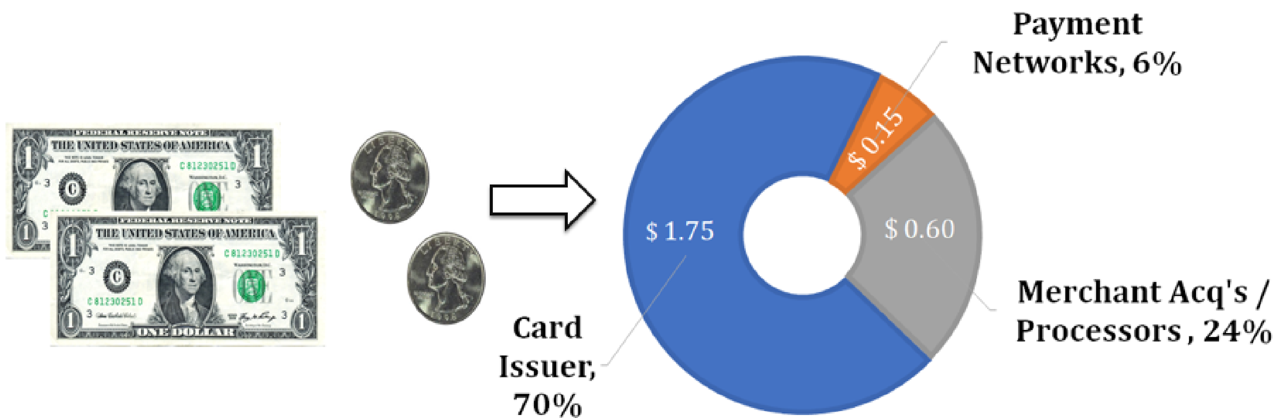
CFPB Attacks Late Fees

March 2023

Payment Economics:

Let's assume you are a bank or financial institution providing credit to consumers. If you grant a mortgage, you are able to demand 20% cash down and you have collateral in a house (to foreclose). If you issue an auto loan, you can demand a certain amount of cash down, plus you have collateral in the car (to repossess). If you provide a credit card to a consumer, you don't get any cash down and you are exposed to an open line of credit with no collateral. This is exactly why we don't invest in the card issuers (i.e., the banks providing credit cards).

The below chart shows the fees associated with a typical $100 credit card transactions. As you can see, the card issuers earn the vast majority of the economics (70% or $1.75 of the $2.50). That is entirely justified, as they are taking the customer and credit risk.



If a consumer doesn't pay the amount charged last month, these entities can get late fee penalties and charge high APRs (annual percentage rates), ranging from the mid-teens into the mid-20%, on unpaid balances. In the 4th quarter of 2022, the average APR was 19.07%, which is a very large annual increase (primarily due to the Fed's 8 interest rate hikes).

As this debt accumulates and grows, some consumers get overwhelmed and declare bankruptcy. In that case, nobody wins - the consumer gets his/her FICO or credit score penalized for 7 to 10 years and the credit issuer takes a full and total write-down.

Payment Trends:

After peaking at 18.8% during the pandemic, eCommerce as a percentage of all retail shopping, has declined to 16.4% (per the National Retail Federation). However, we believe that eCommerce is here to stay and will continue to gain market share over months, quarters, years, and future decades.

During the 2022 holiday shopping season, even with a weakening economy, eCommerce seemed to be the main beneficiary of overall purchase transactions. According to ACI Worldwide research, online transactions (from October through December) increased +21% year-over-year. Looking at metrics released by Adobe Digital Insights, US eCommerce sales hit an all-time record of $212 billion and exceeded their lofty expectations. Consumers love shopping online and appreciate price comparison benefits and convenience.

Other important payment trends were +18% annual growth in BOPIS (buy online, pickup in store), +87% growth in BNPL (buy now, pay later), and digital-wallet transactions climbing +32%. According to Deloitte estimates, households with incomes around $50,000 per year, spent $320 on gifts last year (up +19%), while households with annual incomes above $100,000 spent $650 on gifts, up 4%. During the 2022 holiday shopping season, credit and debit card transactions grew +8%.

