¿Cuál debería ser el futuro de las tarjetas de crédito con recompensas de puntos?

What is in the Cards for Credit Card Rewards?

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RESUMEN

El uso de tarjetas de crédito ha experimentado un auge significativo impulsado por la disposición de los consumidores a endeudarse y la expansión de recompensas generosas. Este documento analiza la acusación persistente de que las recompensas de las tarjetas de crédito producen un "subsidio cruzado regresivo", lo que hace que las transacciones sean más baratas para los ricos y más caras para los pobres. Se menciona que la evidencia de este subsidio cruzado es inusitada y, en última instancia, no concluyente. Este documento aboga por una política de no intervención legislativa ya que regulaciones más estrictas dañarían el mercado de tarjetas de crédito y darían lugar a políticas bancarias contrarias al consumo. Por último, se enfatiza la importancia de la educación financiera en lugar de las regulaciones gubernamentales.

Palabras clave: tarjetas, crédito, recompensas, puntos, legislación.

ABSTRACT

Credit card use has seen a significant boom in use driven by consumer willingness to take on debt and the expansion of generous rewards. This paper reviews a persistent allegation that credit card rewards produce a "regressive cross-subsidy," making transactions cheaper for the wealthy and more expensive for the poor. I explain that evidence of this cross-subsidy is rare and ultimately inconclusive. This paper advocates for a policy of legislative non-intervention as stricter regulations would harm the credit card market and result in anti-consumer banking policies. Last, this paper emphasizes the importance of financial literacy in lieu of governmental regulations.

Keywords*: credit, card, rewards, points, legislation.*

Introduction

Credit cards are revolving credit products used at merchant payment terminals and repeatedly paid down as long as the account remains open.[1] Modern credit card products have come far from the first cardboard Diners Club cards;[2] the Federal Reserve Board and Bureau of Economic Analysis reported that from 1959 to 1999, consumer credit has grown at approximately the same pace as disposable income.[3] The report revealed that since the inception of credit cards in the 1950s, credit card market share increased in direct proportion to the decreasing market share of installment credit products.[4] The largest U.S. consumer credit product in 2021 in terms of user count was the credit card

1 *See* "Credit Cards: Use and Consumer Attitudes", 1970-2000, *Federal Reserve Bulletin*, 623-634. https://www.federalreserve.gov/pubs/bulletin/2000/0900lead.pdf

2 Frankel, Robin, "When Were Credit Cards Invented: The History of Credit Cards", *Forbes*, July 2021. https://www.forbes.com/advisor/credit-cards/history-of-credit-cards/

3 *Federal Reserve Bulletin*, *supra* 1, 624.

4 *Idem*.

market.[5] According to Experian data, an estimated 79 percent or 200 million American adults have at least one credit card or charge card,[6] and the average American owns 3.84 credit cards.[7]

Multiple factors contributed to the exponential growth of revolving credit. First, widespread credit card merchant acceptance in the 1960s offered customers a viable alternative to cash and personal checks.[8] Issuers incentivized consumers to open new accounts by introducing the rewards program and the sign-up bonus.[9] The 1974 Fair Credit Billing Act offered comprehensive consumer protections, making credit cards the preferred way to pay.[10]

In capitalist societies, the use of credit creates economic progress.[11] The rise of industry would not have been possible without the willingness of companies and individuals to take on debt.[12] Credit helps a beginning farmer to purchase a tractor. Credit allows a wealthy investor to quickly seize investment opportunities without the need for liquidity. Credit also helps a low-income consumer smooth out cash flow if their car breaks down. The credit card product is just another convenient type of loan that consumers can leverage. The rewards programs

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[5] "The Consumer Credit Card Market", *Consumer Fin. Prot. Bureau*, no. 5, 2021. https://files.consumerfinance.gov/f/documents/cfpb_consumer-credit-card-market-report_2021.pdf.

[6] Gonzalez, Jamie, Holmes, Tamara, "Credit Card Ownership Statistics" https://www.creditcards.com/credit-card-news/ownership-statistics/#sources Foster, Kevin *et al.*, "The 2020 Survey of Consumer Payment Choice: Summary Results", *Fed. Reserve Bank of Atlanta: Research Data Reports*, no. 21-1, April 2021. https://www.atlantafed.org/-/media/documents/banking/consumer-payments/survey-of-consumer-payment-choice/2020/2020-survey-of-consumer-payment-choice.pdf).

[7] *Idem.*

[8] *See* "The Evolution of Credit Cards", *FIS Global*, July 2019. https://www.fisglobal.com/en/insights/merchant-solutions-worldpay/article/the-evolution-of-credit-cards; *See* "The Complete History of Credit Cards, From Antiquity to Today", *The Points Guy*, 2021. https://thepointsguy.com/guide/history-of-credit-cards/

[9] *See* Trina, Paul, "The Welcome Bonus is the Top Reason Why People Shop for New Credit Cards: here are 3 not to miss", CNBC, 2022. https://www.cnbc.com/select/reasons-why-people-sign-up-for-credit-card/ (*Cf.* "The Reports of the Death of Airline Miles Rewards Cards Have Been Greatly Exaggerated", *JD Power*, 2021. https://www.jdpower.com/business/resources/death-airline-miles-rewards-cards-greatly-exaggerated

[10] Fair Credit Billing Act of 1974, 15 U.S.C. § 1666 *et seq.*, Pub. L. 93-495, Tit. III, 88 Stat. 1511, 1975. *See* Brasler, Kevin, "Why Your Credit Card is a Consumer-Protection Superweapon", *Seattle Time*, February 2018. https://www.seattletimes.com/life/lifestyle/why-your-credit-card-is-a-consumer-protection-superweapon/

[11] *See* Braswell, Greg, Chernow, Elizabeth, "Consumer Credit Law & Practice in the U.S.", *U.S. Fed. Trade Commission*. https://www.ftc.gov/sites/default/files/attachments/training-materials/law_practice.pdf

[12] Nocera, Joseph, "The Day the Credit Card Was Born", *Wash. Post*, November1994. https://www.washingtonpost.com/archive/lifestyle/magazine/1994/11/04/the-day-the-credit-card-was-born/d42da27b-0437-4a67-b753-bf9b440ad6dc/

play a critical role in the credit card market by making credit cards a more enticing way to pay.[13] Rewards programs drives spending among consumers of all economic stratifications, including wealthy consumers who have no real need for credit and the middle and lower-income consumers who find credit critical to go on with their daily lives.[14]

This paper will explore the credit card market, credit card rewards programs, and economic policy. The thesis of this paper is that credit card rewards are, overall, beneficial to society and thus should not be overly regulated. This paper calls for a non-intervention policy toward credit card rewards programs.

Part I will give a broad background on the credit card market and industry-wide changes brought by the advent of modern revolving credit. Accordingly, I will explain how credit card processing works and explore the different types of credit cards that issuers offer. More specifically, I will explore the history of rewards programs and card benefits. I will explain that rewards programs played a crucial part in increasing the number of credit cardholders and transaction volume. I contend that credit card consumers enjoy a competitive market that manifests in better rewards and benefits that other payment methods cannot match. Last, this part will assert that market competition in rewards programs drives spending that contributes to the economy and helps accessibility to credit.

Part II will discuss the value that credit cards and rewards offer. I will discuss modern rewards programs, other value-added benefits, and how consumers extract positive value from rewards programs. Further, I will discuss the convenience and the fraud protections unique to credit cards.

Part III will analyze the costs and benefits of the credit card rewards program. In this pursuit, I will present arguments from academics who oppose the credit card rewards program. I will engage with the view that rewards create a regressive transfer of wealth, resulting in negative externalities to the poor. I will maintain that this argument is misguided and unproductive. If it even exists, I will argue that the regressive transfer of wealth is a product of credit itself, not credit card rewards programs. Regulations attempting to fix the purported inequalities will invite inefficiency. Additionally, I will argue that other pay-

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13 Trina, *supra* note 9.

14 *See* Albright, Dann, "How Do Wealthy Americans Use Credit Cards?", *The Ascent*, January 2022. https://www.fool.com/the-ascent/research/wealthy-credit-card-habits/

ment methods have their respective costs and that the market has already adapted to transaction fees.

Part IV will turn to case law that furthers the economic policy conversation of credit card rewards, namely, case law on the taxability of credit card rewards. In this pursuit, I will explain a credit card use technique called manufactured spending relevant case law that I will discuss. This part will discuss Anikeev v. Commissioner, where the Court held that most credit card rewards were not taxable because rewards are considered rebates and not income. Thus, I suggest that the Tax Court decisions align with my thesis on non-intervention towards credit card rewards programs and ultimately correctly decided when looking at economic and social policy considerations.

In Part V, I argue that regulations on credit card rewards programs would hinder economic prosperity. Thus, I will take a stance of non-intervention towards credit card rewards programs with social policy considerations to back up my arguments. Instead of crippling the credit market through regulation, we should understand credit as the useful financial tool that it is. Accordingly, I argue that financial education should be improved so that lower-income Americans have a better fighting chance for economic opportunity.

Part VI will conclude the paper.

Background

Without a solid background in the credit card market and market competition, it is difficult for the reader to assess the value of the credit card rewards program in the larger economy. Thus, I will discuss the background of the credit card market, the history of rewards programs, and the climate of credit card competition.

