THE CREDIT CARD REWARDS EXPLAINER

EXAMINING ISSUERS' BATTLE TO ATTRACT
AND RETAIN CUSTOMERS WITH PERKS

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KEY POINTS

- **A credit card rewards program is an offering linked to a specific credit card that gives users the opportunity to earn redeemable points, or cash, after completing purchases.** The popularity of these programs has had a massive impact on the credit card industry, with nearly every major card issuer competing for greater market share by trying to push out the most enticing offers.

- **The evolution of the credit card space into a market filled with high-value rewards can be traced back to 2011 when an amendment to the Dodd-Frank Act limited interchange fees on debit cards.** Credit card fees were largely unaffected by the regulation, known as the Durbin Amendment, pushing issuers to look for ways to promote adoption and increase consumers' appetite for credit. This led to massive increases in rewards programs, with issuers attempting to capitalize on their attractiveness to create powerful new revenue drivers.

- **The changes issuers made in response to the Durbin Amendment were largely successful in fulfilling their immediate goals.** Credit card issuers with high-value rewards have been able to get consumers to adopt new card products, boost spending, and increase retention. In addition, greater rewards offerings and a stronger economy have led to an overall increase in consumer appetite for credit.

- **However, these rewards programs are expensive for issuers.** Not only must issuers pay for enticing signup bonuses to bring in new customers, they also have to fund their increasingly attractive rewards structures. The six largest credit card issuers incurred an estimated $22.6 billion in credit card rewards expenses in 2016, more than double the costs seen in 2010, according to Instinet data cited by the Financial Times.

- **To cover these costs, issuers rely on credit card fees paid by both consumers and merchants.** Two highly visible and well-known consumer fees include membership fees and interest. In addition, card issuers reel in considerable revenue from interchange fees paid by merchants as a percentage of each transaction processed. This cut is incredibly significant for card issuers — for example, in Q4 2016, Amex made $4.69 billion in interchange fees, representing over 59% of total revenue, while net interest income was just under $1.4 billion.

- **The credit cards rewards space will likely further evolve as issuers look to strike a better balance between benefits and costs.** Even as issuers continue to jockey to capture a larger share of the rewards market, spending on these programs appears to be reaching a breaking point. In fact, major players in the space are already beginning to find ways to cut costs, including rolling back rewards on their most premium products and partnering with well-known brands to develop less expensive, more creative rewards offerings.

Download the charts and associated data in Excel »

INTRODUCTION

Credit card rewards have become so popular in the US that issuers can make headlines just by launching a new rewards card. This has had a massive impact on the credit card industry, with nearly every major card issuer competing for greater market share by trying to push out the most enticing offers.

For consumers, the emphasis that issuers are putting on these cards has resulted in lucrative perks ranging from big signup bonuses to free travel, or even cash back. And as offers keep getting better, consumers are increasingly inclined to actively seek out the best rewards cards. This has created a market within a market by which credit card issuers are competing for potential customers in the rewards space itself.

The value added from offering attractive rewards is undeniable — in addition to attracting consumers to an issuer's credit card, the opportunity to earn rewards encourages cardholders to spend more money. And due to the stringent application process for such cards, these cardholders are less likely to default on payments. However, in order to drive up usage of their credit card products, and increase payment volume, issuers have had to invest heavily in these products — costs related to credit card rewards have more than doubled in the last six years. And in some cases, issuers don’t expect to see a return on their investment for years, if at all.

To cover these costs, issuers rely on the fees they collect from cardholders and merchants. These fees, including interest from carrying a balance, annual membership fees, and interchange fees, tend to be higher for rewards cards, which aids in funding high-value rewards programs. This approach is not bullet proof, though, as evidenced by JPMorgan Chase's early 2017 decision to cut the signup bonus for its extremely popular Sapphire Reserve card in half. As a result, card issuers are exploring new ways to make their rewards schemes more cost-effective, yet still attractive to consumers. Approaches include striking deals with well-known brands to introduce less costly, more creative rewards, and making rewards more easily redeemable through point-of-sale (POS) terminals.

