Credit Card Rewards: Context, History, and Value

A White Paper on Credit Card Rewards

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A White Paper on Credit Card Rewards



Introduction

Credit card rewards programs are generally very popular among those who participate in them. However, a recent study by Scott Schuh, Oz Shy, and Joanna Stavins that examined the distributional effects of payment choice has thrown their value into question.¹ They argue that cash payers-who are typically lower-income consumers-essentially subsidize credit card users. If such a transfer exists, then rewards programs, by encouraging credit card use, would exacerbate the dilemma.² However, the Schuh, Shy, and Stavins framework lends itself to a very formal and exceedingly limited understanding of rewards, and one that is tangential to the actual issue of rewards. We argue, based on a recent survey of consumers and business owners, that introducing consumer protections or other regulations to the rewards cards, as some have proposed, could have unintended detrimental effects.³

Rewards programs are very diverse in both type and use. The value of evaluating a single rewards program, such as credit card rewards, is diminished unless the broader context is well understood. This paper first examines the history of rewards programs and how they have evolved over time. It is clear that for more than one-hundred years, rewards programs have been popular and a core part of marketing strategies for firms of all stripes.

Against this backdrop we next examine credit card rewards penetration rates among credit card holders across all income groups. We also examine the results of two recent surveys, the first of largely, but not exclusively, credit card holders, and a second of small business operators. The results reveal their views on rewards programs. With this context, we hope to help policymakers make better-informed decisions about consumer protections.

The evidence points to two facts. First, rewards programs are very popular among participants. That is, many consumers participate in them and among the participants, most are highly satisfied. Also, among credit card holders, there is a higher satisfaction with reward cards than nonreward cardholders: 58% of rewards card holders were extremely satisfied with their credit cards compared with 46% of nonreward card holders.⁴ Second, there is evidence that rewards programs encourage consumption among some groups of consumers. By extension, then, credit card rewards programs can play a valuable role in increasing sales and spurring economic activity. For these reasons, they are also highly valued by small business operators.

¹Scott Schuh, Oz Shy, and Joanna Stavins, "Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations." Public Policy Discussion Paper No. 10-03. (Boston: Federal Reserve Bank of Boston, August 31, 2010), available at http://www.bos.frb.org/economic/ppdp/2010/ ppdp1003.pdf

²A Reexamination of Who Gains and Who Loses from Credit Card Payments? (A PERC Study)

³Turner, M. "First Do No Harm: A White Paper on Cardholder and Small Business Operator Views About Credit Card Fees and Surcharges." 2012

⁴MasterCard International Incorporated. "The Rewards Study." (MasterCard, 2011).

Defining Rewards Programs

A simple definition of a rewards program is a marketing program that cultivates an ongoing relationship between a provider of goods or services and customers. Rewards programs focus on the holy troika in marketing recency, frequency, and money—known in marketing circles as "RFM." Rewards programs focus on all three aspects of RFM. For instance, an airline rewards program is linked to activity during a calendar year, and points are earned by making large purchases or a higher volume of smaller purchases. Rewards programs create incentives that help retailers capture and maintain customers.

Rewards programs also help retailers share some of the intangible value of market share and customer behavioral data with repeat customers. VIP perks that come with travel and entertainment (T&E) programs are good examples. These perks offer consumers a cachet that exceeds the actual financial reward; for example, access to a members' lounge at an airport once a certain status level has been achieved. From a business perspective, increased or retained market share and strong and sustained customer loyalty may offer a market valuation far greater than that dictated by current earnings alone.

History of Rewards Programs

Rewards programs have a long history. For example, in 1793, a U.S. merchant started giving out copper tokens that could be collected by the consumer and exchanged for items in the store.⁵ In 1851, the B. A. Babbitt Company began including certificates in packages of Sweet Home laundry soap. When customers collected a specified number of certificates, they could exchange them for color lithographs. In 1872, the Grand Union Tea Company offered tickets to its customers that could be exchanged for merchandise in the company catalog.



