FEDERAL RESERVE BANK OF SAN FRANCISCO

Monthly Review

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March 1972

Record Income—Despite Squeeze

...Western banks report a new high in net income, but they incur rising interest costs and falling rates of return on assets.

Lumbermen's Phase II

...Lumber and plywood prices resume upsurge, reflecting housing demand, production problems, and various pricing dilemmas.

Nation-Spanning Credit Cards

...Credit cards are now firmly established, after a half-decade of rapid growth and achievement of full-scale national coverage.

Editor: William Burke

Record Income—Despite Squeeze

IN 1971, net income of Twelfth District member banks rose 8 percent to a record $520 million. This increase exceeded the previous year's rise in net, largely because of capital gains realized on the sale of investment securities and a nominal credit on extraordinary items. In fact, pre-tax income (before securities gains and extraordinary items) actually declined 7 percent, as District banks were caught by sharply reduced profit margins between operating costs and revenues.

Income results varied widely among individual banks. The largest banks reported a relatively smaller increase in net income after securities gains, and a relatively greater decline in income before taxes and security transactions, than other District banks.

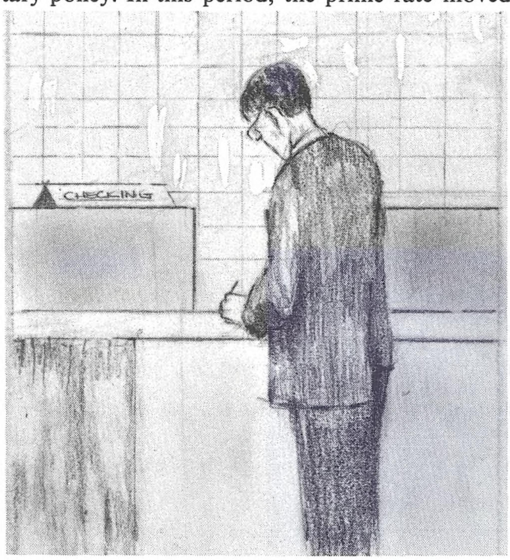
An easier monetary policy led to a 15-percent expansion in banks' earning assets last year, but at the same time that policy contributed to a sharp decline in interest rates and thereby limited the rise in banks' revenues. (Still, it provided the opportunity to secure capital gains from selling securities on a rising market.) Cost pressures from deposit-interest expense meanwhile were particularly severe, since Western banks during most of the year maintained a 4 1/2-percent rate on regular savings deposits, in the face of a massive savings inflow and a decline in their rate of return on loans and securities. Increased provision for loan losses also contributed to banks' higher costs.

Total revenues rise slowly

Total operating revenues climbed to $4,806 million in 1971—a 5-percent rise over 1970's record high but less than half the percentage gain realized in that prior year. A large expansion in total bank credit—a result of last year's more accommodative monetary policy—contributed to this increase, but sharp declines in loan rates and security yields served to limit income growth.

Interest payments and fees on loans declined slightly below the 1970 level last year, but still accounted for two-thirds ($3,192 million) of total operating revenue. Although loan portfolios expanded 12 percent, this was not enough to offset the effect of a 60 basis-point decline, from 8.30 to 7.70 percent, in the average rate of return on bank loans.

While loan rates averaged much lower last year, there was a good deal of see-sawing over the course of the year. During the first quarter, rates generally dropped sharply; there were six reductions in the prime business-loan rate, amounting to 150 basis points in all, as well as reductions in mortgage and consumer-loan rates. In the next four months, the banks' rates edged back up in response to accelerated credit demands, a rise in money-market rates, and a less expansive monetary policy. In this period, the prime rate moved



up from 5 1/4 to 6 percent, and mortgage rates rose from 6 3/4 to 8 percent. The rate increases ceased after mid-August, however, and the subsequent downward movement brought rates by year-end close to the early spring lows.

Loan revenues were affected favorably by changes in the composition of loans, because of interest-rate differentials among loan categories. Business borrowing, which accounted for three-fourths of the loan increase in 1970, was responsible for only one-fifth ($908 million) of the increase in 1971. Corporations took advantage of the lower interest-rate structure to refinance their short-term bank debt through flotations of bonds and an increase in equity capital. Reduced capital spending and limited inventory expansion also contributed to the business sector's relatively modest demand for bank credit.

On the other hand, real-estate loans accounted for almost one-third of the 1971 loan increase, compared with only one-tenth of the prior year's gain. Record housing demands combined with lower rates and greater availability of funds led to very strong mortgage volume, so that District banks expanded their real-estate portfolios by $1.4 billion. Since prime mortgage rates are higher than prime business-loan rates, this shift in loan composition tended to have a favorable impact on loan revenues. Moreover, District banks recorded a substantial ($953 million) increase in consumer loans, in contrast to a decline in the previous year. Effective rates on consumer loans are much higher than other loan rates, so this shift also tended to limit the decline in the rate of return on loan portfolios as a whole.

