

Cho, Sung Ick; Lee, Hwaryung

**Research Report**

## Gains and Losses of the Mandatory Duration Regulation for Rewards Programs by Credit Cards

KDI Focus, No. 42

**Provided in Cooperation with:**

Korea Development Institute (KDI), Sejong

*Suggested Citation:* Cho, Sung Ick; Lee, Hwaryung (2014) : Gains and Losses of the Mandatory Duration Regulation for Rewards Programs by Credit Cards, KDI Focus, No. 42, Korea Development Institute (KDI), Sejong,  
<https://doi.org/10.22740/kdi.focus.e.2014.42>

This Version is available at:

<https://hdl.handle.net/10419/200847>

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## KDI FOCUS

September 4, 2014 (No. 42, eng.)

### For Inquiry:

KDI Communications Unit

15, Giljae-gil, Sejong City, 339-007, Korea

Tel: 82-44-550-4030 Fax: 82-44-550-0652

Writer | Cho, Sung Ick, Fellow (82-44-550-4071)

Lee, HwaRyung, Fellow (82-44-550-4101)

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## Gains and Losses of the Mandatory Duration Regulation for Rewards Programs by Credit Cards

Cho, Sung Ick, Fellow at KDI  
Lee, HwaRyung, Fellow at KDI

**“Introduced in 2010, the regulation obliging one-year duration for credit card rewards programs may have provided card companies with a cost-saving justification for terminating rewards program prematurely. In addition, the recently announced revision to the Regulation on Supervision of Credit-Specialized Financial Business prohibits card companies from altering rewards program associated with a card while the card is valid. This may have the side effect of leading card companies to offer fewer benefits and restricting consumer choices. To address this issue, it is suggested that card companies be encouraged to diversify expiration dates.”**

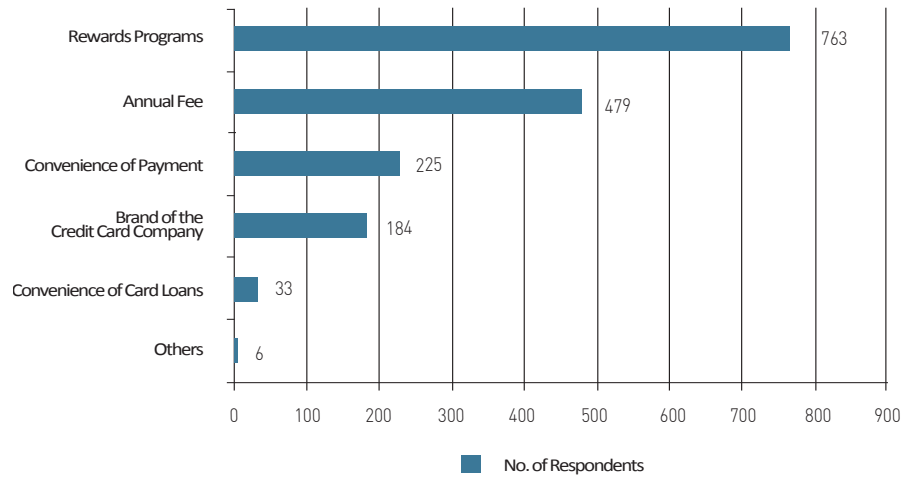
### I. Introduction of the Mandatory Duration Regulation on Credit Card Rewards Programs

The primary role of credit cards in the market is to serve as a convenient means of settlement, differentiated from other payment methods. They also enable consumers to take short-term loans (typically for one month) while offering additional services such as card loans and various rewards programs.

\* This article mainly presents empirical evidence related to the mandatory duration and rewards programs associated with credit cards. The in-depth theoretical analysis of the subject is included in Cho, Sung Ick, “A Study on Switching Cost Induced by Discount on Bundled Products: Including Rewards Programs by Credit Cards,” KDI Policy Study, 2013-07, Korea Development Institute, 2013.

