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.

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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.

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.

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/Aggressive 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		

BACKGROUND

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 not yet 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 late fees.

There has been little prior 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.[1] In the only other known research on the subject, Massoud, Sanders, and Scholnick examined the relationship between penalty fees and risk across issuers.[2] Their study did find that market share was correlated with higher prices.[3] But the study also found evidence that penalty fees are positively related to consumer default risk. According to the authors, this finding "supports the position of defenders of penalty fees such as banks." They conclude that the fees serve an economically useful function. However, that study did not explore other likely alternative reasons why issuers with higher loss rates will have higher penalty fees including the general aggressiveness of the issuer in seeking to grow revenue, and the nature of the issuer. Issuers who are higher-risk may not charge higher fees to compensate for the risk of not being paid back by their borrowers, but it may be that lower-risk issuers tend to be certain type of issuers (a credit union or a regional bank that only gives credit cards to existing customers) and that these issuers because of their consumer marketing strategy rather than because of their low risk also charge lower fees. These alternative explanations are explored here.[4]

In order to examine what other factors are related to late fees, data on the top 100 credit card issuers was collected during summer 2009 both through detailed examination of terms and conditions on solicitations and through examination of financial data.[5] The analysis considered data from ten large issuers and many issuers with medium-sized portfolios.[6] Data on complaints to the Better Business Bureau was also collected.

FINDINGS

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.

Table 1 summarizes all the factors analyzed and ranks them by how well they predicted late fees.[7] The first two columns contain factors related to the type of issuer.

A number of pricing practices were highly predictive of higher 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 (and often multiple possible triggers) such as being late a single day are more likely to charge a higher late fee. Issuers that charge as much as two dollars as a "minimum finance charge" even if the consumer only owes a penny in interest that month have a strong tendency to charge higher late fees.

It could be argued that a few, such as the cash/purchase APR spread—with the typical cash advance APR at a large bank being 10 percentage points higher than the other regular APR's—are somehow linked to risk. Clearly other practices linked to late fee pricing have nothing to do with risk-based pricing, such as minimum finance charge amounts, international fee levels, and the use of the "pick-a-rate" practice. CRL research has shown that the latter three practices are hidden, back-end pricing strategies poorly understood by the consumer and making little sense relative to the costs or risks faced by the issuer.[8] In fact, the "pick-a-rate" practice was prohibited by the Federal Reserve in January 2010 because it was deemed to be a hidden way to manipulate a variable rate index.

Some of the practices highlighted involve spreads between different interest rates. Issuers with up-front pricing (i.e. pricing that is clear, understandable, and in line with what consumers expect to pay when they sign up for the card) tend to charge rates that are not widely disparate.[9]

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/Aggressive 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		

Table 2 focuses just on the factors related to pricing strategy. Issuer risk (as measured by net losses as a percentage of loans) is also shown for comparison. Looking at the list of pricing factors related to late fees in Table 2, it appears that they are correlated with the type of issuer reliant on price gimmicks and tricks and traps in general.[10] A "hairline trigger" for a penalty APR is one that can be triggered by a single incident of a minor infraction such as being late a single day or by a "universal default" provision. Issuers that rely on hairline triggers, high international or cash advance fees, and large differences in price between the rates consumers tend to focus on most compared to the ones that they pay less attention to all tend to charge more in late fees.

Table 2: Pricing Factors Related to Late Fee Amount Charged

	Correlation Coefficient
Cash/Purchase APR spread	0.67 **
Cash advance fee amount	0.62 **
Minimum Finance Charge Amount	0.58 **
Cash advance floor amount	0.58 **
Penalty/Regular APR spread	0.57 **
Whether issuer uses a penalty APR	0.57 **
Hairline trigger for penalty APR	0.57 **
International transaction fee amount	0.50 **
Teaser/Regular APR spread	0.49 **
Cash advance ceiling	-0.45 **
Whether penalty rate cure is "hard"	0.44 **
Issuer utilizes "pick-a-rate"	0.35 **
Issuer allows extra time before late fee	-0.35 **
Whether issuer charges intl. fee if in $	0.29 **
Whether teaser is short	0.28 **
Sells fee-based add-ons in offer	0.12
Net Losses	0.10
Length of grace period	-0.09

* Significant at 5% level

** Significant at 1% level

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.

