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CFPB Proposed Rule Would Revolutionize Framework for Credit Card Late Fees

Proposed Rule Also Suggests Future Efforts to Materially Modify the Framework Governing Credit Card Penalty Fees

SUMMARY

On February 1, the CFPB issued a much-anticipated proposed rule that, if adopted in its current form, would revolutionize the current regulatory regime for assessing credit card late fees by sharply decreasing the maximum amounts consumers may be charged for a late payment and, as a result, the corresponding late fee revenues received by issuers. Specifically, the proposal would (1) lower the so-called "safe harbor" in Regulation Z for late fees by nearly 75 percent—from $30 to $8 dollars—and preclude issuers from imposing a higher fee, which is currently $41, for subsequent late payments; (2) eliminate inflation adjustments to the safe harbor amount, thus "freezing" the $8 safe harbor amount until such time as the CFPB determines an upward (or downward) adjustment is appropriate; and (3) irrespective of the foregoing, cap any late fee amount an issuer may charge to 25 percent of the consumer's required payment amount. Although focused primarily on these three adjustments, the CFPB signals in the release that it is considering other significant changes to the regime now governing credit card penalty fees, including eliminating safe harbors entirely and prohibiting issuers from imposing late fees within 15 days following the relevant due date. The proposed rule represents the most significant development to date in a series of CFPB initiatives aimed at reducing or eliminating bank fees that the CFPB views as harmful to consumers.

Comments on the proposed rule are due by the later of April 3, 2023, or 30 days after publication in the Federal Register. Opposition is likely to be strenuous, including because, based on the CFPB's own analysis, the proposed rule would reduce annual fee income of credit card issuers by billions of dollars annually.

BACKGROUND

A. THE CARD ACT AND SAFE HARBOR

The Credit Card Accountability Responsibility and Disclosure Act (the "CARD Act") was enacted in 2009, with a view to protecting consumers from unfair practices by credit card issuers. As relevant here, the CARD Act requires penalty fees charged by credit card issuers, including late fees, to be "reasonable and proportional" to the omission for which the fee is charged.[1]

As originally enacted, the CARD Act assigned rulewriting authority to the Federal Reserve, including the discretionary authority to "provide an amount for any penalty fee or charge … that is presumed to be reasonable and proportional"—the so-called "safe harbor."[2] In 2010, the Federal Reserve issued a rule implementing the penalty provisions of the CARD Act, including the safe harbor, as amendments to Regulation Z. The safe harbor reflected the penalty fee amounts the Federal Reserve determined presumptively reasonable. Initially, the Federal Reserve set these amounts at $25 for the first late payment and $35 for additional late payments during the next six billing cycles, in each case to be adjusted annually for inflation. Under this safe harbor, a fee was presumed to be permissible as long as it did not exceed these specific dollar amounts. An issuer that chose not to rely on the safe harbor could impose a fee only if it performed an annual "cost analysis" and determined that the dollar amount of the fee represented a reasonable proportion of the total costs incurred by the card issuer as a result of the late payment.[3] In either case, under the Federal Reserve's rule, a late fee could not exceed 100 percent of the required payment.[4]

In 2011, rulewriting authority under the CARD Act was transferred to the CFPB. The CFPB promptly reissued the Federal Reserve's implementing amendments, including the safe harbor and cost analysis provisions, substantially unchanged. Since then, the CFPB's only adjustments to the safe harbor have been to increase the specified amounts to account for inflation. Presently, the inflation-adjusted amounts are $30 for the first late payment and $41 for each additional late payment during the next six billing cycles.[5]

