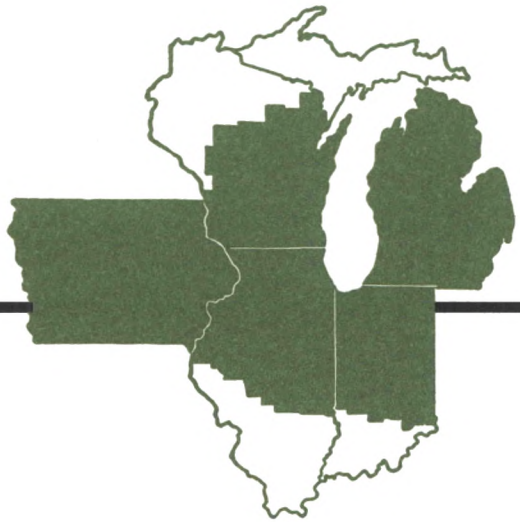
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



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Weaknesses in our financial system

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The excessive demands on our financial mechanism in recent years—caused largely by the need to finance tremendous Treasury deficits—highlight weaknesses in the nation's financial system. A few changes, however, could go a long way toward improving the performance of the system and avoiding crises.

Performance is limited by two types of weaknesses. One includes the whole array of institutional arrangements that tend to delay, and in some cases block the adjustments by which the market mechanism is supposed to realign the supply and demand for funds in a changing environment. These pose *the problem of imperfect markets.*

The other is *the problem of imperfect management.* Included in this category are errors of judgment by managers of financial institutions often resulting from outmoded practices and attitudes and from "overreaching" for profits.

There are no pat solutions for either type of weakness. But efforts to perfect the nation's financial markets and enlarge the role of the price mechanism would probably improve the adaptability of the system and increase its efficiency as an allocator of credit. Channels for the flow of funds between suppliers and users need to be improved, and the capacity of financial institutions to adjust to changing conditions needs to be increased. Actions increasing the flexibility of financial markets and enlarging the role of market prices would also strengthen competitive forces.

Rigidity in mortgages

The choking effects of imperfections in a financial market were illustrated two years ago by the drying up of the mortgage market. The shortage of mortgage funds in 1966 can be traced largely to a complex of rigidities—including the traditional form of mortgage instrument and the legal impediments to price flexibility.

Mortgage contracts as they are generally constituted put lenders in a bind when interest rates are rising. If a lender borrows short and lends long (as most financial intermediaries do) and especially if he is thinly capitalized (as most intermediaries are) he is clearly pinched by long-term, fixed-interest contracts in a time of rising rates. The squeeze is made even tighter by the absence of an effective secondary market for mortgages, except possibly for those guaranteed by FHA and VA, and they are a small part of the total.

Probably the most serious imperfection in the mortgage market results from efforts to control prices. Intended to protect homebuyers from high interest charges, both the usury laws in some states and the ceilings on interest rates on loans guaranteed by the

*Summary of an address given before the annual convention of the Illinois Bankers Association in St. Louis, May 19-21, 1968.

government have severely restricted the flow of funds into mortgages when their yields were no longer competitive with other investments. In 1966 and again in 1968, such regulations clearly worked against the very people they were intended to protect.

Weaknesses in management practices were also pointed up in the credit squeeze two years ago. The impact of the squeeze on savings and loan associations strongly suggests the need for changes in their loan commitment practices, liquidity management, and policies regarding the prices and maturities of share accounts. Changes in these areas would increase the ability of associations to adjust to new market conditions.

Homebuilding was sharply curbed in 1966 because funds were not available even to people prepared to pay the going price for mortgage credit—clear evidence of imperfections in the market mechanism and in management practices.

Another example of market imperfection can be drawn from deficiencies in the private market for agricultural credit. These have included inadequate knowledge in central credit markets regarding the quality of paper generated by many small farm borrowers, lack of facilities for packaging such paper into marketable parcels at competitive rates, and failure to gear loan terms to farmers' flow of funds.

Barriers to competitive prices

Part of the problem of imperfect markets results from government intervention. While aimed at imperfections in the market, or at counteracting their effects, government intervention has often resulted in barriers to competitive pricing.

These barriers may be more common in financial markets than elsewhere. There is the fear, for example, that unrestrained competition in banking will lead to unsound banking practices and too many bank failures. Competition must be restrained, it is said, because bank liabilities comprise most of the money supply. Tradition also identifies high interest rates as inherently bad, even though they may accurately reflect supply-demand conditions like any other price.

Consequently, government regulation has restricted the organization of new banks, changes in bank locations and the types of business of existing banks, as well as investment policies and prices offered for deposits. These and other effects of regulation, while achieving stability, have also probably reduced the efficiency of the banking system in allocating credit. This, in turn, seems to have generated pressure for additional controls on credit flows, especially when it is necessary to limit the total supply of credit, in the interest of economic stability.

