How Merchant-Funded Rewards Give New Life to Customer Loyalty Programs

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and
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Introduction

It is becoming increasingly obvious that outdated bank-funded loyalty programs have lost value. The market is beginning to recognize the value of merchant-funded programs as supplements and even replacements to traditional loyalty programs, but not all such programs are created equally.

For several decades, financial institutions (FIs) have used traditional point-based or cash-back reward incentives as a way to build customer loyalty and increase usage of their bankcard products. According to a 2008 First Data study, 76 percent of consumers belong to a credit card loyalty program. Unfortunately, over time these programs have become increasingly less effective in helping FIs retain customers and influence their purchasing behavior.

The proliferation of nearly identical loyalty programs throughout the marketplace has diminished the ability for companies to differentiate themselves through these programs. In its 2007 report, Sizing Up the U.S. Loyalty Marketing Industry, Colloquy estimates that each household belongs to an average of 12 different loyalty programs—and that less than half of these programs are actively participated in.

Loyalty programs have become commodity items that are ubiquitous and nearly indistinguishable from each other, forcing FIs to undertake costly (and often ineffective) promotional tactics, like temporarily boosting reward percentages, to set themselves apart. Escalating resource constraints have also contributed to the decline in the overall effectiveness of traditional loyalty programs. Because of the deteriorating value of these programs, many FIs have diverted marketing resources—resulting in lackluster programs with decreased appeal and even less relevance to customers.

As a result of today’s slowing economy, consumers are becoming more financially savvy and demanding better terms and rewards from their bankcard loyalty programs. As a condition of their participation in a program, consumers are constantly looking for a broader range of rewards, as well as new ways to accelerate their earnings and reward fulfillment. On the other hand, FIs want more potent reward programs that add greater value to their marketing portfolios, create genuine differentiation in the marketplace and provide higher returns on their marketing investments. Merchants, in turn, seek to participate in bankcard loyalty programs that increase brand awareness, drive traffic to their stores and offer a unique but cost-effective promotional tactic that avoids the problem—discussed later in this paper—of “triple-dipping” often associated with registered-card programs.

Each of these goals can be addressed with a premier merchant-funded loyalty program—an alternative to traditional loyalty programs that combines a bank-sponsored program with merchant-funded rewards. The premier model allows financial institutions to develop customized, highly-effective bankcard loyalty campaigns that meet critical marketing objectives, including:
→ Increased card usage
→ Improved customer acquisition and retention
→ Strengthened relationships with consumers and merchant partners

Premier merchant-funded loyalty programs also give merchants the opportunity to focus their marketing efforts and dollars on relevant, valuable customers, making marketing dollars work harder.

The purpose of this white paper is to provide a better understanding of premier merchant-funded loyalty programs and why they provide a competitive edge. In addition this paper provides an overview of current loyalty programs in the market and guidance on successfully implementing a premier merchant-funded loyalty program.

**Merchant-Funded Loyalty Programs: What It Takes to Be Premier**

Merchant-funded rewards are an important market development that gives FIs the opportunity to share the cost of rewards for bankcard loyalty programs with participating merchants. Aite Group’s 2008 State of Rewards report asserts that “reaching out to and partnering with merchants will become an ever more important force” because of the extra funding that financial institutions need to enhance their loyalty programs. However, most current merchant-funded loyalty programs are encumbered by serious limitations: They are either available exclusively through online merchants, are conventional discount programs that occur only as one-time offers, or are coalition programs in which merchants potentially pay for multiple rewards. These current merchant-funded loyalty solutions are not adequately meeting the business objectives of bankcard loyalty programs, which are increased card usage and improved customer retention. In order to accomplish these goals, FIs must implement loyalty programs that successfully influence the behavior of targeted customers by providing enhanced value and relevance.

Premier merchant-funded loyalty programs are sponsored by FIs and utilize merchant partners to provide rewards and incentives for promotional campaigns. The programs, which can either supplement or replace an FI’s existing loyalty program, are based on rewarding points or cash back for consumer purchases made using an FI’s bankcard in the participating retail stores. In this model, the merchant agrees to fund the points, cash back or discounts in exchange for marketing exposure to the loyalty program’s participants. As a result, the FI is able to provide a highly attractive loyalty-building program, while the merchant gains valuable and exclusive marketing opportunities with the FI’s bankcard customers. Over time, merchant-funded loyalty programs help cultivate mutually beneficial relationships between FIs and merchants that translate into improved long-term consumer loyalty for both entities.

