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MERCATOR ADVISORY GROUP

BEST PRACTICES FOR CREDIT AND DEBIT CARD REWARDS PROGRAMS

A Mercator Advisory Group Research Brief Sponsored by CSCU

May 2015

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Introduction

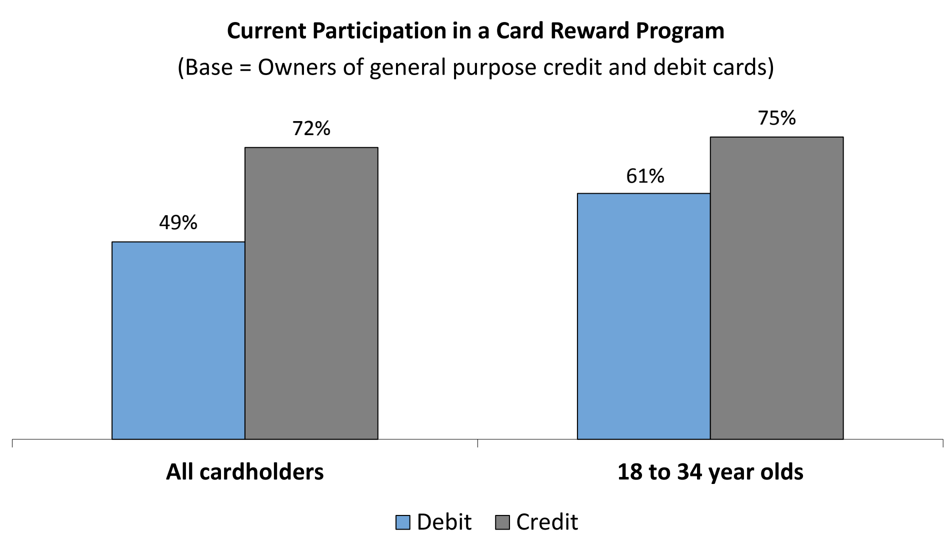
Rewards programs have become a well-known fixture of the U.S. payments card market. Leading credit and debit card issuers continue to set a high bar for competition as they seek to develop a sustainable marketing advantage with their cardholders. Considering the ubiquity of rewards in the U.S. market, it is all too easy for credit unions to overestimate the competitive edge of leading issuers and to feel overwhelmed by the challenge of deploying a competitive rewards program at reasonable cost.

The objective of this white paper is to review the rationale for rewards programs and to identify resources and best practices for credit unions wishing to grow their credit and debit card portfolios.

The Competitive Necessity of Rewards

The simple fact is that nearly 3 out of 4 adult credit cardholders in the U.S. indicate that they currently participate in a rewards program (as evidenced by the survey data in Figure 1). Not surprisingly, debit rewards participation is lower, in part because so many large issuers have been forced to eliminate or avoid introducing debit reward programs in the wake of interchange caps established under the Durbin Amendment to the Dodd-Frank Act (the Wall Street Reform and Consumer Protection Act of 2010). However, this leaves a gap in services that can be, and is, filled, by exempt debit issuers. Notably, rewards participation is higher among the youngest adults, a demographic segment for whom rewards appear to have especial value.

Figure 1: Current Rewards Participation in the U.S. Is High, Especially for Credit Cards



Source: Mercator Advisory Group CustomerMonitor Survey Series, 2014

The high rates of participation in rewards programs illustrate the pervasive competition for cardholders' business. U.S. issuers have created an expectation among consumers that rewards will be available. And, with the proliferation of online card comparison websites for consumers to "shop" for new credit card and bank accounts, card programs with no rewards or low-value rewards quickly drop to the bottom of the list.

Which rewards programs do consumers most often recognize and highly value? Credit card issuers have developed a wide range of rewards delivery options, but as shown by the survey findings recorded in Figure 2, the rewards programs recognized by U.S. consumers as the most commonly offered are cash-back programs (64% of survey participants indicate these are most common), non-travel-related points programs (47% of participants), and flexible redemption programs (40% of participants). Separately, when all credit card rewards participants are asked which rewards type is the most valuable among those to which they have access, cash back is identified as the single most valuable reward type by 44% of participants, followed by flexible redemption programs (19%).