\* This is the translated version of KDI FOCUS released on July 3, 2014.

[Figure 1] Major Considerations in Opening a New Credit Card Account (Multiple Answers Allowed, 1,000 Respondents)



The benefits associated with credit cards are normally granted through a point accrual system (where points accumulated for credit card usage can be exchanged for cash, goods, or services) or through merchant-specific price discounts. These rewards programs are becoming an increasingly important factor when consumers select new credit cards. According to a survey conducted by the KDI Economic Information and Education Center,<sup>1)</sup> about 76 percent of respondents chose reward program as one of the primary considerations when taking out a new card (see Figure 1).

According to the survey, around 76 percent of consumers pointed to rewards programs as major consideration in opening a new credit card account.

For consumers, equally important to the size of the rewards is the actual duration of the rewards program. But from the perspective of a card company, rewards programs are an investment made to draw in consumers; once a critical number of customers have signed on with the company, businesses tend to halt investment in solicitation programs and seek to realize profits with existing customers. For this reason, the question of how long to maintain investment in such programs is a serious consideration for credit card issuers; the duration of credit card rewards programs was deemed imperative to profit increase long before financial authorities expressed interest in regulation.

When card companies enact a strategy regarding the duration of services, consumer responses matter most. Consumers also consider the company's policy on maintaining rewards programs when selecting credit cards.

When credit card companies outline a strategy regarding the duration of rewards programs, great attention is given to how sensitive consumers are to the additional benefits offered by card companies. Consumers form expectations of the duration of rewards program and decide which card to choose based on it. Thus, it is important to establish a clearer understanding of the interaction between card issuers and consumers in order to assess the regulatory effect of mandatory duration for credit card rewards.

The financial authority's history of regulating the duration of rewards programs began with the Regulation on Supervision of Credit-Specialized Financial Business on August 7, 2009. Outlining

1) An online survey was conducted for 1,000 people around the country between April 7 and 11, 2014. Respondents were limited to those aged between 20 and 59, who possess at least one credit card or will open a new credit card account soon.

situations where credit card companies can alter or terminate rewards programs—situations such as bankruptcy, natural disasters, and drastic changes in financial environment—the regulation stipulates that the card company must wait at least one year after it introduces such credit card before it can make any additional service changes. On April 30, 2010, the following clause was added on terms and conditions for standard credit card contract, explicitly defining the mandatory year-long waiting period: “The credit card company shall not make reductions or changes in additional services for at least one year after it issues a new credit card.”

On May 22, 2014, however, a preliminary announcement was made to revise the regulation, removing the specific clause pertaining to the one-year mandatory duration. If the revision is passed, changes to the additional services of credit cards would only be allowed in the very exceptional cases such as bankruptcy or natural disasters. This article evaluates the one-year-duration regulation and the revision to the regulation based on the analysis of the actual duration of credit card rewards program and consumer expectations related to the duration.

## **II . Introduction of One-Year Duration Regulation and the Reduction of the Duration of Credit Card Rewards Programs**

The legislation that forced companies to maintain the programs for a full year was introduced as a means of protecting consumers, guaranteeing the minimum duration of services. When card companies attract customers with tempting rewards programs and then reduce or terminate the benefits prematurely, the marketing strategy becomes detrimental to customers who commit to those cards intending to enjoy the promised benefits over the long term. This is especially important because consumers tend to stay with their cards even with the change in rewards program as they have to incur large costs of switching from one card to another (monetarily and psychologically).

Before moving further, it is important to consider how the rewards programs in question were operated at the time when the duration regulation was introduced. Based on the data collected by the authors,<sup>2)</sup> prior to the regulation, it was actually quite common for rewards programs to last far longer than one year. <Table 1> shows the average duration of the services of credit cards released to the market by year from 2006 to 2009, demonstrating that each maintained their rewards programs for almost three years. When considering this trend in relation to the regulation, the subtext is that the mandatory duration may have been too short to be effective. Such a short mandatory duration regulation might have influenced consumers and card companies in a way the authorities did not intend.