B. RECENT DEVELOPMENTS, INCLUDING THE CFPB'S 2022 ANPR

Over roughly the last year, the CFPB has increased its focus on what it refers to as "junk fees"—or fees that the CFPB considers harmful to consumers because they are not subject to competitive processes that ensure fair pricing.[6] The CFPB has typically characterized late fees among "junk fees," including in a January 2022 request for information that marked the start of "a new effort to help save American families billions of dollars in junk fees" and end bank reliance on these "exploitative" income streams.[7] Two months later, in March 2022, the CFPB issued a report focused on credit card late fees. In the report, the CFPB concluded, among other things, that many major card issuers charge the maximum amount allowed under the safe harbor.[8] In June 2022, roughly two months after releasing that report, the CFPB issued an Advanced Notice of Proposed Rulemaking requesting information regarding credit card late fees, late payments, and card issuers' revenue and expenses, signaling at the time its view that the Federal Reserve's

2010 amendments to Regulation Z "give immunity to credit card issuers against enforcement actions for charging late fees and hiking them annually to adjust for inflation."[9]

CFPB PROPOSED RULE

The CFPB's February 1 proposal is aligned with these earlier statements. In the proposal, the CFPB expresses concern that the current safe harbor dollar amounts are not reasonable and proportional to the conduct prompting the fee, the fee for subsequent late payments is higher than is justified based on consumer conduct and to deter future violations, and additional restrictions on late fees are needed to ensure they are reasonable and proportional.[10] To address these concerns, the CFPB proposes to: (A) lower the safe harbor for late fees to $8 dollars and eliminate any higher safe harbor amount for subsequent violations—i.e., an issuer may charge only an $8 late fee for both the first and subsequent violations; (B) eliminate automatic inflation adjustments to the safe harbor amounts; and (C) cap any late fee amount to no more than 25 percent of the required payment. The proposal would also amend related commentary, including to clarify that the costs that may be considered for purposes of the cost analysis provisions that an issuer may use to determine penalty amounts do not include collection costs incurred after an account is charged off,[11] and otherwise to align the commentary with the proposed rule changes.

In rationalizing these changes, the CFPB relies primarily on Y-14M data that the Federal Reserve has collected on a monthly basis since June 2012 from large firms to assess capital adequacy,[12] and some instances on "Y-14+ data," which includes both the Y-14M data and data separately collected by the CFPB from a group of mass market and specialized issuers.[13] The CFPB suggests that reliance on this data—data that was not available to the Federal Reserve in 2010—is appropriate in light of the dearth of data and other reliable evidence submitted in response to the ANPR.[14] The CFPB also cites this more recent data as a rationale for the significant shift in approach from the Federal Reserve's analysis when the safe harbor rule was first issued. Nevertheless, the proposed rule represents a rebuke of the prior rulemaking by the Federal Reserve and subsequently the CFPB itself.

The bulk of the proposed rule is devoted to justifying the proposed $8 safe harbor figure, with little discussion of the CFPB's proposals to eliminate inflation adjustments and impose a 25 percent cap. Significantly, although the proposed rule is limited to late fees, seemingly based on the CFPB's analysis of data indicating that late fees account for nearly 99 percent of penalty fees,[15] the CFPB seeks comment on a much wider array of possibilities, including whether the CFPB should apply the proposed changes to seriously delinquent charge accounts and other penalty fees, such as over-the-limit fees, returned payment fees, and declined access check fees;[16] eliminate the safe harbors for late fees and other penalty fees entirely; prohibit card issuers from imposing late fees and other penalty fees on consumers that make the required payment within 15 days following the relevant due date on the basis that "card issuers may not incur significant costs to collect late payments immediately after a late payment violation";[17] and, as a

condition to invoking the safe harbor, require card issuers to offer automatic payment options or notification of the payment due date within a certain period prior to the due date.