In this report, BI Intelligence discusses the mechanics of credit card rewards schemes, as well as the major drivers behind their widespread popularity. It also details the benefits rewards offer issuers, the costs they incur, and how these expenses are covered. Finally, the report explains the methods and approaches that card issuers are employing to make their rewards programs more sustainable, while also keeping them relevant and attractive for consumers.

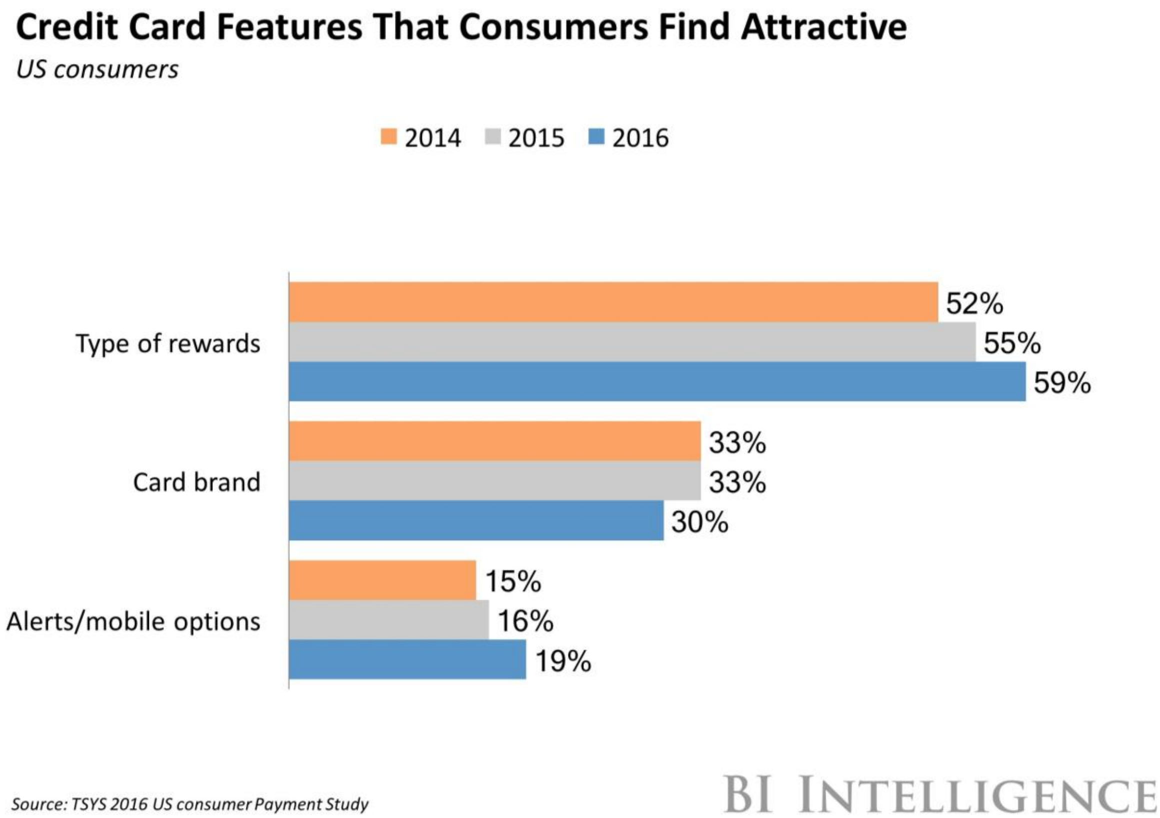
CREDIT CARD REWARDS PROGRAM

A credit card rewards program is an offering linked to a specific credit card that gives users the opportunity to earn redeemable points, or cash, after completing purchases. These programs are provided by issuers — typically banks or credit unions — which supply debit and credit cards connected to users' accounts.

For issuers, rewards have become a major user acquisition channel — almost 60% of consumers rank rewards as a major reason for adopting a credit card, according to TSYS' annual US Consumer Payment Study. In addition, rewards are useful in prompting existing cardholders to use their cards more often relative to other payment options in their wallet. Rewards offerings generally fall into two categories: cash back and points.