Since the regulation was imposed, card companies could have elected to shorten the duration of their rewards programs, rather than lengthening it. According to the data submitted by the

2) The Financial Supervisory Commission acquires information on new card issuance and additional services from card companies on a regular basis, but the authors were not allowed access to the information. Instead, the authors collected data through public notices on the websites of credit card companies, as such businesses are required to make a public notice in the case of reducing or terminating rewards programs.

**<Table 1> Average Duration of Rewards Programs before the Regulation**

| Year of release     | 2006                             | 2007                             | 2008                              | 2009                              |
|---------------------|----------------------------------|----------------------------------|-----------------------------------|-----------------------------------|
| Average duration    | 4 years and 2 months (50 months) | 3 years and 7 months (43 months) | 2 years and 10 months (34 months) | 2 years and 11 months (35 months) |
| No. of observations | 8                                | 22                               | 17                                | 14                                |

Note: Given that only the credit cards with reduced or suspended benefits were observed, it can be predicted that the actual average duration would be greater than the numbers in the table.

**<Table 2> Changes in the Duration of Rewards Programs before and after the Regulation**

|                       | Before the regulation | After the regulation | Declines since regulation |
|-----------------------|-----------------------|----------------------|---------------------------|
| Low-annual-fee cards  | 37.70 (months)        | 25.76 (months)       | 11.93 (months)            |
| High-annual-fee cards | 37.04 (months)        | 22.86 (months)       | 14.18 (months)            |

Notes: 1) Only the cards with reduced or terminated benefits and released after 2007 were included in the sample.  
 2) Cards with low annual fees refer to the cards whose annual fees are lower than the median of those with reduced benefits by 2012, determined among the cards released between 2007 and 2012. Cards with high annual fees have annual fees that are greater than the median.

**Changes in the Duration of Rewards Programs before and after the Regulation (Regression Analysis)**

Regression analysis showed the duration of cards with bigger rewards decreased more than those with smaller rewards in a statistically significant way. This implies that card companies took the mandatory duration into greater consideration when deciding the service duration of the cards with greater rewards.

|  | Duration until the first reduction or termination of benefits |
|--|---|
| Cards with low annual fees dummy × 'after regulation' dummy  | -1.35*** (0.52)   |
| Cards with high annual fees dummy × 'after regulation' dummy | -2.46*** (0.61)   |
| No. of observations  | 92  |

Notes: 1) Only the cards with reduced or terminated benefits and released after 2007 were included in the sample.  
 2) The duration until the first reduction or termination of benefits was divided into four categories—"less than 18 months," "between 18 months and three years," "between three years and five years," and "five years or more"—and analyzed using an ordered logit model.  
 3) "Cards with low annual fees" takes the value of 1 if the annual fees are lower than the median value of those with reduced benefits by 2012 among the cards released between 2007 and 2012, and zero otherwise. The opposite is applied for "Cards with high annual fees".  
 4) Numbers in parentheses are standard errors. Constant term is included. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1.

Financial Supervisory Commission at the request of lawmaker Dae-dong Park, the number of cases where card companies reduced rewards and benefits within two years of passing the mandatory service duration rocketed from 6 in 2010, to 18 in 2011, and to 63 in 2012. The number of cases in which the rewards were reduced within one year dramatically increased from 2 in 2010 to 30 in 2013.

**Before the introduction of the one-year mandatory duration, the rewards programs of credit cards lasted over three years on average. This implies the mandatory duration may have been too short.**

The analysis of the limited data that the authors collected<sup>3)</sup> also confirmed that the one-year obligation became a focal point for card companies when determining how long to maintain rewards programs (see Table 2).

