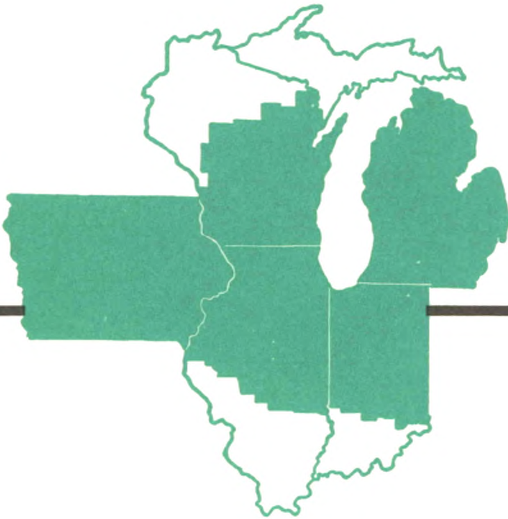
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



July 1972

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THE Trend OF BUSINESS

The economy at midyear

Halfway through 1972, it is clear that the substantial gains in economic activity foreseen by the more optimistic forecasters at the start of the year are being achieved. A rise of at least $100 billion, or 10 percent, in the gross national product (total spending on goods and services) now appears probable. This would be the largest percentage advance since 1951, the first year of the Korean War. After adjustment for price inflation, the increase in activity this year is now expected to approach 6 percent —the largest gain since 1966. Only six of the 27 years since World War II have seen larger increases in total output.

The base of the recovery has broadened in the past 18 months. In the first half of 1971, residential construction led other sectors on the road back to prosperity. In the late summer and fall of 1971, sales of autos and other consumer durable goods increased sharply. In the first half of 1972, orders for machinery and equipment accelerated. The sequence of revival in these sectors—housing, consumer durables, and business equipment—follows the pattern established in earlier recovery periods.

The momentum and breadth of the business upswing in mid-1972 was such that a growing number of analysts have become convinced that sizable gains in the third and fourth quarters are "in the bag." As a result, recent discussions of the economic outlook have shifted to consideration of prospects for 1973. Economic analysts usually do not turn to "next year" until September or later.

All major industrial areas of the Midwest are sharing in the national advance in activity, although not always to the same degree. In addition, farm income is running well ahead of last year because of sharply higher prices for crops and livestock. Prospects for substantial gains in farm income and output for 1972 as a whole are excellent. Farmer optimism is reflected in higher expenditures for farm equipment and other production needs.

Despite increases in activity, resources of manpower, raw materials, and facilities remain ample in most sectors. Except for special situations, e.g., heavy trucks, hides, and beef, most finished goods and materials are readily available. Coupled with substantial increases in output per man-hour, the absence of bottlenecks has aided the efforts of the Price Commission to hold the rate of price inflation in check.

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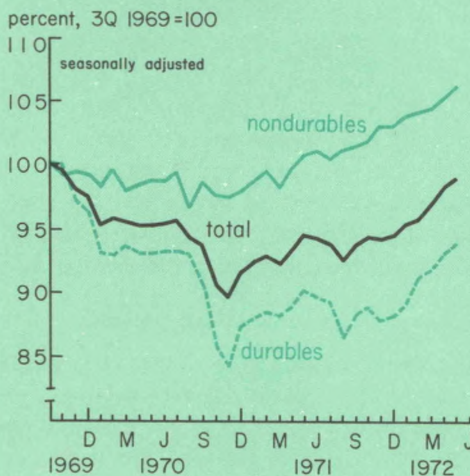
One commonly used measure of the inflation rate is the change in the "implicit price deflator." This indicator is the ratio of total gross national product to what it would have been if 1958 prices and wages still prevailed in all parts of the economy. The average value for this deflator probably will be less than 4 percent higher this year than it was in 1971. This would be the smallest rise since 1967. Last year, the deflator increased 4.7 percent. In 1970, the peak year of the Vietnam inflation, it rose 5.5 percent.

Manufacturing up sharply

In June 1972, activity in mining, manufacturing, and utilities as measured by the Federal Reserve Board Index of Industrial Production was 0.7 percent above the 1969 high. This is about 5 percent above a year earlier and represents an annual growth rate since September 1971 of about 8 percent. However, the manufacturing component of output was still 0.4 percent below the high reached in July 1969. This was a sluggish performance relative to the progress of the total economy, and relative to past experience in manufacturing. The gross national product, in dollars of constant purchasing power, was about 6 percent higher in the second quarter of 1972 than the peak rate reached in the third quarter of 1969. Manufacturing activity has lagged GNP in each previous recovery since World War II, but not to the same degree. In each cycle, manufacturing surpassed its pre-recession peak within two years, and in much less time in some cases.