The 1890s saw the beginning of trading stamps. The Schuster and Company department store in Milwaukee introduced the first trading stamps to the public in 1891, known simply as the Blue Trading Stamp System. Following the success of Schuster, Thomas Sperry and Shelly Hutchinson founded an independent stamp company that supplied stamps to a number of merchants in the same community. S&H Green Stamps (also known as Green Shield Stamps) were awarded to consumers buying from participating merchants, including grocery stores, department stores, filling stations, and others.6 Their use expanded among supermarkets and gas stations, which proliferated as Americans became more mobile. The program still exists today as S&H Green Points, though it is only available to customers of online retailers.

In 1906 Kellogg's launched a premium gift prize (*The Funny Jungleland Moving Pictures* book) for customer who purchased two packages of the cereal. In 1909, Kellogg's changed the give-away to a premium mail-in offer for 10 cents.⁷

⁵ Lonton, Jeff R. "The Trading Stamp Story. Part 1." Downloaded from http://www.studioz7.com/stamps1.shtm

In 1929 Betty Crocker issued coupons that could be used to redeem for rewards such as free flatware. In 1937, the coupons were printed on the outside of packages, and later a popular rewards catalog was issued for customers to redeem points.⁸ In the 1950s, a sister company to the Piggly Wiggly grocery stores began offering its own trading stamps.⁹

In 1981, American Airlines created the first modern rewards program for frequent flyers. Over the ensuing decades, other airlines and hospitality industries followed suit, including hotels and car rental companies. In fact, the next wave of innovation began in the early 1980s with airline frequent flier programs and credit card loyalty programs. In the late 1980s, credit card issuers began introducing a broader array of loyalty and rewards programs. In 1986, the popular "cash back" program from Discover Financial Services, a division of Morgan Stanley, appeared. Discover introduced the concept of providing cash to the credit cardholder at the end of every year based on the total amount of charges. Such programs are still in place, three decades later, and remain highly popular with customers.

Another cash-back option, the AT&T Universal Card, was introduced in 1990, and allowed customers to apply cash-back awards toward the credit card holder's phone bill. Universal Cards offered a compelling incentive for use and were well received by AT&T customers. These experiments opened the eyes of many marketing executives in the credit card industry, and other industries and rewards programs began to flourish. Since the early 1990s, credit card companies have played a leading role in rewards programs. Many other types of businesses started co-branding with financial institutions to share the benefits of frequent and return business with consumers. Of these, gasoline and airline cards are among the most popular.

Figure 1 illustrates the growth of rewards programs over the last century. It is perhaps no accident that rewards programs develop in tandem with innovations in products and innovations in payment technology. Although this may seem coincidental, it does suggest that rewards programs are intimately tied with changes in purchasing and payment behavior. As technological advances such as speedier connections at the point-ofsale drive advances in rewards, retailers and nonfinancial companies have begun to offer prepaid cards with a rewards component.

Figure 1:

Programs that Reward Customers for Loyalty Have Existed for Over 100 Years



⁶Simon, Jeremy M. "Credit card reward programs: a short history." CreditCards.com. 14 November 2006. Downloaded from http://www.credit-cards.com/credit-card-news/reward-programs-a-short-history-1277.php

⁶ Greenbax Enterprises, "About Us." www.greenbaxonline.com/info/GBXAboutUs.asp.

⁷ Rod Taylor, "The Good Old Days," *Promo: Your Guide to Consumer Marketing*, September 1, 2003. Downloaded from http://chiefmarketer.com/campaigns/marketing_good_old_days.

⁸ Angel Gibson, "A Brief History of Loyalty Marketing." Angelgibson.com, June 12, 2009. Available at: http://angelgibson.com/2009/06/12/abrief-history-of-loyalty-marketing/

By the mid-2000s, co-branding and affinity programs pioneered by banks brought rewards programs to almost every industry. "Cash back" was by 2012 the most popular feature of the programs and is the likely source of consumer satisfaction. Today, consumers with credit cards report that credit card programs are the most popular.¹⁰

Ubiquity of Rewards Programs

To gauge the sentiment toward and use of rewards programs, PERC and ORC International surveyed 2,501 consumers (2,000 cardholders—among whom 1,589 were rewards card holders—and 501 noncardholders) during the first quarter of 2012, on a range of topics relating to credit cards and rewards programs. The sample was reflective of the adult population by every meaningful sociodemographic variable including race/ethnicity, income, age, gender, and geography. At the same time, PERC surveyed 538 small business operators on their views about the same issues. The small businesses surveyed were located in the Gulf Coast region (Alabama, Florida, Louisiana, and Mississippi).