<Table 2> illustrates that the duration of rewards programs decreased substantially after the regulation was introduced, regardless of the amount of annual membership fees. For the cards with high annual fees, the duration of rewards programs was shortened by nearly 14 months, while those with low annual fees by about 12 months. What should be noted, however, is that this decline is the combination of the regulation's effect and the bias arising from data limitation. Because the data cover only those cards with reduced or terminated rewards program (as of June 2013), the observed duration is biased downwards, that is, shorter than the average duration for all cards, and the bias would be severer for more recent observations. As such, it is natural that

3) As mentioned previously, the data gathered by the authors are limited to the cards with reduced or terminated rewards programs. As not all cards are covered, the observed duration is biased downwards and the bias would be severer for more recent observations. Therefore, it is necessary to consider the limitation of "out of the cards with reduced or terminated rewards programs only," to interpret the analysis results in the article.

the cards released after the regulation have shorter “observed” duration of rewards programs than those released before.

In light of these limitations, this study rather compares the declines in the service duration between cards with low annual fees and those with higher annual fees as a way to determine how the regulation affected the behavior of card issuers. The cards with higher annual fees typically offer better rewards programs that are intended to attract consumers who place high value on rewards program. Effectively, the regulation targeted cards that offer large rewards. So our focus is how the duration has changed for high-annual-fee cards (typically with great benefits) as compared to the low-annual-fee cards.

Using the low-annual-fee cards as a benchmark, high-annual-fee cards shortened the service duration by more than two months. Before the regulation was introduced, the gap between the two types of cards was only 0.7 months after the regulation; however, the gap widened to 2.9 months. Overall, the service duration of the high-annual-fee cards shortened by nearly two months more than that of low-annual-fee cards.

The results show that the card companies’ tendency to shorten service durations was especially pronounced among cards with high annual fees, where rewards and benefits were an important selling point for consumers. Considering that the duration decision is more crucial for cards with greater benefits, this suggests that card companies rather reduced the service duration in the presence of the one-year mandatory duration regulation. The reasons for the adverse effects of the regulation—which was designed to protect consumers by guaranteeing the minimum duration of rewards programs—will be examined in greater detail.

### 1. A Focal Point or an Indulgence for Card Companies

As mentioned previously, the mandatory one-year duration—introduced when the average duration of rewards programs was over three years—could have somehow justified the earlier ending of the programs. More specifically, the one-year minimum may have encouraged a lower standard for rewards programs, enabling card companies to halt benefits after one year without concern for consumers or “the bona fide (good faith) principle”, while also acting in accordance with the regulation and the terms and conditions for membership.

On the other hand, the minimum duration could have been interpreted as an implicit guideline for card companies to follow when determining how long rewards programs should be maintained. Before the regulation, there was no specific benchmark, meaning that individual companies could make their own decisions. However, the regulation presented the standard of one year, encouraging card companies to establish programs with durations that fell slightly over the government’s guidelines.

Consumers, too, changed their expectations, according to our survey. The results showed that, after the regulation was passed, the anticipated duration of rewards programs had converged to around one and a half years. They also indicated that consumers with lower expectations from their credit card programs tended to become more optimistic after the regulation, while the reverse occurred for those

Card companies could have shortened their rewards programs duration since the one-year regulation.

When card companies decide on the duration of rewards programs, they are likely to have given serious consideration to the one-year regulation.

Card companies now can terminate rewards programs while acting in compliance with the regulation and the terms and conditions for membership, and do so without showing concern for consumers or keeping "the bona fide (good faith) principle".