The Credit Card Market

A 2021 survey by 'The Ascent' found that credit cards are now the most common way to pay; 45 percent of consumers prefer using their credit cards to make purchases.[15] It is important to note, however, that not all credit cards are the same.[16] The market offers a diverse

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[15] Daly, Lyle, "How Gen Z, Millennials, Gen X, and Baby Boomers Use Credit Cards", *The Ascent*, March 2021. https://www.fool.com/the-ascent/research/how-gen-z-millennials-gen-x-baby-boomers-use-credit-cards/

[16] *See* "Fed. Deposit Ins. Cor, Risk Management Examination Manual of Credit Card Activities", 2007. https://www.fdic.gov/regulations/examinations/credit_card/pdf_version/ch2.pdf

range of products that provide different benefits targeted to different customers.[17]

The credit card market includes general-purpose and private-label cards.[18] General-purpose credit cards are those that usually come to mind when talking about credit cards.[19] Consumers use general-purpose credit cards to transact at any merchant that accepts the payment network affiliated with the card.[20] This group of cards includes secured cards, balance transfer cards, student cards, business cards, charge cards, travel cards, cashback cards, etc.[21] Credit card issuers target and market different cards to consumers based on their needs, spending, and repayment habits.[22]

Four credit card networks dominate the U.S. market: Visa, Mastercard, Discover, and American Express.[23] These networks provides the infrastructure to process transactions between merchants and banks.[24] Card Operations of Depository Institutions reported that in 2019, Visa and Mastercard networks supported 576 million credit cards or 83 percent of all general-purpose credit cards.[25] The same year, American Express and Discover networks accounted for the remaining 115 million credit cards.[26] In 2019, 45 million credit card transactions were recorded, totaling $4 trillion in spending.[27]

When a chip reader reads a card, the merchant's bank (acquirer) uses the network to request the issuing bank for authorization.[28]

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17 *Idem*.

18 *Idem*.

19 "Sujit Chakravorti, Theory of Credit Card Networks: A Survey of the Literature", *Rev. Network Econ.*, vol. 50, no. 53, 2003.

20 Mangla, Ismat, "Where Can I Use My Credit Card?", *Experian*, January 2019. https://www.experian.com/blogs/ask-experian/where-can-i-use-my-credit-card/.

21 "8 Types of Credit Cards to Apply For", *Capital One*, December 2021. https://www.capitalone.com/learn-grow/money-management/types-of-credit-cards/

22 Fiorio, Luke *et al.*, "New Frontiers in Credit Card Segmentation: Tapping Unmet Consumer Needs", *McKinsey*, May 2014. https://www.mckinsey.com/~/media/mckinsey/dotcom/client_service/financial%20services/latest%20thinking/payments/mop19_new%20frontiers%20in%20credit%20card%20segmentation.ashx

23 Chakravorti, *supra* note 19, 54.

24 Sarin, Natasha, "What's in Your Wallet (and What Should the Law Do About it?)", *U. Chi. L. Rev.*, no. 87, 2020, 559.

25 "Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions", *Bd. of Governors of the Fed. Rsrv. Sys.*, no. 7, November 2020. (*Cf*. HSN Consultants, Inc. 2020, *Nilson Report*, no. 1169). https://www.federalreserve.gov/publications/files/ccprofit2020.pdf

26 *Idem*.

27 *Idem*.

28 Chauncey, Crail, Dia, Adams, "Credit Card Processing: How It Works", *Forbes*, November 2021. https://www.forbes.com/advisor/credit-cards/credit-card-processing-how-it-works/

The issuing bank (the bank that issued the purchaser's card) verifies the information and approves or denies the transaction.[29] The issuing bank transfers the funds (minus fees) through the network and to the merchant's bank during the settlement phase.[30] The issuing bank receives a portion of the interchange fee to cover the cost of advancing credit, handling, rewards programs, and fraud risk.[31] The network determines interchange fees; the rate the merchant pays depends on the type of card, type of transaction, and the level of risk for that specific transaction.[32]

In contrast, private-label credit cards are store-branded cards not backed by a processing network.[33] Thus, private label cardholders may only use their card at that specific merchant.[34] Because private-label credit cards offer more lenient and extended terms to customers than general-purpose cards, private-label cards generally offer comparatively lower credit limits, higher interest rates to higher credit risk profiles.[35] Consumers open a private-label credit card account to obtain store credit, earn rewards on their purchases, and gain other benefits at their favorite retailers.[36] By offering a store-branded credit card, merchants benefit by leveraging consumer loyalty and boosting sales from their most profitable customers.[37] In 2019, general-purpose credit cards and charge cards accounted for 91.5 percent of all credit card transactions and private-label credit cards accounted for 8.5 percent.[38]

Rewards Programs

A rewards program is a marketing program that "cultivates an ongoing relationship between a provider of goods or services and custo-

[29] *Idem*.

[30] *Idem*.

[31] Palmer, Kimberly, "What Are Credit Card Interchange Fees?", *Nerd Wallet*, Agosto 2020. https://www.nerdwallet.com/article/credit-cards/what-are-credit-card-interchange-fees

[32] "Credit Card Activities Manual", *Fed. Deposit Ins. Corp*, 2007. https://www.fdic.gov/regulations/examinations/credit_card/glossary.html

[33] Kagan, Julia, "Guide to Store Credit Cards", *Investopedia*, May 2021. https://www.investopedia.com/terms/p/private-label-credit.asp

[34] *Idem*.

[35] Irby, Latoya, "What is a Private-label Credit Card?", *The Balance*, June 2021. https://www.thebalance.com/what-is-a-private-label-credit-card-5188474

[36] *Idem*.

[37] *Idem*.

[38] "The 2019 Federal Reserve Payments Study", *Bd. of Governors of the Fed. Rsrv. Sys.*, January 2020. https://www.federalreserve.gov/paymentsystems/2019-December-The-Federal-Reserve-Payments-Study.htm

mers."[39] Rewards programs entice new customers to sign-up and encourage current customers to spend, helping merchants capture increased revenue.[40] In return, cardholders receive something of value for their spending.[41]

The idea of the rewards program predates the credit card, but the prevalence of the credit card rewards program boomed in the 1980s.[42] In the 1980s, the financial services industry saw high demand for premium credit card products that offered travel loyalty rewards.[43] In 1981, American Airlines created the first modern frequent flyer rewards program, and other airlines followed suit.[44] In the same decade, American Express, Visa, and Mastercard offered new premium credit cards with loyalty programs.[45] American Express first debuted its Platinum Card in 1984, carrying a $250 annual fee, 24-hour concierge service, travel insurance, and access to private clubs worldwide.[46] In the mid-1980s, Diners Club introduced their rewards program, Diners Club Rewards.[47] In 1986, Discover introduced the first "cashback" program.[48] Cashback programs return a small percentage of cardholder total charges throughout the year in cashback.[49] During this decade, new credit card products, loyalty programs, and the Diners Club program set the scene for credit card rewards as we know them today.[50]

Competition in the Credit Card Industry

Historically, sticky interest rates have afflicted the credit card industry, or interest rates that do not increase or decrease according to federal rate changes and competition in the credit card market.[51] Due to this

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39 Turner, Michael, "Credit Card Rewards: Context, History, and Value", *Pol'y Econ. Rsrv. Council*, no. 7, August 2012. https://www.perc.net/wp-content/uploads/2013/12/WP-2-Layout.pdf

40 *Idem*.

41 *Idem*.

42 *See* TPG Staff, "The Complete History of Credit Cards, From Antiquity to Today", *The Points Guy*, September 2021. https://thepointsguy.com/guide/history-of-credit-cards/

43 *Idem*.

44 Rosen, Eric, "40 Years of Miles: The History of Frequent Flyer Programs", *The Points Guy*, May 2021. https://thepointsguy.com/guide/evolution-frequent-flyer-programs/

45 TPG Staff, *supra* note 43.

46 *Idem*.

47 *Idem*.

48 Turner, *supra* note 39.

49 *Idem*.

50 TPG Staff, *supra* note 43.

51 Calem, Paul, Mester, Loretta, "Consumer Behavior and the Stickiness of Credit-Card Interest Rates", *Am. Econ. Rev.*, vol. 85, no. 5, 1327.

phenomenon, some academics have asserted that the credit card market has imperfect competition.[52] I argue that this notion of 'imperfect competition' in the credit card market is misguided.

A 1995 paper by Paul Calem and Loretta Mester provides evidence that credit card rates are so sticky because consumers were simply not responsive to rate cuts.[53] If one has a basic understanding of the credit card application, the notion of why consumers are unresponsive to rates makes sense. The application process for credit makes it impossible for applicants to compare credit card interest rates.[54] Most issuers list a range of interest rates that an applicant may receive based on the applicant's creditworthiness. For instance, the Discover it cash back card offers an Annual Percentage Rate (APR) for purchases of 12.24 percent to 23.24 percent.[55] There is no way for the applicant to determine their individualized interest rate until they are accepted and credit is extended. Indeed, issuer algorithms determining cardholder interest rates are shrouded in mystery.[56]

Although all issuers use the FICO score as a general measure of creditworthiness, each issuer uses a proprietary credit card underwriting process that determines an applicant's approval, credit limit, and interest rate.[57] The underwriting process is a mathematical formula and analysis of the applicant's overall financial health to determine whether the issuer should extend credit to the applicant.[58] The algorithm is not openly shared because an issuer's proprietary underwriting process is a trade secret.[59] With the current system's lack of transparency, applicants cannot compare credit card interest rates.[60] Thus, before an applicant applies for a particular card, they have already compared other

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52 *See* Lawrence, Ausubel, "The Failure of Competition in the Credit Card Market", *Am. Econ. Rev.*, vol. 81, no. 50, 1991.

