Economic Analysis of the Consumer Financial Protection Bureau's Proposed Rule

"Credit Card Penalty Fees (Regulation Z)"

by Stephen G. Bronars

Qualifications and Assignment

1. I am a Partner with Edgeworth Economics LLC., a consulting firm specializing in economic and statistical analysis. I worked previously at Welch Consulting (now part of Charles River Associates) for more than eight years and prior to that I was the Leroy Denman Jr. Regents Professor of Economics at the University of Texas at Austin. I have submitted expert reports and testified on economic damages and liability, and on statistical analyses and statistical sampling for litigation. I earned a PhD in Economics from the University of Chicago. I have published many peer-reviewed papers on labor economics, applied microeconomics, econometrics, and applied statistics in academic journals. Edgeworth Economics is being compensated for this report.

2. I was hired by the Credit Union National Association (CUNA) to provide my opinion concerning the economic analyses and empirical evidence cited in the Consumer Financial Protection Bureau's (CFPB) Proposed Rule: "Credit Card Penalty Fees (Regulation Z)."[1] I was also asked by CUNA to provide my opinion concerning the possible economic impact of the proposed rule on credit card issuers, especially credit unions that issue credit cards, as well as credit card customers.

Summary of Conclusions

3. My review of the CFPB's proposed rule and economic analyses indicate that the CFPB did not provide a valid and reliable analysis of the economic impact of the proposed rule on either credit card issuers or credit card customers. The CFPB did not conduct an analysis of the costs and benefits of the changes required by the proposed rule. The CFPB did not provide a valid economic analysis of the impact of the proposed rule on:

[1] Federal Register, Vol. 88, No. 60, March 29, 2023, Proposed Rules, pp. 18906-18951, which will be referred to as the "proposed rule" throughout this declaration.

- The increased frequency of late payments caused by lower late fees.
- Changes in annual percentage rates (APRs), credit limits, minimum payments and other credit card terms caused by lower late fees.
- The increased risk of charge-offs and losses faced by credit card issuers resulting from the increase frequency of late and skipped payments caused by lower late fees.
- The much greater difficulty in adapting to lower late fees faced by credit unions that cannot charge APRs of more than 18 percent.
- Which customers will benefit, and which will be harmed by the mandated decrease in late fees and the resulting changes in other credit card terms.
- The decrease in access to credit, and reduction in credit limits for customers with lower credit scores caused by lower late fees.

4. The CFPB did not conduct a proper Initial Regulatory Flexibility Act analysis and failed to study the economic impact of the proposed rule on small businesses, especially small credit unions. The CFPB also did not study how freezing credit card late fees at $8, which is substantially less than the typical current late fee, would impact credit card issuers and customers in an economy with a higher inflation rate and market interest rates than at any time since safe harbor penalty late fees were first regulated in 2010.

Final Rule in 2010

5. In June 2010 the Federal Reserve Board submitted a Final Rule, which amended Regulation Z, which implemented the Truth in Lending Act, to enact provisions of the Credit Card Accountability Responsibility and Disclosure Act (the CARD Act) of 2009. This 2010 Final Rule set the safe harbor penalty late fee for credit cards at $25 with the provision that (i) the safe harbor penalty late fee is $35 for each subsequent late payment in the next six billing cycles, (ii) the safe harbor fee amounts would be

indexed to inflation, and (iii) credit card issuers could charge a higher penalty fees if they could demonstrate that pre-charge-off collection costs were higher than these amounts.[2]

Introduction

6. The CFPB's proposed rule substantially impacts the credit card market because it: (i) drastically reduces the safe harbor credit card late fee to $8, (ii) eliminates higher safe harbor late fees for subsequent late payments within a six-month period, (iii) eliminates annual inflation adjustments for safe harbor late fees, (iv) requires that a late fee not exceed 25 percent of the required minimum payment, and (v) establishes a 15-day grace period before late fees can be assessed. Because of inflation adjustments, the current safe harbor late fee for credit card late fees based on the Federal Reserve Board's 2010 rule is $30 with a $41 safe harbor for repeated late payments that occur within six billing cycles.

7. The proposed rule mandates a more than 70 percent decline in the safe harbor credit card late fee and a more than 80 percent decline in the safe harbor fee for subsequent late payment violations within a six-month period. The proposed rule will mandate an unprecedented decline in late fees, and the CFPB is unable to reliably predict how this massive policy change will impact credit card issuers or credit card customers. The CFPB's economic analysis of the proposed rule is overly simplistic and narrow in its focus. The CFPB does not estimate the magnitude of the increase in late payments or skipped payments that will result from drastically smaller penalties for late payments. The CFPB presents no analyses or empirical evidence to predict the number of customers who currently make payments on time and avoid late fees but will be incentivized to make late payments because of the substantial decline in penalty fees.

