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Bank Credit Cards and Check-Credit Plans: Development and Implications

Remarks by

Andrew F. Brimmer
Member
Board of Governors of the
Federal Reserve System

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BANK CREDIT CARDS AND CHECK-CREDIT PLANS: Development and Implications

The rapid and widening entrance of many of the Nation's commercial banks into the credit card field has already brought a new dynamism to the banking business, and further changes are clearly visible on the near horizon. However, this latest innovation in banking (like many which preceded it) has posed a number of operating problems for the banks themselves, while raising a range of policy issues to which bank supervisory officials increasingly will have to address themselves.

In the light of these developments, the Board of Governors announced last March 1 the establishment of a Federal Reserve System Task Group on Bank Credit Cards and Check-Credit Plans.

I was asked to assume general responsibility at the Board level for the project. The Task Group has working members drawn from the Federal Reserve Banks of Boston, New York, Cleveland, Atlanta, Chicago and San Francisco, as well as from the Board's own staff. These are the Reserve Districts in which bank credit card activity has been most pronounced. Howard Craven, Vice President of the Federal Reserve Bank of San Francisco, is Chairman of the Task Group.

The assignment of the Task Group (composed primarily of economists but also including representatives of the legal and bank examination functions) was as follows:

- To investigate, analyze and describe the development of bank credit card and check-credit plans;

- To assist in the development of criteria for supervisory examination of banks offering such plans;
- To develop guidelines for current statistical reporting on these plans;
- To evaluate the broader significance of bank credit card and check-credit plans for public policy--including policies relating to check-clearing and the techniques for settling domestic payments, efficiency and competitiveness of the banking structure, consumer credit, and general monetary and credit policy.

The Task Group has made headway in each of these areas. However, by necessity, most of the effort has been devoted to the first task listed above--that is, the development of basic information about bank credit card and check-credit plans as well as a variety of nonbank credit cards. Members of the Task Group have conducted a number of personal interviews with bank officials and other executives responsible for the development and management of different plans. From these interviews and other sources, the Task Group has been able to prepare a preliminary account of the operation of the principal credit plans.

The Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve jointly included on the April Call Report a special question on the dollar volume of credit outstanding under these plans. The Task Group is making suggestions to System officials engaged in the development of a format to assist Federal Reserve bank examiners in reviewing the credit card and check-credit programs of State member banks. Considerable progress has been made in designing a scheme for periodic reporting (most probably on a monthly basis) of bank activity under these plans. Work is also going forward on the implications of these developments for public policy.

At this point, it appears that the Task Group will complete its assignment early next year. In the meantime, enough has already been accomplished on which a brief progress report can be based. In making these observations, however, I must necessarily speak in my personal capacity. Once the Task Group's completed report is presented, I am certain that the Board of Governors and the Federal Reserve System will make known their official views on bank credit card and check-credit plans.

Scope of Credit Plans

So far, we have only a rough estimate of the number of banks offering credit card or check-credit programs and of the dollar volume of credit outstanding under these plans. This estimate was obtained in the April Call Report mentioned above. The statistical tabulations from that report were released recently, but it may be helpful to summarize them here.

As of April 25 of this year, 627 insured commercial banks reported some type of credit card or check-credit operation with total receivables of over $800 million. This amount represented almost one-fifth of the approximately $5 billion outstanding under all forms of consumer credit card plans.

However, the reported figure is not a complete measure of the total number of banks currently operating in this area, because some banks have entered the field since the end of April. Furthermore, several hundred banks are actually local agents for the credit card plans of large city-correspondent institutions. As such, they do not hold the credit card receivables generated in their respective areas but transmit the paper to their correspondent banks. These local agents were not included in theApril 25 statistical summary which was confined to those banks that had direct credit card or check-credit operations. Nevertheless, the tabulations covered all of the larger plans, and they suggest that, so far, not much more than 5 per cent of the Nation's commercial banks are now engaged in this form of lending.