53 Calem, *supra* note 51, 328.

54 Steele, Jason, "How to Compare Credit Card Interest Rates", *Experian*, September 2019. https://www.experian.com/blogs/ask-experian/how-to-compare-credit-card-interest-rates/

55 Discover, *Discover it® Cash Back Application*. https://discovercard.com/application/website/ratesrewards?srcCde=GJVP&_ga=2.154581564.547878646.1650766796-821874480.16 50766796

56 Rice, Lisa, Swesnik, Deidre, "Discriminatory Effects of Credit Scoring on Communities of Color", *Suffolk U. L. Rev.*, vol. 46, 935, 951.

57 *See* Butaru, Florentin *et al.*, "Risk and Risk Management in the Credit Card Industry", *J. Banking and Fin.*, vol. 72, no. 218, 2016.

58 "Risk Management Examination Manual For Credit Card Activities", *Fed. Deposit Ins. Corp*, no. 40, 40-41 (2007), available at https://www.fdic.gov/regulations/examinations/credit_card/pdf_version/ch7.pdf

59 Rice, *supra* note 56.

60 *Idem*, *See* Steele, *supra* note 54.

credit card factors that are important to them.[61] Thus, issuer competition in the credit card market exhibits itself in avenues consumers respond to rewards programs, sign-up bonuses, teaser rates, and other card-related benefits.[62]

Why consumers choose to transact with credit?

In this part, I expand on the value that credit cards offer to cardholders. This part will tie into my thesis by explaining how credit cards are unique in that they offer benefits that other payment methods do not provide. This part contributes to my argument that credit cards benefit consumers, merchants, and the economy.

Rewards

In modernity, rewards cards are generally unsecured credit cards that provide benefits beyond the credit and convenience of a short-term loan. Issuers found that the best way to entice consumers to open an account was to reward them for doing so and rewarding the consumer every time they swipe.[63] Issuers' introduced the "value-added product" to differentiate their product and attract potential cardholders.[64] For instance, the Chase Freedom Unlimited credit card offers new cardholders a $200 bonus if they spend $500 within the first three months of account opening and 0 percent APR for 15 months.[65] In terms of rewards, the card offers 5 percent cashback on travel purchases through the Chase website, 3 percent on dining, and 1.5 percent on all other purchasesall for no annual fee.[66] The $200 sign-up bonus and 0 percent teaser rate are "value-added features" that comprise Chase's new card-

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61 Harzog, Beverly, "Survey: Majority of Americans Not Very Confident in Credit Card Choices", *USNews*, October 2021. https://money.usnews.com/credit-cards/articles/survey-majority-of-americans-not-very-confident-in-credit-card-choices (U.S. News survey found that nearly half of respondents were worried that different cards could earn them more rewards. The survey also showed that a bit more than 36 percent of respondents said that the most important feature of their newest credit card was the rewards program).

62 *See* Power, J., "Credit Card Rewards War Reaches Inflection Point as Competition Grows", *J.D. Power Finds*, *PRNewswire*, August 2019. https://www.prnewswire.com/news-releases/credit-card-rewards-war-reaches-inflection-point-as-competition-grows-jd-power-finds-300905452.html

63 *Idem.*

64 *See* "Risk Management Examination Manual for Credit Card Activities", *Fed Deposit Ins. Cor*, no. 30, 2007. https://www.fdic.gov/regulations/examinations/credit_card/pdf_version/ch5.pdf

65 "Chase Freedom Unlimited® Credit Card", *J. Morgan Chase & Co.* https://creditcards.chase.com/cash-back-credit-cards/freedom/unlimited?iCELL=6C1Y

66 *Idem.*

holder acquisition costs.[67] Of course, Chase is not the only issuer if issuers want to stay competitive in the credit card market, they must offer their own "key differentiators" to incentivize customers to choose their card over that of the competition.[68]

Credit card rewards typically come in basic cashback or issuer currency.[69] A cashback cardholder may redeem their cashback through a check, statement credit, direct deposit, or gift card.[70] Other rewards cards provide cardholders issuer currency, such as Chase's 'Ultimate Rewards points,' American Express's 'Membership Rewards points,' or Delta's 'SkyMiles'.[71] Rewards cardholders may redeem points like cashback or use the points to book flights and hotels.[72] If an issuer has more travel partners or better point redemption rates, potential cardholders deem the issuer's cards more competitive than others.[73]

Issuers also provide cardholders with fringe benefits. For instance, Wells Fargo offers 'Cellular Telephone Protection,' wherein the issuer reimburses the consumer for their lost phone if the consumer pays their phone bill with their Wells Fargo credit card.[74] Chase provides 'Extended Warranty Protection,' wherein the issuer adds an extra year of the product's manufacturer's warranty and credits the consumer's account for the purchase price of the defective product provided the consumer purchased the product with the issuer's card.[75]

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67 *See Fed. Deposit Ins. Cor*, *supra* note 64.

68 *See* Kaushal, Rahul, Mittal, Kamakant, "Focus on Value Added Services by Network Companies: A Paradigm Shift", *Infosys*. https://www.infosys.com/industries/cards-and-payments/resources/Documents/network-companies-paradigm-shift.pdf *See* Power, J, *supra* 62.

69 *See* Proctor, Clint, "Cash Back Vs. Points: Which Type of Rewards Card is Best?", *Credit Karma*, november2021. https://www.creditkarma.com/credit-cards/i/travel-rewards-vs-cash-back-credit-cards

70 DeNicola, Louis, "How Do Cash Back Credit Cards Work?", *Experian*, May 2021. https://www.experian.com/blogs/ask-experian/how-do-cash-back-credit-cards-work/.

71 *See* "Chase Sapphire Preferred® with Ultimate Rewards® Program Agreement", *J. Morgan Chase & Co*. https://static.chasecdn.com/content/dam/card/rulesregulations/en/RPA0444_0477.pdf American Express, "Welcome to Membership Rewards!". https://www.americanexpress.com/content/dam/amex/us/rewards/membership-rewards/mr-terms-conditions-03.2022.pdf "Membership Guide & Program Rules", *Delta*. https://www.delta.com/us/en/skymiles/program-resources/program-rules

72 *See* "Chase Sapphire Preferred® with Ultimate Rewards® Program Agreement", *J. Morgan Chase & Co*. https://static.chasecdn.com/content/dam/card/rulesregulations/en/RPA0444_0477.pdf

73 Genter, J., Lupini, Caroline, "Chase Ultimate Rewards Vs. American Express Membership Rewards", *Forbes*, April 2022. https://www.forbes.com/advisor/travel-rewards/chase-ultimate-rewards-vs-american-express-membership-rewards/

74 Fargo, Wells, "Cellular Telephone Protection". https://www.wellsfargo.com/credit-cards/features/cell-phone-protection/

75 "Guide to Benefits-Chase Slate®", *J. Morgan Chase & Co*. https://www.chase.com/personal/credit-cards/slate/more

One may wonder how issuers are able to offer these competitive rewards and benefits yet still be profitable. Issuers spend lots of money on customer acquisition costs to make their profits over the lifetime of the new (hopefully loyal) cardholder.[76] Indeed, issuers make much of their earnings from interest income and interchange fees they charge on every swipe.[77] Thus, it makes sense why issuers place great importance on the frequency and volume of card transactions.

Convenience

When transacting with credit cards, consumers gain the convenience of not carrying cash. Carrying a card instead of cash decreases the risk, however likely or unlikely, of losing money in a robbery or theft. When a credit card is compromised, most modern cell phone banking applications give cardholders the power to 'freeze' or 'deactivate' their card.[78] Transacting with credit cards also protects consumers from handling cash, a notoriously unsanitary piece of cotton, which is a not minor consideration, especially in the COVID-19 pandemic.[79] Retail businesses also benefit from a cashless business model, to which many have already shifted.[80] I will discuss merchant preference for a cashless business model in Part III.

