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Credit Card Minimum Payments

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Summary

Revolving credit cards generally require a minimum payment for each statement period. The creditor uses a fixed percentage or formula to calculate each month's minimum dollar amount. Low minimum payment requirements have been challenged by consumer advocates as a contributing factor to the mounting credit card debt held by U.S. households and the potential financial problems experienced as a result of that debt. Guidelines on credit card lending, issued in January 2003 by four federal regulators of depository financial institutions, were critical of the general easing of minimum payment requirements by credit card issuers. The guidelines, issued because of safety and soundness concerns, communicated expectations of more prudent practices. Recently, credit card issuers began adjusting their minimum payment formulas, raising the amount of the required monthly payment. Congress has focused on the need to increase consumer awareness of the financial jeopardy that can result from paying only the required minimum. The Bankruptcy Act of 2005 (P.L. 109-8) requires the placement of a standardized minimum payment warning on every periodic statement. Several other bills have been introduced that would enhance the disclosure to card- holders regarding the consequences of just paying the minimum.

This report provides an overview of the issues and congressional action. It will be updated as events warrant.

Background

Although there is no absolute industry standard for credit card minimum payments, they are a ubiquitous requirement of revolving credit card[1] programs. The formulas used to calculate the monthly minimum payment can vary by issuer and type of account, but typically the payment is calculated as a percentage of the outstanding balance.[2] The

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[1] As opposed to charge cards which require the full balance to be paid each month.

[2] Some issuers may calculate the minimum payment as a percentage of the outstanding balance plus any finance charges, late fees, or other fees, issuers may use a flat fee, and others may use (continued...)

periodic statements received by the cardholder do not show the formula calculations. The statement instead presents the cardholder with the dollar amount of the minimum payment for that particular billing cycle.

In the 1970s, the average minimum payment was about 5% of the outstanding balance; by 2000, it was around 2%.[3] The decline in minimum payment requirements is usually attributed to competitive pressures in the credit card industry. Thousands of depository financial institutions offer bank cards to consumers. A downward trend in credit card interest rates, aggressive marketing efforts (by mail, phone, and Internet), and product innovations (such as the elimination of annual fees and creative balance transfer offers) have made it easier for consumers both to obtain credit cards and switch among issuers. Lower minimums, reward programs, and enhanced customer service are examples of creditor practices used to maintain customer loyalty. Easing minimum payment requirements can also be viewed as a technique (similar to new penalty fee structures and shortened grace periods) employed to maintain portfolio profitability by preserving outstanding balances.

Consumer advocates have long been concerned about the growth in credit card debt. At year end 1990, revolving consumer credit outstanding totaled $238.6 billion, and by year end 2000, the total had grown to $678.5 billion. From 2000 to 2004 consumer revolving debt increased an additional $100 billion plus, rising to $787.5 billion.[4] It has been estimated that in 2004, there were 185 million bank credit cardholders and about three out of five of these cardholders were revolvers (carried balances over to the next month).[5] Consumer advocates argue that the aggressive marketing campaigns launched by credit card issuers in the 1990s contributed to an increased dependence on consumer credit. In this view, too many households are holding a level of debt that could easily cause major financial difficulties if the family experienced an unexpected occurrence such as an illness or job loss. Low minimum payment requirements can encourage consumers to take on more debt, but consistently paying the minimum greatly extends the time and cost of paying off that debt.

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[2] (...continued)
formulas that vary based on the APR (annual percentage rate).

[3] Testimony of Travis B. Plunkett, Legislative Director of the Consumer Federation of America, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, E*xamining the Current Legal and Regulatory Requirements and Industry Practices for Credit Card Issuers With Respect to Consumer Disclosures and Marketing Efforts*, hearings, 109th Cong. 1st sess., May, 17, 2005, p.8, at [http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&hearingID=154].

[4] Data from Federal Reserve Statistical Release G.19, Consumer Credit, available at [http://www.federalreserve.gov/releases/g19/hist/cc_hist_sa.html].

[5] Testimony of Dr. Robert D. Manning, Rochester Institute of Technology, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, E*xamining the Current Legal and Regulatory Requirements and Industry Practices for Credit Card Issuers With Respect to Consumer Disclosures and Marketing Efforts*, hearings, 109th Cong. 1st sess., May, 17, 2005, p.3, at [http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&hearingID=154].

Regulatory Actions

In January 2003, four federal regulators of depository financial institutions[6] issued interagency guidance on credit card lending.[7] The guidelines stated that recent examinations of financial institutions by the regulators found credit card account management practices that raised safety and soundness concerns. The guidelines described the concerns and the corrective changes for practices deemed inadequate or imprudent. The guidelines also recognized that the time required to implement changes could vary among individual credit card issuing institutions.