A. REDUCED SAFE HARBOR

In the proposed rule, the CFPB explains that its reduced safe harbor figure "better represents a balance of [1] issuer costs, [2] deterrent effects, [and] [3] consumer conduct, as well as [4] the benefits to issuers that result from relying on a safe harbor amount, like reduced administrative costs, and the possible beneficial effects of lower late fees on subprime cardholders' repayment behavior."[18] The first three factors align with the factors the CFPB is required by the CARD Act to consider, while the CFPB maintains that the final "benefits" factor falls under the CFPB's discretionary authority to also consider "such other factors as the [CFPB] may deem necessary or appropriate."[19]

1. Issuer Costs

Under the CARD Act, the CFPB must consider "the cost incurred by the creditor" from a late payment.[20] To assess issuer costs, the CFPB looked at two data points in the Y-14 data: (1) late fee income and (2) costs associated with the collection of late payments. The Y-14 data includes both pre-charge-off and post-charge-off collection costs, but the CFPB determined that considering only pre-charge-off collection costs is consistent with congressional intent.[21] Based primarily on the CFPB's understanding of commission amounts paid to third-party debt collectors for charged-off accounts, the CFPB estimates in the proposal that 25 percent of collection costs are incurred by issuers post-charge-off and 75 percent pre-charge-off. Accordingly, the CFPB includes only 75 percent of the collection costs reflected in Y-14 data in its data analysis leading to the new safe harbor threshold.

With late fee income and an estimate of pre-charge-off collection costs in hand, the CFPB looked at the ratio of the first to the second over time. For example, for the first three quarters of 2022, total late fee income was $4.46 billion, and 75 percent of the total collection cost data was $896 million.[22] The CFPB made similar calculations from 2013 through early 2022, arriving at the conclusion that late fee income generally exceeded pre-charge-off costs more than fivefold.[23] In other words, based on the Y-14 data, issuers received $5 in income for every $1 spent on pre-charge-off collections, or "revenue that is multiple times higher than issuers' collection costs."[24]

To determine an appropriate safe harbor amount, the CFPB then applied this five-to-one ratio to the $40 maximum late fee amount that, based on the CFPB's review of credit card agreements, is typically disclosed by the large issuers whose Y-14 data was included in the analysis. In other words, based on its analysis of the Y-14 data, the CFPB estimated that, for every $5 collected by issuers, those issuers spent $1 on pre-charge-off collections and, because issuers disclosed that they typically charge up to $40 as a late fee, an $8 (one-fifth of $40) safe harbor would permit an issuer to recover its pre-charge-off collection costs. The CFPB suggests that it views the $8 figure as generous because Y-14+ data shows that the average late fee actually charged by issuers was only $31.[25] Further, according to the CFPB, even if more

consumers pay late by virtue of the reduced safe harbor, collection costs to card issuers would not increase more than fee income.[26]

According to the CFPB, if an issuer's pre-charge-off collection costs are higher than $8, it may choose to determine its late fee amount using the cost analysis provisions or "undertake efforts to reduce collection costs or use interest rates or other charges to recover some of the costs of collecting late payments. Building those costs into upfront rates would provide consumers greater transparency regarding the cost of using their credit card accounts."[27]

2. Deterrent Effects

Under the CARD Act, the CFPB must also consider the deterrent value of any safe harbor amount.[28] To assess deterrent value, the CFPB imputes various effective APRs based on payment amount data in the Y-14 data. For example, the CFPB poses an assumption that the median minimum payment amount was $100 for accounts that paid late during a particular period. According to the CFPB, if a consumer must pay an $8 late fee to "borrow" that $100 for one month, the consumer "incur[s] an effective 96 percent APR[.]"[29] Because the median minimum payment due was actually $39 and about 50 percent of late payers paid less than 10 days late, the "effective APR could be higher than 730 percent for some consumers."[30] The CFPB concludes that these "effective APRs" with an $8 late fee will be a "powerful deterrent."

As evidence that the $8 safe harbor amount would still be more costly to the consumer than making a timely payment, the CFPB also points to "empirical investigations" concluding that late fee payments can be avoided by small and relatively costless changes in behavior.[31] The CFPB largely dismisses studies concluding that decreases in late fees lead to increases in the likelihood of late payments or that higher fees are required to deter cardholders from making a late payment.[32] The CFPB maintains that its own analysis of consumer behavior over time, as reflected in the Y-14 data, showed no meaningful deterrent effect in increasing late fees, including for subsequent late payments.

