Research finds customers' fixation on minimum payments drives up credit card bills

October 6 2008

New research by the University of Warwick reveals that many credit card customers become fixated on the level of minimum payments given on credit card bills. The mere presence of a minimum payment is enough to reduce the actual amount many people choose to pay on their bills, leading to further interest payments.

The research, by University of Warwick Psychology researcher Dr Neil Stewart, is to be published in *Psychological Science*, in a paper entitled "The Cost of Anchoring on Credit Card Minimum Payments". It focuses on the psychological phenomenon of "anchoring" in which arbitrary and irrelevant numbers bias people's judgments.

The research reveals that anchoring affects the way people repay their credit card bills. For those people who make only partial repayments of the outstanding balance (about 35% of card holders), the suggested minimum payment on the credit card statement acts as an anchor and lowers the actual repayments people choose to make.

Dr Stewart said: "These results should be of real concern to credit card companies. Virtually all credit card statements include minimum payments. But this consumer safeguard has an unexpected negative consequence: Minimum payments distort the behavior of many customers in a way that increases interest charges and increases the duration of their debt. Those paying off the balance in full each month seem to be immune, but anyone repaying only part of the debt is at risk—not just those making only the minimum payment."

Dr Stewart conducted two studies. A survey looked at repayments data and suggested minimum repayments from 248 real credit card bills. He found that the card owners split into three broad categories. The first group (58% in this case) repaid their bill in full. This group of people were not influenced in any way by the suggested minimum payment level. No matter how high or low the suggested minimum payment was they repaid their bill in full. A second group (7%) paid only the minimum payment. But it is the third group—those making payments above the suggested minimum but not enough to clear the balance (36%)—who were affected by minimum payments.

Because respondents had credit cards from a variety of different providers, the level of minimum payment requested varied from person to person. Dr Stewart found that the level of repayment actually made by these card holders was closely correlated with the level of required minimum payment. The lower the required minimum payment the lower the actual payment made.

To examine whether minimum payments actually cause lower repayments, Dr Stewart conducted an experiment where some people received normal statements and others received statements with no minimum payment information. The experiment recruited 413 volunteers (54% female 46% male, with an age range of 18-68). Half were given mock credit card bills for £435.76 with a suggested minimum payment, and half the same level bill but without a suggested minimum payment. All were asked to imagine that the bill had arrived that morning and to decide, thinking about their current finances, how much they could afford to repay.

Once again the results found that the minimum payment had almost no affect on those who choose to pay their bills in full. 55% of those with minimum payments on their statement paid the bill in full. The same proportion of those without minimum payments on their statement paid the bill in full. However, the presence of a minimum payment had a large effect on those who chose to pay less than the full amount. When a suggested minimum payment was given the average repayment made by those not repaying the full amount plummeted 70% to just £99 on average (23% of the balance). Those not given any required minimum payment paid an average of £175 – 40% of the balance.

Dr Stewart has calculated that, based on these data, minimum payment information could double the interest charged over the lifetime of the debt. Dr Stewart explained, "It is hard to estimate the cost of minimum payment information. For a particular individual the effect depends on their level of debt and on their repayments, and could be much larger or could be much smaller."

Dr Stewart said: "Although minimum payments are a good idea in principle—because they protect the small number of people who would otherwise make no repayment at all—minimum payments do seem to have an adverse effect on those who repay only part of the bill, even those repaying a large fraction of the bill. From the psychology of anchoring, we know that people are less susceptible to its effects when they have greater knowledge. So helping people understand how much different possible repayments will cost them in the long term should help protect them from anchoring on minimum payments."

On the web

A tool to help people understand the link between repayments and interest charges is available at:
www.warwick.ac.uk/go/decisiontool/

A podcast interview with Dr Stewart in this subject can be heard at:

www2.warwick.ac.uk/newsandeven … _stewart_podcast.mp3

Source: University of Warwick