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The Future of Credit Card Rewards Programs

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WHITE PAPER

TABLE OF CONTENTS

INTRODUCTION

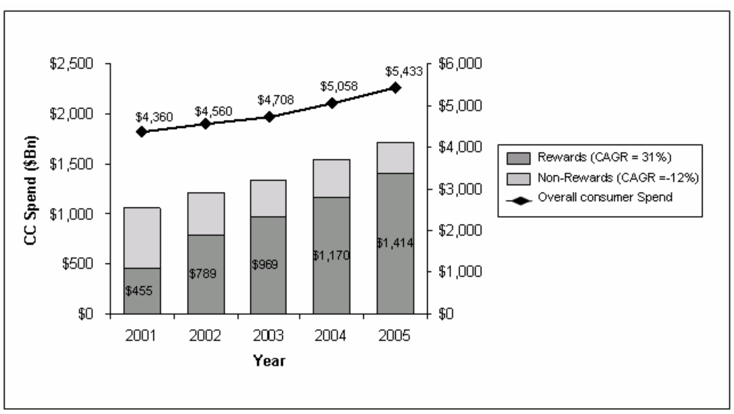
Rewards programs are increasingly the most important feature of payment cards[1]; programs are becoming the foundation of issuer marketing and differentiation, as typified by Citibank's Thank You program, American Express Membership Rewards, and Bank of America's WorldPoints. Robust loyalty operations represent a high barrier to entry and produce a competitive advantage with a longer shelf life than offers related to payment terms, which are easy to replicate. However, the maturing rewards market will alter issuer program value and structure.

Industry loyalty programs have grown to cater to vastly diverse card member needs in an attempt to broaden their appeal beyond the airline miles segment. As a result, the majority of large issuer programs share many of the same qualities and offer similar card member value. While some aspects of large rewards programs are unique, for example Bank of America's new "experiential" redemptions, there is little doubt that the basic rewards offering is becoming a market necessity; no longer a competitive advantage, but instead a commodity. As a result, a heightened focus on cost has the potential to spark a dramatic change in the structure of the rewards industry, potentially enabling coalition programs, white labeling of existing programs, and issuer-association partnerships.

BACKGROUND

Rewards are designed to drive profitable customer behavior, including greater account acquisition, spend and fee revenue, and reduced attrition. The current prevalence of rewards programs is a testament to the success of the mechanism. Rewards cards accounted for 40% of credit card spend in 2001, and by 2005 the figure had grown to 77%. While the trend is necessarily slowing as rewards penetration asymptotically closes in on 100%, consumers are increasingly cognizant of loyalty program value.

Figure 1



On an individual issuer basis, and for the credit card industry as a whole, rewards cards have established their value. In fact, some research has shown that rewards card spend is three times that of a traditional card[2], which could indicate a greater share of wallet concentration. Additionally, when rewards cards first entered the market, acquisition rates were substantially higher than for traditional cards[3].

On an industry level, rewards have motivated a shift from traditional forms of payment to credit cards. In 2005, cards accounted for 38% of consumer spend, up from 30% in 2001[4], a period when rewards spend more than doubled. The growth has been most pronounced in small payments, what some financial services firms have dubbed "everyday spend." This includes supermarket, drug store and gas station charges, among others.

[1] "Payment card" or "card" will be used throughout the paper to refer to general acceptance debit, charge and lending products
[2] Visa payment panel study, 2005
[3] Recently response rates have declined as rewards programs now compete with other reward programs with similar value propositions.
[4] US Census Bureau Statistical Abstract of United States, 2004-2005