Looking at more recent payment trends, we have heard from both Visa and Mastercard that volumes remain healthy. At recent conferences, both Visa and Mastercard reported recent payment trends. Mastercard's SpendingPulse report showed:

- Total retail spending, excluding autos, grew +6.9% YoY (year-over-year).
- eCommerce spending rose +13.2% YoY.
- US In-store purchases grew +5.5% YoY
- Restaurants were up +14.2% YoY, Airlines rose +15.6% YoY and Lodging grew +42.7% YoY

Visa reported that QTD (quarter-to-date) volume and transaction results remain strong. US payment volumes increased +12% YoY, with credit volumes up +10%. The most profitable transactions the card networks handle are cross border, and volumes are up +27% QTD.

The takeaway for us was credit and debit cards remain the #1 and #2 funding sources and payment choices. All three of the payment options we just mentioned (BOPIS, BNPL, and digital wallets) utilize credit and/or debit to transact. Nothing in the payment landscape changes our view that the payment networks have incredibly high barriers to entry and wonderful "moats around their franchises".

Credit vs Debit:

To prove this card dominating thesis even further, if one looks at Visa or Mastercard's 4th quarter 2022 results, you will see even higher revenue and earnings growth. Visa grew revenue by +12% year-over-year and earnings by +21%. Mastercard experienced +11% top line growth and +13% earnings growth last quarter. The secular growth of the card industry remains healthy and intact.

In terms of payment card choice, users say (in a S&P Global Market Intelligence research report) that 71% of their choice is determined by privacy and security. We like to decipher Visa and Mastercard's earnings and break the business down into geographies (US versus international) and then by card type (credit versus debit). The two or three key metrics we like to analyze are purchase volumes, payment transactions and cards issued. Keep in mind, Visa and Mastercard aren't providing the line of credit; a bank or financial institution is granting credit to an individual consumer. Visa and Mastercard are simply the network those card transactions run upon (i.e., the payment rails).

Looking at Visa's 4th quarter 2022 results, we easily can calculate that the average debit card transaction is under $37, and the average credit card transaction is $66. Diving even deeper, one can see that purchase volumes are fairly evenly split between credit (51%) and debit (49%), as well as geography, with 51% coming from US and 49% from international countries. However, a real distinction gets noticed when one looks at payment transactions. Visa is heavily tilted towards debit, at 63% of its transactions, while credit is just 37%. The same noticeable debit tilt can be seen from its embossed Visa cards, with 30% being credit and 70% being debit.

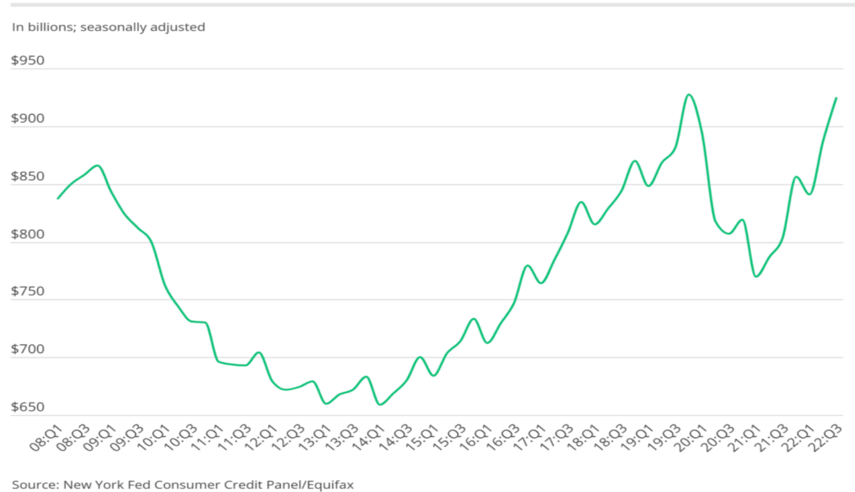
If we analyze Mastercard's 4th quarter 2022, we see stark differences in the underlying type of transactions. For example, 56% of Mastercard's purchase volumes come from credit and 63% come from outside the US. In addition, Mastercard's payment transactions are 43% credit and 76% from international sources. Lastly, Mastercard's card mix is 39% credit, with 77% outside the US.