Few people would question that banking must be regulated. But wherever possible government involvement should be turned toward the perfecting of the market mechanism and away from the substituting of regulation for market forces.

Price ceilings and rationing

The view that more flexible pricing in financial markets would be beneficial throws into question the prescribed maximum rates financial institutions can pay on deposit and share liabilities. These ceilings and the prohibition against interest payments on demand deposits were first imposed to help banks in sound condition forestall shifts to riskier assets—shifts, it was felt, that would result from price competition for deposits.

Prescribed ceilings did not interfere significantly with the performance of the market as long as they were well above the rates actually paid. But when market rates began

pressing against ceiling rates, the flow of funds was redirected, with less flowing to banks and other financial intermediaries and more flowing directly into market investments. The result, in 1966, was a decline in bank deposits and savings and loan share accounts.

While price controls in the form of interest rate ceilings on the liabilities of financial institutions can prevent shifts of funds between different types of institutions, they cannot force funds to flow to those institutions. Any kind of price control destroys the capacity of the market to strike equality between supply and demand, creating the necessity for a direct means of rationing if the commodity or service is to continue flowing through its normal channels.

Management—the public side

Some steps have already been taken on the public side to strengthen market forces, or at least simulate more closely the results these forces would produce if they were operating perfectly. And other steps are under consideration.

In residential mortgages, the Federal National Mortgage Association has adopted the auction technique for establishing prices on commitments to purchase stated amounts of insured mortgages. In other action, the maximum rate lenders can charge for these mortgages has been raised to bring them more in line with effective market rates.

In agricultural credit, the statutory restrictions on interest rates authorized for Federal Land Banks have been removed. And these banks have acquired some experience in writing mortgages that provide for some flexibility of interest rate. In a number of states, usury laws are being revamped to provide less interference with credit flows.

Significant changes could result from the Federal Reserve System studies of the possible benefits of a redesigned discount window. While no decision has been reached, the current thought is that this source of credit should be made more available to member banks and that the discount rate should play a larger role in determining the amount of credit provided from the discount window. Administrative surveillance would still need to play a part in the discount function, but hopefully a smaller one. Implied in such thinking is more frequent adjustment of the discount rate and a closer linkage between the discount rate and rates in financial markets.

Another move under consideration is formalization of the current policy of providing credit through the discount window to help accommodate seasonal needs of individual banks. Such a move would supplement current market flows of funds in response to seasonal pressures and, hopefully, help banks that do not have fully effective linkage with the national money market.

Management—the private side

The improvement of financial markets cannot rest with public agencies alone, however. Banks are making substantial contributions as they broaden their activities and respond to improvements in transportation, communication, business procedures, and financing practices. These developments, which are most apparent among the large banks in large cities, are being extended gradually to smaller banks in outlying areas. A faster pace in perfecting both markets and management will bring substantial benefits. Small banks in outlying areas, would benefit particularly from improvements in their linkage with national markets and in their ability to attract funds and acquire desirable assets consistent with the growth of their trade

areas. New rural demands for fairly large amounts of funds in rural areas require that many small banks develop procedures for handling larger volumes of credit. To meet these demands, small banks must grow and must develop more effective linkage with financial resources outside of their areas.

There are a number of possibilities for strengthening the ability of small banks to serve the growing needs of their communities. One involves the clothing of certain assets with liquidity they do not ordinarily have. For example, there might be ways of pooling the notes of farmers or small businesses in marketable packages or of having these notes serve as the basis for issuing marketable securities. Another applies the same technique to the marketing of liabilities issued by small banks, such as CDs, debentures, and notes. Conversely, credit surplus areas might obtain higher income on their savings by developing more effective means of participating in credits generated elsewhere.

While many small banks could benefit substantially from efforts to develop new secondary market instruments based on business, agricultural, and mortgage paper, the growth route is an even more challenging possibility, and harder to evaluate.

Structure of banking

Not all small banks can grow to optimum size for efficient operation relative to the growing needs of their customers. Yet, changes in the technology of banking, like changes in other fields, promise increased benefits from size. Recent developments in credit cards and the increased reliance on computer facilities are cases in point.

There is no intention here to propose a solution to the issue of branch and holding company banking in Illinois. Nevertheless, it is important to point out that the economic pressures flowing from technological improvements will intensify further. The variety and quality of services demanded will also rise further. And the structure of banking will continue to change.

What form banking will take in Illinois is not clear. But further thought should be given to the possible array of financial institutions that will provide the best services most efficiently. Attention should center on ways the financial mechanism can better meet the requirements of a rapidly changing economy.

Restraints on credit

While better financial markets could set the stage for less interference from regulatory authorities and strengthen free enterprise in banking, more self-reliance and self-discipline on the part of banks is also needed. In efforts to maximize profits and the mistaken belief that all problems of achieving economic stability have been solved, some banks and other establishments (financial and nonfinancial) have become accustomed to operating with very low margins of liquidity and limited ability to adjust to unexpected changes. These establishments have become more vulnerable both to normal economic fluctuations and to changes in monetary and fiscal policy. Concern about the impact of policy changes on such institutions may under some conditions restrain proper execution of policy.