Income from sales of Federal funds—interbank lending of reserves on deposit with the Federal Reserve Bank—declined by 15 percent from the 1970 level. The volume of sales was one-third greater in 1971 than in 1970 (daily average basis), but even this substantial increase in volume could not offset the steep reduction in the Fed-funds rate which followed the easing of reserve pressure on banks. The rate of return on such sales dropped from an average 8.79 percent in 1970 to 5.26 percent in 1971.

Security income soars

Interest and dividends on investments (excluding trading accounts) jumped 26 percent last year,

CONSOLIDATED REPORT OF INCOME OF TWELFTH DISTRICT MEMBER BANKS
(millions of dollars)

	1971P	Dollar Change	Percent Change 1970-71	Percent Change 1969-70
Operating income—Total	4,806.1	+205.0	+ 4.5	+ 10.6
Interest and fees on loans	3,191.7	− 8.8	− 0.3	+ 7.2
Income from Federal funds sold	102.2	− 17.4	−14.6	+ 21.4
Interest and dividends on investments (excluding trading accounts)	802.6	+165.0	+25.9	+ 16.0
Trust department income	128.4	+ 12.2	+10.5	+ 8.2
Service charge on deposit accounts	211.0	+ 3.7	+ 1.8	+ 2.5
Other operating income	370.2	+ 50.3	+15.7	+ 46.5
Operating expenses—Total	4,135.1	+257.6	+ 6.6	+ 12.8
Salaries, wages and benefits	1,200.6	+ 91.6	+ 8.3	+ 12.2
Interest on deposits	1,778.9	+182.6	+11.4	+ 13.5
Interest on borrowed funds (including Federal funds purchases)	176.6	− 67.8	−27.7	+ 11.0
Net occupancy expense, furniture, equipment, etc.	327.4	+ 37.0	+12.7	+ 12.3
Provision for loan losses	120.2	+ 33.6	+38.8	+ 17.0
Other operating expenses	531.4	− 19.4	− 3.5	+ 12.4
Income before income taxes and securities gains or losses	671.0	− 52.6	− 7.3	+ 0.1
Applicable income taxes	161.4	− 61.7	−27.7	− 10.3
Income before securities gains or losses	509.6	+ 9.1	+ 1.8	+ 5.5
Net securities gains after taxes	10.0	+ 12.3	—	+ 85.8
Extraordinary credits after taxes	0.4	+ 18.7	—	−1,307.7
Net income	520.0	+ 40.1	+ 8.4	+ 5.1
Cash dividends paid	247.5	+ 19.6	+ 8.6	+ 3.7

P=Preliminary

and amounted to one-sixth of District-bank revenue. However, this source of revenue accounted for four-fifths of the total *increase* in operating income, compared with one-fifth of the 1970 increase. This rise in income reflected a 21-percent expansion in security portfolios, as the banks, in the face of modest loan demand, invested funds made available by the large inflow of time deposits in U.S. Treasuries and other securities.

Yields on securities declined sharply in 1971, along with other interest rates, but the decline was more rapid at the short end of the maturity spectrum. Thus, the spread between short and long-term rates increased, with 3-month Treasury bill rates falling 80 basis points, compared with a 48 basis-point reduction for long-term bonds and a 53 basis-point decline for 3-5 year maturities. In these circumstances, District banks were able to limit the reduction in their average rate of return by investing more heavily in the higher-yielding intermediate and longer-term maturities. As a result, the average rate of return on Treasury security portfolios fell only 5 basis points to 5.37 percent, despite the much greater decline in yields generally.

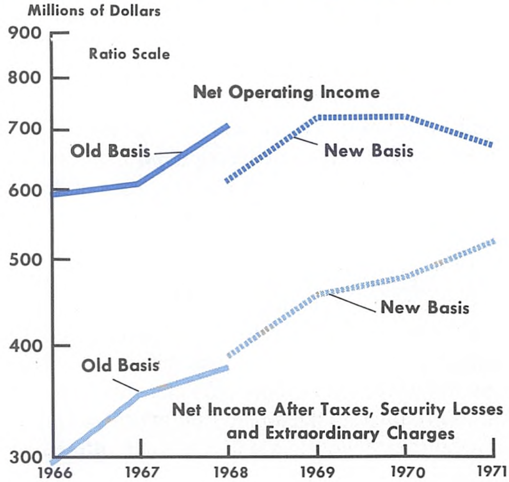
Western banks also invested heavily in municipals, particularly in the first half of the year, with acquisitions being about evenly divided between warrants and short-term notes and bonds. The higher yields realized on bond holdings contributed to a 14-basis-point rise in the average rate of return on banks' municipal portfolios.

