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Give Borrowers A Payoff Nudge

by Glen Fest
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By the look of things, the consumer credit-card business is getting healthier.

Revolving loan balances fell for a fourth straight month in September, at an annual pace of 2.9 percent, according to Federal Reserve data. Delinquencies also shrunk last year, according to the New York Federal Reserve, and personal bankruptcies were off the previous year's pace by as much as 13 percent, according to Epiq Systems, a technology provider to the legal industry.

Does all the good news herald a new era of consumer responsibility in the credit card space? Not exactly.

Though the trends are favorable now, the youngest population of cardholders has some poor habits settling in. The under-30 set is four times more likely than senior citizens to make late payments on card debt despite having fewer cards and lower average balances, according to Experian. And their utilization of available credit is high. Along with consumers age 30 to 46, the millennials are revolving 37 percent of their monthly credit limits, compared to just 14 percent for the "Greatest Generation."

What banks may be faced with in the years to come is a young customer base increasingly challenged to maintain healthy credit, potentially becoming a weak source of revenue as they struggle to pay off higher balances or qualify for mortgages as they age. Banks may need to consider steps now to encourage healthier behavior to maintain viable customer segments in the years to come.

A working paper published in September by the National Bureau of Economic Research showed what a little effort in this regard might accomplish. Examining card data from the eight largest U.S. banks, the researchers, including economists from New York University, the University of Chicago Booth School of Business and the Office of the Comptroller of the Currency, found that a "payoff nudge" could be induced in at least some cardholders, in the form of increased awareness about the substantial, long-term financial penalty for making only minimum payments on cards.

The researchers were studying the effect of disclosure requirements in the 2009 CARD Act. The requirements include providing cardholders with information about the interest savings that would accrue by paying off balances in three years, rather than the lengthier period (often decades) needed to clear balances making only minimum payments.

"The finding was that approximately half a percent of all borrowers shifted their behavior toward this payoff that would allow them to pay off within 36 months," says Johannes Stroebel, an NYU assistant professor of finance who worked on the study. "And it also looks as if most of those people had previously been making payments of smaller amounts."

That 0.5 percent doesn't sound significant, but it supports an argument in a 2011 study published in the Journal of Market Research that presenting the 36-month payment amount might be taken by consumers as a recommendation, prompting them to anchor their repayment plans to this level. And the findings of the more recent study could turn out to be an undercount of the impact given the number of consumers (Stroebel says he is among them) who make their card payments online, where the 36-month payoff disclosure typically is not displayed.

Many institutions are drawing more attention to the minimum payment penalty already. The websites of U.S. Bank and New York's SEFCU credit union, for example, include financial calculators that lets cardholders set their own payoff goals (defaulted at 24 months) and compare the effects with what would happen if only the minimum payoff were made each month. BB&T offers a detailed explanation of the effect of having regular additional charges on cards, where even a $100 difference in additional spending per month can extend twofold or more the balance payoff date.

Stroebel says he and his research team purposefully did not set out to suggest banks take specific actions, such as boosting minimum payments, or to make explicit recommendations for a 36-month or shorter payoff schedule.

"Without making additional assumptions, it's not necessarily clear whether people making larger repayments are necessarily better off," he says. "There's always the possibility that they might now repay credit cards faster but they are doing that at the expense of keeping more expensive debt.

"What we do want to show," he says, is "if you do make disclosures like that, it has the ability to affect consumer repayment decisions."
