Stuck in the Middle: Consumers, Transaction Fees and Loyalty Programs

CONSUMERS COUNCIL OF CANADA

Contents

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A Consumer Perspective Report

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Abstract

This study evaluated consumer attitudes towards the relationship between payment choices and loyalty programs. The impetus for this study was submissions from both sides of the Competition Tribunal case regarding alleged anti-competitive practices by credit card companies. All participants in that case argued that their position was in the best interest of consumers. The goal of this research was to ask consumers how they make payment decisions, how they value loyalty programs, and in focus groups, once the interrelationship was explained, whether any of the common alternatives considered by policymakers would likely change their payment and loyalty choices. The research also aimed to discuss where consumer interests lie in the public policy debate. Loyalty rewards evoked strong feelings among the consumers studied, who showed little faith that lower transaction fees charged to retailers would result in lower retail prices.

Keywords: payments system, interchange fees, credit card networks, loyalty programs, Competition Tribunal, two-sided markets, Visa, MasterCard, merchant discount rate, rewards.

I

Executive Summary

Will informed consumers make different payment choices?

Background

The roots for this research report trace back to the Competition Tribunal's ruling in the case brought against Visa and MasterCard relating to alleged anti-competitive practices of the credit card companies.

The outcome of that process was the Competition Tribunal indicating that while some of the practices may have violated the spirit of competition law, changes would have to come as a matter of public policy. Public policy changes typically involve public input, and the Consumers Council of Canada strongly wished to be able to make an informed contribution to that debate.

Also notable was the certainty with which each side of the case – the Competition Bureau versus the credit card companies as well as other parts of the payments industry – all insisted that their positions were necessary to better protect consumers. The Bureau argued that certain credit card practices meant rising transaction costs would result in higher prices for all customers. The card companies and banks emphasized the importance of consumers knowing that their card would be accepted anywhere there was signage, and that the rewards that accrued through loyalty programs certainly benefit consumers.

No well-rounded research that collected the views of typical consumers was offered by business groups or policy-makers to the public discussion of the issue area.

Methodology

The Consumers Council of Canada sought through this research a nuanced understanding of the associated consumer perspectives.

In four focus group sessions, consumers were asked how they make payment decisions and how they collect loyalty rewards. Then how the two are connected was explained to them – and they were asked about their choices. They also were asked whether any of the common alternatives discussed by policymakers would likely change their payment and loyalty decisions.

To prepare a balanced presentation of the issues to the focus groups a review had been conducted of public testimony to the Competition Tribunal and from 2014 Senate hearings on a Bill to restrict interchange fees. That testimony referenced many other interesting research studies. Representatives from Canada's largest banks, loyalty program operators, credit card companies and merchant associations were interviewed for additional information.

Behavioural scientist Kyle Murray (University of Alberta) was retained to help ensure the focus group sessions conducted for the research would fairly measure consumer attitudes.

Summary Conclusions

Consumers in the focus groups showed little understanding of the payments system and the loyalty system. When informed about how credit card payments, merchant transaction costs and loyalty rewards are related, consumer attitudes about their payment or loyalty choices were largely unchanged. Participants expressed a strong preference for the current situation over any of the commonly discussed alternatives. This preference was based on a skepticism that any reduction in costs to merchants would result in lowered prices to consumers.

A substantial portion of participants viewed discounts for cash payments positively. However, the amount of the discounts that most participants identified as sufficient to change their payment choice was higher than typical credit card transaction fees, and likely unacceptable to merchants. Surcharging for premium card payments and allowing merchants to reject certain cards were both viewed extremely negatively by participants.

Should measures take effect to reduce the funding to loyalty programs, most participants indicated their payment choices would not likely change, as most viewed loyalty rewards as "something for nothing", a reward earned for a spending and payment choice they would have made without the reward.

From a public policy perspective, this is problematic. The rewards of a credit card purchase are much more visible (points!) than the costs. But credit card transaction fees are both a cost to merchants, and the source of much of the funding for loyalty programs, so a substantial portion of the rewards consumers receive originate in their own pockets. As long as the systems are constructed so that consumers are seduced by their own money, there is little incentive for consumers to improve their knowledge, or change their payment choices.

Recommendations

The report concludes with a number of recommendations, the most important of which involve improving consumer understanding of their loyalty programs. A better understanding of how those rewards are accumulated, the risks they are accepting, the different roles of credit card issuers, networks and the costs borne by merchants would be a logical first step to any effective change. The report also identifies a number of areas for further study, based on the findings of the focus group discussions.

The report also recommends that consumer groups need the capacity to participate in any public policy discussion that may result from these issues. Consumers deserve the right to speak for themselves, rather than having vested interests attempt to speak for them.

II
Introduction
Adding the voice of Canadian consumers to the public policy debate about payments.

The Importance of This Research to Consumers

It is only a modest exaggeration to say that every Canadian has a credit card and every Canadian collects rewards for using those credit cards.

But the rise in both credit card use and the popularity of loyalty rewards produced upward pressure on transaction costs. Merchant concerns about those rising costs moved into political action. Canada's Competition Tribunal deflected a three-year case back to the government, saying changes needed to come from new public policy, not the Competition Act.

In the Competition Tribunal hearings, and in hearings related to a Senate bill that proposed dramatic reductions in the costs of payment processing, all participants – merchant groups, individual retailers, banks, credit card companies, loyalty program officials – represented that their position best served consumer interests. If transaction costs were dramatically reduced, lower prices would result, benefiting all consumers. If transaction costs were allowed to remain at current rates, consumers would continue to enjoy the rewards that drive satisfaction and create merchant loyalty. Examples from all over the world were cited and debated.

Yet, the consumer voice – to the extent it was present at all – was almost entirely second hand, derived from foreign experience, or surveys that showed how consumers viewed one segment of the payments system, but not its entirety.[1]

This research is designed to offer a Canadian consumer perspective to the public policy debate. Public policy discussions require public input. Information asymmetry is important. Banks, merchants, credit card companies all have more complete knowledge bases. Consumer groups need to have an improved knowledge base to make a meaningful contribution to the discussion, one that fairly represents the interests of consumers.

Research Questions

During the Competition Tribunal hearings, a number of merchants testified that consumer awareness of transaction costs was low. Consumers did not understand how much it cost a merchant to accept a premium credit card, and if they did understand, they might make different payment choices.

That is the thrust of this research, to learn how consumers make their payment choices and how they make their loyalty reward choices. It was necessary to explain to them – as simply and clearly as possible – how it all works and how merchant costs are connected to their loyalty programs. Following the explanation, the research sought to determine whether that transparency changed their attitudes.

Through the public policy debate, four alternatives have been discussed. Those alternatives were presented to the consumers – after they obtained an improved understanding of how things work – and their attitudes to each alternative were evaluated to determine:

- How do they view some of the point of sale disclosure initiatives contemplated?
- What do they think about discounting for cash payments, and what levels of discounts might change their choices at different price points?
- How would they react to surcharges for certain cards, or if a particular card was declined by a merchant?
- How would they view a cap on interchange fees that might simultaneously reduce prices for all consumers, but also reduce the value of their rewards? How do they weigh merchant transaction costs which may affect prices to everyone against their own personal rewards? Do they believe merchant cost reductions would result in lower prices?
- Which approach is most likely to effect change in their payment choices or loyalty choices?

The structure of this report follows this general order. It covers first the views expressed by merchants, then the counterpoint views expressed by credit card companies. It includes a summary of loyalty programs, as well as a discussion of how the growth of loyalty programs contributed to the merchant vs. payment system tension. The largest segment of the report consists of the results of the focus group sessions.

The focus group discussion leads to its own set of conclusions. Those conclusions are followed by additional conclusions related to identifying where the greater consumer interest lies in these discussions.[2]

III

The Report

The collected viewpoints of merchants, credit card companies, issuers, loyalty programs - and consumers.

Research Methodology Overview

Although the key research question involved "asking consumers" about their attitudes, accomplishing the research involved a great deal more than that.

The project began with the Competition Tribunal case, so the research began there as well. Every single submission to the tribunal was reviewed. That testimony pointed to a number of relevant pieces of third-party research, which were also reviewed. Those papers often drew on other research papers, which were reviewed. The 2014 Senate hearings proved another source of relevant information. Those hearings also pointed to newer, relevant research, which was also reviewed.

Public information about loyalty and rewards provided by a number of leading Canadian providers, including Colloquy, Aimia and Maritz/Bond was reviewed. Kyle Murray (University of Alberta), retained as a behavioural scientist to assist with this project, provided a number of other research papers related to loyalty programs.

The second phase of research included a series of interviews with key market participants. Interviews were sought with all of Canada's major banks, retailer organizations, loyalty programs, as well as both Visa and MasterCard. Success was limited; many targets declined (or perhaps ignored) these requests. Still, complete interviews were completed with a number of these participants, including at least one representative from each of those areas. Some participated only with the understanding that information provided would not be specifically attributed to them or their firm.[3] The Council's researchers also (informally) interviewed selected neighbourhood merchants for more casual input.

That research served two objectives. It improved the understanding of the issues to determine where consumer interests lie, and it will allow the Consumers Council of Canada to better participate in any resulting public policy debate. It also allowed for more accurate and realistic scenarios to be used in the focus groups conducted as part of the research.

The focus group script was developed over multiple iterations, working with Kyle Murray to make sure the questions, the language used to frame those questions and the background information presented to improve the understanding of participants was not significantly biased. The moderators selected for the sessions in Toronto and Montreal also made recommendations, based on their experiences to improve the flow of the sessions and how to integrate the explanations with the open questions and the written exercises.

There are limitations to focus groups. The opinions expressed are drawn from a sample of participants in a single community. Some participants may be influenced by the opinions of others. Opinions and attitudes expressed may not correspond with actual behaviour. Prior to, during and after the focus groups, participants were asked to provide written answers to questions. In some respects, surveys instead of focus groups may have provided more information. However, the topics covered required a significant amount of explanation and the opportunity for participants to ask questions until they understood the information presented.

Some focus group exercises asked consumers to choose between alternatives. Consumers do not always behave in ways one would expect when given choices, particularly as it relates to delayed rewards common in loyalty programs.

While preparations for the focus group sessions were underway, the two largest credit card networks announced reductions to interchange fees (November 2014, effective April 2015.) This action was taken after considerable pressure from the federal government, with the spectre of more severe Australian- or European-style cost caps looming as threats. Aside from possibly increasing participant awareness in the issue, this announcement did not change the project. All parties agree that the Visa and MasterCard proposals may be temporary and that public policy discussions could re-open.

What Merchants Say

Representatives of nine different merchants testified at the Competition Tribunal.[4] Diane Brisebois, president and chief executive officer of the Retail Council of Canada, and Dan Kelly, president and chief executive officer of the Canadian Federation of Independent Business, testified at the Senate committee hearings June 19, 2014.[5] While not every participant agreed on every single point, a number of themes emerged through their collective testimony.

Here are the main points expressed.

The costs of accepting credit card payments rose dramatically. Some offered details about the scope of the cost increases, while others instead compared the costs of card acceptance to other costs of their business. Many of the merchants tied the rising costs to the introduction and popularity of premium cards from 2006 to 2009. Use of premium cards has exceeded what they were initially told to expect, as issuers granted "premium" cards to many customers who had previously not been entitled to them. Furthermore, the growth of the rewards from premium cards encouraged consumers to change payment choices from lower-cost options cash and debit to higher-cost credit. In Senate testimony,[6] the Finance Department suggested that 10 per cent of cardholders have premium cards, representing 35 per cent of the spend in the Canadian marketplace.

The lack of transparency was problematic. Merchants emphasized that they did not know in advance the costs associated with different cards. Coupled with the variety of new cards, this made the card acceptance costs unpredictable, as well as higher. The 2010 adoption of the Code of Conduct reduced these kinds of complaints by improving transparency, but Brisebois said that one merchant told her the key difference of the code is "the difference between getting beaten and being told that tomorrow you're going to get beaten."[7]

The inability to discriminate meant that these (higher) costs have to be shared by all customers. Both Brisebois and Symons use the phrase "Reverse Robin Hood" to describe the scenario in which value is transferred from lower-wealth consumers (who are more likely to pay by cash or debit, and less likely to be entitled to a premium credit card) to higher-wealth consumers.

> "Rising Interchange Fees and the introduction and increased use of premium credit cards have resulted in a "Reverse Robin Hood effect", where higher income earners have credit

> cards with more rewards and benefits. Meanwhile, people who do not have sufficient income to receive approval for those credit cards pay with standard credit cards, cash or Interac debit. As a consequence, it is only those individuals with higher incomes that receive the benefits associated with premium credit cards and such benefits are subsidized by the higher prices paid by all customers, including those who pay with cash and Interac debit." (Symons, Par 45)

Restauranteur Michael Broughton made much the same point: "Today all consumers end up paying higher prices as a result of the costs associated with premium credit cards, regardless of whether or not they receive any of the benefits associated with such cards." (Broughton, par 23)

Consumers aren't aware of this at all. Both Kelly and Brisebois emphasized this in their testimony. "The average consumer has no idea that when they put the credit card into the terminal, that in fact the merchant is losing 2 to 3 per cent of the sale," [8] said Kelly, adding that consumers assume that their annual fees and interest charges finance the credit card industry. Brisebois noted: "One of the big problems in Canada is not that consumers are in the dark about what it costs them to use their credit cards, but rather that they do not realize what it costs us, the retailers and small merchants."[9]

The implication of this is that if consumers were aware, their payment choice could change. "If customers are aware of the real cost of using their credit cards, they can make an informed decision as to whether the additional cost of the transaction is worth the benefits they receive for using their credit card." (Broughton par 25) To further this, Kelly testified about his organization's efforts to lobby to have transaction costs included on receipts, to provide material at the point of sale to encourage customers to pay by cash or debit on Fridays. "If (consumers) knew that by using their premium card they were costing that merchant even more, they might pull out their regular credit card they might have in their wallet or, even better, pay with cash or Interac debit."[10]

Points are a substantial part of the issue. Some merchants referred to the growing emphasis on points and rewards as driving the boost in premium cards. Kelly indicated[11] that increased loyalty programs are often used as an excuse by issuers to introduce new tiers of cards with higher fees. He compared Visa Infinite to CIBC Aerogold Visa. Merchants pay 20 per cent more to process the former, while the consumer gets "almost identical benefits – a few little extra bells and whistles." He said there was no conceptual opposition to rewards, but "Consumers are led to believe the rewards are free, when ultimately merchants and other consumers are paying for them. What I think is incredibly unfair is that the credit card companies and banks give the rewards, but pass the bills to someone else."[12]

Discounts for cash payment would be difficult. Because the merchants operate in competitive markets, many stressed the importance of advertising the lowest possible price. For that reason, many merchants said it would be counterproductive to increase prices to offer discounts for cash payment. "Advertising higher fares is not an option for Air Canada given the markets in which it operates and the price sensitivity for customers for air travel services." (Houle, par 63). Many merchants (WestJet's Li, Best Buy's Shirley, Ikea's Symons) made similar points – that prices would have to first increase to all to allow for effective cash discounts. Further, discounts are viewed as an "opportunity cost", easily ignored by consumers, while surcharging is a tangible cost.

Surcharging would be more effective in changing consumer payment choices. The ability to pass along transaction costs to users of premium cards was supported by many merchants. Sobey's representatives noted that consumer uptake of bringing their own bags for groceries only jumped when a 5-cent surcharge was added for the use of plastic bags. IKEA's Symons noted his firm's experiences with surcharging in the United Kingdom: IKEA surcharges reduced the volume of credit card transactions (many customers switched to debit and cash) and the costs of those transactions (Visa and MasterCard reduced fees). When surcharges were discontinued because of difficulties with point of sale technology, the number of transactions using credit cards increased, and debit cards decreased.[13]

Merchants don't see any benefit to premium cards. Representatives from Best Buy, Sobey's, IKEA and WestJet all testified that their firms received no sales boost because of premium cards. "In the absence of 'premium' cards, I believe that WestJet's customers would spend just as much at WestJet as they do today." (Li) "I am not aware of any jurisdiction where increasing the rewards or other benefits to cardholders has caused cardholders to purchase more furnishings from the IKEA Group." (Symons)

Canadian costs are much higher than other countries. This point was made more emphatically by Brisebois and Kelly than the merchants. "We have among the lowest costs in the world for accepting debit card transactions because of the creation of Interac, and we have among the highest fees in the world for accepting credit cards."[14] (Kelly)

The card networks compete with each other, but really only compete to get bank business. Wal-Mart's De Armas testified that while Visa and MasterCard argue that they are merely intermediaries between banks and merchants, they compete for bank business by offering additional revenue. "This revenue comes from merchants through the payment of interchange fees, which are set by Visa and MasterCard. So as Visa and MasterCard compete for more issuing banks and more products by offering increased interchange fees to Issuers, the burden on merchants from higher Card Acceptance Fees continues to increase." (de Armas, Par 44). "Because neither cardholders nor issuers bear the costs of their payment choices, they have no incentive to use or promote lower cost payment methods." (de Armas, Par 35). Kelly said: "My big 'aha' moment was recognizing that competition for the card brands is not competition for consumers; it's competition for the banks. Banks will choose the cards that make them the most successful."[15]

At the October 9 Senate hearings, a number of merchant group representatives directly addressed the high costs and lack of alternatives. “When it comes to transaction fees, there is no less expensive alternative. The only other options are more expensive. This is not a proper free market system. It is a bidding war of ever-increasing fees. On the left, you have a high rate, and on the right, you have a high rate. Which one to choose? Our problem is the fact that we have no negotiating power with the banks,” said Pierre-Alexandre Blouin, Vice President, Public Affairs, Association des détaillants en alimentation du Québec.[16] Gary Sands, vice-president of public policy for the Canadian Federation of Independent Grocers noted that a member store has equal sales from credit and debit, but the retailer pays $210,000 a year in credit card fees, and $6,000 for debit. “But the customers are buying the same products, shopping in the same store and receiving the same service. This is indefensible. The gap must be closed.”[17]

Lower costs would be shared with consumers through lower prices. The RCC pointed to a study done by Robert J. Shapiro in the United States discussing the effects of a decision to lower debit fees. That study found that about 69 per cent of the first-year savings were passed along to consumers in lower prices. (Shapiro, p 27). It also referenced its own initial reports that tariff reductions in the 2013 federal budget on hockey equipment and baby supplies had resulted in lower retail prices.[18] Kelly testified that the savings to consumers would not be “dollar-for-dollar”, and that some would “rest with the merchant…. I think the federal government is quite attentive to the fact and is not looking to have a win for merchants and zero win for consumers.” Brisebois added that lower costs to merchants could produce other benefits, such as greater employment in the community, or the ability to expand and remodel stores.