Revenue from other sources displayed divergent movements. Income from banks' trust operations rose more rapidly than in 1970, with an 11-percent gain. On the other hand, service charges on deposit accounts increased more slowly than in earlier years, probably because few (if any) new types of charges were imposed during 1971. "Other" operating income meanwhile rose at a 16-percent rate. In this miscellaneous category, trading-account income (a very volatile component) declined 20 percent, but net earnings from foreign branches and Edge Act subsidiaries increased 37 percent, reflecting the accelerated pace of District banks' foreign operations.

Total costs rise moderately

Total operating expenses of District member banks reached $4,135 million in 1971, for a 7-percent increase over the 1970 level. With their strenuous efforts to control costs, banks were successful in slowing the rate of increase to half the 1970 pace. Yet costs still rose at a faster rate than revenues, thus narrowing profit margins.

Record net income based on security gains. . .operating net falls



Wages and salaries (including employee benefits) increased by 8 percent—substantially under the 12-percent rise of the previous year. Benefit costs again increased at a faster pace than wages, but the differential was much less than in other recent years. The holddown on wages and salaries was apparent even though banks added 5,974 new employees—a 5-percent increase—to staff 169 new branch offices and conduct other expanded operations. The actual number of District member banks declined by 8 in 1971, but this change resulted mainly from bank mergers and did not materially affect staffing requirements.

Deposit expense climbs

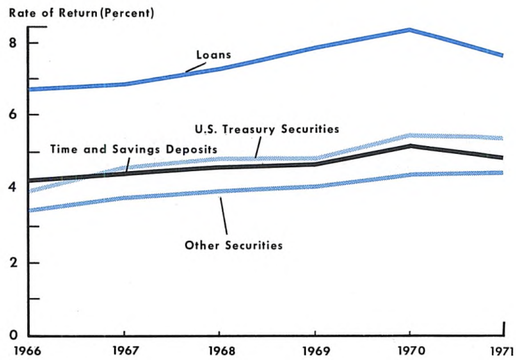
Interest paid on time-and-savings deposits rose 11 percent, accounting for over two-fifths of total expenses and for over two-thirds of the total *increase* in operating expenses. The banks' inability to stem rising interest costs was the major factor contributing to the narrowing of profit margins. A 17-percent growth in time deposits meant an additional $5.7 billion in interest-bearing deposits, and raised the ratio of time to total deposits to over 58 percent. This expansion more than offset the effect of the decline in the average interest paid on deposits, from 5.15 to 4.79 percent.

On many categories of time deposits, particularly large denomination CD's and smaller consumer certificates, banks lowered their rates in line with declines in other money rates. But on regular passbook savings, which account for close to half of their interest-bearing deposits, Western banks continued to pay the ceiling rate of 4 1/2 percent through March. Many banks reduced the rate to 4 percent from April through July, but the 4 1/2-percent rate again became universal during the remainder of the year. This reluctance to cut the rate of interest paid on the largest deposit category reflected the very competitive environment for individual savings, particularly the banks' fear of broadening the already unfavorable spread between their own rates and the rates offered by savings-and-loan associations.

Cost of borrowed funds drops

The downward trend in money market rates markedly affected the banks' cost of borrowed funds, as the expense of Federal-funds purchases (borrowings) and of securities sold under repurchase agreements dropped by 18 percent. The volume of purchases increased by one-fifth—to over $2 billion on a daily-average basis—but the already noted decline in the Fed-funds rate resulted in lower total expense despite the higher level of purchases. The fact that District banks purchased more Federal funds in 1971 than in the prior year

Deposit rates fall, but so do rates of return on earning assets



did not imply greater borrowing needs, because a larger proportion of these funds were resold.

Interest on other borrowed funds declined very sharply, to just $5 million. This reflected a reduction in member-bank borrowings from the Federal Reserve Bank, to $27 million in 1971 from $72 million in 1970 (daily average) plus reductions in the discount rate from 5 1/2 percent to 4 1/2 percent over the course of the year. The expense of Eurodollar borrowings—shown in "other" operating expense—also declined. Banks substantially reduced the volume of Eurodollar borrowings as other less-costly sources of funds became more readily available, while the average rates paid on such funds declined from 8.14 to 6.35 percent for 3-month maturities.

