BANK POLICY INSTITUTE

# Misunderstandings About Credit Card Late Fees

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Credit card late fees are transparent, have been highly regulated for over a decade and apply equally to all customers that fail to pay on time. The Consumer Financial Protection Bureau's proposal to limit the late fee "safe harbor" maximum to $8 (down from $30 for first late payments and $41 for consecutive late payments) does not meaningfully account for the reduced deterrence effect of a substantially lower late fee or the full panoply of costs incurred by issuers for missed payments. Ultimately, the Bureau's proposed revision can be expected to harm the functioning of the market with adverse consequences for consumers.

With deterrence weakened under the Bureau's proposed reduction in late fees, payment delinquencies and credit losses will increase, prompting issuers to manage credit risk by tightening card credit limits or availability and increasing interest rates or other fees. Increased frequency of late payment will rebound to the ultimate harm of consumers through reduced credit scores.

These effects will be borne by all consumers with credit cards, including by those who pay on time (not just by those who violate the terms of card agreements), but will be most pronounced for higher-risk consumers for whom cards may become less readily available. The Bureau does not explain why a consumer is better off with a tighter credit limit or no card at all, as opposed to having a card that charges an avoidable $30 fee for violating the account terms. The Bureau's misguided approach demonstrates a lack of understanding of the nature and importance of these fees to the ecosystem of credit card lending generally.

This note briefly reviews why the proposal to limit late fees, by limiting banks' ability to offset costs and by eliminating or reducing deterrence, will have deleterious effects on the market's ability to serve consumers across the credit risk spectrum. Concurrently, BPI is developing further, detailed analysis of these factors and the Bureau's misunderstanding of them as reflected in the proposal, in an ongoing series of research notes and a formal response to the proposal.

## THE LATE FEE CAP PROPOSAL WILL HARM CONSUMERS

The proposal would harm consumers across the credit spectrum by prompting more customers to pay late and forcing financial institutions, which must meet rigorous prudential standards to manage credit risk, to account for the costs associated with late payments in less satisfactory ways. These changes would likely raise the costs of and reduce access to credit for consumers who pay on time and could adversely affect consumers' credit records to the extent that they become more prone to payment delinquency. The Bureau recognizes this potential for consumer harm in its proposal, as noted in the following quotes:

**The lower late fee amount could drive more consumers to pay late, likely resulting in a higher cost of credit and reduced credit scores for these consumers.**

- "The Bureau recognizes that late fees are a cost to consumers of paying late, and a lower late fee amount for the first or subsequent late payments might cause more consumers to pay late."

- If more consumers make untimely payments because "the fee for doing so is reduced", "consumers could face costs for doing so, including costs like increased penalty interest rates or lower credit scores."

**Besides harming individual consumers, the proposal would subject card issuers to an increased risk of credit losses. Necessary steps to safeguard against that risk would result in consumer harm, especially for subprime consumers.**

- "The Bureau acknowledges that late fee revenue has been concentrated on certain market segments, suggesting that any price responses are also likely to be focused in those segments. In particular, interest rates or other charges of subprime credit cards might increase more than for other cards, and some consumers might find these cards too expensive due to higher interest rate offers."
- "Besides any impact on collection costs, additional missed payments could result in additional delinquencies and ultimately increase credit losses."
  - "Issuers could also increase minimum payment amounts or adjust credit limits to reduce credit risk associated with consumers who make late payments."
  - "Issuers could also increase other prices in a way that would offset revenue lost from reduced late fees."

Despite the Bureau's recognition of the consumer harm that is likely to result from the proposal, the Bureau nevertheless has proposed a substantial reduction in the late fee safe harbor. We elaborate further on this point below.

## LATE FEES ARE COMMONPLACE THROUGHOUT OUR SOCIETY, INCLUDING GOVERNMENT SERVICES

Most Americans know the feeling of rushing to pay taxes or that pesky parking ticket. Penalty fees for late payments are a common feature of contracts involving scheduled payments for goods and services, including rent and utility payments, credit card and auto loan payments, mortgage payments and so on. Federal, state and municipal governments consistently impose high penalty fees for late payments of income, property and other taxes, parking tickets or other fines and other payments owed. Other types of very common contracts, such as for home and auto insurance, may not charge late fees at all but may simply cancel the service after a brief grace period if a premium is not paid by the due date.

