For Release on Delivery
Thursday, November 7, 1968
12 Noon, C.S.T. (1:00 p.m. E.S.T.)

PUBLIC CONVENIENCE AND THE EXPANSION OF BANK CREDIT CARDS

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Before the

American Bankers Association's
Convention on Charge and Guarantee Cards

Palmer House Hotel
Chicago, Illinois

November 7, 1968

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EXPANSION OF BANK CREDIT CARDS

By
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The rapid and widespread acceptance of bank credit cards by consumers should have erased all doubt about the extent to which this innovation in bank financing serves the needs and conveniences of the public. Nevertheless, some features of credit card banking still induce questions among a number of observers. In particular, several aspects of credit cards have attracted Congressional concern -- which in turn undoubtedly reflects the reactions of some segments of the public to bank credit cards. Almost two years ago, some of us in the Federal Reserve System anticipated many of the issues that are currently being raised with respect to this mode of bank financing of consumers and merchants. Reflecting this concern, in March, 1967, the Federal Reserve Board established a System-wide group to explore the implications of the growth of bank credit cards and check credit plans for consumers, the banking system, bank supervision, and the management of monetary policy. After 16 months of work, the Task Group's report was completed and released last summer.[1/] Throughout the period of the project, I maintained liaison between the System Task Group and Members of the Board.

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*Member, Board of Governors of the Federal Reserve System. I am grateful for the assistance of several members of the System's Task Group on Bank Credit Cards and Check Credit Plans. I am particularly indebted to Mr. Robert A. Johnston of the Federal Reserve Bank of San Francisco for assistance in the preparation of the present remarks.

1/Bank Credit Cards and Check Credit Plans: A Federal Reserve System Report, July, 1968, 102 pages.

In general, the Federal Reserve Board shares the conclusions reached in that study: credit cards and check credit are both legitimate and useful services of banks and that at present there is no need for restrictive legislation to circumscribe the orderly development of this innovation. Moreover, it was further concluded that the System already has sufficient supervisory power to prevent the appearance of unsafe or unsound practices. However, the Board did suggest to the Congress in early October that legislation may be desirable to limit consumers' liability for lost or stolen credit cards. At the same time, the Board also stated that it does not see a need for legislation to limit any other aspects of bank credit cards. Nevertheless, a number of bank practices in issuing credit cards to customers were the subject of recent Congressional inquiries, and this is an appropriate time to discuss them. The principal ones involve:

- The inconvenience and potential liability to customers involved in unsolicited mailing.
- The potential liability imposed on the cardholder by the misuse of lost or stolen cards after acceptance.
- The awareness of the customer with regard to his credit limit under credit-card plans.
- The overall impact on consumers.
- The effect on small banks.

As one can see, these are problems primarily of credit cards rather than of check credit. In particular, the mass-mailing is a distinct feature of credit cards, and liability for lost or stolen cards is also primarily a problem of credit cards. Although plastic identification cards are commonly used in check-credit plans, such a card is of no value without the appropriate check forms; therefore for check credit, the stolen card as such does not present major difficulties. Only in their role of providing pre-arranged lines of revolving credit do check credit and credit cards share similar potential problems.

Before exploring these issues further, however, a brief review of recent trends in bank credit card and check credit plans may help provide a better perspective.

Recent Trends

The first complete statistics on credit cards and check credit were gathered as of September 30 last year, and the most recent are those obtained from the June 30, 1968, Call Report (see Table, attached).

In that nine-month period, the number of commercial banks with credit-card programs more than doubled, increasing from 197 at the end of September to 416 on June 30. This is the number of banks with credit balances outstanding on credit-card programs. It does not include the several hundred agency banks which do not hold receivables. On the other hand, since some of the banks carrying balances are participating on a limited basis, the number of banks actually operating a complete plan is somewhat smaller. The number of banks operating check-credit plans rose from 599 to 844 in the same period.