SELECTED OPERATING RATIOS AT TWELFTH DISTRICT MEMBER BANKS

(percent)

	1971P	1970	Change
Earnings Ratios:			
Return on loans (including Federal funds)	7.59	8.32	- .73
Return on U.S. Treasury Securities (excluding trading accounts)	5.37	5.42	- .05
Return on other securities (excluding trading accounts)	4.46	4.40	.06
Income after taxes and before securities gains (losses) to equity capital plus all reserves	10.24	10.56	- .32
Net income to equity capital plus all reserves	10.45	10.13	.32
Cash dividends to equity capital plus all reserves	4.97	4.81	.16
Interest paid on deposits to total time deposits	4.79	5.15	- .36
Time deposits to total deposits	58.50	55.49	3.01

P=Preliminary

Note: These ratios are computed from aggregate dollar amounts of income and expense items. Capital accounts, deposits, loans and securities items on which these ratios are based are average Call data as of December 1970, June 1971 and December 1971; and as of December 1969, June 1970 and December 1970.

District banks took advantage of lower money-market rates to issue $150 million in capital notes and debentures, bringing their total outstandings to $471 million. Because of this expansion in capital indebtedness, interest paid on capital notes and debentures rose by 44 percent during the year.

Net occupancy expense of bank premises, along with furniture and equipment expense, increased about as rapidly in 1971 as in 1970. The rise in these expense items reflected the cost of new branch offices and some new headquarters' buildings, as well as the continuing need for new electronic equipment.

Most District banks made maximum provision for possible loan losses last year because of financial difficulties encountered by some regional and national customers, including several very large firms. Until these problem credits have been worked out, banks can be expected to continue carrying large provisions against loan losses. This expense item rose to $120 million in 1971 and was the fastest growing (39 percent) cost item last year. *Actual* loan losses reached $167 million, for a 52-percent increase over the already high 1970 level. One side effect of the large transfer of funds from undivided profits to reserves for bad-debt losses was a lowering of Federal income-tax requirements for 1971.

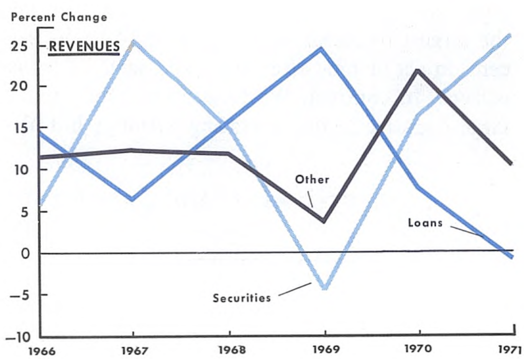
Shifting income trends

With the rise in operating expenses exceeding the rise in operating revenues, District banks' income before taxes and security transactions fell to $671 million, substantially below the 1970 figure. However, applicable income taxes declined even more, as the result of lower earnings, removal of the surcharge, and reinstitution of the investment tax credit. Consequently, after-tax operating income (but before security gains or losses) reached $510 million, modestly higher than in 1970.

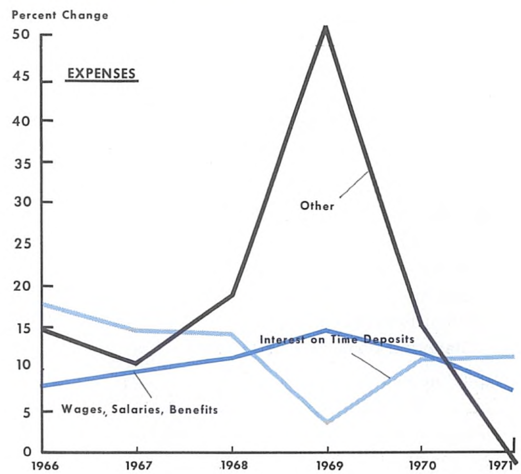
Higher security prices enabled many banks, particularly in the first quarter, to realize capital gains on sales of investment securities, and provided an opportunity for some banks to alleviate situations where they had been "locked in" at the low security prices prevailing in 1969 and early 1970. Thus, District banks reported a gain in this category (after tax effect) in 1971, compared with a nominal loss in the prior year. In extraordinary charges, banks reported a fractional net credit in 1971 as opposed to a significant loss in 1970.

After adjustment for all these items, District banks' net income reached $520 million in 1971, or $40 million above the 1970 figure. Banks also increased their capital accounts by $404 million, with new capital notes and debentures and an increase in common stock accounting for about half of the total gain. The ratio of income after taxes (but before security gains) to equity capital plus reserves declined in 1971, due to higher equity capital and reserves. However, increases were reported for two other key ratios—net income (after security gains) to equity capital plus reserves, and dividends to equity capital plus reserves.

Revenue side shows modest drop in loan but surge in security income



Expense side dominated by rising time-deposit costs



Income trends varied only slightly by size category, judging from comparisons of the 19 largest member banks—those with total deposits of $500 million and over—and all other District member banks. (In 1970, by contrast, the "other" category recorded a somewhat better performance than the large-bank group.) The largest banks had a larger percentage decline in net operating earnings, but their reduction in applicable income taxes was greater, so they reported a slightly higher rate of gain in income after taxes and before security transactions. Yet, because of relatively smaller securities gains, these large banks reported a smaller rate of gain in their net income.