While many confuse the dominant payment networks and believe they are essentially interchangeable, there are major differences between Visa and Mastercard. Visa is the market leader, with #1 card market share, but it leans more debit and more US. Mastercard is more credit and more international. Quite simply, debit is preferred if consumers want predictability, low or no fees, and greater ease of managing their money. Credit is more focused on those that appreciate and need the credit line, free float, and timing of re-payments.

Credit:

In October of last year, the NY Federal reported that credit card demand was accelerating. In fact, the rate that consumers applied for credit cards rose 27.1%. Despite higher applications, card issuers are getting "pickier", and the rejection rate changed by 240 basis points to 18.5%.

Credit card balances have begun to soar, as more purchases are occurring and prices for goods remain high. In the 3rd quarter of 2022, Americans' credit card balances climbed by $38 billion or 15% year-over-year. This was the largest increase in over 2 decades.



As this NY Fed / Equifax / LendingTree chart shows, the total outstanding credit card balance has been climbing.

Following the Financial Crisis, more households relied on debit, to better manage their finances and prevent overspending.

Following the economic shock of COVID and the end of government stimulus payments, US consumers seem to be spending more and leaning on their credit cards. This higher credit card usage unfortunately leads to higher consumer and household debt levels.

Debt:

Total US household debt rose $351 billion in the 3rd quarter and now exceeds $16.5 trillion. For additional perspective, this is $2.36 trillion higher than at the end of 2019, before the COVID pandemic. A recent GOBankingRates survey found that 30% of Americans have between $1,001 and $5,000 in credit card debt. Another 15% of Americans have $5,001 or more in credit card debt and about 6% have more than $10,000 in credit card debt. Supporting these alarming numbers, a recent Transunion study found that the average credit card user was carrying a balance of $5,474, up +13% versus 2021. People obviously don't look to build credit card debt, but it unfortunately is a trend that continues to climb. According to Bankrate, the share of credit card users who carry a balance has increased to 46% versus 39% a year ago.

This isn't just a lower-income problem. While lower-income cardholders are more likely to carry a balance from month-to-month, even those making over $100,000 per year don't pay off their entire balance each month (37% don't pay in full). As spending continues to accelerate, we anticipate a persistent rise in credit card debt outstanding. That same Transunion note estimated that industry delinquencies should rise from 2.1% (during 2022) to 2.6% this year. One needs to understand that while delinquencies are currently fairly low, they are absolutely headed higher. For the first 6 months of 2023, any charge-offs will be a result of those credit cardholders that entered the collection

que between July and December of 2022. As these cardholders age, we anticipate a more challenging credit environment. When the card issuers and banks reported 4th quarter 2022 results, many continued to add to their reserves due to an expected increase in delinquencies. If the US economy enters a recession in 2023, we anticipate delinquencies and charge-offs will move higher. What will happen to debt repayments if consumers lose their jobs?

The US unemployment rate is currently at a 54-year low of 3.4%, and the Fed continues to raise interest rates to try and offset higher wage growth. Companies are responding to higher costs by cutting and tightening their labor force. You know times are getting tough when Alphabet laid off 12,000 people - including 31 of their in-house masseuses (in their perks known as "Googley Extras"). Don't tell Deshawn Watson about that Google perk!

The CFPB:

Running counter to the card issuers fee tactics is the CFPB or Consumer Financial Protection Bureau. Inside of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, the CFPB was formed. Many Republicans claim the agency has become too powerful and that it lacks any real regulatory oversight. Some politicians have complained that the CFPB wields "unchecked powers" and that it pushes a radical and highly politicized agenda, without proper oversight.

On February 27th, 2023, the Supreme Court agreed to hear arguments in a case that challenges the constitutionality of the CFPB's funding mechanism. This Supreme Court case won't be heard until its next term (in October), with a decision likely coming in early 2024. However, this case has the potential to alter every order and action issued by the CFPB in its decade-long history.

