



Mary Carol Garrity, owner of Nell Hill's Home Emporium and two other shops in Atchison, Kan., is affected by card reward programs as both a merchant and a consumer.



Charging Toward *Rewards*

ISSUERS OFFER CARDHOLDERS INCENTIVES TO ENTICE LOYALTY

Like so many of her customers, Mary Carol Garrity now charges almost anything she can—including business expenses for her three upscale furniture, home décor and giftware shops in eastern Kansas—to either her Visa or American Express credit cards.

As a shop owner of 25 years, Garrity has seen an increasing number of patrons opting to pay with their credit cards. She supposes the incentives, such as the cash-back or travel rewards tied to both credit and debit cards, is one of the reasons driving this trend.

“I know it motivates me personally,” says Garrity, who just recently started using two airline reward cards.

Her enticement: “My girlfriends who own businesses get to fly first-class to Europe.”

A long-time cardholder but recent reward card loyalist, Garrity is just the kind of consumer that card networks are hoping to attract. Research shows those with reward credit and debit cards use them more exclusively than cards that don't offer rewards, and reward card transactions often replace cash, check and non-reward card transactions, says Fumiko Hayashi, a senior economist with the Federal Reserve Bank of Kansas City.

Hayashi recently analyzed the effects of credit and debit card rewards on consumers'

payment choices along with Andrew Ching, assistant professor of marketing at the University of Toronto.

“Capturing new cardholders is becoming difficult because most consumers already have both credit and debit cards,” Hayashi says. “Payment card issuers, therefore, are trying to stimulate their existing customers' card usage by providing rewards. It's an incentive for consumers.”

And it appears to be working.

Enticing loyalty

Deborah Hamilton starts every day with a reward, in addition to her coffeehouse latte.



Her morning wake-up is Hamilton's first credit card purchase of the day followed by, "Everything! Everything goes on the card," she says, which gets her that much closer toward another Southwest Airlines ticket.

With the exception of her mortgage and car payments, although she tried, Hamilton pays for all purchases big and small with her Visa. And as a result, the single, 55-year-old grandmother in Kansas City, Mo., racks up five or six plane tickets a year. She's traveled to Napa Valley, Mexico, the Caribbean and the Bahamas, among other places.

A "fanatical" reward credit card holder of 15 years, Hamilton says only death will part her from her card. And then her kids will fight over her airline points, she jokes.

It's this loyalty that card issuers are striving to achieve in hopes of gaining users who would have otherwise paid with cash, check or another card.

It's been reported that many card issuers that launched new rewards programs have seen increases in spending on their cards. However, it is unlikely reward receivers are simply spending more, but are using their reward card in lieu of other payment methods, Hayashi says.

Footing the bill

Reward card issuers target middle- to high-income consumers rather than low-income earners, who don't qualify for high credit limits, or possibly cards at all. As a result, low-income earners may be affected beyond just rewards.

Card programs and the merchant fee structure may distribute income from low-income to high-income consumers, Hayashi says.

This is due to many merchants paying

higher fees to card issuers if their customers use a reward credit card instead of a non-reward credit card or other payment methods. Merchants aren't allowed to reject reward card payments if they accept the network's non-reward card, nor can merchants price-discriminate based on the payment method used.

"As a result, the more customers who use reward credit cards, the higher the merchants may mark up their retail prices in order to offset higher fees," Hayashi says. "Although reward credit card holders are partly compensated for higher retail prices through rewards, other consumers aren't."

Compounding the cost of reward credit card fees on merchants, and possibly their customers, Visa and MasterCard recently introduced interchange fees that apply only to reward credit cards. These fees, which are a percentage of each transaction that the merchant pays to the card issuer, are higher than non-reward

credit card interchange fees. The fees are the same for reward and non-reward debit cards.

Accepting credit cards is increasingly challenging for a smaller business whose volume of sales can't easily offset additional interchange fees like a chain merchant could, says Scott Baird, manager of Georgetown Furniture, a family-owned and operated furniture store in the western Missouri city of Liberty.

"It doesn't benefit the merchants at all," Baird says. "It's kind of a deterrent. We appreciate the business ... but I would rather see someone use a check or the (store's) finance plan."

The majority of the store's customers do pay with a credit card or via the store-offered finance plan, Baird says. It's tough to say, though, how many of those card purchases are

Deborah Hamilton starts every day with a reward, in addition to her coffeehouse latte.



Her morning wake-up is Hamilton's first credit card purchase of the day followed by "everything!"



PHOTO BY CHRIS SCHOENHAUS

TO ACCUMULATE REWARDS, Deborah Hamilton (right) of Kansas City, Mo., uses her credit card for every purchase possible. It's this kind of loyalty that card issuers hope results from reward programs.

ried to rewards and exactly how much that costs Georgetown Furniture.

“One percent here and 1 percent there—it’s small, but they can add up,” Baird says.

But Baird, an avid fly fisherman, loves his personal card: a Visa with Cabela’s rewards. He recently redeemed points for tackle from the outdoor recreation mega store.

“It is difficult to say who actually pays for these rewards,” Hayashi says.

Even if reward card use is fully funded by interchange fees, that doesn’t mean the actual rewards are paid by merchants.

Merchants may impose the cost of the interchange fees on their customers by raising prices. If that’s the case, the customers are actually paying for the rewards. And how merchants and their customers share the costs of interchange fees depends on price elasticity of supply and demand for goods and services, Hayashi says.