Fraud Protections

Opponents may correctly argue that debit cards offer the same conveniences explained in the previous section. However, credit cards offer other significantly more comprehensive benefits than what debit cards provide.[81] For instance, credit cards offer fraud protection unmatched

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76 *See* Flybits, "Optimizing the Cardholder Lifecycle Part 1: Acquisition", *Flybits*, October 2019. https://www.flybits.com/resources/blog/optimizing-the-cardholder-lifecycle-part-1-acquisition/

77 Resendiz, Joe, "How Credit Card Companies Make and Earn Money", *Value Penguin*, September 2021. https://ww.valuepenguin.com/how-do-credit-card-companies-make-money

78 *See* Navy Federal Credit Union, *Freeze or Unfreeze Your Card*. https://www.navyfederal.org/services/mobile-online-banking/card-management/freeze-unfreeze-card.html *See* Discover, *Freeze Account-Frequently Asked Questions*. https://www.discover.com/credit-cards/help-center/faqs/freeze-account.html

79 Larson, Jennifer, "Money Can Be Filthy-Here's How to Protect Yourself from Getting Sick", *Insider*, December 2021. https://www.insider.com/does-money-carry-germs

80 Wang, Claire, "Cash Me If You Can: The Impacts of Cashless Businesses on Retailers, Consumers, and Cash Use", *Cash Prod. Off. Fed. Rsrv. Sys.*, no. 3, 2019. https://www.frbsf.org/wp-content/uploads/sites/7/Cash-Me-If-You-Can-August2019.pdf

81 Sandberg, Erica, "Are Credit Cards Safer Than Debit Cards?", *Experian*, April 2019. https://www.experian.com/blogs/ask-experian/are-credit-cards-safer-than-debit-cards/

by their debit counterparts.[82] When a fraudulent charge occurs on a consumer's debit card, the Electronic Funds Transfer Act (EFTA) provides consumer protection.[83] However, when a fraudulent charge appears on a credit card, the Fair Credit Billing Act (FCBA) provides more comprehensive consumer protections.[84]

Section 205.6 of the EFTA controls consumer liability resulting from debit card fraud.[85] The cardholder's liability depends on how quickly the cardholder reports debit card fraud.[86] If a cardholder reports an unauthorized transaction within two business days of learning of the loss or theft of an access device (an ATM card), the cardholder carries a maximum of $50 liability.[87] If the cardholder fails to report within the two business days, the cardholder faces a $500 maximum liability.[88] If the cardholder fails to notify their bank within 60 days, the cardholder is liable for any and all unauthorized charges made on their account.[89] To make things worse, when a fraudulent charge occurs on a debit card, the funds are extracted from the consumer's bank account immediately.[90] If the cardholder fails to notice unauthorized charges for an extended period, the charges may drain the victim's bank account and tie up the funds while the bank investigates the fraud.[91] The delay may lead to legitimate charges being declined or causing expensive overdraft fees.[92] In this scenario, the bank has little incentive to resolve the investigation quickly since fraudsters ultimately stole the cardholder's money, not the bank's.[93]

In contrast, Section 1643 of the FCBA controls consumer liability resulting from credit card fraud.[94] Nearly all credit cards promise zero

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82 *Idem*.

83 Cash, Kevin, "Credit Card vs. Debit Card: Which Is Safer Online?", *NerdWallet*, July 2021. https://www.nerdwallet.com/article/credit-cards/credit-card-vs-debit-card-safer-online-purchases.

84 *Idem*.

85 Electronic Funds Transfer Act, 15 U.S.C. §§ 1693-1693j, 1978; 12 C.F.R. § 205.6.

86 *Idem*.

87 *Idem*, § 205.6(b)(1).

88 *Idem*, § 205.6(b)(2).

89 *Idem*, § 205.6(b)(3).

90 Cash, *supra* note 83.

91 *Idem*.

92 *Idem*.

93 Holzhauer, Brett, "Here are 3 reasons why paying with a credit card is safer than a debit Card or cash", CNBC, septiembre 2021. https://www.cnbc.com/select/why-paying-with-credit-card-safer-than-debit-cash/

94 Fair Credit Billing Act, 15 U.S.C. § 1643, 1980.

liability for all fraudulent transactions.[95] If a credit card does not offer zero liability for fraudulent transactions, the FCBA caps maximum liability at $50.[96] Additionally, a credit card issuer handles fraud more promptly than a checking account bank because credit card fraud steals the issuer's funds, not the cardholder's. When a credit card customer reports fraud, the issuer will typically credit the customer's account before concluding investigations.[97]

Debunking Purported Costs of Credit Card Rewards Programs

This part will underline an argument made by academics disputing the benefit of rewards programs. I will argue that while their concerns are valid, evidence that rewards programs harm lower-income individuals is inconclusive. Even if given the benefit of the doubt, I argue that these academics greatly exaggerate the cross-subsidy concerns. Further, I propose that one academic's proposal to 'fix' alleged cross-subsidization will destroy the credit card market and harm the economy.

A. The 'Reverse Robin-Hood Problem'

Some academics propose that credit card rewards programs create a regressive transfer of wealth in a "reverse-Robin-Hood problem."[98] I will lay out the background for the argument here. When a credit card network processes a transaction, the network charges the merchant an interchange fee.[99] Debit card interchange fees are remarkably low because the Durbin Amendment artificially capped them.[100] Today, credit card interchange fees are not restricted and thus are set at a profitable rate for banks, making interchange fees the second-highest expense for merchants.[101] To combat credit card interchange fees eating into profits, merchants either provide lower prices for cash transactions, raise the cost of their goods and services across the board, or implement a surcharge for credit card transactions.[102]

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95 Holzhauer, *supra* note 93.
96 Cash, *supra* note 83.
97 *Idem*.
98 Sarin, Natasha, "Making Consumer Finance Work", *Colum. L. Rev.*, no. 119, 1519-1571.
99 *Ibidem*, 1532.
100 *Ibidem*, 1522.
101 *Ibidem*, 1533 (*ob. cit.*, Gackle, Paul, "The Fight over Interchange Fees", *Frontline*, November 2009. https://www.pbs.org/wgbh/pages/frontline/creditcards/themes/interchange.html
102 National Small Business Association, "Credit Card Fee Hikes", *Nat'l. Small Bus. Ass'n.*, March 2022. https://nsba.biz/credit-card-fee-hikes/

Studies have shown that wealthier individuals are generally more creditworthy; 82 percent of all credit card accounts belong to prime or super prime consumers.[103] Thus, high-income consumers are more likely to transact with credit cards[104] and benefit from credit card rewards subsidized partly or wholly by interchange fees.[105] The argument is that lower-income consumers are more likely to use cash or debit because of inaccessibility to credit.[106] As a result, lower-income consumers who use cash subsidize the rewards that wealthy credit card users receive from their transactions.[107]

To fix the alleged "reverse-Robin-Hood problem," Natasha Sarin proposes the Consumer Financial Protection Bureau intervene and eliminate the credit card rewards program.[108] She argues that low-income individuals without access to rewards cards cannot reasonably avoid higher prices brought on by the same.[109] She claims that eliminating the rewards program would decrease consumer incentive to transact with credit cards.[110] According to Sarin, less frequent use of credit cards will lower merchant costs, whereby merchants will reduce their prices and fix the regressive wealth transfer.[111]

1. The Market Fixes Discrepancies in Payment Costs

In the context of the entire economy, evidence of significant cross-subsidies between poor cash users and wealthy credit card users are inconclusive and rare.[112]

Even still, the notion that cards are costly and other payment methods are costless is simply a mistake. Aside from interchange fees, merchants undertake operating costs by accepting cash in their stores.[113] A

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[103] Gonzalez-Garcia, *supra* 6.

[104] Sarin, *supra* note 98, 1529.

[105] *Ibidem*, 1570.

[106] Kumar, Rayni *et al.*, "2018 Findings from the Diary of Consumer Payment Choice", *Cash Prod. Off. Fed. Rsrv. Sys*, no. 9, 2018. https://www.frbsf.org/cash/files/federal-reserve-cpo-2018-diary-of-consumer-payment-choice-110118.pdf

[107] *Idem*.

[108] *Ibidem*, 1571.

[109] *Ibidem*, 1529.

[110] *Ibidem*, 1571.

[111] *Idem*.

[112] Semeraro, Steven, "The Reverse-Robin-Hood-Cross-Subsidy Hypothesis: Do Credit Card Systems Tax the Poor and Reward the Rich?", *Rutgers L.*, no. 40, no. 419, 442-43.

[113] Hayashi, Fumiko, "Cash or Debit Cards? Payment Acceptance Costs for Merchants", *Econ. Rev. of the Fed. Rsrv. Bank of Kansas City*, vol. 106, no. 45, 2021.

cash-accepting merchant undertakes the risk of loss or theft by their employees or from criminals at large.[114] The merchant pays for the time that company managers or higher-ups must spend to count and manage the funds.[115] Large or corporate merchants hire cash transit vehicles to transport the funds to the bank.[116] The inconvenience of accepting cash and the ease of operating cashless[117] has led some merchants, such as online retail giants, mom-and-pop restaurants, and offices, to operate card-only.[118]

Large online merchants and retail giants such as Walmart and Costco have the leverage to negotiate low interchange fees, allowing them to offer their customers convenient payment methods while keep operating costs down.[119]

Further, we are seeing that the broader market is already tackling the issue of credit card interchange fees. Some smaller independent merchants run 'cash-only' to keep prices consistent for everyone and profit from increased ATM transactions.[120] This payment model may work to their advantage and prove more profitable.[121] On the other hand, a more prominent chain merchant such as Spec's Wine, Spirits & Finer Foods accepts all payment methods but provides a discount for cash users.[122] By offering their customers an option to use cash for

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[114] *Ibidem*, 47-48.

[115] *Ibidem*, 45-46.

[116] *Ibidem*, 48.

