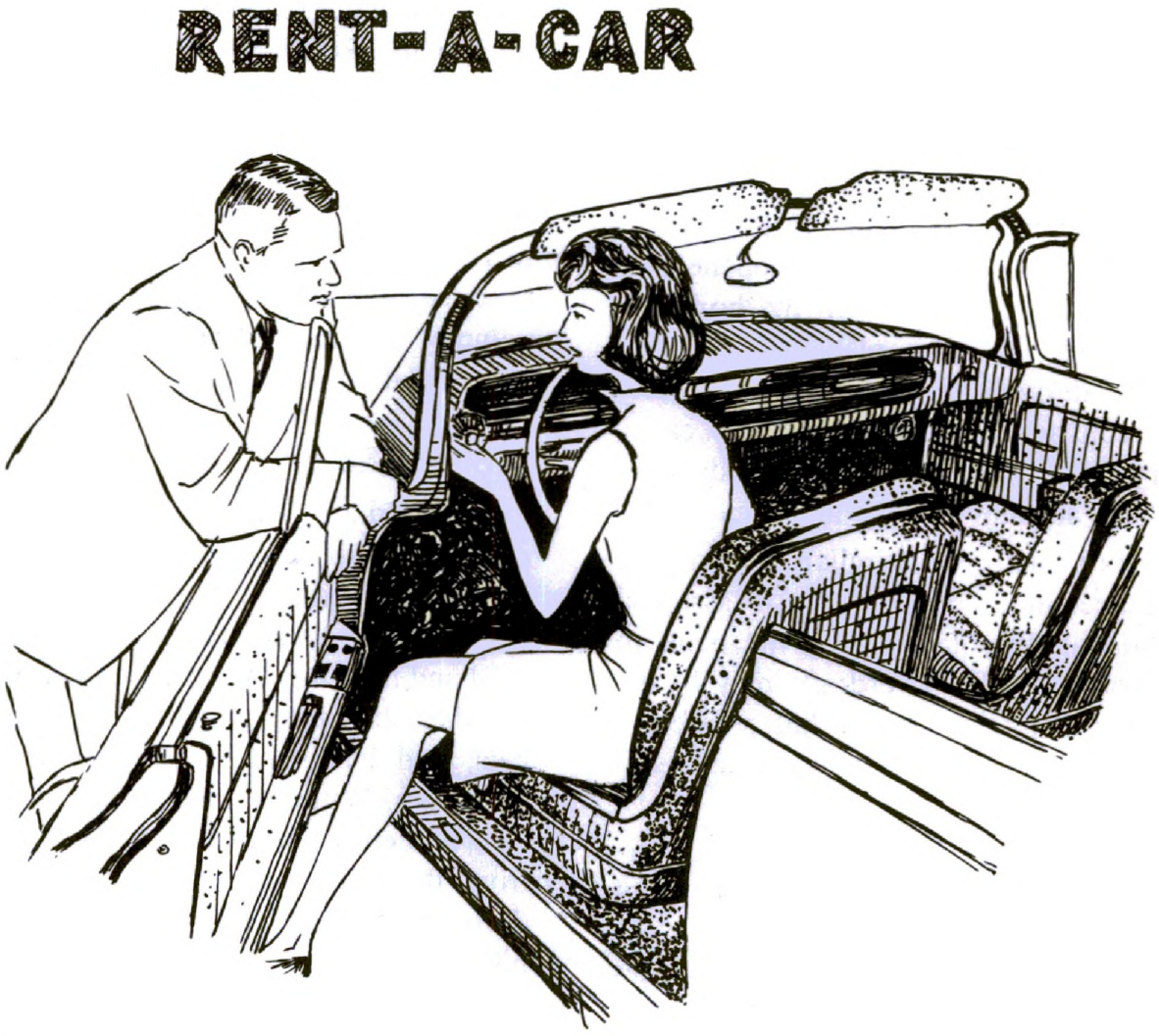
Credit—and Credit Cards



THE bank credit card has now spread across the country, bringing both opportunities and problems to the banking system. As late as two years ago, bank credit-card plans were relatively unimportant except in California; almost everywhere else, they were limited to local merchants and operated by small to medium-sized banks. But last year marked a major turning point for these plans.

In early 1966, some of the nation's largest banks, undoubtedly impressed by the profitability of existing credit-card plans, decided to enter this field, and the largest operator (Bank of America) announced the creation of the first nationwide system through a national licensing scheme. In response to these developments, still more banks decided to issue credit cards. By the end of 1966 new plans were either operating or in the planning stage in the Pacific Northwest, the Chicago area, and many areas of the East; the credit card was now the latest in thing.

