Credit Cards That Offer Rebates and Rewards: Issues for Credit Revolvers and Non-Revolvers

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Introduction

For a fleeting period in the late 1980s, it was fairly easy to select a credit card. The 1988 Fair Credit and Charge Card Disclosure Act, by mandating disclosures in credit card solicitations and applications, made it easy for consumers to compare interest rates and any annual fees. By the early 1990s, however, it was no longer sufficient for consumers to know about credit card features that affected the ***costs*** of credit; they needed to understand the new ***benefits*** offered by credit cards, including cash rebates, credits toward purchases of new cars and computers, frequent flyer mileage, and contributions to non-profit organizations. Thus, today's consumers face a complex and dynamic marketplace for credit cards in which costs must be carefully balanced with benefits. The objective of this article is to highlight some issues relevant to educating consumers about selecting and using credit cards.

Background

Several events were pivotal in altering consumer choice among credit cards. The earliest was the roll-out of the Sears Discover Card in 1986. Not only did the Discover Card compete directly with Visa and MasterCard, but it also offered consumers a cash rebate of up to 1% on purchases. No wonder the card was popular, growing to 32 million accounts at the end of 1994 (Dean Witter, Discover & Co., 1995).

A second key event was the marketing of affinity cards. These credit cards involve a partnership between a bank and a non-profit organization (e.g., a university or an environmental organization) in which the bank gains access to the organization's members and the organization receives a percentage of purchases made using the affinity card (usually bearing both the name of the organization and either Visa or MasterCard). Affinity cards are notable because they demonstrate the importance to consumers of moral benefits as opposed to tangible, economic ones.

A further defining event in the evolution of the contemporary marketplace for credit cards was the introduction of the AT&T Universal Card in 1990. Not only did AT&T compete directly with commercial banks as the issuer of a Visa or MasterCard, but the Universal Card dispensed with annual fees and offered a 10% discount whenever the card was used to make long-distance telephone calls. Within a year of its roll-out, there were 8 million Universal Cards in circulation. By 1995, there were 22 million cardholders (Warner, 1995).

Co-branding occurs when a credit card is sponsored by a financial institution in conjunction with a manufacturer, service provider, or retailer. The names of both parties appear on the credit card, and consumers have the opportunity to earn various rebates and rewards. Co-branding took off in 1992. There must have been something about the letter G that year because General Electric, General Motors, and GTE came out with cards that offered discounts or rebates on selected goods and services ("Why the New Giveback Cards," 1992). Ford followed suit in 1993, and in 1994 Apple offered a credit card that could earn rebates on their computers. Also during the 1993-94 period, Kroger became the first major food retailer to offer a co-branded card, and Nordstrom offered a co-branded card that competed directly with its own in-house credit card ("More Retailers Turn," 1995).

Eventually, some of the companies offering co-branded cards realized they might have created a problem; too many consumers were using the credit cards and earning benefits without running up enough interest charges. In September 1996, GE Capital Corporation informed holders of the GE Rewards MasterCard that they would pay a $25 annual fee if they didn't carry a balance ("Saving Credit Cards," 1996). General Motors decided that the benefits on its gold credit card were excessive and cut in half the amount of money that cardholders could earn toward the purchase of a new GM vehicle (Blumenstein, 1996). Citibank and Apple simply stopped awarding points, leaving program participants with worthless credits (Mannix, 1997).

Aids to Consumer Choice

The credit card choices available to consumers seem to change daily. One recently created credit card combines the feel-good aspects of an affinity card with the rewards of a co-branded card by contributing 1% of purchases to local public schools while also providing a one-half percent cash rebate to the cardholder. Another card allows consumers to create their own credit card by selecting various combinations of annual percentage rates, cash rebates, interest rebates, and even artwork by celebrities on the front of the card itself. With all these choices, where can the consumer turn for objective and useful information?

Among industry sources of information, American Express stands out. Because the vast majority of its cards do not allow consumers to carry a month-to-month balance, American Express is capable of taking a relatively dispassionate position on the choice among credit cards offering revolving credit. American Express recommends that consumers: (1) select a card that offers points or premiums toward a good or service they actually plan to use, (2) avoid going over their credit limit, (3) understand that they must pay their card balance ***in full*** by the payment due date in order for new purchases to be interest free; and (4) check whether cards offering premiums charge a higher interest rate or impose other fees ("Consumer Choices," 1994). Although this advice is sound, it is relatively generic and does little to help consumers choose among benefit cards.