Among the 627 institutions reporting credit card or check-credit plans, 462 (or nearly three-fourths of the total) were member banks of the Federal Reserve System. Of these, 372 were national banks, 90 were State bank members, and the remaining 165 were insured nonmember banks. For all reporting banks, the amount of credit outstanding under these plans averaged about \$1.3 million. By class of bank, the average was \$1.7 million for State member banks, \$1.6 million for national banks, and \$315 thousand for insured nonmember banks. Also, there was considerable concentration by class of bank: the nationals represented three-fifths of the total number, but they held three-fourths of the total credit reported; State member banks represented one-seventh of the number and held just under one-sixth of the amount, while insured nonmember banks represented over one-quarter of the number but held less than one-tenth of the credit outstanding.

Bank credit cards and check-credit plans were reported by institutions in every section of the country. However, the representation was particularly heavy in the Northeast, in the West Coast and in the area around Chicago. In the San Francisco Federal Reserve District, 48 banks reported \$272 million of total credit under these plans. While they constituted only 8 per cent of the total number of banks, they held more than one-third of the volume of credit outstanding in the Nation as a whole. Thus, in the Far West, the amount of credit outstanding per bank averaged $5.7 million, or more than four times that for the country at large. This pattern clearly reflects the earlier and more sustained efforts of some of the large West Coast banks in the bank credit card field. In the Chicago Federal Reserve District, 138 banks reported credit card operations, with $122 million of credit outstanding. This was the largest number reported in any district (accounting for over one-fifth of the total number of banks), but they held only 15 per cent of the total volume of receivables. In this case, the pattern reflects the recently accelerated pace of activity of Chicago banks in the credit card field.

Since the start-up costs required to launch bank credit card plans are usually substantial, such plans currently are operated primarily by the large institutions. Of the 627 banks reporting credit card or check-credit plans in April, 33 had total deposits over $1 billion, representing nearly 90 per cent of the 38 banks in the country in this size category. Another 36 of the reporting banks had total deposits between $500 million and $1 billion; these 36 banks accounted for almost 70 per cent of the banks in this size group in the country at large. There were 159 banks (about one-half of those in this size group in the Nation) with total deposits between $100 million and $500 million. Thus, more than one third of the number of banks reporting had total deposits of more than $100 million. Yet, a fairly large number of small banks also reported operating some form of credit card or check-credit plan. For example, there were 27 banks with total deposits of under $5 million and another

58 with deposits in the $5-10 million range. It is probable that most of the small banks operated check-credit rather than credit card plans, since check-credit programs can be undertaken with a smaller investment.

Major Characteristics of Plans

For those closely associated with bank credit card or check-credit plans, there is obviously no need for a description of these plans. However, for those not so familiar, it may be helpful to sketch their major characteristics. For this purpose, we can draw on the summary descriptions provided by the Federal Reserve's Task Group. The credit card and check-credit plans instituted by banks really cover two types of credit operations that are related but which have important differences in their basic features. Both the credit card and check-credit plans are designed to give the consumer an open-ended or revolving charge account arrangement. The credit card plan requires a direct link with retail merchants who agree to accept the customer's card in payment for purchases. The charge slips are then deposited with the card-issuing bank which credits the merchant's account and bills the card-holding customer. The check-credit plans establish a loan or overdraft account for the cardholder which he then uses by writing checks to make his purchases or to obtain cash. These checks are guaranteed by the issuing bank either through the use of special checks or, in some cases, through card identification. Both types of plans require an agreement between the issuing bank and the individual customer as to the maximum credit that he has available and the terms of repayment.

However, only the credit card plans require a specific arrangement with the retail merchant for honoring the cardholder's credit purchases and subsequent collection through the issuing bank.

Up to now credit cards have achieved wider acceptance than check-credit plans. The cards can be used for a variety of purchases in the localities in which they have been established. Moreover, through arrangements with airlines, hotels and interchange with card-issuing banks in other areas, bank credit cards can serve travel and entertainment purposes. Furthermore, most of the major bank credit card plans permit the cardholder to obtain a cash advance from the issuing and participating banks to meet expenses that cannot be charged directly on the credit card. The cash advance privilege is in effect similar to the loan arrangement offered by check-credit plans.