[117] Perrin, Andrew, "More Americans are making no weekly purchases with cash", *Pew Res. Ctr.*, December 2018. https://www.pewresearch.org/fact-tank/2018/12/12/more-americans-are-making-no-weekly-purchases-with-cash/

[118] *See* Kohli, Diti, "Welcome back to Fenway Park. Leave your cash at home, Boston Globe", April 2022. https://www.bostonglobe.com/2022/04/14/business/welcome-back-fenway-park-leave-your-cash-home *See* Quinton, Sophie, "Paying with Cash? Retailers must take your dollars in these states", *Pew Tr.*, May 2021. https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2021/05/11/paying-with-cash-retailers-must-take-your-dollars-in-these-states

[119] Merchant, Samuel J., "Merchant Restraints: Credit-Card-Transaction Surcharging and Interchange-Fee Regulation in the Wake of Landmark Industry Changes", *Okla. L. Rev*. no. 68, 327, 340. *See* Steinberg, Julie, "Amazon, Visa resolve Monthslong Credit-Card dispute", *Wall St. J.*, February 2022. https://www.wsj.com/articles/amazon-and-visa-reach-global-deal-on-credit-cards-11645092018 *See* Leff, Gary, "How much Citibank and Visa actually overpaid to win the Costco business away from Amex", *View from the Wing*, April 2015. https://viewfromthewing.com/how-much-citibank-and-visa-actually-overpaid-to-win-the-costco-business-away-from-amex/

[120] Reed, Catherine, "10 Reasons Cash Still King in an Increasingly Digital World", https://www.atmdepot.com/2017/09/page/2/ "Accepting Cash Only", *SBA.gov*. https://proxy.www.sba.gov/managing-business/running-business/managing-business-finances-accounting/accepting-cash-only

[121] *Idem*.

[122] Lieber, Ron, "The Damage of Card Rewards", *N.Y. Times*. https://www.nytimes.com/2010/01/09/your-money/credit-and-debit-cards/09money.html

lower prices, Spec's absolves cash customers of the interchange fees associated with credit cards. Offering different prices for different payment methods allows Spec's to cater to customers' payment preferences while maintaining competitive. Additionally, some merchants implement a surcharge for credit cards where state law allows it.[123] Credit card users absorb the cost of transacting with credit in each scenario outlined above. Thus, even if credit card interchange fees do inflate prices, they do not impact cash users.

2. A Credit Card Interchange Fee Cap Will Result in Anti-Consumer Consequences

In her article, Natasha Sarin discussed Section 1075 of the Dodd-Frank Act, called the "Durbin Amendment."[124] Illinois Senator Richard Durbin introduced the bill as a beneficial policy that purported to lower merchant transaction costs and lower prices for consumers.[125] In 2010, the Durbin amendment was passed, capping debit card interchange fees at an unreasonably low rate.[126] As a result of Durbin, merchant interchange fees decreased by $6.5 billion annually.[127] Empirical evidence shows that merchants failed to pass the savings onto the consumers.[128] After the Durbin Amendment went into force, The Federal Reserve Bank of Richmond's Survey reported that only 1.2 percent of retailers reduced prices, and in fact, 22 percent raised prices.[129] Indeed, we have seen

123 Pritchard, Justin, Kartit, Khadija, "Credit Card Surcharges", *The Balance*, January 2022. https://www.thebalance.com/credit-card-surcharges-315423

124 Sarin, *supra* note 98, at 1533.

125 *Ibidem*, 1533-34 (15 U.S.C. § 1693o-2(a) (1)-(2)).

126 *Ibidem*, 1535 (Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 1075, 124 Stat. 1376, 2068-74, 2010 codified at 15 U.S.C. § 1693o-2, 2012).

127 *Ibidem*, 1539 (Mukharlyamov, Vladimir, Sarin, Natasha, "Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards", July 2019, unpublished working paper on file with the Columbia Law Review).

128 *Ibidem*, 1540-42.

129 Bashur, Bryan, "The Durbin Amendment is a Disaster for Banks. Don't Expand it to Credit Cards", *The Hill*, August, 2021. https://thehill.com/opinion/healthcare/567142-the-durbin-amendment-is-a-disaster-for-banks-dont-expand-it-to-credit *See* Longe, Edward, "For the Sake of Consumers, Kill the Durbin Amendment," *Real Clear Pol'y*, September 2021. https://www.realclearpolicy.com/articles/2021/09/07/for_the_sake_of_consumers_kill_the_durbin_amendment_793229.html Tassey, Jeff, "The Durbin Amendment 10 Years Later: A Decade of Loss for Consumers and Small Businesses", *Morning Consult*, November 2021. https://morningconsult.com/opinions/the-durbin-amendment-10-years-later-a-decade-of-loss-for-consumers-and-small-businesses/ (Wang, Zhu *et al.*, "The Impact of the Durbin Amendment on Merchants: A Survey Study", *Fed. Rsrv. Bank of Rich*. https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2014/q3/pdf/wang.pdf

that the Durbin amendment proved beneficial only to merchants who pocketed the difference in interchange fees as additional revenue.[130]

U.S. lawmakers should have foreseen the resulting anti-consumer and pro-merchant consequences of the Durbin Amendment. Ten years prior to the passage of The Durbin Amendment, the Australian government implemented a similar cap on credit card interchange fees.[131] The Australian government expected the cap to reduce the use of credit cards and lower consumer costs.[132] In reality, the main effects were decreased bank revenue, increased merchant profits, and anti-consumer consequences.[133]

The interchange fee cap brought by the Durbin amendment was so restrictive that banks lost profitability from offering free checking accounts.[134] Thus, banks found less incentive to provide consumer-friendly policies, especially to unprofitable lower-income customers.[135] In fact, banks were 35.2 percent less likely to offer a free checking service than they were before Durbin.[136] Experts hypothesize that 65.2 percent of checking accounts would have been offered with no monthly maintenance fees if Durbin were not in effect.[137] In reality, only 30 percent of checking accounts were offered with no monthly maintenance fees.[138] Banks canceled debit card rewards programs and extinguished other fringe debit card benefits.[139] Banks increased fees, such as overdrafts, minimum balance, and nonsufficient fund fees to recapture profitability

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[130] Bashur, Bryan, "The Durbin Amendment is a Disaster for Banks. Don't Expand it to Credit Cards", *The Hill*, August 2021. https://thehill.com/opinion/healthcare/567142-the-durbin-amendment-is-a-disaster-for-banks-dont-expand-it-to-credit

[131] Sarin, *supra* note 24, at 563-64 (Reverse Bank of Australia and Australian Competition and Consumer Commission, "Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access", October 2000. https://perma.cc/59YX-S5KD

[132] *Ibidem*, 564, (Chang, Howard, *et al.*, "The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia", 4 *Rev. Network Econ.*, no. 4, 328, 349, 2005.

[133] *Ibidem*, 565.

[134] Mukharlyamov, Vladimir, Sarin, Natasha, "The Impact of the Durbin Amendment on Banks, Merchants, and Consumers", *U. of Penn. Inst. For Law & Econ.*, Research paper no. 19-06, 3-4, 2019.

[135] *Ibidem*, 4 (providing evidence that banks offset Durbin losses by raising account fees).

[136] Manuszak, Mark D., Wozniak, Krzysztof, "The Impact of Price Controls in Two-Sided Markets: Evidence from US Debit Card Interchange Fee Regulation", *Bd. of Governors of the Fed. Rsrv. Sys. Fin. & Econ.*, Discussion Series, Working Paper no. 2017-074, 2017.

[137] *Idem*.

[138] *Idem*.

[139] Tassey, Jeff, "The Durbin Amendment 10 Years Later: A Decade of Loss for Consumers and Small Businesses", *Morning Consult*, November 2021). https://morningconsult.com/opinions/the-durbin-amendment-10-years-later-a-decade-of-loss-for-consumers-and-small-businesses/

on free checking accounts.[140] The average overdraft charge was $21.57 in 1998 but ballooned to $31.26 in 2012.[141] Most notably, banks adopted unethical banking practices such as debit resequencing, where a bank purposefully rearranges an account's daily debits and credits from highest to lowest, maximizing instances of overdrafts.[142] With debit resequencing, banks unethically capitalize on indigent customers who spend more money than they have available.[143]

To appreciate the effect of debit resequencing, consider Peggy, a single mother of one who lives below the poverty line. On the morning of August 1st, Peggy has $750 in her checking account. Peggy wakes up 15 minutes late for work. With no time to make breakfast or pack lunch, she visits a drive-thru and purchases breakfast for $10. During her lunch break, Peggy buys lunch for $15 and buys her child's school supplies for another $30. She suddenly realizes that it is the first of the month and her rent is due! She pulls out her phone and makes a payment of $730 from her checking account. Throughout the day, Peggy spent $785, an excess of $35 over her available balance of $750. Without debit resequencing, the bank charges Peggy one overdraft fee of $35 because the rent payment was the latest transaction that put her in the negative. However, after the Durbin amendment, the bank implemented debit resequencing to make their free checking accounts profitable. The bank reorganizes Peggy's daily purchases from largest to smallest: $730; $30; $15; $10. In this reality, Peggy's $750 balance is negative after the $730 rent payment and $30 school supplies. As a result, the bank charged Peggy three overdraft fees, totaling a whopping $105 on top of the charges Peggy had made. Peggy shows us that a simple slip of the mind or miscalculation can entail painful consequences for the poor. Feeling taken advantage of, Peggy reevaluates her need for a bank account and decides to close her account.

