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Assessing Cardholder Knowledge Regarding Payment Allocation

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Abstract:

Credit cards are unusual among loan products because customers pay one amount that is then applied to several balances at different rates. Unlike a borrower with different accounts for different purposes, a credit card borrower with a separate cash advance, purchase and low-rate short term promotion or "teaser" balance does not get to choose how their payment gets applied. Almost all credit card issuers allocate payments to the lowest interest rate balance first, and this can have a powerful impact on the effective interest rates. For a borrower to understand the power of payment allocation, they must have knowledge of three distinct things:

1) They must be aware that they are being charged different rates for different types of account activity (for example, separate cash advance rate);
2) They must be aware of the issuer's payment allocation policy;
3) If they are aware of 1 and 2, they still need to be aware of how large an impact this seemingly minor rule can have on a customer's effective interest rate.

This research uses a random survey of consumers to examine their knowledge on these three points. In general, the survey results show that most consumers do not know the correct answer to each of the above three items, and when combined, only a tiny fraction (3%) of the population understands the impact of payment allocation. Although recent regulatory changes will reduce the impact of payment allocation policy, this research still provides important insight into both consumer and card issuer behavior.