Consumer Finance Monitor (Season 6, Episode 10): A Close Look at the Consumer Financial Protection Bureau's Credit Card Late Fees Proposal, with Special Guest Todd J. Zywicki, Professor of Law, George Mason University Antonin Scalia Law School

Speakers: Alan Kaplinsky and Todd Zywicki

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor Podcast, where we explore important new developments in the world of consumer finance and what they mean for your business, your customers, and the industry. This is a weekly podcast show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm. And I'm your host, Alan Kaplinsky. I'm the former practice group leader for 25 years, and now Senior Counsel of the Consumer Financial Services Group at Ballard Spahr, and I'll be moderating today's program.

For those of you who want even more information, don't forget about our blog, also going by the name of Consumer Finance Monitor. We've posted our blog since July 21st, 2011, a day that will perhaps live in infinity when the CFPB got completely organized and stood up and became operational, and there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or to get on the list for our webinars, please visit us as ballardspahr.com. If you like our podcast, please let us know about it. Leave us a review on Apple Podcasts, Google, or wherever you get your podcasts. Also, please let us know if you have any ideas for all the topics that we should consider covering or speakers that we should consider as guests on our show.

So today I am joined by someone that was a guest on our show a little more than a year ago, and that is Todd Zywicki. Todd Zywicki is a George Mason University Foundation professor of Law at the Scalia School of Law at George Mason University. He's a senior fellow at the Cato Institute Center for Monetary and Financial Alternatives. From 2015 to 2017, he was executive director of the George Mason Law and Economic Center. And from 2020 to 2021, he served as chair of the Consumer Financial Protection Bureau taskforce on Federal Consumer Financial Law. From 2003 to 2004, he served as director of the Office of Policy Planning at the Federal Trade Commission. He's the author of more than 130 articles and leading law reviews and peer reviewed economic journals. He's testified multiple times before Congress on issues pertaining to consumer credit. So Todd, a very warm welcome to you. I'm really happy to have you back on the program for a topic that I am about to describe.

Todd Zywicki:

Thanks, Alan. It's always great to be here and talk with you and I enjoy your podcast as a listener as well as a participant.

Alan Kaplinsky:

Okay, well, what we're going to talk about today is a very recent proposal made by the CFPB, and that means made by one individual, Director Rohit Chopra, that is a proposed rule that would make drastic changes in the amounts of late fees that credit card issuers can assess. So the first thing I'm going to do before telling you about what the CFPB did, a little bit of history I think is in order.

In 2009, Congress enacted something called the Credit Card Accountability Responsibility and Disclosure Act, and it goes by the acronym of the Card Act. The Card Act, which is implemented by Reg Z requires that late fees imposed by credit card issuers be reasonable and proportional to the violation of the account terms. It actually talks about all kinds of penalty fees on credit cards, but we're only going to focus on late fees today.

It also authorizes the Federal Reserve Board, which at that point had Reg Z rulemaking authority that was later transferred to the CFPB by the Dodd-Frank Act. And it says, the Card Act says, "In consultation with other agencies, the CFPB is given the authority to establish a safe harbor for specific late fees that are deemed to be reasonable and proportional to the breach of contract or the delinquency." Pursuant to that authority, the Federal Reserve Board initially set safe harbor amounts in 2010 at $25 for the first late payment and $35 for subsequent late payments and made those amounts subject to an annual inflation adjustment. The most recent inflation adjustment, which was made two years ago at the end of 2021, allowed a card issuer to impose a late fee of $30 for the first late payment and $41 for subsequent late payments. Also, Reg Z permits an issuer to assess a late fee that's higher than the safe harbor amounts if it can demonstrate that the higher fee is justified as a reasonable proportion of its internal costs.

So that now I'm going to fast-forward until earlier last year, I think believe I was in March of last year, when the CFPB issued a report on credit card late fees. Let me give you the major findings of the report, which I think will gave everyone at that time a pretty good idea, a roadmap of where Director Chopra was calling. His major findings are that, one, many major credit card issuers charge the maximum late fee allow under Reg Z, under the safe harbor created by the Card Act.

Second, cardholders with subprime and deep subprime credit scores are far more likely to incur repeat late fees in a given year than cardholders that have higher credit scores. And third, in 2019, credit card accounts held by cardholders living in the poorest neighborhoods in the United States paid twice as much on average in total late fees than those in the richest areas. And cardholders, in majority, Black areas, paid more in late fees for each card they held with major credit card issuers in 2019 than in majority white areas. And then finally, that late fees accounted for 99% of the total penalty fees the credit card issuers were charging on credit card accounts and over half of the credit card markets consumer fees.