In any event, the CFPB points to other methods card issuers have used effectively to reduce late payments and facilitate timely payments, such as automatic payment methods, prior notification of payment due dates, reporting the late payment to a credit bureau, decreasing the consumer's credit line, limiting the cardholder's earning or redemption of rewards, and imposing penalty rates.[33]

3. Consumer Conduct

Under the CARD Act, the CFPB must also consider "the conduct of the cardholder."[34] The CFPB rejects the Federal Reserve's earlier conclusion that multiple late payments are associated with increased credit risk and reflect a more serious consumer violation. Instead, the CFPB, again looking to Y-14 data, concludes that most late-paying consumers still pay within 30 days of the payment due date. The CFPB also states its understanding that issuers do not report consumers to credit bureaus until after 30 days following the due date (thus suggesting that late payment is not considered to present credit risk until that

time), and its belief that consumers may have legitimate cashflow reasons for paying late.[35] Again, the CFPB points to other methods card issuers have to address credit risk, such as decreasing the consumer's credit line and imposing penalty rates.[36]

4. Benefits to Issuers and Consumers

The CARD Act affords the CFPB discretion to also consider "such other factors as the Bureau may deem necessary or appropriate."[37] Relying on this authority, the CFPB concludes that it is both "necessary and appropriate" in determining whether a late fee is "reasonable and proportional to take into account the possible impact of lower late fees on cardholders' repayment behavior and finances."[38] According to the CFPB, the current higher late fee amount may disproportionately affect subprime borrowers. The CFPB also posits that even if the industry responds to the reduced fee income by adjusting interest rates or other card terms, consumers will gain overall by the reduced late fees, including through the increased ability of subprime consumers to repay revolving debt using the funds they would have otherwise applied to late fees.[39] The CFPB recognizes that interest rates may increase more for subprime borrowers and lead those borrowers to conclude that the cards are too expensive, but reasons that, even if this were to happen, "[l]ost credit to consumers consciously declining offers because of the card's actual price becoming more salient would constitute no harm to them."[40] The CFPB suggests that a lower safe harbor could also lower issuers' losses from delinquencies by reducing the likelihood and severity of default in the population most prone to default.[41] Further, the CFPB suggests that the $8 safe harbor may still be attractive to issuers because of the cost savings associated with the compliance certainty and administrative simplicity that reliance on the safe harbor affords.[42]

The CFPB's consumer benefits analysis also appears to have been influenced by a view that the consumer credit card market is "imperfectly competitive," and, based on Federal Reserve analysis, issuers earn higher returns on consumer credit cards than other banking activities. This view has at least tentatively led the CFPB to opine that the reduced fee income is unlikely to be fully offset by price increases elsewhere in the consumer credit card relationship. The CFPB also opined for a similar reason that a reduction in penalty fee income is unlikely to reduce the availability of credit cards, or result in increased exit from this market or reduced entry of new issuers.[43]

B. ELIMINATING INFLATION ADJUSTMENTS

The CFPB states that automatic inflation adjustments based, as they now are, on the Consumer Price Index ("CPI") "are not necessarily reflective of how the cost of late payment to issuers changes over time." Instead of adopting automatic adjustments, the CFPB states it will "monitor the safe harbor amount for late fees for potential adjustments as necessary" and make those adjustments on an *ad hoc* basis. It reasons that this approach is appropriate for three reasons: (1) its review of data shows that issuer costs associated with collecting late payments fluctuate more than price levels, so automatic adjustments based on the CPI are not necessarily reflective of how issuer costs change over time; (2) the Federal Reserve considered the

deterrent effect of adjusting the safe harbor amount by inflation, and, in the CFBP's view, deterrence should neither be the driving factor in whether the late fee safe harbor amount should be automatically adjusted according to the CPI nor should it outweigh considerations of issuers' costs; and (3) the two preceding considerations outweigh any efficiency considerations.[44]