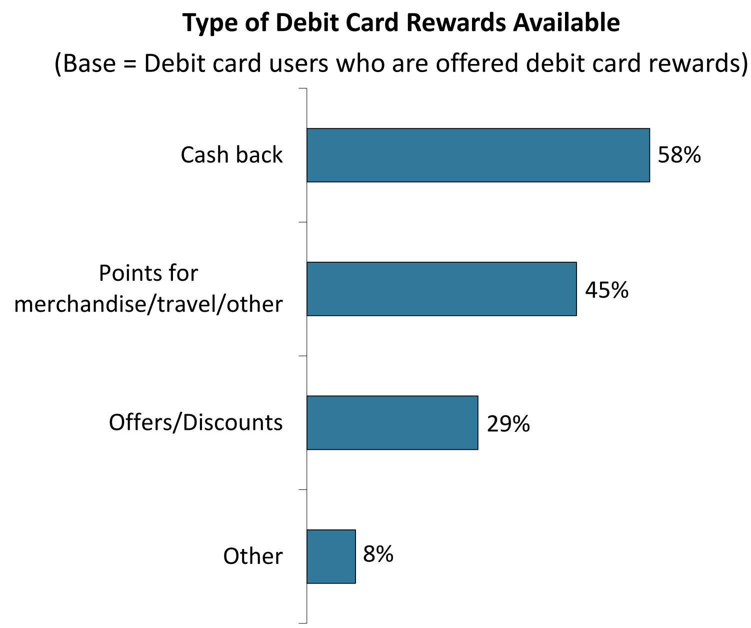
Figure 2: Cash Back Is the Most Common Credit Card Reward Type

Source: Mercator Advisory Group CustomerMonitor Survey Series, 2014

Among debit cardholders, nearly 6 in 10 rewards participants note that cash-back programs are available to them; the next most commonly noted is points-based programs. Underscoring the impact that rewards programs can have to improve card portfolio performance and to drive top-of-wallet brand equity is a related survey finding that nearly 7 of every 10 debit cardholders with access to rewards programs indicated these rewards drove them to make increased use of their debit cards.

It is clear that rewards programs remain important as a key component of consumer payment card products. This is especially true for credit card programs, for which rewards have become essential— a table-stakes item. For debit card programs, rewards can be a competitive differentiator for smaller issuers. Even though we can see that cash back is the most common debit reward (Figure 3), it is not the only reward type that consumers value, and every rewards program strategy should be designed with a clear target (i.e., who is using the card) and clear objective (e.g., activation, usage).

Figure 3: Cash-Back Programs Also Dominate Debit Cards



Source: Mercator Advisory Group CustomerMonitor Survey Series, 2014

Trends in Rewards Program Offerings

Credit Cards

Credit cards typically offer a base earn rate of $1 for 1 point or a cash-back rate of 1%. Some issuers add “bonus” earn rates for certain categories of spending such as gasoline or supermarkets, and they may change these categories quarterly in order to broaden their motivational appeal to different cardholders. Some co-branded card programs, which are co-sponsored by a commercial partner such as an airline, hotel chain, or retailer, may also have bonus earn rates for on-us purchases at the partner, rates that can average from 2% (airline cards) to 3% (retailer cards) to 7% (hotel cards). Enrollment bonuses are also typical for new cardholders (e.g., 25,000 airline miles for opening an account—enough for a round trip ticket). Cash-back programs are currently undergoing earn rate escalation among major issuers, some of whom are now offering base earn rates over 1%.

With all of these options, triggers, and add-ons, the perception of value is almost as important as the actual, calculated value. Mercator Advisory Group believes consumers tend to be confused by their rewards program terms and overestimate the earn rates of their card programs. Consumers surveyed typically perceive the value to be higher than the 1% earn rate, which is in fact most typical. This misperception leaves a market opening for programs that are simple, transparent, and easy for consumers to understand.

Debit Cards

In Mercator Advisory Group's annual review of debit reward programs (conducted at year-end 2014), it was noted that 13 of the top 25 credit unions (by assets) support debit rewards programs, up from 8 of 25 in 2012. Typical earn rates vary considerably from program to program, the most common being between $3 and $5 of spend per point earned. Adding some competitive complexity, 11 of the 13 rewards programs among the top 25 credit unions utilize merchant-funded discount networks for rewards. These programs, which offer significant discounts at specific merchants, can have high visibility with cardholders because of their significant perceived value. Use of these rewards appears to be increasing among credit unions, in part because they support high-value programs at virtually no cost to the issuer (the provider passes revenue to the issuer on behalf of the merchant placing the offer). Just 1 in 4 of the top 25 credit unions charges for cardholders a fee for participation in their debit rewards programs.