8. The proposed rule will almost certainly impact the terms, other than late fees, of millions of credit card accounts but the CFPB cannot reliably predict these changes. The proposed rule will have a substantial adverse impact on credit unions that issue credit cards because of the legal limitations on the (APRs charged by credit unions but the CFPB does not address this issue. The data used by the CFPB for

[2] The CARD Act went into effect on August 22, 2010. The 2010 Final Rule is available at https://www.govinfo.gov/content/pkg/FR-2010-06-29/pdf/2010-14717.pdf

its empirical analyses do not include credit unions.[3] The CFPB does not attempt to explain how credit card issuers will respond to much lower late fees if increases in APRs are limited by regulations, as they are for credit unions. The rule will also disproportionately impact consumers with low credit scores and will likely reduce their access to credit, but the CFPB does not estimate the loss in economic welfare from lower access to credit for this group of customers.

9. The CFPB understands that the proposed rule will have a substantial impact on the credit card market. Throughout the proposed rule the CFPB discusses the many possible ways in which the credit card market may react to the much lower safe harbor late fee.[4] However, the CFPB's discussion of the possible changes in credit card terms and policies falls well short of an economic analysis that would explain and estimate the expected costs and benefits of the changes caused by the proposed rule. By setting dramatically lower safe harbor late fees, the CFPB is initiating a process that will lead to different sets of terms for millions of credit card accounts.

10. The CFPB has started this process without presenting a valid and reliable analysis of the costs and benefits of the expected new credit card terms for either credit card issuers or customers. The new regulations will impact various segments of the credit card market quite differently, so a valid analysis by the CFPB would need to account for the differential impact of the proposed rule on different groups of credit card issuers and customers. The CFPB does not attempt to measure how the proposed rule will adversely impact either credit unions or the millions of credit card customers with lower credit scores who make timely credit card payments and largely avoid late fees. The CFPB repeatedly makes excuses for why it has not presented a proper cost-benefit analysis for the economic impact of the proposed rule. The CFPB's most common reason for failing to analyze and estimate the costs and benefits of the proposed rule for customers and credit card issuers is the lack of appropriate and reliable data.[5]

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[3] The CFPB relies on the Federal Reserves Y-14 data which includes information for larger banks.

[4] Proposed Rule, pp. 18914, 18923, 18933-18936, and 18939-18940.

[5] I counted 29 times in the Proposed Rule when the CFPB indicated that it was unable to estimate or quantify an important measure because it lacked the appropriate data.

The CFPB Does Not Analyze the Impact of the Proposed Rule on the Frequency of Late Payments

11. A fundamental concept in economics is that individuals respond to incentives. If penalty late fees are lowered by more than 70%, as the CFPB intends from the proposed rule, more late payments on credit cards will occur. If higher penalty fees for multiple late payments within a six-month period are eliminated, as the CFPB would prefer, customers skip payments or make multiple late payments within a six-month period at a higher frequency than before. If a 15-day grace period is allowed before a penalty fee is assessed, more credit card customers will take advantage of this grace period and delay their payment. If late fees are frozen at $8 while the cost of other goods and services are increasing due to inflation, the frequency of late payments will increase over time as the real value of the late fee declines. While the CFPB recognizes that each of these responses will happen as the result of its proposed rule, it provides no valid or reliable estimates of the magnitude of any of these responses.

12. The CFPB cites the study by Sumit Agarwal et al., "Regulating Consumer Financial Products: Evidence from Credit Cards" that examined the consequences of the changes in late fees that followed the passage of the Card Act in 2009. The CFPB states that this study "tentatively suggests" that the expected 70% decline in revenue from the large decline in late fees will be less than fully offset by increases in other fees or APRs.[6]

13. The CFPB's suggestion about the impact of the proposed rule is flawed is flawed because late fee revenue depends on both the fee per late payment and the number of late payments that are made. The CFPB has no reliable evidence on the elasticity of the response of customers because, as noted by the CFPB, the Agarwal et. al. study, and another study by Grodzicki, et. al., relied on data from changes that "were implemented in August 2010, as the U.S. economy was still dealing with the aftermath of the Great Recession."[7] The CFPB does not consider these studies to be robust evidence of the causal impact of a reduction in late fees because they rely on before and after comparisons of behavior during a period in

[6] Proposed Rule, p. 18934.

[7] Proposed Rule, p. 18920

which the U.S. was recovering from the Great Recession.[8] In other words, the CFPB cannot reliably predict how lower late fees will impact the frequency of late credit card payments because the data from independent studies coincides with the recovery from the Great Recession.