Note: FRB Indexes of Manufacturing Output.

A number of factors account for the relatively poor performance of manufacturing relative to the economy as a whole since 1969:

> First, the sectors that declined the most and have recovered the least—business equipment and defense equipment—comprise a much larger share of manufacturing than of GNP.
>
> Second, in 1969, U. S. merchandise exports slightly exceeded imports. But in 1971, and thus far in 1972, imports have exceeded exports. The shift in the trade balance may have adversely affected manufacturing activity in the United States.
>
> Third, business inventories of goods rose by more than $7 billion in 1969, compared with about $2 billion in 1971, and the rate of accumulation has remained low in the first half of 1972. A faster rate of inventory accumulation in recent months would have meant a higher level of manufacturing activity.

All three of these factors depressing manufacturing output probably are in the

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process of being reversed. Output of business and defense equipment is rising. The unfavorable merchandise balance in international trade is expected to improve. Finally, inventories are almost certain to rise at a faster pace in the remainder of 1972 and in early 1973.

Durables and nondurables

The varying impact of the recession and the extent of recovery are depicted vividly in the trend of output of major groups of manufacturing industries. Total manufacturing output declined 10 percent from the 1969 high to the low point marked by the General Motors strike in late 1970. By June 1972, virtually all of the lost ground had been regained. In various industries, output dropped much more than the total in 1970, while in other industries the decline was much less. In some industries, activity now is at a new high, while others are still operating at levels well below earlier highs.

Manufactured products are classified either as durables or nondurables. The former are "hard goods" composed principally of wood, metal, stone, or ceramics. Nondurables include "soft goods," such as clothing and carpets that may have a relatively long life, as well as foods, chemicals, and petroleum products that usually are consumed soon after purchase. Durable goods typically are long-lasting, "big ticket" items that are purchased only periodically, often with the use of credit. For these reasons, purchases of durables are often postponable. Most nondurables, on the other hand, are purchased more or less continuously.

Despite strong output trends in such sectors as building materials, autos, and household furnishings, the total durable goods output was still 6 percent below the 1969 high in June 1972. Total output of nondurables goods, in contrast, declined only 3 percent in 1969-70, reached a new high in the spring of 1971, and in May 1972 was 6.5 percent above its 1969 peak.

Defense and space

Within the durable goods grouping, output of defense and space equipment was the hardest hit in the recent recession. Because reductions in arms procurement were a result of altered government policies, these cutbacks were a cause rather than an effect of the recession.

Defense and space equipment output reached a peak in September 1968, a year before the high in total manufacturing. By the first quarter of 1972, output of these industries was down one-third. Even without secondary effects, the decline in defense and space output would have meant a drop of more than 3 percent in total manufacturing. But, of course, there *were* secondary effects, as defense contractors and former defense employees were forced to curtail outlays as their incomes declined.

In recent months, defense output has begun to revive. The uptrend is expected to continue, despite the recent agreements to limit the nuclear arms race. After a long drought, a number of Seventh District firms recently have been awarded defense contracts for aircraft components and ordnance. But defense is only about half as important, relatively, in the Midwest as in the nation. Business equipment is another story.

Surge in business equipment

Midwest centers are much more concerned with the prospect for equipment purchases by civilians—both consumers and businesses—than trade in defense or aerospace. With 16 percent of the nation's population, the five Seventh District states—

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Illinois, Indiana, Iowa, Michigan, and Wisconsin—produce two-thirds of its output of farm machinery, almost half of its construction machinery, about two-thirds of its motor vehicles and TV receivers, one-third of its household appliances, and more than one-fifth of its furniture.

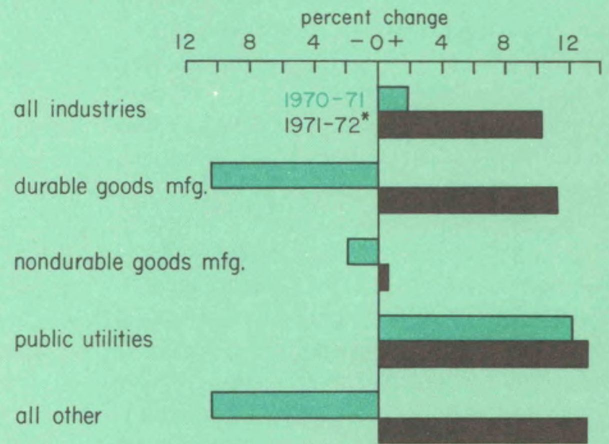
Sales and output of all major classes of consumer durables—motor vehicles, mobile homes, motor homes, appliances, TV sets, furniture, and recreational equipment—have been strong since the late summer of 1971. In part, strength in home furnishings reflects the high rate at which new dwelling units have been completed. Although consumer outlays continue strong, further substantial gains in sales of these items are unlikely in the next two or three quarters.