Considerable variation showed up in state-by-state comparisons, however. Alaska, Nevada and Utah recorded increases in pre-tax operating earnings—the only states to do so—and also recorded the largest increases (ranging from 14 to 36 percent) in net income after taxes and security transactions. In contrast, Washington not only had a large decrease in net operating earnings but also reported the only decline in income, reflecting the economic difficulties which beset that state last year.

Further squeeze in '72?

Western banks continued in a profit squeeze in early 1972 because of falling rates of return on assets, although they tended to delay somewhat in following prime-rate reductions on business loans instituted by the big Eastern banks. In mid-March, the prime rate in effect at Western banks remained at 4 3/4 percent—the high-end of the two-tier prime rate existing at that time—before being raised to 5 percent on April 4. In late January and early February, moreover, many Western banks reduced their mortgage rates, to a range of 6 1/4 to 7 percent for prime conventional mortgages, and in February some banks also cut their consumer rates by approximately 1/2 of a percentage point.

With yields on short-term securities also declining in the early months of the year, banks suf-

SELECTED ASSET AND LIABILITY ITEMS OF TWELFTH DISTRICT MEMBER BANKS
(millions of dollars)

	As of December 31, 1971 P	As of December 31, 1970	Dollar Change	Percent Change
Gross loans and investments[1]	65,638	57,239	+ 8,399	+14.7
Federal funds sold[1]	2,435	1,946	+ 489	+25.1
Other loans	43,957	39,291	+ 4,666	+11.9
Commercial and industrial	16,393	15,485	+ 908	+ 5.9
Real estate	12,648	11,207	+ 1,441	+12.9
Loans to individuals	8,380	7,427	+ 953	+12.8
Agricultural	1,615	1,455	+ 160	+11.0
U.S. Treasury securities[2]	7,182	5,881	+ 1,301	+22.1
Other Securities[2]	11,191	9,187	+ 2,004	+21.8
Securities in trading accounts	873	934	− 61	− 6.5
Total assets	81,662	71,307	+10,355	+14.5
Total deposits	68,016	60,238	+ 7,778	+12.9
Demand	27,769	25,737	+ 2,032	+ 7.9
Demand IPC	22,840	21,320	+ 1,520	+ 7.1
Total time and savings	40,247	34,501	+ 5,746	+16.7
Savings	17,804	15,759	+ 2,045	+13.0
Other time IPC	14,689	12,613	+ 2,076	+16.5
State and political subdivisions	6,084	4,751	+ 1,333	+28.1
Capital accounts	4,781	4,377	+ 404	+ 9.2

[1] Including securities purchased under resale agreements
[2] Excludes securities in trading accounts
P=Preliminary

fered too from a lower rate of return on security investments. A reduction in holdings also served to lower revenues from securities, but on the other hand, a February-March expansion in loans (other than Federal funds) more than offset a January decline and had a favorable earnings effect.

In view of the severe early-1972 squeeze on profit margins, most District banks lowered the interest paid on regular passbook savings from 4 1/2 to 4 percent, effective February 1. Despite bank fears of competitive inroads from savings-and-loan associations, their inflow of savings deposits in February fell off very little from the high January pace, and they then rose sharply in March. As the rate reduction applied to all outstanding savings deposits, it helped considerably in reducing deposit-interest expense. Banks meanwhile continued to exercise stringent controls on other expense items, helped along by Pay Board ceilings on wage-and-salary expense—banks' second largest cost item.

If current forecasts are correct in projecting continued strength in mortgage demand and increased business and consumer spending, there should be a significant expansion in bank-credit demand as 1972 progresses. An overall expansion in private credit demand, accompanied by heavier Government financing, could result in even sharper increases in interest rates than have already occurred in the past several weeks, and could help increase the rate of return on earning assets. If the spread between the rate of return received on earning assets and the rate paid on deposits can be increased from the narrow range prevailing during most of 1971 and early 1972, banks should experience better operating earnings as the year goes on.