C. 25 PERCENT CAP

As to capping any late fee amount to no more than 25 percent of the required payment, the CFPB explains that the current 100 percent limit is not "reasonable and proportional" to an issuer's collection costs.[45] This conclusion is based on the CFPB's stated understanding that card issuers typically pay a contingency fee of between 9.5 and 23 percent to collection agencies for pre-charge-off collections[46] and the CFPB's analysis of data indicating that an issuer would be restricted to charging below the $8 safe harbor less than 10 percent of the time.[47] The CFPB explains that it does not expect this proposal to materially change the late fee income issuers can collect because it would require issuers to impose late fees lower than $8 only when the minimum periodic payment due is $32 or less, and such instances are not expected to be frequent.[48]

IMPLICATIONS

The proposed rule, if adopted in its current form, would revolutionize the current regulatory regime for assessing credit card late fees. The CFPB's evidence justifying the overhaul lies primarily in Y-14 data and the perceived absence of "better" data or evidence. If issuers and other interested parties have such data or evidence or can identify deficiencies in the CFPB's analysis, that information should be marshalled in response to the proposed rule. Equally significant are the CFPB's repeated suggestions that further overhauls to perceived "junk fees" may be in the offing, including applying the proposed late fee safe harbor changes to other penalty fees, eliminating the safe harbors for penalty fees entirely, prohibiting card issuers from imposing penalty fees on consumers that make the required payment within 15 days following the relevant due date, or requiring issuers to offer automatic payment options or payment due date notification within a certain period prior to the due date as a condition to invoking the safe harbor. The CFPB provides no legal basis for these other changes and the CFPB has not actually proposed to adopt them. Notably, however, the CARD Act does not require the CFPB to implement a safe harbor; it merely "authorize[s]" it to do so.[49] For this reason, elimination of the safe harbor entirely should not be ruled out. Issuers should remain alert to further CFPB initiatives directed at potential additional adjustments to the current regime.

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ENDNOTES

[1] 15 U.S.C. § 1665d.

[2] 15 U.S.C. § 1665d (2009).

[3] *Id.*

[4] 12 C.F.R. § 1026.52(b)(2)(i)(A).

[5] See 12 C.F.R. § 1026.52(b)(1).

[6] In December 2021, for example, the CFPB released a report examining the practices of depository institutions with regard to overdraft and non-sufficient funds ("NSF") fees. After finding that "overdraft and NSF fees made up close to two-thirds of reported fee revenue," CFPB Director Rohit Chopra criticized banks for becoming "hooked on overdraft fees to feed their profit model" instead of competing on price and service. CFPB Research Shows Banks' Deep Dependence on Overdraft Fees (Dec. 1, 2021), *available at* https://www.consumerfinance.gov/about-us/newsroom/cfpb-research-shows-banks-deep-dependence-on-overdraft-fees/.

[7] Prepared Remarks of CFPB Director Rohit Chopra on the Junk Fees RFI Press Call (Jan. 26, 2022), *available at* https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-rohit-chopra-on-the-junk-fees-rfi-press-call/. Since December 2021, numerous banks of varying sizes have announced they are reducing or eliminating overdraft or NSF fees. We are not aware of any analysis by the CFPB (or any other agency) as to the potential impact of elimination or severe reduction of fees on the income of banks, particularly community banks, or on future interest rate costs.

[8] CFPB Finds Credit Card Companies Charged $12 Billion in Late Fee Penalties in 2020 (Mar. 29, 2022), *available at* https://www.consumerfinance.gov/about-us/newsroom/cfpb-finds-credit-card-companies-charged-12-billion-in-late-fee-penalties-in-2020/.

[9] CFPB, Prepared Remarks of Director Chopra on Credit Card late Fees ANPR Press Call (June 22, 2022), *available at* https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-director-chopra-on-credit-card-late-fees-anpr-press-call/.

[10] NPRM at 31.

[11] The CFPB's rationale is that when an account has been charged off, the issuer has written the account off as a loss, and any cost in collecting amounts owed that is incurred post-charge-off is related to mitigating the loss. *Id.* at 29. The Commentary issued by the Federal Reserve in 2010 prohibited inclusion of "Losses and associated costs (including the cost of holding reserves against potential losses and the cost of funding delinquent accounts)," but did not explicitly prohibit post-charge off collection costs. Official Commentary to 12 C.F.R. § 1026.52(b)(1)(i).