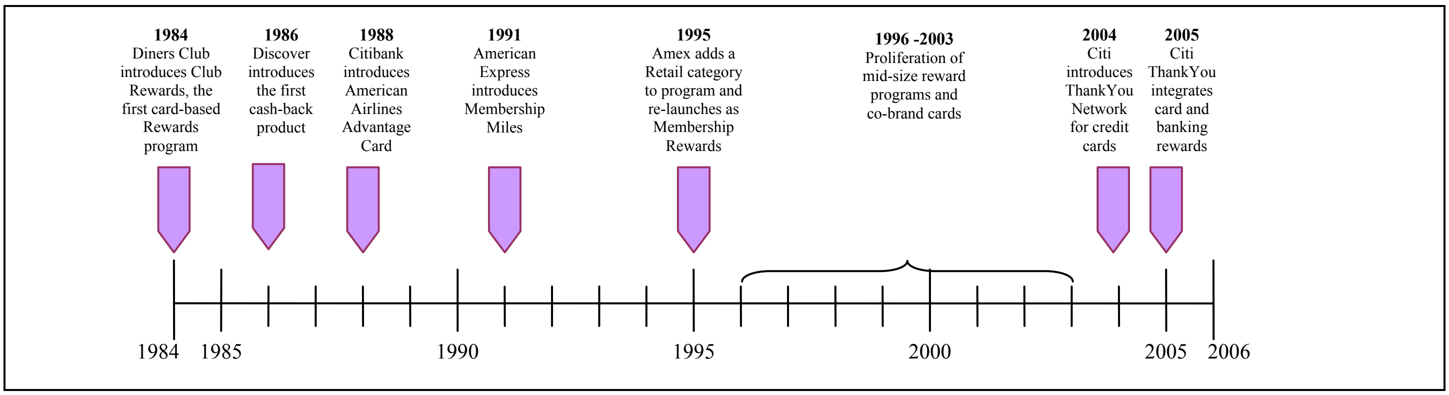
Several issuers have provided additional rewards incentives (e.g., bonus points) to use cards for relatively small purchases, and have rolled out additional time saving technology (e.g., RFID) to expedite the card use process. Judging from recent issuer statements, these measures have successfully improved credit card penetration within this category.[5] [See figure 1 on the previous page.]

HISTORY OF REWARDS

While modern credit cards made their first appearance in the 1950s, credit card rewards were not developed until 1984, when Diners Club created the first rewards program. Diners "Club Rewards" was travel redemption based, which provided the context for most early rewards programs.

By the late 1990's stand-alone credit card rewards programs such as American Express' "Membership Rewards" and Club Rewards offered robust redemption offerings that included retail, dining, cash, air and, hotel options. This multi-reward model is the framework used by several large issuer rewards programs today. [See figure 2 below.]

Figure 2



REWARDS PROGRAM ECONOMICS

"Earn" and "burn" are the basis of card member loyalty value, where "earn" refers to acquiring points and "burn" refers to how those points can be used. While numerous bonus schemes are employed, most loyalty credits are earned at a 1:1, point to dollar, ratio. Redemption value varies by card product, but cards within the same rewards product classes (fee/free and high-end/low-end) offer similar values. [See figure 3 on the following page.]

[5] "American Express Changes to US Charge Card Benefits", July 31, 2006

Figure 3

Card Type[11]	**Cards**	**Value Proposition**	**Redemption Value**[6]
Fee-Based (high-end)	- Amex Platinum/Centurion - Diners Club Carte Blanche - Citi Chairman Card	Access to airport lounges, personal concierge, higher quality customer service, as well as enrollment in high-value Rewards program.	100 – 200 bps
Fee-Based (mid-tier)	- Amex Green/Gold - Citi Platinum Select World MC - Chase Flexible Rewards Select Visa	Enrollment in high-value Rewards program	100-150 bps
Fee-Free	- Amex Blue - Citi Diamond Preferred Rewards MC - Chase Free Cash Rewards Visa - B of A Power Rewards Platinum Visa	Cash back or enrollment in lower value Rewards program	50-125 bps

Offered value is a function of and confined by the benefit created from card economics, discount rate and other revenue streams flowing to the issuer from card member activity. Most card issuers are members of the three largest card associations: Visa, MasterCard and American Express. The interchange rate, which translates into the rate at which issuers receive spend revenue, is set by the associations. Therefore, while some economics are dictated by the issuer, including interest rate and fees, a large portion is common across all issuers within the association. The market has established a risk adjusted pricing band, even where there are differences,. Since card economics are similar across issuers, there is a convergence of issuer loyalty value offers.

[6] Ranges based on average cardmember perceived value of $1 of spend.

COMMODITIZATION

While card products within categories provide similar value, large issuer programs also offer similar redemption options. Citi, Chase, American Express, and Diners each offer retail, cash and air options, while additional categories may also be available. The primary program differentiator is no longer redemption option and value, but has instead moved to marketing. While marketing can and will set programs apart, particularly in the short term, the relative equity of programs will eventually lead to an overarching cost focus. [See figure 4 below.]