Ruth Wilson

PERCENT CHANGES IN SELECTED EARNINGS & EXPENSE ITEMS
TWELFTH DISTRICT MEMBER BANKS 1970—1971 P

	19 Largest Banks[1]	All Other
Operating Income—Total	+ 4.3	+ 5.8
Interest & fees on loans	- 0.7	+ 3.7
Income from Federal funds sold	-13.0	-25.2
Interest & dividends on investments (excluding trading accounts)	+27.7	+11.0
Operating Expenses—Total	+ 6.5	+ 7.9
Salaries, wages & benefits	+ 8.5	+ 6.7
Interest on deposits	+11.3	+12.8
Interest on borrowed funds (including Federal funds purchases)	-28.3	-16.7
Provisions for loan losses	+42.6	+17.6
Income before income taxes & securities gains or losses	- 7.6	- 4.7
Applicable income taxes	-29.3	-15.9
Income before securities gain or losses	+ 2.0	+ 0.7
Net Income after securities gains & extraordinary credits	+ 8.1	+10.1

[1]Includes all District member banks with total deposits of $500 million & over as of December 1971.

P=Preliminary

Lumbermen's Phase II

When the 90-day price freeze came to an end last November, most lumber and plywood items were selling below their ceiling prices, mainly because prices had been artificially inflated during the base period (July 16 to August 15) by the impact of a major rail strike. Since November, however, prices have increased sharply because of rising stumpage prices, seasonal production problems, and the nationwide boom in housing demand. By February, wholesale price indexes for softwood lumber and softwood plywood were almost 7 percent and 12 percent above their respective November levels, and by mid-March prices were even higher.

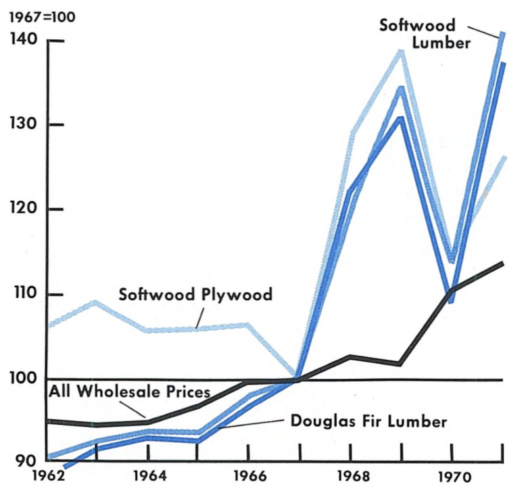
In those instances where demand has been especially strong—in particular, plywood and ponderosa-pine boards—market prices are now well above ceilings. By March 17, the price for a key plywood grade, quarter-inch interior-grade sanded plywood, had risen 19 percent above the ceiling price to $102 per thousand square-feet, and the price for No. 3 pine boards had risen about 24 percent above the ceiling to $132-$136 per thousand board-feet.

The question arises as to how it was possible for certain lumber and plywood prices, under Phase II regulations, to rise so sharply above the so-called ceiling levels. The answer has to do with the workings of the Price Commission's term-limit pricing (TLP) regulations affecting large forest-products producers, as well as the cost problems and lack of regulation of smaller-sized producers.

A number of small and medium-sized mills, which do not need Price Commission permission to raise prices, boosted quotations for certain items above ceiling levels in January. They justified this action on the basis of the rising cost of logs, since timber, being an agricultural commodity and therefore exempt from price controls, had risen in price both during and after the 90-day freeze period.

Five major forest-product companies (sales over $100 million) later posted above-ceiling prices in accordance with TLP agreements with the Price Commission. Under these agreements, each company agreed to limit the average price increase on its entire product-line to 2 percent over the succeeding 12-month period. (The entire product line in most cases encompasses not only forest products but also a diversity of unrelated products, such as mobile homes.) In return, each received permission to raise prices on individual items as much as 15 percent without specific approval for each price change. Once having obtained this clearance, the major firms raised their quotations on plywood and ponderosa-pine boards to prevailing market levels, which meant in some instances a full 15-percent increase. Several other major producers, not under TLP agreements, meanwhile raised their prices by varying amounts as they received approval from the Commission.

Lumber and plywood prices rise to new heights in 1971 housing boom

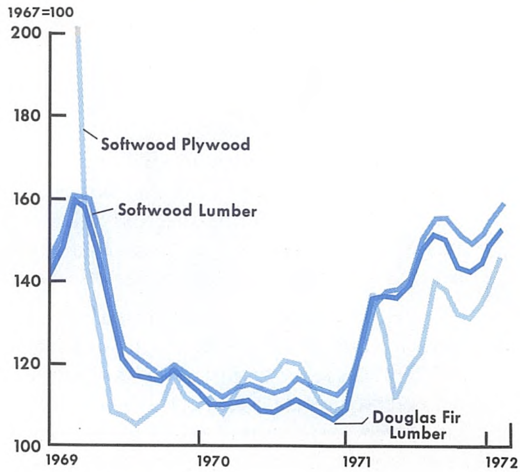


Then, during the first half of March, prices moved upward across the board—for Douglas fir (which had weakened during February) as well as for plywood and ponderosa pine. Most of these increases apparently were initiated by small and medium-sized producers, since the major producers presumably had already posted their maximum permissible increases.

