ELECTRONIC PAYMENTS COALITION

The Value of Rewards

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Retailers often criticize rewards credit cards, arguing that the higher interchange fees that accompany these high-value cards cut into their profits while enriching card-issuing financial institutions. Some have even erroneously claimed that rewards programs constitute a regressive transfer of wealth from poorer to wealthier consumers.

Such claims, however, ignore the numerous benefits that rewards programs offer to retailers and to consumers of all income levels and fail to consider these programs in the context of a two-sided electronic payments market. For cardholders, rewards programs constitute a way to earn cash, airline miles, hotel stays, or other rewards through their everyday spending. For merchants, accepting rewards cards leads to a larger customer base and higher sales volumes. In this way, rewards cards are an important part of a well-functioning electronic payments market and provide tangible benefits to all stakeholders.

THE ROLE OF REWARDS IN THE ELECTRONIC PAYMENTS MARKET

The electronic payments system is a classic example of a two-sided market in which a platform or service serves multiple end-users (in this case, cardholders and merchants). The value that each end-user group derives from using the platform depends on the extent to which the other group participates. Due to this interdependency, market forces exerted by both cardholders and merchants jointly determine the price to participate in the electronic payments system — of which interchange is a component. The resulting price balances the need to attract merchants (e.g., by providing the benefits outlined below) with the need to increase the number of cardholders (e.g., by offering incentives, including frequent flier miles and cash-back rewards).

Importantly, the dynamics of a two-sided market may result in the two end-user groups paying a different price. In the electronic payments market, card issuers typically offer incentives directly to consumers via rewards that are funded in large part by merchant interchange fees — all for the purpose of increasing the overall use of electronic payments, which benefits all parties. In other two-sided markets, the price disparity is even larger: for example, the online restaurant reservation platform operated by Open Table charges one end-user group (restaurants) the entire cost while offering rewards to the other group (consumers) at no cost — effectively charging them a negative price to use the service.[1]

However, government intervention on behalf of one side of the market carries a high risk of negative consequences for the other side, as well as the overall system. A good illustration of this outcome is the Durbin amendment, which imposes interchange fee caps for debit card transactions. As detailed in a recent EPC report, the Durbin amendment has negatively affected consumers in several ways, including a sharp decline in the availability of debit card rewards. Retailers' demands for the right to reject consumers' rewards cards at the point of sale would similarly tip the scales of the two-sided market away from consumers and toward retailers.

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[1] Evans and Schmalensee (2008), "Markets with Two-Sided Platforms," as cited in the U.S. Supreme Court's July 2018 decision in Ohio v. American Express.

VALUE TO CONSUMERS

The vast majority of consumers own at least one credit card, including nearly two-thirds of adults earning less than $40,000 per year.[2] Moreover, most of these cardholders own and enjoy rewards cards. For example, as of 2016, 87% of cardholders owned a rewards credit card, including nearly three-fourths of low-income cardholders earning less than $20,000 per year.[3]

Unsurprisingly, consumers put these rewards cards to good use and prefer to use them over non-rewards options. According to data from Phoenix Marketing International, average monthly spending on a rewards account was 43% higher than average spending on a non-rewards account, and 73% of rewards credit cardholders redeemed their resulting rewards within the past year.[4] Moreover, the preference for spending on rewards cards vs. non-rewards cards holds true across income groups: lower-income cardholders use their rewards cards for more than 70% of their spending.[5]

Given consumers' obvious preference for rewards cards, it is unsurprising that more than 90% of all credit cardholder spending was charged to rewards credit cards in 2016.[6] These data leave little doubt that consumers want and value their rewards cards. In fact, 96% of rewards cardholders consider their card-based rewards programs "very or somewhat valuable," and the majority report that their card rewards deliver value on every purchase.[7]

VALUE TO MERCHANTS

While rewards cards are intended to benefit consumers, they also provide a host of benefits for merchants. For example, it has long been established that consumers who pay with cards tend to spend more than those who pay with cash. This phenomenon, known as "ticket lift," is significant: debit and credit card transactions are 2–4 times larger than cash transactions,[8] and when a merchant first begins accepting card payments, they experience a 10-15% increase in average transaction size.[9]

A closer look at consumer spending habits shows that this effect is even more pronounced for rewards cards. Relative to a non-rewards consumer credit card, a rewards card is associated with an average transaction size that is 25–60% higher.[10] Premium rewards cards generate even greater ticket lift: as shown in Figure 1, the average transaction size of a premium rewards card ($83) is more

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[2] Federal Reserve Board (2018), "Report on the Economic Well-Being of U.S. Households in 2017."