In contrast to consumer equipment, demand for business equipment remained sluggish through most of last year. From the 1969 peak to the low point in early 1971, output of business equipment declined 15 percent. This output rose slowly and erratically in 1971. Since last January, however, the advance has been steady and fairly rapid. In the four months ending in May, business equipment output rose at an annual rate of more than 13 percent. Nevertheless, output of these industries in May was still 8 percent below the 1969 peak.

New orders and order backlogs for business equipment have been increasing steadily this year, but the situation has varied widely from sector to sector. By far, the most vigorous expansion by class of equipment has been trucks, both light and heavy.

In the first five months of 1972, truck sales were almost 40 percent above last year's record level. Heavy trucks are especially strong, with capacity limiting availability of some major components. Producers now expect to sell a record total of 2.5 million trucks this year—up from the previous high of 2.1 million set in 1971. Most major producers of trucks and components are pressing expansion plans, because demand has outrun expectations.

Sales of farm machinery were about one-third above last year in the first five months. Certain types of construction equipment are showing similar spectacular gains. Other industries reporting substantial improvement include electric motors, materials handling equipment, and shipbuilding. Even orders for machine tools are up sharply from last year's reduced level.



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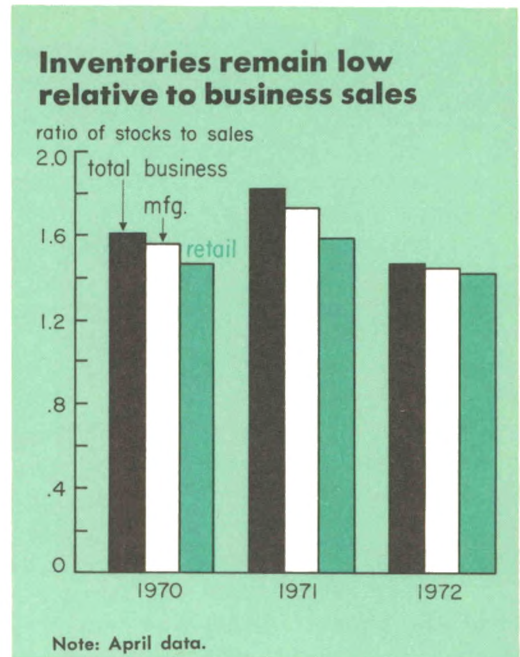
Strength in capital goods demand mainly represents replacement and modernization outlays to improve operating efficiency and product quality. Demand for heavy equipment for basic industries—steel is the prime example—is still quite slow. Demand for railroad equipment has failed to pick up, as expected, despite obvious needs for replacements. But the financial difficulties of major railroads may be alleviated by government loans or subsidies.

The uptrend in business equipment has been aided by liberalized depreciation rules and the restoration of the investment tax credit in 1971. Even without these inducements, however, improved liquidity, rising profits, and, most important, the revival of sales and orders probably would have brought a revival in business investment.



Note: April data.

Inventories remain low

While expenditures on business equipment were increasing at a faster pace in the first half of 1972, the rate of investment in business inventories remained slow. At the end of May, the book value of manufacturing and trade business inventories totaled $184 billion, up 3.5 percent from a year before, while wholesale prices were up about 4 percent. Business sales in May totaled $122 billion, up more than 10 percent from the year-earlier level.

Because business sales have increased faster than inventories, the inventory-sales ratio was only 1.51 in May, down from 1.60 a year earlier. The April-May inventory-sales ratio was the lowest since October 1966, and about the same as the average for the period since World War II. In manufacturing, the inventory-sales ratio at 1.69 in May, compared to 1.85 a year ago.

Some writers have referred to the failure of inventory investment to accelerate as one of the "weak spots" in the economy. Quite the contrary, rapid inventory building, with rising inventory-sales ratios, is inherently temporary, and, therefore, a source of instability in a business expansion. In light of recent developments, more rapid inventory building appears likely to be a growing factor in any further acceleration in general activity. The possibility exists that inventory building would become excessive and create uncertainty as to the duration of the uptrend in 1973, but in judging the nearer-term outlook, the moderate rate of inventory investment must be counted as a factor of strength.