There could be unanticipated consequences for a dramatic interchange fee cut. This point was not raised by merchants, who testified primarily about the impact of transaction fees on their business. In his Senate testimony and an interview conducted as part of this research, Kelly noted that if interchange fee reductions cut revenues to banks and other issuers, banks would act to find that revenue elsewhere. He noted that caps on Australian exchange rates resulted in 24 per cent fee increases for small businesses over the next three years. “Banks aren’t going to just say ‘oh well’. I feel fairly strongly that’s just not going to happen,” said Kelly in an interview.

What the Payments Industry Says

As with the merchant testimony, no summary is going to capture every single point made by every single participant in the Competition Tribunal and Senate proceedings. Here are some of the major arguments[19] presented.

If the benefits to merchants didn't exceed the costs, merchants would not accept credit cards. Some form of this argument was made by virtually every participant. Some elaborated by enumerating the many benefits of credit card transactions to merchants. Consumers tend to buy more when they buy on credit, using money they do not have in their bank account, and the credit risks are not carried by the merchant. Merchants are paid quickly by acquirers and enjoy improved access to international customers, including on-line access. Merchants receive protection from fraud and theft associated with other forms of payment. Faster, more efficient transactions can reduce line waits and staff costs. There are record-keeping advantages and automatic currency conversions. Credit transactions can increase credit card rewards, making it easier for consumers to purchase than if they made a purchase with cash.[20]

> "..if the Application were correct that accepting credit cards raises consumer prices with no commensurate benefit to the merchant, few merchants would elect to accept credit cards and instead would offer their products and services at lower prices and thereby win business from card accepting merchants."[21]

The card companies noted that many merchants once had proprietary credit facilities, but switched to larger firms because the cost was lower than the cost of operating their own credit purchase system. Grocery and fast food merchants have only recently started to accept credit cards on the basis that it makes sense to do so.

Some of the merchants' issues have been addressed by the Code of Conduct. Merchants now have 90 days notice about fee changes and can see cost/card-type breakdowns, agreements use plain language and provide penalty-free cancellation.

The payment market is very competitive. Many merchants complained that Visa and MasterCard dominated the market, with little meaningful competition between them. Credit company representatives argued that they compete with many payment alternatives – cash and debit, but also cheques, Paypal, money orders, gift cards and other methods.

Alternatives have costs. Cash and cheques require personnel, counting and accounting, plus security costs, related to their handling and transportation, and counterfeiting and theft losses. "Other forms of payment are not necessarily lower cost forms when the benefits of accepting Visa cards (increased sales, the ability to extend immediate credit for a purchase, guarantee of payment) are taken into account."[22] MasterCard's closing submission went further, stating "when you take into account bad debt losses, there is no cross-subsidy (from cash and debit customers to credit customers) at all."[23]

Credit card companies don't determine how much merchants pay – acquirers do. In Senate testimony, both MasterCard and Visa noted how little interchange fees had changed: No change for MasterCard since 2009; a 4-per-cent rise on average over six years from Visa.[24] If merchant fees are rising, it is because of greater use of premium cards (an Issuer policy), greater use of "card-not-present" transactions (which have higher fees) and greater acquirer costs reflecting the introduction of new technologies (chip cards, tap cards).

The costs of credit card transactions are just one example of costs that vary by customer. Some customers require a lot of sales assistance, while others proceed directly to self checkout. Some require free shipping. Some require parking. Not every hotel guest uses Wi-Fi or the complimentary breakfast. Not every IKEA shopper has a child that uses the ball pit. In that context, most of the credit card representatives questioned why there was so much focus on one particular expense for merchants.

In addition, credit card transactions have benefits – swifter checkout, shorter lines, more efficient record-keeping – that apply to all customers, no matter how they pay.

Canada's costs may be higher than most, but that's due to interchange restrictions in other jurisdictions. Canada's costs are similar to those in the United States, which also does not restrict interchange fees. In return, Canada – and the United States – enjoy a number of advantages. Markets with capped interchange are not as developed or sophisticated. "Canada has the most sophisticated electronic network in the world. We're behind the United States in e-commerce, maybe, but it's far more developed than any other market. We all reap the benefits of that – there's better fraud protection, better card security and other benefits. The fees are higher, but the benefits are still apparent."[25]

Point of sale transparency may be helpful, but there are concerns. Some testimony focused on the practical concerns. Under current technology, merchants do not have the ability to put the transaction cost on the receipt because those costs are not actually known at the time of the transaction. Others made a philosophical objection, noting that merchants can disclose any of their other costs – taxes, heating, labour – but choose not to.

Allowing merchants to surcharge or deny certain cards would create numerous problems. Many testified to the Australian experience, where excess surcharging became frequent enough that limits were required. As a result, surcharging was commonly viewed as a simple transfer from consumers to merchants. Beyond that, there was testimony about other concerns. Many consumers already pay an annual fee for premium cards and will react more negatively to additional surcharges, or occasions where their card is outright denied. This reduction in use will make credit card companies less likely to reduce rates, not more likely.

> "After a decade of surcharging being allowed in Australia, Visa and MasterCard's interchange rates are at the regulated maximum. They could not be higher – because the regulation prohibits it. They could be lower, if surcharging were effective to lower interchange rates, but they are not lower. There is no evidence that surcharging, even when undertaken for one or two decades, lowers interchange. Indeed the evidence is expressly to the contrary."[26]

Merchants may not surcharge "responsibly". Numerous respondents brought up Australia again, noting that some merchants surcharged well above the actual costs. Some respondents brought up the United Kingdom.[27] Industries such as travel and hospitality, where purchases are more commonly made online, were the most notable offenders. Others noted that some merchants would choose to surcharge all cards, using a blended rate, which is not a signal to switch to lower-cost cards, but to switch from cards altogether.

Required limits to interchange fees will create an imbalance. The credit card companies noted that they derive their revenues from transactions. Their goal is to set the interchange fee (which they do not collect) to maximize card use, which maximizes use of their networks. There was considerable effort made to describe the system as "two-sided", akin to a newspaper which depends on a subscriber base for revenue or readership, and advertising base that is willing to pay to reach those readers. "If interchange rates are set too high, merchants will stop accepting cards. If interchange rates are set too low, issuers will be under-compensated for the value they deliver to their cardholders, and the features that attract cardholders will be diminished."[28] Visa's Brian Weiner noted that it is also in Visa's interests for fees to be lower, to the extent that those lower fees would encourage increased merchant acceptance and more transactions on its network.[29]

Multiple participants made the point that issuers' response to interchange reductions would harm consumers. "If interchange were regulated and artificially lowered, then the banks would have to make up that compensation either by cutting off credit to people on the margin or raising the fees or curtailing product benefits that consumers enjoy today," Don Lebeuf, MasterCard head of customer delivery told the Senate hearing October 1.[30]

Discounting would actually be very effective, more effective than merchants argue. Numerous card representatives disagreed with merchant positions that discounts would not be effective. In its closing, MasterCard noted that Canadian Tire money was an "iconic Canadian example of widespread, full-fledged cash discounting. It is just silly to say Merchants can't discount. They may not want to, but they sure can."[31] Others objected to merchant testimony that suggested retailers would need to increase prices to provide cash discounts. "Merchants already build the cost of acceptance into the prices they charge consumers. There is no justifiable reason why merchants would have to raise prices merely to discount off those same prices."[32] MasterCard's closing also pointed out Shoppers Drug Mart (one of the merchants to testify) has an Optimum program that provides discounts to its members. "You get more points for using your credit card and your Optimum card than if you use cash. Shoppers Drug Mart could set it up the other way to give more points for cash or debit if they wanted to."[33]

(There were other instances of card companies poking merchant testimony, noting that Sobey's, Wal-Mart and WestJet all had co-branded credit cards, lowering their costs of participating in particular networks, and that WestJet does not accept cash on in-flight purchases.)

The evidence that merchants will lower prices as result of cost reductions is underwhelming. Some went so far as to suggest that there was no such evidence, with many references to Australia's experience.[34] Others noted that there may be cost reductions but that offsetting changes – higher annual fees, increased bank fees, reduced rewards, etc. – would leave consumers no better off. There were also references to the lack of changes in consumer prices in the United States since debit interchange regulation was enacted in late 2011.

Loyalty Programs

History

Before Air Miles and Petro-points, there was Club Z. Before Club Z, there was Canadian Tire Money and before that, there were green stamps. Loyalty programs – marketing programs designed to build loyalty by providing incentives to profitable customers[35] – have been part of business since the earliest merchants sought repeat business from the earliest customers.

Loyalty programs can include a variety of concepts: Buy nine and the 10th one is free, peel and win, scratch and save, roll up the rim to win. All tools to offer incentives to customers. Today's loyalty programs are much more sophisticated than that. Retailers still operate their own loyalty programs – Shoppers Optimum, Petro-Points, The Scene, are all popular programs today. Purchases at a retailer accumulate rewards that can be redeemed at the retailer, and are not much different in concept than Canadian Tire money or Club Z points.

But the largest programs in Canada are generally known as "coalition" programs. Air Miles and Aeroplan are the two largest loyalty programs in Canada, and their operators LoyaltyOne (Air Miles) and Aimia (Aeroplan) also run loyalty programs in other countries. The "Air" and "Aero" elements of the program names are important clues about how modern loyalty programs grew.

In 1981, American Airlines introduced its Frequent Flier Program. The goal was to improve brand loyalty for a relatively homogenous industry (a flight is a flight) by rewarding them for frequent use. More flown miles led to free tickets and upgrades. Other airlines followed quickly, and other industries also followed. Hotel chains and car rentals – adjunct industries to air travel and with similar challenges to create brand preference – introduced their own loyalty programs.

It became logical for these industries to partner up with the frequent flier programs. Rewards/points/miles accumulated at one merchant could be used at another merchant. Air Canada created Aeroplan as its frequent flier program in 1984, and it later became a separate entity. Air Miles was introduced in 1992 with 13 sponsors, including Bank of Montreal, and rapidly expanded to include retailers in many major categories, as well as credit card partners MasterCard and American Express.

By broadening their members, the loyalty providers could target consumers beyond elite travellers. Not everyone could earn enough "miles" to get a free flight to Paris, but the principle – amalgamating purchases at selected merchants and allowing consumers to redeem those accumulated rewards at other vendors – proved popular with regular consumers. Credit card companies and loyalty programs became partners.

The ability to reward consumers for card memberships by providing them with rewards/points/miles ("points" will be used from here on), is an important lever in credit cards' fight for market share among consumers. Card issuers buy points from loyalty programs and give them to customers with every purchase. Purchases from specific retailers can earn more points, but customers can redeem those points at other retailers – not necessarily the one where the points were earned, and the loyalty program finances those rewards.

The growth of interchange fees has allowed issuers to fund greater rewards, and this development caused much of the tension between merchants and card companies that led to the Competition Bureau action. This particular topic is detailed in the section "What Changed".

Today

Facts and Figures – In summary:

- Nine of 10 Canadians are members of a loyalty program.[36]
- Households belong to an average of 8.2 loyalty programs.[37]
- The most popular rewards are vacation flights, followed by groceries and gas.[38]
- Canadians are less interested in joining new programs and more likely to dispense of unused and irrelevant programs.[39]
- 38 per cent of Canadians enrolled in loyalty programs stopped actively participating in at least one loyalty program in 2013. Only four per cent formally request to leave a program; the balance is passive defection.
- The life span of a "mile" is about 30 months. That is, there is a 30-month lag between when Aeroplan travel rewards begin to be accumulated and when they are used.[40]
- On cards where there is no annual fee, rewards typically accumulate at about 1.5 per cent of the spend. On cards where there is a fee, rewards typically accumulate at closer to 2 per cent of the spend.[41]
- Quebec residents are more likely to spend their rewards more quickly.[42]
- Communities that have large numbers of recent immigrants tend to have well-established cultural and service relationships, and don't rely as much on loyalty programs.[43]
- 54 per cent of Canadians would not consider getting a credit card that did not have a good loyalty program attached to it.[44]

Issues – The number of components in the complete loyalty and payments system can complicate relationships. Consumers can accumulate Air Miles by buying gasoline at Shell and paying with the BMO Air Miles World MasterCard. Points can be redeemed at any number of merchants. Where does the consumer loyalty lie? With Shell, BMO, Air Miles, MasterCard or where the points are redeemed? Are the consumers loyal to a brand, or just a program?

Colloquy's Jeff Berry warns that rewards have become commoditized with little differentiation – the opposite of what loyalty programs were created to do. Members use rewards for items they would have purchased anyway (groceries, for example), so the discounts don't represent the value of loyalty membership,[45] and don't drive incremental purchases.[46]

The growing popularity of cashback rewards indicates consumers value cash above other rewards – or perhaps that cash can't be devalued in a way that points can be.

There is no novelty in having a card or a program today. One key word is "engagement" – efforts to get consumers to use programs, because, once they are engaged with a program, they tend to spend more.[47] Vendors use transaction data to deliver more personalized rewards. Consumers are looking for more flexibility and control, more ways to earn points and more ways to exchange them.[48]

Consumer needs continue to change with generations. "The baby boomers and Gen[eration] X-ers were trained under the 'collect and get for merchandise' when they were growing up. A millennial generation expects a lot more of a brand. They expect us to know them better and have a relationship with our brand."[49]

Millenials are more willing to modify how they shop to maximize benefits from loyalty programs, and are significantly more interested in non-monetary benefits from brands.

"Sixty-eight percent of Millenials will change when and where they shop, if it means getting more program benefits. And a third of Millennials even confessed that they've bought something they didn't need or want, in order to earn points or maintain status benefits."[50]

A number of loyalty participants noted that consumers want information from loyalty programs, but don't value the information they currently receive. Aimia calls this "offer anarchy" and notes that, if uncontrolled, it could follow the path of telemarketing in the 1990s and e-mail spam in the 2000s.

Consumer Issues – In its 2013 report *Customer Loyalty Programs: Are Rules Needed?* Public Interest Advocacy Centre identified currency revaluation and expiry of rewards as the most significant consumer irritants in rewards. That report concluded that the policymakers should consider defining loyalty currency as a form of non-cash payment and it should enjoy protections similar to other forms of payment.[51] Canadians do value their rewards, and the accumulated, but unredeemed entitlements can be viewed as a form of "savings". A revaluation of accumulated awards would effectively erode those savings.

Loyalty program providers have the ability to revalue rewards, though representatives noted in interviews that consumer backlash against such moves can be quite severe. Program policies may allow them to cancel points if there is no account activity and place an expiry date on earned points. Some programs allow for the transfer of accumulated rewards from one account to another – for a price – while others forbid it.

The industry uses the term "breakage" to describe rewards that are never redeemed. Breakage rates have declined from about 17 per cent to about 11 per cent, but levels for specific types of rewards can vary more widely.[52] High breakage rates actually provide a short-term boost to loyalty programs. They have received the revenue, but have no corresponding expense at redemption. However, high breakage rates are also an indication that members are not participating in a program, or can't accumulate rewards fast enough to redeem them for something valuable.

More than half of Canadian consumers (55 per cent) reported experiencing frustration when redeeming rewards from loyalty programs. The main reason, according to 49 per cent of respondents, is that the rewards have little to no appeal.[53]

Reduced Interchange Fees – The November 2014 announcement from Visa and MasterCard that they were voluntarily reducing interchange fees, effective April 1, 2015, will likely have a 'knock-on' effect on loyalty programs. These are discussed in the section "The Future".

What Changed

Merchants pinpointed the rise of transaction costs to a period from 2006 to 2009. Some went so far as to specifically attribute the rising costs to issuers offering greater rewards to consumers, through the introduction of premium cards (with higher interchange fees) and then a steady migration of more and more consumers into premium cards.

The testimony of card company and bank representatives provides helpful information on two forces that drove this process. The first is a desire of Visa and MasterCard to capture market share from American Express. American Express typically offers greater rewards to consumers, but also has higher transaction costs. But because it acts as both an issuer and an acquirer, there is no interchange fee.

Visa's Brian Weiner and TD Bank's Chris Hewitt testified that Visa introduced the Infinite Card (a premium card) as a direct response to American Express. "TD structured the Infinite Card to offer a suite of rewards and benefits to Cardholders in order to attract 'high income' and 'high spend' cardholders. TD designed its rewards and benefits to encourage these Cardholders to use their 'premium card' to spend more often and for larger purchases." [54]

MasterCard's Kevin Stanton testified about another motivation that resulted in the introduction of premium cards. He described a sector of consumers labelled "transactors". They spend more frequently, but routinely pay off their balance each month. Their transactions make them valuable to MasterCard's networks, but the absence of interest revenue makes them less attractive to issuers. MasterCard identified a competitive weakness in this segment, and developed "high-spend" and "premium high-spend" products, with higher interchange rates, but "issuers were also required to ensure that Cardholders would receive additional benefits for using these products."