Recently, the Bureau set its sights on late fees charged by credit card issuers when a customer doesn't pay the minimum amount due on time, arguing in a Feb. 1 Notice of Proposed Rulemaking that the typical credit card late payment penalty is too high. The proposal followed almost a year of Bureau statements disparaging credit card late fees as "illegal," which of course is patently false. Contrary to late fees being "illegal," the Bureau is actually the agency that sets the standards for credit card late fees that companies follow. In its proposal, the Bureau argues that the typical penalty – which is well within a "safe harbor" previously authorized by the government for such fees – far exceeds issuers costs associated with a late payment.

But late fees are not just about costs. In fact, the same statute authorizing the current safe harbor also requires a late fee to be "reasonable and proportional to the omission or violation," of which costs are just one factor to be considered; the other two factors are deterrence (does the late fee help deter consumers from paying late) and consumer conduct (for instance, repeat violations). In its proposal, and in violation of the statute, the Bureau does not meaningfully consider these latter two factors and somewhat summarily concludes that late fee penalties ought to be more strictly regulated.

Contrary to the Bureau's rhetoric, it was the Federal Reserve – not the industry – that set the amount of how much can be charged, and the Bureau has been increasing that number in line with inflation ever since, as required by its own regulations. There is little reason – or evidence – to believe that the market's current late fee structure in general diverges from what is "reasonable and proportional" when considering the factors relevant to such a determination. These factors include that late fees serve as a deterrent to late payment and the consumer financial behaviors that lead to late payment and that help to prevent other consumer harm that could result from paying late. In addition, late fees offset the operational and administrative costs to the bank of collecting late payments and the risk that late payment will lead to default, resulting in even higher costs to the issuer. They are also an important factor in managing credit risk and promoting safety and soundness in the banking system, as required by regulators under prudential standards.

The Bureau's proposal seems to be predicated on the false notion that late fees are designed to exploit consumers by extracting profits from them while they are under duress. But the Bureau provides no evidence to substantiate this biased presumption. If there are specific circumstances where the social costs tied to effects on consumers outweigh the legitimate role of the late payment penalty, then the Bureau should document, explain and address them. Likewise, if there are circumstances where late fees are used unwisely, causing too many late payers to fall further behind, then the Bureau ought to document and address those, but the Bureau does not substantiate either claim. Instead, the Bureau wrongly indicts all current late fee practices in the credit card market as harmful, contrary to fundamental economic precepts and empirical evidence.

## THE DETERRENCE AND INCENTIVE ROLES OF LATE FEES

The incentive role of a late fee primarily is to foster positive financial habits by motivating greater, long-run attention by consumers to their spending and finances and how these may affect their ability to meet their debt obligations. Late fees are designed to encourage on-time payments and promote responsible financial behavior. Without the disincentive of a late fee, consumers are more likely to miss payments and may be at further risk of account closure or accruing additional debt. Indeed, this is why late fees are so common throughout our society.

The rule establishing the existing safe harbor has been in place for over 12 years and was deliberately set to provide a deterrent effect. It seems obvious that a late fee of $8 will have a reduced deterrent effect compared to a $30 late fee, and the Bureau concedes as much but does not attempt to quantify the impact on consumers from reduced deterrence. The Bureau provides an extensive description of how it purportedly considered deterrence, but the analysis is superficial and not supported by credible data or research. The Bureau purposefully avoids a meaningful assessment, essentially just stating, without support, that an $8 penalty for both first and subsequent late payments would provide sufficient incentive for on-time payment.

Nor does the Bureau sufficiently grapple with the detrimental consequences of the reduced deterrent effect of a significantly lower late fee safe harbor. Creditors price credit to cover losses, expenses and a reasonable return and to meet prudential standards for managing risk. With deterrence weakened consequent to the proposed reduction in late fees, delinquencies and credit losses will rise, prompting issuers to seek other ways to manage those losses.

One such response may include increasing the up-front interest rate. Another would be to increase other fees, such as annual fees. However, introducing an annual fee will result in those who present relatively less risk (e.g., subprime borrowers who pay on time) subsidizing higher-risk cardholders (e.g., subprime borrowers who pay late).

If a card issuer cannot generate sufficient increased revenue through a higher interest rate or by increasing other fees to offset increased credit losses (because, for instance, raising the interest rate might discourage borrowing by less risky customers) the issuer must then reduce the credit losses. That would mean reducing credit availability, which will harm the highest-risk consumers primarily. It is not clear why a consumer is better off with no credit card as opposed to one that charges an avoidable $30 fee for violating the account terms.