These fees are the most damaging to lower-income individuals, the same people the Durbin amendment purported to benefit.[144] It is no longer profitable for banks to merely offer free checking without these fees.[145] Today, free checking accounts are less common and less desir-

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140 *Idem*.

141 Servon, Lisa, "Column: The Bank Fees You Don't Even Know About", *PBS*, June 2017. https://www.pbs.org/newshour/economy/column-bank-fees-dont-even-know.

142 *Idem*.

143 *Idem*.

144 Mukharlyamov, *supra* note 134, 32.

145 *See Ibidem*, 3-4.

able than they once were.[146] Extensive bank penalties and fees cause lower-income individuals to distrust financial institutions.[147] As a result, lower-income individuals have become disproportionately underbanked.[148]

3. Credit Card Market Competition Will Cool

Aside from the cards that offer credit to the risky subprime market, the credit card market is still red-hot with competition.[149] The credit card competition among issuers today is borne by profitability.[150] In this market, issuing banks one-up each other with better sign-up bonuses, better earning rates, and better redemption options.

Take a look at what issuers are offering: the Citi Double Cash is a no-annual-fee card that provides a combined reward of 2 percent unlimited cashback on all charges.[151] The Apple Card is a no-annual-fee card that offers 3 percent on all purchases at Apple, 2 percent on Apple Pay purchases, and 1 percent cashback on all charges.[152] The Apple Card also offers cardholders great software that individualizes the cardholder's credit, interest, and fees and makes them easy to understand.[153] The no-annual-fee Wells Fargo Active Cash Card offers a $200 sign-up bonus, 0 percent APR for 15 months from account opening, and unlimited 2 percent cash rewards.[154]

Shoehorning issuers to make a profit with capped interchange fees will throw a wrench into the credit card market. With low interchange fees, issuers will be unable to subsidize the current credit card bene-

146 *Ibidem*, 4 ("[T]he share of free basic checking accounts (accounts with a $0 monthly minimum for all customers, regardless of account balance) decreases from 60 percent to 20 percent as a result of Durbin").

147 Fed. Deposit Ins. Cor 2017 FDIC National Survey of Unbanked and Underbanked Households 4, October 2017. (30.2 percent of unbanked households surveyed indicate their distrust of banks as the reason why they are unbanked).

148 *Idem*. ("[U]nbanked and underbanked rates were higher among lower-income households…").

149 *See* Staples, Ana, "The Credit Card Market is Officially Booming: Here's What it Means for You", *Bankrate*, November 2021. https://www.bankrate.com/finance/credit-cards/credit-card-market-is-booming/

150 Resendiz, *supra* note 77.

151 "Citi, Citi® Double Cash Card". https://www.citi.com/credit-cards/citi-double-cash-credit-card

152 "Apple Card", *Apple*. https://www.apple.com/apple-card/

153 *Idem*.

154 Wells Fargo, *Wells Fargo Active CashSM Card*, https://creditcards.wellsfargo.com/active-cash-credit-card/

fits.[155] Reward programs will disappear, without rewards to entice cardholders to swipe, bank profits will drop dramatically, and competition will cool.[156] Wealthier cardholders who transact with the largest volume and the frequency will likely stick their unrewarding card in their sock drawer because they do not need credit for everyday purchases.[157] With profitable customers leaving and revenue dropping, issuers will probably turn to fees to regain profitability. Where have we seen this before?

Just as the Durbin amendment forced banks to implement fees to stay profitable, similar legislation that caps credit card interchange fees will likely cause issuers to do the same for their credit card products. Thus, once the wealthier customers leave, the lower-income customers who need the credit will be left holding the bag. It is likely that without much room for profitability from transactions, issuers who remain in the market will begin offering products more akin to those currently available in the subprime credit card market.[158]

In the subprime market, the only issuers that stand to profit are those that implement small credit limits, exorbitant annual fees, late fees, and high-interest rates to hedge their risk.[159] Indeed, these subprime issuers make most of their profits from fees than interest or interchange fees.[160] Anti-consumer policies plague the subprime credit card market, disproportionately affecting lower-income individuals who require the credit aspect of their credit cards.[161] With a restrictive cap on credit card interchange fees, it is likely that a great financial tool to build credit and earn rewards will become an expensive, undesirable, and predatory product.[162]

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155 James Caddy, et al., *Consumer Payment Behavior in Australia: Evidence From the 2019 Consumer Payments Survey*, Rsrv. Bank of Australia Research Discussion Paper, 2020. https://www.rba.gov.au/publications/rdp/2020/pdf/rdp2020-06.pdf (Australian credit card interchange fees led to the reduction of credit card rewards programs).

156 *See* Grant Halverson, *In a World First Australia Will Seek to Eliminate Card Interchange*, Retailer Banker Int'l (Aug. 8, 2018), https://www.retailbankerinternational.com/news/world-first-australia-will-seek-eliminate-card-interchange/ (Elimination of card interchange cause Australian consumers to suffer increased fees and charges while not receiving any benefits).

157 *See* Caddy, *supra* note 155, at 19.

158 Borrowers with a FICO score of 580-619 are considered 'subprime.'

159 Elliott, Diana, Lowitz, Ricki, "What Is the Cost of Poor Credit?", *Urban Inst*, September 2018. https://www.urban.org/sites/default/files/publication/99021/what_is_the_cost_of_poor_credit.pdf *See also* Anderson, Margo, "From Subprime Mortgages to Subprime Credit Cards", *Fed. Rsrv. Bank of Boston*, no. 21-22, 2008.

160 Lambarena, Melissa, "How Do Credit Card Companies Make Money?", *Nerd Wallet*, May 2021. https://www.nerdwallet.com/article/credit-cards/credit-card-companies-money

161 Elliott, *supra* note 159.

162 Sarin, *supra* note 24, at 565.

4. Credit Will Become Inaccessible to Lower-Income Individuals

A May 2019 report by the Federal Reserve indicated that 22 percent of American adults are either unbanked or underbanked.[163] The report shows that the majority of the unbanked or underbanked population are lower income.[164] Underbanked individuals often pay for expenses with cash and rely on alternative financial services such as money orders, check-cashing services, and predatory businesses such as payday lenders and auto title loan agencies.[165]

The 2017 FDIC National Survey of Unbanked and Underbanked Households provides context on the topic.[166] Stemming from the survey, 52.7 percent of unbanked households cited "not enough money to keep in an account" as the reason for not having one;[167] 30.2 percent cited "Don't trust banks" as the reason; 29.9 percent of unbanked households that previously held an account reported that "Bank account fees are too high"; 24.9 percent of unbanked households that previously held an account reported that "Bank account fees are unpredictable."[168]

The survey shows overwhelming evidence that unbanked and underbanked households are wary of hefty bank fees and there are many: monthly maintenance fees, overdraft fees, minimum balances, and ATM fees.[169] However, the consequences of being unbanked carry a steep price over time, including high costs for credit. Without a bank, the unbanked and underbanked seek credit from exploitative payday lenders, auto title loan agencies, and pawnshops.[170] Payday lenders, for example, typically charge interest of $15-$20 for every $100 borrowed, an effective 391 percent to 521 percent APR.[171] Further, these institutions do not report borrowers' positive payment history to the credit

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163 "Report on the Economic Well-Being of U.S. Households in 2018", *Bd. of Governors of the Fed. Rsrv. Sys*, no. 25, May 2019. https://www.federalreserve.gov/publications/files/2018-report-economic-well-being-us-households-201905.pdf

164 *Idem*. ("One percent of those with incomes over $40,000 are unbanked, versus 14 percent of those with incomes under that threshold.")

165 *Idem*.

166 Fed. Deposit Ins. Cor, *supra* note 146, at 4.

167 *Idem*. (I interpret "not enough money to keep an account" as a proxy for the inability to meet the account's minimum balance. Failing to meet the minimum balance incurs a 'monthly service fee.').

168 *Idem*.

169 *Idem*.

170 *Idem*. at 17

171 Macey, Jonathan, *"Fair Credit Markets: Using Household Balance Sheets to Promote Consumer Welfare", Tex. L. Rev.*, no. 100, 683, 711, 2022.

bureaus.[172] On the other hand, if the borrower defaults, the payday lender will sell the debt to third-party debt collectors known to report the default.[173]

From the FDIC survey, I extrapolate that implementing restrictions or limiting interchange fees for credit cards will further isolate lower-income individuals from credit.[174] As argued above, these changes will make credit card issuing unprofitable. Issuers will turn to fees, which will exacerbate the problem of credit-invisible and underbanked lower-income individuals.[175]

Case law on taxability of rewards

Next, this paper will explore the taxability of earned rewards. Some cardholders receive a not-insignificant amount of rewards from issuers as compensation for their credit card spending. Below, I go into the background on manufactured spending and its taxability according to a recent Tax Court case. When looking at economic and social policy considerations, I suggest that the Tax Court correctly decided the case.