However, lack of Price Commission authorization forced a certain number of firms in each size category to maintain ceiling prices during this time period, in some cases because their profit margins were already above base-period maximums or their particular costs had not risen. These firms, flooded with orders for items that they had been selling at below-market prices, then began to sell off the inventory they had on hand and stopped accepting new orders for the affected items. This action diverted business to mills with higher prices and firmly established their quotations as the effective "market" prices.

At recent Price Commission meetings in Portland and San Francisco, those companies operating at ceiling levels complained that they could not compete for timber with other firms which already had raised prices by as much as 15 percent. Their arguments were influential in causing the Commission to lower the maximum individual price increases permitted under new TLP contracts from 15 to 8 percent, and the *average* permissible increase from 2.0 to 1.8 percent. This new limit will not improve their competitive position relative to firms operating under existing TLP agreements, however, but it could prevent their position from deteriorating with respect to other major producers.

Price upsurge resumed in recent months, despite Phase II controls



Producers who have been caught with low ceilings on particular items have taken several different steps to gain some form of price relief. For example, they have switched production to more profitable items, switched sales to the export market (where ceiling regulations do not apply), and channeled more production through company-owned distribution outlets. However, some of these moves have simply created tighter supply situations and greater price pressures in markets where demand already is very strong.

Yvonne Levy

Publication Staff: Karen Rusk, Editorial Assistant; Janis Wilson, Artwork.

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Proposed Regulatory Changes

The Board of Governors of the Federal Reserve System proposed two changes in its regulations covering member-bank reserve requirements and Federal Reserve check-collection procedures, in order to provide more equitable and more efficient banking services. These changes would involve putting all banks—city and country, member and non-member—upon the same payment basis as regards Federal Reserve check collection, and would involve giving member banks of equal size equal reserve requirements.

The Board proposed restructuring reserve requirements applicable to net demand deposits of Federal Reserve member banks, by instituting a system of requirements based on the amount of such deposits regardless of the bank's location. (Regulation D) Further, it proposed requiring all banks served by the Federal Reserve's check-collection system (again regardless of location) to pay for checks drawn upon them, in immediately available funds, the same day the Federal Reserve presents the checks for payment. (Regulation J)

Under the present system, Federal Reserve "city banks"—typically the larger banks in larger cities—must maintain reserves equal to 17 percent of the first $5 million of demand deposits and 17 1/2 percent of demand deposits exceeding $5 million, while all other member banks must maintain 12 1/2 percent reserves on the first $5 million and 13 percent on the remainder of their demand deposits.

Under the revised system, all member banks would have reserve requirements of 8 percent on the first $2 million of demand deposits, 10 percent on the portion from $2 million to $10 million, 13 percent on the portion from $10 million to $400 million, and 17 1/2 percent over $400 million. (No reserve changes would be made for time-and-savings deposits, bank-related commercial paper, or Eurodollar borrowings.) The net reduction in required reserves would amount to almost $3 billion, or roughly one-tenth of total required reserves. About $2 billion of reserves would be absorbed, however, by the other proposed change, which would make universal the already widespread practice of prompt settlement for checks presented through the Federal Reserve's clearing system.

Faster settlement of check transactions could reduce by two-thirds the Federal Reserve's "float," which amounts to more than $3 billion (daily average basis) for the nation as a whole. This float arises when payment is delayed a day or two and banks have the temporary use of funds for which the Federal Reserve has not yet received payment. Some banks might be hit harder than others by the check-collection change, but Federal Reserve discount facilities could be used to keep individual member banks from being unduly affected. In addition, since the proposed changes would result initially in a net release of reserves to the banking system, Federal Reserve open-market operations could be utilized as needed to neutralize the effects on monetary policy.

Nation-Spanning Credit Cards

CREDIT CARDS, after a half-decade of rapid growth, are now a firmly established banking service. As recently as 1965, only a relative handful of banks (generally smaller banks) operated credit-card plans, but then a rapid expansion began, leading to effective national coverage by 1968. Today there is no doubt of the wide public acceptability of credit-card plans and of their place in the national financial scene. In the future, moreover, credit cards promise to introduce elements adaptable to a more sophisticated electronic-transfer system.

In September 1967, when the phenomenon was first surveyed, 197 banks offered plans with $633 million in outstanding balances. By mid-1971, 1,514 banks offered plans with $3,895 million in outstandings. The fastest growth occurred in the 1968-69 period, when nationwide coverage was first achieved, but credit cards then began to enter a period of consolidation. Nonetheless, between mid-1970 and mid-1971, in the face of a sluggish economy, outstandings jumped 28 percent and the number of active accounts increased by 19 percent.