On the basis of historical relationships, inventory investment is likely to rise from the slow pace of recent quarters to an annual rate of $10 billion or more in late 1972 and early 1973. In recent months, however,

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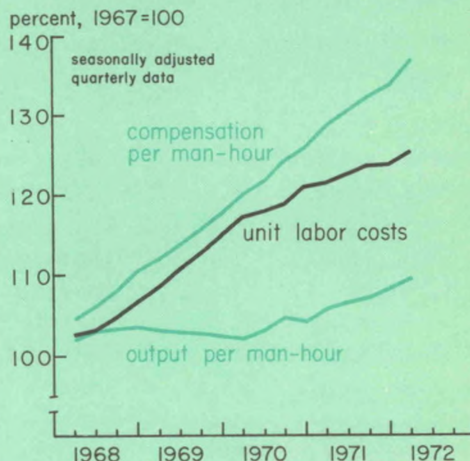
some business firms have continued policies of reducing inventories further, or at least are keeping a tight rein on expansion. Managers emphasize better inventory controls through improved planning, computer accounting, more efficient warehousing, and use of air freight and other rapid means of delivery. Some firms have been able to cut inventories because they have shortened product lines, and are offering a narrower product selection to customers.

The fact that inventory management techniques have improved is significant. But there are other considerations. Low inventories appear adequate so long as new supplies and components can be obtained from vendors on relatively short delivery schedules, which can be expected to be maintained. If order lead times continue to lengthen, however, and if shortages of certain vital supplies and components develop, additional quantities may be ordered as a precaution. This process may become cumulative and help create shortages.

Summary

As the third quarter begins, the business expansion appears to have the momentum required to sustain an uptrend through the year and into 1973. Consumer spending remains vigorous, expenditures on business equipment are increasing, and some government programs are expanding at a faster rate. With the possible exception of residential construction, activity in all major sectors of the economy is either stable or rising. Although unemployment rates remain relatively high, employment has increased steadily and rapidly since last fall.



Despite recent increases in prices of meat, hides, and some building materials, the general price level is advancing at a slower pace than at any time in the past four years. Whether price inflation will remain in check as the gap between actual and potential activity narrows in the months ahead is not clear. Rising output per man-hour is helping to offset the pressure on the price level generated by rising spending. But labor costs per unit of output have continued to climb, although at a slower rate, because average increases in compensation have continued to exceed gains in productivity. Cost-push inflation is still present, therefore, and demand pressures are building on a broad front. A testing period lies ahead.

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Bank credit cards

Millions of Americans now carry embossed plastic cards issued by banks that represent power to purchase an ever-widening range of goods and services. Bank credit cards are used to buy clothing, hardware, appliances, furniture, recreational equipment, and gasoline. They also are used to pay for restaurant meals, car rentals, airline tickets, hotel rooms, and medical services—even to make charitable contributions and to obtain cash advances. Growing acceptance of the cards by vendors and consumers has made it possible for people to acquire most of the necessities and comforts of life—and to travel throughout the nation—without handling cash or writing checks. The reckoning comes later, when the monthly bill arrives by mail from the card-issuing bank.

Bank credit cards have become firmly entrenched in the nation's payments mechanism in recent years. Moreover, the techniques developed in handling bank card credits and payments may be helping to create the "cashless, checkless" society envisaged by those who believe the existing system of payments is archaic and behind the pace of advancing technology.

Recent progress of bank credit cards has largely overcome earlier doubts about their viability—doubts that were associated with the faltering beginnings of pioneer plans in the 1950s and early 1960s. A welter of individual bank credit card plans, largely uncoordinated, has been superseded in large part by two national systems—BankAmericard (National BankAmericard Inc., NBI) and Master Charge (Interbank Card Association Inc.). The "Big Two," growing and competing side by side, have developed nationwide credit slip clearing facilities. Operating under essentially similar arrangements and regulations, the two systems[1] now include about 1,200 card-issuing banks and 8,000 agency banks. (There are about 13,500 commercial banks in the country.) They have more than 20 million active cardholders, whose cards are honored by more than 1 million merchants and businesses.

About 200 independent bank card plans are still operating, mostly quite small. The Big Two now account for more than 90 percent of total receivables outstanding. Apparently, few independent plans are being launched, and existing independent plans are still converting to the national systems.

The parent organizations of BankAmericard and Master Charge are headquartered, respectively, in San Francisco and New York. They stand ready to franchise (BA) or to license (MC) qualified banks that agree to pay fees, to file periodic reports, and to operate by broad rules and regulations. Card-issuing banks have wide latitude in their relations with cardholders and merchants and in methods of operation. Franchises or licenses are not exclusive for given territories, but entry has become more diffi-

[1]At the end of 1971, the BankAmericard group reported 246 card-issuing banks, and $1.8 billion in receivables outstanding; the Master Charge group reported 981 card-issuing banks (defined as those that hold 100 percent of receivables) and $2.3 billion in receivables.