Among all rewards program types, the survey finds that credit card rewards programs enjoy the highest penetration among credit card holders. The penetration rate of credit card rewards program among respondents who were cardholders (2000 individuals) was 79%, followed by airlines rewards programs at 74%. These figures match those reported by a recent Master Card survey¹¹ and another survey by FirstData in 2008 that found 76% of credit-card-holding consumers were members of credit card rewards programs.¹² Figure 2 shows the seven program types with the highest penetration rates.



Figure 2: Percentage of Credit Card Holders by Rewards Programs

Source: PERC/ORC Consumer Survey (N = 2000, all credit card holders)

Focusing on credit card rewards programs alone, it is clear there is a fairly high rate of participation across all income groups (Figure 3). Even within the group earning less than \$20,000 annually, 70% carry a rewards card. This is a clear contradiction to the notion in Schuh, Shy, and Stavins' report that only high-income groups have rewards cards. The higher penetration is also a marked improvement from 2007-2008 when, according to an Ohio State University study, only 48% of credit card owning households with annual incomes less than \$20,000 participated in any form of credit card rewards programs.¹³ The 2012 PERC survey shows an improvement of around 46% in rewards card ownership for the lowest income group. For the broader population, the rewards credit card penetration among credit card holders rose from 61% in 2007-2008 to 79% in 2012.

¹⁰ PERC/ORC Consumer Survey 2012. See also, Sharon Brant, "Credit Card Rewards – Consumer Insights" (First Data, 2008), available at: www. firstdata.com/downloads/thought-leadership/fd_creditcardrewards_research.pdf

¹¹ MasterCard, , "The Rewards Study."

¹² Sharon Brant, "Credit Card Rewards – Consumer Insights" (First Data, 2008), Available at www.firstdata.com/downloads/thought-leadership/fd_creditcardrewards_research.pdf

¹³ Ohio State University, "2007-2008 Consumer Finance Monthly Survey." See also Table 2 in Schuh, Shy, and Stavins, " Who Gains and Who Loses from Credit Card payments?"



FIGURE 3: Percentage of Credit Card Holders Enrolled in Credit Card Rewards Programs

Source: PERC/ORC Consumer Survey, 2000 credit card holders

The current penetration rate of rewards programs (79% from PERC 2012 Consumer Survey) among all credit card holders is the highest ever. The percentage of rewards participation among credit card holders has steadily increased over the years as well (Figure 4). This has been mirrored by a similar increase in percentage spending on rewards credit cards. For instance, the 78% of credit card holders with rewards credit cards in 2012 accounted for 92% of total spending on all credit cards (Figure 4). The increasing trends and the overrepresentation of rewards credit card spending indicate that consumers place a high value on rewards credit cards.

In fact, when asked directly in the 2012 PERC Survey, 84% of rewards credit card holders rated credit card rewards programs at 5 or above on a scale of 1 to 10, where 1 was of no value. Further, 69% gave credit card rewards programs a 7+ rating. This high rating appears consistent across all income groups (Figure 5). The PERC survey also shows that among all major financial

Figure 4: Rewards Credit Card Participation Rates and Spending



Source: The Rewards Study by MasterCard.¹⁴ Note the PERC/ORC Consumer Survey of 2012 puts rewards credit card penetration at 79% whereas the MasterCard Survey of 2011 puts the same number at 78%. Spending on rewards credit cards is shown as a percentage of total spending on all credit cards.

and nonfinancial rewards programs, credit card rewards programs received the highest ratings, with more rewards credit card holders giving them a 5+ or 7+ rating than any other program (Table 1). Interestingly, debit card programs are the least embraced, with 65% of debit rewards card holders in the sample giving them a 5+ rating. This indicates that credit and debit rewards card holders view credit card and debit card programs very differently.