Now, let's now go to the notice of proposed rulemaking. That came out very recently as I indicated. Let me very quickly run through what the CFPB did and then I have a lot of probing questions for Todd about that. Number one, first and foremost, and this is the most important takeaway in terms of what the CFPB did in this proposal. It's not a final reg yet, just a proposal. It reduced the safe harbor amounts and it reduced them from $30 for the first violation of $41 for the first subsequent breaches of contract or delinquencies to a flat $8, an enormous reduction in the late fees that could be a charge if this actually becomes final.

The CFPB stated in its discussion of the proposal that after analyzing available evidence, considering the applicable statutory factors, the Bureau preliminarily determines that a late fee of $8 for the first and subsequent late payments is presumed to be reasonable and proportional to the late payment violation to which it relates. It also stated that lower fee amounts to the proposed $8 safe harbor would still have a deterrent effect on people paying late. And of course we're going to have a lot of fun with that in a couple of minutes. It also reduced the maximum length fee amount. Right now you can charge 100% as a late fee of the minimum payment. So in other words, you can charge the lesser of that amount, or $30 if it's a first delinquency, and $41 for subsequent delinquency. They're reducing that to 25% of the minimum payment.

As a result of that, one way to think about it, though the CFPB never really states this, but this is how I look at it, an issuer using the safe harbor can charge a late fee equal to the lesser of $8 or 25% of the minimum payment. And then it goes on to say, "For issuers who choose to use a cost analysis to charge a late fee or other penalty fees that are higher than the safe harbor amounts, the proposal would revise the official staff commentary to clarify that the costs that the issuer may consider in its analysis do not include collection costs that are incurred after an account is charged off."

Now, there are other things that we have time to get to we will deal with toward the end of the program, other things that are not part of the proposal but about which the CFPB is seeking comment. There's some very extreme things there as well. But I think that is enough of a foundation for Todd Zywicki to go to town here.

So Todd, the first thing I want to talk about is the most important part of the proposal, namely the reduction of the safe harbor from $30 for the first late payment, then $41 to a flat $8 for all late payments. My question is, how did the CFPB justify such a drastic reduction in the credit card late fee? I then want to know what you believe the flaws are in its rationale.

Todd Zywicki:

Well, first thanks for that great overview and introduction Alan. This is one of those sort of slick things that regulatory state does where they fiddle with one little definition and it has huge implications not only for the regulatory framework but as well

for ordinary Americans because as you said, the original late fee rule by the Federal Reserve slightly reduced the prevailing late fees at the time to $25. I think it had been $39 before that. This dramatically reduces it from $25 to $8. And so this is a much larger impact on late fees.

The original Credit Card Act regulations did additional things as well in the Credit Card Act itself involving the ability to reprice account interest rates over the limit fees and things like that that acted in tandem with the late fees, but as we'll talk about the mere fact that they went from about $39 to $25 at a variety of impacts that they were actually able to measure. And so what the CFPB did was come in here and seemingly use a completely different methodology in determining what a reasonable unproportional fee was compared to what the Fed did in the past. Their discussion of why they thought the Fed did it wrong, I found to be very cursory and unpersuasive in the rule, but obviously using a radically different methodology to calculate it.

Alan Kaplinsky:

Yeah. So tell us what they did. How did they deviate from the Fed's methodology?

Todd Zywicki:

Well, all they focused on was is you mentioned the... What is it? The pre-default cost of collections. In particular, one thing that the Fed had considered in their rule and the Card Act says should be considered, is the deterrent effect of the rules. And so here, as you said, they really make no effort. They just hint they wave their hands and say that there will still be a deterrent effect, but they don't really in any way try to measure the effect on how many consumers will pay late, what'll be the effect on loss rates, all those sorts of things here. But more to the point, what they really fail to do is examine the entire effect of what these rules are going to have in terms of the impact on consumers and in particular subprime consumers.

One of the things we need to understand here, Alan, as we start digging down on this, is a small minority of consumers' routine pay their credit card bills late. The overwhelming number of consumers, including subprime consumers, pay their credit card bills on time. Those who do pay late know they're paying late. It's not that they're aware that there's a fee, they're aware they're paying late. It's not like as the CFPB tries to do with this appropriate, I'm calling it a junk fee, that somehow consumers don't know they're paying late, they don't know the fee. It's clear that they do. The CFPB itself cites evidence that the consumers learn from this, that they're deterred, that after they pay late, they don't pay late again for a while.

And so what the overall impact of this is, as we'll talk about it, is to force the overwhelming number of consumers who pay their bills, their credit card bills, on time we'll have to subsidize those who pay late. The number of those who pay late is almost certainly going to be up and increase. Those who are going to be impacted the most, just like the last Credit Card Act rules, will be subprime borrowers here that are supposedly going to help.