Credit outstanding under bank credit-card and check-credit plans totalled $1,599 million on June 30, 1968, or 43 per cent above the $1,116 million of September 30, 1967. The credit-card component grew faster. It increased by 50 per cent, from $633 million to $953 million, while check credit was up about one-third, from $483 million to $646 million.

These national trends confirm the continued expansion of credit-card and check-credit plans. They also confirm that these plans are providing valuable new service to customers. There is a definite place in the financial system for these bank-operated charge and revolving credit plans. It is quite clear that well-run credit-card and check-credit plans are regular parts of modern banking services. Their status is no longer in doubt.

Regional data classified by Federal Reserve Districts are also shown in the attached Table. These give a picture of the geographic spread of credit cards and check credit. The San Francisco District continues to be the principal center of credit-card banking, with $435 million, or 46 per cent of the total outstanding as of last June 30. The Chicago District followed in second place with $153 million in outstandings. The next three in order were the banks in the New York, Atlanta and Richmond Districts with $120 million, $49 million and $47 million, respectively. There was much less concentration in check credit. While San Francisco was also first with just over $142 million, the New York District was very close behind with a total just below $142 million. Then followed Philadelphia with $83 million, Boston with $64 million, and Chicago with $62 million. In the four North-East Districts, check-credit is still the more popular plan with banks, but elsewhere credit-card plans tend to be the more important. However, since major new regional credit-card plans have been announced recently, the relative positions of the two types of plans may change within the near future, and in any case continued growth can be expected.

It may be recalled that we also have a statistical series which allows us to trace developments in this field on a monthly basis. Since January this year, the Federal Reserve System has been gathering data on the volume and amounts outstanding under these plans as part of its consumer credit reporting. The credit-card and check-credit figures were first published in August and cover approximately 95 per cent of the national total. These figures indicated that by the end of September, bank credit card receivables amounted to $1,021 million, and check credit outstanding totaled $663 million. As soon as we have had sufficient experience with this monthly series, it will be adjusted to allow for the existing element of understatement. This series will then provide a useful current picture which bridges the six-month interval between Call Report data.

We can now turn to an appraisal of the questions with respect to the impact and implications of bank credit cards for consumers outlined above.

Mass-Mailing of Unsolicited Credit Cards

Banks have found that the most effective way of reaching customers at the initiation of a new credit-card plan is to mail a large number of unsolicited cards. This method solves simultaneously the problem of having enough stores signed to the bank's plan to make the card useful to consumers and of having sufficient people using the card to make forming the plan attractive to merchants. Reliance on the alternative method of depending upon application returns entails considerable delays in reaching a profitable volume of business, delays which may be unacceptable when trying to compete with other banks' plans.

There are risks involved in the mailing of a large number of credit cards. However, banks can and do institute safeguards. It is not necessary to review the practices banks have followed to reduce their exposure to losses, but the techniques are now well known -- thanks in part to the mistakes of others. To a large degree, the path before new entrants is now smoother, although not without obstacles. Finally, once credit card plans have been established in most areas of the country, the problem of the unsolicited mass-mailing will be diminished considerably. The mass-mailing is a feature of new plans, not established plans.

After the completion of the System's report on "Bank Credit-Card and Check-Credit Plans," the Board of Governors of the Federal Reserve System considered the appropriateness of unsolicited mass-mailing and concluded that banks should, as a matter of business judgment, be permitted to use the mass-mailing technique to start their plans. The principal effect of prohibiting this practice might be to erect barriers in the way of new entries in the field. But the Board also recognized that some care had to be taken to reduce inconvenience for customers and to protect the banks themselves. It instructed its examiners to check "to make sure that banks realize the importance of developing mailing lists from their own records and carefully screening before use." The screening should be designed not only to check credit-worthiness of customers but also to minimize the number of duplicate cards.