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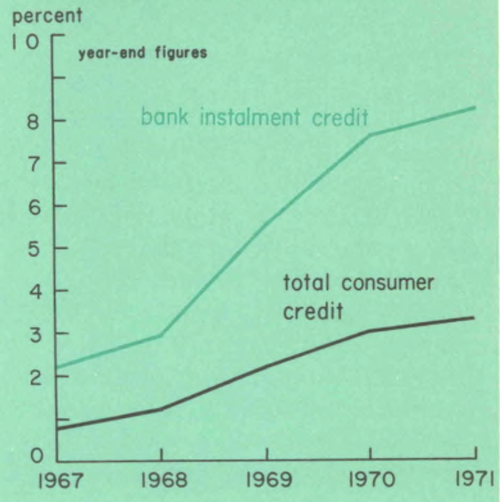
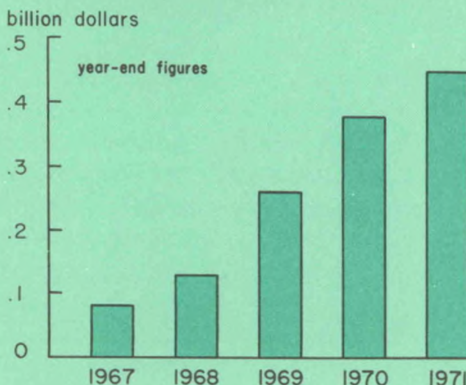
cult as card plans have blanketed the nation and card-issuing banks have gained in expertise.

Recent rapid growth

At the start of 1972, $4.5 billion of receivables were outstanding on bank credit cards, up 18 percent from a year earlier. As recently as 1967, receivables outstanding were only $830 million. Sales of goods and services and cash advances on bank cards in 1971 were about double average outstandings, or $9 billion. On the basis of results in the first half of 1972, informed bankers believe that outstandings and transactions on bank cards will increase at least 20 percent in 1972.

Total consumer instalment credit outstanding at commercial banks amounted to $55 billion at the end of 1971. Of this, 8.2 percent represented outstandings on credit cards. This proportion has increased steadily. At the end of 1967, it was only 2 percent. For card-issuing banks, the share of consumer credit accounted for by card credit is, of course, much larger than for all banks.





Outstandings on bank cards at the end of 1971 were only about 3.3 percent of all consumer credit outstanding—instalment, single-payment, charge account, and service credit. This proportion had increased each year since 1967, when it was less than 1 percent. But this comparison greatly understates the relative importance of bank credit cards in the sectors they serve.

Bank cards play a small role in such important types of consumer credit as instalment loans for the purchase of motor vehicles, mobile homes, recreational vehicles, home improvements, and bills owed to doctors and public utilities. Bank cards are closely competitive with instalment credit, revolving credit, and charge accounts provided by merchants, and with oil company and "travel and entertainment" (T&E) credit cards. Outstandings on bank cards

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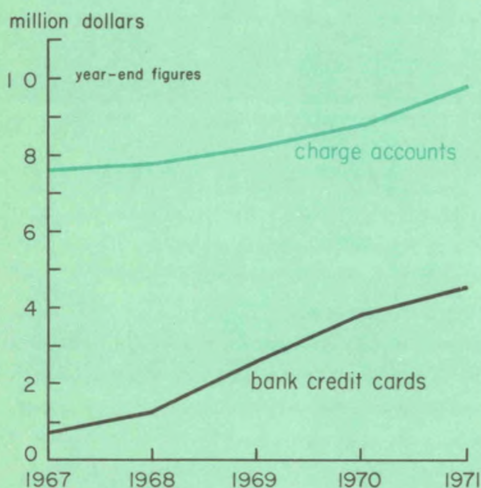
now probably account for 15 to 20 percent of all consumer credit in their scope of operations. This share has been growing yearly.

Bank cards in the Midwest

A few Seventh District banks, mainly in Michigan, established credit card plans in the 1950s. But banks on the West Coast and in the New York area led the development of large volume credit card banking. In 1966, several large Chicago banks decided to launch a cooperative plan known as the Midwest Bank Card System.

In their haste to sign up merchants and consumers, some bank card issuers, in Chicago and elsewhere, encountered many problems that were alleviated, or overcome, only through concentrated effort over a period of years. A large number of unsolicited bank cards were mailed to hurriedly drawn lists of prospects. (This practice was outlawed in the Consumer Credit Protection Act passed by Congress in October 1970.)



Losses on receivables owed by poorly screened card users and losses on fraud associated with stolen cards were heavy in the 1960s. Processing credit data and sales slips proved to be unexpectedly difficult, and expensive.

In 1969 and 1970, most of the large card-issuing banks in the Seventh District joined either the BankAmericard or Master Charge systems. At the end of 1971, 258 Seventh District banks (about 10 percent of the total) issued cards or participated in holding receivables. Total outstandings on credit cards issued by district banks were $450 million at the end of 1971, 10 percent of the national total. This ratio had not changed much in two years. Since the Seventh District accounts for about 16 percent of the nation's personal income, and about 16 percent of total bank loans and investments, the Seventh District is behind the nation in credit card use.