A premier merchant-funded loyalty program improves upon standard merchant-funded rewards solutions by making the program more relevant and compelling to both cardholders and participating merchants. In order for a merchant-funded loyalty program to be considered a premier program it must include the following components:
Consumer segmentation to customize programs, rewards and communications

Understanding consumer purchasing behavior is essential to the success of any loyalty program. It is especially critical to a premier merchant-funded loyalty program, because using this insight to segment customers appropriately helps achieve the marketing goals of the merchant partners who fund the program. Mercator Advisory Group’s 2008 Merchant Funded Discount Network report asserts that customer data is the “primary lever” for recruiting merchants into a reward network because it provides “the information necessary to deliver targeted and tailored incentives, rewards or discounts to the customers that will be most likely to engage.” Proficient use of customer data results in a program that is demonstrably more valuable to the sponsoring FI, its merchant partners and their mutual customers.

National brick-and-mortar merchant participation

Most current merchant-funded loyalty programs feature rewards and offers from online merchants only because it is cheaper and simpler to administer online-only programs. This situation does not meet the needs of most consumers, since only one to four percent of consumer credit card spending is online. A premier merchant-funded loyalty program incorporates the participation of national brick-and-mortar merchants to increase the breadth of the merchant partner network, providing customers with more discount options and more opportunities to earn and redeem rewards—leading to greater participation in the program and better results. In fact, Aite Group’s 2008 State of Rewards report reveals that “variety of offers and discounts” was tied with “cash-back reward value” as the most cited reason that customers prefer a particular loyalty program.

Local and regional merchant participation

Partnerships with local and regional merchants give FIs the ability to provide additional choices and offers within the program that are potentially even more appealing and useful to customers. Linking themselves to local establishments also enables FIs to build a more favorable community presence. Additionally, local and regional merchants are desirable participants in a premier merchant-funded loyalty program since they are often willing to fund a larger percent of rewards on their transactions than national merchants. This is because participation in a premier merchant-funded loyalty program provides these merchants with marketing channels and customer analytics to which they typically do not have access.

Ongoing merchant participation

Most merchant-funded programs today cannot support automated, ongoing participation of merchants in a bankcard loyalty program. Instead, the programs offer one-time online discounts or in-store coupons. The foundation of the premier merchant-funded program is the automatic awarding of extraordinary bonus points or cash back credits in conjunction with the bankcard program. No coupons are required—consumers simply use their FI payment device at participating online or brick-and-mortar merchants, and the extra discounts or rewards are immediately applied. In addition to ongoing program participation, the premier merchant-funded program also provides targeted, one-time opportunities for the merchant to market special offers to specific segments, in a variety of ways.
Mutually beneficial partnerships

Making a premier merchant-funded loyalty program successful requires merchant friendly partnerships that encourage active collaboration and coordination. Merchant participation is critical to the success of a bankcard loyalty program, so FIs must design relationships with merchants that are equally beneficial to both parties. When implemented properly, premier merchant-funded loyalty programs help FIs meet their immediate business goals while creating a platform for promoting additional and more profitable bank programs, products and services. In order to understand what makes the emergence of premier merchant-funded loyalty programs so important and timely, it may help to examine them in the context of other prevalent types of loyalty programs.

A Comparison of Loyalty Programs

Today’s marketplace features multiple types of loyalty programs, from FI-sponsored to merchant-sponsored, to something in between. However, as noted by The Tower Group in its *Customer Loyalty in Retail Banks* report, “Such programs are simple and often inflexible in design in that they are designed for masses of customers and have very little customization capability.” The table below illustrates the differences between various types of loyalty programs.

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<th>Type</th>
<th>Funding</th>
<th>Pros</th>
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| Premier merchant-funded program | • Ongoing program, overlaid on FI credit or debit program where consumers receive bonus points/cash back at participating merchants  
• Periodic one-time promotions  
• Programs can also be stand-alone for debit and subprime initiatives  
• These programs are key to enterprise loyalty | • Ongoing promotion: 3%-25% depending on merchant category and channel  
• One-time discount and coupons: 10%-40% | • FIs can lower costs, increase traditional program relevance and influence key marketing objectives – acquisition, retention and usage  
• Merchants have access to a new marketing channel and a viable consumer base  
• Program administration costs are generally higher for FIs, but are usually offset by higher performing programs |
| Traditional FI bonus points and cash-back program | • Ongoing program where consumers receive points/cash back for purchases using FIs credit or debit card  
• With points-based programs, consumers redeem their points for merchandise and travel rewards | • 100% funded by FI  
• Ongoing promotion: 1%-1.5% on credit card  
• 0.25%-0.40% on debit card | • FIs have control over entire process and can execute using long-standing models  
• Programs are expensive and becoming a commodity in the marketplace |
<table>
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<th>Table 1. Comparison of Loyalty Programs (continued)</th>
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<td><strong>Type</strong></td>
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<td><strong>Member coalition and registered card program</strong></td>
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<td><strong>Online-only merchant-funded program</strong></td>
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<td><strong>Merchant-funded discount program</strong></td>
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<td><strong>Proprietary merchant program</strong></td>
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Understanding the Problems with Traditional Loyalty Programs