Compliance and Reputation Concerns

Rewards are not, strictly speaking, a regulated element of credit and debit card accounts. Yet they clearly affect consumers' choices and behaviors regarding their accounts, a fact that has not escaped the Consumer Financial Protection Bureau (CFPB). So far, the CFPB has telegraphed its interest in this topic and indicated its intent to monitor rewards programs. Of central concern is any lack of disclosure or lack of terms transparency which might lead consumers to make a bad selection of accounts or make poor use of accounts. Issuers and their rewards partners must monitor the clarity of their rewards program terms on an ongoing basis to avoid including misleading language or policies. Rewards must also be easy to redeem, with clear terms set out for any points expiration policies.

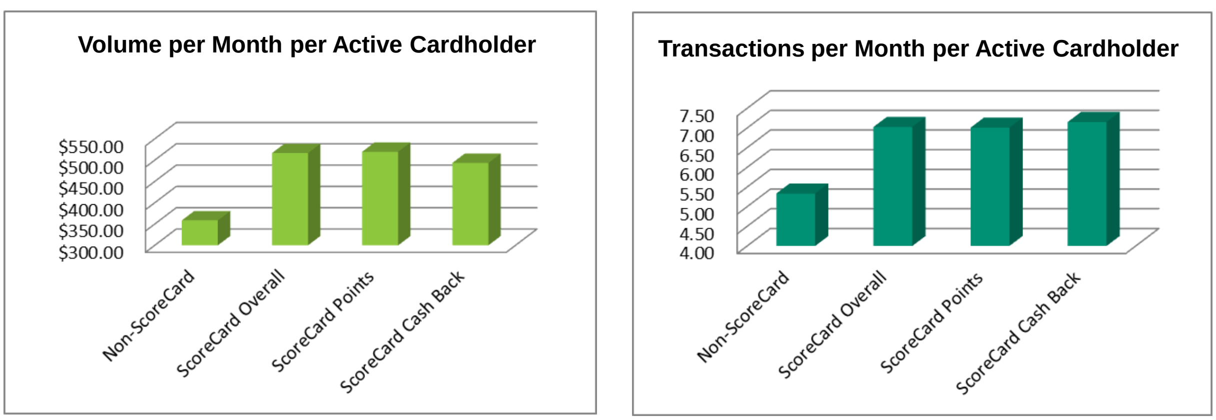
Points expiration policies can specifically drive regulatory and operational concerns. Programs that establish expiration dates for points are certainly subject to scrutiny since this is a potentially misleading practice. We note that, perhaps as a result, leading credit card issuers in the United States have been moving away from points expiration in order to present the most pro-cardholder position possible. Eliminating expiration has other positive program benefits. A study by CSCU's partner FIS noted that expiration-based programs actually have higher redemption rates (15% more over 10-year+ programs) and therefore higher costs. Such redemptions tend to spike around maturity dates, causing service volume challenges for the administrator and/or rewards program administrator as well as potentially worrying cardholders who might mistakenly interpret their points as "lost."

Making a Difference with Rewards

Rewards programs have proliferated and issuers may now feel compelled to offer rewards to remain competitive despite the fact that it is hard to gauge the actual contribution of rewards programs to portfolio performance. Quantifying the value of rewards programs for portfolio performance is challenging because it is difficult to set up measurement and control groups within an operating card program. In a 2010 study conducted by the Federal Reserve[i] with a major credit card issuer, it was found that within one calendar quarter after the issuer introduced a 1% cash-back program to all the accounts in the portfolio, average spending per account offering cash back increased by $68 per month and average outstandings per account increased by over $115 per month. Over a longer, nine-month period, spending on the account increased $76 and outstandings increased $197 per month. The study noted there was little evidence that cardholders' total spending and borrowing had increased across all their cards, but rather that spending activity had been moved to the rewards card. This finding demonstrates the competitive importance for issuers to support a rewards program, especially among cardholders in demographics that might have multiple payment cards from which to choose. Effectiveness of rewards was particularly noted with inactive accounts, 11% of which became active after the introduction of rewards. Again, these results underscore the importance of establishing clear objectives for a rewards program during the design stage.