Although the Federal Reserve System is committed unequivocally to providing ultimate liquidity in times of stress, the central bank was never intended as a substitute for the prudent management of individual banks. Moves to perfect financial markets will make it easier for managements of soundly managed banks to adjust to changes in the supply and demand for funds. That could be of great benefit to their communities and, in times of stress, to the nation.

Returns to labor and capital in agriculture

The government's farm commodity programs are intended to give farmers operating essentially full-time businesses about as much income as their labor, capital, and management skill would bring in another activity. After years of such programs—and billions of dollars of government subsidies—the goal of parity for most farmers is about as remote as ever. There are, however, substantial differences within agriculture itself. Many farmers manage too few resources to achieve returns comparable to nonfarmers, while others appear to be earning incomes quite comparable with nonfarm incomes.

Incomes have increased faster for farmers than for others in recent years, but the gap is still wide. The Department of Commerce estimated the median income for farm families at $4,841 in 1966, as compared with $7,582 for other families.

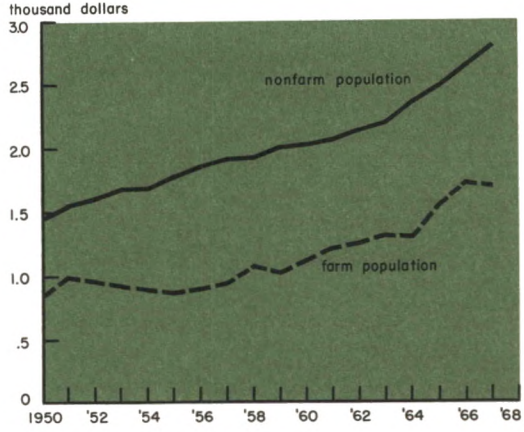
Estimates by the Department of Agriculture show a similar picture. In 1967, for example, income per person living on farms averaged just under $1,700—about 60 percent of the $2,800 averaged by other people.

Both estimates tend to understate the real income of farm families. The Department of Commerce estimated only money income, making no allowance for the value of home produced food or the rental value of farm dwellings. The Department of Agriculture tried to allow for non-money income by including estimates for the value of produce and rental of the farm dwelling. But it did not allow for other factors, such as differences in the purchasing power of money income and income tax provisions for farm and nonfarm families. These factors also affect the level of real income.

Professor Dale Hathaway of Michigan State University has estimated that farm families need about 86 percent as much money income as nonfarm families to maintain comparable levels of consumption. Even so, estimates by both the departments of Agriculture and Commerce suggest that average farm incomes would have to be substantially higher to be on a par with average nonfarm incomes.

Hathaway points out, however, that not all people living on farms operate the farm for a living and not all people operating farms

Income per person
living on farms well under that for nonfarm population



live on them. Farmers often have other sources of income, and many who are not farmers have large farm interests. Yet, when people are categorized by broad occupation or industry group, agriculture still comes off poorly in the figures.

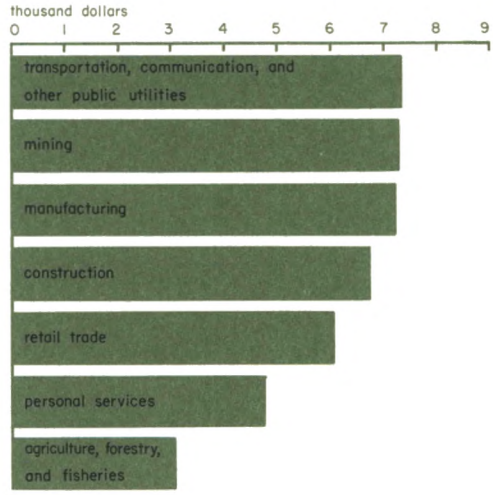
According to estimates by the Department of Commerce, money income of full-time, year-round farmers, farm managers, or farm laborers is substantially less than any other occupational group. The median income for farmers and farm managers was $3,547 in 1966, for example, compared with $6,856 for all male workers. Industry groups show much the same pattern. Median incomes for people working full-time in agriculture, forestry, and fisheries in 1966 were about 57 percent of the median for the next higher group (personal services) and 48 percent of the median for all groups.