There are three primary reasons for the relative ineffectiveness of current programs and the need for financial institutions and merchants to implement premier merchant-funded loyalty programs:

- Commoditization of standard point-based and cash-back programs
- Cost constraints on loyalty programs
- Merchant participation in multiple programs

Commoditization of traditional point-based and cash-back programs

Because these traditional programs have become so pervasive, customer participation is primarily based on the quality and breadth of rewards. If another bank comes out with a more lucrative offer, customers often abandon one card program and flock to another. According to a 2008 Aite Group survey, 28 percent of consumers actively research loyalty programs to find a more favorable one to switch to. This situation has made it difficult for FIs to build significant differentiation in order to maintain active participation in their programs over time. One of the only options available to banks is to increase the reward percentage, resulting in dramatically higher program costs with limited long term effects. As a result, many FIs currently believe that traditional reward-based programs no longer provide the required returns on their marketing investments.

Cost constraints on loyalty programs

Traditional loyalty programs that are entirely funded by a sponsoring FI are an expensive undertaking, and they must accomplish the goal of either increasing bankcard usage or reducing customer attrition in order to yield a positive return on investment (ROI). Due to the diminishing value of most point-based loyalty programs, the pressure for FIs to reduce the marketing costs associated with these programs is increasing, making attainment of a positive ROI even more difficult to maintain over time. As program expenditures are cut, banks often require a greater number of points in order for customers to earn reward fulfillment. As a result, these programs become less valuable to the consumer, diminishing their effectiveness to the financial institution. Finally, as consumer participation decreases, so do the opportunities to use the platform to promote more profitable banking services such as mortgages, direct deposit and online or mobile banking.

Merchant participation in multiple programs

Merchants are often obliged to participate in multiple registered card and coalition programs managed by third-party entities. This sets the merchant up for a “triple-dip” scenario, in which a consumer can use one bankcard to participate in several loyalty programs simultaneously. When a transaction occurs using that bankcard, the merchants must pay out several reward payments for each of the participating loyalty programs that the consumer is signed up for (see figure 1). This dramatically increases the cost to the participating merchant, while diminishing the effectiveness of the loyalty program and the ROI for the merchant. Many merchants have been inundated with similar coalition programs from a variety of marketing vendors, creating significant program confusion for themselves as well as their participating customers. Merchants that are disciplined, and engage only in FI-sponsored programs and their own proprietary programs, can avoid this situation.
A Better Alternative Is Available

The problems with most current bankcard loyalty programs demonstrate the clear need for financial institutions to implement a more effective alternative, or as Colloquy puts it, “resist the siren call of simple cash-back rewards schemes to provide differentiated reward programs while controlling costs.” By adopting a premier merchant-funded loyalty program to improve bankcard usage and customer acquisition and retention, FIs can meet their immediate marketing objectives while building a long-term platform to enhance awareness and growth of more profitable enterprise products and services. First Data and its partner, Affinity Solutions, have observed that FIs implementing a premier merchant-funded loyalty program enjoy a two percent average increase in annualized customer retention and a four percent increase in average account profitability (including interchange and fee income). Customer acquisition activities also experience significant improvement from premier merchant-funded loyalty programs: Participating institutions increase the number of acquired accounts by an average of 15 percent.

Premier merchant-funded loyalty programs solve the challenges associated with traditional loyalty programs by creating much needed differentiation in a crowded marketplace while reducing or controlling program costs. In the premier model, the points or cash back that customers earn are supplemented with additional points, cash back or discounts paid for by participating merchants. This results in more valuable rewards for an FI’s bankcard customers—without the additional cost of increasing point accrual rates or lowering redemption thresholds. Based on an analysis of actual spending patterns, Aite Group asserts in its 2007 Loyalty & Rewards: A Market Overview report that the dollar value of rewards received by a consumer in a merchant-funded program is typically 25 percent higher than in a bank-funded program. Most importantly, this 25 percent increase in reward value is paid for by the merchant which gains valuable and exclusive marketing opportunities with the FI’s bankcard customers.