Although the bank credit card has basked in the spotlight for several years now, relatively few reliable statistics were available on the subject until quite recently. Even now, the available statistics combine bank credit cards with other plans which, though often regarded as substitutes, are not exactly the same as credit cards. The other types are check-credit plans and nonbank credit-card

plans—which include the so-called travel and entertainment (T&E) cards such as American Express, Diners Club and Carte Blanche.

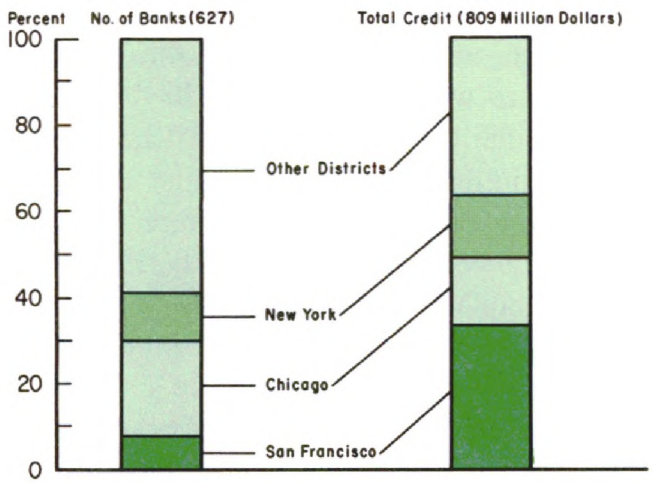
Type I: check credit

Check-credit is a method whereby a bank automatically makes consumer loans on a pre-arranged revolving credit. The customer applies for a line of credit and, if the application is accepted, an account is opened on borrowed funds against which the borrower writes checks. In some plans, checks with distinctive designs are provided to identify check-credit accounts, while in other cases, ordinary checks with no special identification beyond the account number are employed.

Overdraft plans are similar in that the existing account of a customer is assigned an additional line of credit by the bank to cover overdrafts. The overdrafts may be accidental or deliberate; in the latter case the line of credit plays the same role as a check-credit account.

For both the check-credit and the overdraft plan, the check remains the instrument for making purchases, and so the adoption of either variation involves minimum changes in existing banking procedures. Both types of plan compete with credit cards because of their provision of revolving credit, but they avoid the heavy administrative costs and the credit-control problems of a credit-card plan. Furthermore, customer-pleasing features such as check-guarantees can easily be added through the use of identification cards or special checks designed like travellers checks. Nevertheless, in comparison to the bank credit card, these plans do not produce significantly large increases in credit volume. The reason, as will be seen, lies in the special characteristics of the credit card.

District holds one-third of credit outstanding in all bank-credit plans



Type II: T&E card

Intermediate between the check-credit plan and the bank credit-card plan is another revolving-credit plan, the T&E card. Because of some obvious similarities, the bank credit card and the T&E card are frequently lumped together, but they appeal to different markets, and banks play different roles under each plan. With the bank credit card, banks run the entire operation, extending credit from the day a merchant deposits a sales draft to the time the cardholder pays his bill. With the T&E card, a bank becomes involved only if the cardholder, after signing the appropriate bank agreement, decides to let his bill go on a revolving-credit basis or to use his card to borrow from the bank.

The principal advantage of the T&E card is that it allows the bank a credit-card service to its customers with a minimum of direct expense; the bank only has to set up an organization to administer revolving credit. But at the same time, the bank will not obtain as large a volume of operations from this plan as it would from its own plan. First of all, T&E cardholders generally have superior credit ratings and therefore are less likely to resort to revolving-credit to pay their bills — and when they do so, they tend to be in debt for only short periods of time.

T&E cards thus are basically a conveni-

Everything Card

"Dear Customer: We're sending you Everything, and it costs you nothing." So read the blurb which a major New York bank used in a recent mailing of a million "Everything Cards" to a half million of its select customers. Some 21,000 retail establishments in the New York metropolitan area, mostly clothing and other soft-goods stores, are enrolled under the plan. . . . The first day's response to the new plan literally blew a fuse at the bank's specially installed switchboard, despite the use of 77 special phone lines for clearing credit purchases above floor limit and for handling "instant" loans at bank branches.

ence service for people who want to avoid carrying cash but who do not need credit on a regulary scheduled basis. Furthermore, T&E cardholders need not even sign up with a bank to obtain revolving credit, since they can repay major transportation expenses on a time-payment basis with the card company. This is the only exception to the requirement that accounts are due when billed, but it is an important one, since these big-ticket items are the ones most likely to be deferred and most likely to have otherwise required bank financing.

