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THE BANK CARD AND THE PAYMENTS MECHANISM

Remarks of George W. Mitchell

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Two powerful forces in our economy--technology and competition--are changing the mechanics of money transfers and the management of money positions in ways that are at least as revolutionary as the introduction of the checking account over a century ago. The process of change is evident at the Federal Reserve, in the commercial banking system, and is now beginning to be apprehended by other financial institutions, businesses and consumers.

In the past, money instruments, habits and practices have changed rather slowly both because the banking environment, the milieu of money, was sheltered from the necessity for change and because a better technology for more expeditious handling of the growing volume of transactions was not economically available. But in recent years, as the computer and improved wire transmission capabilities have created opportunities for change, competitive banking attitudes have activated that opportunity.

This fermenting mix of opportunity and incentive in our banking system has set in motion far-reaching changes; it brings us here today to discuss the role of the credit card in the revolution of the money system. This revolution has, incidentally, given all of us in the payments business a common bond of frustration and anguish for our inability to master the computer and its appurtenances, of humility for failure to achieve our own expectations--even promises--of a better mousetrap and, at times, of discouragement sufficient to wonder whether change is worth the trouble it entails. However great our disappointments have been, I doubt that anyone came here today to throw in the sponge, backtrack, or let someone else do the job. Innovation in banking hasn't come easily but this meeting is evidence it is taking hold and its title attests to the fact that the results are already with us.

In merchandising a change, innovators should not expect to realize their goals by breaking a "tape" with a final burst of energy. But to mix the metaphors a bit, in innovation of this kind there comes a certain stage where it's "downhill all the way." Many phases in the evolution of the payments mechanism are in that stage--it is "downhill all the way" because as techniques of doing things better have been shown to be operational more and more people have gotten interested in exploiting the new technology.

Conventional concepts of money and money instruments are not well suited to explaining the nature of the technological thrust which is altering our transaction money habits. Basically most people still think of money as coin and currency, as treasure to keep under a mattress or in a safe deposit box, as having an intrinsic value, as something we can see, touch, and feel. People who study the system more carefully are aware that coins and currency are not the kind of money used for over 90 per cent of the dollar volume of the economy's transactions. But even the sophisticates tend to take too narrow a view, focusing on bank deposits without sufficient attention to the electronic revolution.

Most of today's money is an electronically stored ledger account in some bank's computer facility. This bank account money, whose efficiencies and integrity rightly concern us, bears little resemblence to the coins and notes of old. But so is it vastly different from hand-posted and machine-posted ledger accounts. The nature of money is changing more rapidly now than ever before, and we must not lose sight of the purpose of change. From the user's standpoint modern money should afford a secure, convenient, economical, certain, and traceable transaction for every man's payments and receipts. These several attributes of an efficient money provide the criteria by which we should evaluate alternative means for effecting electronic transfers.

The security precautions for electronic money, for example, have little use for vaults, safes, or armored carriers. Increasingly security involves the physical protection of computer or terminal facilities, development and implementation of reliable means of activating them, and the assurance that banking institutions offering these services remain sound financially and technically able to carry out the instructions of their customers. Some may deprecate the transition in the form of money from metal bullion to hand-posted ledgers to electronic "bytes" but none can dispute the superiority in convenience and security of the electronic transfer.

History provides some interesting contrasts between the electronic deposit system and payment technologies of the past. Paul Einzig, in his absorbing account of primitive monies refers to the cost and hazard of transporting such monies as stones, metal bars, and cowries, and how the nature of these money forms affected trade and travel. Travelers, for example, could not carry or ship enough money to buy much or get very far from home.

Einzig notes that the existence of slavery in some parts of the world was judged by some to be based largely on the absence of an easily portable currency of high value. "Slaves were needed both as a currency which provides its own transport and as carriers for other bulky and heavy currencies. African potentates or merchants when traveling some distance, spent, on their way, not only the currencies their slaves carried in payment for their current requirements, but also the slaves themselves."