Alan Kaplinsky:

Yeah. So your belief is, and it seems intuitive to me that if you reduce the late fees to $8, that's even to subprime borrowers, that's not a lot of money, okay? Today with the $30 and $41 that could be considered a significant amount of money and I would think would be more of a deterrent. It just seems almost intuitive that that would be the case, don't you think?

Todd Zywicki:

Yeah, it's not just intuitive, it's basic economics and it's well supported by empirical evidence. Alan, you and I and a lot of others for a long time have been critics of the economics and the economic analysis that the CFPB does, going back of course to when Richard Cordray was the director. And I have to say, reading through this report, even by the very, very poor standards of evidence that the CFPB has used for the years, this is really a nadir. This report and the economic analysis goes into this report is the worst I've ever seen to tell the truth. And that is saying something considering how bad a lot of the economic analysis has been out of this agency.

They ignore all of the evidence. Pretty much they ignore all the evidence that has been done on the Card Act. The only studies they support are studies that have been debunked cause and we can talk about these in more detail, but they rely very heavily on studies that have been debunked because they misunderstood the law and the progression of the Card Act. They ignore all

the studies that show exactly what you're saying, which is that reducing late fees will cause more late fees, it'll cause higher interest rates, it'll cause reduction in credit. And really, they talk a lot about evidence-based policymaking at this CFPB. But this is one of the biggest examples of policy-based evidence making that I've ever seen. We can unpack some of these studies to talk about it in more detail, but yes, it only defies not only common sense, but all economic analysis we have.

Alan Kaplinsky:

Yeah, let's dig a little deeper into the studies that they rely upon that have been debunked. Which studies are you referring to?

Todd Zywicki:

The CFPB relies very heavily on a study by Agarwal and his co-authors from 2015. They also rely on an unpublished PhD dissertation by a fellow named Nelson. Now, what the problem with this is, and we discussed this in the CFPB Task Force report as well, is that those studies suffer from a fundamental flaw that is revealed in subsequent studies, such as a paper by Dowl, that was presented by the Philadelphia Federal Reserve. What they purport to do, what Agarwal purports to do, is take a snapshot of what the credit card market looked like, especially for subprime borrowers prior to the enactment of the CARD Act, and then they compare that to what the terms and conditions of cards looked like after the CARD Act.

Now, the problem with that is that most of the provisions, not all of them, but most of the provisions in the CARD Act were anticipated in a 2008 rulemaking by the Federal Reserve that was proposed even earlier in 2008. The CARD Act itself then codified most of those provisions. Now, there were some differences. There was no flat cap on late fees, for example, in the Federal Reserve regulations. But other things related to over-the-limit fees, double cycle billing, billing to just interest rates, all that sort of stuff, happened with the Federal Reserve regulations and in anticipation of the eventual passage of the Credit Card Act when it was introduced. So the fundamental problem with the Agarwal study is that it treats as the pre-period a period that is not truly a pre-period because it was already distorted by the Federal Reserve regulations that were passed in 2008 and were anticipated by the market before that.

What you have to do is back up further and break out the period before the Federal Reserve regulations, and then break out each of the three phases of the CARD Act as it was introduced. When you do that, the studies that have looked at that, both the Dowl study and then confirming that the Grodzicki study, is that they find that there was actually an impact on consumers from the CARD Act. Grodzicki finds there was an impact from the subsequent price controls on late fees. The problem is that when the Agarwal study just simply doesn't acknowledge the existence of those Federal Reserve regulations, and so it doesn't have a proper control group for what we can think of as the quote pre-period before the law went into effect.

Alan Kaplinsky:

Yeah. Now, you've spelled this out in the Taskforce Report. The question I have that a lot of people or listeners are probably wondering, where do I find that Taskforce Report? Because yeah, of course, as I'm sure you are painfully aware, when the new leadership came into the CFPB, they waived a magic wand and they said, "There is no Taskforce Report. Forget everything in there."

Todd Zywicki:

Well, the Taskforce Report is still available for now at least on the CFPB website, and they have put the Scarlet letter stamp, as you noted, that it did not comply with FACA. And of course as last time we talked, we had no opinion on that, right? We never thought every day through with that. But is still available there. It's in volume one on pages 596 is beginning there as you recall.

But the flaws on this report, and this rule making are not just limited to that, there's a study that came out subsequent to the Taskforce Report, a really important paper by Grodzicki and co-authors. Grodzicki, they look specifically at these impacts of regulating late fees, this marginal reduction of late fees, and they isolate that effect, that particular effect of late fees. What they find is, again, basic economics, which is they find that confirming earlier studies of the credit card market going back to a

paper by Massoud, which they mentioned in passing and we mentioned in the Taskforce Report. But they find that reductions in late fees increase interest rates. They find forced reductions in late fees, especially increased interest rates for subprime borrowers. They find that reductions late fees lead to increased usage of late fees, right?