Returns to agricultural resources

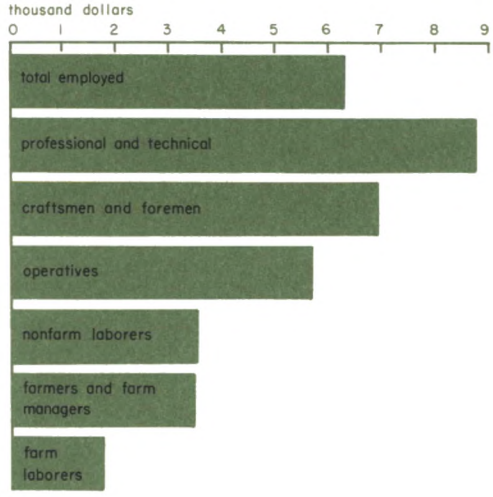
Farmers, unlike most other occupations, often have substantial financial investment in their business—mostly in real estate. Numerous studies have been made on the rate of return from farm real estate, compared with other investments. Such studies necessarily involve some fairly arbitrary estimates, since farmers' incomes do not come in neat packages that separate "returns to capital," "returns to labor," and "returns to management." The usual estimation process starts with gross income, including non-money income. When estimated production costs are subtracted, the remaining net income constitutes the farmer's current return on his capital and the labor and management (supplied by him and other members of his family). Returns to capital are usually derived as the residual left after deducting estimated charges for labor and management from net income.

Money incomes* in agriculture relatively low, whether workers grouped by:

industry . . .



or occupation



*Median money income, full-time male worker, 1966.

Despite their many shortcomings, such estimates can provide a basis for rough comparisons of returns on capital invested in agriculture with returns on other types of investments. Such comparisons indicate lower returns to capital in agriculture than in other investments. Rates of return to farm real estate trended downward after the late 1940s, according to Department of Agriculture estimates—from a fairly high 8 percent then to around 3 percent in the late 1950s. The average so far in the 1960s has been between 3 and 4 percent. Over the same period, rates of return from other equity investments, such as common stocks, have averaged higher. The average earnings-price ratio for 500 stocks, while also trending downward until recently, has fluctuated between 6 and 7 percent since the late 1950s. With the boom in business activity and rising interest rates, the difference has become even greater since 1965.

Underpaid but wealthy

Yet, despite the apparent disparity between incomes of farmers and people in other pursuits, many farm people acquired substantial net worths. In 1962, the Board of Governors of the Federal Reserve System conducted a survey of the financial characteristics of different groups. Farm operators and their families were found to have net worths twice that of other families—$44,000 on the average, compared with $22,600. Part of farmers' higher net worth can be attributed to lower levels of consumption by farm families and their tendency to invest higher proportions of income in productive assets. But a larger part can no doubt be attributed to sharp increases in the prices of physical assets owned by farmers—especially land.

The value of farm real estate is estimated to have increased about $100 billion since 1950—an annual average increase of $6 billion. That is equal to 46 percent of the average annual net farm income during the same period. In eight of those 18 years, the average annual capital gain was equal to at least half the income from farming. The rising value of farm assets constitute only "paper-profits" for most farmers—profits that would quickly disappear if farmland prices dropped. But land prices have declined only one year out of the last 18.

Other evidence

Average or aggregate figures on farm income obscure the wide range of incomes and wealth within agriculture. Sizes and types of farms are, of course, important factors affecting levels of income. Large farms often use new technology more efficiently than small farms, with the result that production costs per unit of output tend to be lower and incomes higher.

The range of incomes from farms of different sizes and types is even greater when total incomes are compared—including imputed capital gains and income of farm families from sources other than their farm. The effect of rapidly rising land prices and the resulting steep rise in the net worth of farm owners increases, of course, with increases in size of farm.

A recent study by the Department of Agriculture sheds new light on the levels of income of farm people. In the study, the actual incomes of farmers (including net income from farming and net gain in worth) were arrayed by size of farming operations. The returns to labor and capital were then compared with what equivalent resources might have earned elsewhere in the economy. Farm operators were assumed to have taken nonfarm jobs requiring comparable education and experience and 1) leased their real estate and became landlords or 2) sold their farms

and invested the equity in common stock.

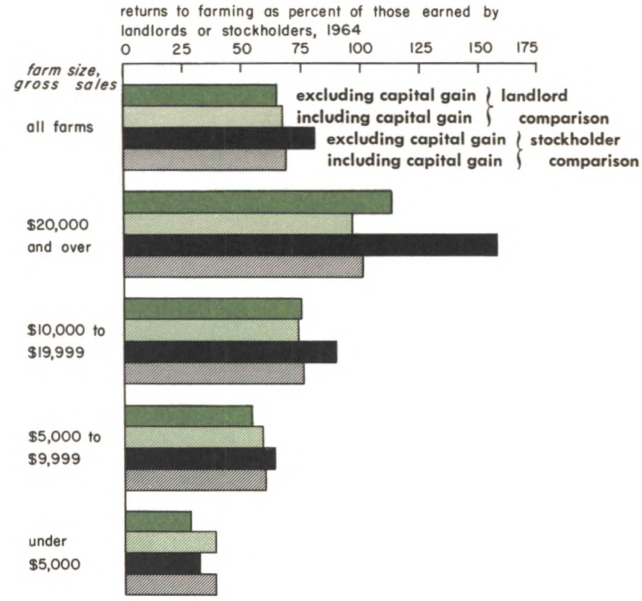
Labor earnings and returns on capital

A person's earnings from labor are generally associated with age, education, and sex. In this study, such relationships were established for use in estimating wage-equivalents for farmers operating different size farms and for other unpaid members of the family, compared with urban workers. Operators of farms with sales grossing more than $20,000 were estimated to have a wage rate about 5 percent higher than the average wage of manufacturing workers. Operators with farms at the other end of the scale, grossing less than $5,000, were estimated to command a wage about 20 percent less than the average manufacturing employee. The difference was attributed mainly to the lower education and older age of farmers on the smaller or less productive farms.