A section of the January 2003 guidelines dealt with minimum payment requirements. The agencies recognized a pattern of general easing of these requirements in recent years, noting that new formulas can have the effect of delaying principal payment. Of particular concern were accounts experiencing "negative amortization," a situation where the monthly minimum payments consistently fall short of even covering all of the finance charges and fees and therefore the outstanding balance continues to grow. The situation can be exacerbated by programmatic, recurring over-limit fees and other charges. The regulators view these fees as inappropriate if they are primarily intended to increase recorded income for the lender rather than as a tool to enhance the borrowers' (cardholder) performance or their access to credit. Liberal repayment programs can increase credit risk, mask portfolio quality, and compound or protract consumer debt. The account management changes expected by the federal regulators included minimum payment requirements that would effectively amortize the current balance over a reasonable period of time.

During the two-year period since the guidelines were issued, a number of large issuers of bank credit cards (including Bank of America, Citibank, MBNA, and JPMorgan Chase) have begun increasing their minimum payment requirements. The average minimum payment is expected to rise to about 4%. The following example shows what a difference an increase from 2% to 4% could mean to a cardholder. A cardholder with a $10,000 balance in a payment program with a 2% minimum and a 16% interest rate would need more than 40 years to pay off the balance and pay a total of $19,329 in interest. The same cardholder with a 4% minimum would need about 14 years and pay a total of $4,931 in interest.[8]

Increasing the required minimum has raised concerns about the potential impact on both consumers and credit card issuers. Although consumer advocates have supported larger minimum requirements, they have called on issuers to phase in any increases gradually. In addition, clear disclosure of an increase given well in advance of any change would help consumers avoid delinquency or default. Another suggestion was exempting existing debt from the new minimum. Credit card issuers are concerned about the

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[6] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

[7] The Federal Reserve Board, "FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices," joint press release, Jan. 8, 2003, at [http:www.federalreserve.gov/boarddocs/press/bcreg/2003/20030108/default.htm].

[8] Mara Der Hovanesian, "Tough Love For Debtors," *Business Week*, Apr. 25, 2005, p. 99.

potential of an increase in losses from delinquencies and defaults. General agreement is that consumers need to be better informed and educated on the benefits and drawbacks of credit cards and other financial products.

Federal Legislation

Congress has used its oversight role to actively monitor the advances, changes, and growth of the credit card industry. Most recently, in May 2005, the Senate Banking, Housing, and Urban Affairs Committee held a hearing on the current industry practices and the existing laws and regulations that govern consumer disclosures.[9] The hearing also covered the marketing of credit cards. Minimum payment requirements were included in the discussion and the testimony from consumer advocates, industry representatives, and regulators.

An omnibus Bankruptcy Act was enacted in April of 2005. Section 1301 of P.L. 109-8 provided for new disclosures for minimum payments. This section amends the Truth in Lending Act that is implemented by the Federal Reserve Board's Regulation Z. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 requires new generic disclosures on the front of each periodic statement received by a credit cardholder. The information must include a warning that indicates paying only the required minimum will increase both the total interest paid and the time it takes to repay. A hypothetical example of these consequences must be presented. Finally, a toll-free number where the cardholder can find an estimate of the time it would take to repay their individual account balance will be included. The Federal Reserve is directed to prepare a table in order to standardize the information provided to cardholders using the toll-free phone resource.

Five other bills (S. 393, S. 499, S. 1040, H.R. 3492, and H.R. 3852) addressing credit card industry practices, with provisions that would enhance disclosures regarding minimum payments, have been introduced in the 109th Congress. All five would mandate a personalized notice providing information to the cardholder about paying off their outstanding balance using the minimum rate. The notice would include the total time to pay off the balance as well as the total cost. This information would be included in the cardholder's periodic statement. The legislation has not been reported from committee.

Consumer advocates have expressed their approval of personalized disclosure notices. The Federal Reserve has sought public comment on how the Board should implement the minimum payment and other amendments made by P.L. 109-8 to the Truth in Lending Act. The Federal Reserve requested data or comment on specific issues presented in a series of questions.[10] The issues reflect the potential problems raised by alternative approaches to estimating repayment periods, assumptions used in various calculations, the different terms and conditions connected to the variety of credit card programs offered by depository financial institutions, and the need for clear and

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[9] Testimony from the hearing can be found on the committee's website, see [http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=154].

[10] Federal Reserve press release Oct. 11, 2005, at [http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051011/default.htm].

conspicuous disclosures. Personalized notices could raise similar issues. In addition, personalized notices could significantly raise the card issuer's costs. The benefit of requiring them for all cardholders, even those who routinely pay off the full balance each month, could be questioned.