In addition, both card companies expanded the number of interchange fee categories as they targeted industries such as fast food, grocery stores and gas stations. And the card companies did not challenge merchant testimony that the number/portion of premium cardholders soon exceeded initial estimates.

Economics Break

There is something of a 'tug of war' to the debate. Merchants want lower costs, but what would they do with those lower costs? They might pocket the savings, simply adding wealth to owners. They could lower prices to gain competitive advantages, but if costs were lowered to all, how much advantage could be gained? Perhaps they will use it to expand stores, hire more staff, renovate and generate more economic activity in the community.

The higher fees redirect money through issuers and loyalty programs back to consumers. It is certainly not a direct path, and it may not be "dollar-for-dollar." Banks and loyalty programs will take their share along the way. Banks employ in their communities as well, and distribute profits to shareholders. Loyalty programs accumulate rewards which are spent.

This project is not designed to be an economics term paper,[55] but one participant in the discussion did share some useful information with researchers related to premium cards.[56]

Here is the breakdown they provided on a notional $100 billion of spending, with a 1.85 per cent interchange rate (a premium card rate).

$1.85 billion revenue to the issuer
-$0.25 billion kept by the issuer*

=$1.60 billion to loyalty programs*
-$0.345 billion kept by loyalty programs**

=$1.255 billion distributed by loyalty programs to members for travel, retail and entertainment and cashback.

$1.255 billion is spent back in the economy.

*Issuers also receive membership revenue and interest revenue, and incur expenses producing cards, generating statements and running the program. The amount that flows to loyalty programs reflects all of these figures.
**Similarly, loyalty programs also have expenses.

Questions for Consumers

The review of the testimony, supporting research studies and interviews produced a number of conflicting views – points that made for interesting questions for the focus group discussions. To cite a few examples:

Merchants believe that if consumers had a better understanding of the costs of credit card transactions, they might choose alternative payment methods. Do consumers share that view? Would they accept lower rewards if it accompanied lower costs to everyone?

Merchants and credit card representatives have strongly different views about the effectiveness of cash discounts. How do consumers view them?

Would surcharging on credit transactions lead consumers to choose lower cost cards, debit or cash, as merchants suggest, or to general distrust of credit cards?

Would interchange rate cuts, which would lower costs to acquirers, who may lower merchant discount rates, which would reduce costs to merchants, ultimately lead to lower prices to consumers? Merchants suggest it would. Card companies are skeptical.

The Four Alternatives

Through the review of the testimony and auxiliary research, four alternatives to address the merchants' concerns about rising interchange fees have been repeatedly made. These four were selected as the most likely to be implemented, and thus to be presented as alternatives under consideration in the focus groups. Here are brief descriptions of the alternatives.

Point of Sale Cost Transparency

The principle is that consumers could or should be informed of the merchant's costs in processing any transaction. This "information" could come in many different forms, ranging from a line printed on the receipt in which the merchant's costs were disclosed, to more extravagant signage at checkout, information pop-up boxes during online transactions, or even allowing cashiers to ask consumers to choose a different form of payment that would cost them less. Immediately after the Competition Tribunal decision, the Finance Minister indicated that Canadian business owners, entrepreneurs and consumers deserved "fair and transparent rules on the type of payment system they use." This position was emphasized in a subsequent throne speech ("They deserve to know the real cost of paying by debit or credit card.") and in the 2014 federal budget ("the Government will work with stakeholders to promote fair and transparent practices and to help lower credit card acceptance costs for merchants, while encouraging merchants to lower prices to consumers.")[57]

Discounts for Cash or Debit Purchases

This approach has been suggested frequently by credit card networks, and rejected just as frequently by merchants. In the Competition Tribunal testimony, many merchants expressed skepticism, noting that forgone cost savings are treated as opportunity costs, and not taken seriously by consumers. Sobey's representatives noted that discounts for customers who brought their own bags did little to change behaviour, while a 5-cent surcharge on plastic bags in the Toronto area proved a great motivator. Card companies noted that merchants' original loyalty programs – Canadian Tire money for example – essentially offered consumers discounts on future purchases for cash payment.

Surcharging Premium Cards or Denying Certain Cards

Two rules of Visa and MasterCard restrict surcharges and rejecting specific cards, and the Competition Bureau attempted to get these rules struck down as anti-competitive.

Merchants testified that giving them the ability to surcharge certain high-cost premium cards would encourage some consumers to choose lower-cost options. Not accepting those high-cost premium cards would have a similar effect. Card companies strenuously object to this approach, underlining the importance of consumers being able to know that if a merchant posts a credit card sign in its storefront, it accepts all of that company's cards, not just selected ones, and that no extra charges result.

Capped Interchange Fees

This approach has been implemented in different forms in different countries. Visa and MasterCard's November 2014 announcement of voluntary reductions loosely falls into this category, though many merchants sought more dramatic reductions. Merchant organizations point out that payment systems operate just fine in Australia, where fees are capped. Credit card companies note that it's difficult to predict all the possible effects. But lower interchange fees definitely result in lower revenues to issuers. That could result in many other consequences as issuers attempt to recoup these amounts – higher annual membership fees, lower loyalty rewards, fewer services, and higher transaction costs and fees for other services – which could result in other knock-on effects.

The Focus Group Sessions

A fundamental premise of the merchants' position in the Competition Tribunal case was that if consumers better understood how the payments system worked, and how credit card transaction fees increased the costs to merchants on all goods, their payment choices would change.

That formed the basis of the focus group sessions for this research. It was necessary to explain how the system worked, presenting the views of the different participants as fairly as possible, and to evaluate consumer attitudes. To see if attitudes changed, information had to be gathered about consumers' spending habits and payment decisions before any explanation of how things worked. Because loyalty rewards were such an important factor in the escalation of merchant transaction costs, it was necessary to learn how consumers valued those programs.

As outlined earlier in the report, the most important questions involved (1) how consumers weighed personal benefits from point program participation against the benefits that might be transferred to all consumers and merchants should transaction fees be lowered; and (2) which of the alternatives being considered to address this issue would be most likely to alter consumer behaviour?

Session Information

The services of Research House were retained to host four two-hour sessions, two in Montreal (December 1, 2014) and two in Toronto (December 3). One of the Montreal sessions was conducted in French. Participants were screened to ensure they all used credit cards and were members of at least one loyalty program. Small business owners, employees in the payment and loyalty/rewards industry were excluded. The number of "retail" employees in each session was limited. Each session had nine or 10 participants. Consumers Council of Canada researchers viewed each session.

The narrative for each session was created by the research team with the assistance of Kyle Murray (University of Alberta), a behavioural scientist with extensive experience with research on consumer attitudes, cognition and behaviour.[58]

The group moderators made many suggestions to improve the flow, clarity and engagement. The expertise of the Montreal moderator was relied upon to ensure that the French-language session was equivalent to the English session.

The explanations of how the payment system works, how loyalty programs work and how the two are related needed to be accurate enough to fairly represent the position of all payment system participants, but not so detailed as to bewilder focus group participants. It was considered essential to not ask questions about the "cost" of something without also discussing some of the "benefits" associated with that cost.

Each session included discussion about the four alternatives under consideration. The order of these alternatives was randomized among the sessions to reduce any bias that might result from specific ordering. Written exercises were used before, during and after the session to collect individual views.

Limitations

The research team was mindful of some of the limitations of focus groups. Attitudes expressed may not match actual behaviour. Dominant participants can sometimes steer participants towards certain views. The results capture the views of a small sample of the population in a specific location at a specific time.

Key Findings

Here are the most important findings from the focus groups. These are followed by more detailed discussions about the main topic areas.[59]

Understanding about payment system is low.

Very few participants expressed much of an understanding of how the payment system worked. Many were surprised to learn that merchants have to pay any costs to process a credit card transaction. There is a general misunderstanding about the role of credit card companies and issuers. They primarily identify the cards they use with the credit card network, and not the issuer. As a result, they assume that credit card companies get a much larger share of transaction fees than they actually do.

Understanding about loyalty programs is also low.

There is a universal understanding that spending generates rewards and that more spending generates additional rewards. There was very little understanding of how loyalty rewards are funded, and how they may be connected to credit card fees. Participants overestimated how fast their rewards accumulate, and also frequently complained that rewards were not accumulating fast enough. Yet, loyalty program membership was the second strongest factor in deciding what credit card to use (behind only "what my bank had available").

Payment transparency does little to change consumer attitudes.

When the basics of how credit card fees affect merchant costs were revealed, participants showed very little sympathy for merchant positions. There was some sympathy for smaller, local merchants and some newfound appreciation of why some smaller merchants did not accept credit card payments. Almost universally, participants doubted that if transaction costs to merchants were reduced, that prices to consumers would be lowered as a result. Some of the views expressed would be best characterized as extremely cynical.

Of the four alternatives, discounting for cash was the only one viewed favourably.

While merchants doubt the practicality of cash discounts, they may also be discouraged by the levels of discounts participants would expect to change their payment choices. At three (somewhat arbitrary) price points of $20, $75 and $200, consumers generally indicated that discounts of approximately 10 per cent would be required to change their payment choices. This dramatically exceeds the merchant costs of credit card transactions. There was a much smaller segment that indicated they would pay cash instead of credit on lower price items for a 2 per cent discount. At higher price levels ($1,000), participants suggested cash discounts would have almost no effect, because they were wary of carrying large amounts of cash – and as one participant noted, many retailers won't accept $100 bills anyway.

Card surcharging and rejection were widely disliked.

Consumer reaction was almost universally negative to these concepts. There was a split on how they might behave the first time it was encountered. About half said they could switch payment methods or cards, but about half said they would leave the merchant. There was some agreement that people might accept this over time, but also that merchants who did not surcharge would gain favour with participants.

Point of Sale Transparency was viewed either neutrally or negatively.

The sessions included a few different implementations – signage at the storefront, information printed on the receipt, and an outright request by a cashier that a consumer choose a lower cost form of payment. Participant reaction to the signage and the receipt information was somewhat neutral – it wouldn't be effective and could easily be ignored. The specific request was viewed as likely to be successful, but also viewed as unwanted pressure.

Merchant cost reductions that reduced prices and rewards would be disliked, but would not change behaviour.

An exercise was included in which interchange fees were reduced, merchants reacted by lowering prices and consumers received lowered rewards. Generally speaking, this was viewed negatively, as participants remained skeptical that merchant cost reductions would produce consumer price reductions. However, most participants also suggested that this scenario would likely become accepted by consumers, and their payment and loyalty choices would not change. In part, this was because loyalty rewards were viewed as "bonus" benefit for paying by credit ('still getting something for nothing'). Other participants noted that most consumers would easily accept – or perhaps not notice at all – lowered rewards, as they were not well understood in the first place.

None of the alternatives compared favourably to the current scenario.

Asked to compare the current combination of payment and choices to the alternatives, the current scenario was favoured. Note that this exercise was based on a single price point ($100), a single cash discount (1.5 per cent) and a reasonable estimate of price reductions ($0.50) and reward deductions ($0.75) on an imagined interchange fee cap. Different assumptions would produce different results.

Results by Topic Area

Attitudes about Credit Cards and Payments

Prior to the focus group sessions, participants answered a few questions about their purchasing and loyalty habits. Each session opened with a discussion about how they came to own the cards they use most often and how they decide how to pay for a purchase.

Most participants identified their most frequently used credit card by the name of the network. Only two respondents did not include "Visa" or "MasterCard" in their response – one said "Amex" and one said "BMO". Of the others, just nine included the name of an issuer, and five included the name of a loyalty program in the response.

Most participants owned one or two debit cards and one to three credit cards. There were some outliers who owned up to 10 or 12 credit cards. When asked how they came to own the card they used most frequently, the majority position was that their card choice fell from their bank choice – it was a card they obtained through their bank many years ago. A substantial portion of the participants could not recall how or when they got their card. A notable minority specifically chose a credit card because of the associated loyalty program. (For example, they valued PC Points, so obtained a PC Financial MasterCard.) There were some interesting exceptions – participants who responded to Internet advertising or filled out an application when they walked by a card promotions booth. Few of the participants said they paid an annual fee for their card.

The vast majority indicated they know how they will pay when they enter a store. The most common exception is when they planned to make a small purchase and pay cash, but ended up making additional purchases and using credit.

There did appear to be a direct relationship between purchase size and payment methods for most participants. Cash was used for low-value purchases, credit cards for high-value purchases, with debit sometimes used interchangeably with cash, or between cash and credit. As for the demarcation point where cash purchases turned into credit purchases, the answers clustered around $10, $20 and $100. Four participants said they use credit for every purchase. Two indicated they use it only for extremely large purchases. Collection of loyalty rewards was often cited as a reason to use credit for purchases – and a reason to select certain merchants. A few participants noted that they would use debit more frequently, but there was a limit to the number of “free” debit transactions to which they were entitled.

Beyond point collection, benefits to card use by our participants included: convenience over carrying cash, the time buffer between when a purchase is made and payment is required, fraud and security protection that includes being able to get transactions reversed, easier record-keeping, insurance and the ability to establish a credit history.

More than half of participants make purchases online. Almost universally, payments were made by credit card. Paypal was used by a few, and debit and electronic money transfers by none of our participants. Paypal was praised for its security, but criticized for its complexity by those who have used it.

When asked why they might choose one credit card over another, points was the most common response. There were references to specific benefits such as insurance (including making it easier to rent cars), the level of credit available on different cards, and the overall state of finances (so that any balances carried are carried only on the lowest-interest cards).

Participants were asked to enumerate benefits that merchants enjoyed from credit card purchases. The responses included: “impulse shopping, higher spending, it’s trackable, foreigners can make purchases without needing local currency, you don’t have to deal with petty cash or large amounts of cash, faster transactions, shorter lines, easier record-keeping, the ability to target customers based on spending patterns.”

During the discussion about the payments system, participants were asked to estimate the total transaction costs that a merchant pays on a $100 credit card transaction. The answers ranged from $0.25 to $15, The mode and median were both $2. Some participants expressed that they had no idea merchants had to pay at all.

Attitudes about Loyalty Programs

As part of the pre-session questionnaire, participants were also asked about their favoured loyalty programs, and questions about how rewards were earned, the rate at which they were earned and origins of the funding of their rewards.

In line with the overall population, the most common answers to loyalty programs were Air Miles and Aeroplan, Canada’s two largest programs. Six responded with either “Visa” or

"MasterCard".

Every single participant expressed a basic understanding that rewards were earned on purchases. When asked about the rewards accumulated on a $100 purchase, nine responded that they were not certain and offered no guess. Eight offered language around "it depends". About half (20) included a number in their response. They ranged from $0.10 to $20. The mode responses were $1 and $5 (five each) and $10 (four).

During the focus group discussion participants were asked to write down their answers to the question: "Where does the money come from that funds the rewards?" The question was deliberately worded vaguely, so that respondents could respond with an organization (banks, merchants, credit card companies) or with a process (transaction fees, membership fees, interest on credit card balances). The responses varied widely, and many included "maybe" or "perhaps" in their responses. "Merchants" was the most frequent response. Not one participant identified the funding as originating with the loyalty program (i.e. Air Miles or Aeroplan). During the discussion that followed, participants were uncertain about how the rewards were funded.

Participants were asked how they selected the program they use most often. A distinct minority started by selecting the loyalty program they wished to collect and then selected the credit card associated with that program. The majority indicated that the loyalty program was one associated with their credit card choice, which came first. Reward accumulation was a by-product of a credit product.

Participants spoke very highly of their favourite loyalty program, and wanted to share their experiences to the point of proselytizing. Many discussed how they once participated in multiple programs, but are now active in one or two for simplicity. Perhaps related to this, more participants favoured programs that permit collection from multiple sources (Air Miles) than single merchant programs. However, multiple participants spoke favourably of Shoppers Drug Mart's Optimum program.

Participants admitted that they sometimes spend more than they intend in order to collect rewards, but rarely purchase something they don't need just to acquire points. They also prefer rewards relevant to them. Some noted that "cash-back" options may be attractive or even more lucrative, but some preferred rewards. Participants were attracted only to programs that had rewards they valued, whether it was free groceries, trips or cash back.

Transparency

In the section that followed, the moderators offered some details on how merchant transaction costs, the payment system and rewards were connected.[60] Participants learned that credit card transaction costs end up being split between three parties – card companies, issuers and acquirers – and typically range between 2 to 3 per cent.

Participants were asked to estimate how the transaction fees were split between those three groups.

Participants were split as to whether credit card companies and issuers received the largest share. The followup discussion indicated that some participants believed credit card companies were owned by banks. The discussion around this particular point was among the most interesting of the sessions, and varied between sessions. There were clearly some participants who were sympathetic to merchants, small merchants in particular. “I’m starting to feel really bad because I had no idea that merchants had to pay. I think I might behave differently.” Others now understood why some local restaurants wouldn’t take credit cards.

But those opinions were clearly the minority. Some participants expressed sympathy for the card companies, acquirers and issuers. “The credit card companies are assuming all of the risk, they should get a portion of the fees. When there are fraudulent issues, they absorb the cost.” “The card issuers are paying us back in the form of rewards.” “If credit card companies aren’t getting much of the transaction fees, and they’re not getting the interest, what are they getting?”

Still more directed extreme skepticism, to the point of cynicism, that merchant cost reductions would lower prices.

“If they go and do this (reduce costs) tomorrow, you’re not going to see prices lowered by 14 cents, 25 cents. They’re just going to say ‘woo hoo’ like everybody else. They’re going to get the money instead of the banks, so I suppose it’s the lesser of two evils.”

“If they lower these fees, I can bet that if I went into any one of these stores, you’re not going to see a drop in any one of the prices. Because the average person has no clue about any of this.”

Later in the focus group, participants were asked about attitudes toward interchange fee reductions (see below). Participant reaction at that stage was very similar.