Table 1: Rewards Program participant attitudestoward rewards programs

Rewards Program Category	% Rating Program 7+	% Rating Program 5+	% Rating Program Less than 5
Credit card	69	84	15
Airline	56	71	28
Retail	51	74	26
Grocery store	58	78	22
Hotel	47	66	34
Gasoline	55	71	29
Debit card	50	65	35

Source: PERC/ORC Survey (ratings provided by only those enrolled in rewards programs for that category.) (A rating of 1 = program is of no value; a rating of 10 is of "tremendous" value.)

14 MasterCard, "The Rewards Study."

The combination of high participation, high spending, and high satisfaction makes credit card rewards programs stand out from other rewards programs. As such, changes to credit card rewards programs would likely result in a nontrivial change in consumer behavior. These changes and responses to these changes could easily result in unintended consequences of policies aimed at altering credit card rewards.

Figure 5: Attitude toward Credit Card Rewards Program among Credit Card Rewards Program Participants



Source: PERC/ORC Consumer Survey (Respondents include all 1,589 rewards credit card holders,)

It is not only the credit card holders, but also merchants who highly valued credit card rewards programs. In the PERC small business survey, approximately 80% of small business operators who had their own rewards programs said that those programs boosted sales. This could stem from customer retention. Research by the consultancy firm Brian & Company indicates that a 5% increase in customer retention can boost customer net present value by 35% to 95%.¹⁵ In addition, approximately 50% of small business operators in the PERC survey claimed that accepting rewards cards brought in more sales (Figure 6).

Figure 6: Business Believe Rewards/ Reward Cards Programs Generate Sales



Source: PERC Small Business Survey of 2012 (Respondents included 92 business operators with their own rewards program and 314 credit card accepting business operators.)

With such high values placed on rewards programs, do consumers or business operators really want any new regulations on rewards programs? The surveys conducted by PERC provide some interesting answers. Approximately 83% of consumers oppose regulation on rewards programs even if it means slightly lower prices and the opposition is consistent across all income groups (Figure 7). A study of consumer and small business operator attitudes toward regulations found strong resentment to regulations in both groups.¹⁶ This appears to indicate that lower-income credit card users do not feel that issuers are taking advantage of them. The finding is also consistent with Figure 5, which shows high satisfaction among lower-income credit card rewards participants, and Figure 3, which shows high rewards participation rates among lower-income credit card holders. In short, lower-income credit card holders participate in credit card rewards programs, value them, and do not want them regulated.

¹⁶ Turner, M. "First Do No Harm: A white paper on Card holder and Small Business Operator Views about Credit card fees and Surcharges." May 2012, A PERC study. INSERT a proper citation.

Some may argue that if rewards cards are removed, then the consumers will start using cheaper methods of payment such as debit cards. However, there are good reasons to believe that there will not be one-for-one substitution among payment methods.¹⁷

Figure 7: Percentage of Credit Card Holders Who Oppose Regulation on Reward



Source: PERC/ORC Consumer Survey (N=2000 credit card holders)

Credit cards with associated rewards programs also drive up sales. The average amount spent monthly on nonrewards credit cards was \$333 among MasterCard Survey respondents. This compares with \$800 for rewards credit card holders, although we do not have total spend figures.¹⁸ Although the average spending on both rewards cards and nonrewards cards has declined over time, the average spending on rewards card remains higher than that on nonrewards cards (Figure 8). Because these numbers do not control for income and other subgroup differences, the actual values may change after controlling for relevant factors. However, additional sources also support the tenet that rewards programs lead to higher sales.¹⁹



Figure 8: Average Spending on reward and non reward cards

Source: The Rewards Study by MasterCard. 20

According to PERC's survey of small business operators, nearly three-quarters say that accepting credit cards brings in additional business. In addition, approximately one-half say that accepting rewards credit cards boosts sales. This judgment probably stems from experience, given that approximately 80% of small business operators who had their own rewards programs believed that rewards programs encouraged spending. Agarwal, Chakravarti, and Lunn (2010)²¹ also find that consumers generally spend more when offered 1% cash back rewards. They find that average spending increases by \$68 per month in the first quarter after the cash-back rewards program begins.