Money transport costs and inconveniences have not been entirely abolished with the disappearance of primitive monies. We still spend large sums for secure shipment of coin and currency and the movement of checks. But the latter are so efficient that the cost of their essential movement is not large relative to their aggregate value. Today we travel and trade worldwide without slaves to carry money or to be used as money, and for the most part we have ceased to carry even paper money. Instead we depend on money adjuncts--travelers' checks and credit cards.

The growing use of credit cards to effect transactions complicates our perceptions of how the payments system works. Increasingly, we are faced with a blurring of the distinction between money (coin, currency and demand deposits), near money (time deposits and short-dated money market paper), and credit. While on a business or personal balance sheet money and near money are assets and credit already used is a liability, unused credit lines--particularly those connected with credit cards--are sources of liquidity often equal, or superior to, demand deposits and currency as a transactions medium.

Retailing practices increasingly make it feasible for an individual to use money and credit cards interchangeably to pay vendors of products or services. As the credit card system now works, a payment of this kind is a loan and can only be liquidated in the longer run by a money transfer. However, the nature of the entire transaction cannot be fully revealed without considering the essential part played by the credit card and the concomitant reduced role of both currency and deposits. While neither credit cards, travelers' checks, nor any intermediate instrument can, strictly speaking, qualify as money, these devices can be used to make the management and transfer of money balances more convenient, to record transactions efficiently, and to avoid exposure to theft or loss.

The temporary substitution of credit, via a bank or non-bank credit card, for actual money transfers has some significant implications for individual money management and for overall judgments about the economy's money needs.

The typical income recipient has a cash flow pattern primarily based on weekly, semi-monthly, or monthly payments. If he is a wage or salary worker he is paid after his service is rendered and in that sense he extends credit to his employer equivalent, on average, to one-half of his wage. His pattern of payments is quite varied. He pays cash for his food and household supplies more or less as he consumes them. He pays rent and insurance in advance, taxes as the liability accrues and in general pays for clothing and durable goods before and as they are being used up.

In this payment system consumers extend credit to their employers and use credit directly or indirectly in varying degrees in connection with their purchases. Credit cards have wedged their way into this hodge-podge of payment practices partly by displacing vendor credit and other types of consumer credit extended by banks. But in addition, the card has simply displaced cash as a method of payment. This latter effect shows up in a transitory increase in borrowings.

Since vendors do not ordinarily have a cash price and a credit card price, the system deprives cash purchasers of the opportunity to save the cost of credit during the grace period and the net additional expense of carrying the transaction through additional bookkeeping phases. At the same time, temporarily using credit for money (as opposed to longer-term borrowing) obviously offers the household money manager a widened opportunity. He does not need to withhold or withdraw money from his cash flow for spending as he acquires goods and services but can defer settlement up to the end of the grace period. Thus, spending activities can be more precisely related to cash inflows. In fact, ingenious household money managers could very nearly operate on a non-interest cost overdraft basis if their banks had no minimum balance requirement. As tendencies in this direction become more widespread, the implications for monetary growth rates should not be ignored.

Perhaps the more important point to recognize in this connection is that the custom of a grace period between the date of sale and the date of final payment creates a kind of financial vacuum. We have yet to see credit cards used extensively as vehicles for completing transactions entirely without any grace period. But on a pilot basis, using point-of-sale terminals, balances have been transferred either from one account to another in a particular bank, or from one bank to another. As this system progresses beyond the pilot stage (as I think it one day will), it will have a powerful influence on money use and money requirements. In the longer run probably no device has a greater potential for displacing currency and checks than the "card."

This is apparent if we review recent developments and trends in money transfer practices. At the moment a great deal of attention is being given to measures which will increase the overall efficiency of the check. Thus, by expanding the areas served by existing Federal Reserve facilities offering overnight collection and creating new Regional Check Processing Centers as needed, the Federal Reserve expects to achieve, through maximum use of present-day computer and transportation technology, a more rapid and more economical transfer of funds by check. These measures will come near to universalizing next-day settlement and will reduce check sorting and transport costs close to practical minimums.

Even as more efficient ways of handling checks are being put into place, electronic transfers are coming into their initial use. For the most part, they now appear as income crediting and preauthorized debiting. The crediting system is a gyro-type transfer and operates entirely within the banking system. For example, the employer authorizes his payroll account to be charged on the same day that his employees' accounts are credited. No checks are issued; the transfer is by electronic means and the employee has a notification understanding with his bank. This system is extensible to all types of regular income flows in addition to wages and salaries such as annuities, pensions, social security and welfare payments, dividends and interest.