A Federal Reserve System publication, *Shop: The Card You Pick Can Save You Money* (1995), offers similarly broad advice, but it adds specific information about the credit card plans offered by 154 financial institutions. The information about credit card costs is precise (e.g., annual fee, variable vs. fixed interest rates, grace period, and APR), but the information about card benefits is extremely vague. For example, the guide tells the reader whether a program offers rebates on purchases, but not the size or conditions for using these rebates. The Federal Reserve guide is not very helpful, then, to consumers who wish to balance the costs and benefits of various credit card plans.

Consumer Reports downplays the value of credit card "perks" in a recent article ("House of Cards," 1996). It points out, for instance, that even cash rebate programs may be less attractive than they sound because there is often a minimum amount that must be charged before one can earn the full 1% refund. The magazine's overall advice is to focus primarily on the cost of using a credit card—the annual percentage interest rate and any fees.

The most useful credit card information from a consumer group comes from Bankcard Holders of America (BHA), a Virginia-based, private, non-profit organization dedicated to informed decision making by consumers. When credit card programs were only distinguished by their costs, BHA's major educational thrust was to identify low-interest and no-fee credit cards. With the growing popularity of rebate/premium cards, BHA began publishing a list of programs and a guide to evaluate these cards. In a 1995 publication, BHA offered much the same general advice as American Express and the Federal Reserve, but BHA also developed various scenarios based on different spending and payment patterns for rebate and frequent flyer programs.

The first scenario involves a rebate program and what BHA describes as a typical consumer. This consumer is a credit revolver with an annual charge volume of $2,750 and a monthly balance of $1,750. In this situation, consumers are usually better off seeking the card with the lowest interest rate and ignoring rebate and reward programs. The second scenario is for a non-revolver with $4,000 worth of annual charges, paid in full each month. Here, the benefits of the program may exceed its costs, but consumers should be aware that some rebates do not "kick in" until a minimum number of points are obtained. In virtually every case, the net benefits are small, unlikely to be redeemed in the near future, or both.

The next two scenarios apply to frequent flyer programs, almost all of which charge annual fees. For the typical revolver, these cards are a poor deal. Assuming an annual charge volume of $2,750, it will take nearly a decade to earn a "free" ticket with most of these cards. In the meantime, consumers will be paying an annual fee and potentially a higher interest rate for the privilege of acquiring mileage bonuses. In the worst cases cited, consumers would double their annual interest payments, from about $200 to $400. The airline ticket could end up costing several thousand dollars.

The final scenario described in the BHA guide involves a revolver who has an annual charge volume of $25,000 and carries a monthly balance of $12,000. Again, the extra interest costs of the frequent flyer card versus a no-frills, low-interest credit card are substantial, amounting to an additional $1000 or more. The 25,000 frequent flyer

miles earned will likely be worth far less than the additional $1000 in interest charges.

The basic thrust of BHA's publication is to emphasize that rebate and frequent flyer cards make sense only for those cardholders who are high spenders and carry no balance. BHA does a good job of explaining the costs of various programs, but it does virtually nothing in terms of comparing these costs to any benefits. This comparison is particularly important in the case of frequent flyer programs in which the annual fees may be substantial and the benefits may be highly restricted or long-term. Yet, the BHA publication and other consumer education materials suggest that "non-revolvers" don't face any risk in choosing a credit card. They are getting something for nothing, so why worry? In fact, even non-revolvers face problems unless they recognize the consumer education concepts of opportunity costs and present value.

Opportunity Costs and Present Value

Most consumers who pay off their credit card balance each month think they are getting something for nothing if their credit card provides a reward or rebate without charging an annual fee. Truly savvy consumers know, however, that they need to go one step farther. They need to select among the various no-fee cards in a way that minimizes the opportunity costs of the credit cards foregone and maximizes the present value of any discounts on purchases, cash rebates, or other rewards.