- **Cash back.** A cash back offering allows consumers to earn back a percentage of the amount they spend — usually around 1%, according to Discover. Some cards may also accrue cash once the balance is paid off. Cash can be redeemed in a number of ways, including by having funds sent directly to the cardholder, or paying down a credit card bill.

- **Points.** This approach gives cardholders the ability accumulate points under a specific rewards structure — one point per dollar spent, for example. Cardholders can redeem their points for any number of items, including gift cards, hotel stays, plane tickets, and more. These programs can be quite valuable given the plethora of potential prizes, but points can also be difficult to redeem due complex and sometimes confusing fine print.



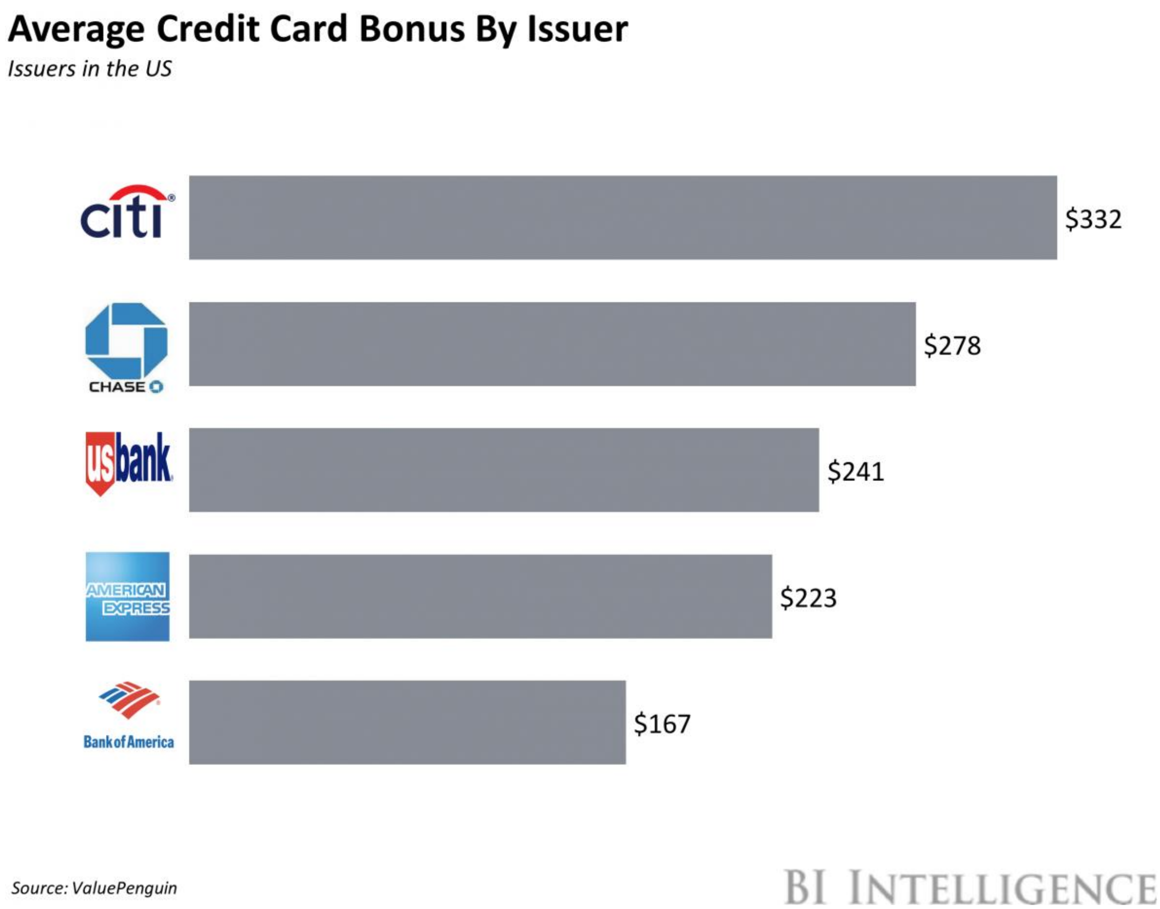
Credit Card Features

It's important to note that rewards programs can vary from the above, with many unique to their specific issuer. That's because, as consumers increasingly choose cards based on rewards, issuers need to find different and attractive ways to appeal to shoppers. In addition, issuers are increasingly attaching one-off rewards to their products. These can be earned almost instantly, but generally only once.