A. Manufactured Spend, 'Gaming' of the Rewards Program

Not all cardholders play by the rewards program rules. For instance, manufactured spending is a well-known 'gaming' of the program that issuers work to limit.[176] Manufactured spending is the process of maximizing credit card spend, receiving rewards on that spend, converting the spending back into cash, and profiting from the transactions.[177] For example, a cardholder may purchase Visa gift cards with a rewards card, receive rewards from the purchase, liquidate the Visa gift cards into money orders, and cash the money orders in to pay off the credit card.[178] The process is not precisely straightforward as the logistics are

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[172] Sandberg, Erica, "What Happens If I Stop Paying My Payday Loan?", *Experian*, May 2019. https://www.experian.com/blogs/ask-experian/what-happens-if-i-stop-paying-my-payday-loan/

[173] *Idem.*

[174] *See* Mukharlyamov, *supra* note 134, at 35 (following Durbin, the number of unbanked individuals significantly increased).

[175] *Idem.* (Issuers heighten fees to regain profitability after an interchange fee cap, leading lower income individuals to forego use of credit).

[176] Dootingh, Erik, "Amex Sign-Up Bonus Clawbacks and Hitting Minimum Spend Requirements", *Reward Expert*, June 2020. https://www.rewardexpert.com/blog/amex-sign-up-bonus-spend-requirements/

[177] Reyes, Nick, "Manufactured Spending Complete Guide", *Frequent Miler*, December 2020. https://frequentmiler.com/manufactured-spending-complete-guide/

[178] *Idem.*

difficult to navigate.[179] For most cardholders, the reward is not worth the amount of work required.[180] However, a minority of fanatic credit cardholders engage in the activity if the rewards they receive from credit card spending exceed the fees they pay to convert the cash equivalents into cash.[181]

As far as the government is concerned, 'gaming' of the rewards program is not criminal, but credit card issuers frown upon the practice.[182] Notably, American Express is one issuer that disapproves of manufactured spending and forbids it altogether.[183] Unlike Visa or Mastercard that partner with issuing banks to supply credit cards to customers, American Express acts as both the issuing bank and the network.[184] As the network, American Express has the burden of acquiring new merchants and assuring existing merchants that accepting their cards makes financial sense for their business.[185] As the issuing bank, American Express must ensure its cardholder base is healthy and heartedly rewarded for their spending.[186] Thus, American Express's business model hinges on a balancing act between serving its merchants and its cardholders.

Manufactured spending risks the health of both American Express's customer and merchant bases. The practice risks devaluation of credit card points and diminution of card benefits for most cardholders who play by the rules.[187] The practice also risks merchant adoption of American Express' transaction network. Suppose American Express cardholders buy unprofitable products, such as Visa gift cards with their re-

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[179] *See* generally *Idem*.

[180] Ott, Gilbert, "Amex Shuts Down Points & Miles Fanatics Abusing Spending Rules", *God Save The Points*, December 2020. https://www.godsavethepoints.com/amex-shut-downs-paypal-key/

[181] *Idem*.

[182] Mecia, Tony, "Is it OK to Pay Myself With my Own Business Credit Card to Earn Rewards", *Creditcaards.com*, October 2018. https://www.creditcards.com/education/buy-boost-reward-points- manufactured-spending-1433/

[183] "Program Terms & Conditions for Card Members" *American Express*. https://www.americanexpress.com/content/dam/amex/us/rewards/membership-rewards/mr-terms-conditions-03.2022.pdf?tier=LF&mrk=&stoken

[184] Chakravorti, Sujit, Shah, Alpa, "Underlying Incentives in Credit Card Networks", *Antitrust Bull*, no. 48, 53,56, 2003.

[185] *See* Resendiz, Joe, "Where and How Widely are Visa, Mastercard, Discover and American Express Credit Cards Accepted?", *Value Penguin*, January 2022. https://www.valuepenguin.com/where-visa-mastercard-american-express-discover-accepted

[186] *See* Steinberg, Ethan, "What's the Difference Between a Credit Card Network and Issuer?", *The Points Guy*, April 2020. https://thepointsguy.com/news/whats-the-difference-between-a-credit-card-network-and-issuer/

[187] Ott, *supra* note 180.

wards card. If these unprofitable transactions become too obvious or frequent, American Express will lose favor with these merchants.[188]

Seeing manufactured spend as a threat to profitability, American Express bans on manufactured spending in the terms and conditions of each of its credit cards.[189] American Express is known to 'claw back' reward points and even close the credit card accounts of those engaging in manufactured spending to enforce the rule.[190]

Prudent merchants have also limited the practicability of manufactured spending. On December 19th, 2020, Walmart promulgated a "Manufactured Spending Policy" memo that entrusts its employees to stop manufacturing spending transactions.[191] Although Walmart cites "significant customer service and operational impacts,"[192] the more likely cause for the disallowance of manufactured spending is its impact on Walmart's bottom line.

Fortunately, we see that the market has taken steps to limit the practicability of manufactured spending. Granted, there are no statistics on whether American Express' and Walmart's actions effectively curb manufactured spending. Notwithstanding, I find the market's adaptions inspire confidence in the deterrence efforts to make rewards programs fair to all cardholders. The U.S. Tax Court case *Anikeev v. Commissioner* examined the taxability of credit card rewards derived from manufactured spending. I will discuss this tax court opinion below.

B. IRS Guidance on Frequent Flyer Miles and Rebates

In 2002, the IRS promulgated Announcement 2002-18, which provided an (albeit weak) stance that frequent flier miles attributable to business travel are not taxed.[193] Revenue Ruling 76-96 provides the IRS's longstanding policy deeming rebates a discount on purchased products, not taxable income.[194]

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188 *See* Eckler, Mike, "Why American Express Pushes for Higher Merchant Acceptance", February 2020. https://www.practicalecommerce.com/why-american-express-pushes-for-higher-merchant-acceptance (American Express is already on the back foot because merchants already pay higher AmEx interchange fees).

189 American Express, *supra* note 183.

190 Pepper, Stephen, "Amex Going Clawback-Happy for Grocery Store Spend", *Frequent Miler*, July 2020. https://frequentmiler.com/amex-going-clawback-happy-for-grocery-store-spend/

191 Greg The Frequent Miler, *Walmart Manufactured Spending Policy Memo: "That Activity Should Be Stopped"*, Frequent Miler (Dec. 14, 2020), https://frequentmiler.com/walmart-manufactured-spending-policy-memo/

192 *Idem*.

193 I.R.S. Announcement 2002-18, 2002-1 C.B. 621 (I.R.S. 2002).

194 *Rev. Rul.* 76-96, 1976-1 C.B. 23.

C. Case Law-Anikeev v. Commissioner

In Anikeev v. Commissioner, the Tax Court addressed whether reward dollars from credit card spending were taxable income.[195] During 2013 and 2014, the Anikeevs held two Blue Cash American Express Cards.[196] The Blue Cash card offered up to 1 percent rewards on eligible purchases for the first $6,500 spent in a year and up to 5 percent rewards on eligible purchases beyond $6,500.[197] American Express did not limit the amount of rewards dollars that could be accumulated within a given year.[198] The Anikeevs engaged in manufactured spending on the Blue Cash cards to collect substantial reward dollars.[199] More specifically, the Anikeevs charged over $6.4 million in Visa gift cards, gift card reloads, and money orders to accumulate $313 thousand in reward dollars.[200] The Anikeevs did not report the rewards dollars as income in their taxes, so the IRS issued a notice of deficiency for 2013 and 2014 tax years.[201]

The Anikeev Court held that the reward dollars associated with the purchase of Visa gift cards were rebates and not taxable.[202] On the flip side, the Court also found that "direct purchases of money orders and the cash infusions to the reloadable debit cards" were taxable because they were nothing more than 'cash transfers'.[203]

1. The Anikeev Court's Impact on Credit Card Rewards

The Anikeev decision seems arbitrary at first glance – what is the material difference between purchasing Visa gift cards and reloading those same cards? Yet that is where the Court drew the line, contorting its decision to kill two birds with one stone. The Court reinforced the notion that credit card rewards fit within the meaning of an untaxed 'rebate' under Revenue Ruling 76-96. The Court also limited the viability of manufactured spending, an undesirable practice that benefits one cardholder at the expense of everyone else. The decision aligns with

[195] *Anikeev v. Commissioner of Internal Revenue*, 121 T.C.M. (CCH) 1163 (T.C. 2021).
[196] *Idem* at *2.
[197] *Idem*.
[198] *Idem*.
[199] *Idem* at *3.
[200] *Idem*.
[201] *Idem* at *3-*4.
[202] *Idem* at *7.
[203] *Idem*.

a favorable pro-credit card rewards stance by limiting the potential 'gaming' of rewards programs.

The Call for Non-Intervention Towards Credit Card Rewards Programs

Credit is the oil to the economic engine. Credit allows borrowers to gain access to capital that creates jobs, grows the economy, and provides an avenue for borrowers to climb the socioeconomic ladder.[204] A credit card is simply one financial tool that bridges the gap between consumers and lenders. Credit card rewards programs have generated popularity and loyalty to the credit card market by providing a net positive value to all parties.[205] Cardholders benefit because they gain value every time they swipe.[206] Merchants gain brand association, transaction convenience, and increased traffic by accepting cards.[207] Issuers profit from the volume and frequency of transactions, offering rewards to increase consumption, loyalty, and the number of new cardholders.[208] Increased consumer spending brought on by rewards programs benefits all aspects of the economy.[209] I offer a plan to assist lower-income individuals in securing financial security while bolstering the integrity of the credit card market. A federal program to subsidize financial education in public schools would allow all Americans to have the same chance to secure financial stability.