Finally, as more consumers become delinquent on their accounts as the "deterrent" becomes a relatively low "late payment convenience fee," there may be a reduction in consumers' credit scores. Consumers may choose, at the expense of their credit history, to prioritize more immediate perceived needs or extended convenience. Indeed, late fees can be less consequential to consumers' long term financial health than the reduced credit scores that may result from weakened deterrence.

## THE RISK-BASED PRICING ROLE OF A LATE FEE

Banks that issue credit cards manage credit risk in a variety of ways—and indeed, are required to manage credit risk for prudential safety and soundness purposes. Risk can be managed through pricing (principally, the interest rate charged), deterrence (late fees) or altering how much credit is made available (credit limits). One essential role of a late fee is to account for the risk a customer will fail to repay the balance and interest payments owed, which would impose losses on the card issuer.

Even with advances in credit scoring, banks can only approximately measure a consumer's repayment risk when providing a line of credit such as a credit card. Further information based on the consumer's behavior becomes available to the issuer over time, and objectively speaking, missing a payment due date even once indicates heightened repayment risk. A late fee serves to offset the cost of this increased risk at the time it becomes apparent – when the payment is missed. For purposes of the statute, the risk that a consumer will not pay her bill constitutes a "cost associated with the violation" for card issuers.

In other words, an issuer cannot perfectly determine upfront the relative riskiness of customers when the customer opens an account — even within a given risk segment, such as subprime, some consumers will prove to be higher-risk than others. Some will proceed to consistently pay on time, improving their credit score and ultimately qualifying for a lower rate card. Others will pay on time less consistently, occasionally missing a payment or two, which indicates greater likelihood of longer-term delinquency. A late fee is a way of pricing this increased delinquency risk, as an alternative to repricing the account at a higher interest rate, which is apt to have a longer-term impact on the consumer's cost of borrowing. Seen this way, a late fee is a natural extension of the upfront, risk-based determination of the interest rate based on a customer's credit score.

From the consumer's perspective, when assessing the costs of using a credit card, consumers generally may factor the costs of anticipated late fees alongside the interest rate charged if a balance isn't paid in full each month. That is, to the extent they behave rationally, consumers will weigh the possibility that they might have to delay a payment beyond the due date and thereby incur the late fee, knowing that this risk increases as the balance and minimum required payment increases.

The higher the late fee, the more strongly the consumer would be encouraged to mitigate the risk of late payment by using their card more cautiously. In other words, incorporating a high late fee alongside the interest rate into the overall, anticipated cost of borrowing may motivate a consumer to reduce the likelihood of paying late by maintaining a smaller balance and appropriately managing other debt obligations. Moreover, with fee income potentially increased and credit risk thus reduced, the bank may be able to offer a lower interest rate up front. The Bureau's proposal ignores this economic justification for a higher late fee.

The flip side of this, of course, is that a lower late fee will change the consumer's calculus of the overall cost of borrowing (inclusive of the up-front interest rate and anticipated, possible late fee) and may alter his or her borrowing decisions—he or she may be more likely to pay late and accumulate a revolving balance, which the Bureau acknowledges. Creditors will respond in turn—by meeting prudential safety and soundness standards and managing credit risk using other levers, such as increasing other prices or reducing the amount of credit offered.

## COLLECTION COST CONSIDERATIONS

Credit card issuers incur various costs from missed card payments, among which are the costs of operating a collections department to recover missed payments. The Bureau estimate that an $8 assessed fee suffices to cover these costs is incorrect, because (for reasons to be documented in a forthcoming BPI research note) it is based on an underestimate of the costs incurred to collect from late payers and overestimate of the proportion of the assessed late fees actually received by the issuers (the net assessed fees).

Costs associated with collection activities include:

- Recovery expenses and servicing costs, including costs related to engaging with customers who are delinquent, including agents, operational support and third parties; letters and calls associated with fees and payments, and credit bureau support;
- IT costs associated with customer service communications;
- Costs of personnel allocated from other areas of the bank to support collections (e.g., HR, finance, legal, compliance, audit, risk management);
- Infrastructure costs (e.g., facilities, customer service technology needs, phone lines).

However, the Bureau considers only the first of the above categories, due to limitations of the data used for its cost analysis. The Bureau does not appear to consider the fixed or overhead costs comprising the other three categories.

