



PHOTO BY GARY BARBER

Racking Up rewards:

Do consumers really benefit?

When retiree Bill Lee uses his American Express card to make a purchase, his family reaps the rewards. If it can be paid for with plastic, Lee, of Raymore, Mo., will swipe his card to complete the transaction.

With every purchase, Lee receives airline miles, which he collects and eventually exchanges for plane tickets.

“I use my card basically every day,” Lee says. “Anything I have to buy, I charge it and just pay it off at the end of the month so I can get the miles.”

Lee has sent his children and grandchildren

on trips to San Francisco, Florida, Texas and Michigan, all on miles he receives by using his card. He also enjoys other perks as a cardholder, such as rental car insurance and access to airlines’ airport clubs.

“It is a nice benefit,” Lee says. “I’ll use the miles for a trip myself every once in a while.”

As credit card issuers increasingly use rewards programs to persuade consumers to pay with plastic, the number and types of rewards available to cardholders have continued to grow. From cash-back bonuses to free gas to points that can be used for vacations, hotel nights or merchandise, consumers are offered

plenty of incentives to use a card at the register rather than cash or a check.

But those rewards can come with a cost, and it's not clear whether consumers actually benefit from rewards programs in the end, says Fumiko Hayashi, a senior economist with the Federal Reserve Bank of Kansas City.

Merchants who accept cards as payment are assessed interchange and other fees by card issuers and other parties. In return, merchants might pass on those costs—and the cost of the rewards—to consumers in the form of higher prices, says Hayashi, who has researched the fee structure extensively.

However, card networks say merchants benefit from rewards programs because customers who use a rewards card tend to make higher-value purchases. In addition, the card industry argues, rewards can reduce overall costs for merchants and consumers because cardholders are using an efficient, quick and secure payment method.

“Whether rewards programs benefit consumers—or society at large—depends on several factors,” Hayashi says. “The key questions are: Who ultimately pays for rewards, and how do rewards programs affect consumer behavior?”

While it's difficult to determine absolute answers to those questions, there's little doubt that card rewards enjoy tremendous popularity among consumers, much to the disappointment of some retailers.

History of rewards

Card rewards date to at least 1984, when Diners Club began offering airline miles to cardholders. Other card companies jumped in, including Discover, which offered what was soon an industry standard: a cash-back

bonus to cardholders based on the volume of purchases made with the card. Today, it is not uncommon to find cards offering cash-back bonuses of 3 to 5 percent on purchases made at certain retailers.

Soon, rewards programs grew to include other benefits, such as discounts on products offered by affiliates of card issuers and donations to charities.

Debit card rewards are still relatively new and tend to be less generous than credit card programs, Hayashi says. For a debit card transaction, consumers can get about 0.25 percent of the purchase's value back in rewards, while a credit card transaction results in rewards averaging about 1 percent of the purchase value. The difference in rewards levels likely is due to lower interchange fees for debit cards.

While the rewards offered by issuers have grown during the last several years, estimates of how many cardholders have a rewards card varies from less than half to about 70 percent. Today, websites such as creditcardratings.com allow consumers to shop for the best rates and rewards programs. Many card issuers also allow consumers to choose from a menu of available rewards.

Debate brews

Though many consumers enjoy using their rewards cards for the benefits they provide, the feeling sometimes isn't mutual on the other side of the transaction. For Scott Zaremba, president and owner of Zarco 66 Inc., credit card transactions—especially those tied to rewards—leave little room to make a profit, he says.

The fees charged by card issuers and banks take a significant cut out of the gasoline sales of Zaremba's eight convenience stores in eastern Kansas, he says. Depending on the type of card and the rewards tied to each card, Zaremba might pay 3 percent or more of each sale to cover card fees, the majority of which is due to interchange fees.

“The direct impact over the years has been



huge,” Zaremba says of the fees. “It’s extremely hard on a small business. There can be huge differences in the fees from each card. It’s all over the board.”

As is the case with other retailers who accept card payments, Zaremba’s agreements with the card networks don’t allow him to price his products differently depending on the card a customer uses. He must accept all cards regardless of the fees associated with each.

Zaremba started offering his own incentive—a discount of 3 cents per gallon for customers who pay with cash. He recently installed automated cash acceptors at the pumps at one of his stations in Lawrence, Kan., in order to make cash transactions as convenient as possible. He hopes the experiment will result in more customers paying with cash.