Given the popularity and participation rates in credit card rewards programs and how positively small business operators view credit card holders, it would be surprising if the rewards did not lead to new sales. Even small changes in sales can have large effects. If we assume that credit card rewards result in an increase in total merchant sales of just 1%, then rewards may be driving up spending enough to cover all the higher costs

¹⁷ Op. Cit

¹⁸ MasterCard, "The Rewards Study."

¹⁹ Taylor, G.A. and Neslin, S.A. "The Current and Future Sales Impact of a Retail Frequency Reward Program." 2005. http://loyaltylogistics.net/ img/Retail-Frequency-Reward-Program.pdf

²⁰ Ibid.

²¹Sumit Agarwal, Sujit Chakravarti, and Anna Lunn, "Why do Banks Reward their Customers to Use Their Credit Cards?" (Chicago: Federal Reserve Board of Chicago, Dec 30,2010), available at http://papers.srn.com/sol3/papers.cfm?abstract_id=1719054

of accepting credit cards that result in high-income consumers subsidizing low-income customers. As such, estimating the true distributional impacts of policies that alter the credit card rewards landscape is likely difficult and prone to unintended consequences.



Conclusion

Rewards programs are part of the fiber of the American economy. They are woven through both the warp and the weft. Over time, they have become both pervasive and popular. In fact, it is hard to imagine a scenario in which consumers do not expect rewards programs, including for travel, shopping, grocery, and credit.

On their most basic level, rewards programs are marketing tools designed to increase consumption, loyalty, and to attract new customers. All evidence suggests that they succeed on all three fronts, which largely explains their ubiquity within the American economy.

Without exception, taking a very minimalistic approach, nonparticipants subsidize participants. Those who do not use coupons, carry swipe cards on their key chains, have their membership card stamped each time they buy a sandwich or rent a DVD, or use rewards credit cards all confront prices that include the costs of rewards programs. Small business owners and operators, for the most part, consider the fees paid for accepting credit cards, including rewards cards, as a cost of doing business—in the same category as rent or utilities. Of course those who do not want to enroll in rewards programs for whatever reason—concern over privacy, belief that costs exceed benefits—are free to abstain. However, remedying the cross-subsidy from nonparticipants to participants via a surcharge or by charging different prices to nonparticipants, as has been proposed by Scott Schuh, Oz Shy, and Joanna Stavins, is practically impossible.²²

Most small business owners and operators are not sophisticated price setters. They do not marginally adjust prices up or down in response to costs associated with rewards programs. They are far more likely to estimate total operating costs, and mark up wholesale prices by an amount to cover costs and provide a reasonable expected return (profit) or they are price takers and charge what the market will bear.

According to the PERC small business survey, 37% of business operators say they will not pass on any savings (from reduced merchant fees) to the consumer. Another 20% say they will pass on some savings but not all. Far more likely, given well established, deeply engrained consumer expectations about rewards programs, is that attempts to rectify a perceived unjust cross-subsidy will dramatically affect consumer behavior in a manner that is detrimental to the economy. In fact, 9 in 10 credit card holders surveyed by PERC and ORC reported that they would either discontinue using their rewards credit card altogether, or reduce their use in response to imposed fees.²³

Given the well-established relationship between credit card use (and particularly rewards credit cards) and consumption, even a small change in spending behavior would yield large and largely negative economic consequences.

²²Scott Schuh, Oz Shy, and Joanna Stavins, "Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations." May 4, 2011. http://www.ecb.europa.eu/events/pdf/conferences/ecb_oenb/Schuh_Shy_Stavins.pdf?aacf3e1299b73e75081bae633665ccf1

²³The PERC/ORC SURVEY Consumer Survey which consisted of 1589 reward credit card holders

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