[3] Phoenix Marketing International (2016), "2016 Credit Card Monitor Report."

[4] *ibid* and Phoenix Marketing International (2012), "New Phoenix Research Shows Consumers of All Income Groups Benefit from Credit Cards Rewards Programs."

[5] *ibid.* Lower-income cardholders defined as those earning between $20,000 and $29,999 per year.

[6] Phoenix Marketing International (2016), "2016 Credit Card Monitor Report."

[7] *ibid.*

[8] Peter T. Dunn & Company LLC (2018), "Illustrating the Value Provided by Electronic Payments." Peter Dunn is a founder of the management consulting firm Edgar, Dunn & Company and presently provides global advisory services through Peter T. Dunn & Company. He has over 40 years of experience in strategic consulting in payments.

[9] Mastercard (2017), "Measuring the Value of Electronic Payments to Merchants."

[10] Peter T. Dunn & Company LLC (2016).

than 30% higher than the average transaction size of a standard rewards card ($62).[11] Moreover, the additional spending generated by a premium rewards card more than offsets the higher interchange fees associated with these cards, resulting in a net benefit to both merchants and cardholders. As Figure 2 illustrates, on average merchants pay an additional 26 cents interchange fees for each transaction paid for with a premium rewards card, but earn an additional $24.25 in revenue for these transactions compared to purchases made with a non-rewards or standard rewards card.[12]

Although large retailers sometimes neglect to consider all the facts as they lobby for government intervention to lower interchange costs (and, by extension, curb consumer rewards programs) most small businesses recognize the value derived from accepting rewards cards. In a recently conducted survey of small business operators, approximately three-fourths of respondents reported that accepting credit cards brings in additional businesses, and half reported that accepting rewards credit cards in particular boosts sales.[13]

Beyond ticket lift, merchants who accept rewards credit cards also enjoy the myriad benefits associated with accepting electronic payments in general, including:

- **Additional retail channels.** Electronic payments also allow merchants to take advantage of other sales channels via e-commerce and mobile commerce avenues, which are growing rapidly.[14]

- **Faster transaction time.** Electronic payments cut down on checkout times and are processed twice as fast as cash and several times faster than checks, allowing retailers to move customers quickly through the checkout process.[15]

- **Reduced cost of cash.** Card acceptance reduces costs associated with counting, storing, safeguarding, and transporting cash, and limits losses from mislaid or stolen cash — all of which are significant expenses that retailers often overlook. A recent study conducted by a retail industry research firm found that the average retailer spends more than 9% of the value of their cash transactions counting, auditing, and depositing cash.[16]

- **Prompt, guaranteed payments.** Beyond helping merchants avoid the costs of cash, electronic payments reduce the risks to retailers associated with credit loss. Electronic payments are

[11] Capital Policy Analytics (2019), "Both Consumers and Merchants Benefit from Rewards Cards." Based on data from Peter T. Dunn & Company LLC (2016).

[12] *ibid*.

[13] Policy & Economic Research Council (2012), "PERC Small Business Survey of 2012" quoted in Turner (2013), "Credit Card Rewards: Context, History, and Value."

[14] Policy & Economic Research Council (2012), "Credit Card Rewards: Context, History, and Value."

[15] Digital Transactions (2018), "Many Merchants Expected to Erase Signature Requirements From Their Checkout Counters."

[16] IHL Group (2018), "Cash Multipliers: How Reducing the Costs of Cash Handling Can Enable Retail Sales and Profit Growth."

deposited directly into the merchant's account, and issuers, not merchants, take responsibility for losses if a customer who uses a credit card is ultimately unable to pay.[17]

This wealth of benefits means that merchants who accept electronic payments, including rewards cards, receive great value in exchange for the interchange fees that they pay. In fact, data shows that the value that U.S. merchants receive from accepting credit cards (+8.5% of transaction value, on average) far exceeds what they pay (3.5%), resulting in a higher net value (+5.0%) than their European, Australian, or Canadian counterparts receive.[18]

CONCLUSION

While it is understandable that merchants aim to minimize costs, calls for regulations that would curtail rewards programs, whether by capping interchange rates directly or allowing retailers to refuse to accept rewards cards at the point of sale, are misguided. Such a position fails to consider the important role of rewards in balancing the credit card market or take into account the tremendous value that rewards cards deliver to consumers and merchants alike. When the benefits of accepting electronic payments are weighed against the costs, the data clearly demonstrate that interchange fees that merchants pay are easily outweighed by the value they receive in return, including increased sales, lower costs, faster transactions, prompt and guaranteed payments, and the expansion and sustenance of an inclusive and secure payment system for all.

