennials**

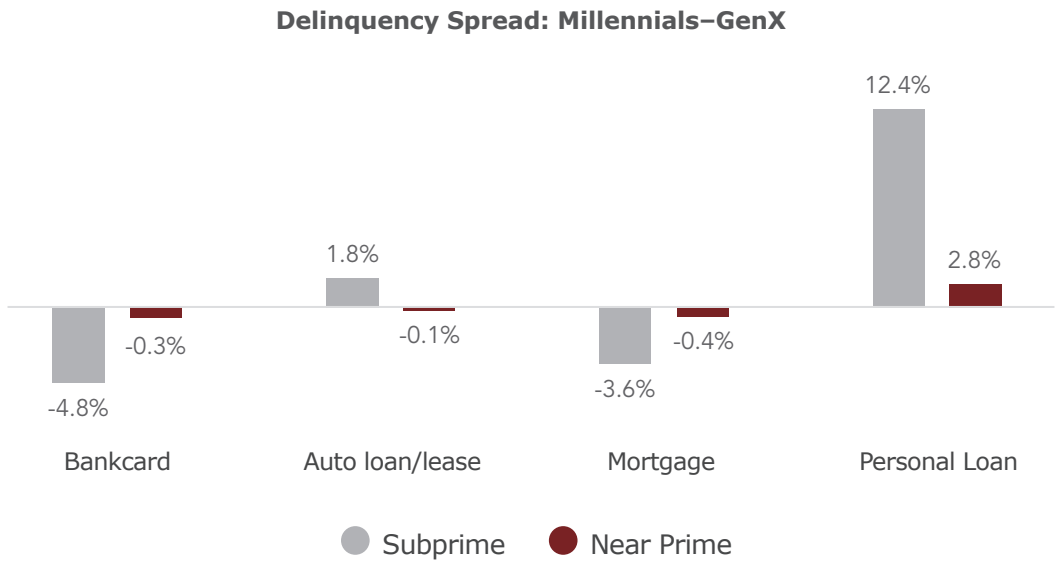
| | Young Millennial (1988-1996) | Old Millennial (1980-1987) |
|---|---|---|
| I often struggle to make the minimum payments on some or all of my loans | 36% | 38% |
| I occasionally have trouble making the monthly payments on my loans | 23% | 15% |
| I generally have no problem making the minimum monthly payments on my loans | 27% | 24% |
| I generally have no problem making the minimum monthly payments on my loans, and sometimes or often pay more than the minimum | 14% | 24% |

Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

## DELINQUENCY RATES

Despite the percentage of Millennials who say they struggle to make their minimum payments, they're successfully managing their debt, when compared to Gen Xers. A study by TransUnion found that, when comparing Millennials' and Gen Xers' delinquency (Figure 3):

FIGURE 3: **Delinquency Rates**




Source: TransUnion

- **Millennials outperform Gen Xers on credit cards.** While they use credit cards less than Gen X, subprime Millennials actually outperform Gen X by 4.8%, with a 23% and 28% serious delinquency rate, respectively.
- **Millennials behave most like Gen X with auto loans.** TransUnion observed some difference in auto loans, as subprime Millennials perform worse than Gen X. Millennials had a 13% delinquency rate after 12 months, compared to nearly 11% for Gen X. This difference could potentially be a result of longer loan terms.
- **Limited exposure to subprime supports mortgage lending.** Millennials' mortgage loans perform better, with a 3.6% lower delinquency rate than Gen X. The limited access to subprime mortgages for Millennials, with more stringent underwriting standards than Gen X experienced, may have resulted in improved performance on those loans.

- **Personal loans show signs of weakness.** Both subprime and near prime personal loans for Millennials have higher delinquency rates than their Gen X peers. It's possible the combination of easy access to subprime personal loans coupled with online fraud could lead to adverse selection in personal loans for Millennials.

## SO WHAT

Touting superior rates and service is not a winning competitive strategy for community-based FIs. And according to consumers themselves, speed of the application and the decision process is not that big a factor with auto loans—meaning that competing on "experience" is no ticket to success, either. Competing on product superiority and innovation is the direction mid-size FIs must pursue to take market share from the megabanks. And perhaps just as importantly, reinventing auto loans and bundling checking accounts could help community-based FIs win over deposit accounts they're losing to the bigger banks today.

# REINVENTING CONSUMER LOANS

To better compete with the large banks in the lending markets, community-based FIs will need to find new strategies. While many mid-size FIs believe they have superior rates and service, the cross-sell numbers in Table A show that Millennials are often selecting the megabanks and large regional banks they already bank with for their borrowing needs.

***Community FIs have an opportunity to better compete by innovating on the loan product itself.***

If community-based FIs can't differentiate on price, and can't compete on experience, what's the alternative? Competing on product quality. Three tactics to do that include: 1) Providing flexible credit terms; 2) Offering access to future funds; and 3) Bundling accounts.

## PROVIDING FLEXIBLE CREDIT TERMS

In its report *Designing High-Quality, Small-Dollar Credit*, the Center for Financial Services Innovation (CFSI) wrote:

> "Offering borrowers choice and flexibility can increase the likelihood that they have a positive borrowing experience. Allowing applicants to choose the size, length, and terms of their loan can boost take-up rates and contribute to the successful repayment of a loan."

In a follow-up report, *A Snapshot of Quality and Innovation Among Small-Dollar Credit Installment Lenders*, CFSI identified "structuring loans to support repayment" as an important guideline for lenders to follow. One practice within this guideline—allowing flexibility in setting repayment schedules that match borrowers' income schedules—was found in only a few of the lenders that CFSI reviewed, however, suggesting a gap for community-based FIs to fill.

An example of this comes from UK-based QuikQuid's FlexCredit product. Upon application approval, the product provides borrowers with a personalized credit limit enabling them to choose their own loan amount and repayment schedule. It gives customers the choice to repay their loan all at once or over the course of several months, up to a maximum term of 10 months.

## OFFERING ACCESS TO FUTURE FUNDS

Millennials' borrowing needs aren't one-shot deals. These consumers are entering, or are in the middle of, life stages that require multiple and ongoing borrowing needs. Innovative loan products that recognize future borrowing needs can help community-based FIs gain share. Examples of this include:

- **LendUp.** LendUp customers earn the ability to access more money at lower rates by repaying an existing loan and completing credit education courses.
- **Kasasa.** Kasasa Loans include a "take-back" feature that allows borrowers to pay more than their minimum payment, and access—i.e., take back—those funds in the future.

## BUNDLING ACCOUNTS

With more than half of Millennials saying they would open a checking account if that's what they had to do to get a loan with flexible term and faster payback capabilities, community-based FIs can take back deposit product share by bundling checking accounts into their loan offerings. This won't work, however, unless FIs offer superior lending products.

Wells Fargo announced that it would underwrite customers for their entire credit limit. Typically, customers seeking credit apply for individual products—e.g., loans or credit cards—separately. Wells said it would show customers their entire unsecured credit limit with Wells, allowing customers to choose how to allocate their credit limit among products. For example, customers planning a house renovation could choose to put 50% of their credit limit on a credit card and put the other 50% in a loan.

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AFTER 15 YEARS IN THIS BUSINESS, Cornerstone Advisors knows the financial services industry inside and out. We know that when banks and credit unions improve their strategies, technologies and operations, improved financial performance naturally follows. Cornerstone takes financial institutions from strategy to execution through an array of advisory offerings, including Strategy, Contract Negotiations, Performance, Technology, Mergers & Acquisitions, Payments, Risk Management, System Selection & Implementation, and Delivery Channels.

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