14. The CFPB said that in developing the proposed rule it studied the impact of the decline in late fees after a customer is outside the six-month period of higher late fees due to repeated late payments. The study attempted to determine whether the lower late fee in "month seven" leads to a distinct rise in late payments. The CFPB states "In a random subsample from account-level data available in 2019 from the Y–14 data, this statistical analysis did not support that the lower late fees in "month seven" have an effect on the late payment rate, at conventional confidence levels."[9] A study based on a random subsample of credit card accounts during the transition in month seven from a possible elevated late fee to the standard late fee is inadequate for estimating the elasticity of the response of all credit card customers to the substantially lower late fees mandated in the proposed rule. The CFPB has not reported the magnitude of the effect it found or the sample size in its own unreliable study. The CFPB's "month seven" study is based on a relatively small and unrepresentative sample of credit card accounts and focused only on the subsequent payments of accounts that recently incurred a late fee.

15. The CFPB repeatedly claims that even with a more than 70% decrease in penalty late fees the cost to credit card issuers per late payment is unlikely to increase. The CFPB seems to believe that its inability to obtain a reliable estimate of the impact of the proposed rule on the frequency of late payments is unimportant because the proposed $8 safe harbor late fee currently covers the costs associated with each late payment regardless of the number of late payments. The CFPB also presumes, without providing an economic analysis or empirical study, that providing incentives for more late payments will not spill over into higher costs to credit card issuers through more delinquencies and more charge-offs.

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[8] The CFPB states that the Grodzicki et. al. study "suggests that consumers may engage in more late payments when they are less costly to consumers" but "does not consider this robust evidence that the proposed $8 safe harbor late fee amount would not have a deterrent effect." Because the changes implemented in August 2010 occurred while still dealing with the aftermath of the Great Recession it would be "difficult to attribute consumer finance statistical trends to particular events." Proposed Rule, p.18920.

[9] Proposed Rule, p. 18920

16. Even if the CFPB is correct and the decline in late fee revenue will be less than fully offset by an increase in other fees or APRs, some current credit card customers would not receive a credit card account if the late fee was $8 for every late payment. Any customer who would be denied a credit card because of the mandated reduction in penalty late fees is clearly made worse off by the CFPB's proposed rule. The CFPB has not attempted to estimate how many customers would lose their credit card because of the proposed rule.

The CFPB Provides No Economic Analysis to Determine the Overall Impact of the Proposed Rule

17. The CFPB states that the Federal Reserve Board noted in its 2010 Final Rule that "it would be inconsistent with the purpose of the [CARD Act] to permit card issuers to begin recovering losses and associated costs through penalty fees rather than through upfront rates.''[10] Despite this statement the 2010 Final Rule set a $25 safe harbor fee, allowed for a higher late fee ($35) for repeated late payments within a six-month period, and indexed safe harbor late fees to inflation.

18. The CFPB claims that the "recent profitability of consumer credit card businesses suggests that these markets are imperfectly competitive" which indicates to the CFPB that other fees and APRs may not increase to completely offset the decline in late fee revenue.[11] The "recent profitability" that suggests to the CFPB that there may be a lack of competition among credit card issuers, is during a period when the Federal Reserve kept interest rates historically low, and the Federal Government provided trillions of dollars in economic consumer assistance to mitigate the economic consequences of COVID-19 policies. These government policies reduced credit card delinquencies and charge-offs and contributed to the financial health of credit card issuers.[12] As market interest rates and inflation increase, and if the economy heads into a recession, the profitability of credit card issuers will change and the CFPB's suggestion that the credit card market is imperfectly competitive may look much different.

[10] Proposed Rule, p.18913.
[11] Proposed Rule, p. 18933.
[12] https://fred.stlouisfed.org/series/CORCCACBS and https://fred.stlouisfed.org/series/DRCCLACBS

19. Although the CFPB suggests that the credit card market might be imperfectly competitive, the CFPB March 2022 Credit Card Late Fee Report found that many credit card issuers charged late fees that were lower than the safe harbor late fee. The Report also explained that some credit card issuers offer credit card accounts with no late fees. Competition among credit card issuers involves different combinations of fees, awards, and APRs. Because credit card accounts are differentiated products, with a variety of different features, an appropriate study of the impact of the proposed rule should consider the effect of mandated lower late fees on all features and terms of credit card accounts.

20. The CFPB also suggests, with no economic justification, that credit card late fees contribute to excessive profits if they exceed pre-charge-off collection costs and contribute to covering the costs associated with future losses and charge-offs. By mandating substantially lower late fees the CFPB expects customers to face higher "upfront rates" to cover losses from charge-offs. However, the CFPB does not study the costs and benefits of these changes or identify which credit card customers would be made better off, and which would be harmed, by the mandate for lower fees and higher APRs, annual fees, or other "upfront rates." The CFPB also does not address what the impact of the proposed rule will be for credit unions that are prohibited from raising APRs above 18 percent for credit card accounts.

21. Late fees are one component of the terms of the unsecured loan that customers receive when they obtain a credit card. The card's annual fee, APR, credit limit, and the minimum payment conditional on the credit card balance are other important factors that determine the credit card's value to the customer. The supposed gain to a customer from 70% lower late fees may be more than offset by a lower credit limit, higher APR, higher annual fee, or higher minimum payment conditional on the credit card balance.