If you have the option of paying your credit card bill late and basically getting a free extension of credit for $8, that's a pretty valuable option for many consumers to have. I mean, I could just go on and on and on how really truly dumb this stuff is.

Alan Kaplinsky:

You're on a roll.

Todd Zywicki:

I'm on a roll here, right? But you mentioned for example, the deterrent effect, right? They say, "Well, we are going to consider whether there's deterrent and there will still be a deterrent here. There will still be a deterrent to people paying late at $8." And I read that and I thought, "Yeah, well sure, but making armed robbery a misdemeanor would still have some deterrent effect." But that's not the relevant question here, right? The relevant question is what is the deterrent effect? What are the overall cost to consumers as a result of this? What are the offsetting effects? And essentially, this rule either implies there will be no offsetting effects to consumers in terms of higher interest rates and the like, or they just kind of wave their hands around, and we could talk more about this, they claim, "Well, whatever costs there are won't be fully passed through to consumers." So we can talk about why that is, but we do know that a lot of the costs will be passed through. That's what all the studies show.

Alan Kaplinsky:

Yeah. So let me go back to a couple things. One of the things that they said in the release is that you can't collect collection costs that are incurred after an account is charged off. Does that mean, are they basically saying, whatever the principle amount is or the total amount that's owed, let's say somebody owes a thousand dollars and you charge it off because there hasn't been a payment of six months, and I think of the recounting rules you have to charge it off, is that thousand dollars can't be reflected the actual dollar amount of the charge off? Or are they talking about costs that are incurred after a charge off?

Todd Zywicki:

I'd be interested in your reading of this, Alan, but I understood it to be the narrow reading, which is that you can't use late fees to make up in any way for the cost associated with a charge off I mean, is that how you read it? I mean, that certainly doesn't seem to me to be required by the Card Act.

Alan Kaplinsky:

Yeah, I don't think it's required by the Card Act at all. In fact, I would say it's contrary to the Card Act.

Todd Zywicki:

Well, and they have this crazy definition of reasonable and proportional. One of the arguments they make is, "Well..." The average minimum payment that consumers have to make on a credit card on average for the entire country is $100, and they say, "Well look, an $8 late fee on a $100 balance is close to a 100% APR. Isn't that a deterrent?" Yeah, but the question is, so what? Why do we care what the minimum payment is relative to the late fee? It's like what is the average balance on somebody who pays late? If it's $2,000 rather than $100, $8 versus $30 makes a big difference, right? I have literally no idea why they think comparing the average minimum that consumers have to pay at any given month with the late fee makes any sense at all in terms of what is reasonable and proportional.

Alan Kaplinsky:

Yeah. The other thing, you mentioned this, I think you said Grodzicki. That demonstrates that if you reduce late fees, that card issuers are going to react by restricting credit for less than... Prime customers are going to increase interest rates for all. Do they even acknowledge that study? What do they do with that study?

Todd Zywicki:

It's a very good study. There's one problem, they have a problem with one of their interpretations I think. But generally it's a pretty good study. It's squarely on here. I'm being honest here, I feel like I read this one paragraph five times in their rule. I feel like I'm fairly intelligent. I literally could not understand why they thought this study wasn't probative. It just sounds like... We talk about hand waving, but I could not see any real effort to say why this isn't relevant, why it's not the important study. It's worth summarizing because this was a new study to me when I saw this because I hadn't looked at the materials since the Taskforce Report in 2020.

And so what they find is quite striking, which is it's not just on late fees, it's on the interaction late fees and the like. And so a lot of these things are really pretty obvious. Like you said, it's basic economics, which is when interest rates rise on credit cards, people purchase less. They spend less other credit cards, especially subprime borrowers. When interest rates increase, people borrow less on their credit cards, right? When late fees decrease, consumers respond. A decrease in late fees leads to consumers increasing the purchase they make, increase the borrowing that they make, it increases the number of late payments that they make, right? Which is the cornerstone of this whole initiative by the Biden White House is this behavioral economics idea that these are hidden fees, that this idea of junk fees taps into these ideas that these are fees that consumers don't know about. They're tricked into paying all these sorts of things. The reality is they do. They know, and it seems quite clear that consumers, and we've known this for a long time, consumers focus on the terms of a credit card that matter to them.

Alan Kaplinsky:

Yeah. But they would argue, and I'm being the devil's advocate here, that if you're shopping for a credit card, you're never shopping on the basis of what late fees are being charged. You're looking at, if you're somebody that revolves your account and you don't pay it off each month, I guess you might look to see if there's an annual fee, what's the interest rate that I'm going to pay the periodic rate of interest. But it would be a strange individual that would shop base on late fees.