**<Table 3> Changes in Consumer Expectations Regarding the Duration of Rewards Programs after Regulation**

| Expected duration before regulation | Changes in expected duration of benefits |              |              | Total |
|-------------------------------------|--|--------------|--------------|-------|
|                                     | Decrease                                 | Same         | Increase     |       |
| 1 year                              |  | 153 (45.54%) | 183 (54.46%) | 336   |
| 1 year and a half                   | 15 (31.25%)                              | 20 (41.67%)  | 13 (27.08%)  | 48    |
| 2 to 3 years                        | 215 (50.95%)                             | 129 (30.57%) | 78 (18.48%)  | 422   |
| 4 years or more                     | 89 (61.38%)                              | 56 (38.62%)  |              | 145   |
| Total                               | 319 (33.54%)                             | 358 (37.64%) | 274 (28.81%) | 951   |

Notes: 1) The 49 respondents who expected the duration to be around 6 months were excluded. The blank means no answers are applied.

2) "Decrease (Increase)" refers to the cases where expected duration of benefits has been shortened (lengthened) after the introduction of regulation.

with high expectations. Roughly 54 percent of these pessimistic consumers—those who expected the rewards programs to end after around one year—lengthened their expectation to one year and a half or longer post-regulation. Consumers whose expectations matched the year-and-a-half duration tended to maintain their expectations, while more optimistic consumers shortened their expectations (see Table 3).

The implementation of government policies regulating the credit card industry has had ramifications for card companies and consumers alike. Once there was a regulation stating that one year was the minimum benchmark for rewards programs, both parties adjusted their expectations and the previous standard—three-year programs—became regarded as too long. The authorities, rather unconsciously set too short of a guideline for the service duration for card issuers.

## 2. Changes in the Card Holder Demographics and the Response of Card Companies

Every consumer has different needs and expectations regarding their credit cards; some seek out specific cards for their payment options, others for their short-term loans. The expectations over the duration of rewards programs also are likely to vary. Regression analysis of the consumer questionnaire (see Table 4) revealed that the expected duration of rewards programs and the awareness of the possibility that additional services may end early vary depending on consumer types. In general, regular credit card users and male consumers tend to expect the rewards programs to last longer, and those who are unmarried, highly educated, or spend large amounts on credit tend to be more aware of the possibility of rewards programs being canceled prematurely.

It is helpful to categorize consumers into two groups: consumers who are attentive to the behavior of the card companies, and those who are not. It is the first group of consumers that card companies keep in mind when determining the duration of rewards programs. If there are more consumers in the first group, also known as "sophisticated consumers," the service duration is likely to be lengthened to meet their expectations. Prior to the introduction of one-year mandatory duration, card companies supported additional services for a substantial amount of time without specific regulation as a means of maintaining the trust of these sophisticated consumers.

<Table 4> Consumer Demographics and Varying Expectations on Rewards Programs

|  | (1) Expected duration | (2) Awareness of the possibility of early termination (aware = 1) |
|--|-----------------------|---|
| Average monthly amount spent on credit cards (KRW million) | 0.11**(0.05)          | 0.11*(0.06)   |
| Sex (Male = 1)   | 0.24**(0.12)          | 0.04(0.13)  |
| Marital status (Married=1)                                 | -0.07(0.16)           | -0.34*(0.18)  |
| Age  | 0.01(0.01)            | -0.003(0.01)  |
| College students or higher                                 | 0.09(0.16)            | 0.63***(0.18)   |
| Graduate students or higher                                | 0.27(0.22)            | 1.02***(0.26)   |
| No. of observations  | 1,000                 | 1,000   |

Notes: 1) Numbers in parentheses are standard errors. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1.  
 2) Ordered logit analysis applied for (1) and logit analysis for (2). Constant terms were included but not reported.  
 3) Duration is divided into five ranges of 6 months, 1 year, 1.5 year, 2 to 3 years, 4 years or more.

<Table 5> Consumer Demographics and Changes in Expectations on the Duration after the Introduction of Regulation

|  | Was the shortened duration expected? (Yes=1) |
|--|--|
| Average monthly amount spent on credit cards (KRW million) | 0.08(0.06)                                   |
| Sex (Male = 1)   | -0.07(0.14)                                  |
| Marital status (Married = 1)                               | -0.16(0.19)                                  |
| Age  | -0.01(0.01)                                  |
| College students or higher                                 | 0.39**(0.20)                                 |
| Graduate students or higher                                | 0.53**(0.27)                                 |
| No. of observations  | 951  |

Notes: 1) Numbers in parentheses are standard errors. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1.  
 2) Logit analysis is applied. Constant term is included but not reported.  
 3) 49 respondents who expected the duration to be around 6 months were excluded.