Returns to farm operators' capital were related to what similar equity could earn if the farms were leased or equivalent capital was invested in stocks. Both comparisons included provision for capital gains. For the landlord comparison, rent was established at about 6 percent of recent land values and the annual rate of capital gain was estimated at 5 per cent. Hence, the total return on invested capital to landlords ranged from 11.1 percent in 1959 to 11.8 percent in 1966. For the stockholder, dividends were estimated at an average of a little more than 3 percent. Estimates of capital gain of common stocks varied widely for individual years—from 7 to 13 percent—with the result that estimated total returns to stockholders ranged from 16.6 percent in 1959 to 11.0 percent in 1966.

Viewed in this way, the estimates show a disparity between incomes from agricultural and nonagricultural pursuits similar to earlier studies. In 1959, for example, returns to farming were roughly half what farmers could have earned by working full time off the farm and investing their capital either as landlords or stockholders.

Returns to larger farmers
comparable to those
in other occupations



In 1966, which was an exceptionally good year for farmers, some of them did considerably better than they could have as landlords or stockholders, even though farm earnings in the aggregate were still about a fifth below the earnings estimated for the landlord and stockholder comparisons. The differences were due to size of farm.

Size of farms

A breakdown of farms by size shows substantial differences between farms that may be considered "commercial" and those considered marginal or part time. In 1964 and

1966, for example, farmers with operations grossing sales of more than $20,000—an average of about $60,000—had total net earnings (including capital gains) averaging around $20,000. In most instances, that was considerably more than they could have earned, according to these estimates, if they had used their capital as landlords or stockholders and obtained off-farm employment.

Farmers selling products in this volume accounted for slightly more than 16 percent of all farms but nearly 70 percent of all farm production and government payments to farmers. Farmers with gross sales between $10,000 and $20,000 accounted for 16 percent of the farms and 17 percent of the cash receipts and government payments. Their total incomes ranged from $6,600 to $9,000 in those years—about three-fourths as much as landlords and stockholders with similar investments in 1964 and slightly more than four-fifths as much in 1966. These returns are within the range Hathaway estimated as needed for farm families to live at levels comparable to those of nonfarm families.

Farmers grossing less than $10,000 in sales did not fare nearly so well. Even in the fairly good year of 1966, farms in the $5,000 to $9,999 class had incomes equal to only about two-thirds those of the landlord and stockholder comparisons. Farmers with sales less than $5,000 did even less well. Their net incomes were only about a third those of landlords and stockholders with similar resources.

Many of the people operating these small farms are, of course, grossly underemployed. The resources under their control are usually far less than needed to keep one person fully occupied. According to the Department of Agriculture, farms with sales under $5,000 require only about 23 manhours of labor a week—little more than half-time. This is against about 109 hours—more than two and a half manweeks—for farms with gross sales of more than $20,000.

Nonfarm earnings

Although nonfarm sources of earnings were not considered — the study being intended to compare only returns to farm resources—these earnings must be included in an evaluation of the well-being of people liv-

Capital gains and off-farm income help boost total income

Gross receipts (dollars)	Number of farms (thousands)	(percent)	Returns from farming: Net income	Returns from farming: Capital gains	Off-farm income	Total income
			(dollars per farm)			
20,000 and over						
1959	325	8	11,506	4,489	1,914	17,909
1966	527	16	17,539	6,298	2,252	23,837
10,000 - 19,999						
1959	503	12	5,091	1,521	1,322	7,934
1966	510	16	6,869	2,173	1,594	10,636
5,000 - 9,999						
1959	693	17	3,160	1,061	1,545	5,766
1966	446	14	3,989	1,527	1,913	7,429
Under 5,000						
1959	2,576	63	1,114	509	2,378	4,001
1966	1,769	55	1,071	813	3,421	5,305
All farms						
1959	4,097	100	2,773	1,042	2,071	5,886
1966	3,252	100	5,049	2,013	2,738	9,800

SOURCE: USDA, "Parity Returns Position of Farmers," 1967.

ing on farms. Many farm people derive large parts of their income from sources other than their farm. More than a third of the total income of farm families was earned from off-the-farm sources in 1966.