Bank credit card plans are still in the developmental stage, and their features and scope of operations vary substantially. The number of cardholders active in individual plans varies from a few thousand to over a million while the number of merchants signed up ranges from less than 1,000 to over 75,000. No accurate estimates are possible at this time of the total number of bank credit cardholders. The merchants that sign up with the credit card plans agree to accept a discount on the charge sales tickets that they deposit with the bank. The cardholders agree to pay a finance charge on any balance that is not paid off within a specified grace period -- usually 30 days. The discount imposed on the paper deposited by the merchants normally ranges from 2 percent to to 5 per cent, with noticeable concentration around the middle of the range. The exact discount depends on the kind of business and the average sales ticket. For example, those credit card plans that cover airline ticket purchases normally impose only a 1 per cent discount on the airlines because of the high dollar amount of the average sale. The merchants participating frequently are required to pay a nominal rental fee on the imprinting machines used in the credit card transactions. Nearly all of the credit card plans impose a finance charge of $1\frac{1}{2}$ per cent per month on the unpaid balances of the cardholders, although for a few plans this charge is 1 per cent a month.

Check-credit plans levy similar monthly charges on the customer, but the range is wider, varying from 3/4 of 1 per cent to 2 per cent per month. Usually the grace period which is allowed before the charges are imposed is shorter than under credit card schemes. In some cases, banks charge additional fees under check-credit plans -- such as checking account service charges and a fee for each check cleared. Also credit life insurance is sometimes required.

Supervisory Examination of Bank Credit Card Plans

While the analytical work on the characteristics and policy implications of bank credit card plans is continuing, the Federal Reserve System is currently giving consideration to the inclusion of a special section in its examination report to assist in appraising these plans in the regular examination process. This step would complement the recent action of the Comptroller of the Currency in adding a special section to the examination report for national banks.

The specific questions to be included are still being formulated and reviewed within the Federal Reserve. However, sound examination practices and the form already in use in the examination of national banks clearly suggest the type and range of questions a Federal Reserve examiner must have in mind when he appraises the credit card and check-credit programs of State member banks. In general, he must focus on:

- The type of plan in operation i.e., credit card or check-credit, and whether owned or operated on an agency basis.
- The number of cards or check-credit accounts outstanding, the volume of loan activity to which they give rise, the number of participating merchants, the discounts allowed them, and the interest rate and other charges to which borrowers are subject.
- The adequacy of credit standards, including the compilation of information on applicants' financial position before issuing credit cards or opening check-credit accounts.
- The existence of safeguards to limit misuse or abuse of credit cards or check-credit accounts, including the setting up of credit ceilings, specific repayment requirements, and collection procedures (especially the cancellation of cards or the closing of check-credit accounts).

- The adequacy of procedures to determine the financial responsibility of merchants before admitting them to the program.
- The bank's charge-off policy on delinquent accounts and the establishment of reserves against which possible loans can be charged.

The above examples are simply illustrations of the type of considerations which will be embodied in the Federal Reserve's special examination form. The specific questions and the date for introducing the form will probably be settled in the near future.

Future Assignments of the Task Group

As mentioned above, the first assignment of the Federal Reserve's Task Group was to compile as much information as possible on the bank credit card and check-credit plans currently in use. Because of the great variety of plans and the large number of banks involved, this has proved to be a difficult and time-consuming effort. It is now planned to go back in the near future to the 600-odd banks which reported in the April Call Report that they were actively engaged in the credit card business with a detailed inquiry to obtain further information on the nature and extent of their credit card operations. This phase of the project will probably involve a number of personal interviews with banking officials to supplement the written responses to the questionnaire on which the Task Group expects to rely for most of its detailed information. The results will provide a benchmark against which to appraise future developments.

In the meantime, the Task Group has been developing a program for regular monthly statistical reporting of bank credit card and check-credit plan activity. We are hopeful of instituting the current reporting program by the end of the year.

The final stage of the study will be an assessment of the implications of bank credit card developments in such areas as bank competition, banking structure, bank supervision, consumer credit, consumer spending and saving habits, and changing techniques for handling domestic payments. This concluding phase of the study will also include an examination of credit card and revolving credit programs offered by other types of businesses -- especially those issuing travel and entertainment cards, the major oil companies, airlines, retail merchants and other nonbank institutions.