Our analysis shows banks that are aggressive in credit card practices besides pricing tended to charge higher late fees. Two measures of aggressiveness included how heavily issuers used mail solicitations relative to their size. (This was measured using the volume of new account solicitations as well as the volume of cash advance checks sent in the mail to existing customers

relative to issuer size.) Heavy mailing of new account solicitations is a sign of an aggressive growth strategy. Among measures of aggressiveness, cash advance checks mailed were a particularly strong predictor of late fees.

Recoveries as a percentage of losses were included in this analysis because issuers that are aggressive in general might extend that practice into collections. Therefore they tend to recover more losses, even if this comes at the expense of reputation or questionable practices. While aggressive issuers may have higher losses, they will also recover a higher percentage of those losses if they use high pressure collection tactics such as making collection calls earlier, more frequently, and use more aggressive collection practices (such as the types of threats made regarding the consequences of not paying or utilizing arbitration forums which are an alternative to courts that are potentially confusing and biased against consumers as a collection tool). Recoveries were also found to be a good predictor of late fees, with higher recoveries implying higher late fees. This is the opposite of what one would expect if late fees were compensation for risk.

The volume of complaints to the Better Business Bureau relative to the size of the issuer was a factor that was also significantly related to late fees. The vast majority of complaints tracked were on issues unrelated to late fees, and covered a whole range of issues including other aspects of pricing or collection issues. Therefore, this seems to be more an indication of the general practices of the issuer. Issuers employing practices that cause complaints in general also tend to charge higher fees, a further indication that fees are defined mainly by an issuer's profile rather than costs or deterrence. All of the issuer aggressiveness variables were better predictors of late fees than risk.

Table 3: Other Aggressive Issuer Indicators Related to Late Fee Amount Charged

	Correlation Coefficient
Cash advance check volume/outstndgs	0.30 **
Recoveries as a percent of losses	0.23 *
BBB Complaints/outstandings	0.22 *
Issuer growth rate	0.17
Solicitation volume/outstandings	0.13
Net Losses	0.10

* Significant at 5% level

** Significant at 1% level

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 whether an issuer was a credit union. In fact, almost half of the variation in late fee amounts can be explained by

whether the issuer is a credit union. The median and the average late fee charged by credit unions was $20. For banks, the median late fee was $39 while the mean was $35.

Table 4 focuses on the variables related to issuer type.[11] Credit unions charged lower fees. Credit card banks, institutions that primarily focus on credit cards, tended to charge significantly higher fees.[12] Large issuers also tended to charge higher fees.

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.[13] Securitizing credit card receivables passes on much of the risk of loss to investors, however issuers still receive a disproportionate share of the increased profit if they raise interest rates or fees.

All of the issuer type variables were better predictors of late fees than risk.

Table 2: Issuer Type Factors Related to Late Fee Amount Charged

	Correlation Coefficient
Whether issuer is a credit union	-0.68 **
Whether issuer is a credit card bank	0.35 **
Percent Securitized	0.27 **
Issuer Size	0.24 *
Card loans as % of total loans	0.12
Net Losses	0.10

* Significant at 5% level

** Significant at 1% level

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.

Of 28 possible explanatory variables CRL examined, credit losses had the second lowest correlation with the level of late fees (see Table 1) and were not statistically significant.[14] Of 28 other variables, 22 were statistically significant—or about 80%—and most were significant at the 1% level.