Like farm income, off-farm income varies widely with the size of the farm operation. Farmers with more than $20,000 in gross sales had off-farm incomes of about $2,200 in 1966—roughly 11 percent of their total net income. At the other end of the scale, off-farm income accounted for more than three-fourths of the earnings of farmers with gross sales less than $5,000. This lower-income group had off-farm incomes averaging more than $3,400.

These smaller operations accounted for more than half the number of farms but less than 7 percent of the farm products. The low level of productivity on these farms hardly qualifies them as bonafide farm operations. Many are properties on which retired people live. Yet, because this group is usually included in statistics describing agriculture, commercial farms often have features attributed to them that distort the picture.

To say this is not to dismiss the problem of low agricultural income by defining it away. Certainly, programs to benefit low-income groups are needed. But for bonafide operators with strong managerial skills operating farms large enough to use new technology effectively, farming appears to provide returns comparable—or nearly comparable—to those acheived in other pursuits. Returns in agriculture clearly have been high enough to cause farmers to bid up the price of farmland and greatly increase their new investment in farming.

Contrary to popular opinion, commercial agriculture is growing rapidly. Even though the total number of farms has declined in recent years—from more than 4 million in 1959 to around 3.2 million today—the number of larger commercial farms has increased sharply. There were, for example, 60 percent more farms grossing $20,000 or more in 1966 than in 1959. However, farms grossing between $10,000 and $19,000 increased slightly, from 503,000 to 510,000 over the same period. Farms grossing under $10,000 declined a third, to 2.2 million.

Bank credit cards: saturation in the Midwest?

In less than two years, bank credit cards have become a common banking service throughout much of the Seventh Federal Reserve District—Iowa being the major exception. Almost 1,000 banks—half the insured banks in district portions of Illinois, Indiana, Michigan, and Wisconsin—offer credit card services. Because of ceilings on interest charges in Iowa, bankers there say credit card plans cannot be developed profitably.

Although bank credit card plans have been used in the district since 1952, only a handful of banks in Indiana, Michigan, and Wisconsin offered the service before 1966. In the mid-1960s, banks searching for ways to expand their services began exploring the opportunities afforded by credit cards. With the widening acceptance of credit cards generally, the growing availability of efficient processing equipment, the increasing evidence that credit cards could be profitably provided, and the rise in competition from sources both in and outside the district, banks entered the credit card field in force in 1966 and 1967.

In their drive to establish credit cards as a convenient means of financing consumer purchases, banks in the district have taken on more than 4,250,000 credit card accounts. More than 84,000 merchants accept one or more bank cards issued in the district.

Nevertheless, in March, district banks were carrying only $145 million of credit outstanding on credit card plans. Of this total, more than $75 million was held by Illinois banks, $42 million by Michigan banks, and the remaining $28 million shared by banks in Indiana and Wisconsin.

The amounts outstanding under credit cards are small compared with other forms of bank loans to individuals. Of the $5.3 billion of single payment and instalment loans outstanding in March to individuals at member banks in district states where credit cards are offered, less than 2.7 percent was loaned on credit cards. More than $2 billion was outstanding on automobile loans, and more than $1.7 billion on other types of instalment loans to individuals.

Variety in bank cards

Three types of credit card plans are used in the district. Some banks operate their own; some are affiliated with such travel and entertainment plans as American Express and Carte Blanche; and some are affiliated with other banks having their own credit cards.

Many factors influence a bank's choice of plan: the objectives of its management, the market it wants to serve, and the cost of initiating and operating different types of plans. Choices are affected by the competition in the area and whether the state allows branching and banking by holding companies.

Only 25 district banks are affiliated with travel and entertainment cards. Under these plans, banks extend credit to cardholders for the amount of their purchases on the card. These plans are the least costly for banks to introduce and operate, but the market is limited both by the cards being issued usually to only higher income groups and by their

being accepted at only a few types of stores.

Even fewer banks—eight in the district last December—operate independent credit card plans. Under these plans, a bank solicits cardholder and merchant accounts, operates an authorization center controlling large purchases and overuse of cards, processes the sales slips received from merchants, and bills the cardholder monthly. The bank accepts only sales slips generated by its cardholders, and the card can be used only with merchants that have signed up with the bank.

Most of these independent plans were developed in areas with no direct competition from other credit cards. Many are offshoots of an earlier era when credit cards were intended primarily to improve methods of handling local merchants' accounts receivable. With the development of competition and the resulting fragmentation of their markets, some independents sought affiliation with other credit card systems. While the remaining independents have strong positions in some communities, there are probably few opportunities in the district today for the successful introduction of new independent card plans.

Most district banks offering credit card service are affiliated with plans sponsored by other banks. Three credit card systems are widely used in the Seventh District—Midwest Bank Card in Illinois and Indiana, and First Wisconsin Charge Card and Michigan Bankard, respectively, in those states. Although each developed along slightly different lines, they are generally typical of the credit card systems in operation elsewhere in the United States.

The large systems

The major credit card systems in the district differ from independent credit card operations mainly in providing for the participation of many affiliated banks.