So I think isn't that really... I mean, CFPB isn't saying that these fees are hidden like other kinds of junk fees that President Biden talked about when they had that before the State of the Union message. He brought Chopra up there and I think the FTC, Lina Khan, she may have been up there and they talked about how hotels are charging these hidden fees and cable companies and then they lump late fees in there. They mush it all together and I guess they hope you forget that the real junk fees are the things that consumers really don't know about as opposed to a late fee on a credit card.

Todd Zywicki:

And that's a crucial point, Alan, which is that I think it's important to understand that there is, in my opinion, a germ of sense in what they're doing on some of these things like resort fees. We're Tila guys, right? We understand the idea that a mandatory fee that everybody has to pay is effectively part of the cost of the credit, right? So if everybody has to pay a resort fee, that's effectively the cost of the hotel and it doesn't make any sense. There's no sensible economic reason why you would break it out other than to try to trick consumers, right? But it's important to distinguish between something like that, which seems designed to trick consumers, and something like behavior-based credit card fees like late fees or other things that are related to a consumer's risk and a consumer's behavior with respect to how they respond to those things.

I do think they're being too charitable to their arguments about late fees. Yes, they argue that people don't shop on late fees, but they go one step further and they basically say that consumers don't understand that they're going to have to pay late fees. They don't understand what the price is going to be. And now I will admit this is a tricky issue, right? Because we have this question in economics called adverse selection, which is you don't want to be the bank that competes on the margin of providing the lowest late fees, right? Why? Because consumers will shop on late fees if they expect to pay late all the time, right?

So to your point, transactors, people who pay their balance every month like me, and I'm sure like you, what do I shop on? I shop on benefits, I shop on no annual fee, I shop on cash back, I shop on miles and that sort of thing. Turns out people who evolve, what do they shop on? They shop on interest rates. The evidence is clear, they are more likely to shop on interest rates, they're more likely to know their interest rate when they have a card and the like. And so consumers do pretty obviously focus on these different margins. What we've done now is obviously is basically cartelize the industry by imposing one particular maximum late fee that eliminates any opportunity to compete on that even if they wanted to.

Alan Kaplinsky:

So let me ask you, we're going to move away from that. Again, I'm putting on my devil's advocate hat and I'm saying to you, Todd, the CFPB isn't telling credit card issuers that they can only charge $8 and they can only charge 25% of the minimum payment. That's just a safe harbor. The general rule is that if their costs are higher than that, they can charge a late fee that's reasonable and proportionate to their costs. So why doesn't that take care of the problem?

Todd Zywicki:

Well, obviously I don't represent clients, you do. But to tell a client "Why don't you roll the dice and see if you can persuade them after the fact that this is a reasonable and proportional cost?" you could do that. What we know or what seems to be the case based on the last original Credit Card Act is the entire market pretty much adjusted from the evidence I've been able to see, is nobody chose the option of generally going above the safe harbor amount. What they did instead was raise interest rates on all consumers, but especially on subprime borrowers.

One of the things that's going on with late fees is that over the limit fees have pretty much disappeared and they dramatically reduced access to credit for subprime credit card holders and slash their credit lines, both their ability to get a card and their credit lines. This is I think a really big issue that they ignore that needs to be focused on, which is it's not just higher interest rates and the like, but when a consumer, this great paper by Greg Elliehausen, who was the economist for the taskforce in Hamlin, he had this paper and they found what happened to all those subprime consumers who lost credit cards under the Card Act. Instead, they all switched over to personal finance installment loans, which are often more expensive, they're less convenient. Sure they're an option, but consumers had preferred to have a credit card rather than an installment loan, which makes perfect sense. And so they just basically dropped out of the credit card market.

And so this is what the CFPB is missing when they say, "Well, not all these costs will be passed through. We can't find all the cost pass through." Well, that's because if somebody doesn't have a credit card anymore, they're not paying a late fee, right? If you lose your credit card, then it's beside the point what the rules are. And so of course it's not going to be passed through because a lot of consumers who would otherwise have credit cards or higher credit lines just disappear from the market. And that's a real hardship obviously for those people.

Alan Kaplinsky:

Yeah. Let me ask you also about their elimination of the cost of living adjustment.

Todd Zywicki:

Oh yeah.

Alan Kaplinsky:

They just got rid of that, waved their magic wand. That strikes me as extremely unfair.

Todd Zywicki:

It's absurd, right? Which is why? Because I mean it's a proxy for what it's going to cost to collect, to try to... Even if you use their flawed definition of reasonable proportional, as wages increase, for example, as the electricity it costs to run the call center to try to collect a bill, as that all increases, the cost of collecting debt goes up.

