For The CFPB, Evaluating 'Junk Fees' May Be Complicated

By Andrew Stivers (March 23, 2022, 3:56 PM EDT)

The Consumer Financial Protection Bureau announced in January that it wants to do something about what it calls junk fees in consumer finance, starting with a request for information.[1]

While these fees account for a significant part of the cost of financial products for some consumers and a significant source of revenue for some firms, they can also serve important functions in the market. Determining them to be junk is more complex than just noting that they are substantial.

The announcement identified the following areas of interest to the CFPB:

- Fees for things people believed were covered by the baseline price of a product or service;
- Unexpected fees for a product or service;
- Fees that seemed too high for the purported service; and
- Fees for which it was unclear why they were charged.

Aside from general agreement that a close look at add-on fees is likely to be valuable — the Federal Trade Commission staff prepared a report on a similar issue titled "Economic Analysis of Hotel Resort Fees"[2] — the characterization that fees seemed too high in some cases raises the question of how a regulator might make such a determination.

What does it mean to call out fees that seemed too high for the purported service?

Three of the four issues cited above seem like straightforward consumer protection questions. But the fourth is harder to understand. Given the research cited in the CFPB press release, it seems likely that at least some of the fees of interest are late fees, overdraft fees and nonsufficient funds, or NSF, fees.

These are particularly interesting because, unlike resort fees analyzed in the earlier FTC study, which are mandatory, across-the-board price bumps, these fees are conditioned on consumer activity. That means the fees may influence not only whether consumers use the financial products but how they use them.

Before taking a closer look at the factors that could influence fees and whether they were too high it is worth noting that the research cited in the press release does not address these questions.

As part of the motivation for raising the concerns listed above, the announcement cites research showing that credit card late fees and...
banking overdraft and insufficient funds fees bring significant revenue to those firms.

The release says, "The CFPB's research has found several areas where back-end fees might obscure the true cost of a product and undermine a competitive market." However, the cited reports do not seem to show more than that these fees are significant. As discussed below, this does not bear on the value of the fees.

The credit card report is, generally, a report on the consumer credit card market.[3] It finds that total fees represent about one-fifth of credit costs, and late fees are almost 90% of that. These fees appear to have dropped since passage of the Credit Card Accountability Responsibility and Disclosure Act and are on average "well below the $40 inflation-adjusted [safe harbor] figure in 2020 dollars."

Similarly, the CFPB's 2021 report on overdraft and NSF fee reliance[4] documents that many banks derive a majority of fee revenue from overdraft and insufficient funds fees. Neither report supports the hypothesis that the fees obscure the true cost of a product, much less that they undermine a competitive market.

Turning back to relevant factors that could influence fee-setting, for an economist, a price or fee often serves to incentivize buyers and sellers to balance market activity. From an Economics 101 standpoint, that simply means motivating sellers to provide enough supply, while motivating buyers to match their purchases to that supply.

In that basic framework, prices and fees are understood to be set to maximize profits with consideration of how sensitive consumers are to price. I suspect that what the CFPB means by too high relates to this basic framework.

That is, they may suspect that a significant difference between the amount of the fee and the cost to the firm of providing the service indicates that demand has been manipulated through a competition or consumer protection violation. This is to say, they likely view the fees as junk, serving no useful purpose.

The problem with applying this framework to usage-conditional fees, like a late payment fee, is that the actual price setting motivations are likely to be more complex in this context and, therefore, judging whether a fee is too high for the purported service requires a much more sophisticated understanding of what the fee is doing.

For example, many fees are charged as part of a multipart pricing system. Firms may offer a base access price and then charge for various voluntary — or at least not firm-mandated — related services. A profit-maximizing firm will not typically set these prices independently. Instead, they consider how the interrelated demand for each service they provide affects the others.

Whether a price or fee is higher or lower than the cost of providing that service may be the result of a relatively complex set of optimizations by the firm and covering the total cost may involve cross-subsidies between various parts of the service. Focusing on one part of the total cost — which can raise consumer protection concerns as the FTC work on resort fees shows — may obscure how that part interacts with the whole.

In addition, some prices, like overdraft fees and NSF fees, may be used to deter moral hazard by account holders. For example, absent a high late fee, a credit card account holder may have incentives in some cases to delay payment to use their available money for other purposes.

Thus, in addition to the reasons related to multipart pricing, a credit card company may also charge a fee that appears unrelated to its costs of carrying debt and administrating the late payment process in order to deter credit card holders from using available money for other purposes. That is, the firm may set the fee to offset the gain to the consumer of delaying payment, thereby ensuring that their interests are protected.
Generally, the question of how high a penalty should be to induce appropriate deterrence — or whether a deterrent penalty is effective or appropriate — is complicated for both industry and law enforcement. Somewhat paradoxically, balancing these two factors — multipart pricing and deterrent pricing — may result in fees that are set too low to induce socially optimal deterrence.

All of the above suggests that establishing a purported purpose and then determining whether the fee was too high would be a daunting task for regulators or other stakeholders.

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