Under the First Wisconsin Charge Card and Michigan Bankard plans, affiliate banks sign up merchants in their trade areas, furnish the sponsoring bank with names of customers to be issued credit cards, and serve as initial banks of deposit for sales slips coming in for collection. The sponsoring bank—First Wisconsin National in Milwaukee or Michigan National in Lansing — issues credit cards, operates the authorization center, processes sales slips, and bills cardholders.

This arrangement allows affiliate banks to offer credit cards without incurring the considerable expense of developing systems of their own. Also unlike independent plans, it allows them to provide cards their customers can use outside the immediate trade area. It allows the sponsoring bank to expand the areas of both its credit card operations and its potential consumer lending.

Michigan Bankards are offered in Michigan by 74 banks. So far, more than 600,000 credit cards have been distributed for use at some 12,000 retail businesses in Michigan. More than 900,000 First Wisconsin Charge Cards have been issued through 145 banks, and almost 5,000 Wisconsin merchants accept the cards.

The Michigan Bankard can ordinarily be used only at businesses signed up with affiliate banks in Michigan. The only interchange agreement with another system is in the Upper Peninsula of Michigan, where sales slips are exchanged with First Wisconsin.

First Wisconsin is a member of Interbank Card, a still larger affiliate system set up to exchange sales slips nationally. Banks affiliated with the Interbank system issue cards of their own design, but all cards carry a symbol identifying them as acceptable to any bank or merchant in the system.

Merchants receiving another Interbank

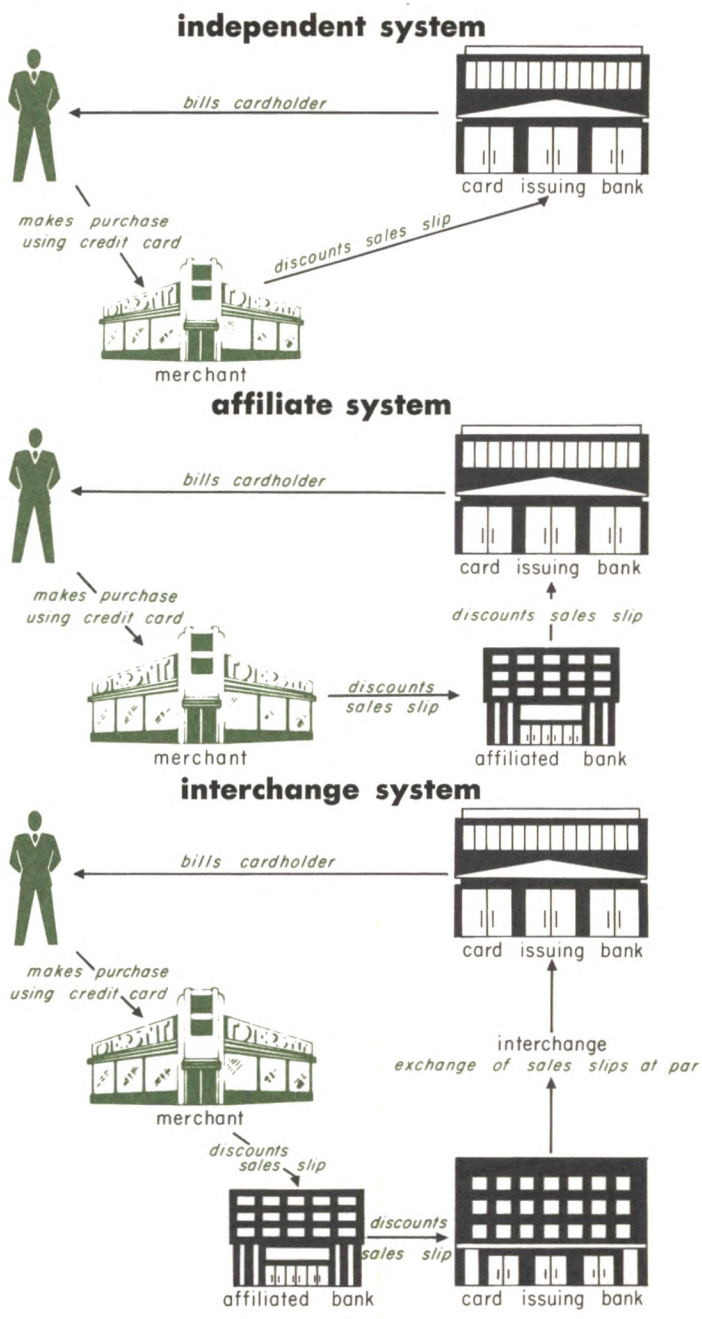
card handle it as though it were a local card, phoning the authorization center about large purchases, and depositing sales slips at their local bank. Settlement between banks is made by sending a draft on the bank that issued the card being sent through the usual clearing channels and by airmailing the sales slip to that bank.