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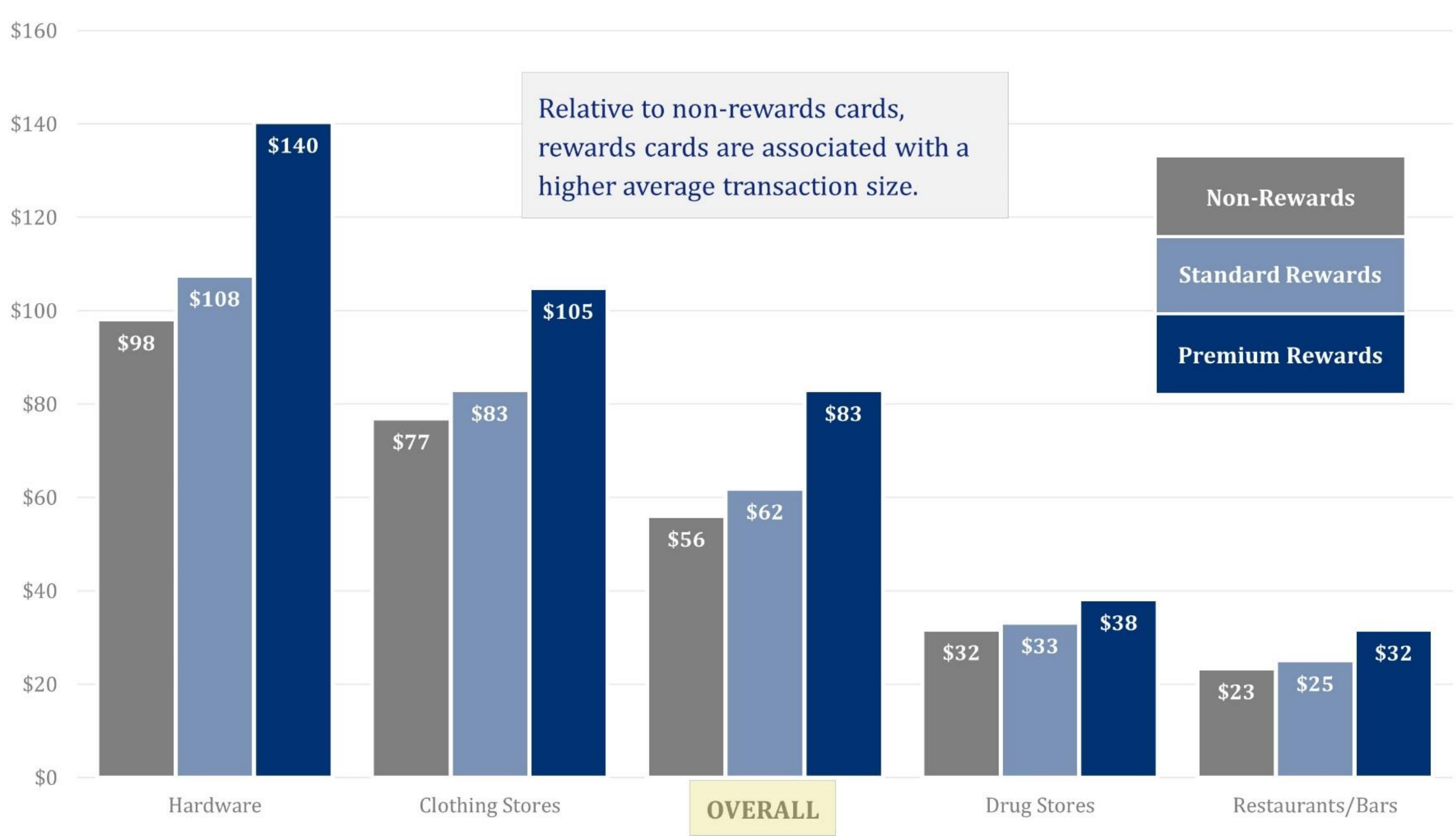
[17] Peter T. Dunn & Company LLC (2018), "Illustrating the Value Provided by Electronic Payments."