- **Signup bonuses.** Roughly 86% of the rewards credit cards that major issuers offer come with a signup bonus, according to ValuePenguin. These cards provide perks to users either for simply opening an account, or when they spend a certain amount in the first few months. Both Chase and American Express (Amex) have premium credit cards that offer shoppers the ability to earn 50,000 points as part of a signup bonus.

- **Subscriptions.** Some credit cards come with access to subscription memberships, which can be a very alluring offer if paired with a popular service or site — users of the Amex Blue Cash Preferred card were granted a one-year membership to Amazon Prime, for example.

- **Gift cards.** New cardholders may also receive access to store-specific gift cards. The Amazon Rewards Visa card from Chase is deployed with a $70 Amazon gift card, which is instantly applied to the user's account.



THE CREDIT CARD REWARDS LANDCAPE

The evolution of the credit card space into a market filled with high-valued rewards didn't happen overnight. Rather, this shift can be traced back to 2011 when new financial legislation limited interchange fees on debit cards, making credit cards a more lucrative product for issuers. The interchange fee is the cut of a consumer's transaction that a merchant pays to the cardholder's issuing bank after a payment is processed.

The Durbin Amendment. In 2011, the Durbin Amendment to the Dodd-Frank Act put a cap on interchange fees collected via debit card transactions by financial institutions with more than $10 billion in assets. This cap forced issuers to limit interchange fees to 24 cents per transaction, which is roughly 45% less than the previous average of 44 cents.

- **Banks lost significant revenue from this change.** Big banks may have lost roughly $14 billion annually from the limit on debit card interchange fees, according to a 2014 Federal Reserve paper.

- **These financial institutions were left looking for ways to recoup this lost revenue.** This resulted in a decrease of debit card rewards, higher ATM fees, and increased fees for deposit accounts, from 3% to 5%.

Meanwhile, the Durbin Amendment left credit card fees largely unaffected, pushing issuers to look for ways to promote adoption and increase consumers' appetite for credit. This led to massive increases in rewards programs, with issuers attempting to capitalize on their attractiveness to create powerful new revenue drivers. In the last few years, issuers have truly pushed the envelope on their offerings, with some of the biggest firms making headlines.

- **Citi and Visa beat out Amex for the Costco card portfolio.** In March 2015, Costco announced that Citi would become the exclusive issuer of Costco's cobranded credit cards, replacing Amex, while Visa would take over as the card network. This deal may have been in part fueled by the rewards program on the Citi card — Citi cardholders can earn 1% more cash back on fuel, restaurants, and travel, compared with Amex. It's important to note the significance of this portfolio — the Costco customer base that Citi acquired, which totals roughly 12 million, made over $52 billion in purchases in the first six months after the switch, and exhibited $6 billion in loan growth, according to the firm's earnings call.

- **Chase released its Sapphire Reserve card, which challenged the entire industry.** In August 2016, Chase released this very valuable card, with a rare 100,000-point signup bonus, a $300 annual travel credit, and 3x the points on dining and travel. It saw immediate success with tens of thousands of consumers signing up in the first two days after its launch. This card helped the bank increase the adoption of its credit cards and eventually became a marketing tool.

- **Likely in response to the Sapphire Reserve, Amex made several changes to its premium rewards card.** In October 2016, Amex increased the number of points that cardholders can earn from airfare purchased on their Platinum card, from a maximum of 2 points per $1 spent to 5 points. The card issuer also recently announced some added perks, including a new stainless steel design.

BENEFITS TO ISSUERS

The changes issuers made in response to the Durbin Amendment were largely successful in fulfilling their immediate goals — credit card issuers with high-value rewards have been able to get consumers to adopt new card products, boost spending, and increase retention.

