FINANCIAL SECURITY FOR ALL

MAY 30, 2019 BY PERSONAL-FINANCE

The High Cost of Credit Card Minimum Payments

The High Cost of Credit Card Minimum Payments

Barbara O'Neill, Ph.D., CFP®, Rutgers Cooperative Extension, oneill@aesop.rutgers.edu

When it comes to managing your money, compound interest can be your friend (e.g., through systematic long-term investing) or your enemy (e.g., by making minimum payments on outstanding debt). This article will focus on the latter; specifically, the high cost of credit card minimum payments. Of all the credit card traps that are out there, and there are quite a few (e.g., late fees, over-the-limit fees, transaction fees, annual fees, skip-a-month offers, payment protection plans, etc.), minimum payments are the most dangerous and costly.

Why? First, minimum payments provide a false sense of security. Card users think everything is "fine" with their credit as long as minimum payments are being made. In reality, though, they could be taking on more debt than they can afford. At some point, making even minimum payments will become difficult. In addition, minimum payments cost more, lots more, over time. Items purchased on credit cards where only minimum payments are made can end up costing hundreds, even thousands, of dollars more that their original cost.

An example of the latter is someone who owes $10,000 on a credit card with an 18% annual percentage rate (APR) and a minimum payment of 3% of the outstanding balance. Assuming that only minimum payments are made, it will take 20 years to repay this debt and the total repayment would be $19,421, almost double the original amount borrowed. This number includes the original $10,000 balance, plus $9,421 in interest, according to Advantage Publications, a Boston company that sells Credit Card Smarts calculators to teach consumers about the high cost of paying just the minimum.

Like home mortgages, debt that takes decades to repay will cost 2 to 3 times the amount borrowed. Many people have no idea how much they pay out in interest because they make small amounts over long periods of time. Also, the outstanding balance constantly changes every time a new purchase is made and every time payments are made. As minimum payments are made, a credit card user's balance (slowly) declines. So, too, will the required minimum payment, which is a percentage of the outstanding balance.

Ideally, credit card bills should be paid in full to avoid interest charges. In reality, however, about 55% of American credit card users are "revolvers" who carry forward (revolve) an outstanding balance. Within this group are those (an estimated 11% of card users) who routinely make just minimum payments. In the past, many people had no idea how much minimum payments were costing them over time because they focused only on the monthly minimum. This will soon change. Effective in February 2010, the CARD Act (2009 credit card law) requires credit card issuers to include a "payoff statement" to disclose to consumers the period of time and total interest it will take to pay off a card balance if only monthly minimum payments are made.

The best way to get out of debt is to put time on your side by shortening the time it takes to repay it. This can be accomplished by negotiating a reduced interest rate with creditors (so more principal is repaid with each payment) and/or paying more than the minimum due. Even small amounts added to minimum payments can produce awesome results. Below is a table based on data derived from the Credit Card Smarts calculator (see http://www.advantagepublications.com). Notice the repayment time and interest saved by repaying 6% of the outstanding balance versus 3% of the outstanding balance for various amounts of debt.

For example, let's look at an outstanding balance of $6,000. When $6,000 is owed and a minimum payment of 3% of the outstanding balance is made, it will take 17 years to completely pay back the debt. The total amount repaid will be $11,538: the $6,000 owed, plus $5,538 of interest. In other words, you will pay back almost double the amount that was originally borrowed! As the amount of the monthly payment rises, however, there is a big difference in the number of years it will take to pay back the $6,000. With a monthly payment amount of 6% of the outstanding balance, the number of years that it takes to repay debt is cut by more than half: from 17 years to 7 years. In addition, there is interest savings of $3,619 ($5,538 by making 3% minimum payments minus $1,919 by making 6% minimum payments). Note that, the larger the outstanding balance (e.g., $9,000 versus $3,000), the greater the savings in both interest and debt repayment time by paying twice the required minimum payment. That is because larger amounts of principal are being repaid each month (compared to just making minimum payments) which, in turn, lowers the amount of interest charged on a smaller outstanding balance the following month. Of course, minimum payments and double minimum payments are also larger on high outstanding debt balances.

Credit Card Payments: 3% and 6% of Five Different Outstanding Balances

Outstanding Balance	Monthly Payment: 3% of Balance	Years in Debt and Interest Cost for 3% of	Monthly Payment: 6% of Balance (Twice	Years in Debt and Interest Cost for 6% of	Time Saved by Making 6% of	Interest Saved by Making 6% of

	(Minimum Payment)	Balance (Minimum) Payment	the Minimum Payment)	Balance (2x the Minimum) Payment	Balance Payment Versus 3% of Balance Payment	Balance Payment Versus 3% of Balance Payment
$3,000	$90	14 years and $2,625	$180	6 years and $938	8 years	$1,667
$6,000	$180	17 years and $5,538	$360	7 years and $1,919	10 years	$3,619
$9,000	$270	19 years and $8,451	$540	8 years and $2,899	11 years	$5,552
$15,000	$450	22 years and $14,276	$900	9 years and $4,860	13years	$9,416
$20,000	$600	24 years and $19,130	$1,200	9 years and $6,494	15 years	$12,636

Source: Credit Card Smarts Calculator (2006). Boston, MA: Advantage Publications.

Making minimum payments has been described as “treading water.” You are not in trouble with creditors, as long as bills are paid on time, but you are not getting very far in paying off outstanding debt. As shown above, zero balances on credit cards can be years, even decades, away. Paying more than the minimum is like someone swimming toward shore.

Progress is visible because payments are large enough to both cover required interest payments and make a dent in the amount owed (principal).

Want to avoid the minimum payment trap? Follow these tips from financial experts:

• Know What You Owe- Make a list of all outstanding debt balances with the names of creditors, monthly payments, and APRs (interest rates).

• Run the Numbers- Type the words "Credit Card Minimum Payment Calculator" into an Internet search engine and calculate the cost of making minimum and larger payments on various amounts of debt.

• Read the Numbers- Check your credit card statements after February 2010 for "health warnings" (modeled after required disclosures of risks for smoking cigarettes) about the cost of making minimum payments.

• Pay Cash- Instead of making new purchases with a credit card and adding them to outstanding balances, save up and pay cash (or use a debit card) to avoid interest charges.

• Set a Goal- To know how much to save, set a target date and dollar amount and work backwards. For example, $3,000 for a big screen television in a year requires weekly savings of about $58 ($3,000 ÷ 52).

• Find a Deal- Some retailers offer no-financing deals with words such as "180 days same as cash." This means that you'll pay no interest as long as you pay for the purchase within the stated time frame.

• Prepare for Emergencies- Consider making minimum payments on credit cards for a while if you lack an adequate emergency fund (cash assets equaling at least 3 months expenses). Use all available cash to build up cash reserves. Then switch to making larger payments once the emergency fund is in place.

FINANCIAL SECURITY FOR ALL