A national exchange system makes bank credit cards more competitive with travel and entertainment cards. It also makes it possible for bank customers to purchase a broader range of services over a greater area.

A unique system

Midwest Bank Card is a regional exchange system. Headquartered in Chicago, it is unique among systems providing interchange privileges. Organized by five Chicago banks in the fall of 1966 to provide a means of competing with each other while offering merchants and cardholders the benefits of interchangeable credit cards, Midwest Bank Card is now the largest credit card system in the district and one of the largest in the country. Because of the unit banking structure in Illinois, the originating banks developed a system that provided: 1) credit cards acceptable to all merchants participating in the system but individualized for each sponsoring bank, 2) independent action for sponsoring banks, 3) arrangement for clearing sales slips between sponsoring banks, 4) opportuni-

How the systems work



ties for participation by correspondent banks, and 5) open membership to any commercial bank.

There are now 14 sponsoring banks in the system—all in Illinois, Indiana, and Michigan, and 13 of them in the Seventh District. More than 820 banks participate in the system—750 of them in the district. The system has more than 3 million cardholders and the cards are honored by more than 60,000 Midwest merchants.

Midwest Bank Card's central office coordinates activities of sponsoring banks much as a clearing house. It maintains standards for credit cards, forms, and equipment; arranges for the interchange and clearing of items; establishes requirements for merchants and banks participating in the system; and promotes technical development of the system. The office has no operating facilities and prescribes no standard price for credit card service.

Sponsoring banks operate much the same as Michigan National and First Wisconsin in soliciting affiliated banks, and the affiliates perform the same functions.

Who extends the credit?

Even though nearly 1,000 district banks provide credit cards, only 58 have credit outstanding on them. Because the bank sponsoring the card bills the customers, it also extends the credit to them—the credit being extended on the basis of revolving loans. The affiliated bank only extends credit for the few days between discounting of the sales slips and receipt of funds from the sponsoring bank.

Although this affiliate arrangement lodges most of the credit with a few large sponsoring banks, there appears to have been no substitution of credit card borrowing for other forms of consumer borrowing at affiliated banks. The effect is apparently to increase total consumer credit, rather than reduce the affiliate banks' portfolio of consumer credit.

In some cases, affiliates may participate with the sponsoring bank in the revolving credits generated by cardholders. This arrangement is not widely used in the Seventh District, but it may provide a possible avenue for future expansion of consumer lending at smaller banks.

To the extent that credit cards substitute for charge accounts at local merchants, their use may tend to reduce merchant needs for bank financing to carry accounts receivable. There are no indications, however, that the financing needs of merchants have been declining. The increased ability of small merchants to compete on credit sales may even increase business activity and indirectly increase, rather than decrease, merchant needs for local bank credit.

Competition in revolving credit

With the participation arrangements available in the district, banks of all sizes can offer credit card service without committing large amounts of resources. Banks not wanting to offer credit cards can offer alternatives in the form of check credit, overdraft, or other revolving credit plans.

These alternatives have some advantages over credit cards. Where credit cards can be used only with a participating merchant, these credit plans can be used anywhere. The only requirement is that the business be willing to accept a check. Also, if a customer needs cash, he can get it by using his credit facility at the bank.

Check credit plans provide a customer a line of credit he uses with specially prepared checks. Use of a check activates a loan that he can repay in full or on a revolving basis.

Overdraft plans are similar, except that

loans against the customer's line are activated by checks drawn against his regular checking account. If the balance in the account is not sufficient to cover the check, the customer is automatically given a loan. As with check credit, he can repay the loan when he receives his statement, either in full or on a revolving basis.

Despite the advantages of check credit, overdraft, and other forms of revolving credit, relatively few district banks have used these plans as substitutes for credit cards—an obvious exception being in Iowa, where, with no credit card services, eight banks offer revolving credit or overdraft plans. Elsewhere, 111 banks offer these alternatives to credit cards, but 79 of them also offer cards.

There are several reasons for a bank offering both check credit and credit card services. Many banks, seeing differences in the markets served by credit cards and the other forms of revolving credit, provide both to serve a wider spectrum of credit needs. Other banks consider check credit an answer to most special credit needs but also provide credit cards either to meet local competition or to be active in a service that could become increasingly important.

A number of banks began offering check credit in the late 1950s and early 1960s. By the mid-1960s, 57 offered check credit. The number almost doubled in 1966 and 1967 but still grew slower than the number offering credit cards.

Because banks can offer check credit with little expense — the processing procedures are similar to those already used for checks and loans—there may be substantial opportunities for further expansion of check credit and overdraft plans. The number of banks offering credit card plans could also increase further. However, there are few areas of the district outside Iowa where customers do not already have access to credit card service. Unless the form of credit cards and the services they provide are significantly changed, future growth in credit cards in the Seventh District will probably be reflected largely in the amount of credit outstanding, and possibly in the number of banks affiliated with existing systems, rather than in the number of banks issuing cards.

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