Although the actual number of customer complaints seems to be relatively low, the fact remains that some customers do not like unsolicited cards, and banks should take steps to reduce the amount of annoyance. The

Board has recommended as a general practice the use of "pre-mailers." These pre-mailers give the customer the opportunity to have his name removed from the mailing list. The pre-mailer also helps banks in alerting the customer to look for a card, and may enable the bank to correct mailing addresses.

Liability of Fraud Losses

Customer liability for fraud losses was the major topic discussed in the Congressional hearings last month, at which I testified on behalf of the Board. To some extent, this is a problem of the mass-mailing, but it is not limited to that since cards can be and sometimes are fraudulently used after the customer accepts the card. While in practice most banks do follow a very lenient policy in these cases, I think that the banks need to do a better job of informing cardholders of their policy about these losses. There is too much uncertainty and this is reflected, quite properly, in Congressional concern.

With regard to the first type of fraud -- the unauthorized use of cards stolen before they are received or accepted by the proper person -- we know that most banks do not attempt to collect from the intended recipient. If there are banks which do, at least the Board is not aware of them. Moreover, it seems evident that they would have legal difficulties. In addition, the trend is for states to pass laws specifically exempting from liability the customer who has not accepted or begun to use an unsolicited card. Illinois, Massachusetts, New York and Wisconsin have passed such laws, and other states are considering similar legislation.

In the case of cards stolen or lost after being accepted by the cardholder, the situation is less clear. Most banks require their customers to inform them when the card is lost or stolen, whereupon the banks accept liability for any fraud losses. As for the liability of the cardholder prior to informing the bank, there is much more variation in banks' policies. Some banks seek to collect in these cases from the customer for all losses occurring before the bank is notified. Others do not attempt to collect, even where the customer does not report the loss or theft of the card. Still other banks (and the statutes of Illinois and Massachusetts) specify an upper limit on the dollar liability of the customer.

The majority of the banks that the System has contacted follows the practice of absorbing losses, but do not reveal that policy to their customers for fear they would be unduly careless in their handling of the card. This is often true even where the bank informs the customer that his liability is limited to $50 or $100. These announced limits are primarily designed to make the customer take care in the handling of the card and to stimulate prompt reporting of lost or stolen cards. Thus, actual policy is often much more lenient than announced policy. In contrast, a minority of banks notify the customer of his contractual liability for losses between the time the card is lost and the bank is informed and try to collect in these cases. But a New York court recently relieved the customer of liability where the card was misused before he knew of its theft and, therefore, was unable to inform the card issuer of that fact.

The most common practice appears to be that of being somewhat ambiguous. Even where limits are specified either by the bank or by state law, the banks generally do not attempt to recover on fraud losses. Ambiguity may encourage greater care on the part of customers while avoiding the public relations complications of trying to collect. It leaves open the option of trying to collect when a customer has been unusually negligent.

Although ambiguity does have its advantages, I would still recommend that banks inform their customers of their potential liability. It is possible to do this clearly in the literature accompanying the card. I have seen recently that a number of banks have developed statements which achieve this objective in a simple, straightforward manner. I realize that a bank may not want to undertake massive advertising campaigns on the question of fraud liability, since such campaigns might unnecessarily attract even more attention to the opportunities for fraud in a new field which -- unhappily -- has already been discovered. Nevertheless, at a minimum, announcements mailed by banks should reassure customers that they are not responsible for cards stolen before they are received. Such announcements should specify what a customer's maximum liability is after acceptance of the card. Of course, whether a bank actually attempts to collect infrequently, if at all, is a decision for management. But uncertainty on the part of the customer as to the potential liability while not as susceptible to advance determination, is in rather the same category as uncertainty about true interest rates. In any event, failure to disclose the terms of liability are no longer tolerable standards of business conduct for card issuers.

