New Credit Card Late Fee Regulation

Strategy and Unit Economics Impact

By Andrew Thiesse, Travis Gray, and Dave Wasik

Executive Summary

In the latest of a series of moves to reduce ”junk fees” from banking products, the CFPB has announced new regulation to reduce credit card late fees to a maximum of $8 per incidence, without higher safe harbor amounts for subsequent violations. While this regulation will only apply to card issuers with greater than 1 million credit cards, this regulation will lead to large reductions in approval rates, especially for subprime borrowers, and reduce the profitability of existing credit card portfolios. While these changes are designed to protect the consumer, card issuers will almost certainly take actions to recoup profitability elsewhere, likely through increased annual/monthly membership fees, new product designs, and increased interest rates.

In this paper, 2nd Order Solutions (2OS) analyzes the proposed regulation in three sections.

1. **Historical precedent and current landscape**: An overview of current policy and comparison to previous policy that impacted credit card late fees. Previously the CARD Act caused a reduction in late fees as well as overlimit fees, but research showed that banks made up for this by increasing interest rates, decreasing line sizes, and increasing other fees such as balance transfer and cash advance fees. Currently over 25% of late fees are incurred by subprime and deep subprime accounts (6% of accounts.)
2. **Case study**: We created and analyzed the impact of the proposal on a synthetic subprime credit card portfolio. We found that with no other changes the approval rate on new originations would decline by almost 50% in the 600-680 FICO score range. When running a break-even analysis for these groups, an annual membership fee of approximately $45 would be needed to return this segment to previous levels of profitability.
3. **Back book impacts**: We considered impacts to existing card accounts and ways banks might mitigate the financial impacts of the regulation. Similar to their response to the Card Act, banks will likely look to other revenue drivers such as annual fees and penalty repricing to improve the profitability of the back book. One mitigating factor for card portfolios is that reduced late fees will reduce minimum payments for delinquent customers. This will reduce the size of the payment needed for the borrower to get the card back to current status.

Contents

Introduction

Overview of New Regulation

On March 5th, an amendment to Regulation Z was announced by the CFPB, changing the late fee structure for credit cards provided by issuers with > 1 million open card accounts. It was deemed that these issuers are receiving late fee income that exceeds the costs of collections by a factor of 4. The CFPB has deemed it sufficient for most issuers to be able to cover collections costs with a late fee of $8 and has removed automatic inflation adjustments for that amount for issuers that have 1 million or more open accounts. While the regulation suggests that issuers with greater than 1 million open accounts will feel the legislation first, the wording in the final rule leaves an opening for Small Card Issuers to feel the impact of this in the future. Companies would only be able to charge above this amount so long as they could prove the higher fee is necessary to cover their incurred collections costs (CFPB).

Current Late Fee Structure	New Late Fee Structure
$30 late fee penalty for first time offenders $41 maximum late fee for any subsequent offenses within the next 6 billing cycles	$8 maximum late fee

The CFPB has designed the fee change with the aim of ensuring late fees are "reasonable and proportional" to the cost incurred by the issuer. While these changes are being made to protect the consumer, issuers will need to address the financial ramifications of how these changes will affect the current backbook, future originations, and consumer behavior moving forward.

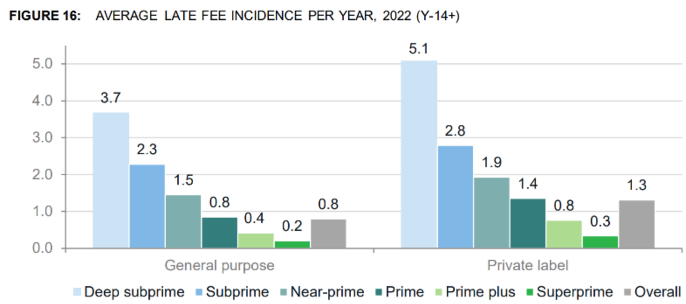
Historical Precedent

We've seen a similar scenario play out before. In 2009 the CARD Act had a component of its policy that reduced credit card fees. At the time there was uncertainty as to how banks would respond and what the net impact on consumers would be. The immediate impact was that average credit card late fees were reduced by 33%, though the regulation allowed the maximum fee to rise with inflation. According to the CFPB consumers saved $7 billion on late fees from 2011-2014 due to the change. However, in 2013 the Boston Fed released a report examining the effects of the CARD Act on consumer banking and found that banks assigned lower credit limits, increased interest rates (Boston Fed), and increased fees associated with balance transfers and cash advances. We expect the new changes to have similar effects with consumers saving on late fees while issuers make changes elsewhere in product terms to mitigate the impact.