22. Other than suggesting that the decline in late fees would not be fully offset, based on unreliable empirical studies, the CFPB has not attempted to estimate how much the proposed rule would increase annual fees and APRs. The CFPB does attempt a back-of-the envelope calculation that is meant to "illustrate an upper bound of the offsetting potential effect" on APRs of a mandated late fee of $8. Based on the Y-14 data the CFPB uses, late fee payments would decline by 72.3 percent, which represents 5.8 percent of interest payments to credit card issuers, so APRs would increase by no more than 5.8 percent

or about 2 percentage points on an APR of 34.7 percent.[13] By the logic of the CFPB, if the $8 late fee is 72.7% less than the current late fee for the typical credit card issuer, as long as the number of late payments increase by 257% after the proposed rule is implemented, dollars of late fee payments will remain constant and the typical credit card issuer will not change APRs or other credit card terms.[14] The CFPB's arithmetic is simplistic and completely ignores the possibility that a massive decline in late fees, followed by a massive increase in late payments, would substantially increase the risks faced by credit card issuers and warrant higher APRs even if late fee dollar payments remained stable.

23. The CFPB also does not study how much the proposed rule would lower credit limits or increase minimum required payments. Faced with the possibility of a substantial increase in late payments, and the increased risk of losses and charge-offs, credit card issuers may reduce credit limits, deny credit card accounts to some customers, or raise minimum payment requirements. Without studying and understanding the impact of mandated lower late fees on credit card terms it is impossible for the CFPB to assess which credit card customers will be made better off and which customers will be made worse off by the proposed rule.

24. For customers who rarely pay late fees the proposed rule is very likely to have an adverse effect. Whether credit card issuers raise annual fees or APRs, or whether they reduce credit limits or increase minimum payments to counteract the effect of much lower late fees, each of these changes are less favorable for customers. In addition, unlike late payments, these changes in credit card terms apply to all customers, not only to the customers who make late payments on their credit card accounts.

25. It is also possible that some current credit card customers would not receive a credit card account if the late fee was $8, with no higher fee for multiple late payments within a six-month period. The CFPB has not attempted to estimate how many customers would no longer have a credit card because of the

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[13] Proposed Rule, p.18934.

[14] If the number of late payments increases by 257%, the dollars paid from an $8 late fee will equal the dollars paid from a $29.30 late fee. $8 is 72.7% less than $29.30.

proposed rule. Any customer who would be denied a credit card because of the mandated substantially lower penalty late fees is clearly made worse off by the CFPB's proposed rule.

26. Rather than attempting to estimate the number of credit card customers who will see a decline in their credit limit, an increase in their minimum payment, or who are denied a credit card, the CFPB instead speculates about differences between naïve and sophisticated customers.[15] This speculation, based on theories in psychology and behavioral economics, is misguided. The CFPB's March 2022 Credit Card Late Fee Report shows that over 85 percent of accounts had zero or one late payment in 2019.[16] The 85 percent of customers who consistently make payments on time may be unfamiliar with the details of the structure of late fees, because high late fees do not impact their marginal decisions. With much lower late fees, however, many more customers may become better informed about late fees and consider skipping multiple payments each year. The CFPB has not attempted to estimate how its proposed rule will impact access to credit for consumers with lower incomes and less favorable credit scores and instead tries to suggest, based on no reliable evidence, that its mandate for lower late fees may improve the information flow from credit card issuers to customers.[17]

27. The CFPB does consider the possibility that customers will turn down credit card offers because the terms are unfavorable due to the rule, but incredibly does not consider this a potential loss in consumer welfare. The CFPB states that "Lost credit to consumers consciously declining offers because of the card's actual price becoming more salient would constitute no harm to them."[18] This conjecture is completely false for many customers with lower credit scores who do not make chronic late payments and

[15] Proposed Rule, p. 18935.
[16] These calculations are based on Figures 3 and 4 in the CFPB's March 2022 Credit Card Late Fees Report.
[17] The CFPB states that it "acknowledges the possibility that consumers who were more likely to pay attention to late fees than to other consequences of paying late, like interest charges, penalty rates, credit reporting, and the loss of a grace period, might be harmed in the short run if a reduction in late fees makes it more likely that they mistakenly miss payments. The Bureau has not quantified this effect but notes that reducing late fees may increase issuer incentives to find other approaches to make the consequences of late payment salient to consumers, including reminders or warnings." Proposed Rule, p. 18935.
[18] Proposed Rule, p. 18934.

would prefer a lower APR and a much higher late fee that is rarely incurred, but would balk at a credit card with a lower late fee and higher APR.