If credit card rewards are funded by interest

or finance charges, those card users are paying, at least in part, for the rewards. For debit card issuers, revenue is generated from both interchange fees and account holders.

Just like consumers, merchants and card issuers are motivated by reward cards. Their enticement: customer loyalty.

‘Cost of doing business’

The average consumer in the United States has five to seven credit cards, says Ben Woolsey, marketing director of CreditCards.com, a website for consumers to research and compare offers from leading card networks in the United States.

Reward programs are driven by card competition. By offering incentives, card issuers build loyalty and extend the lifespan of the card, which may offset the expenses of offering the program.

To ensure consumers reach for their card versus another form of payment, issuers are offering countless reward programs as incentive.

“Rewards have become a cost of doing business” for the credit and debit card industries, Woolsey says.

Beyond airline miles and cash-back

options, these days, rewards range from merchandise (Disney products and Starbucks coffee, for example) to gasoline rebates (like the Chase PerfectCard Platinum MasterCard) to savings in a child's college fund (like the Citi Upromise Card.)

Rewards have increasingly become an expectation by cardholders, who are more savvy about receiving value in each transaction, says Jennifer Schulz, vice president of consumer credit products for Visa USA.

"(Visa strives) to create reward programs that are relevant to their customers' interests and lifestyles and ultimately foster customer loyalty," she says.

In the early 1980s, Visa introduced one of the first mainstream reward programs, the AAA Visa card. It wasn't until about a decade later that Visa, and other issuers, began

Many reward cards are co-sponsored by merchants in an effort to offset the added expense of accepting this type of payment method while building customer loyalty, Hayashi says. Often rewards are greater when the card is used at the co-sponsor merchant's location. Additionally, the cardholders may receive discounts or free merchandise from the sponsoring merchant, such as Target. Both incentives may cause cardholders to shop there rather than at competitor stores such as Kmart or Wal-Mart.

Small merchants might not be able to issue co-branded cards, but may join issuers' reward programs by offering discounts on their merchandise to increase sales and gain customer loyalty.

Because all merchants who accept cards pay higher fees for reward cards anyway, it may be advantageous for individual merchants to partner with a card issuer, Hayashi says.

Collecting rewards

Cars with license plates from states all around the Midwest circle the block surrounding Mary Carol Garrity's main store in downtown Atchison. Shoppers—mostly women—are eager to get inside Nell Hill's, the eclectic "home emporium" Garrity named after her grandmother.

Inside, customers make their way to the cash register, knickknacks in one hand and their plastic card in the other.

After his wife, Jo, selected a few things for their kitchen back home in Topeka, Ken Edwards paid for her purchases, like he does for the majority of their purchases, with a Discover reward credit card.

When choosing their credit card, one feature was most important to the Edwards couple: Discover's cash-back reward program.

"Well, you can always use cash," Ken says, adding that as long as it's convenient and Discover offers this reward, he'll use the card.

There are several factors to consider when choosing a reward program debit or credit card, Woolsey says. Cardholders need to consider terms of the rewards, interest rates, annual fees and other member benefits.



MARY CAROL GARRITY (LEFT) helps customers make furniture selections for their homes. As a seller of large-purchase items, Garrity sees most of her customers pay with credit cards.

partnering with merchants, which has resulted in significant growth in the reward card market. Now, roughly half of consumers in the United States have at least one reward credit card of some type.

Many cardholders don't realize some conditions of reward programs can negate the rewards the cardholder receives, Woolsey says, adding it's the reward aspect that often affects



PHOTO BY SCOTT INDERMAUR

Rewards have increasingly become an expectation by cardholders, who are more savvy about receiving value in each transaction.



consumer behavior. As a result, cardholders use their cards exclusively in hopes of maximizing their purchases.

Hayashi's research shows reward programs entice both credit and debit card holders alike. The choice to use a reward credit card versus a reward debit card is often a matter of preference, just like the type of reward program chosen. A possible determinant of consumer payment choice is using a debit card to avoid carrying a balance on a credit card, or reduce interest costs on a credit card balance.

Consumers who carry a balance on their credit cards use debit cards more often, and those who don't tend to use credit cards more often.

Regardless of whether a debit or credit card is used, consumers with either a reward debit or reward credit card use this card more exclusively. And consumers who receive rewards from both debit and credit cards distribute their transactions more equally between the cards.

There are distinct groups, in addition to income levels, who most use reward card programs, according to Hayashi's research.

Generally, female consumers tend to use debit cards more frequently than male consumers, while Asian-Americans use credit cards more exclusively. Younger consumers use both

KEN EDWARDS OF TOPEKA, Kan.: pays for his wife's purchase with his cash-back reward card. He says as long as he gets rewards, that card will be his preferred payment method.

credit and debit cards more often than older consumers, as do those with higher education.

The credit card market will eventually reach a saturation point—again. After a large number of high-income earners hold reward cards, issuers will target first middle- and then low-income earners, Hayashi predicts.

“Right now, issuers are competing for consumers,” Hayashi says. “And this will keep increasing rewards.”

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BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

PAYMENT CARD REWARDS PROGRAMS AND CONSUMER PAYMENT CHOICE

BY FUMIKO HAYASHI AND ANDREW CHING

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COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.