State of Late Fees Today

By year end 2022 the average late fee assessed was $32, the highest level since prior to the CARD act. This is only $3 below the original safe harbor of $35, which itself was only allowed when customers had multiple delinquencies. Late fees accounted for $14.5 billion in revenue in 2022 and were the largest source of fee revenue for credit card issuers (10% of all interest & fees charged by financial institutions).

The proposed amendment to Regulation Z will implement a cap on late fees of $8 per incidence. Absent any mitigating factors this would result in a decrease in revenue of $10.8 billion annually across the industry. While the average consumer incurs a late fee once in a calendar year, subprime and deep subprime customers tend to incur late fees more frequently. As a result, subprime and deep subprime customers make up only 6% of the population but generate over a quarter of all late fees. Issuers that specialize in subprime and deep subprime card, as well as private label cards will be particularly impacted by these regulatory changes.



Late Fee Incidences from [2023 Consumer Credit Card Market Report]

Commentary on the Regulation

While most of this paper focuses on the impact of the new regulation, it's worth spending a moment on whether this regulation is good for consumers. Banking regulators, especially the CFPB, must wrestle with several potential definitions of "good for consumers", including:

Transparency: is the late fee structure of the credit card easy to understand? A late fee is easy to understand; if you pay late, you get a fee. Keep that in mind when we (attempt to) explain an increase in penalty repricing rate later in the paper.

Cost of Credit: how expensive is it for borrowers to get credit? "Expensive" can be defined as the total fees and interest associated with the card. Reducing the average late fee by ~75% will take a huge bite out of the cost of credit for subprime borrowers, even after mitigating product changes like membership fee increases and increased interest rates are factored in. What's unfortunate about this change is that higher late fees, unlike higher membership fees, enable lower cost of credit for customers who pay on time, and higher cost of credit for those who don't.

"Proportionate" Fee Structure: is the current late fee structure reasonable given the infraction? As mentioned earlier in this section, credit limits, and therefore average balances for subprime borrowers have trended down since the implementation of the CARD Act, but the average late fee has in many cases gone up. Paying $35 for being late on a $10,000 loan seems reasonable, but paying $35 for being late on a $1000 loan could reasonably be viewed as disproportionate.

Broader Access to Credit: for many thin-file or subprime borrowers, a credit card is a broadly available way to establish/re-establish a good credit history. One of the regulators' objectives in the recent past has been to open access to credit to reach more unserved/underserved borrowers. Even with the product changes described later in this paper, these late fee changes will work against this objective.

Overall, the late fee regulation is a net positive on many of these dimensions. Our worries are: (1) a reduction in late fees, which are very transparent and easy to understand, will be replaced by secondary terms which are far more opaque; and (2) lower late fees will lead to an increase in the cost of credit to consumers who pay on time because of increases to interest rates, membership fees, etc.

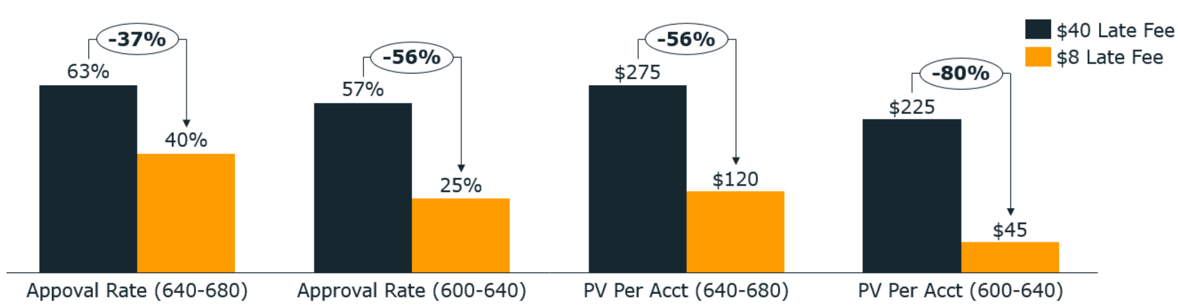
Front Book Effect

Case Study – Subprime Credit Card

Here, 2OS provides a case study of a hypothetical subprime card issuer to evaluate the potential effects of the new regulation. We assume the issuer today offers a product with a $0 annual fee and a 26.99% APR; the objective is to evaluate impacts to both volume of new credit card originations as well as estimated present value (PV) of these originations. We assume here that a new credit card is approved when PV > 0.

Fico Ranges	PV Per Account ($40 Late Fee)	Approval Rate	PV per account ($8 Late Fee)	Approval Rate	% Decline in Total PV
640 - 680	$ 275	63%	$ 120	40%	72%
600 - 640	$ 225	57%	$ 45	25%	91%

*Internal Valuation Model using synthetic data to mimic a predominately subprime portfolio. Average Line size for these two segments is $720.
*Assumed Discount Rate of 20%



As a base case we examined the impact of simply reducing late fees from the current value of $40 to the proposed $8 level. The effects can be seen to varying degrees across the entire portfolio. The largest impact is on the lowest FICO score range of 600-640 where there was an 80% reduction of PV per account and 56% reduction in approval rate for this segment of the portfolio. The impact is largest within this group because credit limits, balances, and purchase volume tend to be smaller, meaning late fees make up a larger percentage of revenue for these accounts. We used a simple threshold of PV > $0 for approval, assuming a discount rate of 20%.