When other factors were controlled for using multiple regressions, there was no longer any positive relationship between losses and late fees. Four regressions specifications are shown in Table 5, each with and without the loss variable included. Regression coefficients are provided and standard errors are reported parenthetically. In each regression, the dependent variable is losses as a percentage of managed loans. The first equation uses the three independent variables

that have the highest simple correlation with fee levels. The second and third regressions use the top three lender type variables and the top three practice-based variables respectively. The final regression shown is a stepwise regression using all possible practice and lender type variables as potential predictors. Four independent variables were retained in the model (aside from credit losses which was forced into the model even though it did not meet the criteria for inclusion). Aside from credit losses, all variables retain their expected sign and 10 of 13 were statistically significant. In general, while most practices remained significant predictors in the multiple regression models, when the credit union factor is accounted for, other lender type variables no longer held significant explanatory power.

The most important result is how credit losses performed in the multiple regression models. The performance of this variable was remarkably consistent across models. In every model it was small and insignificant. The loss variable also changed sign from what it was using the simple correlation statistic in every model (with a beta value between -0.05 and -0.09 in all cases). The importance of this sign should not be overstated since the coefficient was insignificant. However, it does add weight to the conclusion that losses have absolutely no positive relationship with fee levels when other factors are taken into account.

Table 5: Combining Factors Associated with Late Fee Pricing into a Single Statistical Analysis using Multiple Regression

	Combined		Lender Type		Practices		Stepwise (Combined)	
		w/Losses		w/Losses		w/Losses		w/Losses
Credit Union Dummy	-5.91** *(2.25)*	-8.17** *(2.47)*	-15.76** *(1.68)*	-14.81** *(1.81)*	---	---	-8.14** *(1.99)*	-9.64** *(1.97)*
Credit Card Bank Dummy	---	---	0.55 *(2.26)*	1.07 *(2.23)*	---	---	---	---
Percent Securitized	---	---	0.02 *(0.04)*	0.01 *(0.03)*	---	---	---	---
Cash/Purchase APR spread	0.87** *(0.20)*	0.61** *(0.21)*	---	---	0.91** *(0.20)*	0.80** *(0.20)*	---	---
Cash advance fee amount	1.81* *(0.73)*	1.80* *(0.78)*	---	---	2.49** *(0.65)*	2.69** *(0.74)*	1.33 *(0.73)*	1.30 *(0.74)*
Minimum Finance Charge	---	---	---	---	3.21* *(1.64)*	3.23 *(1.73)*	---	---
Hairline trigger for penalty APR	---	---	---	---	---	---	6.96** *(1.62)*	5.57** *(1.60)*
Extra time before late fee	---	---	---	---	---	---	-8.49** *(2.59)*	-9.11** *(2.74)*
Net Losses	---	-0.09 *(0.07)*	---	-0.06 *(0.08)*	---	-0.05 *(0.07)*	---	-0.05 *(0.06)*

* Significant at 5% level

** Significant at 1% level

CONCLUSION

It is clear that the structure of penalty fees within a typical issuer's pricing structure does not vary based on risk. Late fees instead appear to be driven by at least two general factors:

- Issuer aggressiveness: "aggressive" issuers tend to rely on deceptive pricing gimmicks rather than up-front pricing. These issuers also appear to be aggressive in general, both in the mail and in collections. Not surprisingly, aggressive issuers also tend to have higher losses.

- Issuer Profile: Credit unions tend to have median late fees that are about half those of other issuers. Large banks reliant on credit card revenue and that securitize much of their receivables also tend to have higher late fees. Also not surprisingly, the latter group tends to have higher losses than the former.

To the extent that penalty fees move with losses, this relationship is best understood to be a reflection of other factors. Issuers do not price penalty fees for risk. Instead, they price based on an overall pricing philosophy (e.g. up-front pricing versus shrouded revenue generation), and this is reflected in their fee structure.

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[1] Joshua M. Frank, "Dodging Reform: As Some Credit Card Abuses Are Outlawed, New Ones Proliferate," Center for Responsible Lending, December 2009, available at: http://www.responsiblelending.org/credit-cards/research-analysis/Dodging-Reform-As-Some-Credit-Card-Abuses-Are-Outlawed-New-Ones-Proliferate.html. Dodging Reform looked at the nature of tiered late fees and found that about 90% of people are charged the highest price. This study treats this highest fee which the vast majority of consumers receive as the late fee amount for purposes of comparing fee amounts across issuers.