Type III: bank credit card

The prime advantage of the bank credit card is its simplicity: banks can even use it to attract loan demand without first establishing a regular banking relationship in the traditional sense with the customer. Cardholders do not have to be depositors of the bank which issues the card. Thus, in effect, the card-issuing bank is able to make consumer-type loans to other banks' customers as well as its own.

One alternative, check-credit, is at a disadvantage because most people, when planning on major purchases, will obtain revolving credit through a retail store rather than through a bank. In contrast, the bank credit card fits easily into habits already established by department-store and oil-company cards. In the public's mind, this is just another plastic credit card, but one with a greater acceptance at a number of different businesses. And in further contrast to check-credit and overdraft plans, there is no need to minimize the number of transactions in order to avoid service charges on the checking account.

Another alternative, the T&E card, also has important shortcomings. The excellent credit rating of T&E cardholders means that they are least likely to resort to revolving credit, the stage where the bank finally makes a loan under this plan. In contrast, bank credit cards rely upon a mass market—they are designed for local expenditures on a wide range of items and are issued to people with average incomes.

Of course there is some overlapping of markets, in regard to both the cardholders who use these cards and the purchases they make. Yet the fact remains that the bank relies upon a high volume of revolving credit for its credit-card revenues. There is no membership fee for the cardholder and merchant discounts tend to be low. Therefore, the interest from revolving credit must be the main source of income, and the bank's goal must be to stimulate the regular use of cards by a large number of people for a wide range of purchases. A high volume of card transactions is required to support the credit balances needed to produce sufficient interest income.

A fully-operational credit-card organization has other advantages too. As it is geared to handle a mass of small transactions with a minimum of decision-making, this organization can easily take over from the bank-office level those functions whose processing costs are high relative to their return. A prime example would be small personal loans; in some banks, all personal loans below a certain size are processed as credit-card cash advances, and overdraft facilities for depositors can be treated in a similar fashion. There are also the benefits arising from the usual requirement that merchants accepting cards open an account with the bank operating the plan. In practice this requirement is a further source of new customers; since many merchants dislike having several accounts, non-card banks tend to lose accounts to the card-issuing bank.

The major disadvantages of a full credit-card plan are simply the reverse of its advantages. Mass issuance of cards and high volume of transactions create both heavy start-up costs and high credit risks. The latter can be a particularly difficult problem, since the mass distribution of cards, which is at the heart of the plan's ultimate profitability, prevents application of unduly restrictive credit standards. Lack of a regular banking relationship with all cardholders also increases risk. The pressures to recover initial expenses and to reach a profitable level of operations too quickly may force a bank to be overly generous in its initial issue of cards and may thereby expose it to even higher credit losses.

The first few years are the key ones: this high-cost period determines whether a bank abandons its credit-card plan, as some major banks have done in the past, or whether it finally achieves a profitable position. In a well-run plan, the profits can be substantial —but so too are the costs of reaching that position.

The statistics

Statistics on the credit-card phenomenon are rather scanty, but some data are available from the April 27 Call Report of the three Federal bank-regulatory agencies. As of that date, $809 million in credit was outstanding at the 627 banks which offered some kind of plan.

Unfortunately, no exact breakdown is possible between bank credit-card plans and T&E cards and check-credit plans, although it is estimated that about 60 percent of the total is in bank credit-card systems and the remainder in other plans. Moreover, there are probably more than 627 banks involved with credit cards, since in many areas (Illinois, for example) correspondent banks offer cards and service merchants but do not carry any credit balances. In the Call Report, also, some banks probably over-stated their lending, while others did not report at all, because of some confusion as to what kind of loans should be classified as credit-card and check-credit loans. Despite these qualifications, however, the returns do permit some useful generalizations to be made on the subject.

At the moment, credit cards and check credit appear to be a big bank's game. Of the 40 largest banks — those with deposits of $1 billion or more — all but five offer some kind of credit-card or check-credit plan, and in the $500 million-$1 billion deposit-size category, over two-thirds of the banks have a plan. Thereafter, percentage participation falls off rapidly with size. For banks with less than $5 million in deposits, fewer than .5 percent offer a credit plan. Yet 48 percent of the banks with credit outstanding under these plans had less than $50 million in deposits.