The impact of rewards programs on portfolio performance, long term, can be significant. A recent comparative study by FIS looked at the long-term track record of credit and debit BINs within the FIS ScoreCard rewards program versus BINs not in the program. In 2014, credit ScoreCard BINs averaged 44% higher payment volumes than non-ScoreCard BINs. As noted in Figure 4, cash-back implementations and points programs achieve somewhat different outcomes.

Figure 4: FIS ScoreCard Rewards BINs Outperform Non-Rewards BINs



Source: FIS

Over a six-year period, volume per active debit account grew 27.52% in ScoreCard BINs but only 6.75% in non-ScoreCard BINs. Consistent with the Federal Reserve study mentioned above, the activation rate was higher for ScoreCard BINs (84.37% active) than for non-rewards BINs (80.39% active).

The case study below exemplifies how adding a rewards program can achieve goals beyond volume growth and activation. The addition can tap into a new segment of members who do not hold a credit union's credit cards.

Case Study: Rewards Drive Results for CoVantage Credit Union

CoVantage is a Community Development Financial Institution serving a loyal member base. This CDFI had traditionally offered a simple, competitive-rate credit card but wanted to increase its appeal to credit card members who are transactors as well as to those who are revolvers. A straightforward new rewards program was specified that offered 1 point per $1 spend, redeemable for merchandise, travel, or statement credit. It was rolled out to a test group of 500 existing accounts as well as all new accounts in September 2014. These new accounts have a slightly higher variable APR than that of CoVantage's non-rewards credit card.

Between the September 2014 launch and April 2015, 2,000 new accounts were opened, nearly three times as many accounts as during the same time period in the previous year. CoVantage's rewards cards now average $333 in monthly purchase activity, compared to an average of $178 for the legacy non-rewards portfolio. Total portfolio outstandings across both rewards and non-rewards products are up 16% year over year. Driving this growth was a marketing campaign that included a product brochure, a member email to non-CoVantage cardholders, a double points promotion during the November-December shopping season, and staff sales contests.

The CoVantage team notes the importance of tying the product design to the needs and values of its member base, good promotion, and targeting members with the highest likelihood to accept the new card offer.

Portfolio results will of course vary from one credit union to another because of differences in member profile and geographic profile of different CUs. But moving from a non-rewards credit card to a rewards card has another benefit for CUs—in addition to growth in incremental spend and outstandings, moving to a reward card qualifies the product for a higher interchange rate under Visa and MasterCard rules. In CSCU's experience, a 7–9 basis point lift in interchange revenue on a core rewards card is a realistic expectation. Higher interchange tiers are also accessible through premium card products (Visa Signature or MasterCard

World) that accrue higher levels of rewards to the cardholder. Again, individual credit unions will need to determine if their member base contains sufficient prospects to merit offering such a premium card product.

Credit unions with under $10 billion in assets may also drive increased debit portfolio revenues by restricting their debit rewards to signature-based transactions.

Rewards programs have their costs, of course. FIS estimates that within its ScoreCard debit rewards programs, there is a 15 basis points redemption cost per dollar transacted. The offsets to the costs are the sum of:

Increased spending volumes

+

Increased outstandings and related interest income

+

Increased activation rates

+

Incremental interchange revenue

Creating a Valuable Program Specifically for Your Members

Given the strong competition from the largest credit and debit issuers nationwide, credit unions might think that their ability to offer a customized program to their members is limited. However, credit unions have a wide range of program features to choose from in order to select those most likely to appeal specifically to their members and to leverage their staff's strengths. These include:

- **Activation campaigns, bonus spending tiers, and time-limited promotions.** As exemplified by the CoVantage case study above, rewards promotions can be very effective in driving volumes during peak shopping seasons as well as in energizing staff sales efforts.

- **Combined credit/debit household rewards.** The marketing investment in a rewards program can be shared across debit and credit portfolios to provide a multiplier effect to program effectiveness. The case study about the Evansville Teachers Federal Credit Union (on the next page) offers an interesting example of the benefits.