The CFPB is actually funded by the Fed, not Congress, which clearly has "ruffled the feathers" of certain politicians. Back in October of 2022, the US Court of Appeals for the 5th Circuit said that the CFPB's funding mechanism violated the Constitution and that its funding should come from Congress and the US Treasury. If the SCOTUS decides to narrow the CFPB's footprint and alter its regulatory architecture, it has the potential to dramatically alter the entire financial services ecosystem.

Returning to our main point of charging fees for access to credit, another angle that card issuers have taken is to institute ***late fees*** to help offset the losses they forecast. On February 1st, 2023, the CFPB proposed (click here) significant changes to the Credit Card Accountability Responsibility and Disclosure Act of 2009 (often called the CARD Act).

Rohit Chopra is the CFPB director, and he believes that card issuers' late fees amount to levies that are deemed by the CFPB to be "illegal junk fees". Specifically, the CFPB has now capped those at $8 per occurrence. It determined that this was the proper amount to cover collection costs incurred due to a late payment. For perspective, the Fed looked into this issue and said that issuers could charge $41 per occurrence. Clearly, the CFPB thinks it can be done for less, which it why, in its preliminarily findings, the CFPB stated that late fee income currently exceeds collection costs by a factor of five (i.e., the 5x reduction from $40). Diving further into the CFPB details, card issuers would be able to charge above this $8 threshold, if they can prove that a higher fee is necessary to cover incurred collection costs. In addition, late fees would be capped at 25% of the required minimum payment while the current rules allow late fees to equal 100% of the minimum payment. Using their estimates, the CFPB believes it could reduce late fees charged to consumers by $9 billion per year (from $12 billion a year down to $3 billion).

President Biden
@POTUS

Right now, credit card companies charge an average of $31 whenever you can't pay your bill on time. On top of interest.

It doesn't cost these companies $31 to process a late payment. And my Administration is working to cut most of those fees to $8.

2/1/23, 4:35 PM

If you just think this is a consumer issue and not a political issue, just look at this tweet written by President Biden, on the same day the CFPB made its announcement. The current administration is clearly a fan of the CFPB.

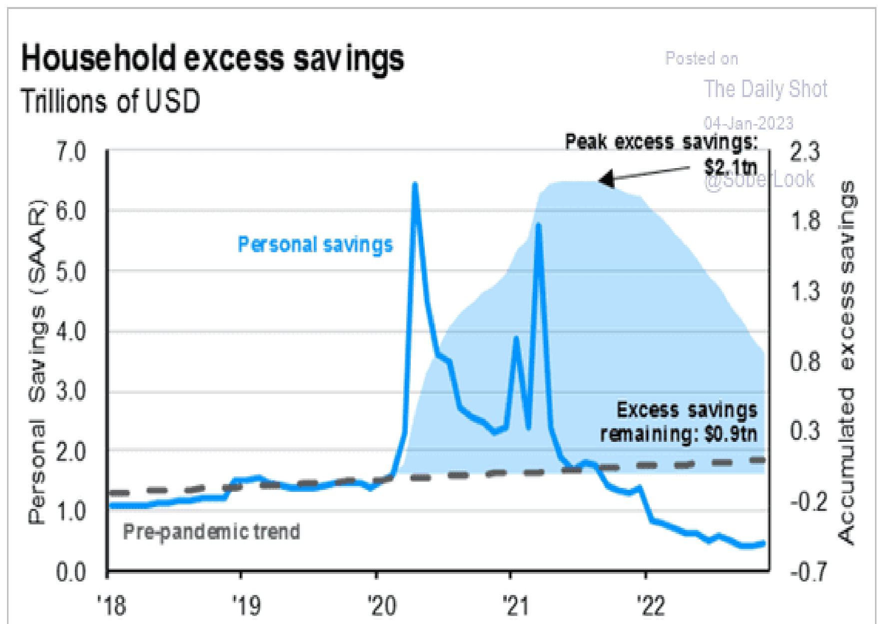
With a GOP-led House, we would expect stricter oversight of CFPB Director Rohit Chopra. In mid-December, Patrick McHenry (R, North Carolina) told Chopa at the House Financial Services Committee "You can look forward to a few more of these invitations next year."