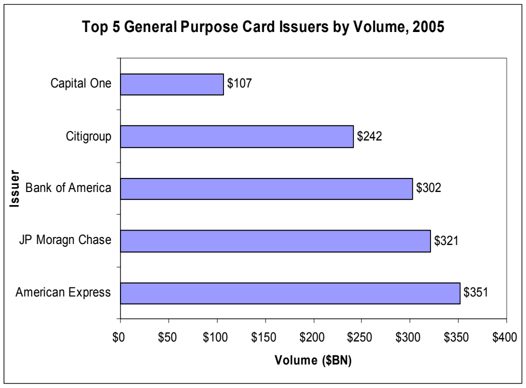
Figure 4

Issuer[7]	Program	Features
American Express	Membership Rewards	• Air Rewards (both points transfer and credit) • Other Travel (certificates and points transfer) • Experiential • Merchandise (through consolidators) • Retail (gift cards and certificates) • Cash Back
citi	ThankYou Network	• Air Rewards (consolidator) • Other Travel (certificates) • Experiential • Merchandise • Retail (gift cards and certs) • Cash Back
CHASE	Flexible Rewards	• Air Rewards (consolidator) • Merchandise • Retail • Cash Back
mbna	WorldPoints	• Air Rewards (consolidator) • Experiential • Merchandise • Retail (gift cards and certs) • Cash Back

As program commoditization increased, acquisition response rates to rewards card offers declined dramatically. With similar value propositions, rewards cards struggle to differentiate themselves and consumers see little value to switching programs. Rewards programs, once an issuer advantage, are becoming a market necessity. As developed rewards programs become ubiquitous and commoditized, competition will move away from a rewards focus. However, with the necessity of rewards within a narrow value band, issuers will attempt to minimize program expense. [See figure 5 on the following page.]

[7] Source: Program Websites

Figure 5



PROGRAM COST

As rewards programs turn increased attention to cost, the largest players have substantial scale advantages. Scale provides a cost advantage in administration and redemption expense, as larger issuers have greater economics of scale and purchasing power. While cost inequality is a current reality, cost competition will magnify the significance of this gap.

Even among large players, however, there is an increasing need to scale rewards programs. Traditional reengineering provides a foundation of program cost effectiveness, but scaling options including coalition programs and white labeling may provide a longer term solution.

TRADITIONAL REENGINEERING

Established loyalty programs have always had a dual focus; to provide a well-rounded program that stimulates activity, while concurrently optimizing program cost efficiency to derive the greatest benefit from card activity. Traditional reengineering focuses on cost containment through program efficiency, typically resulting in relatively minor changes to the program; changes that have a bottom line benefit but do not significantly alter the customer value proposition.

While traditional reengineering is and will continue to be a focus, large loyalty programs may require more substantive change to address loyalty cost.

COALITION PROGRAMS

Coalition formation may be one such substantive change. Coalition programs could be formed by issuers partnering with non-credit card merchants, such as retail and gas, to increase loyalty program value and reduce administrative expenses. This type of program provides a common loyalty currency issued by all participating merchants that can be combined toward a single redemption. An example of this model is Nectar in the United Kingdom (UK), which was launched in 2002. The Nectar coalition, now the largest loyalty program in the UK, is anchored by a credit card issuer (originally Barclaycard, now American Express) partnered with a large grocery chain (Sainsbury), gas retailer (BP) and department store (Debenhams). Loyalty points earned at any of the coalition partners are combined into a common point bank.

Within a coalition, a large card issuer would likely be the anchor, providing the foundation of participants and point banks. In the United States, the recent agreement between Citibank and Expedia may signal the beginning of a coalition built around the Citibank ThankYou program. In November 2006, Expedia's loyalty program agreed to issue ThankYou points. ThankYou points earned on Expedia purchases can be combined with Citibank rewards points earned through card spend and banking transactions, in a common point bank. Citibank is likely to expand their fledgling coalition into other non-competing industry sectors, similar to Nectar.

WHITE LABELING

Program white labeling could represent another cost driven transformational initiative for large issuers. White labeling involves established rewards issuers managing other merchants' loyalty using components of their own programs, without external use of the brand name. Without the branding concern, managing other card issuers' programs is even a possibility.

Externalization, through coalitions and white labeling, is an available route for large issuers to leverage their loyalty programs, minimizing cost. However, in an industry were rewards are a necessity, small issuers are left in the cold. Small issuers, however, can stay in the game by combining administrative and vendor negotiating power.

ASSOCIATION REWARDS

The association is well situated to act as an issuer conglomerator. In fact, associations already offer turn-key rewards programs for their issuers. Visa Extras is the largest example of an association rewards program with nearly 1,000 issuer participants. Smaller issuers and business card products allow Visa to administer the rewards program, while issuers retain the right to specify program cost through customer earn rate control.