Point of Sale Transparency

At this stage, the discussions moved to the four alternatives under consideration. The exact order of each alternative was randomized in each session. Participants were asked about their attitudes towards signs at the checkout stage that show the consumer how much a credit card transaction might cost them, notification on a receipt that indicates the merchant’s transaction costs, as well as a face-to-face request from a store representative to select another form of payment because credit card transactions cost them 2.3 per cent.

Most participants doubted that signage or transaction information on the receipt would be either effective or offensive. Both could be easily ignored. The personal plea, however, was viewed to be both more effective and offensive. Participants – particularly women – said they would be more likely to change their payment choice if requested by staff. Yet many also found it a form of pressure that made them uncomfortable or guilty, and would prefer not to be asked. Participants were more forgiving of a small, local merchant who chose to do this. Many compared this to charities looking for donations at the checkout counter. One participant thought transparency should run both ways. "Would I be able to walk up to them and say: 'Could you show me what you purchased this item for, wholesale?"

Discounting for Cash or Debit

After a short explanation, participants were asked how much of a discount would be required to get them to pay with cash instead of credit on a $20 purchase, a $75 purchase and a $200 purchase. Most participants expressed some enthusiasm for this concept, but the median and mode responses at all three levels were 10 per cent. Still, a small portion indicated some willingness to change at levels as low as 2 per cent.[61]

Participants were also asked about a $1,000 purchase. Very few indicated willingness to consider a cash discount at this level, because it would require a special trip to the bank, adds to theft or loss risk, and the potential lost loyalty points on such a large purchase.

Participants indicated less of a discount would be required when using a debit card. Large scale debit purchases were more feasible than cash (none of the inconvenience or risk elements), but less than credit (may not have funds in account, no loyalty).

Cash discounting is already part of the marketplace, some participants noted, as small merchants will sometimes agree to cash transactions to shelter revenues from tax (they believed).

One participant noted many merchants actively discourage cash. "A lot of stores won't take a $100 bill. It's cash, but they wont take it because of fraud. Nobody carries $100 bills."

Surcharging or Denying Premium Cards

The discussions connected these two alternatives in some ways, as they were the two rules the Competition Bureau sought to eliminate. But they were separated in some parts of the discussion, because consumers could theoretically support one alternative while rejecting the other.

Participants were overwhelmingly negative to both concepts, noting that premium cards often have a membership cost, and that surcharges could offset loyalty rewards. Asked how they might react, about half of the participants said they would leave the store if they encountered a surcharge, while the other half said they would likely choose another form of payment. In any case, it would strongly discourage them from using those cards again. It led many participants to wonder if their own favoured card qualified as "premium".

Participants were asked if merchants were allowed to surcharge for premium card payments or all card payments, how much did they expect merchants would charge. The answers ranged from 0.25 per cent to 10 per cent, with the median and mode of 2 per cent.

Four respondents suggested fixed dollar figures. A couple of participants answered with variations of “whatever they could get away with”.

In the context of an Internet purchase where a credit card surcharge was only disclosed at the end of a long process, about half of the participants said they would abandon the purchase, unless it was a truly unique item they couldn’t get anywhere else.

If anything, reaction to having premium cards denied was even more negative. Many participants wondered why anyone would try to use that card again.

Asked if reactions would change with time, participants conceded this could happen. Many pointed to the introduction of the GST as a parallel – instant hatred eventually yielding to grudging acceptance.

Interchange Limits that Reduce Costs to Merchants and Rewards to Consumers

This was perhaps the most critical scenario to test because it best combined the interrelationships between payment choices, merchant costs and loyalty programs. In the weeks before focus groups, it also became the most likely outcome for the policy discussion, with Visa and MasterCard’s announcement.

To start, participants were told of the recent announcements, and noted that much lower costs had been legislated in other countries. Then they were asked for written responses to whether lower merchant transaction costs would result in lower prices. Out of the 38 participants in the four groups, one wrote yes. Three gave ambivalent answers (”yes and no”, “maybe if there was publicity”). The balance said “no”, and many flavoured their responses:

“They want to make as much as possible.”

“They are there to make profit for themselves.”

“Merchants are hungry for money. They feel they need all the profit possible.”

“Merchants want to put more money in their pocket.”

“Costs aren’t divulged. Costs are hidden.”

“Not in a billion years.”

“I think merchants figure the average consumer has no idea about this, so what would they know.”

“The merchants aren’t suddenly going to drop the prices if the fees go down.”[62]

Participants were informed that reduced interchange fees would likely have consequences from issuers, who could raise annual card fees, increase interest rates or reduce the funding of loyalty programs. The overwhelming majority thought issuers would alter loyalty programs. Many related past experiences with devalued or lost rewards, or noted that nobody understands how they work right now. The consensus in one of the Toronto sessions favoured interest rate increases because most said they always paid their bills on time. Participants were asked if their rewards were halved – if points accumulated at half the current rate so that it took twice as long to obtain a specific reward – would their payment choice change. Almost all indicated they would not change their payment choices or loyalty program. “You’re still getting something for nothing.” “I’ve picked one that I’m going to use anyway. I’ll be disappointed but I’m still going to buy groceries. It’s still a bonus.” The participants who more actively sought points, or used point decisions to drive credit card choices, were angrier about this possibility.

All in All, the Status Quo Is Preferred

In a session-ending exercise, participants were asked to ordinally rank some of the alternatives presented. Among the alternatives, cash discounts was slightly preferred to interchange fee caps, while card surcharging rated well behind. It must be noted that this exercise used specific numbers based on assumptions that may not be accurate. For example, a theoretical $100 purchase was used, with a $1.50 discount for cash, an interchange cap that resulted in a $0.50 reduction in price (merchant passes along some of the cost reduction with a lower price) and a reduction of rewards from $1.50 to $0.75. Many of the participants used extremely mathematical utility models “this alternative is $0.25 better”, when they had virtually no understanding of the concepts two hours prior. Different assumptions would have yielded different results.

Still when the alternatives were compared to the status quo – a $100 credit card purchase generating $1.50 in rewards – it was preferred to the cash discount and the interchange cap scenario. This wasn’t universal. Portions of the respondents preferred the $1.50 discount, and some would also give up $0.75 in rewards to lower the price by $0.50.[63]

Other Observations

For most of the observations, the results from the Montreal and Toronto sessions have been aggregated. No large-scale discrepancies existed between the two groups. A stronger affinity for “smaller merchants” manifested in the French-language session in Montreal, which may be a coincidence or reflect a cultural effect.

There was very little awareness of the Visa and MasterCard announcements to voluntarily reduce interchange fees, which occurred less than one month earlier. There were isolated participants who had some knowledge of the merchant concerns about transaction charges because of “friends who owned small businesses”.

Concerns about “privacy of personal information” were not included in the focus group script and were not brought up by participants, except in one session when there was a short discussion about the relative merits of Paypal and credit cards for online purchases.

The Future

The voluntary reductions of 10 per cent to aggregate interchange fees announced by Visa and MasterCard take effect April 1, 2015. However, the proposal relates to a blended or weighted average of costs. Some interchange fees will be reduced more than others to achieve a balanced reduction.

There are a number of potential implications for this fee reduction on the payment and loyalty systems. The most obvious is that it will reduce the revenue to issuers. That could trigger any number of reactions. One obvious implication is that issuers could reduce funding to loyalty programs. One bank representative indicated they hoped to keep loyalty programs untouched, focusing on cost reduction. "Across the issuer base, emphasis is being placed on cost structures, cost reductions, anything to bring the cost base down. Everyone is focusing on using materials better, being smarter in the way costs are incurred." [64]Benefit reductions would be more likely on the higher-cost premium cards, as more dramatic interchange fee reductions would need to be made to bring the blended average costs towards the 1.5 per cent goal. Raising annual fees, and increasing interest costs were also in consideration. If the decision to cut rewards was made, it would be more likely on the redemption side. "Research shows that the up front earning message is more compelling. It's more effective to tell customers about the accumulation of rewards."[65] In other words, consumers are likely to react better if changes are made to how many points are required to redeem for rewards, rather than if changes slowed the rate at which points are accumulated.

Reduced rewards, particularly among the higher-end cards, could lead a portion of consumers towards American Express, as happened in Australia.

Interchange reductions could have other more subtle effects. The transaction cost reductions could be used by retailers to improve funding of proprietary reward cards, such as Shoppers Optimum, Petro-Points. Retailers that offer co-branded cards (Canadian Tire, Costco) can also use higher retail margins to improve the value proposition of their cards, offsetting the decline that might come from issuer funding. Lowered consumer rewards could also result in lower overall credit card use. If it takes more time or more spending to accrue rewards, some consumers may choose alternatives such as debit.

The Canadian cost cut does not match that in Australia, for example. One of the few facts that all participants agree on is that Australian loyalty rewards were reduced as a result of the interchange fee caps. There are very few credit card based loyalty programs in the

European Union.

Finance Minister Joe Oliver announced updates to the code of conduct April 13, 2015. The key updates are changes that specifically include smart phone mobile payments, a requirement for premium cards to be clearly branded and for consumers to be "informed" of the fees that cards impose on business owners.[66] Some measures were introduced to appease merchants: a requirement that interchange rate reductions will flow through to merchants fully, a new complaints handling process, and giving merchants more flexibility to cancel contracts. There was no information about how consumers would be informed that premium cards impose higher merchant fees.

Further in the Future

Looking further ahead, technological developments could change the payments system and its relationship with loyalty rewards. Both in testimony and in interviews, market participants identified a number of developments that could, as they grow in popularity, force change on the current system.

The phrase "digital wallet" was not common during the Competition Tribunal hearings, but systems that would put all the information currently on a debit or credit card onto a smartphone are expected to grow rapidly. The simplicity of waving a phone over a terminal in a store, and selecting a particular payment method through the phone would appear to be welcomed by consumers. The variety of systems, and variety of participants (financial institutions, wireless providers, credit card networks, merchants) could create a fractured world. Google and MasterCard launched Google Wallet, an app for Android phones that uses MasterCard's PayPass merchant terminals, but it's only available in the United States. Canada's banks are all working on systems,[67] or have versions in the market.[68]

Paypal is a small, growing presence in payments, and consumers store value online and Paypal's PayPay allows merchants to accept PayPal payments.[69] Apple Pay introduced its digital wallet in October in the United States. A bank representative worried that Apple Pay posed a threat to interchange revenues, because they already have millions of credit cards on file, and transactions made through an Apple device could be flipped over automatically to Apple Pay.

Loyalty programs indicate they are worried that divergent technologies could "balkanize" the loyalty market by introducing many non-compatible technologies. Another concern is that marketers – eager to use all the data they have collected about each consumer's purchasing habits – could trample consumers' privacy rights.[70]

A Question of Balance

The credit card companies all testified about the importance of balance in a two-sided market. Their goal is to maximize transaction activity on their network, and they set interchange rates in an attempt to optimize this. Card companies emphasized that basic interchange fees had not changed much (or at all) recently, but the growth in overall card use, the number of premium cards and the growth in higher cost “card not present” transactions had pushed card transaction fees to merchants. According to the networks’ theory of balancing a two-sided market, the signal to the market that things are out of balance occurs when merchants begin to decline to accept credit. Merchant testimony – particularly in the Senate hearings – indicated this was unfeasible. Only the smallest of merchants could stay in business without credit. Without this signal, card networks have no incentive to change policies or pricing.

The potential skewing effects of loyalty programs on payment choices is not a uniquely Canadian, nor particularly recent, observation. Broadly speaking, the issue is also relevant in the United States, where interchange fees are similar and loyalty programs are prominent, as well. Debit payment was identified as particularly vulnerable in Sujit Chakravorti’s 2003 paper on loyalty. That paper noted: “The effects of providing incentives to convenience users may distort the use of other payment instruments that may be less costly to use, such as debit cards.” It also noted the different motivations of the participants: Financial institutions would like to encourage the most profitable payment, merchants desire the least-expensive, secure payment instrument, and consumers should choose the payment instrument that offers the greater benefit.

Research Conclusions

Consumer Rights & Responsibilities

The Consumers Council of Canada advocates for eight globally recognized consumer rights and responsibilities, plus an additional one that has become increasingly important in an interconnected world.

1. Basic Needs

- The right to basic goods and services which guarantee survival.
- The responsibility to use these goods and services appropriately. To take action to ensure that basic needs are available.

2. Safety

- The right to be protected against goods or services that are hazardous to health and life.
- The responsibility to read instructions and take precautions. To take action to choose safety equipment, use products as instructed and teach safety to children.

3. Information

- The right to be given the facts needed to make an informed choice, to be protected against misleading advertising or labelling.
- The responsibility to search out and use available information. To take action to read and follow labels and research before purchase.

4. Choice

- The right to choose products and services at competitive prices with an assurance of satisfactory quality.
- The responsibility to make informed and responsible choices. To take action to resist high-pressure sales and to comparison shop.

5. Representation

- The right to express consumer interests in the making of decisions.
- The responsibility to make opinions known. To take action to join an association

such as the Consumers Council to make your voice heard and to encourage others to participate.

6. Redress

- The right to be compensated for misrepresentation, shoddy goods or unsatisfactory services.
- The responsibility to fight for the quality that should be provided. Take action by complaining effectively and refusing to accept shoddy workmanship.

7. Consumer Education

- The right to acquire the knowledge and skills necessary to be an informed consumer.
- The responsibility to take advantage of consumer opportunities. Take action by attending seminars and workshops, work to ensure consumer education takes place in schools.

8. Healthy Environment

- The right to live and work in an environment that is neither threatening nor dangerous and which permits a life of dignity and well-being.
- The responsibility to minimize environmental damage through careful choice and use of consumer goods and services. Take action to reduce waste, to reuse products whenever possible and to recycle whenever possible.

PLUS – Privacy

- The right to privacy particularly as it applies to personal information.
- The responsibility to know how information will be used and to divulge personal information only when appropriate.

The following table/matrix sets out summary attributes of the issue being explored by this research through the lens of consumer rights and responsibilities.

Consumer Rights & Responsibilities Matrix		
Consumer Protection Issue	**Rights Affected**	**Responsibilities Affected**
A poor understanding of loyalty programs can lead to higher debt, credit issues	Basic needs, information, consumer education, choice	Basic needs, information, consumer education, choice
A poor understanding of the payment system can also lead to higher debt,	Basic needs, choice, consumer education, information	Basic needs, choice, consumer education, information
Consumer interests are not well represented at the policy level	Representation	
Rewards can be easily revalued or lost altogether	Basic needs, safety, information	Basic needs, safety, information
Consumers' privacy rights can be threatened by zealous loyalty programs	Privacy, Information	Privacy

Consumer Rights & Responsibilities Matrix: Table 1

The Effect on Consumer Rights & Responsibilities

Basic Needs – The pursuit of rewards is one factor that leads some consumers to purchase more than they might otherwise. As a consequence, it can contribute to consumers falling into a debt trap, where funds that ought to be spent on meeting basic needs are instead diverted to pay interest on earlier (ill-conceived) purchases. The cost of meeting basic needs may escalate when it is done on credit.

The proliferation of cards and rewards programs may also lead consumers to establish more lines of credit than they understand. This may have similar implications to their ability to meet basic needs. It may also affect their credit score.

The focus groups also indicated that a portion of the population uses earned rewards – actually, specifically targets rewards (PC Points) – to purchase groceries.

Safety – There have been several notable examples of identity theft associated with breaches of corporate databases and card readers of customer transaction data. (Target 2013, Home Depot 2014).

Information – Consumers expressed very limited understanding of how quickly their rewards accumulate, yet the collection of rewards was of high importance to them when they considered alternatives. Rewards can be devalued at any time, and their accumulated value can easily be lost to time. A substantial portion of consumers are participating in a program that they do not understand well. Information may be theoretically available to them, but when rewards are presented as “free” for making a particular payment choice, or choosing a particular merchant, motivation to investigate rewards programs is minimized.

Consumers do have a responsibility to seek out information, but the “trigger’ to stimulate such a search is often missing. There is nothing more than curiosity to motivate a consumer to search out whether their credit card is a basic or premium card. Rewards accumulate either way; the only difference is how much the transaction costs the merchant.

Choice – Most consumers have a wide variety of credit card choices, even within a single banking relationship. Based on the focus group findings, however, a small percentage of consumers have a reasonable understanding of the relative merits of loyalty programs. In considering the difference between point accumulation, mile accumulation or cashback, consumers can struggle to find a way to make meaningful comparisons. Most participants in our focus groups had little understanding as to whether or not they owned a premium card, and what benefits were attached to their particular program.

In some cases, consumers have little awareness as to how they came to own the rewards programs they use. They are added by issuers without an option for consumers to choose whether or not to participate.

Representation – Consumers have a right to express their interests in the making of decisions. This applies to consumers in the aggregate, and is a fundamental element of this proposal. Every participant in this debate – at the Competition Tribunal and at the Senate – related their position as being to the benefit of consumers. Consumers need a powerful advocate around transaction services, which is clearly an area fraught with ambiguity and competition issues. Conventional consumer organizations are not receiving any of the big industry contributions towards consumer protections similar to those received by organizations such as FAIR from securities regulators.

Redress – One of the consumer benefits to the current payment system is the protection offered in exercising their right of rescission under consumer protection laws when card companies enable them to cancel a transaction.

Consumer Education – Consumers were even less informed about the mechanics of the payment system than about the loyalty programs. They were extremely surprised to learn about who gets paid and for what purposes when the basics of the credit card payment system were explained. In the focus groups, they did not see retailers as institutions they trust, and many had similar cynicism toward banks. They did express some sympathy to small retailers, suspecting that smaller businesses are paying more per dollar of sales for the transaction service they receive. While information about loyalty programs is generally available, information about the payment system is generally harder to find.

Privacy – Participating in rewards programs frequently means giving up privacy concerning purchasing habits. This topic was not a major focus of the focus groups, although it did come up spontaneously. The research of loyalty programs, however, showed it to be a major concern, as firms struggled with finding the right balance of delivering personalized important rewards based on spending patterns and the consumer's right to privacy.

