

For release on delivery

Statement of
Andrew F. Brimmer
Member, Board of Governors of the Federal Reserve System
before the
Subcommittee on Financial Institutions
of the
Committee on Banking and Currency
United States Senate

October 9, 1968

I appreciate the opportunity to appear before this Committee to explore with you some of the questions raised by the entry of commercial banks into the credit-card field.

In releasing the Federal Reserve System's study of Bank Credit-Cards and Check-Credit Plans at the end of July 1968, the Board commented on several problems with respect to credit-card practices, such as unsolicited mailings and letting each cardholder know his specific credit-card limit. The Board also indicated that steps were being taken in its examination procedures to assure reasonable practices by State member banks. We are continuing to follow carefully the experiences of banks in the promotion and development of credit cards, so that we may analyze their implications for the customer as well as the bank.

Recent Trends

Let me first summarize the spread of bank credit-card and check-credit plans since September 30, 1967, the date of most of the information contained in the study. In the following nine months, the number of commercial banks operating credit-card programs more than doubled, increasing from 197 at the end of September to 416 on June 30, 1968.^{1/} The number of banks operating check-credit plans also increased substantially, from 599 at the end of September to 340 at the end of June. These figures are given in Table 1 attached to my statement.

^{1/} The number of banks that reported outstanding balances on credit-card programs. This excludes nearly all of the several hundred agency banks which do not hold credit card receivables.

Credit outstanding on bank credit-card and check-credit plans amounted to a total of \$1,599 million, on June 30, 1968, an increase of 43 per cent from September 30, 1967. During this period, amounts outstanding on credit-card plans increased 50 per cent to \$953 million while amounts outstanding on check-credit plans increased about one-third to \$646 million.

As I indicated in my statement before the House Committee on Banking and Currency on November 3, 1967, the Federal Reserve System has developed a program of current monthly reporting of credit extended and repaid and the amount outstanding under bank credit-card and check-credit plans. Beginning with June, 1968, figures, this new series has been included as part of the Board's monthly report on consumer credit. The monthly figures for January through August, 1968, are shown in the attached Table 2.

The monthly reporting on this new series has been covering about 95 per cent of the total bank credit-card and check-credit operation, since it has not been possible to maintain complete monthly reporting because of the lag in obtaining reports from the additional banks continually entering the field. The monthly series, however, appears to give a reasonably accurate measure of the changes between call reports. As soon as we have had sufficient experience with this monthly reporting, it will be adjusted to allow for the understatement as we do with the other consumer credit series that we publish.

Examination of the monthly data that have been collected for the first eight months of this year shows a steady increase in the amount of credit outstanding under both credit-card and check-credit plans. In July and August, credit card receivables increased nearly \$70 million, or almost 3 per cent, and outstanding balances on check-credit plans increased \$42 million or 7 per cent. To some extent the increase in the summer months may reflect vacation expenditures. Much longer experience will be necessary, however, before a precise seasonal pattern can be determined.

Problem Areas

I will now discuss briefly some of the problems connected with the issuance of credit cards that are of concern to all of us.

The major problems seem to be:

- 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 over-all impact on consumers.

Credit cards present special problems that do not arise in check credit. In particular the mass-mailing is a distinct feature of credit cards. Another special problem concerns liability for use of lost or stolen credit cards. While plastic identification cards are sometimes 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 is not a problem. Only in their common role of providing pre-arranged lines of revolving credit do check-credit and credit cards share similar potential problems.

Mass-Mailing of Unsolicited Credit Cards

Banks have found that the most effective way of starting a new credit-card plan is to mail a large number of unsolicited cards. This is necessary to resolve 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, of course, risks involved in the mailing of a large number of credit cards, but these risks have been minimized by safeguards instituted by the banks. Generally the rosters of potential cardholders have been based upon lists of the banks' own customers: first of all demand depositors; to a lesser extent savings depositors; and, still less frequently, borrowers. The criteria used for screening such lists include requirements such as a \$300 to \$500 minimum average balance and no insufficient-funds checks for the previous six months in the case of demand

accounts or a \$500 balance in the case of savings accounts. In some cases, banks run additional credit checks on some or all of their potential cardholders. While these internal lists are the main source of names, some banks have on occasion purchased outside lists from such sources as credit bureaus and retailers. Banks have had more problems with purchased lists than with internal lists. The care currently exercised by banks reflects this awareness of the shortcomings of outside mailing lists.

In addition, the Board of Governors, after the completion of the System's Report on "Bank Credit-Card and Check-Credit Plans" has taken steps to encourage care in the selection of names for the mass-mailing. It has instructed its examiners to check "to make sure that banks realize the importance of developing initial mailing lists from their own records and carefully screening them before use." The screening should be designed both to check credit-worthiness and to minimize duplicate cards.