Credit card usage is heaviest in the San Francisco Federal Reserve District, dominated by California where bank cards got an early start and expansion was fostered by extensive branch banking. The San Francisco District still accounts for 25 percent of the nation's bank card receivables, but this is down from 50 percent in 1967. Bank card use is also relatively large in the Northeast, the South, and the Southwest.

About 80 percent of the bank card receivables in the Seventh District are held by ten banks. Some of these banks have 100 or more affiliated banks, which may be located in states other than the card-issuing bank. Affiliates may participate in a portion of the receivables generated by the cardholders of the card-issuing banks. Others

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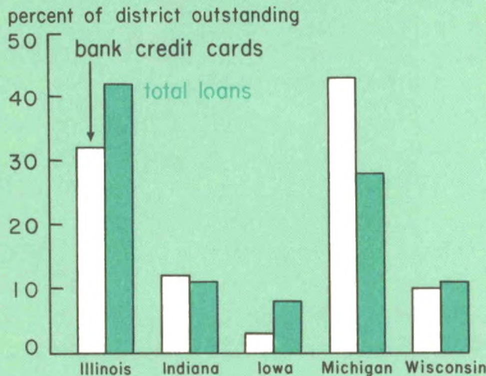

act only as agents, accepting the deposit of sales slips from merchants and forwarding these to their correspondents. Usually agent banks handle their own merchants' deposits and service these accounts, while the card-issuing banks hold and service cardholders' receivables.

Affiliated banks are important to card-issuing banks that do not have extensive branch systems. Agency banks, often too small to have their own plans, help sign and hold merchant accounts and make cash advances to cardholders—the latter function is restricted to banks. Illinois remains a unit bank state, while Indiana, Iowa, Michigan, and Wisconsin restrict new branches to a defined area in the vicinity of the parent bank.

Relations with cardholders

Application blanks for bank cards are prominently displayed on merchants' counters and in bank lobbies. In addition, banks make extensive use of direct mail solicitations. Cards are now issued only after careful credit checks, so careful, in fact, that possession of a bank card often is useful as a reference when cashing checks or obtaining other types of credit. Bank cardholders tend to have higher incomes and more education than the population as a whole. Many cardholders have two bank cards, just as they may have two or more oil cards. Banks may issue cards to individuals in any state, but they usually restrict new cards to their normal marketing areas.

Bank cards are issued for limited periods of time, usually one or two years, with expiration dates embossed on the face. Cardholders are assigned credit limits—as low as $300, but often more—which may be raised after favorable experience. The name of the card-issuing bank appears on the card (either front or back), but it may be inconspicuous. As a result, cardholders may be unaware which bank holds their accounts.

Each vendor is assigned a "floor limit" for bank card purchases. Sales in excess of this amount, generally $50, must be authorized by the bank, through a phone call. Smaller transactions are conclusive and irrevocable when the customer signs the sales slip. Authorizations are recorded against the unexpended balance of the cardholder's credit line. If a new transaction would cause a cardholder's balance to exceed his credit limit, bank officials may raise the limit. Experiments are under way with electronic "point-of-sale" authorization systems in which clerks insert bank cards into a device that communicates with the card-issuing bank's computer. Under these systems, there may be a "zero limit," and all transactions are added immediately to the cardholder's outstanding debt. Although expensive to install and operate, a nationwide network of such devices would greatly increase the ef-

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ficiency and improve the security of the bank card systems.

Cardholders are billed monthly. The bill lists the amount due, the billing date, and other pertinent information, and is accompanied by the sales slips or itemized listing of transactions. If a cardholder pays his bill within the grace period, usually 25 days from the billing date, no finance charge is incurred. Cardholders may receive free credit for two months or more from the date of transactions because of the time consumed in processing, transporting, and billing sales vouchers.

Cardholders wishing to use the revolving credit feature of their bank cards may make monthly partial payments, which may be an amount related to the credit line or a percentage of the outstanding balance, usually 5 percent. Debts outstanding beyond the due date are assessed a finance charge, commonly 1.5 percent per month, or an effective annual rate of 18 percent. Laws in some states limit the finance charge on such debts to lower rates. Most banks maintain they cannot operate card plans profitably at rates lower than 18 percent because of the relatively low average outstanding amount. For one thing, credit criteria must be more restrictive and volume, therefore, is curtailed. As a result, bank cards typically have not flourished in states with low rates.

The average outstanding balance on active bank cards is about $250. The most profitable cardholder accounts, of course, are those with large balances that are carried beyond the grace period. In most banks, less than 50 percent of sales volume becomes subject to finance charges.