Report Conclusions - Focus Groups

This study proposed to examine how consumers' attitudes towards their payment and loyalty choices might change if they were provided greater transparency about how much it costs merchants to process credit card transactions, and they better understood how those credit card fees funded the benefits they receive through loyalty programs.

The short answer is that it doesn't. When asked to weigh the personal, tangible benefits of rewards against the benevolence of lower costs for all, consumers expressed a strong preference for the former. This preference is founded on conviction that merchants would not lower prices at all if costs were reduced. Of 38 participants in four focus groups, only one expressed that merchants would definitely lower prices if transaction costs were reduced. Some participants indicated that their payment choices might change in any case at smaller, local merchants, now that they understood the issue.

To be clear, the results of this research do not lead to a conclusion that merchants would not pass along savings to consumers. Rather just that consumers do not believe that will happen. This skepticism leads them to prefer the personal rewards they can see to general rewards they cannot see.

Among the four alternatives most often considered through the public policy debate, discounting for cash payments was viewed most positively by consumers. But when they identified the amount of discounts that might be required to change their purchase decisions, the majority selected levels of discounts far above merchant transaction costs. Point of sale disclosure of transaction fees was considered harmless and ineffective, except for personalized pleas, which were considered both annoying and effective. The two measures sought in the Competition Tribunal Hearings – surcharging for premium card payments and giving merchants the opportunity to reject certain high-cost cards were both viewed very negatively by focus group participants.

There was a begrudging acceptance that capped interchange fees that reduced costs and rewards could be an acceptable compromise. Depending on the level of reductions and its impact on loyalty program funding, it could be viewed as a modestly negative outcome for consumers, who accepted that loyalty program reductions occur from time to time anyway as programs are revalued. Still, it was not likely to change many participants' spending patterns, as they viewed loyalty rewards as "something for nothing" – a reward earned for a spending and payment choice they planned to make even without the reward.

Other Focus Group Observations

General consumer understanding of how the payment system works and how rewards are generated is low. Many participants expressed surprise that merchants paid to process credit card transactions. Many consumers attribute to credit card companies that which should be attributed to banks and other issuers. Consumers appear to have little to no financial literacy about what is perhaps their most common financial transaction. They appear to be disinterested, because they do not consider the associated costs to be theirs to bear in any way.

It is also true that consumers have influence in the aggregate that they do not see as individuals. In any number of instances they expressed cynicism about their ability to effect any change. Yet, the testimony from all the other participants indicate that aggregate consumer preference is a significant force.

Consumers endorsed many aspects of the current credit card payment system, the speed of transactions, reliability, reversibility, ease of access to credit, global availability, warranties, insurance and security advantages. They also perceived many benefits to merchants from credit card payments.

In one of the focus group discussions, two participants made notable observations about the relationship between merchants and cash. One participant said that he didn’t think cash discounts would be feasible, because merchants don’t want cash. Most merchants, he noted, won’t accept $100 bills. Another participant noted that small merchants will often accept cash – with an understanding that such transactions can be kept out of records for income tax or GST/HST threshold calculation purposes.

Participants perceived many benefits to merchants from credit card transactions. It seems more likely that merchants would like to enjoy all the benefits of credit card use, but would like it to cost less.

Another interesting comparison between consumer attitudes in the focus groups and merchant testimony to the Competition Tribunal is that merchants are as skeptical about premium card spending as consumers are about merchant price reductions. Many merchants testified that they did not see any additional revenues from premium card users. It was sworn testimony, subject to examination. Yet premium card holders are defined by the fact that they have higher income and/or greater spending. Could the merchant perspective be an outcome of portfolio loyalty programs, where rewards are accumulated by shopping at vendors A, B and C, but spent at vendor D? Merchants might not see additional spending out of their premium customers, but might see new customers instead. Merchants have their own loyalty programs and have never had a problem rewarding their own most loyal customers (10th coffee is free!), spreading the costs of those rewards over their least loyal customers (the ones who never get to 10 coffees). The relationship between the customer and merchant is disjointed through credit cards and portfolio loyalty programs, such that merchants do not perceive, or cannot measure, the connection.

Report Conclusions - Consumer Interests and Other Observations from Research

Part of this research proposal involved evaluating where the consumers' interests lie in this debate over credit card payment costs. The focus group results show that consumers value the personal rewards that accrue to them through loyalty programs more than the "theoretical" benefits that may accrue to all consumers if credit transaction costs to merchants were lowered.

The focus groups also showed that there is a considerable gap between what consumers think they know and what they actually know. The study showed that when consumers learn more, their attitudes reflect a cynicism about the competitiveness of the marketplace (merchants won't lower prices) and a fatalism about their ability to effect a better system (you're still getting something for nothing).

Are the attitudes that consumers express a foundation for good public policy, or is there a distinction to be made between what's best for consumers as individuals and what's best for consumers in the aggregate? Is this an instance in which consumers value the rewards because they are personal and visible, while the costs are borne by all, and virtually invisible?

Evaluating where 'the consumer interest' lies – for individuals and collectively – is challenged by the complexity and lack of transparency in the payments system.

Individual Consumers

Individual consumers expressed numerous knowledge gaps – low understanding of the payments system, an even poorer understanding of their loyalty programs, little knowledge as to whether they owned a basic or premium card. This information is discoverable. It's in the fine print of agreements, and there are many web sites that help consumers evaluate card choices and reward programs. It is just that there is little reason to do so when consumers are made to feel like they are getting "something for nothing" through credit-card funded loyalty programs. That attitude is very effective in motivating consumers to pay with credit instead of cash or debit. It can be very effective in building loyalty to merchants or issuers.

But consumers who receive rewards for credit card purchases are not getting something for nothing. They are getting something, but that something is funded by the purchases and payment choices that they and other consumers make. A substantial portion of the rewards consumers receive originates in their own pockets – a possible interpretation is that they are being seduced with their own money.

Consumers will need to be motivated to improve their understanding. There are two other barriers that challenge a consumer's ability to improve their understanding or effect change. Credit cards and loyalty programs are almost totally intertwined, and loyalty programs are considerably more complex than they used to be.

Credit cards and loyalty programs are almost impossible to disentangle. If a consumer was motivated to avoid loyalty programs altogether, could they? 'Yes', but with considerable difficulty. There are 268 credit cards listed in the Financial Consumer Agency of Canada's credit card selector tool database.[71] Only 27 (about 10 per cent) have no annual fee and offer no rewards, and eight of those 27 are cards designed for students. More importantly, even if a diligent anti-loyalty consumer were to select one of these cards, the only net effect would be on themselves. Any credit card purchase would generate the same level of interchange revenue to issuers and result in the same merchant discount fees to merchants. The only change would be that the consumer would receive no rewards, while other consumers received some. (There may be other features of those cards that consumers value.)

Loyalty programs are considerably more complex. The simplicity of the "buy nine, get the tenth free" programs of a single retailer is much easier to grasp. Consumers are likely to view those with the understanding that the merchant offering the discount is funding the program. That the costs are borne by the non-frequent customers is also fairly obvious. Over time, however, through the connections with payment systems and portfolio programs, rewards are much more complex to follow. The simplicity of "buy here, earn points" trumps the desire for many consumers to search for a more detailed understanding of what's in their interest.

Aggregated Consumers

Determining where consumer interests lie in the aggregate is also challenged by the complexity, the number of participants and interrelationships. The recent interchange reductions by Visa and MasterCard will (thanks to federal clarification) reduce merchant discount rates. Merchants may lower prices to consumers, but may also choose to retain a portion of that cost savings for re-investment or as profit. Lower revenues to issuers may or may not impact spending on loyalty programs. That may or may not result in reduced accumulation rates or require greater accumulations for redemption. Issuers may or may not alter the price of other services to other customers to compensate for lost revenues. That is a very complex set of participants and a very lush decision tree for any econometric analysis.

An econometric approach could help determine where consumers' best interest lie, but doing so would require a large number of assumptions. Consider the 1.00 per cent "in play", that is the difference between the current 1.5 per cent interchange fee and the legislated 0.5 per cent in Australia. If that 1.00 per cent were to flow to merchants, even if they "pocketed it" (as the vast majority of focus group participants feared), it would ultimately be spent. It could be spent on expansion, higher salaries, delivered to investors through dividends or used to build a fabulous cottage for a sole proprietor. At the other extreme, if the 1.00 per cent remained with issuers, it too might be spent on providing loyalty rewards to consumers. It could be spent on issuer expansion, payrolls or dividends as well. The net value to consumers – and the welfare of the economy as a whole – depends on a lot of assumptions about how that money is distributed.

Two other considerations: The most popular reward is airline travel, an industry in which "regular" prices are very fluid, presenting another challenge with how to value rewards. Secondly, it is unlikely that the "optimal" solution is optimal for all consumers, and some scenarios will result in some consumers being better off, while others are worse off. In the current environment, the argument that consumers who pay with cash are "subsidizing" consumers who pay with premium credit cards is fairly easy to follow. But are consumers who pay with basic cards net beneficiaries or net contributors?

Both individually and in the aggregate, it is difficult to determine where consumers' interests lie.

Other Conclusions and Observations From Research

Interchange fees share many of the characteristics of loyalty programs. The rates set by the card networks differ between industry and vendor type. Larger companies, firms in certain industries and companies that form stronger bonds through co-branded cards all receive cost advantages over smaller merchants.

How much choice do merchants have? Consumers may have little choice about whether the credit cards they use have attached rewards; the testimony from merchants that they also have "no choice" carries some resonance. The credit card networks testified about the nature of two-sided markets, and how their sole objective was to maximize the value of transactions on their networks. Yet the key "signal" that a two-sided market is out of balance occurs when one side withdraws – in this case: merchants decide not to accept credit cards. But is the current scenario truly a two-sided market? Do the economic fundamentals apply when one of the two sides is effectively a duopoly – Visa and MasterCard represent more than 90 per cent of credit card transactions – and not a perfectly competitive market? Again, this issue warrants a more sophisticated economic analysis. But when consumers can find only a few credit choices that exclude rewards, and when merchants testify that they also feel like they have no choice, it would suggest that further public policy debate is warranted.

Loyalty programs are increasingly being used for 'daily living" expenses. The earliest loyalty programs involved an element of efficiency. The marginal cost of filling an empty airplane seat, an empty hotel room, or an idle rental car is very low. Over time, however, with the movement of reward collection through "every day" purchases, the rewards are also being used for regular expenses – food through grocery programs, gasoline and even cashback. Consumers report increasing frustration with their ability to redeem air travel rewards, likely because airlines have become much more efficient in filling planes on their own with more active pricing policies and online reservations. The costs to fund these programs is much more substantial.

Some bank fees are rising. According to published reports, each of Canada's five major banks is raising fees for some banking services, or is in the process of doing so, roughly concurrent with the reduced issuer fees.[72] Anticipated by some, this may just be an interesting coincidence of course.

Ottawa continues to prioritize transparency. Two key components of the updated code of conduct are measures that require card companies to clearly brand "premium" cards and for consumers to be "informed" that premium cards impose higher costs on merchants, though, so far, there have been no details about how that information would be disclosed.

IV

Recommendations

Filling gaps in consumer knowledge and protecting consumer interests.

Consumer Education

This project's objective was to learn how consumers make their payment choices, their loyalty reward choices and whether additional understanding of how those two choices are related might change consumer attitudes.

The research revealed substantial gaps in consumer understanding of both the payment and loyalty systems. Because these gaps are so substantial, and the stakes are also substantial, the most important recommendations involve consumer education.

- Consumers lack basic understanding of the payments system. They need to better understand that their financial relationship is *primarily* with the card issuer, and not the card network. They need to better understand whether they own a premium card or a basic card.
- Consumers also lack a basic understanding of loyalty programs – how they are funded, the rate at which rewards are accumulated, the "price" of redeeming rewards and the time value risk of owning accumulated rewards. Many are likely entitled to benefits of which they are not aware.
- There are resources in the public domain to improve some of these elements. The FCAC has a helpful web tool, for example that offers feature comparisons among credit cards.[73] There are many web sites that offer comparisons of loyalty programs. Broadly speaking, this information can be discovered. Consumers have very little motivation to improve their understanding as long as the prevailing view is that rewards are "free" for making a payment choice they would already make. It is possible that the new disclosure requirements mandated by the federal government will contribute to greater consumer enlightenment.
- The responsibility of improving this knowledge is shared by all participants in the market, including consumers themselves.

Policy

Recent actions indicate the transaction costs and their relationship to rewards is clearly an area of interest to policymakers.

- The impact of the voluntary interchange fee reductions from Visa and MasterCard need to be evaluated closely. There have been many discussions of implications around the potential impact on merchant costs, consumer prices, funding of loyalty programs, compensatory increases in other charges. The actual effects of a small fee reduction may be difficult to isolate and track, but it is vital to further policy discussions that all the effects of this initial change be known. If the actions taken so far prove ineffectual in satisfying the marketplace, options for legislation designed to pass along visible savings to consumers should be developed and offered for public discussion.
- The value of accumulated rewards can be eroded or eliminated. They are highly valued by consumers. If consumers view accumulated rewards as "near currency", are there protections that should be established? More draconian interchange fee reductions (or other changes) could dramatically re-shape loyalty programs and affect the accumulated value currently held in loyalty programs. Consumers would be better served if any public policy change considered the effects on these unredeemed rewards.
- The virtual currencies created within rewards programs deserve to be monitored as components of the system of money, with greater transparency and public reporting. Consumers would benefit from a renewed public discussion in this area. From a policy perspective, the close relationship between rewards and "real money" makes it difficult to discern wither this is a provincial responsibility under contract law or a federal responsibility as part of the money supply.
- Future policy discussions also need to be mindful of the benefits consumers value most, the ease of payment, record keeping advantages, convenience, protection and security measures, warranties and insurance benefits offered.

Messages for Retailers

The focus groups produced two key messages for retailers:

- There is a vast consumer distrust of retailers, and no belief that reduced costs will result in lower prices to consumers. Participants communicated that retailers are not sufficiently competitive to need to pass savings on to consumers. Merchants would benefit from learning what techniques would be effective in restoring consumer belief in price competition.
- A portion of consumers also expressed a willingness to pay cash in return for a small discount. Merchants have the ability to test whether consumer behaviour matches expressed preferences and the flexibility to try different approaches. Moreover, there

may be a simple benefit to simply expressing the ability to discount for cash, even if it is not at a level to motivate instant consumer change. Simple signage of, (for instance) "1 per cent discount for cash or debit" could add some awareness of the issue for all consumers, engender consumer-led discussions about merchant costs, as well as possibly change the payment choice for a small slice of the population.

Networks, Loyalty Programs and Issuers

These participants in the payments chain likely conduct extensive consumer research, and use those findings to optimize results. Their positions are well-served when consumers view loyalty rewards as "something for nothing".

- If improved transparency is a public policy goal, it may benefit these companies to take the first step. Consumers may value the firms that do the best job using plain language in all communications, for example, or provide customers reminders of benefits to which they are entitled but do not frequently use.
- There would be a considerable public policy benefit to greater transparency from issuers related to the collection of transaction fees and funding of rewards.
- Seek better ways to preserve consumer anonymity while still providing the benefits to a consumer of being known for their appropriately rewarded behaviour abstracted from personal identity.
- This research generates numerous ideas for future study. Among them is an examination of the motivations behind changing demand for rewards programs. Once focused on high future value, low marginal cost air travel, growth now comes from immediate value, high marginal cost areas like groceries and cashback. What is driving that change? And is that change in the consumer interest?

A Consumer Voice in Public Policy

Consumers deserve to have a voice at any public policy discussion related to these issues. The capacity for consumer groups to listen to consumers and conduct sophisticated independent research is vital to enriching the public discussion and formal decision-making processes about this complex public policy environment, which to-date has been dominated by vested interests. However, the free rider problem exists, where every individual is too busy to contribute time or money to the 'capacity to participate' and each consumer prefers to 'free ride' on the effort of others. This is a classic case for a 'public good' where the public must finance the 'capacity to participate' or it will not exist. Many private interests and lobbyists are content to allow the under-representation of consumer views to continue, so the future is not particularly bright. All the same, consumers deserve the right to speak for themselves, rather than having vested interests speak for them. Consumers may not be found to have a consensus view, but even the sound of the voices of a discordant choir is preferable to silence or listening to the wrong song altogether.

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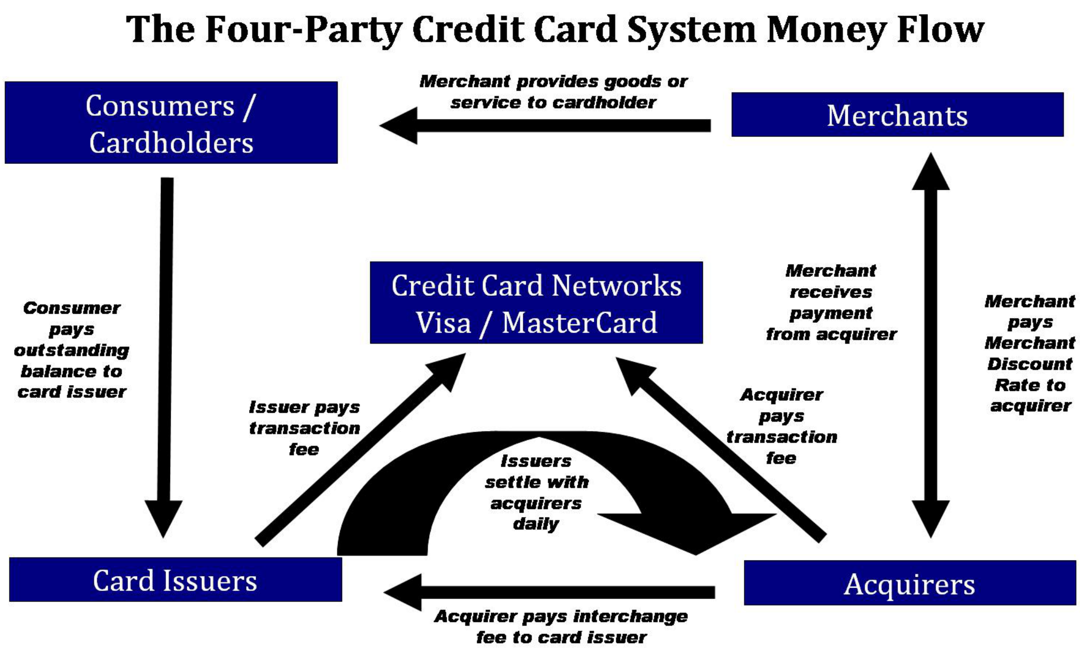
Appendices

Appendix 1 - How the Payment System Works



The first thing one might notice about the four-party credit card system is that there are five parties involved: consumers/cardholders, merchants, card issuers, acquirers and the credit card networks. (These parties are defined in the glossary below).