It is still very early in this Congress, and they need to tackle the looming debt ceiling issue, but we anticipate Republicans will try to rein in the CFPB, especially since so many believe the agency lacks transparency and accountability.

Household Savings:

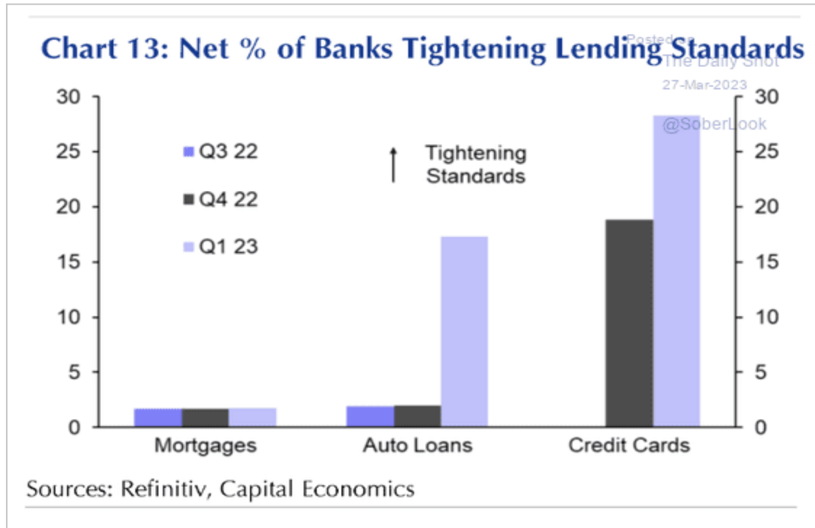
In the 4th quarter of 2022, according to the Federal Reserve Bank of New York, consumer credit card balances climbed +6.6% or an additional $61 billion to $986 billion. This surpasses the pre-pandemic high and just shows how US consumers are heavily relying on their credit cards. 90-day delinquencies increased to 4.01%, up from 3.2% a year ago and the age group with the largest payment problems were consumers in their 20's and 30's.

As this chart shows, over the last year or so, the amount of savings or household surplus has materially declined. In fact, household savings has turned negative, and more consumers are relying on credit.



Too many US consumers are living paycheck to paycheck. According to a survey by Pymnts.com and LendingClub, 166 million people or 64% of US consumers, were living paycheck to paycheck in 2022.

Middle-class and upper-class US households (that have steady and well-paying jobs) don't have huge problems paying their bills. However, the lower class needs credit to "make ends meet". In high inflationary periods, the cost of living is rising much faster than their monthly income. To offset this CFPB rule, we expect minimum payment requirements will be raised. This unfortunately will put additional stress on lower income and subprime consumers that are just struggling to survive. These people are using credit to stay afloat and the CFPB thinks these rules will help.



Delinquencies and losses continue to rise, across the FICO spectrum. January data shows impairments rose from December levels, when they were already at 3.98%. Annualized default rates increased 75bps to 9.47% and unfortunately are highest in the lower FICO segments.

As this chart from Refintiv and Capital Economics shows, banks are tightening their lending standards, especially in the credit card sector. With the banking chaos this month, we expect lending will continue to restrict.

Our Opinion:

We don't have a "dog in this fight" and frankly don't want to go "down this rabbit hole". A $9 billion annual savings to US consumers sounds like a great idea, especially if it would help the lowest income earners in our society. However, one has to understand and realize there are consequences to these types of regulatory decisions, just like there were consequences for the Durbin Amendment (click here). Don't get us started on that issue…

Our immediate takeaway is that this isn't good for all card issuers (i.e., American Express, Discover, Capital One), but it is especially challenging for private label card issuers like Bread Financial and Synchrony Financial. Most card issuers do not provide details on late fees but Discover has disclosed that late fees are less than 4% of its revenue.

William Blair Research found that subprime and deep subprime accounts represent 12% of all accounts but equate to 42% of total late fees. Goldman Sachs Research published that late fees make up roughly 9% of revenues for each of the top 5 credit card issuers, but it represents 20% for Bread Financial and 16% for Synchrony. Even more impactful, GS reported that late fees account for 60% and 40% of Bread's and Synchrony's earnings.