- **Relationship rewards.** Beyond credit and debit card usage, credit unions can include rewards for enrolling in certain services (like the online banking/direct deposit offered by Evansville Teachers Federal Credit Union), achieving certain balance tiers, or cross-selling products. Such an integrated program drives cross-sell and activity and keeps the program highly visible to all members, whether or not they currently hold a credit or debit card with the credit union.

- **Merchant-funded rewards.** Rewards partners like CSCU and FIS maintain relationships with merchant-funded rewards providers that can source name-brand national merchant offers that have high perceived value to cardholders. Care must be taken to integrate these special offers into the overall rewards program so that members are not confused by offers that seem separate from their points-based activity.

Case Study: A Return to Credit Issuing Drives Householded Rewards for Evansville Teachers Federal Credit Union

Evansville Teachers Federal Credit Union (ETFCU) in Evansville, Indiana, returned to direct credit card issuing in 2013 seeking to benefit from the opportunity to combine credit rewards with an existing FIS ScoreCard rewards program in its debit card portfolio. Providing members with the ability to “household” their rewards points (that is, accumulate points across all their household credit and debit accounts) drove member engagement and redemptions as well as accelerated the growth of the new credit card product. The program offers 1 point/$1 spend on credit cards, and 1 point/$2 spend on debit cards. Members who have a Platinum Rewards Checking account and meet certain criteria each month receive 500 bonus points for that month, promoted to members as “a $5 value.”

The key to the success of this rewards program was selling staff on the program’s approach and the real value of reward points. The new program helped convey the value of points previously accrued under the debit program, and made it clear that points were easy to earn and redeem through ETFCU’s website. Because the program introduction also coincided with the credit union bringing its credit cards in-house, this greatly increased the points value earned by members.

With staff education and experience, reward points have become a central element of the credit union’s culture. Staff monitor member redemptions of rewards, which average about 75% for cash each month. The program has been promoted through email and branch communications as well as radio and billboards. Points summaries are made available on account statements and e-statements. Active bonus programs and promotions keep members and staff engaged with communicating the benefits to members.

Strategic Recommendations

As credit unions seek to better compete with major financial institutions and in some cases to return to credit card issuing in order to grow their assets, the ability to support a competitive rewards program becomes increasingly important. As many credit unions have shown, the best practice is not to simply tack on a "canned" rewards package that operates on autopilot. Rather, the most successful rewards implementations are highly visible, enjoy strong staff support, and leverage multiple payment cards and potentially other deposit and loan products.

To best select the features for such a program, a credit union must understand the needs of its members, how well it is meeting those needs, and the competitive forces to which the members are exposed. Adding a rewards-based credit card can open up appeal to a previously untapped segment—transactors. Adding rewards to a debit product can increase share draft account sales to younger consumers.

Rewards can support a credit union's overall marketing strategy, serving as a focal point for periodic product promotions as well as driving ongoing transaction activity. External resources and expertise are available to support programs tailored to the needs of a specific member base. The important thing is to assess the competitive challenge, to clearly define the organization's objectives, and most important, to select an approach that meets the needs of the member base.

Endnotes

[i] Sumit Agarwal et al., *Why Do Banks Reward Their Customers To Use Their Credit Cards?,* Federal Reserve Bank of Chicago, 2010.

About Mercator Advisory Group

Mercator Advisory Group is the leading independent research and advisory services firm exclusively focused on the payments and banking industries. We deliver pragmatic and timely research and advice designed to help our clients uncover the most lucrative opportunities to maximize revenue growth and contain costs. Our clients range from the world's largest payment issuers, acquirers, processors, merchants and associations to leading technology providers and investors. Services include *Banking Channels, Credit, Commercial and Enterprise Payments, Debit, Emerging Technologies, Global Payments,* and *Prepaid* practices, which provide research documents and advice; *CustomerMonitor Survey Series*, which report and analyze primary data collected in our biannual consumer surveys; and *Consulting Services*, which enable clients to gain actionable insights, implement more effective strategies, and accelerate go-to-market plans; offerings include tailored project-based expertise, customized primary research, go-to-market collateral, market sizing, competitive intelligence, and payments industry training. Mercator Advisory Group is also the publisher of the online payments and banking news and information portal *PaymentsJournal.com*. Visit www.mercatoradvisorygroup.com.

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