We actually see this going all the way back to the earliest studies, believe it or not in the Fair Debt Collection Practices Act, where what you see there is as the cost of collections go up relative to what you can collect. What do you see? You see adjustments in the market. You start moving away from smaller accounts, right? So consumers who don't have as high of a credit line, it starts to become not even worth it to extend a credit card to say a young person for a 500 or a thousand dollars credit line because you're effectively not going to... It doesn't become affordable to collect it because remember they're setting the average cost of collection here. But as a proportion, the cost of collecting a thousand dollars account is a lot higher than the cost of collecting a $10,000 account. You generally have to make the same number of phone calls and everything else. So setting that line too low and not adjusting for cost of living is going to over time erode the access for lower income consumers.

Alan Kaplinsky:

So let's talk about the process that they're engaged in here. I get the sense that they're moving uncharacteristically fast here. They issued a report, I think it was in March of last year. The ANPR came out I think in July. And now we have a proposed reg. There's a common period. I can't recall exactly when it expires, but it's not a lengthy period of time. Would I be too cynical to say that this sounds like a fait accompli, that no matter what people comment, they're going to promulgate this regulation?

Todd Zywicki:

That looks right to me, Alan, which is this does look like a fait accompli. What we have to understand is this is a big political priority in this White House. Don't forget, they rolled out the specific thing the CFPB was doing. At the same time, the FTC rolled out some stuff. Other agencies are looking at this question. And that may account for why they rushed it, was that the White House imposed a deadline and that deadline was sometime before the State of the Union, as you'll recall, the president himself trumpeted this during the State of the Union. And so it seems to me this is a political issue that they are determined to ram this through. I think that's confirmed by the fact that when the FTC is doing their similar ANPR with regard to junk fees, Christine Wilson, who you may have seen recently resigned from the FTC because she was so outraged at the dereliction of due process and that sort of thing, she wrote a dissenting opinion basically listing dozens of questions that the FTC had not considered in announcing their junk fees rule.

And so what it looks like here is this is a political train that is leaving the station that is going to be rammed through the CFPB, the FTC and everybody else. I'll just add a footnote to that, Alan. This is a big problem, which is the CFPB is going to find itself in court with respect to this appropriations challenge and it's constitutionality. This Supreme Court has already made noises that they are very skeptical about the whole structure of independent agencies. The more that agencies like the CFPB and the FTC, which claim to be independent agencies act just like partisan ramrods, this is going to hurt these agencies in the long run if they're going to basically subordinate good sound sort of practices of independent agencies in deliberation and doing good evidentiary foundations for what they're doing. This could really come back to bite them if the Supreme Court notices how slip shot these practices are becoming.

Alan Kaplinsky:

Yeah. So let's turn to, okay, they finalized the reg, and I tend to agree with you, this is a done deal. They're probably paid lip service. I'm sure they're going to get a lot of industry comments and they'll read them, but I don't think they'll do much to change it here. So there will be lawsuits, right? I can imagine that the litigation will go on for a while. If you were involved in bringing a lawsuit, what are the types of challenges that you would have? What would you put in the complaint?

Todd Zywicki:

Well, I think the most obvious one here is the APA challenges. As we have talked about, they literally just ignore evidence studies, research that is inconsistent with the conclusions that they decided they want here. As we said, for example, they ignore the critiques of the Agarwal study and the other studies they rely on to claim that there's not going to be any impact on consumers from this. They simply ignore other studies, or why they don't pay attention to them makes no sense. So the APA requires them to obviously show some evidentiary basis for what they're doing here. They've got a real problem there. They've

got a real problem with this sort of hand waving about deterrents and the extent to which that is something that they should have considered in a less slip shot manner than that they had here. So an APA challenge like that is always challenging to say the least. But given the very poor evidentiary analysis that supports this rule, that one strikes me as one that might be an inappropriate basis.

A second basis that you and I have discussed is the Card Act itself requires consultation with other agencies. Like everything else in this rule, it gives you like one sentence that says we consulted with other agencies. Obviously, it would be important to know what they did with respect to that. I think particularly striking is, this is such a radically different approach from what the Federal Reserve did when they set the safe harbor the last time. And to simply abandon that definition without any real explanation why, suggest less than full consultation.

Now having said that, I just was talking a moment ago about independent agencies. The Fed isn't exactly covering itself in glory as an independent agency either when it comes to a lot of these things like independence from the administration on things raging from ESG to everything else. So it could very well be that their consultation consisted of both of them asking what the White House, what they were supposed to do and then just doing it in uniformity. But they really provide very little information in the rule about the consultations that they did with other agencies and why they changed the definition so much.