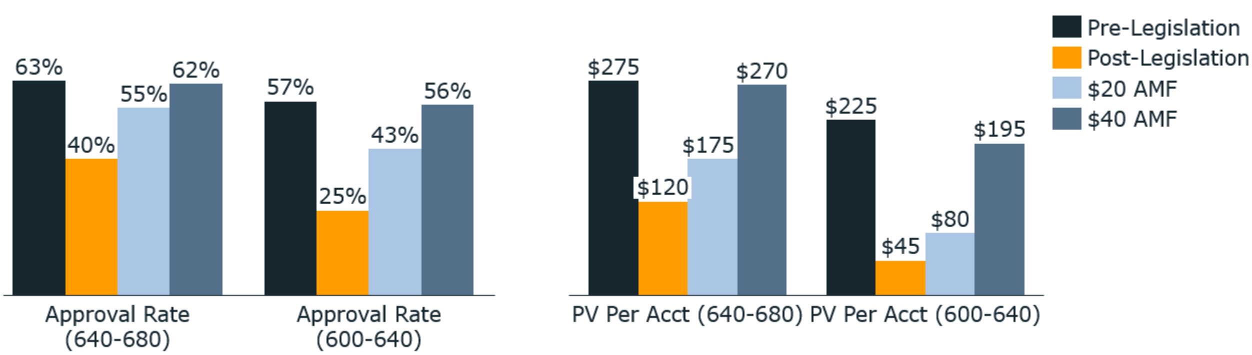
Break Even Analysis

We next examined what banks might do in response to the loss in late fee revenue. They will likely look for other revenue sources in order to sustain business in these segments. While this analysis focuses on the addition of an annual membership fee (AMF), there are other changes described below that can be made to bring incremental revenue and positive PV for segments of the portfolio most affected by new regulation.

Break Even Annual Fee Test

Fico Ranges	PV ($20 AMF)	Approval Rate	PV ($40 AMF)	Approval Rate
640 - 680	$ 175	55%	$270	62%
600 - 640	$ 80	43%	$195	56%

*Attrition due to introduction of AMFs is taken into account



Introducing an AMF of $20 brought the number of accounts approved to pre-regulation levels. There was still a sizeable reduction of average PV per account, however, introducing the $20AMF started to increase the approval rate off the portfolio. The $40 fee still left PVs lower than pre-regulation levels, with the fee needed to achieve breakeven for average PV per account being $45.

Another option banks might turn to is increasing interest rates. In our simulation any reasonable values we tested had minimal impact due to lower credit lines and balances in the subprime customer segment. This may be a more viable approach in higher FICO ranges, though banks will need to balance the increase in revenue with any potential reduction in application volume.

Back Book Effect

Existing Customer Impact

The results of stress testing our synthetic portfolio show that higher risk cohorts of customers face the greatest opportunity for a decline in revenues due to upcoming late fee regulation. With this information, financial institutions can identify what segments of their customer base are going to be most greatly affected. To minimize losses or bring revenues closer in line with expectations, there are several tactics financial institutions might use.

Monthly/Annual Membership Fees – A monthly or annual fee could be added to existing no-AMF products, or these fees might be increased on products that already have them. A monthly fee may be more palatable for the consumer while smoothing out cash flows for the product. However, adding a fee or increasing a fee for a subprime card could create negative customer sentiment, increasing the possibility of customer attrition. That attrition is most likely to come from customers who are less risky. In severe cases increased fees could even cause some customers to stop paying their card entirely.

Increasing APR – Raising APRs will drive revenues up for most cards but would have higher leverage in segments where the credit limit and utilization are high. While this would increase revenues, it seems to have more drawbacks than adding a monthly fee or AMF. Increasing APR would cause a similar change in terms to be sent out, increasing the possibility of attrition. Also, increasing APRs will not reprice current balances, and payment allocation would make it so lower APRs stay on the books for longer. In lieu of increasing purchase APR, banks may opt instead to increase the penalty APR for past due customers, which can apply to all forward balances starting at 1 day past due. Once a customer is 60+ days DQ a higher rate may be applied to both current and future purchases. While a penalty APR can only be applied to previous balances until a cardholder makes 6 months of on time payments, it can still be applied to new purchases moving forward.