Credit cards and other credit plans are concentrated in a few geographic areas, principally the Pacific Coast, the Midwest and the North East. The Twelfth District leads,

having twice the credit outstanding of any other district — or about one-third of the national total — and it is followed by the Chicago and the New York Federal Reserve Districts. On a state basis, the leaders are California, New York, Pennsylvania, Illinois and Massachusetts, in that order. In terms of numbers, the Chicago District is first because of the local predominance of unit banks.

In the field of bank credit cards alone, the San Francisco District's role is even more striking — bank credit cards account for perhaps 80 percent of the District's credit-plan outstandings, as against roughly 50 percent elsewhere. Indeed, with the single exception of Alaska, the credit card is a regular feature of the District banking scene.

California leads the way in bank credit cards, followed by Illinois (Chicago), Pennsylvania (Philadelphia and Pittsburgh), and New York. As of the April Call Report, New York City did not have any major bank credit card in operation; that area's large total in outstanding credit was due largely to T&E cards and check-credit. However, one major New York City bank has since started a credit-card operation, and still others might follow.

Effects on banking practice

The key to a successful credit card program lies in the control of credit—for example, supervising the distribution of cards with their associated lines of credit, and supervising their subsequent use to prevent excessive indebtedness and, most important, fraud. Generally the task of credit control is greatest during the first years, but it then becomes more manageable as the bad cards are gradually eliminated. Credit supervision is ultimately a technical problem but by no means a minor one.

Another aspect of credit control concerns the policy of each bank regarding the amount of credit it commits relative to its total resources. The total commitment can be substantial, since cash advances are a regular feature of most plans. Additionally, since these lines are unsecured and automatic, the bank may expose itself to unpredictable surges in credit demand which it must meet by adjusting its asset protfolio. The bank cannot reduce credit lines that have been widely advertised without destroying much of its earlier selling efforts aimed at creating a credit-card habit. The mass distribution of cards makes it administratively difficult to cut back on credit lines; thus the success

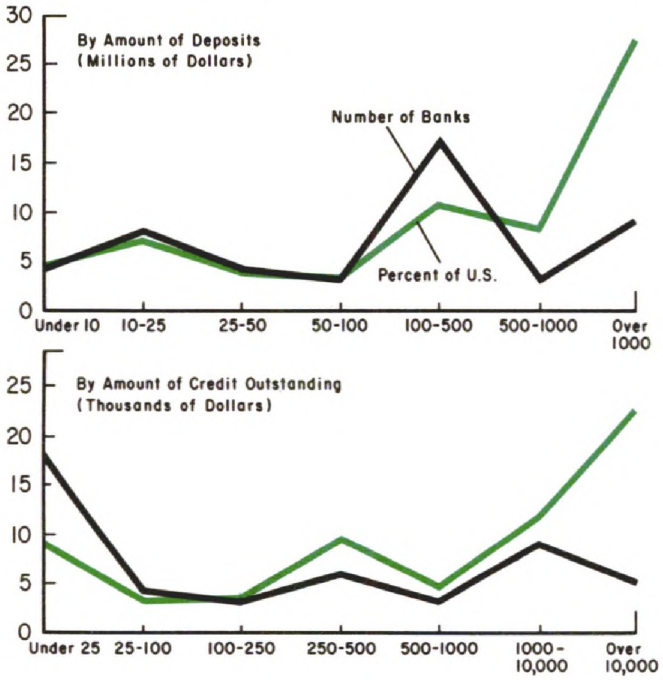
BANK CREDIT CARDS AND CHECK-CREDIT

Total Credit Outstanding as of April 25, 1967
(Amounts in millions of dollars)

	National banks		State member banks		State non-member banks		All banks	
Federal Reserve District	No. of banks	Total credit	No. of banks	Total credit	No. of banks	Total credit	No. of banks	Total credit
1. Boston	28	44	11	13	8	2	47	59
2. New York	34	61	25	46	11	9	70	116
3. Philadelphia	23	20	7	40	9	6	39	66
4. Cleveland	27	54	1	*	8	1	36	55
5. Richmond	16	18	5	12	7	2	28	31
6. Atlanta	51	40	7	3	23	5	81	48
7. Chicago	78	95	12	18	48	9	138	122
8. St. Louis	22	10	6	2	17	2	45	13
9. Minneapolis	15	4	1	*	6	*	22	4
10. Kansas City	29	10	6	1	5	*	40	12
11. Dallas	19	3	3	2	11	5	33	10
12. San Francisco	30	248	6	13	12	11	48	272
Total	372	607	90	150	165	52	627	809

*Less than $50,000.
Source: Federal Reserve Board of Governors.