The benefit of association rewards is that program administration cost is diffused among the participants and program management requires minimal involvement from issuer staff. Associations are not, however, a small issuer rewards panacea. The basic programs associations provide are not as robust as large issuer schemes, and between participating issuers, rewards are no longer a competitive product aspect. Association programs, however, effectively address the market requirement of rewards, while reducing the administrative cost to participating issuers.

Administrative expense sharing is not the only cost benefit of this rewards commune. The association also has the combined purchasing power of its membership, allowing favorable partner pricing. Additionally, combined program investment and association relationships with merchants make program development, both technology (e.g., point of sale rewards) and marketing, possible at a level on par with large issuers.

ASSOCIATIONS, REWARDS, AND ESTABLISHED PROGRAMS

While well situated to be influential in the card rewards area, associations face a problem of inertia. Issuers are highly invested in their own programs and have a substantial development lead. Substantial sums have gone toward developing programs and issuers have a vested interest in continuing the program while a cost and marketing advantage over smaller competitors remains. As program competitive advantage deteriorates, however, large issuers may be willing to externalize their program, and one available distribution channel is the association.

Partnering between major issuer rewards programs and associations to create a small number of massive scale programs that dominate the space may be a reasonable development model. Issuers would unlock the value of their investment in loyalty, associations could earn additional revenue through distribution, and smaller issuers could offer a competitive program without incurring exorbitant cost.

Partnering would likely occur through "natural lines," traditionally close relationships between large issuers and associations. These partnerships include Visa and Bank of America, Citibank and MasterCard, and American Express issuing Membership Rewards across their network platform. American Express may have an advantage due to program establishment and brand consistency, but also must overcome the potential cannibalization of its proprietary issuing business.

Figure 6

Program	*Accounts*	*Points Issued*
Aeroplan[10]	5 MM	62 BN
Amex Membership Rewards[8,9]	9 MM	105 BN
Bank of America WorldPoints[8,9]	22 MM	91 BN
Citi ThankYou Network[8,9]	22 MM	72 BN

UNLOCKING THE VALUE OF REWARDS PROGRAMS

Under a situation where large issuer rewards programs are distributed through associations, the loyalty program itself may be established as a standalone entity. For example, in 2005 Aeroplan was spun off from Air Canada. Aeroplan sells miles to a variety of partner merchants, including retail partners and issuers, who provide the miles to customers. The program has over 5 million members redeeming over 1.5 million flights per year. When it became independent to Air Canada in 2005, the IPO price suggested a valuation of CAD $2 billion, or about US $1.6 billion. Using Aeroplan as an example of a large-scale, broad coalition loyalty program with numerous partners could be worth US $325 per member. Obviously, replication of the Aeroplan model would require issuer programs to be retooled and refocused in order to widely distribute rewards currency externally, but the potential payoff could compensate for near-term costs. [See Figure 6.]

CONCLUSION

It is clear that program cost containment coupled with commoditization will spur a change in program substance and management. Reengineering will give way to a revision of traditional program economics, including a change in program structure and management. Coalition programs, white labeling, and association rewards will provide the models of industry externalization. The external result of these changes will be that the largest loyalty programs will emerge bigger, permeating multiple industries; while internally, program value will be unlocked turning a cost center into a profit generating activity.

[8] Assuming 30% of credit card accounts are enrolled in the proprietary loyalty program. Based on 2005 figures from *The Nilson Report*, January 2006.
[9] Assuming 30% of total purchase volume on credit cards earn at 1 point per dollar. Based on 2005 figures from *The Nilson Report*, January 2006.
[10] Source: *Aeroplan 2005 Annual Report*

About FischerJordan

FischerJordan, headquartered in New York City, is a boutique management consulting firm founded in 2004 by alumni of the Mitchell Madison Group and Inductis. FischerJordan has delivered hundreds of millions of dollars of bottom line impact to Fortune 100 financial services companies through its focus on analytics-driven marketing strategy, rewards/loyalty strategy, and reengineering strategy.

About Scott Henry

As an engagement manager at FischerJordan, Scott Henry has executed several high impact projects involving loyalty program management and transformation at Fortune 100 financial services firms. Prior to joining FischerJordan, Mr. Henry was an antitrust attorney working at Shearman & Sterling involved in multi-billion dollar transactions in a variety of industries and a financial product analyst at Deutsche Bank specializing in domestic equities. Mr. Henry holds a JD/MBA from Wake Forest University.

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