Banks are modifying their practices to reduce the customer annoyance that accompanied earlier mailings of unsolicited cards. While the number of customer complaints received by banks is usually a small percentage of the issue, according to bankers and better business bureau officials contacted, the fact remains that some customers do not like to receive unsolicited cards. To minimize this problem, many banks starting operations within the last year have sent out so-called "pre-mailers." These pre-mailers tell the

customer that a card is being sent unless the customer indicates to the bank that he wishes his name removed from the list. Thus, the customer is able to refuse a card before it is sent. The pre-mailer also helps reduce the prospect of fraud by alerting the customer to expect the card and also informs the bank of changes in addresses.

Liability for Fraud Losses

One of the major objections to the unsolicited mass-mailing is that the card may be lost or stolen, and the cardholder might be threatened with liability for these losses even though he never received the card. But the same problem could exist for requested cards and renewals of existing cards; therefore this is not entirely a problem of the mass-mailing. There is also the question of liability for the wrongful use of a card stolen or lost after a person has accepted or used it.

With regard to the first type of fraud--where the card is lost or stolen before it is accepted or received by the proper person--we do not know of any bank that has attempted to collect from the intended recipient of the card. Within the last few days, we have talked to major banks in California, Illinois, Maryland, Missouri, New York, and Virginia. These banks do not seek to hold the cardholders responsible in these cases--nor have any of them done so in the past. Furthermore, it would appear doubtful that the customer would be held to have any legal liability in these

cases. Recent statutes in Illinois, Massachusetts, New York, and Wisconsin specifically exempt from liability the customer who has not accepted or begun to use an unsolicited credit card.

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 bank accepts liability for any fraud losses. As for the liability of the cardholder prior to informing the bank, the situation is obscure. Some banks seek to collect from the customer in these cases for losses. Others do not, even if 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 in any event. Where the bank absorbs the fraud loss, it often does not reveal that policy to its customers generally for fear that they would be unduly careless in their handling of the card. The majority of the banks that we have talked to follow the practice of absorbing losses. 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. Nevertheless, 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.

The most common practice appears to be that of being somewhat ambiguous on the cardholder's liability once he has accepted a card and of absorbing all fraud losses arising from cards used without the cardholder's consent. Even where the limits on liability are specified, the banks may not attempt to recover fraud losses. Similarly where States, as in Illinois and Massachusetts, set upper limits on cardholders' liabilities, the banks often do not attempt to collect within the legal limitations.

In summary, banks generally appear to follow the practice of absorbing all fraud losses before the customer accepts the card. In addition, a substantial proportion of banks absorb losses after the cardholder accepts the card, although the cardholder is not usually informed of this policy.

Credit Limits

Most banks follow the practice of telling cardholders of their credit limits. This conclusion is based upon both our knowledge of specific banks' practices and recent examination reports. As you know, the Board revised its examination procedures to cover the question of whether or not customers are informed of their limits.

Since the change in examination procedures was instituted in mid-August, examiners of the Federal Reserve System have examined 36 State member banks that have credit-card or check-credit plans.

Each of these banks had established specific credit limits under these plans and followed the practice of informing its credit-card customers of the credit limits.

Over-All Impact on Consumers

There remain other questions as to how credit-card and check-credit plans affect consumers, particularly as to the impact of the costs of such plans and any tendencies toward encouraging excessive indebtedness.

With respect to the question of whether or not credit cards increase the cost of goods to consumers, it is only possible to indicate the probable answer. Given the present minor size of credit-card plans compared with all kinds of consumer credit, it does not seem that the expansion of credit-card plans would have a noticeable effect on general prices. Furthermore, it is not certain that credit cards do raise prices. While it is true that the retailer is faced with an extra cost in the form of the so-called merchant discount every 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 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 the evidence, while not conclusive, suggests 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 limit. 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. The result is that such plans experience much lower delinquency ratios--less than half that of credit-card accounts according to our credit-card report.

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 over-all expansion of the economy and only a fraction can be attributed to credit-card and check-credit plans. 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 \$5,531 million--of which the instalment component was up \$4,324 million. Therefore, the credit-card and check-credit plans made up less than twelve per cent of the increase in instalment credit extended consumers during the nine-month period.

Summary

On the question of credit cards lost or stolen before the customer receives and accepts them by signing or using them, it seems doubtful that the customer legally is liable for any losses, and banks do not try to collect in such cases. The banks, however, do not always make this clear to their customers, although there is no obvious reason why they should not. The Board certainly would urge that banks advise their customers that they are not liable for losses from unauthorized use of cards they have not accepted.