West dominates large-bank activity in credit-plan accounts



of a credit-card plan may require a bank to make fundamental policy changes in its credit priorities.

There is also the administrative problem of handling the mass of paper created by the credit card. It may well be that the credit card reduces reliance on checks and thereby reduces the burden of handling checks. Indeed, the credit card is quite likely to reduce the number of checks written, since one check per month can pay for a number of transactions that normally require payment by separate checks. But one problem is now replaced by another; the bank now must process an even larger volume of paper, including both the sales drafts that would normally be paid by check and those that replace former cash purchases.

The immediate effect of the credit card is an increase in internal clearing problems. Ultimately, some have argued, it is a step toward the "checkless society." This is true only in the sense that the system puts pressure on the banks to develop a technology capable of handling transactions more quickly and cheaply. The techniques which can process sales-drafts can also do the same thing for checks. Thus the credit card—although it may be an indirect step toward a more sophisticated payments transfer mechanism—in the meantime tends to increase the banks' burdens.

Effects on banking structure

As the statistics indicate, the credit card is typically a service offered by medium-or large-size banks. The high start-up costs put a premium on financial strength, and the recent trend to regional and national coverage points even more to the advantages of size. Consequently, there is concern that the credit card will weaken the competitive position of the smaller banks.

But this pessimism may be unwarranted, since the major banks are now adapting their plans to allow varying degrees of participation by smaller banks. A prime example is the California Bankcard Association, whereby 73 banks of varying sizes have formed a joint program. Under this program, a central organization owned by the banks and set up as a non-profit organization takes care of certain tasks created by the use of a common card. The individual banks can share fully in all plans of the credit-card program, regardless of size. In fact, approximately one-third of the membership consists of banks with deposits of $10 million or less.

In an alternative development, the Bank of America under its licensing program has permitted correspondent banks of its licensees to issue BankAmericards under their own name or some common name, and to extend credit if they wish. This arrangement is being used in Colorado and Ohio. Another variation is the agency-bank arrangement, whereby a bank avoids the risk of a full credit-card operation by participating on a limited basis, accepting sales-drafts deposited

by merchants and processing card applications of its customers. The agency arrangement, besides being widespread on the Pacific coast, is dominant in the Chicago area, where unit banking makes it essential to achieve adequate coverage.

These new variants of the normal pattern of "one-bank-one-card" help encourage smaller banks who are trying to enter the credit-card field. As there is no inherent barrier to the entry of smaller banks, it is still too early to tell whether the credit card will ultimately shift the competitive advantage more towards larger banks.

Quite apart from inter-bank competition, the bank credit card may also affect the position of banks relative to other financial institutions. Bank credit cards are already involved in business accounts-receivable financing and in some consumer-credit activities previously financed by non-bank institutions. However, banks are limited in their ability to take over larger-sized contracts by their relatively low credit limits (often only $300) and by credit requirements which are stricter than those of many consumer-finance companies. Nonetheless, the basic administrative machinery of a credit-card plan can, in principle, be adapted to larger credit contracts, and thereby can support the expansion of the banks' competitive position in the lending field.

But this relative improvement should not be exaggerated. Bank credit cards now account for about one-sixth of all credit extended by credit cards, but this still leaves five-sixths in other hands. Moreover, they amount to less than 1 percent of all non-auto consumer credit ($62 billion outstanding in April). Therefore, bank credit cards have far to go before they can become a dominant factor in consumer credit, let alone in bank lending.

Future Effects?

Bank credit cards, to conclude, have attracted well-deserved attention since they are an important innovation in banking services. For the individual bank, the credit card presents a difficult management choice of whether or not to enter this field. If the bank does decide to enter, then there are critical operational problems created by the issuance and control of cards. And while these problems can be costly and difficult to resolve, the trend is toward greater bank participation in this or similar credit programs. After all, cards can be very profitable, and besides they may be necessary as a defensive reaction to a competitor's program.

In the overall banking system, credit cards currently absorb only a small part of total bank resources, and they are not yet an essential banking service. Partly for this reason, the most important policy tasks of the regulatory agencies at this time are likely to be in supervision — to insure that there are proper credit standards — and in market structure — to preserve the ability of small banks to compete in this area — rather than in the area of monetary control. All in all, the bank credit card may create difficulties for individual banks, but its recent growth testifies to its ability to provide a useful and popular banking service.

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