The CFPB Does Not Study the Impact of the Proposed Rule on Credit Unions

28. The economic analysis in the proposed rule is fundamentally flawed and inadequate because it does not study the impact of the proposed rule on credit unions that issue credit cards. Credit unions are required to comply with the proposed rule but, due to Federal government regulations, can charge a maximum APR of 18 percent. Credit unions will respond differently than commercial banks to the very large reduction in late fees mandated by the proposed rule but the CFPB has not studied the impact of the rule on credit unions.

29. The CFPB explained in their March 2022 study of Credit Card Late Fees that in the fourth quarter of 2020 the most common late fee was $25, below the safe harbor late fee. The CFPB stated that lower average late fees were "driven by the practices of smaller banks and credit unions."[19] Because of the requirement that APRs for credit unions can be no more than 18 percent, the proposed rule will have the most harmful impact on credit unions even though, as a group, the CFPB has recognized that credit unions charge some of the lowest late fees in the market. The CFPB provides no economic rationale for mandating lower late fees for credit unions, knowing that credit unions are the credit card issuers least able to offset the reduction in late fees and still cover losses from delinquent and charged-off accounts through higher APRs.

A Regulatory Flexibility Act Analysis is Required but Was Not Conducted

30. The CFPB is required to conduct an Initial Regulatory Flexibility Act analysis and a final Regulatory Flexibility Act analysis unless it can certify that the rule will not have a significant economic impact on a substantial number of small entities. The CFPB estimates that there are approximately 2,785 small credit unions that report credit card assets and would be affected by the proposed rule. The CFPB also acknowledges that it does not have a reliable measure of credit card income or revenue for small

[19] Credit Card Late Fees, CFPB, March 2022, p. 14.

credit unions because credit unions are not required to report credit card income separately in NCUA call reports.[20] The CFPB states: "to assess whether the proposed rule would have a significant economic effect on small entities, the Bureau considers the significance of credit card late fee revenue as a share of the total revenue of affected small entities."[21] The CFPB "considers total late fee revenue to be an upper bound on potential impacts of the proposal on small entities."[22] Despite lacking data on credit card income and late fee revenue for small credit unions the CFPB still concludes that credit card income is a small enough component of total revenue at small credit unions for the proposed rule to not have a significant economic effect on these businesses.

31. The CFPB's economic reasoning in determining whether its proposed rule would have a significant economic impact on 2,785 small credit unions is simply incorrect. The CFPB is effectively arguing that it would not be "significant" if thousands of small credit unions were no longer able to issue credit cards because credit card assets of credit unions look comparatively small to the CFPB. It is completely inconsistent with the Regulatory Flexibility Act for the CFPB to consider a regulation to have an insignificant effect on small businesses even though the regulation will severely hamper the ability of small credit unions to effectively compete with larger banks in the credit card market.

32. The CFPB does not deny the possibility that many small credit unions that currently issue credit cards will no longer be able to compete with larger banks that can adjust to lower late fees with higher APRs. The CFPB also does not deny the possibility that small credit unions will be less able to compete effectively with banks for credit card customers with lower credit scores because of their inability to offer a higher APR to adjust to lower late fees. The CFPB has not studied the impact of the proposed rule on credit unions and is satisfied to conclude that the credit card offerings of credit unions are economically insignificant and unworthy of a Regulatory Flexibility Act analysis.

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[20] Proposed Rule, p. 18940.
[21] Proposed Rule, p. 18940.
[22] Proposed Rule, p. 18940.

The CFPB Provides No Economic Analysis to Determine Efficient or Optimal Late Fees

33. Late fees are one of the tools that credit card issuers use to discourage late payments. The proposed rule discusses other ways that credit card issuers can discourage late payments and remind customers to make timely payments.[23] Credit card issuers already send reminders to customers of upcoming due dates and notify and work with customers to make a payment after a payment is late or has been missed. The CFPB has not presented evidence that credit card issuers have made insufficient efforts to discourage customers from making late payments. The CFPB has not indicated whether (and by what amount) the frequency of late payments would decline if more messages were sent, or more phone calls were made, to customers in the days leading up to their accounts' due dates.

34. Competing credit card issuers rely on interest rates, penalty late fees, and proactive efforts to remind customers to make on-time payments. Penalty late fees discourage customers from falling behind on their credit card payments after other efforts have failed. Late fees are also a way for credit card issuers to differentiate between customers with different risks of default. Penalty late fees would be used in a competitive market in a way that efficiently manages risk and discourages late payments and would not be constrained by pre-charge-off collection costs of credit card issuers.

35. The CFPB does not present an economic analysis of the optimal penalty late fee consistent with competitive (normal) profits but instead presumes that "reasonable and proportional" late fees must be no larger than the pre-charge-off collection costs incurred by credit card issuers.[24] However, the CFPB has not presented a rational economic argument for why an optimal late fee in a competitive market should equal pre-charge-off collection costs. There is no logical reason why the safe harbor late fee should be low simply because efficient spending on pre-charge-off collections is low. This argument ignores the effect of late fees on discouraging late payments and is equivalent to arguing that the optimal fine for littering should be no higher than the cost of hiring workers to pick up the litter.