- **Customers are more willing to adopt cards attached to impressive rewards.** Chase reported a 35% increase in new card accounts in Q3 2016, after launching the Sapphire Reserve card, according to First Annapolis. The big signup bonus, travel credits, and ongoing points structure likely had a major impact on the bank's ability to get consumers to adopt the new credit product.

- **Rewards cardholders who actually redeem rewards spend more.** In 2015, rewards cardholders who redeemed rewards spent approximately $1,128 per month, while those who didn't redeem only spent $645 per month, according to JD Power. For additional context on card spending, Chase saw an over 50% lift on credit card spending after the release of the Sapphire Reserve card.

- **Those with rewards cards hold larger balances.** Owners of premium rewards cards tend to carry a balance that is "likely well in excess of the $3,000 average for the industry," according to payments executive Kameliya Vladimirova, who was interviewed for a UBS study. This provides banks with an opportunity to earn greater revenue from interest.

- **Interestingly, many consumers fail to take advantage of the cards.** Although consumers are clearly attracted to credit card rewards programs, many leave their rewards unused — up to $16 billion in loyalty points go unredeemed every year. This allows issuers to benefit from consumers adopting their cards and using them, without having to pay out all of the related costs.

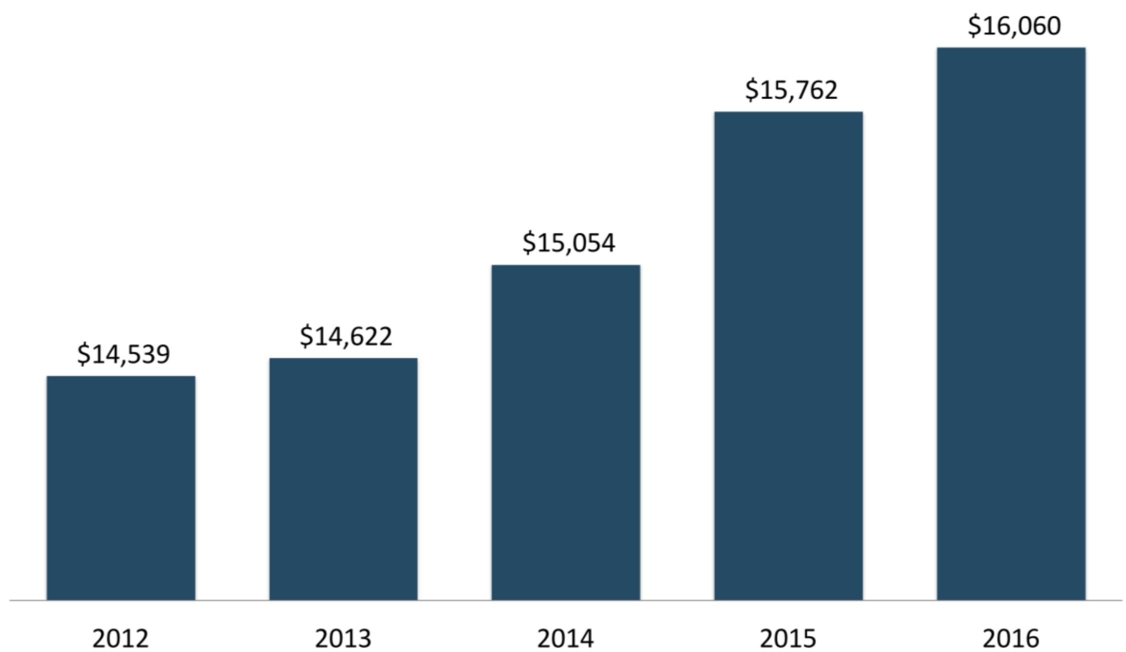
Meanwhile, greater rewards offerings and a stronger economy have led to an overall increase in consumer appetite for credit.

- **The number of credit card payments reached nearly 33.8 billion in 2015,** representing a 6.9 billion increase from 2012. The value of these purchases also grew, albeit at a slower rate, from $610 trillion to $3.16 trillion, according to the 2016 Federal Reserve Payments Study.