Some Policy Implications

With respect to the implications of different bank practices in this rapidly developing area of credit, many questions cannot as yet be answered. However, one matter which must necessarily concern bank supervisory authorities has been the way in which some plans were launched, especially the broadside distribution of credit cards to unscreened mailing lists. Those banks experiencing the most difficulty in this respect have recently taken steps to bring some degree of orderliness in their procedures, but their initial problems clearly demonstrate the need to be especially careful in the opening of new programs. The use of credit cards or check-credit plans does not alter the essential requirements of sound credit administration--including maintenance of proper credit appraisals and suitable controls against unauthorized or improper use, and insistence on appropriate collection methods.

Another aspect of the widening use of bank credit cards which poses a number of questions concerns the handling of credit card sales slips as part of the Nation's check collection system. Much of the recent public discussion of this issue centered on the question of whether certain of the multi-bank credit plans should be assigned a Federal Reserve-ABA routing symbol-transit number. There were reservations within the Federal Reserve System about taking this step, reservations based on the following reasons:

- Collection of such credit card sales slips as cash items is an improper use of the Nation's check collection system.

- It is contrary to the desired objective of limiting expansion of check volume.
- The proposal discriminates against unit bank credit card plans.
- Such an arrangement is not part of the domestic payments mechanism, but is in furtherance of the retail credit sale transaction.
- In effect, this step would amount to an unwarranted Federal Reserve subsidy of the multi-unit credit card plans by providing a means for the accounting and settlement of such operations.

Rather than using the check collection channels, it was suggested that sales slips be sent by the retailer or his depositary bank directly to the central office of the credit card plan. However, the basic issue is not the technical one of routing symbol-transit numbers, but the problem of avoiding a substantial and undesirable increase in the number of cash items that would be put into collection channels. There is already much concern about the continuing upward trend in the volume of checks and consideration is being given to various ways of minimizing this trend, such as the promotion of wire transfers of funds.

Another basic issue is the locus of the costs of operating credit card plans. Such costs include the expenses of moving the sales slips from participating merchants to the central office and the encoding and other qualifications of the sales slips to permit their use as an input in central office bookkeeping procedures. Some of the sponsors of bank credit plans have felt that the bank check collection system should absorb these costs as a fringe benefit to the banks comprising a particular plan. While to my knowledge no precise measure of operating costs is publicly available, one estimate places such costs at about 2½ per cent of the dollar volume of credit extended under credit card plans -- with roughly one-third of the costs being incurred in getting the sales slips from the merchant and processing them through the accounting system.

In the meantime, whether the above objections are valid or not, a mutually acceptable procedure has been arrived at for the assignment of the FRS-ABA routing symbol-transit number for multi-bank plans. Nevertheless, the fundamental question of who will carry the cost of operating the clearing machinery for bank credit card systems remains to be resolved. The issue will become even more significant as multi-bank credit card interchange systems, regional, or national in coverage, are launched. It seems evident that the purely local or metropolitan systems will place little burden on the traditional check clearing mechanism operated by the Federal Reserve System, since the sales slips would most probably be handled through city clearing house arrangements. But it also seems evident that the regional systems will generate a flow of sales documents that will add to the volume of work now performed by the nation-wide check clearing machinery of the Federal Reserve System.

The spreading use of bank credit cards also raises a number of questions with respect to the future competitiveness of the banking system and competition between banks and other sources of credit -- although here again there are no definite answers at this time. As the statistics cited above demonstrate, the credit card business is highly concentrated among large banks. If the credit card becomes a principal means of bank lending to households, the big banks in the Nation may acquire an even larger share of consumer credit. On the other hand, the availability of check-credit plans -- which require a smaller initial investment and have lower operating costs -- may well enable smaller banks to continue to compete in the field.

Another question about the future competitiveness of banks is also posed by evolving practices in the credit card business. Normally a merchant participating in the plan must have an account with the bank offering the plan (or with its agent) in order to receive payment on the deposit of sales slips. Thus, the credit card plan becomes a vehicle for attracting deposits of business firms -- as well as a means of lending to consumers. Whether further concentration in the banking business will result from this feature of bank credit cards remains an open question. It is possible that the development of agency arrangements, whereby small banks handle the local credit card programs for their large city correspondents, is a way in which these banks can participate in credit card banking and thus maintain their competitive position in local markets.

Finally, credit card banking and the feasibility of linking to automatic data processing raises implications as to the future of our banking structure. The extent of the changes that will come, and how rapidly, cannot be stated now, nor can all of the problems that may be encountered be precisely identified in advance.

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