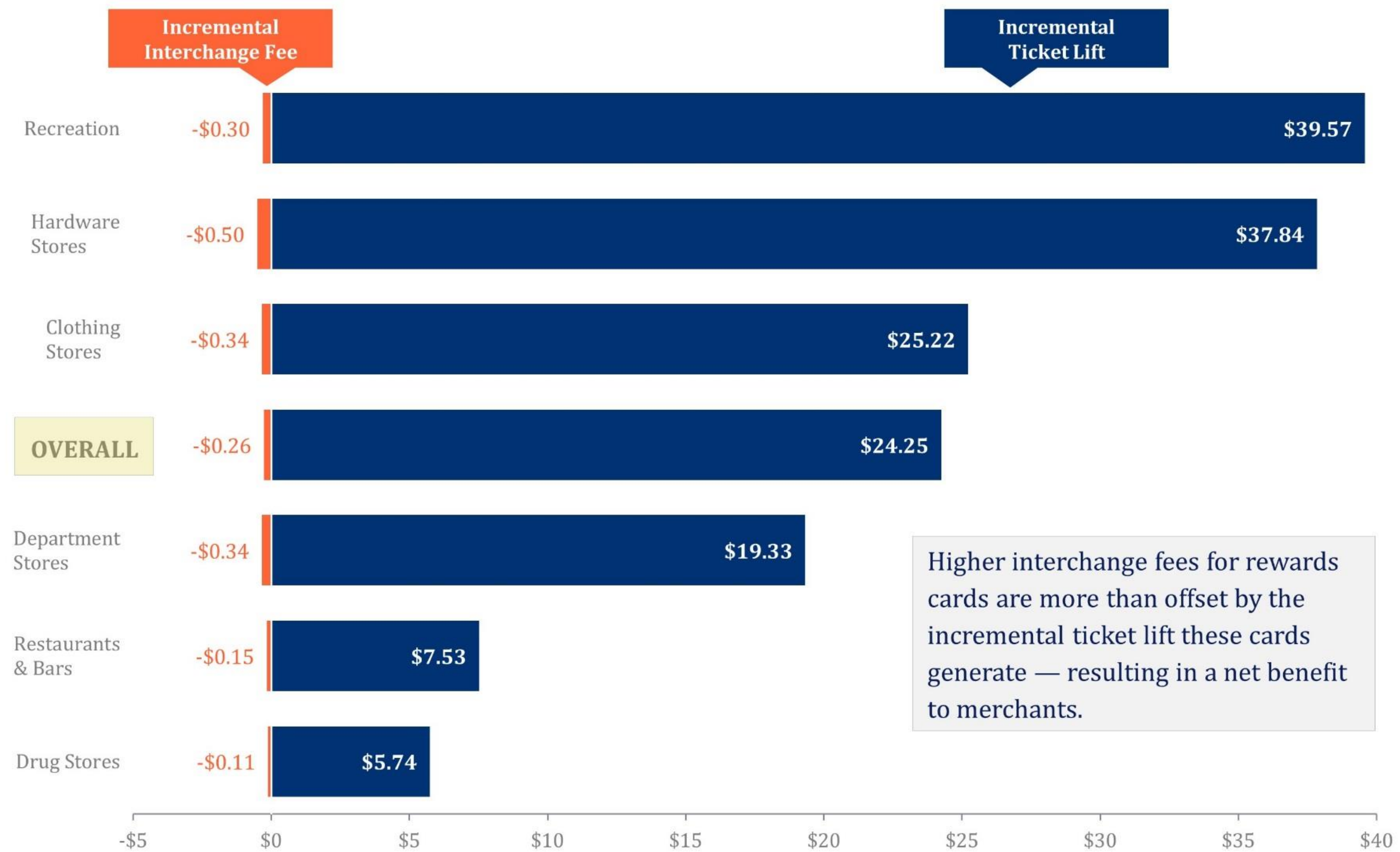
[18] Capital Policy Analytics (2018), "The Costs And Benefits Of Interchange." Based on data from Peter T. Dunn & Company LLC.

Figure 1: Average Transaction Size, Rewards Cards vs. Non-Rewards Cards



Source: Peter T. Dunn & Company LLC (2016). Available at http://capitalpolicyanalytics.com/2019/02/both-consumers-and-merchants-benefit-from-rewards-cards

Figure 2: Incremental Interchange Cost vs. Incremental Ticket Lift for Premium Credit Cards*



*Comparison of premium rewards cards to non-rewards and standard rewards cards.

Source: Peter T. Dunn & Company LLC (2016). Available at http://capitalpolicyanalytics.com/2019/02/both-consumers-and-merchants-benefit-from-rewards-cards