



A Just Fee or Just a Fee?

An Examination of Credit Card Late Fees

CRL Research Report: Credit Cards
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EXECUTIVE SUMMARY

The Federal Credit CARD Act of 2009 made important improvements in the credit card market, with most of the Act's provisions taking effect in February 2010. One part of the Act that has not yet been fully implemented is the requirement that penalty fees be reasonable and proportional to the borrower's violation.

Congress left the interpretation of the exact meaning of "reasonable and proportional" to the Federal Reserve. Before the Fed can

define reasonable and proportional, an understanding of the nature of penalty fees is essential. Why do issuers charge them and what determines the amount that they charge?

The majority of penalty fees collected by issuers come in the form of late fees. Therefore, we took a closer look at the dynamics of late fee charges to help understand how issuers set fees.

There has been little research on what drives late fee pricing.

Prior CRL research found that the prevailing tiered fee structure used by large issuers is not intended to create proportionality and appears designed to create an illusion of low and proportional fees while instead allowing for hidden price increases. In the only other known research on the subject, researchers concluded that penalty fees are positively related to consumer default risk. However, that study did not explore other likely alternative reasons why issuers have higher or lower penalty fees, such as increasing fees to grow revenue or offering lower fees as a consumer marketing strategy. Various alternative explanations for late fee rates are explored here.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, the nation's largest community development financial institution.

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Summary of Findings

CRL's research indicates that many other factors besides risk influence the level of late fees charged by issuer. Table 1 below outlines these factors and their relative influence.

Finding 1: Issuers that use deceptive or aggressive pricing practices in other areas related to credit cards tended to charge higher late fees. Nine of the top ten best predictors of late fees were related to deceptive or aggressive pricing.

A number of pricing practices were highly predictive of late fee charges. Many of these related practices are deceptive in that they are hidden back-end pricing strategies that are poorly understood by the consumer and make little sense relative to the costs or risks faced by the issuer. For example, issuers that charge a penalty interest rate for very minor triggers, such as being late a single day, are more likely to charge a higher late fee.

Finding 2: Issuers that are aggressive in areas outside of pricing tended to charge higher late fees. For example, issuers that send out a lot of cash advance checks or are aggressive in recovering losses charge higher late fees.

Among measures of aggressiveness, a particularly strong predictor of late fees was cash advance checks mailed. These are typically blank checks that have much higher interest rates and fees that issuers often heavily promote as a "convenience" to consumers. The volume of complaints to the Better Business Bureau relative to the size of the issuer was another factor that was also significantly related to late fees.

Finding 3: The type of issuer is strongly associated with late fee charges. The single best predictor of the amount an institution charges as a late fee is whether the issuer is a credit union. Credit unions charged a median fee of \$20 compared to banks' \$39 for late fees.

Of 28 variables tested by CRL, the single best predictor of late fee prices was type of issuer – whether an issuer was a credit union. In fact, almost half of the variation in late fee amounts can be explained by whether or not the issuer is a credit union.

Credit card banks, institutions that primarily focus on credit cards, tended to charge significantly higher fees than credit unions. Issuers that securitized a higher proportion of their receivables charged higher fees. It has been hypothesized by some experts that securitization changes issuer incentives, encouraging risk-taking and higher fee levels. Large issuers also tended to charge higher fees. In all cases, the type of issuer was a better predictor of late fee levels than risk (as measured by an issuer's net losses on their credit card portfolio).

Finding 4: Credit losses are a very weak predictor of late fee amounts. Only the length of a payment grace period had less relation. When other variables were included in the statistical analysis, higher risk was not correlated with higher late fees.

Table 1: Summary of All Factors Related to Late Fee Amount Charged

Rank (most to least predictive)	Type of issuer-- factors related to Lower fees	Deceptive/Aggre ssive pricing-- factors related to Higher fees	Consumer- Friendly pricing-- factors related to Lower fees	Type of issuer-- factors related to Higher fees	Other Aggressiveness measures related to Higher
1	Issuer is a credit union				
2		Cash/Purchase APR spread			
3		Cash advance fee amount			
4		Minimum Finance Charge Amount			
5		Cash advance floor amount			
6		Penalty/Regular APR spread			
7		Whether issuer uses a penalty APR			
8		Hairline trigger for penalty APR			
9		transaction fee amount			
10		Teaser/Regular APR spread			
11			Ceiling on cash advance fee		
12		Penalty rate cure is "hard"			
13				Issuer is a credit card bank	
14		Issuer utilizes "pick-a-rate"			
15			Extra time allowed before late fee		
16					Cash advance check mail volume
17		International fee applies to dollar transactions			
18		Teaser is short			
19				Percent of Loans Securitized	
20				Issuer Size	
21					Recoveries as percent of losses
22					BBB Complaints
23					Issuer growth rate
24					Solicitation mail volume
25		Sells fee-based add-ons in offer			
26				Card loans/total loans	
27				Net Losses	
28			Longer grace period		

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Of 28 possible explanatory variables examined, credit losses had the second lowest correlation with the level of late fees, and therefore were not statistically significant. Of 28 other variables, 22 were statistically significant (or about 80%) and most were significant at the 1% level.

CRL research reveals that issuers do not price penalty fees for risk. When other factors were controlled for using multiple regressions, any positive relationship between losses and late fees disappeared. The results suggest that, rather than as a means to deter behavior, issuer practices reflect an underlying revenue and pricing philosophy; this philosophy along with issuer type (most notably whether an issuer is a credit union) drive any observed relationship between losses and penalty fee prices.