The question of legislation has arisen on this question, and it may be helpful to restate the comments I made on behalf of the Board before the Subcommittee on Financial Institutions of the Senate Committee on Banking and Currency. The Board felt as a matter of principle (1) that the entire burden of loss arising from cards stolen before being received by the customer should rest entirely on the issuer and (2) after acceptance, the customer could become liable for losses before the bank is informed but the liability on the customer should be small. The issuer is in a much better position to bear losses and control them. In any event, the customer should be clearly informed of his liability.

The Board also felt that some legislation may be required. To be effective and equitable, such legislation should apply to other credit cards, including travel and entertainment cards, gasoline company cards and so on, as well as to bank credit cards. The legislation might be at either the State or Federal level. It is not self-evident that a Federal law is needed -- although it may be. In states such as Illinois which have laws on this subject, the legislation has apparently had no adverse effects on the banks' operations while helping clarify the position of the cardholder. In recognizing the desirability of legislation with respect to cardholder liability, the Board still feels that there is no need for legislation regulating other aspects of bank credit-card and check-credit plans. Present authority is sufficient to insure that sound banking practices are followed.

Credit Limits

On the question of notification of cardholders of their credit limits, there seems to be no problem. As far as we know, most banks do tell cardholders what their limit is; this is not the case for most non-bank cards, by the way. In addition, the Board has revised its examination procedures to determine whether a bank informs its customers of their limits. Since the change was instituted in mid-August, 36 state members with plans have been examined, and all followed the practice of telling their customers what their limit is.

Over-All Impact on Consumers

Questions also were asked as to how credit-card and check-credit plans affect consumers, particularly as to the impact of the costs of such plans and whether they have an inherent tendency toward encouraging excessive indebtedness. With respect to the question of whether credit cards increase the cost of goods to consumers, it is not possible to give a definite numerical answer, but the probable impact can be indicated. Given the present minor size of credit-card plans compared with all kinds of consumer credit (they represent about one per cent of all consumer credit), it does not seem that the expansion of credit-card plans has a noticeable, direct effect on general prices. Furthermore, it is not certain that credit cards even tend to raise prices. While the retailer is faced with an extra cost in the form of the merchant discount each time a credit-card purchase is made, it does not follow that there is a net increase in costs or that the purchase would have been made without a card. To the extent credit cards replace high-cost merchant-operated credit plans, they reduce costs; and to the extent they attract customers who wish to buy on credit, they generate increased sales which may offset any increases in costs. Thus, although the evidence is admittedly not conclusive, it does suggest that credit cards have not had -- and at present magnitudes are not likely to have -- any noticeable impact on general price levels.

There is also the question of whether individual consumers might get deeply into debt because of easy credit extended through these plans.

Again it is difficult to point to a quantitative conclusion. The average line of credit extended under credit-card plans is in the neighborhood of $350. This is not so high as to be a cause in itself of a customer incurring excessive indebtedness. In addition, the credit standards aim at middle-income consumers who by and large can afford to contract debt within the applicable limits. The same considerations apply even more strongly to check-credit plans. Here the average line of credit is $1,000, but the credit standards are even more stringent.

Furthermore, the general trends in the use of consumer credit do not indicate the existence of a serious problem. Although the level of consumer credit has been rising recently, much of this has been a reflection of the overall expansion of the economy, and only a fraction can be attributed to credit-card and check-credit plans. For example, the increase in credit-card and check-credit outstandings between September 30, 1967 and June 30, 1968, was $483 million. In the same period, total consumer credit jumped by $5,581 million -- of which the instalment component was up $4,324 million. Therefore, the credit-card and check-credit plans made up less than 12 per cent of the increase in instalment credit extended to consumers during the nine-month period. Credit-card plans and check-credit plans are not yet either a dominant force in consumer credit or a direct problem for general monetary control.