- **Households are taking on more credit card debt.** Credit card debt per indebted household has steadily increased for the past four years, growing from an average of $14,539 in 2012 to $16,060 last year, according to the 2016 American Household Credit Card Debit Study.

Average Credit Card Debt Per Indebted Household

US households



Source: Nerdwallet 2016 American Household Credit Card Debt Study

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THE COST OF REWARDS

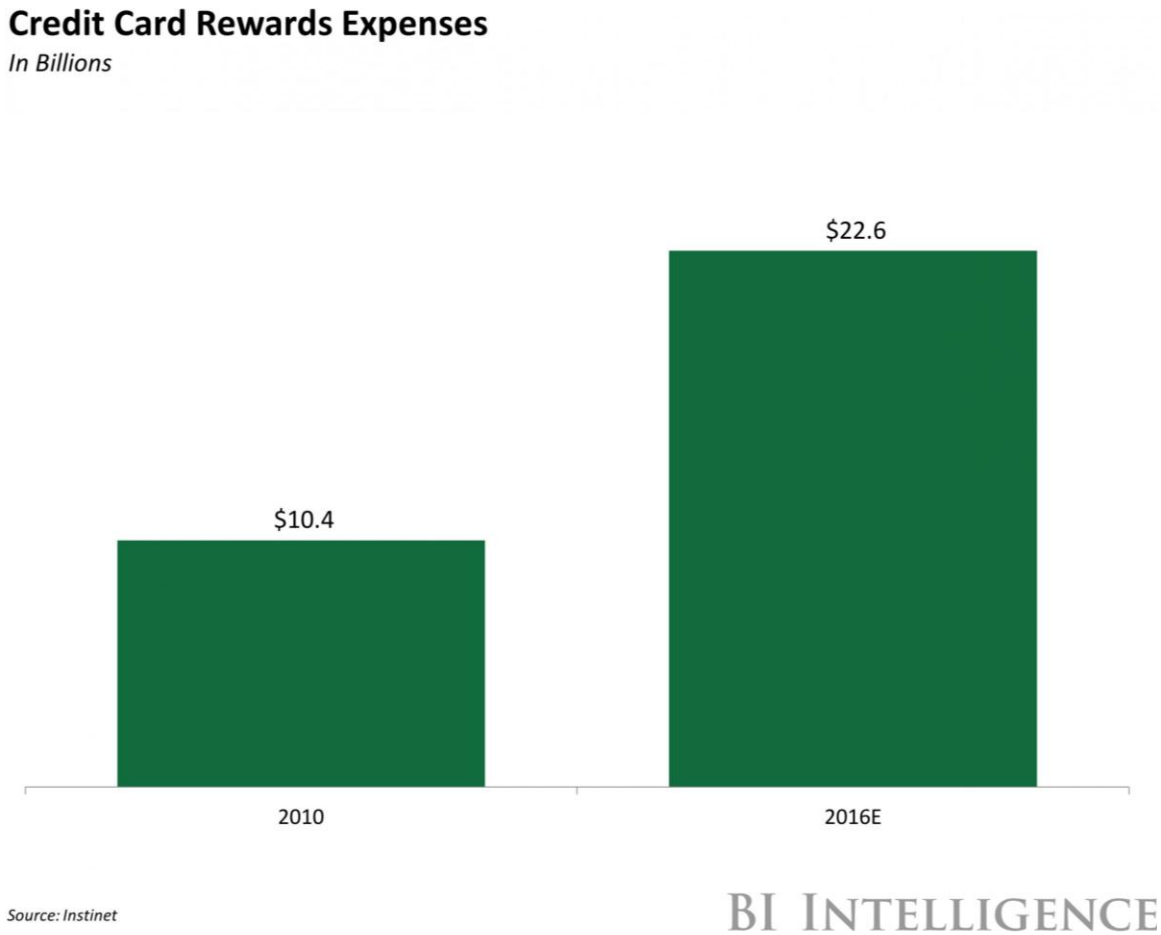
Despite the benefits, funding these rewards programs results in steep costs — not only are issuers tasked with paying for enticing signup bonuses to bring in new customers, they also have to fund their increasingly attractive rewards structures.