In preauthorization systems for paying bills, the transfer is initiated by the payee in accordance with a written understanding with the payor as to amounts and timing of withdrawals from his account. This method of transfer also operates entirely within the banking system and without paper other than the original agreement. Preauthorization has been used primarily for utility bills but is extensible to any kind of recurrent, regular payments.

Several schemes for achieving efficient entry into electronic processing by an economical and early conversion into machine language are being tried. A device called "bill check"--in which the payor endorses a bill and fixes a date for transfer from his bank account to that of the vendor--is under active consideration in the Atlanta area. This device is an outgrowth of a payments system survey sponsored by the Federal Reserve Bank of Atlanta and the Georgia Institute of Technology, with the cooperation of banks in the Atlanta District and particularly in the City of Atlanta. The project has been ably directed, first by Paul Han and later by Allen Lipis. A clear and concise summary of the project and the "bill check" proposal can be found in the Savings and Loan News for August 1972.

Going beyond these SCOPE-type transfers is the point-of-sale terminal activated by a bank credit card. This, when fully developed, will incorporate advantages in convenience, safety and economy to consumers that neither currency nor checks can hope to realize.

Under such a system, a purchase can be billed directly to the card owner's deposit, as well as to his unused credit lines. The depositor might make the choice at the time of sale, or he might have some automatic arrangement for bringing the credit line into use only after his deposit balance has fallen below some critical level--perhaps zero. Many banks already offer credit lines that, in effect, automatically cover overdrafts.

Many of the features of such a system have been shown to be operationally feasible. After some costly experiences credit card issuance and control problems have been very much reduced. Security and insurance features have also been improved. The development of "descriptive billing," a tremendous technological step, seems certain to achieve very substantial cumulative reductions in paper shuffling, sorting and verification. This technique, incidentally, were it applied to bank statements, probably would stretch out the economically useful life of the check by truncating its flow and eliminating the necessity of returning it to the payor.

The major problem of the bank credit card, as I see it, is the danger that the public responsibility which goes with the management of a device so closely and intimately related to money may be given too low a priority. Although banks are accustomed to functioning in a quasi-public capacity, they act in deference to specific regulation or controlled competitive conditions. There is some question of the degree to which these considerations are adequately effective so far as credit card services are concerned. Moreover, at this point in their development, many card operations are in the red or only marginally profitable. Consequently, accommodation of the public interest, if it involves additional costs, may be outweighed by profit considerations. For these reasons it would seem to me desirable for the industry to review those operations in which public concern has already been expressed or may come to the fore and attempt to reach solutions which are consistent with performing a quasi-government activity related to money.

In making the comments that follow, let me emphasize that I recognize the efforts bank managements have been making to make their credit card systems responsive to legitimate public needs. As the Senate Committee on Banking, Housing, and Urban Affairs noted in a recent report, "credit cards are presently issued by commercial banks, retail merchants, department stores, oil companies, airlines, travel and entertainment companies, and others. Much of the growth in credit cards has been beneficial to consumers, but problems have also arisen with this relatively new type of credit mechanism which require corrective legislation ...."

Given the multiplicity of issuers, it was inevitable that problems should arise. But among the issuers of credit cards, banks have been in the forefront of providing proper customer service for their accounts. This point was made forcefully to the Senate by Kenneth V. Larkin, Senior Vice President of the Bank of America, in testimony last year. Mr. Larkin pointed out that banks were receiving complaints about their credit card accounts, but the number of complaints had to be weighed against the 500 million transactions and 200 million billings taking place yearly. He indicated that the record of banks in servicing consumer complaints has been good in the past, and will improve in the future, and I am sure he would confirm that statement today. Yet it would be a mistake not to continuously review credit card operations to learn where further improvements will need to be made.

To illustrate the nature of emerging public concerns, let me comment briefly on four facets of card utilization most of which have already surfaced in public discussion and Congressional consideration.