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[23] Proposed Rule, pp. 18919, 18922, 18923, and 18935.

[24] The CFPB estimates that approximately 75% of collection costs in the Y-14 financial data they examine are incurred prior to an account being charged off. Proposed Rule, p. 18911.

The CFPB Did Not Study Whether the Proposed Rule Will Reduce Credit for Subprime Customers

36. The March 2022 CFPB Credit Card Late Fee study found that in 2019 subprime and deep subprime credit card accounts represent 12% of accounts and 42% of late payment fee volume.[25] The study also found that the average deep subprime credit card account was charged 12 times more in late fees than the average "superprime" account in 2019.[26] Subprime and deep subprime customers made more late payments and more repeated late payments within the same six-month period, compared to prime and "superprime" customers.[27]

37. Not all subprime and deep subprime credit card customers incur late fees; 47 percent of subprime accounts paid no late fees in 2019 and an additional 15 percent had only one late payment all year. In addition, according to the CFPB, about 48 percent of deep subprime accounts had three or more late payments in 2019.[28]

38. Subprime and deep subprime customers, as a group, are much more likely to be impacted by the CFPB's proposed rule. Credit card issuers may respond to drastically lower late fees by providing much less credit and higher APRs (except for credit unions) to customers with lower credit scores. The unintended consequence of the CFPB's proposed rule may be less credit offered to customers with lower credit scores even though many of these customers nearly always pay their credit card bills on time and occur one or fewer late fees per account per year. While the CFPB recognizes that this may occur, it has not estimated the loss in welfare to customers with lower credit scores if they are denied a credit card or are issued a credit card with a higher APR and lower credit line.

39. Credit card issuers use late fees to help manage risk. Late fees, in addition to payment histories and other information, are used to identify which customers pose a higher risk for continued chronic late payments, delinquent accounts, and possible account charge-offs. An account that has incurred multiple

[25] These calculations are based on Figures 3 and 4 in the CFPB's March 2022 Credit Card Late Fees Report.
[26] Credit Card Late Fees, CFPB, March 2022, p. 14.
[27] The CFPB also reported that the average deep subprime customer has, on average, at least two credit cards.
[28] These calculations are based on Figures 3 and 4 in the CFPB's March 2022 Credit Card Late Fees Report.

late fees per year, at a cost of $30 or more per late payment, is unlikely to receive a credit limit increase. However, if the late fee is reduced from $30 to $8 a customer who previously missed one or fewer payments per year may now find it in their best financial interest to skip three payments per year and incur $24 in late fees. The new much lower safe harbor late fee weakens the strength of the information to the credit card issuer when an account has multiple late payments in the same year. The weaker signal due to a much lower penalty late fee may make it more difficult for customers to obtain higher credit limits, which results in a decline in consumer welfare.

40. The CFPB has not attempted to study how the information value in late fees is diminished by the proposed rule or how the rule impacts the ability of credit card issuers to manage risk, especially among customers with weaker credit histories and lower credit scores. If the proposed rule is enacted, it will be more difficult for credit card issuers to distinguish between higher and lower risk accounts.

The CFPB Does Not Study the Options Facing Credit Card Customers

41. The CFPB does not attempt to explain why customers with approximately the same credit score can have very different late payment experiences. The fact that accounts with late fee payments have higher outstanding balances offers a possible simple explanation – perhaps the minority of credit card customers who repeatedly make late payments have made more expenditures than they can afford given their economic situation. The CFPB reported that in 2019 the median minimum due for all credit card holders was $39, while the median minimum payment was $100 for credit card holders with a late payment.[29] Accounts that incur late fees have a median minimum payment that is 156% higher than the median minimum payment for all accounts even though subprime and deep subprime accounts, which likely have lower credit limits, are over-represented among accounts that paid late fees.[30]

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[29]This is for the period between September 2021 and October 2022 in the Y-14 data. Proposed Rule, pp. 18919-18920.

[30] Because the CFPB has not made their data available, it is unclear what the average credit card balances are for accounts that make payments relative to all accounts. According to publicly available Federal Reserve data from earlier this year, the average account appears to have a balance of about $1,700. https://www.newyorkfed.org/microeconomics/hhdc/background.html

42. If late fees are lowered and annual fees or APRs are increased, the millions of subprime and deep subprime credit card customers who pay their bills on time and typically avoid late payments will be partially subsidizing customers who make late payments. The CFPB does not study the cross-subsidization of credit card customers within groups defined by credit score categories, but its proposed rule will penalize subprime customers who pay their credit card bills on time relative to customers who chronically make late payments.