- **Large signup bonuses result in major outlays.** Take Chase's Sapphire Reserve card, for example — the 100,000-point signup bonus, which came with the stipulation that customers spend $4,000 in the first three months, ended up reducing the bank's profits by $200 million to $300 million in Q4 2016, according to Bloomberg.

- **Underlying rewards structures last through the entire life cycle of a credit card.** Since points are accrued on an ongoing basis, the costs associated with these programs mount over time. For example, points for the American Express Membership card are believed to be worth 1.9 cents, which means if just one consumer earned 20,000 points, they could redeem $380 in rewards.

- **Issuers must partner with successful brands to make their rewards redeemable.** To compete in the rewards space, it's essential for card providers to partner with popular brands that can catch consumers' interest. However, with all of the top issuers seeking these partnerships, building such relationships is expensive. Chase recently struck deals with Southwest Airlines, United Airlines, and Amazon, among others, which will cut revenue by about $900 million annually, according to Fortune.

Amid large signup bonuses and a race to partner with the most popular brands, banks have seen total rewards expenses skyrocket. The six largest credit card issuers incurred an estimated $22.6 billion in credit card rewards expenses in 2016, more than double the costs seen just six years earlier in 2010, according to Instinet data cited by the Financial Times. That said, banks are able to leverage high consumer demand to increase fees associated with their credit card products, reducing the burden of covering these rising costs.



Credit Card Expenses

Credit card fees are an important way that issuing banks recoup the costs of their rewards. While such fees are clearly top of mind for consumers who want to avoid high interest charges, or paying hefty annual membership fees for cards that they don't use, they are even more pertinent for card issuers. That's partly because credit card fees generate massive revenue that can help fund high-priced rewards.

Two highly visible and well-known fees include membership fees and interest:

- **Annual membership fees.** Premier rewards cards like the Amex Platinum and Citi Prestige card come with substantial annual fees, reaching $450 a year. These high annual fees are used to help cover the large signup bonuses that usually accompany premier rewards cards.

- **Annual percentage rate (APR).** APRs for rewards cards [tend](#) to be higher than for other products — the average APR on a cash back credit card is 20.9%, while a business card averages 15.37%.

Credit Rewards Cards

Credit card issuer	Credit Card	Rewards offered	Conditions on rewards	APR	Annual fee
AMERICAN EXPRESS	**Blue Cash Preferred**	• 6% cash back at US restaurants, 3% at gas stations and department stores • 10% cash back at US restaurants within first six months • $250 Sign-up bonus	• Cash back drops to 1% after reaching $6,000 • $250 is earned after spending $1,000 in the first three months	0% intro APR for first 12 months, 13.74% - 23.74% after intro	$95
	Platinum Card	• 5X points on eligible flights booked or hotels • $15 a month in Uber credits in the US • $200 airline credit • 60K point sign-up bonus	• 60K points are earned after spending $5,000 in the first three months	No interest as complete balance is paid each month	$550
CHASE	**Chase Sapphire Reserve**	• 3X points for every $1 spent on restaurants and travel • 50K point sign-up bonus • $300 annual travel credit	• 50K points are earned after spending $4,000 in the first three months	15.49% - 24.24%	$475
	Chase Freedom Unlimited	• 1.5% cashback on all purchases • $150 statement credit	• $150 statement credit after spending $500 in first three months	0% intro APR for first 15 months, 15.49% - 24.24% after intro	$0
citi	**Citi Prestige**	• 3X points for every $1 spent on air and travel • 50K point sign-up bonus • $250 annual air travel credit	• 50K points are earned after spending $5,000 in the first three months	15.74%	$450

Source: Company websites

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Credit card rewards by card

Another critically important fee when it comes to covering rewards is the interchange fee. As discussed earlier, the interchange fee is the payment that a merchant makes to a cardholder's issuing bank. For a premier rewards card, this fee represents roughly 2.2% of a transaction, according to Vladimirova and as cited by UBS. This cut is incredibly significant for card issuers — for example, in Q4 2016, Amex made $4.69 billion in interchange fees, representing over 59% of total revenue, while net interest income was just under $1.4 billion.