Alan Kaplinsky:

One other thing that I have learned about, Todd, since this regulation got proposed is that there are a lot of small banks that issue credit cards. I don't know the exact number, but I'm told it's quite a few. To be considered a small bank, you have to have assets of less than 850,000. So there are quite a few small banks that are considered small businesses. There was a speed bump put into Dodd-Frank that says that the CFPB has to convene a panel consisting of I think the small business administration and someone from the CFPB and there may be somebody else that needs to be on the panel. They've decided they're not going to do that. They don't think it has a significant economic impact on a large number of small banks. It seems to me that they're treading on thin ice there too. What do you think?

Todd Zywicki:

That seems right to me. I mean that's not something that you see challenged very often usually because agencies, they aren't going to just end-run small businesses because there's such a powerful political constituency. But there is an interesting thing going on here, Alan, which is they're kind of dropping a one-two punch simultaneously on small banks as we're aware, but most people aren't, overdraft fees are also very important to small banks. And so at the same time the CFPB is going to hit late fees on credit cards, they're hitting overdraft fees on bank accounts, which is a one-two punch to small banks in terms of if they've got those operations, two different revenue streams. Large banks can find other revenue streams, right? They'll just sell you more broker services or something like that. But one of the things I think is very striking about this that tells us a lot about this CFPB is those were two areas that Director Cordray largely avoided because of the impact on small banks and small issues.

So if you recall, David Silberman was deputy director for a while at the CFPB and he had a background in the credit card industry from his time with the labor union and co-branded cards issued by labor unions and that sort of thing. This CFPB does not seem to be constrained by what they are going to be doing to small banks, by pulling them with the overdraft issue which has the exact same issues as credit card late fees, which is causing people who don't overdraft to subsidize those who do, this late fees. That combination's going to fall particularly hard on small banks. And so to simply avoid this abrief process is pretty bold when you consider that this is really putting small banks a bit in the crosshairs to drop these things at the same time.

Alan Kaplinsky:

Yeah. Yeah. One final thing I wanted to get your reaction to is if, I guess you could call this adding insult to injury. At one point during this document that included the proposal to change the late fee, they asked for comment on whether they should amend Reg Z to provide for a courtesy period which would prohibit late fees imposed within 15 calendar days after each payment due date. And whether the courtesy period should apply only the late fees assessed by a card issuer who are using the safe harbor or if it should apply generally.

And then they went on said they want to comment on whether as a condition of using the safe harbor for late fees, it should require card issuers to offer automatic payment options such as for the minimum payment amount or to provide notification of the payment due date within a certain number of days prior to the due date. And then whether it should eliminate a higher safe harbor amount for subsequent violations other than late payments. And then whether they should eliminate the safe harbor amount entirely for a late fees or eliminate the safe harbor amount entirely for all penalty fees. So yeah, that's having insult to injury I would say, right?

Todd Zywicki:

Yeah, I mean the whole framing of this rule is fundamentally flawed, right? I mean they start off with the obvious point. Subprime borrowers pay more in late fees than prime borrowers. It's duh, that's why they're subprime, right? And it's like they act like that's some remarkable thing, but then they go on and they're trying to use this rule to deal with wealth issues. They're trying to use this rule, they stress that it has racial issues, right? It's really just this whole scheme of trying to use this for wealth redistribution purposes effectively in a variety sorts of ways. And you see what they're doing there by really talking about tinkering with the real intricate balancing of product services here and the like, which is much more complicated than they're weighing in on this.

And I'll add one last thing in terms of unintended consequences, which is they say, "Well, yeah, creditors might do other things other than imposing late fees." So for example, they might report you to credit reporting agencies more aggressively to try to make sure that people pay. I mean, are consumers really going to be better off if just lenders just become more aggressive about dinging their credit when they pay late? Is that really a solution to this that borrowers are going to be happy with? Or maybe they become more aggressive about seeking debt collectors on them and that sort of thing. Selling the debt, the things you were talking about about if they can't recover the cost of charge offs, maybe they just become more aggressive about collecting the debt.

They really haven't thought this through and they really haven't thought through what impact I think this is going to have on consumers, small banks, the economy at large. It's just sort of pie in the sky kind of stuff. I think the list of things you just described kind of describes how somewhat utopian and is sort of pixie dust this whole process is. It's a wishlist rather than its serious economic regulation from what I can tell.

Alan Kaplinsky:

Yeah. The other thing that this cross subsidization thing has really got me concerned, the fact, I mean it seems like almost like Director Chopra hopes that credit card issuers raise their interest rates because then the good customers will be subsidizing the people who are always delinquent. And there's something unfair about that, I think.