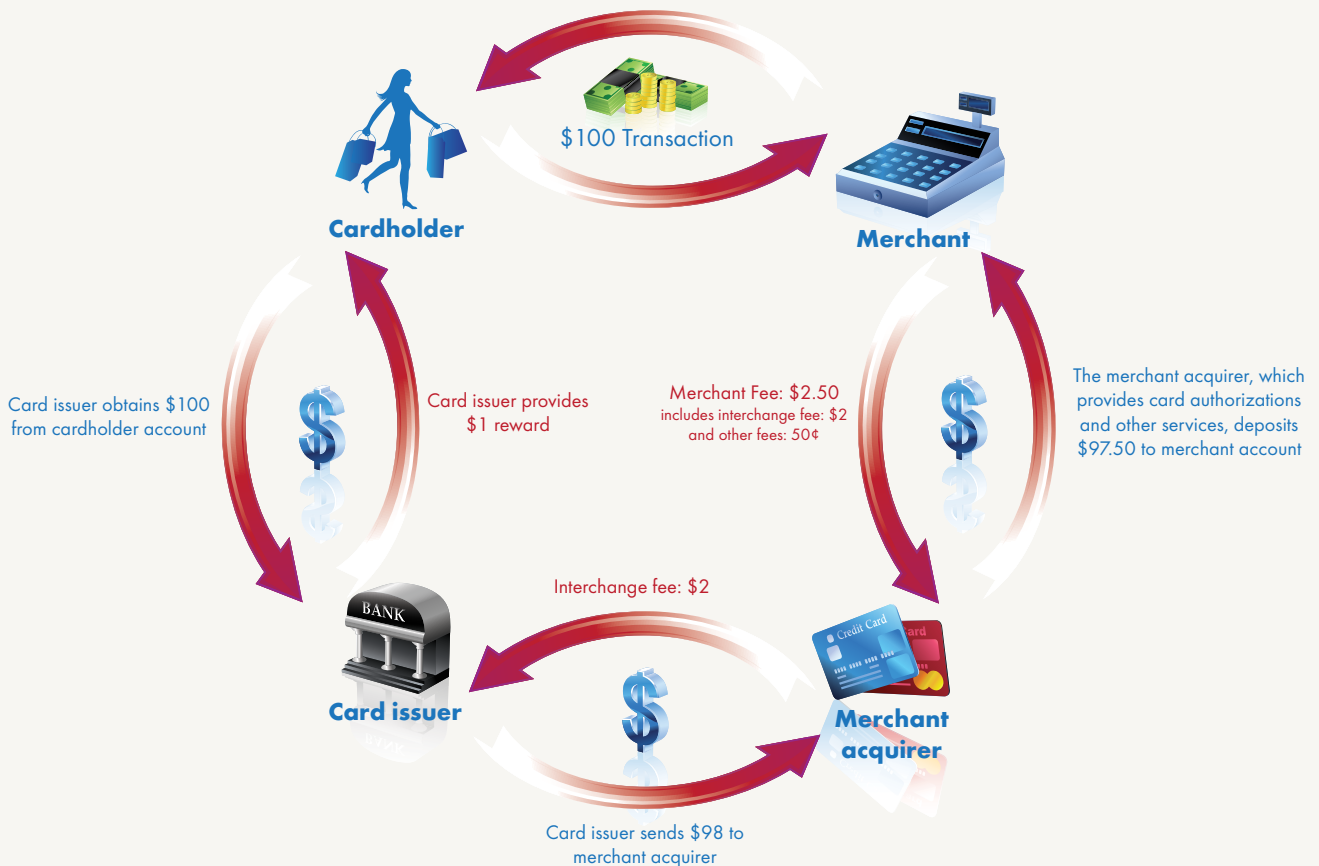
“The credit card companies are not giving the consumer more for their money through rewards,” Zaremba says. “Consumers need to realize that ‘Hey, I’m better off saving my own money to go on vacation rather than have someone set this all up for me through a credit card.’”

Zaremba’s views are typical throughout the gas station and convenience store industry. Tom Palace, executive director of the Kansas Petroleum Marketers and Convenience Store Association of Kansas, says convenience stores, along with retailers in other industries, are becoming more vocal about the issue.

“The credit card companies make more on a gallon of gas than we do,” Palace says. “It really drives down to the consumer when almost 3 percent of the cost of the product is

Card Rewards

When consumers pay with plastic, the transaction involves more than just a buyer and seller. Several other parties are involved, and each is responsible for assessing certain fees. Here is one example of how a card purchase flows through the payments system.



tied to credit card fees.”

But those in the credit card industry say consumers benefit by being able to use a convenient payment method and merchants receive significant benefits in return for paying interchange and other fees.

According to the Electronic Payments Coalition, a group representing the payment card industry, about two-thirds of American families use electronic payments routinely, and that number is expected to grow during the next several years.

“One of the big benefits to merchants—in addition to the obvious one, increased sales—is that the card issuers bear all of the credit risk,” says Sharon Gamsin, vice president of communications at MasterCard Worldwide.

According to MasterCard, the average U.S. interchange fee was 1.8 percent in 2008, while average credit losses were 2.4 percent of credit card sales volume. Those losses are absorbed by the card issuer.

“So if merchants attempted to increase sales on their own by reverting back to extending credit themselves, the credit losses alone would far exceed any cost merchants pay to accept payment cards today,” Gamsin says.

In addition, the idea that consumers pay more for goods as a result of interchange fees makes sense “only if you believe that consumers pay more for goods because merchants pay fees for rent, labor, insurance (or) maintaining the parking lot,” Gamsin says. “Like any valuable service, electronic payment systems have costs associated with them, and merchants should pay their fair share.”

Consumer impact

While merchants and the payment card industry continue to debate the issue of interchange fees and card rewards, there is little argument that the level and cost of rewards programs have increased.

However, Hayashi says it’s not clear whether the growing cost of rewards drives

interchange fees higher or vice versa. Card issuers can fund rewards through other sources, such as assessing fees to cardholders or through the interest payments collected on outstanding balances.

Still, in some cases, there is evidence that a close relationship between the more generous rewards and higher interchange fees might exist, Hayashi says. In 2005, MasterCard and Visa introduced new card categories that charged higher fees to merchants while providing more generous rewards to cardholders. Hayashi’s analysis of the fees associated with these new cards showed that merchants consistently pay higher fees for the cards that have more generous rewards.

Though more research is needed, Hayashi says the current level of card rewards might be too generous. As a result, consumers could be paying more for goods and services.

“Higher levels of rewards,” Hayashi says, “may imply higher retail prices.”



BY BILL MEDLEY, SENIOR WRITER

FURTHER RESOURCES

“DO U.S. CONSUMERS REALLY BENEFIT FROM PAYMENT CARD REWARDS?”

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