Impact on Small Banks

Finally there remains the question of whether small banks and their customers will be adversely affected by the spread of credit-card plans. To answer this, I would rephrase the answer I gave about the general impact on consumer credit. At the current level of credit-card outstandings, there is no reason to suppose that a complete credit-card plan is an essential service for a bank. It may be a desirable service, but it remains a relatively minor part of banking. Banks can specialize in other areas or they can substitute other services. The number of banks offering check-credit and overdraft plans indicates the viability of this alternative. Should a small bank not be prepared to offer its own credit-card plan, there is in most areas the alternative of being an agent of another bank. Then it is still able to service its merchants' accounts, and it is usually able to recommend cards for its customers. Moreover, many banks do not regard agent status as an inferior alternative; it has the advantages of minimizing cost and risks while still offering a credit-card service. Moreover, the spread of franchise plans and the development of the joint credit-card association as a form of organization make it easier for smaller banks to offer a credit-card service. And as our credit-card Report showed, many small banks have offered their own plans for some time. Therefore, I see no reason to modify the conclusion reached in the credit-card Report that the small banks as a group will not be adversely affected by the spread of credit-card plans, or for that matter, check-credit plans.

Some questions were also asked about how customers of small banks would fare if their present banks had not offered cards. The answer is quite clear. If no other bank in the area offers cards either, there is no change from the present. If another bank does operate a plan, customers can still apply for cards with that bank and, if a merchant, open an account in order to accept the others bank's cards. They do not have to give up their current banking connections to use the credit-card service.

Concluding Remarks

From the foregoing comments, it should be obvious that I believe bank credit cards are providing a service that bank customers find useful. I see no inconsistency between the widening use of this form of consumer credit and the requirements of sound banking practices.

Most of the recent questions brought up in Congress concerned the periphery of credit-card plans. They did not dispute the basic merits and operations of the plans. Like any new development, credit-cards, and to a lesser extent, check-credit, bring problems. Many of these, mass-mailing, for example, diminish with time. Others, such as the question of liability for fraudulent use of cards, will be a continuing though hopefully also a diminishing problem. As I indicated in my testimony to Congress, the banks are taking steps on their own to reduce these problems and doing it in most cases without additional regulatory measures, the pressures of the market being sufficient in most cases. Except in that one area of fraud liability, where some specific legislation may be desirable as to all credit cards -- bank and non-bank, alike -- it seems clear that banks do not need additional legislative regulation. Banking in the past has been accused of being unwilling to change. Therefore, when banks do develop an imaginative new serice, they should be encouraged so long as such innovation is consistent with the furtherance of the public's welfare. The degree of consumer and merchant acceptance of credit cards and check-credit plans shows that banks are meeting the need for a new financial service, and financial services are the job of banks.

Bank Credit Card and Check-Credit Plans
(Amounts in millions of dollars)

Federal Reserve District	Credit Card Plans				Check-Credit Plans			
	September 30, 1967		June 30, 1968		September 30, 1967		June 30, 1968	
	Number offering plan	Amount out-standing	Number offering plan	Amount out-standing	Number offering plan	Amount out-standing	Number offering plan	Amount out-standing
Boston	14	21.8	20	36.9	57	57.3	73	63.8
New York	16	64.8	27	120.4	69	98.0	81	141.8
Philadelphia	6	12.3	12	14.0	37	60.6	50	82.6
Cleveland	6	26.9	26	36.1	32	32.0	58	44.0
Richmond	5	28.2	15	47.4	30	17.2	51	27.4
Atlanta	20	30.6	39	48.9	69	22.2	92	35.0
Chicago	35	126.2	92	153.0	111	53.4	160	62.4
St. Louis	10	12.3	39	26.2	41	11.5	56	15.9
Minneapolis	5	.1	24	1.4	39	5.6	61	9.1
Kansas City	6	6.4	15	12.3	41	9.4	72	15.6
Dallas	7	8.1	21	21.0	28	4.5	36	5.9
San Francisco	67	295.3	86	435.3	45	111.5	54	142.2
All districts	197	633.0	416	952.9	599	483.2	844	645.7