However, as competition pushes issuers to offer increasingly attractive rewards, it's becoming harder to cover the costs. For example, Chase isn't expected to break even on its Sapphire Reserve card investment for five and half years, even though it's been successful in driving up adoption and usage of the bank's wider credit card portfolio, according to data from Sanford C. Bernstein & Co. research cited by by Bloomberg. Such large-scale rewards programs are largely unsustainable, and issuers must look for ways to provide consumers with a similar credit card experience, without sacrificing potential profits.

REWARDS WILL CONTINUE TO EVOLVE

While issuers are likely to continue to jockey for a larger share of the market, rewards spending is unlikely to significantly increase over the next five years. In fact, major players in the space are already beginning to find ways to cut costs. Here are a few trends we expect to see in the years ahead:

- **Issuers will have to walk back some of their most costly rewards.** To improve the value proposition of rewards, issuers will need to pull back on their most expensive rewards offerings. We've already seen evidence of this with Chase's decision to cut back on the some of the perks associated with its Sapphire Reserve card, which included reducing the 100,000 point signup bonus to 50,000, according to The New York Times. Going forward, issuers will likely need to avoid trying to out do the entire market with headline-making, high-priced rewards, and opt for a more moderate approach.

- **Partnerships need to be built with the most popular brands in the world to develop more creative rewards.** Teaming up with brands that consumers are attracted to enables issuers to market their credit product without touting the traditional, high-priced rewards that customers flock to — for example, Amex recently announced that it's revamping some its rewards for its premium Platinum credit card, teaming up with Uber to give users up to $200 in credits annually. Staying ahead of consumer trends and interests is expected to become a major focus for issuers as they look to find the most relevant and attractive partners to woo consumers.

- **Issuers will need to find ways to reduce cardholders' ability to game the system.** With the increase in the value of rewards, there's been an outbreak of consumers opening and closing multiple accounts in order to take advantage of initial offerings. Issuers are tackling this problem in a number of ways — Citibank only allows customers who haven't opened or closed the same card within the last two years to earn points, for example. Meanwhile, Amex is using analytics to identify and suppress gamers, while working to create new offers to incentivize long-term loyalty. Experimenting with new tools like machine learning to improve analytics will be instrumental in helping issuers identify and deny churners.

- **New platforms and technology will be introduced to make it easier for consumers to redeem rewards.** Given the red tape associated with redeeming rewards, greater opportunities to cash in could shift consumers' focus from the value of rewards to how often they can actually use them. Two companies taking steps to accomplish this are Mastercard and financial services tech firm FIS, both of which have created their own solutions — Mastercard Pay with Rewards and Premium Pack, respectively — to allow consumers to pay with earned rewards at POS terminals. Such technologies could have a major impact on the credit card rewards landscape if enough issuers adopt them, and consumer sentiment toward rewards can effectively shift.

THE BOTTOM LINE

- The popularity of credit card rewards programs has had massive impact on the credit card industry, with nearly every major card issuer competing for greater market share by trying to push out the most enticing offers.

- The evolution of the credit card space into a market filled with high-valued rewards can be traced back to 2011 when an amendment to the Dodd-Frank Act limited interchange fees on debit cards, making credit cards a more lucrative product for issuers.

- The changes issuers made in response to the Durbin Amendment were largely successful in fulfilling their immediate goals. Credit card issuers with high-value rewards have been able to get consumers to adopt new card products, boost spending, and increase retention.

- However, funding these rewards programs results in steep costs. Not only are issuers tasked with paying for enticing signup bonuses to bring in new customers, they also have to fund their increasingly attractive rewards structures.

- To cover these costs, issuers rely on credit card fees paid by both consumers and merchants. These include membership fees and interest on the consumer side, and interchange fees paid by merchants.

- The credit cards rewards space will likely further evolve as issuers look to strike a better balance between benefits and costs. Even as issuers continue to jockey to capture a larger share of the rewards market, spending on these programs appears to be reaching a breaking point.

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