43. The CFPB provides an example of the consequences of late payment fees using information for the median credit card account that incurred a late payment fee in recent Y-14 data.[31] In the example the CFPB states that "the costs of paying late fees are quite steep both under current late payment fee amounts and under the proposed safe harbor amount." The CFPB states that the median customer who delays the $100 payment for the entire month, and then pays an $8 late fee, has implicitly paid $8 to borrow $100 for one month "incurring an effective APR of 96 percent."[32] While an effective APR of 96% framed in this way may seem "quite steep" to the CFPB, a late credit card fee of $8 may be an attractive choice compared to the other available options.

44. Before considering other options available to credit card customers facing difficult financial tradeoffs, note that the proposed rule also fixes the safe harbor penalty late fee at $8 even for repeated late payments within a six-month period. The hypothetical median customer in the CFPB example can therefore consistently make the minimum payment every other month for an annual cost of $48. For the hypothetical median account considered by the CFPB, the annual cost of making a minimum payment every two months rather than every month is a small percentage of the outstanding credit card balance. In addition, with the proposed 15-day grace period rational customers facing difficult economic tradeoffs would delay their payments 15 days past the due date, even in months when they make a minimum payment. Because of the proposed rule, the option to make six rather than 12 payments per year may

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[31] Proposed Rule, p. 18919-18920. The CFPB has not studied whether the typical minimum payment for accounts paid late will remain about the same after the large decline in the safe harbor penalty late fee.
[32] Proposed Rule, p. 18920.

seem attractive to customers who are struggling financially, but it will cause these customers to accumulate even more credit card debt and expose the credit card issuer to greater risk of losses.

45. The CFPB does not examine the tradeoffs facing individuals choosing to repeatedly pay late fees on their credit card accounts. A financially struggling but rational customer may well prefer paying an $8 credit card late fee instead of bank overdraft fees, auto loan late fees, obtaining a payday loan, cash advance, or pawn shop loan, or falling behind on rent, utility, or phone payments. The proposed rule may make skipping a credit card payment and paying an $8 late fee the most attractive option for individuals facing a range of unfavorable choices during periods of financial distress.

46. The CFPB has not studied how many credit card customers would choose to skip a credit card payment and pay an $8 penalty late fee when faced with difficult economic tradeoffs. The magnitude of this effect depends on the amount of financial distress faced by customers and the range of fees, penalties, and interest that would be incurred if other payments were skipped. Skipping a credit card payment for a late fee of $8 is an even more attractive option to credit card customers with the highest outstanding balances and minimum payments.

47. The CFPB has not studied whether an increase in late payments that would result from a drastic reduction in penalty late fees might cause more accounts to become delinquent and eventually result in more charge-offs and greater risk to credit card issuers. If credit card late fees are substantially reduced customers are incentivized to put a higher priority on making rent, auto loan, utility, and phone payments rather than making the minimum payment to their credit card accounts. Because the $8 fee may consistently be preferable to other fees and service interruptions, an unintended consequence of the proposed rule may be to encourage customers to fall further behind on their credit card accounts than they would have otherwise, accumulate more credit card debt, and increase the risk of charge-offs and losses.

48. The CFPB presents no economic analysis to support its view that the losses and collection costs of accounts that are charged off should only be covered by interest rate payments and other “up front” fees. There is no economic rationale for the bright line that the CFPB has drawn to separate late fees from the costs and losses from charge-offs. The CFPB has not presented evidence concerning the subsequent

behavior of the minority of credit card accounts with multiple late payments in a year. The CFPB does not report what fraction of credit card accounts with multiple late payments in the same year will become delinquent accounts or what fraction will eventually be charged off and sold to a third-party debt collector. Summary statistics presented in the proposed rule provide some empirical support for the connection between accounts that incur late fees and delinquent accounts. The CFPB states that 14% of late fees are assessed to accounts that never make another payment.[33]

49. The CFPB has not studied how substantially lower late fees will reduce incentives for credit card customers to make timely payments and whether this will increase the share of credit card accounts that are delinquent. The CFPB has also not studied whether a higher frequency of late payments, caused by the proposed rule, may also contribute to more accounts being charged off.

50. The CFPB report on late fees showed that the distribution of late fee payments is quite skewed. Calculations based on figures in the March 2022 report show that in 2019 about 74 percent of all credit card accounts had no late fee payments and just over 10 percent of accounts had three or more late fee payments.[34] If the reduction in safe harbor late fees causes credit card issuers to respond by raising annual fees and APRs, most credit card customers who make no late payments will be required to pay more in annual fees or interest to subsidize the late payments made by a minority of customers.

The CFPB Did Not Make Data Available to Interested Parties

51. The CFPB conducted analyses in its March 2022 study and in the proposed rule and did not make these data available to commenters and interested parties. In addition, the data used by the CFPB, the Federal Reserve's Y-14 data, does not include data representative of many credit card issuers who will be required to comply with the new rule. Credit unions are not represented at all in the Y-14 data.