Todd Zywicki:

Yeah, it's both unfair and inefficient, right? There are two things that can happen is one, yes, you might get some subsidies. And we see that that is in fact the case. Whether it's credit card fees or overdraft fees, whatever it is, you get that. But the second thing is, is to the extent you make it more difficult to price risk accurately, some people just get dropped out of the market. Don't forget that the first round of the credit Card Act where they affected the ability to change interest rates and do various other things, had not just the effect of leading that higher interest rates, but it also led to less access to credit cards for subprime borrowers and a reduction in credit lines precisely for subprime borrowers. And so you can't just redistribute. It's unfair, number one, but it's also inefficient and it ends up hurting the most credit worthy subprime borrowers who would pay on time, but they're unable to, but they end up subsidizing subprime borrowers who don't.

Alan Kaplinsky:

Or the other thing that could happen is more credit card issuers will go to risk based pricing. So they'll segment their portfolio. And the people with the lower credit scores, they will jack up their interest rates. So they'll end up paying much higher interest rates when they revolve, which could end up being more than the late fees.

Todd Zywicki:

That's right, yeah. And so those who pay on time among subprime borrowers will end up having to pay higher interest rates to subsidize those who decide not to pay because they're late. In the fantasy world of the CFPB, people are paying late because they just don't realize it. So all this emphasis on giving them notice and all that sort of thing, there's no evidence that the bulk of people are paying late because they aren't aware that they're paying late, as opposed to they're paying late because that's their best option. What we know is if you reduce the cost of paying late, they're going to pay late more often. That's clear from the Grodzicki study.

Alan Kaplinsky:

So Todd, in establishing the cost of collection and coming up with the safe harbor of an $8 late fee, the CFPB relies very heavily on so-called Y-14 data. And I'm wondering, I have two questions. One is, what is Y-14 data? And how is it relevant to determining costs for the entire credit card industry and establishing a safe harbor that will apply to everybody?

Todd Zywicki:

Yeah. It's not exactly clear. This is apparently data that is pulled from the Federal Reserve, the Federal Reserve collects, and it seems to include the largest banks and largest credit card issuers. So I think the way that CFPB thinks about this is it's a sample of the industry that is useful. Well, there's two problems with that, which is, first, the obvious problem is it's not a representative sample if it's only the largest banks. We know that the large banks have different cost structures, especially on things such as this, where there are certain economies of scale in terms of collection activity and that sort of thing. And so we know even on things like processing debit card transactions and stuff, smaller banks just have higher cost for a lot of things.

And so trying to extrapolate this to the entire industry, including smaller banks, I think, is problematic. The second problem is that there's really... How do you comment on this? Where does this data come from? Or can we get access to this data to figure out how they're using it, how they're making the calculation? And this has been a chronic problem with the CFPB since its inception. If you recall, when the CFPB was set up, it was the claim, which you don't hear very often anymore, the claim was, "We're going to be the first evidence-based agency." They were going to be a model in data based in evidence-based policymaking. But going all the way back, they've been very guarded about letting people to have access to the data that they are relying on.

And I've been talking about this for years. This goes all the way back to the Cordray years. Michael Flores and I did a comment on some of their overdraft studies where we noted that they presented the data in that case in a way that was really hard to figure out what's going on. They just purely presented median transaction size. It didn't even present the normal descriptive data that you usually get with an economic study, much less give people access to it. They did the same thing when it came to the arbitration study, if you remember that one, where they presented the data in a particular way. And we asked to get access to that data for the comment that Jason Johnson and I did, and they refused to do it.

And this is a big problem. This is a big problem with an agency like this that has a single director, that I've written about this for a decade as well, which is you don't have the internal checks and balances that you have, at least in theory, at a place like the Federal Trade Commission, where minority commissioners can get access to data, can get access to economic analysis and the like. Here, we just have to take their word for it. And the regulatory state and due process is not set up to just take the word for it of government actors, but that's basically what they're telling us we have to do here is just accept that what they've done is representative and that they've handled the data responsibly and accurately.

Alan Kaplinsky:

Yeah. And I guess theoretically, someone can make a FOIA request to get the data, but they would never get a response to that that would be timely.

Todd Zywicki:

That's right. Good luck with that, trying to get that information in any timely manner.

Alan Kaplinsky:

Yeah. It's really a disgrace. Okay. Well, we've really have very thoroughly discussed this proposal. We'll have to wait to see where things stand, Todd. Probably after it gets finalized, we'll probably want to get together again to further explore it. So thank you again for taking the time to be a guest on our show. I really do appreciate it.

Todd Zywicki:

As always, great to see you too, Alan. Thanks.

Alan Kaplinsky:

To make sure that you don't miss any of our future episodes, subscribe to our show on your favorite podcast platform, Apple Podcasts, Google, Spotify, or wherever you may listen. Don't forget to check out our blog, consumerfinancemonitor.com for daily insights on the financial services industry. And if you have any questions or suggestions for our show, please email us at podcast, that's singular, podcast@ballardspahr.com. Stay tuned each Thursday for a new episode. And thank you very much for listening. Have a good day.