1. Card security.
2. Treatment of losses.
3. Discounts for cash.
4. Non-recourse arrangements.

Card security. A credit card which is completely secure against loss, theft, counterfeiting or misuse will probably never come into existence but there are a variety of techniques for reducing exposure to these hazards and insuring those that remain. The industry's early experience with card issuance and distribution has resulted in greatly strengthened security arrangements. But card manufacture and distribution practices and measures to cope with card counterfeiting are not comparable in effectiveness to the safeguards now in place for currency and administered by the Bureau of Printing and Engraving, the Treasury, the Federal Reserve, and the Secret Service. Partially in lieu of such extensive prophylactic measures, card systems have built in a tolerance to a higher level of loss experience and invested more heavily in an early warning system of unauthorized use. The public issue involved is the cost of such surveillance and the prevailing level of losses compared to the cost of additional safeguards of the type used for currency. Since card users pay the cost of card use--and abuse--in one way or another, they are entitled to the benefits of the most cost-effective program.

<u>Losses</u>. The acceptance of a certain level of losses from card misuse can be justified as the cheapest method of dealing with those types of losses whose aggregate is predictable and whose occurrence is random. But, if losses are known to be concentrated on certain types of identifiable transactions, card holders who do not engage in these transactions should not have to share that loss experience. Away-from-home transactions, for example, since they have a higher loss experience and involve greater surveillance costs, should be subject to some differential cost treatment in fairness to card holders who do not contribute to those costs.

<u>Discount for cash settlement</u>. The most important advantages of the credit card as a money adjunct can only be realized when it can be used directly to transfer funds from one bank account to another or as a full substitute for cash or a check. Generally, this role for the card is regarded as awaiting the availability of point-of-sale terminals. But even now, a card could be used to generate an electronic transfer comparable to present preauthorization transactions. The terms of the transaction could be made machine readable at the time of sale and the transaction consummated at the close of business or on the following day.

One important gain to the public from cash payments is to make the card usable for vendors who operate on small margins, such as supermarkets. A second advantage is to add to consumers' choices the alternative of a card arranging cash payment at a lower price than would be available for convenience credit.

Non-recourse arrangements. Perhaps the most controversial aspect of bank credit card use today has to do with the character of non-recourse arrangements card issuers have made with vendors. Although built in the main on existing banking practices where banks have assumed credit risks on purchased paper, the conversion of non-recourse precedents to credit card paper has resulted in serious disadvantages to some card holders. They have dealt with unscrupulous merchants who have been qualified as participating vendors but who clearly could not meet criteria comparable to those applicable to card holders. Bearing in mind that banks are intermediaries between buyers and sellers, the public interest, in my view, requires a thoroughgoing concern for the integrity and responsiveness of vendors.

First, banks should exercise great care in selecting merchants for the credit card network that are honest and reputable. Prior to signing up a merchant for the network, the bank would conduct a careful check on the merchant's character and reliability. This check would be similar to the checks presently made by a bank prior to extending credit to a borrower. Beyond this original screening, the record of vendors should be reviewed continuously just as card holders should be screened continuously.

Second, card issuers could establish a system for investigating and responding to consumer complaints. It would be ascertained whether consumer complaints regarding a particular merchant are meritorious, give notice of the charges to the merchant and give him an opportunity to respond. The mere fact that the merchant is made aware that he will be held accountable for his merchandising activities should have an ameliorative effect upon retail practices.

Third, bank card users might be given the right to stop payment on credit card drafts. The customer's rights as a bank card user should be no less than his rights as the drawer of a check. This right to stop payment could be made part of the written agreement between bank and card user and bank and merchant, and made known fully to the card users.

Service charges would probably have to be imposed to compensate the bank for costs it would incur in the handling of stop-payment orders much as service charges are now usually imposed for stop-payment orders on checks. Such service charges would also have the desirable effect of discouraging frivolous actions by consumers in stopping payment or in rescinding the transaction.

This list of public concerns would not exist if it were not for the effective work banks have done in promoting card use, and making it an integral part of household financial management. The credit card is one of the most innovative devices which modern technology has made available to consumers, and its future is bright so long as all of us who are participating in the evolution of the payments mechanism do our part.

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