Figure 1: Registered card programs increase transactions costs to merchant.
Furthermore, when implementing a premier merchant-funded loyalty program, FIs can mix and match a variety of merchants and retail categories to create unique, targeted incentive programs that competing financial institutions cannot easily duplicate. This mix can include any combination of online retailers, national merchants, regional merchants and local merchants—and is essential to implementing a program that customers find relevant and valuable enough to actively participate in.

Customer segmentation is critical to the success of a premier merchant-funded loyalty program and is a key incentive to merchant participation. Cardholder demographic information and historical transaction data are used to create segments that give merchants key insights into the purchasing behavior and characteristics of the customer base. By participating in the FI’s loyalty program, merchants gain the opportunity to send targeted promotional offers to designated segments. It should be noted that merchants do not receive direct access to customer data; instead, the FI executes communication on the merchant’s behalf. As the customers transact and earn rewards in the program across many merchants, the segmentation models are updated and refined. Merchants do not generally have any access to customers’ overall purchasing behavior, so this type of analysis is extremely valuable to their marketing efforts. Incorporating in-depth segmentation modeling into the program enables the FI and its merchant partners to refine the program and its accompanying promotions to maximize opportunities for their mutual success.

**Implementing a Premier Merchant-Funded Loyalty Program**

Implementing a premier merchant-funded loyalty program quickly and successfully may appear challenging. Indeed, it requires:

- Creation of an extensive network of varied merchant partners, including both online and brick-and-mortar merchants
- Integration of an assortment of data components
- Application of segmentation and analytics

Fortunately, financial institutions can partner with experienced service providers like First Data to accomplish these tasks efficiently. It is imperative that FIs engage with a service provider that has a proven track record of managing relationships with participating merchants and settling rewards accounts on a timely and accurate basis. It is also critical for FIs to partner with a service provider that can provide the in-depth reporting and analytics necessary to measure the profitability of the loyalty program, as well as to enable well-informed refinements and modifications on an ongoing basis.

The First Data Merchant-Funded Loyalty Program provides a full range of services, including data analytics, Web hosting, rewards scoring and account management, marketing communications, cross-product functionality to support enterprise rewards programs, and transaction and SKU-level capabilities. Through its partners, First Data also has relationships with nearly 10,000 merchants that are willing to participate in merchant-funded loyalty programs, along with an extensive network to recruit regional and local retailers using our proven merchant recruitment methodology. With First Data’s assistance, any FI can execute a premier merchant-funded loyalty program that far exceeds the rapidly deteriorating effectiveness of traditional programs. And merchants can benefit, as well, by joining the First Data/Affinity Solutions network of participating retailers to become part of an FI-sponsored loyalty program.
First Data powers the global economy by making it easy, fast and secure for people and businesses around the world to buy goods and services using virtually any form of payment. Serving millions of merchant locations and thousands of card issuers, we have the expertise and insight to help you accelerate your business. Put our intelligence to work for you.

Our Loyalty Solution allows financial institutions and merchants to increase retention, deepen customer and partnership relationships and boost profits while reducing costs.

For more information, visit http://www.firstdata.com/product_solutions/loyalty_solutions/index.htm

About the Authors

Julie Bohn, Vice President of Product Development, and Molly Plozay, Vice President of New Product Development, are responsible for market research and development within First Data’s Card Services division. Each has 18 years of experience in the card processing industry, with the last two years focusing on strategic products such as Merchant-Funded and Enterprise Loyalty.

Julie has managed many market development efforts including business case and market strategy for data warehousing, analytics, cardholder privacy and utilities for several of the largest card issuers in the United States. She has been an integral part of many new product launches—for example, development of a transaction pricing platform that enabled First Data to become a market leader in pricing innovation for retailers and card issuers.

Nearly 10 years of Molly’s career have been focused on cardholder marketing products such as pricing, rewards, dual cards and communications. Prior to her current role in strategic market research, one of Molly’s large projects involved restructuring legacy systems through creation of a client-definable rules engine. This platform is used currently to support multiple business functions such as reward processing, account management, interactive communication, credit application and credit protection. Additionally, Molly has brought many new products to market including an innovative pricing solution that received a patent in 2004. She has several patents pending, as well.

For more information, contact your First Data Sales Representative or visit firstdata.com.