Other Options - There are other portfolio management strategies worth leveraging once the regulation is in place. Financial institutions could begin to focus on spend enhancement strategies such as merchant specific incentives to drive higher spending. Buy Now Pay Later could be pushed to help drive spending and increase fee income in other areas. After the Card ACT was implemented, several banks reduced line sizes for the segments most affected by the regulation. However, credit line decreases are a negative customer experience and have only limited ability to manage losses, since most high-risk consumers utilize most of their credit line. Lastly, enhancing customer management strategies through fresh marketing materials developed around payment reminders, the benefits of making on-time payments could have a modest impact on customers keeping their payments on track.

Collections Impact

We believe that the change in late fee amounts will also affect collections performance. Smaller late fees mean that the payment needed from a delinquent customer decreases. This will likely result in two main impacts:

Increased entry rate into delinquency – Lower late fees will create less of a deterrent to borrowers going delinquent. Paradoxically this could lead to a higher incidence of late fees being charged by the bank and, as a result, the reduction in late fee revenue financial institutions observe may not be directly proportional to the size of the fee reduction. Card issuers will likely invest more in autopay strategies and incentives, which are more commonplace in term loans. More tailored messaging strategies paired with a focus on customer retention should become a larger part of the issuer's Collections strategy moving forward.

Reduced roll rates – While initial delinquencies will rise, the payment needed for the customer to become current will be much lower. The minimum payment for a credit card is calculated as (1% + fees incurred during the billing cycle + finance charges incurred during the billing cycle). The reduced minimum payment will be most pronounced in customers with lower balances where late fees currently make up a larger portion of the required minimum payment. Smaller minimum payments should lead to fewer customer rolling forward into later stages of delinquency.

Effects to Net Credit Loss and Operational Expenses – The combination of increased entry rate and decreased roll rates will have offsetting effects, though it's too early to tell how those effects will net out. As part of the final regulation, card issuers have the opportunity to "show their math" if they feel that their Collections costs are in excess of the $8 late fee amount. The final rule made a point of excluding Recoveries (post charge off collections) expenses from the calculation, which makes it less likely that an issuer could justify a higher late fee amount based on high costs to collect.

Changes to loss forecasts

A downstream consequence of the impact on collections is that loss forecasts for the bank may be less accurate for the foreseeable future. Many such forecasts rely on assumptions regarding delinquency and roll rates to project forward charge-off losses. As the relationship between these factors changes, as well as their relationship to external factors such as unemployment rate, banks may find that their forecasting models require regrounding.

Testing and Monitoring

It will be critical for financial institutions to monitor the effects that this regulation has on their portfolios so they can react appropriately. Creating monthly views of late fee revenue, incidence of late fees, and overall segment level profitability along relevant dimensions will allow institutions to best identify portions of the customer base that are most negatively impacted. Once these segments are identified, targeting these groups with testing around some of the product changes listed above will be necessary. Testing what size fee will minimize attrition for certain portfolio segments will allow institutions to carve some of that revenue back, as well as provide them with data to build out new products with this regulation in mind.

Conclusion

This regulation is designed to protect consumers from fees that are not “reasonable and proportional” to the cost incurred by the issuer. While it will reduce the cost of credit for subprime consumers, financial institutions will likely adjust to partially recoup revenues and margins. Furthermore, these changes will likely result in less access to credit for those in the subprime and deep subprime segments; a space where access to credit already has challenges.

This change to late fees and the subsequent changes to product structure and terms will affect departments throughout a financial institution from acquisitions/valuations, loss forecasting, collections, and others. An enterprise-wide focus on implementing and monitoring the new changes will be critical. Time will tell how institutions adjust their strategies and policies moving forward, but the CARD Act is proof that the industry has previously gone through historical change such as this and come out of the other side healthy.

Acknowledgements

This report was prepared by Andrew Thiesse, Travis Gray, and Dave Wasik.

Andrew Thiesse is a Senior Business Analyst at 2nd Order Solutions who has over 7 years of experience in financial services, split between consumer and commercial credit. At 2nd Order Solutions, he has worked on projects throughout the credit life cycle. Most recently, he helped to develop a credit line increase strategy and initial line assignment policy for a large North American Credit Union.

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For more information on this study and a deeper dive into the analytic work we are doing, follow up with your 2OS contacts to set up time to discuss this work and other ways 2OS can accelerate lenders' progress on projects from across the credit lifecycle.

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About 2nd Order Solutions

2nd Order Solutions (2OS) is a boutique credit risk advisory firm that specializes in solving the world's most challenging credit problems. 2OS was founded 15 years ago and consults to a wide range of banks, card issuers, fintechs, and specialty finance companies in the US and abroad. 2OS has deep experience with lending businesses across Card, Auto, Small Business, and Personal Loans at all points in the credit lifecycle. For more information please visit our website at 2os.com.