<Table 4> confirms that unmarried, high-spending, and highly educated consumers—supposedly sophisticated consumers—are more aware that rewards programs may end early. Also, as seen in <Table 5>, most highly educated consumers who were aware of the government regulation anticipated that it would lead card companies to shorten the duration of rewards programs after it passed.

In summation, consumers who are sensitive to the behavior of card companies predicted that the one-year minimum duration regulation would rather accelerate the early termination of rewards programs. Moreover, it is likely that sophisticated consumers, now aware that any reward programs offered would likely not be available for the long term, have responded by taking out fewer cards as a result of the regulation. On a consumer level, the regulation should have affected the composition of card holders who sought out cards with big rewards programs—that is, a much smaller proportion of them would be sophisticated consumers.

What this study proposes is that credit card companies opted to shorten the duration of rewards programs in response to the decline in the fraction of sophisticated consumers. As mentioned earlier, card companies typically support additional services as an investment in a larger consumer base, ideally delivering new customers with a minimal time commitment. Especially to recruit the sophisticated consumers, card issuers need to maintain rewards programs for long. When the number of sophisticated customers declined in response to the regulation, it allowed the card companies to decrease their level of investment by shortening the duration of their rewards programs.

It is likely that “sophisticated consumers” would sign up for fewer new cards than they may have before the regulation. The card companies have responded by reducing the duration of rewards programs.



### III . Evaluation on the Preliminary Announced Legislation (banning changes or suspension of rewards programs)

Currently announced for future legislation, a revision of the Regulation on Supervision of Credit-Specialized Financial Business removes the clause that allows changes to rewards programs on the condition that the card companies did not make any reduction or changes for at least a year since released. As previously discussed, the uncertainties associated with the duration of rewards programs have caused unexpected problems. It is positive that the current revision will eliminate these uncertainties. Above all else, it is considered as an expression of the government's determination to protect consumers, especially given the current policy initiatives surrounding the delivery of accurate information to consumers and the removal of ambiguity in promotional messages.

There is, however, a possibility that this revision might result in negative consequences for consumers. This article mainly addresses the duration of rewards programs, but the amount (or quality) of these additional services is also an important consideration for the card companies in question. Future rewards programs may make it harder for consumers to accumulated the points for card use or reduce the amount of discounts offered. At present, an individual card's rewards plan can be represented as a combination of the amount/quality and duration of rewards programs, and consumers can choose between two combinations: (more benefits, short duration) or (fewer benefits, long duration). Although consumers did not know the exact duration of rewards programs, they would have rationally expected bigger benefits to end sooner. Some consumers would prefer greater rewards while others place more value on greater stability.

Under the current revision, the duration of rewards programs would be fixed at five years, the period for which a credit card is valid. As one of the strategic variables regarding rewards programs is fixed, card companies would only be able to differentiate cards based on the amount or quality of rewards and benefits. Given that the revision would eliminate the option of ending rewards programs early, card companies would be left with no option but to reduce the amount or quality of rewards. Consumers will then be worse off as they are given no choice but to take out credit cards with few benefits. These limited options will have a substantial impact on "cherry pickers," or those who choose credit cards based on their benefits and then are quick to switch cards once the benefits are reduced. Considering the fact that card companies have made complaints about this type of consumers, the revision should be welcome, at least partly, by card companies.