Private label credit cards tend to be more discretionary and have a higher client concentration in the subprime area. Since late fees are more common among issuers at the lower end of the consumer credit sector, this will ultimately lead to more restrictive lending practices. Right now, charge-offs and delinquency rates have begun to climb higher and are already exceeding pre-pandemic levels.

What will happen to available credit to subprime consumers if card issues retreat from the market? Will retailers suffer with lower sales? Will the card issuers institute annual fees to make-up for lost revenue? Will they now put annual maintenance fees on all clients? Will APR's skyrocket?

The reality is that the card issuers will figure out how to earn their appropriate spread (for the risk they are taking), or they will stop doing business in this part of the market. The CFO of Bread Financial summed it up best by saying "$8 is the equivalent of a venti latte" and that banks will seek to recoup this elsewhere. He said, "there's a cost to credit and banks will find a way to claw that back."

We believe the card issuers will adapt and adjust much faster than regulatory bodies proposals. If credit issuers cannot earn a decent risk-adjusted spread, we expect fees will be pushed onto retailers. For example, we anticipate private label issuers will look to their retail partners and force them to rebate some fees inside of their revenue

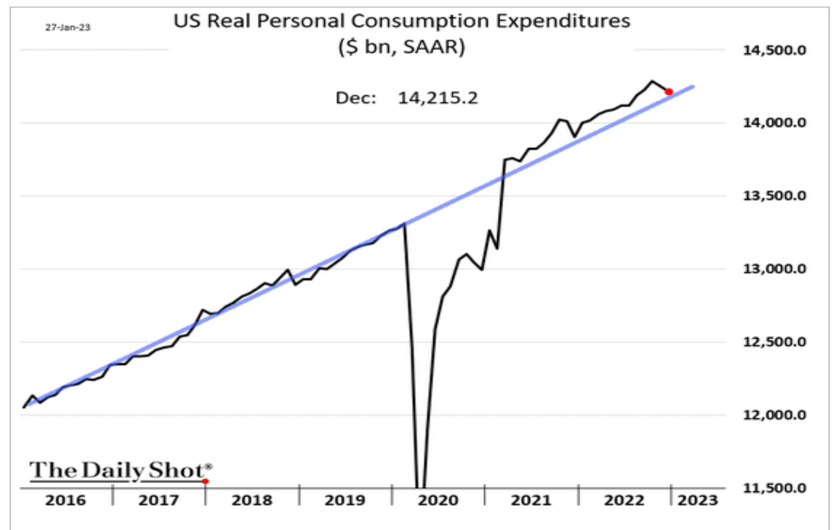
sharing agreements. Synchrony has disclosed that 60% of its late fees are tied to its revenue sharing agreements, where it can earn additional fees from its retailers. In simple terms, these entities are no different than a bank; just trying to earn a spread between their cost of capital and the revenue it can earn from its customers. The second derivative (of actions like this) often make credit harder to get for the people that need it the most.

Our Conclusion on Late Fees:

Americans drive our economy, and it is estimated that consumer spending accounts for 70% of overall GDP. We would love to see $9 billion a year go directly back into the pockets of subprime US consumers, as we are confident, they would spend those funds (like they did with stimulus checks).

However, we believe this CFPB goal will be circumvented and offset in multiple ways. What isn't helpful, in a well-functioning market, are rules introduced by government entities, that typically do more harm than good. These types of regulations often have secondary impacts that bureaucrats don't appreciate or understand.

As this chart of PCE (personal consumption expenditures) shows, spending is continuing to climb, following the dramatic drop-off during COVID. The trend line is up and to the right and we believe it should continue going forward.



The questions we have highlighted and mentioned are the items we are monitoring. The card industry has until April 3rd, 2023, to provide commentary on this rule. We expect this CFPB proposal on late fees to go into effect in 2024. We'll be closely watching for the ramifications...

We look forward to speaking with you soon!

Warren Fisher, CFA
CEO of Manole Capital Management

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