[2] Nadia Massoud, Anthony Saunders, Barry Scholnick, *The Cost of Being Late: The Case of Credit Card Penalty Fees*, 32-33 (October, 2006), http://www.newyorkfed.org/research/conference/2006/Econ_Payments/Massoud_Saunders_Scholnick.pdf.

[3] The study found market share to be significant in predicting interest rates and significant in one of three regressions regarding late fees. The authors hypothesize that a significant coefficient for this variable implies that large issuers have some monopoly power to set prices in the market.

[4] An additional cause of possible correlation that is not addressed here is that causation may be the reverse of what Massoud et al implies. In other words, instead of high prices being a result of high losses, high prices *cause* high losses.

[5] Although the Top 100 issuers were used in the analysis, due to missing data in some fields, about 80 to 90 data points are used in each regression or correlation coefficient. All statistics cited had a sample size of over 80, with about 40% of the sample coming from credit unions. The top 10 issuers hold about 90% of all balances, so that the top 100 issuers include many medium-sized credit card portfolios. Solicitation and mail volume data came both from Mintel Comperemedia, a proprietary database and from examination of individual offers posted online by the issuers.

[6] The smallest issuers in the dataset analyzed had about $90 million in credit card receivables.

[7] Ranking is based on bivariate correlation coefficients between the variable in question and credit losses as a percentage of receivables. Absolute values of the correlation coefficients are used in the rankings.

[8] Joshua M. Frank, "Dodging Reform: As Some Credit Card Abuses Are Outlawed, New Ones Proliferate," Center for Responsible Lending, December 2009, available at: http://www.responsiblelending.org/credit-cards/research-analysis/Dodging-Reform-As-Some-Credit-Card-Abuses-Are-Outlawed-New-Ones-Proliferate.html.

[9] This interpretation of pricing spreads is consistent with Ryan Bubb & Alex Kaufman, "Consumer Biases and Firm Ownership," Harvard University working paper, May 2009.

[10] This pricing philosophy in the credit card market is discussed in detail in: Joshua M. Frank, "Why Free Markets Can Sometimes Turn into 'Peacock Markets': The Evolution of Credit Cards," Journal of Economic Issues, June 2010; and Joshua M. Frank, "What Does the Credit Card Market Have In Common with a Peacock?" 24-40 The Lydian Payments Journal, 2009.

[11] Issuer type is used in this document to refer to the definition of the identity of the issuer such as whether it is a credit union or a bank that focuses on credit card loans. Issuer profile in this document refers to other key characteristics that identify the strategy and practices of the issuer (e.g. type of pricing they tend to do).

[12] Which issuers were "credit card banks" was defined using the FDIC's labeling of bank peer groups. If a bank holding company was or had within it a bank designated by the FDIC as a "credit card specialty bank," then it was given that designation in the dataset. The FDIC defines a credit card specialty banks as an "Insured commercial banks whose lending activities are focused on credit cards are in one of three peer groups within this special line of business peer group." Most of the top ten issuers are designated as credit card specialty banks, including banks with a broad range of product lines such as Bank of America and Chase. However, other banks with many lines of lending but that are less prominent in credit cards such as Fifth Third Bancorp and SunTrust Banks, Inc. have no credit card specialty bank.

[13] Kathy Chu and Byron Acohido, "Why banks are boosting credit card interest rates," USA Today, November 14, 2008, available at: http://www.usatoday.com/money/industries/banking/2008-11-09-bank-credit-card-interest-rates_N.htm

[14] While it could be argued that this indicates these results, with a smaller sample size, have less power than Massoud et al (2006), it is quite clear that the regression had sufficient power in general to detect any strong relationships. All of the other variables had the expected sign, and 80% of the other predictive variables were statistically significant, with most being significant at the 1% significance level. Furthermore, the lack of significance was not due to the simplicity of the initial correlation methodology--raising the sophistication of the methodology by considering the variable simultaneously in a multiple regression did not improve the relationship. It instead eliminated any positive correlation.