Bankers find it difficult to make profits on card plans, overall, when the proportion of cardholders paying accounts within the grace period is substantially more than half. "Sophisticated" cardholders, especially those who use cards for business expenses, not only pay on time, but delay payment as long as possible, in the same manner as corporate disbursing officers who seek to economize on cash balances.

Relations with vendors

Bank cards have been a boon to many merchants, especially smaller firms, who are now able to sell on credit to a much larger number of potential customers and compete with larger stores. Similar advantages are offered by the travel and entertainment cards, but those plans do not usually provide immediately available funds, and discounts paid by merchants are larger than for bank card plans.

To compensate banks for their services, vendors are charged discounts on the dollar volume of their bank card sales that usually range from 1 to 6 percent, with an average of less than 3 percent. The amount of the vendor's discount is determined by negotiation. The discount percentage may depend partly on sales volume, but the most important factor is the average size of the sales tickets. The higher the average sales ticket, the lower the rate of discount. Costs of handling a sales ticket for 50 cents are as large as for one of $50.

Merchants and other businesses that honor credit cards usually continue to maintain accounts at banks whose customers they had been prior to entering the plan. If they accept two bank cards, an increasingly common practice, vendors usually must maintain at least two bank accounts.

Sales slips are deposited by vendors with other receipts in their banks. If the bank is an agency bank, it sends the slips to its correspondent who sorts and distributes the slips to the various card-issuing banks on

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which they are drawn. Sales slips of the major plans are treated as cash, i.e., immediately available funds. Risks on the receivables are borne by the card-issuing bank, which may share receivables and risks with agency banks that are also "participating" banks.

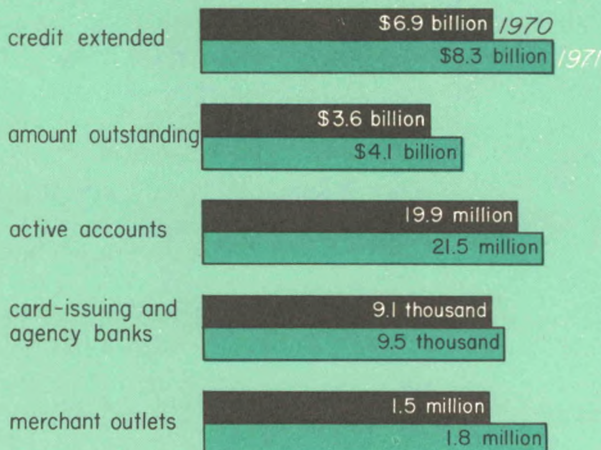
Vendors have certain obligations. Aside from getting authorizations for sales over the floor limit, they should check customers' signatures with those on the card, and compare card numbers with those appearing on the current revoked card list.

Because bank card credit slips are the equivalent of cash, many participating merchants find them preferable to customers' checks or to regular charge accounts. Expenses of credit investigations, bookkeeping, and collections are assumed by card-issuing banks. As a result, smaller merchants frequently have abolished their own charge systems in favor of bank-cards, even though this action may have offended some old customers. Because sales slips are nonnegotiable, there is little danger of loss through theft or robbery.

Card-issuing banks do not set a minimum size for sales tickets, but some vendors may set a lower limit—such as one dollar. Overall sales tickets on bank cards average about $17 to $18. Gas station sales slips average about $8, while airline ticket sales average about $100.

The development of travel and entertainment cards and oil company credit cards paved the way for the Big Two bank card plans to operate on a national scale. Today, stations of almost all major oil companies, most hotels, and most higher-priced restaurants honor bank cards. Also, the cards are widely accepted by variety stores, discount department stores, and specialty stores, and many service establishments.

Conspicuous among the types of stores that do not accept bank cards are large department stores and grocery chains. Executives of large department stores believe their own credit arrangements preferable overall, and help hold their customers. Moreover, they value the opportunity of sending "stuffers" to customers along with bills. In the case of large food chains, pre-tax profit margins are about 2 to 3 percent of sales, and a discount could not be passed on to customers unless the practice were general. (Food chains frequently honor bank cards for non-food items.) Nevertheless, experiments are under way in a number of department stores and food stores to determine whether card plans



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would add to profits by increasing customer purchases. If the average sale is increased by credit cards, merchants may be able to absorb discounts without raising prices.

One problem for vendors honoring credit cards is the possibility that customers may demand a discount for cash. This practice is frowned on by the banks, who maintain that it violates the Truth-in-Lending Act under which terms of trade must be publicized and available to all customers.

Profit and loss

Are credit card plans profitable to banks? The answer varies, but a majority of bank card plans, when fully costed, probably are not in the black at the present time. If card plans are profitable, are they as profitable as the bank's operations as a whole? The answer is generally "no." Is the potential profitability of bank card plans promising? The answer is an emphatic "yes" from some bankers and an equally emphatic "no" from others.