The situation is quite uncertain with respect to losses stemming from cards which have been lost by a customer who has accepted the card. The state of the law is still unclear since court decisions depend upon how clearly the liability provisions are spelled out to the customer, the amount of care taken in verifying the credit-card transaction, and so on. In a few cases, as mentioned before, States have adopted legislation dealing with the matter of liability, but banks may be reluctant to enforce cardholders' liabilities under such statutes. The banks' policies vary: some apply strictly the clauses spelling out liability; other specify liability policies but in practice rarely or never hold the customer liable; still other banks follow policies which fall somewhere in between.

At a minimum, telling the customer his potential liability appears to be the best policy. I would like to submit for the record an example of one of the best methods banks have devised to do this.

In forms sent to customers along with its card, Wells Fargo Bank of San Francisco clearly states that cards lost or stolen before receipt are not the customer's but the bank's responsibility. Just as important it specifies the liability of the customer for fraud losses should the card be stolen or lost after the customer has accepted it. The bank sets a \$50 ceiling on losses before notification that the card is lost, with no liability after notice. This is a responsible approach to this problem, and I offer it as an example of the steps banks are taking to meet their responsibilities in informing their customers.

As I have indicated, the actual dimensions of the problem of people being held responsible for losses that may arise when their credit card is stolen or lost appear small. We have no figures on the dollar amount collected from cardholders, but it would not appear to be substantial for several reasons. The biggest dollar losses would arise from cards stolen before customers ever receive the cards. We know the banks absorb these losses. Next, we also know that the majority of banks do not in practice try to collect from customers for losses incurred before receiving notification. Furthermore, these banks also account for the majority of dollar outstandings. There remain those banks which try to collect in cases of obvious negligence by the cardholder and a still smaller number of those which try to collect as a regular practice.

Even though the liability for misuse of lost or stolen credit cards has been small, there is an important matter of principle as to the extent to which the consumer should bear this burden. I believe that the entire burden of loss arising from the misuse of lost or stolen credit cards before they are received or accepted by the customer should be borne by the issuer. After acceptance and use of the card by the customer, I believe that the liability imposed on the customer should be small, inasmuch as the issuers are better able to bear the losses and to control them. Some small liability on the part of the customer is probably desirable to encourage responsible handling of cards and prompt reporting when cards are lost or stolen. Finally, the customer should be clearly informed of his liability.

In order to achieve this result, some legislation may be desirable since not all issuers will follow such a policy unless it is required by law. The legislation might be at either the State or Federal level. And clearly, to be effective, such legislation would have to apply to travel and entertainment cards, gasoline company cards, airline cards, and other credit cards as well as to bank credit cards. Credit cards issued by banks account for less than ten per cent of the total amount of credit outstanding under all types of credit cards.

With respect to other aspects of credit-card operations, I do not see the need for additional legislation at this time.

Fortunately, the consumer not only has a right to look to legislatures and supervisors to protect his interests, but he also can count on the self-interest of those who seek his patronage. It is good business for issuers of credit cards to do what they can to make sure that people who hold their cards look upon them as a benefit and not a burden. In the particular sector of the business in which we have supervisory responsibilities, the Board has found that banks not only are ready to cooperate with us in complying with sound standards of operation, but are, themselves, seeking new solutions to old problems.

Table 1.

Credit Cards and Related Plans of Commercial Banks
(Amount in millions of dollars)

	<u>Sept. 30, 1967</u> <u>1/</u>		<u>Dec. 31, 1967</u> <u>2/</u>		<u>June 30, 1963</u> <u>2/</u>	
	Number having plans	Amount Out- standing	Number having plans	Amount Out- standing	Number having plans	Amount Out- standing
Credit card plans	197	633	385	823	416	953
Check-credit and revolving credit plans	593	483	729	522	340	646

1/ Federal Reserve study, Bank Credit-Card and Check-Credit Plans, July 1968.

2/ Federal Deposit Insurance Corp., Report of Call.

Table 2.

Bank Credit-Card and Related Plans^{1/}
(Federal Reserve Series - In millions of dollars)

	<u>Outstanding at end of month</u>		<u>Extended during month</u>		<u>Repaid during month</u>	
	<u>Credit-Card Plans</u>	<u>Check-Credit Plans</u>	<u>Credit-Card Plans</u>	<u>Check-Credit Plans</u>	<u>Credit-Card Plans</u>	<u>Check-Credit Plans</u>
<u>1963</u>						
Jan.	315	531	147	85	139	71
Feb.	317	543	120	78	113	66
Mar.	322	549	125	76	120	70
Apr.	359	570	158	95	121	74
May	378	536	152	97	133	81
June	914	600	155	93	119	79
July	945	622	172	103	141	81
Aug.	983	642	176	103	133	33

^{1/} The Federal Reserve monthly series covers about 95 per cent of the total bank credit and check-credit operations.