In addition to the above, the costs associated with late payment can include capital costs (for meeting internal and regulatory requirements of holding more capital for higher-risk customers) and provision costs (for holding additional reserves for higher-risk customers). There also is the opportunity cost of late or missed payments that banks are not able to put to other productive uses.

Moreover, the Bureau arbitrarily considers only pre-charge-off costs to be permissible or relevant for issuers to consider and ignores post-charge-off costs. This exclusion is contrary to the explicit language of the statute requiring consideration of costs incurred because of the violation or omission of the card agreement – in other words, the costs related to the missed payment, including those that continue to accrue after an account is charged off. This exclusion also has no basis in economic principles or general business practices. For instance, just as risk-based pricing of loans via higher interest rates for individuals with lower credit scores incorporates premiums for expected loss of principal and interest on loans that default, there is no reason why late fees should not cover some, if not all, of post-charge-off collection costs.

Since $8 is far too low of a late fee to cover an issuer's collection costs for delinquent and charged-off card accounts, issuers will seek other ways to increase revenue to cover those costs. Issuers might increase interest rates or increase other fees, such as annual fees. If a card issuer cannot generate increased revenue through higher interest rates or up-front fees to offset the loss in revenue from late fees, the issuer would then seek other ways to reduce costs—which likely means reducing credit availability to certain borrowers, which will harm the highest-risk consumers primarily.

## BASED ON THESE CONSIDERATIONS, AND BECAUSE THE MARKET IS COMPETITIVE, LATE FEES ARE NOT A SOURCE OF WINDFALL PROFITS

The credit card market is extremely competitive, with multiple providers offering a wide variety of cards with different benefits and fee structures. Further, regulations administered by the Bureau require extensive disclosures in any application or solicitation for a credit card account of any late payment or other fee, which

allows consumers to comparison-shop based on these different fee structures. In fact, there are numerous, widely used websites that rely upon these extensive public disclosures by issuers to help consumers compare different cards with different fees and interest rates.

Because the market is competitive and fees are transparent, late fees are part and parcel of an efficiently functioning market. The late fees charged by issuers are consistent with the above considerations of risk, deterrence and cost; they are not a source of windfall profit.

Moreover, it is not in banks' interest to push consumers further into delinquency through excessive use of late fees, and in fact, banks provide numerous services to help consumers avoid paying fees. For example, banks offer the ability to pay by phone or via digital channels for immediate crediting. Banks send due date reminders through various channels, including text messages, offer and encourage autopay enrollment and educate consumers about the importance of responsible credit management.

These programs and initiatives operate to avoid substantial late payments and demonstrate a fundamental truth about the credit card industry and issuing banks — banks want their customers to be successful and pay on time. Banks are most successful when their customers are successful, and any narrative or claim that banks want customers to pay late so they can generate significant late fees is contradicted by the facts and data.

One recent example demonstrating the fallacy of this narrative is card issuers' actual conduct during the COVID-19 pandemic when many issuers voluntarily waived late fees and other penalty fees to help consumers who may have been experiencing financial or other hardship. For example, "over 25 million consumer credit card accounts representing approximately $68 billion in outstanding credit card debt entered relief programs in 2020, figures vastly higher than in prior years."[1] Issuers also waived late and NSF fees.[2] While 2020 is unique in terms of the degree to which issuers offered forbearance and waiving of late fees, programs to provide relief to consumers, such as offering debt management plans, have been standard industry practice pre-dating the pandemic.[3]

## CONCLUSION

The Bureau's proposed $8 late fee limit would likely harm consumers by leading to higher interest rates and fees and lower credit scores. Measures such as higher interest rates would be necessary steps for banks to offset the costs associated with more frequent late payments under the prudential requirements they face to manage their credit risk. The Bureau's proposed much lower late fee would reduce the deterrent effect of the late fees currently permitted under the regulatory safe harbor that motivate consumers to make prudent financial choices – any resulting surge in late payments would ultimately raise costs for and impose other harms on consumers across the board.

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[1] CFPB, *The Consumer Credit Card Market* at 9 (Sept. 2021) ("In response to pandemic-related hardship, issuers provided a considerable number of payment deferrals and fee waivers to their cardholders in 2020."), available at: https://files.consumerfinance.gov/f/documents/cfpb_consumer-credit-card-market-report_2021.pdf.

[2] *Id.* at 54, 56, and 114-120.

[3] *Id.* at 138-141.