52. It is problematic that the CFPB relied only on Y-14 data that provides information from the largest banks and no information about the credit unions that will be impacted by the regulation. This

[33] Proposed Rule, p. 18394. This correlation is not evidence of a causal effect between missing one late payment and the chance of default, but the CFPB did not study whether encouraging more late payments might cause more delinquencies and charge-offs.
[34] These calculations are based on Figures 3 and 4 in the CFPB's March 2022 Credit Card Late Fees Report.

omission is even more glaring because credit unions face an 18% limit on the APR for their credit cards and the larger banks do not. As explained above, credit unions face more limited options for reacting to the mandated large decline in late fees. The CFPB should have relied on data that would have allowed it to study the unique situation faced by credit unions, but it did not.

The CFPB Did Not Study the Impact of Freezing Safe Harbor Late Fees

53. The CFPB has not studied how freezing the $8 safe harbor late fee will impact the credit card market as a fixed $8 fee becomes worth even less in real terms due to inflation. The CFPB has decided to eliminate the automatic inflation adjustment for penalty late fees while inflation is higher than it has been since the passage of the CARD Act in 2009.[35] Because inflation is higher than it has been in decades, a fixed $8 safe harbor late fee is declining in real value at a much faster rate than it would have previously. The failure of the proposed rule to index safe harbor late fees to the CPI could have unanticipated and unintended consequences in inflation continues at the rates we have seen in the past two years.

54. An important benefit of an inflation-adjusted safe harbor penalty late fee, which maintains the value of the late fee in real dollars, is that it provides regulatory certainty to credit card markets. If the CFPB is concerned that nominal fees might change too quickly, the proposed rule could have allowed for indexing of the safe harbor late fee every other year, or once every three years. The CFPB suggests that the safe harbor late fee will be increased in future years, but it is uncertain when, and by how much, the safe harbor fee would be adjusted.[36] This regulatory uncertainty benefits neither credit card issuers nor credit card customers.

The CFPB Did Not Study How the Proposed Rule Would be Impacted by Higher Market Interest Rates

55. The CFPB did not study how the proposed rule would impact the credit card market in the presence of nominal interest rates that are much higher than they have been since the passage of the

[35] In the 12 years between 2009 and 2020 the Consumer Price Index (CPI) increased at an annual rate of only 1.84% per year. According to the latest data from March 2023, the CPI increased by about 5.0% over the past 12 months and by 14.0% over the past two years. https://www.bls.gov/cpi/data.htm
[36] Proposed Rule, p. 18937.

CARD Act in 2009. In the 12 years between 2009 and 2020 the average one-year Treasury Bill rate was about 0.68 percent. During April 2023 the average one-year Treasury Bill rate was 4.71 percent.[37]

56. The opportunity cost of loanable funds is much higher now than it has been in years. This is especially important for a credit union that cannot charge an APR of more than 18 percent to its credit card customers. The differential between the APR on a credit card from a credit union and a one-year Treasury Bill is much lower than it was been for most of the months since 2009. If the safe harbor late fee is reduced to $8 it will be even more difficult for credit unions to adjust to the increased risk of losses and charge-offs given the relatively high opportunity cost of loanable funds.

57. Higher inflation and interest rates can also have an important impact on customer incentives to repay credit card balances in a timely fashion. As interest rates have risen, it may be more attractive for customers to delay credit card payments as it becomes more difficult to make other loan payments such as for auto loans.[38]

58. Consumers facing transitory difficult financial circumstances are in a different situation today, with higher car loan payments and other expenses, than they were prior to the increase in inflation and interest rates over the past two years. The CFPB has not studied how higher interest rates on other personal loans would impact the frequency of late payments among credit card holders. The CFPB has also not studied the unique situation of credit unions, that may only charge an APR of 18 percent, in an environment in which market interest rates are substantially higher than at any time since the passage of the CARD Act.

The Safe Harbor Late Fee is the De Facto Late Fee

59. If the proposed rule is adopted the CFPB expects that a relatively small minority of credit card issuers will use the cost analysis provisions to charge late fee amounts above the $8 safe harbor late fee.[39]

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[37] https://fred.stlouisfed.org/series/DTB1YR

[38] The average interest rate on a 48-month new automobile loan at commercial banks was 5.07% over the 12-year period from 2009 to 2020. In the most recent Federal Reserve data the average interest rate on a 48-month auto loan was 7.46%. https://fred.stlouisfed.org/series/TERMCBAUTO48NS

[39] Proposed Rule, pp. 18917 and 18933.

This is likely correct because the CFPB has taken the position that a higher penalty fee cannot be justified by showing that it deters late payments, is helpful for risk management, or helps offset losses due to charge-offs. If the proposed rule is adopted the only apparent justification for a late fee above the safe harbor level of $8 that the CFPB would consider is pre-charge-off collection fees that are more than $8 per late payment.

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