What Is a Minimum Payment on a Credit Card?

Description

The minimum payment on a credit card is the lowest amount you must pay to avoid paying late charges and damaging your credit score.

When you're struggling to pay off your full balance, the minimum payment on a credit card can feel like a godsend. But be careful: minimum payments can easily give you a false sense of security, leading you into a debt snowball (the bad kind) that incurs more and more interest every month.

To find out why let's take a deeper look at minimum payments.

What is a credit card minimum payment?

The minimum on a credit card is the minimum mandatory amount that you must pay per billing cycle. When you pay at least the minimum, you keep your account in good standing, which means you won't pay late penalties or let a missed payment damage your credit score.

To be (extra) clear: when you hear that someone "missed" a payment, it means they didn't pay the minimum on their credit card. If that person doesn't pay the minimum within 30 days, their card provider will report the missed payment to credit card bureaus. That's when it hurts your credit score, as payment history (which includes missed or late payments) makes up 35% of your score.

Making the minimum is absolutely essential to stay in good standing. But a minimum is just that — a *minimum.* Unless the minimum is the only balance you have on a credit card (in which case, good job), paying only the minimum will terminate your card's grace period and trigger its annual percentage rate (APR). The longer you carry a balance, the more you pay in interest, which can become a major drain on your budget.

What happens if you pay only the minimum?

Pay the minimum on a credit card and you'll get, well, minimum results. Your account will stay in good standing, sure. But the longer you pay only the minimum, the more debt you'll accrue.

Let's look at an example. Let's say you have a credit card with a 20% APR, a $6,000 statement balance, and a $180 minimum payment. If you paid only the minimum, it would take you around 50 months to pay off the entire $6,000. Not only that, but during those 50 months, you'll also pay around $2,830 in interest. Yes. Let that sink in for a second. You'll pay around a third in interest than your original charge.

How's that even possible? Easy — your credit card has a high APR. With a high APR, a major portion of your payment covers the interest, not just the balance.

Going back to our example, 20% of $6,000 is $1,200. If we break that up by months (APR is, after all, an annual rate) we'd see that you'd pay roughly $100 in interest on your first payment. Your minimum payment is $180, which means $100 goes toward interest charges and only $80 goes toward your principal. By the end of this first payment, your owed balance decreases to only $5,920.

That's why it's super important to pay more than the minimum, ideally as much of your statement balance as possible. The more balance you pay off, the less wealth high APRs can siphon away from you.

What happens if you don't make the minimum payment?

Paying the minimum keeps you in good standing. But if you don't pay at least the minimum, things can spin out of control fast.

First off, by failing to pay the minimum by your statement's due date, you're breaking the contractual agreement you signed when you took out the card. Technically speaking, you're defaulting on your credit card. Though your credit card provider may not label your account a default just yet (often it takes several missed payments to reach that status), you're putting yourself in a precarious position.

At the very least, you'll get hit with a late penalty, usually a flat rate, such as $20 or $30. On top of that, your APR will go into penalty mode, meaning you'll pay a higher APR on all late charges. Not only that, but your credit card issuer will report the late payment to credit bureaus, hurting your credit score, though often they'll only do this if you're more than 30 days late on the payment.

Finally, if you miss enough payments, your credit card issuer will label your account a default, which can have a serious impact on your credit score. Fail to comply, and your card issuer may even take legal action.

How is the minimum payment calculated?

Credit card issuers don't all calculate minimum payments in the same way. But they do follow predictable methods you should be aware of.

The most popular is the percentage method. In this way, your card issuer will take a percentage of your total balance — usually 2% to 3% — and set the result as your minimum. For instance, if your statement balance is $6,000 and your card issuer uses 3% to calculate the minimum, your minimum payment would be $180.

Other credit card issuers will use a flat rate, say $25 to $35, to set your minimum. Still others will do a combination of the two, giving you a floor flat rate, the “minimum of the minimum,” along with a percentage rate if your balance exceeds a certain point.

How does the minimum affect your credit score?

Unless you don’t pay the minimum every month, paying at least the minimum will have a positive impact on the “credit history” portion of your credit score. Given that credit history makes up 35% of your overall score, paying the minimum may seem like a good way to build credit.

But this isn’t always the case.

Paying only the minimum could affect another portion of your credit score, the credit utilization ratio. This ratio measures how much credit you’re using versus how much credit lenders have extended to you. So, for example, if you charge $4,000 to a card with credit limits of $5,000, your credit utilization ratio would be 80%.

In order for the utilization ratio to positively impact your score, it should be lower than 30%. As your ratio creeps above 30%, credit bureaus take that as a sign of over-leveraging your credit.

Now let’s bring this back to the minimum payment. If you’ve maxed out your card, paying the minimum doesn’t help lower your credit utilization ratio. In that case, you’ll hurt your credit score, since your credit limits will continue to appear overextended.

Can you use credit card rewards to pay the minimum?

Nice try, but it’s not likely. Though you can earn some serious rewards on Canada’s top rewards credit cards and cashback cards, you won’t be able to use them as a substitute for your minimum payment.

You can use your rewards or cashback to credit your account (lowering your current balance), but nine times out of 10, your credit card issuer won’t accept them in place of your minimum payment.

Foolish bottom line on minimum payments

The minimum on your balance is important to pay. If you don’t pay the minimum, you’ll incur late fees and rack up high interest on a penalty APR. On top of that, you could damage your credit score by failing to meet the minimum within 30 days of your billing statement’s due date.

But, if you can do it, pay *more* than the minimum. In fact, pay *all* of your account balance. The less you carry on your credit card, the less interest you’ll pay overall. And, when you’re in the business of saving money, paying zero interest on credit cards is at the top of the checklist.

For those Canadians who have already charged an immense amount to a credit card, there are ways out of high-interest charges. One is to take out a balance transfer credit card. These cards typically come with a low promotional APR period, during which you'll pay less toward interest and more toward your principal.

The promotional period doesn't last forever (usually a few months to a year), but if you pay off a majority of your credit card debt before it ends, you'll save a *lot* in interest.

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