[12] This data is collected via a form—Form FR Y-14M—and only from bank holding companies with consolidated assets exceeding $50 billion. The purpose of the Federal Reserve in collecting this data is "to assess the capital adequacy of large firms using forward-looking projections of revenue and losses, to support supervisory stress test models and continuous monitoring efforts, and to inform the Federal Reserve's operational decision-making as it continues to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010." *See* Federal Reserve, FR Y-14M, Capital Assessments and Stress Testing, *available at* https://www.federalreserve.gov/apps/reportingforms/Report/Index/FR_Y-14M. This data—referred to in the proposed rule as "Y-14 data"—was also relied on by the CFPB in its March 2022 report focused on credit card late fees and in its periodic CARD Act reporting to Congress. The Y-14 data includes the following with respect to credit card portfolios: reported net fee income assessed for late or nonpayment accounts (late fee income for purposes of the CFPB's proposal); reported costs incurred to collect problem credits; reported amount of the late fee charged on a particular account; and reported total payment amount on a particular account.

ENDNOTES (CONTINUED)

[13] NPRM at 17-18.

[14] *Id.* at 17, 46. The CFPB also refers at various times to data collected directly from credit card issuers to support the CFPB's biennial report on the state of the consumer credit card market as required by the CARD Act. At the same time, the CFPB acknowledges that "while the data and research available to the Bureau provide an important basis for understanding the likely effects of the proposal, the data and research are not sufficient to fully quantify the potential effects of the proposal for consumers and issuers." NPRM at 96.

[15] NPRM at 32.

[16] The CFPB does not propose amending the safe harbor applicable to "seriously delinquent" charge card accounts,12 C.F.R. § 1026.52(b)(1)(ii)(C), or to other types of penalty fees. The CFPB would clarify that late fees not meeting the seriously delinquent standard in Regulation Z are within the scope of the $8 safe harbor. NPRM at 81.

[17] NPRM at 80.

[18] NPRM at 67.

[19] 15 U.S.C. § 1665d(c)(4); NPRM at 51, 61.

[20] 15 U.S.C. § 1665d(c)(1).

[21] NPRM at 40.

[22] The CFPB estimates that this includes 73 percent of total consumer credit card balances at the end of September 2022. NPRM at 42.

[23] NPRM at 43.

[24] NPRM at 41.

[25] In addition, although the Y-14 data only encompasses large issuers, the CFPB states that it has no reason to expect that pre-charge-off collection costs for small issuers would be higher than for larger issuers. NPRM at 50.

[26] NPRM at 47.

[27] NPRM at 52.

[28] 15 U.S.C. § 1665d(c)(2).

[29] NPRM at 53-54.

[30] NPRM at 54.

[31] NPRM at 58.

[32] The CFPB reasons that these studies were "confounded by other market changes," such as the Great Recession; based on questions posed to consumers on hypothetical late payment amounts that are "less informative;" or are otherwise of limited relevance. NPRM at 56, 58.

[33] NPRM at 53, 62-63.

[34] 15 U.S.C. § 1665d(c)(3).

[35] NPRM at 64.

[36] NPRM at 66.

[37] 15 U.S.C. § 1665d(c)(4).

[38] NPRM at 60 (citing 15 U.S.C. § 1665d).

[39] NPRM at 61.

ENDNOTES (CONTINUED)

40 NPRM at 105.

41 NPRM at 61.

42 NPRM at 51.

43 NRPM at 103.

44 NPRM at 77-78.

45 NPRM at 85.

46 This range is based on information provided to the CFPB in response to information requests issued under order for purposes of complying with the CFPB's periodic CARD Act reports to Congress. NPRM at 85.

47 NNPRM at 86.

48 NPRM at 48.

49 15 U.S.C. § 1665d(e).

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