**Under the revision, consumers are left with product characterized by (fewer benefits, long duration) combination.**

**Such a restriction of consumer choice could worsen overall consumer welfare.**

On a broader scale, however, the new measure restricts business activities of companies as well as limiting consumer choice. Typically, corporate management is only regulated to such a degree when its effectiveness can be justified. In addition, though this revision has clear advantages in terms of eliminating uncertainties for consumers and simplifying competitive

structure for businesses, it also has the effect of reducing consumer welfare by limiting consumer choice. The correct measurement of these gains and losses would be required to see which effect overwhelms. Finally, while the business convention of offering five-year contracts still prevails among creditors, card companies may be able to respond to the revision by offering cards with bigger rewards and a shorter validity period (that is, effectively shorter duration of the rewards program). On the consumer side, there is no uncertainty about the expiration date at the time of card issuance. Thus, the authority may remove the uncertainty regarding the duration of rewards program and restore consumer choice at the same time by inducing firms to offer various lengths of validity period under the revision. Then this could be the resolution to welfare-loss.

Unlike Korea, where a five-year validity period is standard for credit cards, the United States offers a range of choices from two to ten years, with two or three years being the most common.<sup>4), 5)</sup> As the U.S. system exemplifies, it is not difficult for a consumer to have credit cards of various terms of validity circulating in the market. Such a system can result in a flooded market, making it difficult for consumers to make informed decisions. Nevertheless, it is suggested to encourage firms to diversify expiration dates as it can greatly enhance consumer choice, so long as the system is accompanied by efforts to improve information delivery.

#### IV. Conclusion

This article analyzed how both consumer choice and credit card rewards programs have changed since the introduction of regulations governing the minimum duration of rewards programs. Persistent uncertainties around the duration of programs made it difficult for consumers to select appropriate credit cards, with some consumers suffering losses due to rewards programs ending too soon.

As a result, financial authorities instituted a regulatory framework banning any reductions or changes to rewards programs for at least a year. The regulation did not, however, address the uncertainties around the duration of the rewards programs properly. Unfortunately, the one-year mandatory duration distorted consumers' expectations and card companies' strategies, further shortening the actual duration of the credit card benefits.

The problem lies not in that card companies terminated rewards programs too soon, but in that consumers had to make decision with uncertain information about the key factor—the duration of rewards programs. A more appropriate policy response would have been to remove the uncertainty. While the one-year mandatory duration did reduce the degree of uncertainties,

**Diversifying validity periods may eliminate uncertainties and restore consumer choice. Should this be encouraged, the flexibility of card companies to choose among various terms of validity could be the resolution to the welfare-loss issue.**

4) U.S. Department of the Treasury, Office of the Comptroller of the Currency, "Comptroller's Handbook: Credit Card Lending," p.21. ([www.occ.gov/publications/publications-by-type/comptrollers-handbook/credit.pdf](http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/credit.pdf), last visited on June 25, 2014)

5) As a matter of fact, the diversity of validity periods in the United States is a result of the credit management of the members, not a marketing strategy. Different terms of validity are assigned to members according to their credit scores, as some require more frequent assessment of their credit than others. Still, marketing remains one of the purposes of differentiating validity terms, as card companies can take advantage of the opportunity to contact consumers during the renewal process.

it did not eliminate them sufficiently.

As the one-year mandatory duration regulation did not achieve the policy goal, the situation continues to unfold and the official policy decision is still in progress. The financial authorities have announced a revision to the regulation to ban any change in rewards programs while a card is valid. The proposed amendment is positive in that it is expected to eliminate uncertainties related to the service duration. At the same time, however, it may stunt the use of a widely embraced marketing tool—the inclusion of additional services on credit cards—potentially forcing card companies to reduce the benefits of future contracts.

Under these circumstances, encouraging card issuers to diversify the expiration dates for cards would appear to be a positive alternative. Instead of the current five-year validity periods, card companies could offer more options such as one-, two-, or ten-year periods, which would provide more leeway to offer a variety of additional benefits. Given that the period of validity is clear at the time of opening a card account, it will minimize uncertainties and help restore consumer choice. ■

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