Consider the following example. A person holds a credit card that earns frequent flyer mileage at the rate of one mile per dollar charged. There is an annual fee of $60 for the card, payable at the beginning of each year, and the consumer can expect to charge $15,000 worth of goods and services per year. In two years, the consumer will have earned 30,000 miles, enough for a round-trip airplane flight anywhere within the continental United States. At the end of 25 months, the consumer will have paid $180 fees for a flight that would have cost, say, $400 if the consumer had planned ahead, purchased a non-refundable ticket, and stayed at the final destination over a Saturday night. Clearly, the card was a good deal, right?

Now add the concept of opportunity costs. Suppose that instead of using the credit card earning frequent flyer miles, the consumer had used a no-fee card returning 1% on all purchases. Over the two year period, the rebate would have amounted to $300. So the airline flight actually cost $180 in fees ***plus*** $300 in foregone savings. Now the flight that might have been purchased for $400 in cash costs $480 with the credit card benefits. Of course, purchasing the airline ticket with cash might have actually cost a bit more, say $500 or even $600, but then also consider that there are blackout periods on the use of frequent flyer miles, and seats are not always available even when blackouts are not in effect.

There is another potential pitfall in considering the value of a credit card benefit program—its present value. Some of the most popular co-branded credit cards allow consumers to earn up to $500 per year in credits toward the purchase of a new General Motors or Ford vehicle. With a 5% rebate, you have to spend $10,000 a year to reach the $500 credit. After seven years, you can earn the maximum award, a $3500 credit. Compare this card with a 1% rebate card. Each year you would be earning $100 in rebates, money which if invested along the way would amount to $1000 in cash at the end of seven years. There is still a substantial gap between $1000 in cash and $3500 in purchase credit, but the $3500 is only worthwhile if you can afford a new car and want one. Otherwise the ***option*** of a $3500 discount is worth substantially less than $3500 in cash.

One can argue with the specific figures used in the above examples. Nevertheless, the basic point remains valid. When calculating the value of credit card reward programs, one must include the potential value of foregone credit cards as well as the present value of future benefits. Only then can one compare the costs and benefits of a credit card incentive program.

Conclusions and Educational Implications

Knowing about opportunity costs and present value will help those consumers who are lucky enough to be able to pay off their credit card balances in full each month or nearly each month. What about those consumers who carry a substantial balance from month to month? Should they forget about co-branded cards and simply look for a card with a low APR and no annual fee? An analysis by Mayer and Zick (1996) found that, with one exception, there is no necessary relationship between the various benefits offered by credit card

programs and the APR and annual fees attached to them. The analysis found that across the 154 programs described in the Federal Reserve guide, there was no correlation between either APR or annual fees and the availability of benefits such as rebates, extended warranties, travel accident insurance, auto rental insurance, and credit card registration. The one exception was travel discounts; one does tend to pay a higher APR, higher annual fee or both for the right to earn frequent flyer credits. Other than this one benefit, though, the analysis shows that even credit card revolvers should shop on the basis of both credit card costs and benefits and know how to compare benefits across programs.

A variety of activities may be useful in driving home the complexities of choosing among credit cards. *Consumer Reports* offers a worksheet for calculating the value of frequent-flier programs ("Frequent-Flier Miles," 1996), but most people recoil from filling out such forms. One option would be to ask consumers to state a cash amount they would be willing to pay to directly purchase frequent flier credits or other rewards. For example, would people pay $50 in exchange for 5000 frequent flier miles? How about $100 or $200? Why? Alternatively, one could ask for the cash amount a person would be willing to receive in exchange for credit card benefits. Would these amounts be the same as those for purchasing rewards? It is likely that people will accept relatively small amounts of cash for the promise of future discounts or free items, and they will hesitate to pay cash for additional frequent flier miles or other benefits. Either way, the results would indicate that credit card benefits may be less valuable in the minds of consumers than they appear on paper.

An additional activity would involve having participants describe their credit cards—how many they carry, how much they pay in annual fees and interest rates, and what benefits, if any, they think they are earning. Then, have people engage in mock trading of cards to see if a better credit card option exists. People who carry co-branded cards might also discuss the extent to which they have received various benefits. Especially telling would be a comparison of cash rebates with the other rewards offered by co-branded cards.

Consumer education concerning credit cards has traditionally been directed at vulnerable groups, especially young and low-income populations. The new credit card programs offering rebates and rewards represent an opportunity to broaden the scope of credit card education to older and higher-income groups because all consumers face the challenge of minimizing the costs and maximizing the benefits of their credit cards.

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