A. The Market Is Capable of Adapting to Inefficiencies

Earlier in the paper, I examined academics' arguments against credit card rewards: eliminate credit card rewards programs because it results in a lower-income to higher-income cross-subsidy. I addressed this point, arguing that the existence of a regressive cross-subsidy is not conclusively proven.[210] Even if a regressive cross-subsidy did exist, I argue that attempts to rectify the perceived cross-subsidy will negatively affect the financial market and prove detrimental to the consumer.[211]

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[204] Ban, Loana, "The Impact of Credit on Economic Growth in the Global Crisis Context", *Procedia Econ. and Fin.*, no. 6, 25, 27, 2013.

[205] *See* Turner, *supra* note 39.

[206] *Idem* at 10.

[207] *Idem* at 11.

[208] Steinberg, *supra* note 186.

[209] *See* Turner, *supra* note 39.

[210] Semeraro, *supra* note 112, at 442-43.

[211] *See* Mukharlyamov, *supra* note 134.

Recent history has shown that even with good intentions, legislation to regulate a thriving industry will spell consequences that actively hurt the underserved lower-income population, not help them.[212] Suppose lawmakers apply legislation similar to the Durbin amendment to the credit card market consumers will lose valuable rewards, credit would be accessible to fewer Americans, and the poor would pay more to gain access to and use credit.[213] Instead, lawmakers should apply a policy of non-intervention to the credit card market and allow the market to resolve any inefficiencies.

The market has already shown that it solves payment inefficiencies: Some merchants operate cash-only and profit from ATM transactions;[214] others operate cash-less, forgoing the cost of managing cash and the risk of robberies;[215] large merchants like Walmart, that are known for offering low prices, leverage their size to negotiate low interchange fees.[216] The market continues to adapt to unfair rewards program 'gaming' practices such as manufactured spending, inspiring confidence in the market's ability to regulate itself.[217]

B. The Need for Financial Education

Considering my paper's contribution on the topic, the argument for 'fixing' credit card interchange fees to fix a 'cross-subsidy' that may or may not exist is misguided and unproductive. Instead, I offer a discussion on a federally subsidized financial education program to help low-income consumers understand financial products and support their financial security. Understanding credit and how to build credit is essential because it impacts almost all parts of a person's life.[218] A landlord considers an applicant's credit scores to determine whether to rent to the individual.[219] An employer checks a potential hire's credit scores

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[212] *Idem* at 35 (loss of bank profitability led to increase in fees, resulting in significant increase of unbanked individuals).

[213] *See* generally *Idem*.

[214] Reed, *supra* note 120.

[215] Wang, *supra* note 80; Perrin, *supra* note 117 (Americans are becoming less reliant on physical currency).

[216] Merchant, *supra* note 119, at 340.

[217] *See* American Express, *supra* note 183; *see also* Greg "The Frequent Miler", *supra* note 191.

[218] Demyanyk, Yuliya, "Your Credit Score Is a Ranking, not a Score", *Fed. Rsrv. Bank of Cleveland Econ*. Commentary no. 2010-16, November 2010. https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/2010-economic-commentaries/ec-201016-your-credit-score-is-a-ranking-not-a-score.aspx

[219] *Idem*.

before extending an offer for a position.[220] An individual's credit score determines whether the individual will spend 90 minutes on a bus or 20 minutes in a car.[221] Credit plays a crucial role in leveraging an individual's financial history to build their future "out of poverty and into financial security."[222]

Even though one's income is not a data point used to calculate the credit score, the lowest income earners in society do not have access to the same financial products that are available to wealthier individuals.[223] So then, why do lower-income individuals have fewer credit cards, lower credit scores, and a harder time getting access to financial tools? Yes, many factors are at play, and academics can discuss them without end. In this paper, however, I argue that the U.S. education system fails to address the lack of financial education that effectively sets lower-income individuals up to fail.

The United States ranks number one worldwide in Gross Domestic Product[224] but ranks 14th for financial literacy.[225] Poor financial literacy contributes to the problem of millions of Americans who are trapped in a cycle of debt.[226] An unsustainable cycle of debt creates stress and desperation that is not easy to escape.[227] In a 2019 survey, 59 percent of Americans said they lived paycheck to paycheck.[228] Further, 35 percent of U.S. adults did not have enough cash or credit to weather a $400 emergency, a figure similar to pre-pandemic levels.[229]

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220 *Idem*.

221 *Idem*.

222 Cornfield, Jill, "Low-income Americans Get Double Squeeze From Poor Credit and High Fees", *CNBC*, September 2018. https://www.cnbc.com/2018/09/19/poor-credit-keeps-low-income-people-paying-higher-fees-and-stiff-interest-rates.html (quoting Margery Austin Turner, senior vice president for program planning and management at the Urban Institute).

223 Mills, Claire, *et al*., "The State of Low-Income America: Credit Access & Debt Payment", *Fed. Rsrv. Bank of N.Y.*, no. 4, 2022. https://www.newyorkfed.org/medialibrary/media/press/the-state-of-low-income-america-credit-access-debt-payment-march-2022 (only half of low-income households have access to a credit card).

224 Silver, Caleb, Rasure, Erika, "The Top 25 Economies in the World", *Investopedia*, February 2022. https://www.investopedia.com/insights/worlds-top-economies/

225 Silver, Caleb, James, Margaret, "Financial Literacy for Children," *Investopedia*, March 2022. https://www.investopedia.com/the-push-to-make-financial-literacy-into-law-4628372

226 *Idem*.

227 *Idem*.

228 Schwab, Charles, *2019 Modern Wealth Survey*, https://www.aboutschwab.com/modernwealth2019

229 "Report on the Economic Well-Being of U.S. Households in 2020", *Bd. of Governors of the Fed. Rsrv. Sys.*, May 2021. https://www.federalreserve.gov/publications/2021-economic-well-being-of-us-households-in-2020-dealing-with-unexpected-expenses.htm

Unfortunately, only seven U.S. states require a high school personal finance course for graduation.[230] Thirty-eight states have no plans to implement a personal finance course.[231] Where do these children learn about money? Family is a popular answer, but data shows that parents do not give children the financial education they need. A BECU survey of 1,000 U.S. adults found that 72 percent of parents were not talking to their children about finances.[232] Even if a parent talks to their children about money, children born to wealthier parents are better set up for success than children born to poorer parents.[233] People with less money receive fewer opportunities to learn financial principles, practice putting knowledge into action, and build a solid foundation.[234] As a result, children of poorer parents receive unequal financial education.[235] With family not filling the need, we turn back to the education system.

Financial education can weaken systemic barriers to credit.[236] Expanding access of financial education in schools would make a difference to lower-income individuals' financial future and allow individuals of all economic stratifications to see the benefits and participate in the financial market.[237] I propose that the federal government award education subsidies to public schools that implement a financial literacy class as a core subject for graduation.

Conclusion

The credit card is a beneficial credit product for the economy that has seen a significant increase in usage over the few last decades. Proposing regulations to cap credit card interchange fees or kill the

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[230] Smith, Kelly, "These States Now Require Students To Learn About Personal Finance", *Forbes*, April 2022. https://www.forbes.com/advisor/personal-finance/states-mandating-personal-finance-in-school/ (five more states are preparing to implement financial education courses in high school).

[231] *Idem*.

[232] "BECU Survey Discovers Majority of Parents Aren't Talking with Kids About Money", *PR Newswire*, October 2019. https://www.prnewswire.com/news-releases/becu-survey-discovers-majority-of-parents-arent-talking-with-kids-about-money-300930307.html

[233] Cavanaugh, Afton, "Rich Dad vs. Poor Dad: Why Leaving Financial Education to Parents Breeds Financial Inequality & Economic Instability", *Child. Legal Rts. J.*, *búm* no. 34, 59, 2013.

[234] *Ibidem*, 61 (Dan, Kadlec, "Financial Education: A Job for Teachers or Parents? Bus", *Time*, October 2012. http://business.time.com/2012/10/08/financial-education-a-job-for-teachers-or-parents/ (asserting that financial literacy "accounts for as much as 50 percent of the wealth gap" in America).

[235] *Idem*.

[236] *Idem*.

[237] *Idem*.

rewards program in the misguided pursuit of "eliminating the regressive cross-subsidy" would be unpopular and ineffective. If legislation restricted the free credit card market, we would see anti-consumer results like the results of the Durbin Amendment. Instead of eroding the profitable credit card market, I propose that effective financial education in public schools would better serve consumers. Since issuers profit from the frequency and volume of transactions, more financially prudent cardholders joining the credit cards rewards program would allow issuers to profit and for all cardholders, irrespective of economic stratification, to enjoy the benefits of consumer-friendly financial products.

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"Chase Sapphire Preferred® with Ultimate Rewards® Program Agreement", *J. Morgan Chase & Co*. https://static.chasecdn.com/content/dam/card/rulesregulations/en/RPA0444_0477.pdf

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