Responses to a survey of commercial banks taken by the Federal Reserve System in August 1971 showed that only 25 of 82 banks that reported earnings and expenses on credit cards calculated a profit on this operation in 1970. Several banks indicated that they either could not determine profitability precisely or did not believe their results could be compared with the experience of other banks because of differences in accounting. Most of the banks responding to the survey reported, however, that they expected either higher profits, or lower losses, in 1971. Some banks believe that they are doing better on bank cards in 1972 than in 1971. Significantly, only two banks (not Seventh District banks) in the survey reported they intended to drop their card plans.

Profitability of card plans depends in part on the time the plan has been operating because start-up problems are inevitable. Total volume is important to achieve economies of scale, but profitability also depends to a larger degree on efficiency of operation, and on the characteristics of cardholders and vendors serviced.

Like other corporations, banks are not required to report profits or losses by departments. However, profit-minded bank executives often insist on such evaluations for internal purposes. In the case of card plans, there are important differences in the way bank accountants treat revenues and expenses.

On the expense side, bank accountants differ as to the manner in which they charge departments for space, how they allocate overhead, and how they determine the rate at which departments are charged for funds used. On the revenue side, banks differ in the manner in which they credit operations of various departments with compensating balances, and the extent to which credit is given for new business brought in to other departments (or business retained) because of card plans.

Contrary to a widespread impression, bad debt write-offs do not account for the bulk of card plan expenses. Such charge-offs amounted to 3 percent of average outstandings in 1970. Within this total, fraud losses were about 0.6 percent nationally. Costs of funds, which may vary widely with money market conditions, and operating expenses are much larger than charge-offs for most bank card plans.

Start-up costs probably doom any new card plan to losses for the first two or three years or more. As volume expands, lists of cardholders are "shaken down," and costs of operations are brought under control—especially the processing of the huge volume

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of sales slips—profitability may be achieved.

Through a variety of techniques, banks have been able to reduce substantially "mail fraud" losses resulting from cards being stolen before they reached the intended recipient. Lost or stolen cards (other than mail fraud) will always be a problem, but here again techniques have been developed to minimize unauthorized charges. Prompt notification is, of course, essential. Use of pictures on cards to prevent unauthorized use may become general, but improvements in techniques of manufacture and cost reductions are essential.

Federal law has limited a cardholder's liability for use of a lost or stolen card to $50 since early 1971. But most banks had been absorbing such losses before the legislation, unless there was evidence of extreme carelessness or collusion. Banks typically do not press cardholders for the $50 liability on lost, stolen, or improperly used cards.

Card-issuing banks are unanimous in their attitude toward prosecutions for fraud. They are prepared to push charges to the full extent of the criminal law.

Improving the profit picture

Banks have been able to improve profits or cut losses on card plans by screening applicants more carefully, by eliminating inactive consumer accounts, and by eliminating low-volume vendors. In formulating these policies, there is a continuing balancing of risks against possibilities of gains. New equipment and improved operating methods have reduced costs of handling sales slips.

To increase credit card income, banks can raise vendor discounts when competitive conditions (and the Price Commission) permit. Another method is to raise loan limits of established card users to increase average outstandings. Some banks are experimenting with programs that combine check credit plans, overdraft privileges, and instalment loans in a single package. If the average credit outstanding for individual cardholders can be raised to $400 or $500, profits would increase dramatically.

Profitability might be increased by charging annual fees for cards (as travel and entertainment plans do) or by shortening grace periods. But such steps would be taken reluctantly because of the possibility that card usage would be adversely affected.

Currently, banks operating card plans are concerned about legislation pending in Congress that would require changes in their operations, especially in billing practices, that would be costly. They believe enforcement of some proposed consumer protection measures could increase operating costs and reduce potential profitability of card plans.

Further growth assured

Most of the largest banks, and many smaller banks, have committed substantial resources—funds, facilities, and manpower —to bank card programs. Credit outstanding on the cards has accounted for a steadily growing share of total consumer credit, and this trend probably will continue.

Certain large banks have examined the possibilities of card plans periodically and have decided not to enter the field. They foresee no substantial profit opportunities in these plans. Usually, these banks maintain that a credit card program does not fit their plan of operations and that their customers—consumers and vendors—do not desire this service. Despite the holdouts, it is apparent that credit card banking is firmly established on a broad national base. Virtually all qualified consumers and vendors can obtain these services from one or

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more local banks.

Bankers who are enthusiastic about the future of bank cards expect the plans to assume a growing role in consumer finance. They foresee a time when most consumer-oriented services of banks—loans, deposits, and checking—will be consolidated with the bank card plan as the focal point.

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