The flow of funds can be quite difficult to follow. The diagram above is actually simplified, as interchange fees don't actually "flow" from acquirers to card issuers. Rather they are deducted from the amounts card issuers pay to acquirers during the settlement process.

Here are the steps involved with a typical transaction.

1. The issuer issues a credit card to a cardholder.

2. The cardholder provides the card (or the card information if it's an online/telephone transaction) to the merchant in order to make a purchase.

3. The merchant sends the card information and purchase information to the acquirer in order to obtain authorization for the transaction.

4. The acquirer forwards this information to the appropriate network, which in turns forwards the information to the appropriate issuer for authorization.

5. The issuer authorizes the transaction to the network, which passes this authorization

on to the acquirer.

6. The acquirer advises the merchant that the transaction has been authorized, and the merchant completes the transaction with the cardholder. (At this point, no money has changed hands. The only change is that the consumer may have received the purchased good or service.)

7. Typically at the end of the day, the merchants "batch" their approved transactions and send the information to the acquirer. The acquirer will "settle" those transactions. That involves depositing the full value of the transactions into the merchant's account for that day.

8. Typically daily, the network "clears and settles" transactions between issuers and acquirers on a net settlement basis. This means that card issuers will direct to acquirers the total value of the transactions, less the interchange fee.

9. At month end (most frequently) the acquirer will charge merchants the total merchant discount fee on all processed transactions for that month.

10. Acquirers and issuers also pay network access fees, or transaction fees or assessment fees to the card networks. The frequency of these payments can vary.[74]

11. Issuers will charge the full value of the transaction onto the cardholder's monthly statement.

12. The cardholder is obligated to settle the credit card bill monthly, or pay interest on unpaid balances.

To evaluate all of these transactions from the perspective of all five participants:

Consumers/cardholders – Receive goods or services from merchants, pay outstanding balance to card issuers.

Merchants – Provide goods and services to consumers, receive payment for full amount from acquirers (usually within a day of the transaction). Pay fees to acquirers later, typically monthly.

Credit Card Networks – Receive transaction fees from both issuers and cardholders. Amounts from issuers to acquirers are settled through the network, but not retained by it.

Acquirers – Pay full amount to merchants for daily transactions. Receive payment of fees from merchants later. Receive funds from issuers – via the credit card network – net of interchange fees. Pay transaction fees to credit card networks.

Issuers – Pay acquirers – via the credit card network – the amounts owed for daily transactions, less the interchange fee. Pay the credit card networks a transaction fee. Receive payments from consumers.

That's a lot of moving parts, and a lot for a consumer to take in. The transactions are much more simple to evaluate from the consumer's perspective. You buy a good or service and pay the balance on your credit card. But explaining the payment network to a consumer in the context of a focus group to explain how the funds flow is a more significant challenge.

The Department of Finance took a simplified approach to reduce this complexity in its presentation to the Senate May 29, 2014. It focused not so much on the flows of individual fees, but rather on the difference between what the merchants charge consumers and what they receive from acquirers after all expenses. This amount eventually ends up in three separate parties: issuers, card networks and acquirers, after a variety of transactions.

In its simplified example to Senators, the Finance Department estimated a typical merchant “pays” $2.36 on a $100 transaction. That is, they receive $97.64 after all the fees are paid. (This does not represent any single transaction, but is likely a weighted average of all transactions.)

That $2.36 ends up in three smaller amounts:

$1.69 ends up with the issuer. This is the interchange fee.

$0.12 ends up with the credit card networks, after receiving fees from issuers and acquirers.

$0.55 remains with the acquirer.

The amounts from this exercise were verified with some of the industry sources in this research. All indicated that the amounts were reasonable approximations of a much wider range of actual costs. These figures and this presentation of “fees paid by merchants for credit card transactions eventually end up with three different parties” were used in the focus group sessions.

Glossary

Cardholders: Those who make purchases from merchants using their credit cards.

Merchants: Vendors that accept payment in exchange for providing goods and services.

Issuers: Financial institutions (banks, trust companies, credit unions, caisse populaire, etc) that issue cards to customers. Issuers set fees and interest rates for cardholders and give cardholders rewards for credit card use.

Acquirers: Companies that provide credit card network services to merchants. These services include the processing of credit card transactions by connecting merchants to credit card networks. They also provide the equipment to serve these connections at merchants’ locations. Leading Canadian acquirers include Chase Paymentech, Moneris Solutions, Global Payments and Desjardins.

Credit Card Networks: Provide authorization, clearing and settlement for transactions for customers who pay using their cards. The two dominant credit card networks in Canada are Visa and MasterCard.

Merchant Discount Fee/Merchant Discount Rate: The amount that a merchant must pay to process a transaction. Typically in the range of 1.50 per cent to 3.00 per cent, it is paid to the acquirer, but the amount ultimately ends up in three places – the acquirer, the issuer and the credit card network.

Interchange Fee: The amount due to issuers from acquirers. It is deducted from the amounts that the issuer pays the acquirer to settle transactions. The interchange fee is set by the credit card network and can vary, based on a number of factors, including: the type of business the merchant is in, the type of card owned by the cardholder and whether or not the card is present during the transaction. (Internet and phone transactions, where the card is not present, have higher risks, and so, higher fees.)

Network Fee: The fees paid by issuers and acquirers to the credit card networks are also known as "service fees", "transaction fees" or "assessment fees", but all are based on a percentage of transaction value.

Two-sided Market: Payment systems are two sided because the use of the product or service by consumers on each side of the market makes the product or service more valuable to those on the other.[75] More consumers using credit cards leads to more merchants accepting them, and vice versa. Other markets that function the same way include newspapers (readers and advertisers) dating sites (men and women), shopping malls (shoppers and merchants).

Appendix 2 - About Acquirers

The thrust of the research involves consumers and their attitudes towards merchants, loyalty programs and credit cards. As they have no direct relationship with acquirers, this report has largely avoided incorporating the perspectives of acquirers.

Yet acquirers did provide testimony to the Competition Tribunal, and their perspectives warrant secondary inclusion. Global Payments Canada President Jordan Cohen and TD Merchant Services President Jeff van Duynhoven provided testimony that outlined some of the benefits that acquirers provide to merchants.

Because merchants are paid same day or next day, and acquirers collect their fees from merchants at month end, merchants have a cash "float". Acquirers bear chargeback risks. If a customer gets a charge reversed by the issuer, acquirers are responsible for collecting those amounts from merchants. If the merchant refuses, or goes out of business, that's a loss to the acquirer. Outright merchant bankruptcy also results in losses for acquirers, and they are also liable for merchant fraud, if merchants process transactions they have no intention to complete.

Recent developments on the acquirer part of the business include the rollout of "chip" technology to retail locations at significant development and hardware costs. Acquirers also develop different solutions for their clients. Restaurants will be more eager for wireless solutions so customers can pay at their table. Gas stations will favour integrated solutions that include payment at the pump.

Cohen testified about the variety of "costing" options available to merchants, based on "costs plus" or "base rate plus". Other acquirers offer "average cost" or "bundled rates", a single blended rate for all cards. This may be preferred by some merchants, but acquirers accept a certain risk to this as the composition of any merchant's bundle may change from month to month.

Van Duynhoven testified that the acquirer business is "fiercely competitive" between his firm and five major competitors. Their largest expenses are the interchange fees paid to issuers, assessment fees paid to credit card networks, equipment costs (including depreciation), technology cost (research and development) and service costs.

He identified the competitors as: Moneris Solutions, Global Payments, Chase Paymentech, First Data and Elavon. In Quebec, Desjardins Payment Solutions was also a competitor.

Moneris was created as a joint investment between Royal Bank and Bank of Montreal. Global Payments leverages an exclusive marketing alliance with CIBC and National Bank.

Chase Paymentech began operations in 2002 with the purchase of Scotiabank's acquiring business. First Data is a subsidiary of a U.S. company and Elavon is based in Atlanta.

Appendix 3 - Chronology of Events

The rapid rise in credit card transaction costs produced two important outcomes in 2010. First, the complaints and discussions with the Department of Finance resulted in a Code of Conduct, that addressed some of the issues. It didn't address costs, but did recommend that issuers provide a minimum 90 days notice of fee increases, stop the "unilateral" altering of contracts, use plain language and allow merchants to cancel contracts without penalty.[76]

Canada's Competition Bureau filed a case in December 2010 with the Competition Tribunal, alleging that the policies of Visa and MasterCard violated Section 76 of the Competition Act. The Tribunal received testimony from all the participants in the case, including a selection of merchants, representatives from the credit card networks, the Canadian Bankers Association, and a number of expert witnesses called by the participants. The Competition Bureau targeted credit card rules that prevented merchants from surcharging, and required merchants to "honour all cards". Closing arguments were made in 2012, and the ruling was announced in September 2013.

The ruling was that, although the credit card company policies may be anti-competitive, Section 76 covered rules about "reselling" and did not apply to this case. The Tribunal suggested that changes could be warranted but would have to come from public policy.

Senate bill S-202 *An Act to Amend the Payment Card Networks Act* was introduced in 2014. Similar legislation had been introduced in other years, but on the heels of the Competition Tribunal ruling, this Bill gained importance. The Bill proposed Canada adopt similar interchange fee restrictions as Australia, 0.5 per cent for merchants, 0.3 per cent for public institutions and zero for charities. A series of hearings included testimony from merchants, credit card companies, government officials, but also groups left out of the Competition Tribunal hearings – retail organizations (Retail Council of Canada, Canadian Federation of Independent Business), consumer groups (Consumers Association of Canada) and loyalty programs (Aimia).

In the meantime, political pressure was still being applied. Immediately after the Tribunal ruling, the finance minister remarked that businesses and consumers deserved "fair and transparent rules on the type of payment system they use." In the October 16 Throne Speech, the government added "Canadians are tired of hidden fees. They deserve to know the real cost of paying by debit or credit card…. [we will] empower consumers by requiring disclosure of the cost of different payment methods." In the 2014 federal budget, the language was similar: "The Government will work with stakeholders to promote fair and transparent practices and to help lower credit card acceptance costs for merchants, while encouraging merchants to lower prices to consumers."

Finance Minister Joe Oliver re-iterated this point in early September, saying he expected credit card companies to voluntarily agree to lower interchange fees within "months, not years."

On November 4, Visa and MasterCard each announced plans to reduce the annual effective interchange rate in Canada to 1.5 per cent for five years, beginning April 1, 2015. This represents approximately a 10 per cent reduction from average fees, which were estimated to be 1.61 per cent for Visa and 1.74 per cent for MasterCard.

In making the announcement, Visa clearly indicated it was doing so to avoid a legislated solution. "Visa has long maintained our opposition to regulatory approaches which impair a functioning market and that position has not changed … the nature and content of the undertaking will avoid the kinds of regulatory measures that, when attempted in other markets, have left consumers worse off." [77]

Oliver followed the announcement by indicating that there was no plan for further government regulation.

On April 13, 2015, Oliver announced a number of updates to the Code of Conduct. Some were designed to address merchant concerns, including a provision that ensured that the Visa/MasterCard interchange fee reductions would be passed along fully to merchants, giving merchants greater flexibility to break contracts, shortened renewal periods and a new complaints handling process. Premium cards will be clearly branded and consumers must be "informed" of the fees that premium cards impose on business owners, although there were no details on how that information would be communicated.

Appendix 4 - The International Experience

Australia

Much of the Canadian discussion focused on the Australian experience. In 2003, Australia implemented some of the measures contemplated in Canada. Australia capped interchange fees, and removed credit card restrictions on surcharging. In 2006, the interchange fees were changed to 0.50 per cent, and in 2013, new legislation was introduced to restrict surcharging to reasonable card acceptance costs.

In Canada, both sides saw evidence from Australia's experiences to support their position. Merchants pointed to the fact that the market worked similarly in Australia, and continued to operate smoothly with the lower interchange fees.[78] Australia adopted chip and tap technology at the point of sale. Card companies pointed to studies that questioned whether cost reductions to merchants had resulted in cost savings to consumers,[79] noted a decline in rewards/benefits to consumers,[80] rises in fees as issuers coped with lower interchange revenues, and dramatically underscored the excess surcharging when merchants were given the opportunity.[81] They also noted that the cards exempt from the interchange restrictions – American Express and Diners Club – had increased market share, by appealing to high-spend consumers – and, ironically, adding to merchants' transaction costs.

The Reserve Bank of Australia published another review of Card Payments Regulation in March 2015, allowing for another round of public submissions as part of a regulatory review. That report traced the history and development in Australia. It also included a very illuminating analysis of why competition between credit card networks could move transaction costs higher, not lower.

> "Where the market structure is such that there are two payment networks whose cards are accepted very widely (i.e. merchants accept cards from both networks), and where consumers may hold one network's card but not necessarily both, competition tends to involve offering incentives for a consumer to hold and use a particular network's cards (loyalty or rewards programs, typically). A network that increases the interchange fee paid by the merchant's bank to the cardholder's bank enables the cardholder's bank to pay more generous incentives, and can increase use of its cards. However, the competitive response

> from the other network is to increase the interchange rates applicable to its cards. That is, competition in well-established payment card networks can lead to the perverse result of increasing the price of payment services to merchants (and thereby leading to higher retail prices for consumers). This phenomenon has been most clearly observed in the US credit card market, which has not been subject to any regulation…."[82]

Other highlights from the Australian report:

- The value of card transactions has grown 8.8 per year since 2002, above the growth of household consumption, indicating the 'death spiral' that some observers predicted when interchange fees were first limited, did not happen.
- Card markets continue to innovate, with chip cards and contactless authentication for lower-value transactions. Adoption of contactless technology in Australia has been among the highest in the world.
- Rewards on credit cards have tended to fall, but the introduction of "platinum' and "super-premium' cards makes comparisons over time difficult.
- Surcharges occur on approximately 4 per cent of transactions, most commonly in the "card-not-present" environment (13 per cent), than in the "card present" (2 per cent). Further improvements to the surcharging rules were set out as an objective for the next round of updates.
- Average merchant fees for Visa and MasterCard transactions have fallen *more* than the reduction in interchange fees, 63 basis points in total. Merchant costs for American Express have also fallen.
- American Express and Diners Club have gained market share, but recently have been offered as "companion cards", provided to cardholders as a package with a MasterCard or Visa card. Both cards access the same credit facility, but Cardholders are offered more reward points for spending on the American Express Card.
- On the critical subject as to whether the cost reductions have produced lower prices, the report says it is impossible to measure how these reductions have flowed through into prices for consumers. Rather "just as with reductions in any other business costs – such as wages, taxes, the cost of energy, etc – that influence the prices charged by business in any industry, it seems reasonable to assume that they have mostly flowed through to lower retail prices for consumers, just as it is reasonable to assume that increases in merchant costs are similarly passed on to consumers over time. While the presumption that interchange rates influence the retail prices for goods and services faced by consumers has been questioned by the international schemes and in studies funded by them, it has been widely accepted by others."[83]

The final point does seem to contradict much of the earlier credit card testimony in

Canada, although one person's "it seems reasonable" can be another's "there is no evidence". (Just as "absence of evidence" does not necessarily mean "evidence of absence".) This RBA report does not touch on whether issuers have increased other costs to consumers to offset lost interchange revenues. A 2014 report from the European Credit Research Institute quotes "some economists" suggesting that 30 to 40 per cent of lost interchange fee revenue was compensated for by setting higher fees to cardholders.[84]

While Australian comparisons were certainly the most prevalent, developments in the United States, United Kingdom and European Union are also featured in Canadian testimony.

United States

As a result of a legal settlement, merchants in the United States have been able to surcharge credit card transactions since early 2013. However, there are disclosure requirements and 10 states – including New York, California and Texas – have laws that prevent surcharging. Competitive concerns –surcharging might lead consumers to alternative vendors – have prevented surcharging from gaining much traction. This was the result of a 2005 class action suit against Visa, MasterCard and the largest card-issuing banks. The suit alleged that the card company rules restrained competition on card acceptance fees, violating antitrust laws. The settlement (after seven years) resulted in relaxed "steering" rules, which effectively allowed surcharging. The "Honour All Cards" rule that prevents merchants from declining certain cards was maintained.

Some participants also examined the Durbin Amendment, a 2011 law that effectively capped debit interchange fees. Merchants pointed to studies (Shapiro) that indicated a considerable benefit to consumers in the form of price reductions. Card companies (van Duynhoven) testified that larger merchants benefited substantially, while small and mid-size merchants saw very little change in the fees they were charged by acquirers.

Prof. Todd Zywicki testified to the Senate that Durbin had dramatically reduced access to free chequing, and increased bank fees, harming low-income consumers. He said he found no evidence that large retailers – who benefited most from the interchange fee reductions – had passed their reduced costs to consumers via lower prices.[85]

European Union

The European Commission proposed reforms to retail payment rules in 2013, and, by the end of 2015, the European Parliament and Council of European Union are expected to approve an amended version. The requirements are similar to those in Australia – interchange fees on credit card transactions capped at 30 basis points, (20 basis points for debit), although some variations will be allowed. The EC noted that interchange fees are unseen by consumers but cost retailers and ultimately consumers tens of billions of euros each year. "Capping the interchange fees will reduce costs for retailers and consumers and help to create an EU-wide payments market. This should encourage innovation and give more scope for payment providers to offer new services."[86]

United Kingdom

The United Kingdom was largely overlooked in Competition Tribunal testimony, save for the witness reports of Peter Dunn. He noted that surcharging had been permitted for the past 20 years, but had only risen in the past few years, primarily in online transactions. The most common industries to surcharge included airlines and travel, as well as cinema and theatre tickets.

British regulators tabled their investigations into domestic interchange fees in 2014 as EU legislation neared adoption.

Appendix 5 - Focus Group Questionnaire, Script and Exercises

THIS SECTION TO BE COMPLETED BEFORE THE SESSION STARTS:

What credit card do you use most frequently?

What are the main benefits you associate with using that card, not including the ability to delay paying for your purchases, and accumulating points / miles/ other rewards?

Is there a dollar amount at which you usually switch from paying by cash or debit to paying by credit?

What is the amount?

What credit card loyalty program do you use most frequently?

Can you briefly describe how you earn points/miles/other rewards?

For every $100 you spend, approximately how much value in "rewards" do you think you earn?

FOCUS GROUP SCRIPT/ BRIEFING NOTES

(Note that this is the script prepared in advance of these sessions. In the actual sessions, this may not have been the EXACT wording used.)

Script Sections

1. Introduction
2. Understanding Personal Spending
3. The Payments System
4. Loyalty Rewards Programs
5. Here's How it Works
6. POS Transparency

7. Discounting
8. Surcharging
9. Transaction fee limits and reduced rewards
10. Conclusion

Sections 6 through 9 should be randomized through the different sessions
Montreal 5:15: 6 7 8 9
Montreal 7:30 7 6 9 8
Toronto 5:15 8 9 6 7
Toronto 7:30 9 8 7 6

Introduction (5 mins)

Good evening, and thanks to all of you for coming out tonight to help us with some research.

In this evening's session, we'd like to learn more about how you make your spending decisions. We're not particularly interested in what you choose to buy, but we are interested in how you choose to pay for your purchases.

There are two important considerations before we get started.

First, the discussion tonight is research in the name of research. There is no commercial interest. It is not being sponsored by any company or business group. (*If asked, indicate you can provide more information after the session.*)

Second, we will be asking you questions about your personal spending choices. I want to assure you that this information will not be used for any purpose other than this research project.

As much as possible, we need your uninterrupted attention for this period of time. If you have a cell phone, if you can, please turn it off. If that's not possible, then please put it in silent mode.

There are no right or wrong answers to the questions I will ask. I simply want to hear your personal perspective. We are not trying to form a consensus, so if you have an opinion that differs from others in the room, please express it.

I want to assure you that all your responses are completely confidential. Our discussion is being recorded – this is done so that I can listen attentively without having to take too many notes. At a later time, while writing the report, I will listen to our recorded conversation so I ensure I have captured your feedback accurately. I can also assure you that we will not reveal your names to the sponsor, and the comments you make today will not be attributed to you personally. So please be candid, open and honest with your responses.

A few of my colleagues are behind the one-way glass. They are here this evening because they are very interested in what you have to say. Yet, it would be very distracting if they were in this room with us. You will quickly forget that they are there.

Understanding personal spending (10 mins)

We'd like to get things started by asking each of you how you pay for the purchases you make in person. You can pay for purchases any number of ways. The most common are cash, credit cards and debit cards, but you may also use cheques, gift certificates, prepaid cards or rewards from a points program.

How do you pay for most purchases you make in person?

Do you know how you're going to pay when you enter a store, or do you sometimes decide only at the checkout counter?

Before we started, we asked each of you to write down if there was a dollar threshold up to which you normally pay cash? What is that amount?

What kind of purchases do you choose to make by credit card and what by debit card and what by cash? What influences your choice?

How many of you make purchases online? How frequently do you do so? What methods do you use to pay for your online purchases?

Payments system (15 mins)

How many credit cards do you have? How many debit cards do you have? Of all those cards, how do you choose which one to use?

How did you come to own the credit cards you use most often?

* * *

What do you see as the benefits to a merchant when a customer uses a credit card?

(Listen for mentions of the following benefits. If not mentioned, probe….)

Consumers can purchase items without having cash on hand, or even cash in their bank account.

Merchants get paid quickly, before the customer has the funds to pay their credit card bill.

If the credit card is fraudulently used, the merchant still gets paid.

Credit card transactions are processed quickly with new technology

Do you prefer to swipe, insert or tap? Why is that?

When a store accepts a credit card purchase, there are costs associated with that transaction.

INDIVIDUAL EXERCISE #1: How much do you think these costs might total on, say a credit card purchase of $100?

(Have each participant record the amount on a piece of paper. Allow them to express it as a $ figure or as a %, whichever they prefer. Then, have each person reveal their answer.)

Loyalty rewards programs (15 mins)

Now I'd like to ask you a few questions about another dimension of your credit card purchases. Most credit cards now allow you to accumulate rewards that you can use in the future. Every time you use your card for a purchase, you may receive additional benefits. Among them may be miles or points or dollars or cashback refunds at the end of the year, and they may come from your credit card or a separate program such as Air Miles, Aeroplan or Shoppers Drugmart Optimum. Many of these programs are collectively known as loyalty programs, and we'd like to ask a few questions about these loyalty programs.

Each of you indicated that you were a member of some loyalty program to qualify for tonight's session.

How do you choose loyalty programs? Have you joined a program specifically because of the rewards, or does the card choice come first and the rewards follow from that?

Do you know how fast your points or miles accumulate? How much do you have to spend to earn one?

Do you ever pay for something with a credit card instead of cash or debit because you know you are getting points/miles?

Do you ever make a decision to spend a little bit more than you intend so that you can collect more rewards, perhaps to receive a special offer of more points?

Do you prefer loyalty programs from a single place like PC Financial or Shoppers Drug Mart Optimum, or those that offer a number of sources, like Air Miles or Aeroplan?

INDIVIDUAL EXERCISE #2: Where does the money come from that funds the rewards?
(Have each participant record their answer on a piece of paper. Then, have each person reveal their answer.)

Here's a simplified version of how it works…. (10 mins)

So far, we've talked a little bit about how you make your payment choices, how the payment system works, and how you collect rewards.

Now we're going to talk about how all those topics are connected.
Here is a printed summary to help you follow. (*"How it Works" Handout to accompany this section*)

Earlier we talked a bit about how much merchants pay on the credit card transactions. It probably won't surprise you that they'd like to pay less than they're currently paying. When we talked earlier, you guessed that the costs might be from xxxx to xxx per cent. (*Use figures from earlier discussion*). The actual number is typically between 2 and 3 per cent. There's a range because different types of credit cards have different costs. There's a difference between Visa and MasterCard, but there are also differences within Visa or MasterCard, depending on the type of card you own. There are also differences depending on the type of industry the merchant is in. And costs are higher in transactions where the physical card is not present like in telephone or internet transactions. But for now that 2 to 3 per cent is a reasonable average.

So if you put a $100 purchase on a credit card, the store will generally receive about $97 to $98 on that purchase. But they get that $100 the next day at the latest, and pay for the transaction costs later.

The transaction costs, the $2 or $3 on that $100 purchase, eventually reaches three other parts of the credit card network.

MODERATOR TO HAVE THESE THREE GROUPS WRITTEN (BUT OUT OF SIGHT) ON FLIP CHART PAPER. REVEAL JUST BEFORE THIS DISCUSSION. Part of it ends up with the firm that provides the equipment at the checkout counter (Moneris, Chase Paymentech). Part of will be for the credit card company, Visa or MasterCard. And the final part goes to the issuer of the card, TD Bank, Scotiabank, Citibank etc.

Do you want to guess which of those three groups receives the largest share? (*quick poll / show of hands*)

So, Canada's merchants have lobbied the government, and the government has pledged to lower the amounts merchants pay. One of the main points that these merchants made is that it costs them more to accept credit card transactions than it does to accept debit cards or process cash. Because of credit card rules, they cannot charge more to credit card customers, and they can't refuse to accept the higher cost cards, so they say that the rules leave them with no choice but to build these costs into the overall price of the goods and services they charge everyone.

Have any of you heard or read anything about this issue recently? What do you remember?

The merchants suggest that people who pay in cash end up paying a portion of the costs for those who pay for credit, and that's not fair.

Now, the credit card companies and the companies that issue the cards make a number of points when this argument comes up. They will note that people who pay with credit cards tend to make larger purchases than those who pay with cash, and that's good for merchants. We discussed some of these things earlier. They note that they provide credit to customers, which allows them to make purchases without having the money on hand, and that merchants receive their payments by the next day at the latest. And they note a specific merchant won't bear the risks of fraud directly.

The banks who issue cards will also note that they use the money they receive from credit card transactions to cover their expenses, to provide numerous rewards to customers through loyalty programs, as well as generate a profit above the expenses and rewards.

The key point being made by the banks and credit card networks is that a part of what it costs merchants to process credit card transactions ends up back with consumers in the form of points or miles or other rewards.

Next, we will discuss some of the alternatives that have been suggested by merchants and the government. We'd like to hear what you think about these suggestions and how they might influence your decisions.

(The following four sections will be randomized, to reduce the effect of the order in which they appear.)

POS transparency (10 mins)

One of the options being discussed is a rule that would require merchants to show consumers at the cash register how much it may cost the merchant to process the transaction. It might come in the form of a sign, or some information printed on the receipt, or perhaps a cashier could even say "using a credit card will increase our costs by 2.3 per cent." Some say adding this information to every sale would be useful to consumers and might lead some people who were considering paying by credit to choose an alternative.

What effect do you think it would have if this information was provided at the checkout on a sign before you have to make a payment choice, or if the cost of processing the credit card transaction was shown on your receipt afterwards?

Would your answer differ if you were dealing with a local merchant with whom you have a relationship and a large company?

If instead of just a sign or a notice on your receipt, the merchant asked if you would be kind enough to pay cash for your purchase because it reduces their costs, how would you react? How do you think most consumers would react? Would your answer differ if you were dealing with a local merchant instead of a large company?

Knowing this, does it matter to you what it costs the store to process a credit card transaction? How do you weigh the costs to the store against the convenience – and the rewards – that a credit card transaction provides to you?

Discounting for cash (and debit) (10 mins)

Another alternative being considered is to instead reduce prices for people who choose to pay with a method that costs merchants less, such as cash or debit. Merchants often object to this approach, because they say it is necessary for them to advertise the lowest possible price for competitive reasons. But on the other hand, people have said that this is actually how some of the earliest loyalty programs worked. If you remember Canadian Tire Money, with that smiling Scottish guy or the rolling tire logo, if you paid in cash, you would receive paper that you could use at Canadian Tire to reduce the price of a future purchase.

INDIVIDUAL EXERCISE #3: How much of a cash discount would need to be provided to get you to switch from credit to cash? On a $20 purchase? On a $75 purchase. On a $200 purchase.

(Ask attendees to write down their answer to this question and then collect the responses.)

If you're buying a $1,000 item, maybe a large-screen TV theatre system, how do you typically pay, cash, debit or credit? Discuss the reasons. Among those of you who would prefer to pay with credit, How much of a discount might you need to make that size of a purchase with cash or debit?

With your own purchase decisions, would your answer differ if you were dealing with a local merchant with whom you have a relationship and a large company?

Let's consider a $50 item, and you have two payment choices. One is to take a 2 per cent cash discount and pay $49 in cash. The other option is to pay $50 on credit and receive a future coupon value – like Canadian Tire money. How large would that coupon need to be to make that your likely choice, compared to $49 in cash?

Surcharging (10 mins) and Card Rejection (10 mins)

Another alternative being considered involves changing the rules for credit card use. There are two rules that some merchants would like to see changed. One would allow "surcharging", so that merchants could add to the price for customers who paid with premium, higher-cost credit cards, or perhaps any customer who paid with credit.

What do you think of this rule? Why is that? DISCUSS.

Individual Exercise #4: If surcharging were allowed, how much do you think

merchants would surcharge?
(Ask attendees to write down their answer to this question and then collect the responses.)

How might you react the first time this happened? How do you think most consumers would react?

(Answers will probably indicate a one-time shock factor, but re-ask with a longer-term perspective.)

But over time, after six months of surcharges, do you think those attitudes might change?

Would your answer differ if you were dealing with a local merchant with whom you have a relationship, compared to a large national or international company?

The other rule would give merchants the ability to reject certain cards. Under current rules, if you accept Visa, you must accept all Visa cards, basic or deluxe. The same goes for MasterCard. Some merchants would like the ability to say "no" to certain cards that have higher fees.

The credit card companies note that these rules are important to protect consumers. Consumers need to know that if a store has a Visa or MasterCard sign, that the card in their wallet will definitely be accepted.

What do you think of this rule? Why?

If you went to pay with a credit card and the merchant said they didn't accept that particular card, what would you do? What do you think most consumers would do?

Would your answer differ if you were dealing with a local merchant with whom you have a relationship, compared to a large national or international company?

What if this came after a few minutes of work to make a purchase online? If it cost you an extra 1 per cent to use your card on an internet purchase, would you click away from the transaction or pay the extra 1 per cent?

Interchange Caps – Lower Costs and Lower Rewards (10 mins)

This is probably the most crucial of the scenarios being examined, because it's the one where *rewards and payments are most directly linked. We need to ensure this has adequate time.*

The final scenario being considered would involve reducing the fee paid by merchants. Visa and MasterCard just announced plans to voluntarily reduce the amounts that would flow from merchants to card issuers for transactions on their networks. Other countries have imposed much lower cost limits.

Some merchants have indicated they are happy to see the cost reductions, though they were hoping for larger reductions. The amounts they will have to pay to accept credit card transactions will be reduced. But others have suggested that it might lead to many other consequences that would ultimately be bad for consumers. To make up the lost revenues, banks could increase annual fees for credit cards. It might mean higher interest rates on outstanding balances. And it could mean lower amounts available to fund reward programs.

We have a couple of questions in this area, but let's start with this one.

Individual Exercise #5: If the credit card costs were lowered to merchants, do you think they would pass along those savings to consumers with lower prices? How so?
(Ask attendees to write down their answer to this question and then collect the responses.)

Do you think banks and other card issuers would be more likely to raise interest rates or increase annual fees or change up their loyalty programs? What makes you say that? What would be your preference?

If the government imposed larger reductions in these transaction costs and that meant your points would accumulate at half their current rate, so it took twice as much spending to generate a mile, or a specific reward, would that affect your willingness to participate in loyalty programs?

And in turn, would that then change how you pay for your purchases? Would you be more likely to pay in cash? By debit? Would you carry more cash in your wallet as a result?

Do you think most consumers would think the same?

Would your revised payment choices differ between a favourite local small business and a larger international company?

Closing (15 mins)

We've talked about some of the alternatives being discussed. We'd like to finish with a little exercise that compares some of the alternatives.

We have prepared a handout (*circulate*) to cover how some of the alternatives would work and how you might compare them.

For the sake of this exercise, let's say that you are making a $100 purchase on a credit card and, when you do that, you receive the equivalent of $1.50 in loyalty rewards/points.

Alternative A is a discount for paying in cash. The merchant instead drops the price to $98.50, if you pay with cash, but as a result, you don't earn any points.

Alternative B involves the government more strictly limiting transaction costs. The merchants reduce their prices to $99.50 because their transaction costs are lower. But your rewards are cut too, so you only earn half as many points or miles, just $0.75.

Alternative C involves giving merchants the ability to surcharge for credit card purchases. They increase the credit card price to $101, but you still earn the $1.50 in rewards.

On the form, take a few minutes and rate those options for us. First, rank them from 1 to 3, from the alternative you would be most likely to choose to least likely to choose.

Which is your favoured and why? Which is your least favoured and why?

Now, consider the current scenario, where you pay for your $100 purchase with a credit card and receive loyalty rewards or points of $1.50. Comparing the current scenario to alternatives A and B only, how would you rate those three, based on how likely you would choose each payment

How might your choices change if we were asking about a $20 purchase or a $1000 purchase instead, but the ratios remained the same?

This evening we have considered a number of different scenarios that could change how the payments systems work. Here's a summary to remind you (*Handout Summary "Five Alternatives"*)

* * *

We've discussed adding information at the checkout counter. Allowing a merchant to tell you exactly how much a credit card transaction costs them to process and asking customers to pay with cash instead.

Another alternative is cash discounting. That would allow consumers to pay a lower price if they chose to pay with lower cost alternatives such as cash.

We've covered potential changes to current credit card rules. One change would allow merchants to add a surcharge to transactions that used higher cost premium credit cards. Another change would allow merchants to refuse to accept payment from higher-cost premium credit cards. In both cases, merchants say this will better allow them to align the costs of credit card transactions with those who use the cards

And finally, we've discussed the possibility of the government imposing much lower limits on all credit card transaction fees. That would reduce costs to merchants, who could, in turn reduce prices to consumers. But it could also result in a large reduction or even elimination of loyalty reward programs, and possibly higher costs for annual credit card memberships and credit borrowing.

Considering those five alternatives, which of those do you view favourable or unfavourably? Indicate your choices with a check mark or "x" on the sheet.

What is your favourite? Why? What is your least favourite? Why?

That ends tonight's discussion. Thank you all very much for taking the time to talk with us about these issues.

I'd like to ask you all to sign out at the front desk as you leave, and there you can collect your own loyalty reward for helping us with our research this evening

(If there has been an interest, you can disclose that tonight's session is part of a consumer research project by the Consumers Council of Canada.)

Participants will sometimes ask interesting questions when milling about afterward. We should keep our ears out for these comments.

END OF SESSION EXERCISE AND QUESTIONNAIRE

First Name Only : ______________________

Assume that in the current situation, an item is priced at $100. When you pay for that $100 item with a credit card, you receive the equivalent of $1.50 in loyalty rewards/points. How do you rate that against the following alternatives?

	Description	Pay	Rewards
	Current	$100 on credit	$1.50
Alternatives			
A	Discounts for cash	$98.50 in cash	$0
B	Reduced transaction fees, reduced rewards	$99.50 credit	$0.75
C	Additional charges for credit card payment	$101 on credit	$1.50

Please indicate your preferences, where “1” is your most likely choice and “3” is the least likely choice

Alternative A Alternative B Alternative C

__________ ____________ ____________

Comparing the current example with Alternatives A and B only, please indicate your preferences, where “1” is your most likely choice and “3” is the least likely choice.

Alternative A Alternative B Current

____________ _____________ ____________

Five Alternatives

For each alternative, indicate with a check mark those that you view as favourable, and an “x” to identify those that you view unfavourably. If you are unsure, leave empty.

Information at the Checkout ▫
This would allow the merchant to show information about credit card fees, or require them to disclose the cost of processing credit card transactions on receipts.

Cash Discounting ▫
Provide consumers with lower prices at the cash register if they choose to pay for a purchase with cash or debit instead of credit.

Changing Card Rules to Allow Surcharging ▫
Allow merchants to add an additional cost at the cash register for customers who wish to pay with premium credit cards that have higher transaction costs. This will align the costs of the premium cards with those who use them, instead of allocating those costs to all consumers.

Changing Credit Card Rules to Allow Merchants to Decline Certain Cards ▫
Allow merchants to refuse to accept certain premium credit cards that have higher transaction costs. This will prevent the costs of premium cards from affecting prices to all customers.

Government-imposed Reductions to Transaction Costs ▫
Government regulations could impose limits on credit card transaction costs to merchants. Merchants could use those reduced costs to lower prices to consumers. Consumers would also likely see reduced (or eliminated) benefits from loyalty programs, and higher costs for credit card membership.

Appendix 6 - Complete Focus Group Results (Data)

Each of the focus group sessions included three sets of questions that required written responses from participants. The first set was handed to participants before their session started. The second set included a number of questions asked at various intervals through the session. The final questions were asked at the conclusion of the session.

In this section, the project researchers report on the written responses from the three sets of questions. Note that this represents the responses from 38 focus group participants in Toronto and Montreal. The responses are very interesting and revealing, but it is an extremely small, selective sample from which to draw any meaningful conclusions.

Pre-Session Questions

Participants were required to write down their answer to these questions while in the reception area prior to the focus groups.

Q: What Credit Card do you use most frequently?

Only two respondents did not include “Visa” or “MasterCard” in their response – one said “Amex”, one said “BMO”. Of the other 34, just nine included the name of an issuer, and five included the name of a loyalty program in the response.

The key takeaway was that the participants more closely associated their credit card to the network than to the issuer or loyalty provider.

Q: What are the main benefits you associate with using that card, not including the ability to delay paying for your purchases, and accumulating points/miles/other rewards?

The responses were not what was expected. Answers such as “travel insurance, special event tickets, it’s easy to tap, it’s accepted everywhere, online purchases, etc.,” had seemed possible. Those could have been later tested against their specific card. Instead 37 very diverse responses were received, many of which fell into the categories specifically excluded in the question (”I can pay a month later, I get Air Miles, etc..) Among the more interesting responses were “maintaining a good credit rating to increase my future credit limit”, “extended warranties”, “easier to track purchases” and “car insurance, trip cancellation insurance.”

Q: Is there a dollar amount at which you usually switch from paying by cash or debit to paying by credit?

Eleven respondents said “no”. The balance indicated a number.

Q: What is the amount?

Four participants said they use credit for every purchase. Two indicated they used it only for extremely large purchases – $3,000 or more for one, “cars and vacations” for the other. Otherwise, the answers clustered around $10, $20 and $100.

Q: What credit card loyalty program do you use most frequently?

The most common answers were Air Miles and Aeroplan. Six responded their loyalty program as either “Visa” or “MasterCard”.

Q: Can you briefly describe how you earn points/miles/other rewards?

Every single respondent expressed an understanding that rewards were earned based on purchases by a credit card or at certain retailers.

Q: For every $100 you spend, approximately how much value in “rewards” do you think you earn?

Nine respondents said they were not certain and offered no guess. Eight offered vague language around “it depends”. About half (20) included a number in their response. The numbers ranged from $0.10 to $20. Here is a breakdown:

$0.10 - 1
$1 - 5
$1.50 - 2
$3 - 1
$5 - 5
$10 - 4
$20 - 1
$5 to $20 - 1

In the sessions, a few participants insisted that the $5 amount was correct. Later specific cards were checked, and it was found that some did provide 5 per cent cash back rewards on short-term promotions for purchases made at specific merchants, but then reverted to a more conventional 1 per cent to 2 per cent reward after the short-term promotions ended.

In-Session Questions:

These questions were asked at different points during the focus group sessions.

Participants were asked to write their responses as each particular topic was being introduced or discussed.

Q: How much would you estimate are the total transaction costs that a merchant is required to pay on a $100 credit card transaction?

Two participants declined to guess. A few participants responded with ranges (i.e. “$2 to $3”). In those cases, the midpoint of the range (ie $2.50) was used. Here is a breakdown:

$0.25 - 1
$0.50 - 1
$1 - 4
$1.50 - 1
$2 - 12
$2.25 - 1
$2.50 - 1
$3 - 2
$3.50 - 1
$5 - 9
$10 - 2
$15 - 1

Q: Where does the money come from that funds loyalty/rewards?

This question was intentionally worded vaguely, to allow participants to express the source as either a firm (banks or merchants or credit card companies) or as a process (i.e. transaction fees, annual membership fees or interest on credit card balances, etc). The responses were varied. Many participants included qualifiers such as “maybe” or “perhaps” in their responses.

The mode response was “merchants/vendors/retailers”.

Merchants - 10
Consumers - 4
Bank/caisse populaires - 4
Consumer interest payments - 2
Interest or merchants - 2
Advertising/marketing/promotions - 2
Markups on everything I buy - 2
Bank or retailer - 2
Purchase price - 2
Credit card company fees - 1
Purchases of all clients - 1

Profits/government incentives - 1
Cash between the store and consumer - 1
Manufacturers brands - 1
Merchant and credit companies - 1

One interesting observation is that not one participant linked the funding directly to the loyalty program ("Air Miles" or "Aeroplan"). All seemed to understand that the funding came from elsewhere.

Q: How much of a cash discount would need to be provided to get you to switch from credit to cash on a $20 purchase?

This question was asked after the concept of alternatives being considered to reduce credit card transaction costs was introduced. A few respondents indicated that no discount was necessary, as they already paid for $20 purchases with cash. Participants were allowed to express their answer as either a percentage or a dollar figure. Percentage responses were converted to dollars, as the majority replied in dollars. Responses ranged from $0.20 to $5. The median and mode response were $2.

Under $1: 5
$1: 7
$1.50: 2
$2: 12
$2.60: 1
$3: 1
$5: 7

Q: On a $75 purchase?

Again, a few participants said no discount would be necessary, as they already paid for $75 purchases in cash. Responses ranged from $1.25 to $20. The median was $5 and mode was split among $3.75 (5 per cent), $5 (6.7 per cent) and $7.50 (10 per cent)

Under $2: 6
$2.25: 1
$3: 1
$3.75: 4
$4: 1
$5: 4
$6: 1
$7: 1
$7.50: 4

$9: 1
$9.75: 1
$10: 3
$11.25: 3
$15: 3
$20: 1

Q: On a $200 purchase?

Responses ranged from $4 to $60. Median and mode responses were $20 (10 per cent).
$4 to $7: 8
$10: 6
$15: 1
$20: 11
$25 or $26: 2
$30: 3
$40: 3
$60: 2

Note that the median and mode discount rate is the same for both the $20 and $200 purchase.

It would be improper to conclude that consumers would behave consistently with the numbers expressed here. But their initial responses suggest that the cash discounts required to motivate changes in payment could exceed the amounts merchants would find acceptable.

Q: If surcharging for credit card transactions were allowed, how much do you think merchants would surcharge?

This question was asked after introducing the concept of allowing merchants to surcharge for either premium credit card payments, or all credit card payments. Four respondents indicated a specific dollar figure, rather than a percentage, and two of those four included language specifying that they thought it would be a "fixed rate". The balance of respondents expressed it as a percentage, ranging from 0.25 per cent to 10 per cent. One responded "as much as they could get away with".) The median and mode response were 2 per cent.

Q: If the credit card transaction costs were lowered to merchants, do you think they would pass along those savings to consumers with lower prices?

This question was asked after the introduction of the concept of fee constraints that would reduce the costs of processing credit card transactions to merchants.

One respondent said yes. Three gave ambivalent answers (“yes and no”, “maybe”) indicating that merchants might have to, if there was enough publicity/public awareness of the issue.

The balance of the respondents answered “no”. Many included comments that indicated cynicism on the issue, including:

“They want to make as much as possible.”

“They are there to make profit for themselves.”

“Merchants are hungry for money. They feel they need all the profit possible.”

“Merchants want to put more money in their pocket.”

“Costs aren’t divulged. Costs are hidden.”

“Not in a billion years.”

End-of-Session Questions

Each session concluded with exercises to help assess the relative preferences of the four alternatives presented. In the first, participants were asked to ordinally rank preferences of the three alternatives to the current scenario. In the current scenario, an item is priced at $100. When you pay for that $100 item with a credit card, you receive the equivalent of $1.50 in loyalty/rewards points.

Alternative A was a cash discount of 1.5 per cent, so the consumer paid $98.50 in cash, but earned no rewards.

Alternative B considered capped transaction fees, that resulted in reduced rewards. This involved making some assumptions, but for simplicity, it was assumed that the merchant would share a portion of the reduced costs with consumers, lowering the credit card price to $99.50. But the lower transaction fees would also lower loyalty rewards to $0.75.

Alternative C involved a surcharge for the credit card purchase. The credit card price would rise to $101, but the consumer would continue to earn $1.50 in rewards.

No alternative reflecting point of sale disclosure nor the “decline cards” was workable in this exercise.

Post-Session Exercise

Label	**Pay**	**Rewards**	**Description**
Current	$100 credit	$1.50	
Alternative A	$98.50 cash	$0	Discount for cash
Alternative B	$99.50 credit	$0.75	Reduced transaction fees, rewards
Alternative C	$101 credit	$1.50	Credit surcharge

There are obviously a number of serious limitations with this exercise. It considers $100 purchases only. It makes a number of assumptions about levels of cash discounts merchants would consider, the size of price reductions if interchange fees were capped, a guess about the size of reduction in loyalty rewards. Only expressed preferences can be measured, which will not match actual behaviour.

Here is a summary of the responses to this exercise:

	First Choice	**Second Choice**	**Third Choice**
Alternative A	16	9	11
Alternative B	14	18	4
Alternative C	6	9	21

Comparing just A and B, 18 preferred A, 18 preferred B
Comparing just A and C, 23 preferred A, 13 preferred C
Comparing just B and C, 28 preferred B, 8 preferred C

This was a difficult exercise to use, as some participants had difficulty understanding the options. Many also took an extremely granular view of the choices, when it was designed to get more of a first-response “knee-jerk” reaction. Some participants, for example, wondered why (comparing B to C), anyone would pay $1.50 more to receive just $0.75 in loyalty rewards. That’s a fair point – as complex as this exercise seems, it is an over simplification of what could actually occur.

But if one were to measure just attitudes, it would reflect a relatively even split between discounts for cash payments and a small reduction in both price and loyalty rewards, with both alternatives favoured over surcharges.

This exercise was re-run with the current scenario added as an option. Alternative C was eliminated from this exercise, as no rational consumers should consider paying $1 more on credit to buy the same product and receive the same reward.

Here is a summary of responses to that exercise:

	First Choice	**Second Choice**	**Third Choice**
Alternative A	7	9	17
Alternative B	5	17	11
Current	21	7	5

Comparing just A to current, 8 preferred A, 25 preferred current.
Comparing just B to current, 9 preferred B, 24 preferred current

Comparing just A to B, 15 preferred A, 18 preferred B
Five of 33 respondents preferred BOTH A and B to current.

All of the similar warnings and limitations apply to this exercise. But it does appear that the current scenario is viewed as or more favourably to any of the alternatives. Yet, there is a significant portion that would sacrifice $0.75 in loyalty rewards to save $0.50 in cost. But again, the exercise was done with some haste, and some of the participants displayed a surprising amount of attention to detail about $0.25 advantages to one approach over another, when two hours earlier, they had little idea at all about how fast their rewards accumulated or how they were funded.

In the session's final scenario, participants were asked to give a simple "positive" or "negative" rating to the alternatives discussed.

	Positive	**Negative**	**Neutral**
Point of Sale disclosure, information at checkout	19	18	1
Discounting for cash purchases	37	1	
Changing card rules to allow surcharging	2	36	
Changing card rules to allow merchants to decline	3	35	
Government imposed reductions to transaction costs that would reduce loyalty rewards	21	16	1

Notes

1. Gauthier (2012), for example
2. The report is accompanied by appendices (English only) that elaborate on points touched on in the report. Appendix 1 provides an overview of how the payments system works, as well as some definitions. Appendix 2 discusses acquirers. Appendix 3 provides a timetable of events. Appendix 4 includes how this issue is treated in other countries, most notably Australia, which was referenced very frequently in testimony. Appendix 5 is the scripts and exercises used in the focus group, and Appendix 6 is an analysis of the results of the written exercises from the focus groups.
3. Obtaining these views with attribution would not have been possible. The viewpoints were collected and presented to help understand how industry participants perceive or interpret subject matter.
4. Li, de Armas, Van Impe, Jewer, Daigle, Symons, Broughton, Houle, Shirley
5. Senate, Issue 13
6. Senate, Issue 12
7. Senate, Issue 13
8. Senate, Issue 13
9. Senate, Issue 13
10. Senate, Issue 13
11. Interview, Aug 1, 2014
12. Interview, Aug 1, 2014
13. Symons, para 54-60.
14. An expanded discussion of other markets is included in Appendix 4.
15. Interview, Aug 1, 2014
16. Senate, Issue 15
17. Senate Issue 15
18. Although a study by the Consumers Council of Canada noted that U.S. consumers experienced equivalent price reductions on hockey equipment without any tariff reductions. http://www.consumerscouncil.com/index.cfm?id=13948
19. This section is drawn from numerous submissions to the Competition Tribunal, senate testimony and interviews conducted by our researchers.
20. Specific benefits from Sheedy, Stanton
21. MasterCard opening submission
22. Visa opening remarks Par 23
23. MasterCard Closing submission, par 557.
24. Senate, Issue 14.
25. Interview with a payment system representative
26. MasterCard closing par 270
27. See Appendix 4 for more

28. Visa opening submission
29. Weiner, par 5
30. Senate,Issue 14
31. MasterCard closing submission, par 250
32. Sheedy, par 70
33. MasterCard closing appendix, page 245
34. See Appendix 4 for more
35. Yi 2003
36. Aimia Infographic and Bond 2014
37. Aimia Infographic and Bond 2014
38. Aimia Infographic
39. Berry, 2013
40. Interview with Aimia
41. PIAC and MoneySense
42. Interview with Aimia
43. Berry, 2013
44. Maritz, 2013
45. Berry 2013
46. Bond 2014
47. Bob Groppe, VP MasterCard, Colloquy Webinar, Sept 2014
48. Groppe
49. Mike Scafidi, Pepsi, Colloqy Webinar October 2014
50. Bond 2014
51. Bishop 2013
52. Interview with loyalty representatives
53. Berry 2013
54. Hewitt, par 25-28
55. Although it would be a really interesting one
56. The information was shared with our researchers to help consumer awareness. We cannot verify the accuracy of the figures.
57. Federal budget, p 186
58. The script for the session, including participant exercises, is in Appendix 5. Analysis of the aggregated written exercise results is in Appendix 6.
59. More details are available in Appendix 6.
60. The complete script is in Appendix 5.
61. A complete breakdown is in Appendix 6
62. These attitudes were all expressed at a time when retail gasoline prices were moving substantially lower in both Toronto and Montreal.
63. This exercise is discussed in more detail in Appendix 6.
64. Interview with a bank representative
65. Interview with a bank representative
66. Curry 2015
67. Steiner 2015.
68. CIBC and Rogers hit the market in late 2012 with credit card transactions through a smartphone. RBC

Wallet in 2014 allows debit and credit
69. Weiner
70. Aimia, Moving Pictures 2013
71. See: http://itools-ioutils.fcac-acfc.gc.ca/STCV-OSVC/ccst-oscc-eng.aspx
72. Global News, April 14, 2015
73. Although it may assume greater knowledge about credit card basics and terminology than is warranted.
74. TD testified to the Competition Tribunal that it paid Visa quarterly
75. Semeraro 2013
76. The Financial Consumer Agency of Canada cited in 2013 card issuers for numerous violations but refused to name the companies involved, and issued no penalties.
77. Visa Issues, 2014
78. Senator Pierrette Ringuette who sponsored S-202, made this point frequently
79. Many pointed to Chang, Evans and Garcia (2005)
80. Leggatt
81. Sheedy and van Dynhoven, for example
82. Reserve Bank of Australia, 2015
83. RBA 2015
84. Malaguti and Guerreri, 2014
85. Senate, Issue 15
86. EC Press Release July 24, 2013