Areas of growth

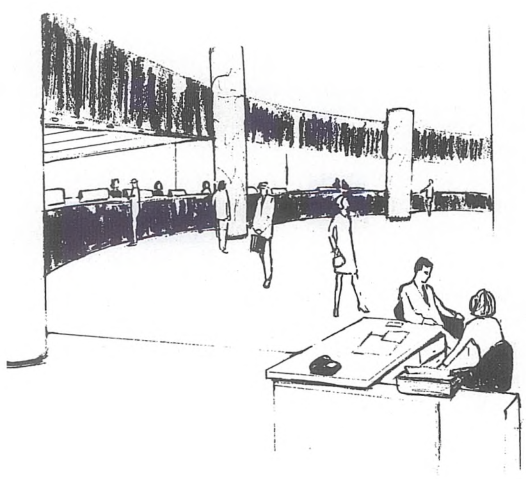
The West dominated the credit-card scene in earlier years; Twelfth District banks accounted for 47 percent of total outstandings in 1967. Outstandings of these banks tripled to $894 million by mid-1971, but with the rapid growth elsewhere, the Western share last year dropped to just 23 percent of the total. (By way of contrast, Western banks accounted for only 14 percent of total bank assets in each of those years.) In mid-1971, the Northeast (including the Boston, New York and Philadelphia Federal Reserve Districts) held $974 million in outstandings, while the South and Southwest (the Richmond, Atlanta and Dallas Federal Reserve Districts) held $1,003 million in outstandings. Banks in the Midwest and Plain states held $1,024 million last year.

Despite the rapid expansion, credit cards still represent only a minor part of total bank credit and total consumer credit. In mid-1971, they accounted for a little over 1 percent of all bank credit and for 9 percent of bank consumer lending. At the same time, they accounted for 3 percent of total consumer credit (bank and non-bank).

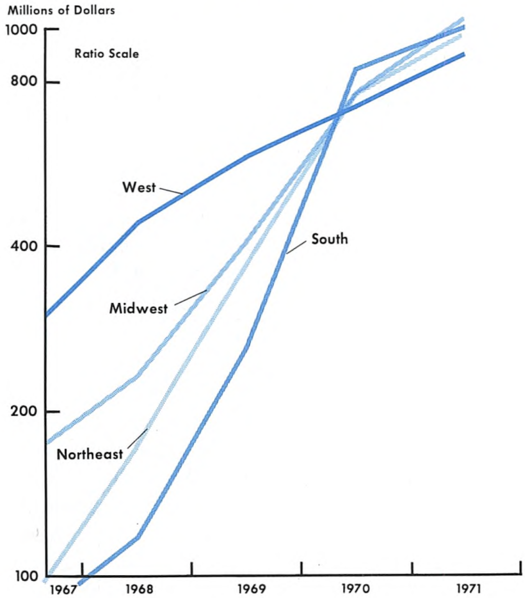
A more significant comparison can be made by measuring credit-card credit against the yardstick of total consumer revolving credit—a field dominated up to now by retail charge accounts and department-store revolving-credit plans. Bank cards now make up 23 percent of revolving-credit outstandings, accounting for one-half of the total increase in this field during the last three years. This shift is not surprising, since credit cards have been expressly designed to supplement or replace credit formerly carried by retailers.

What cardholders get

The rapid acceptability of credit cards bears witness to their usefulness to consumers. They provide a convenient charge-account service, with



Credit cards enter consolidation phase, after very rapid early growth



revolving-credit privileges, at a large number of retail outlets. On the basis of national and (more recently) international interchange plans, they can serve as travel-and-entertainment cards—and without the annual membership fee required for regular T&E cards. They can be used in most cases to borrow up to $500 in cash, with repayment on a revolving basis if desired. They can provide protection in some cases against overdrawn checking accounts, through the use of automatic cash advances when insufficient funds are in the account.

The cost of credit cards to consumers depends primarily on how they are used. Consumers can avoid all charges if they use them only for charge purposes, and then pay the total due within a grace period of twenty-five days after billing. Just under one-third of all accounts avoid interest charges by repaying in full. Customers who do not repay all of their outstanding balances within the grace period are subject to charges on the remaining balances ranging up to 18 percent a year. Those who use cards for cash advances are subject to other charges, which in California vary between 2 and 4 percent of the loan, but further charges are not applied until the end of the succeeding grace period.

Although the nominal rate of interest is often taken as a measure of the cost of credit-card borrowing, the effective rate is usually lower. Unlike most bank loans, the interest is not applied the moment the customer obtains the use of bank funds; instead, charges may not begin for up to two months, depending on the billing cycle, and the cost is correspondingly reduced. Typically, banks average only 13 percent on card outstandings instead of 18 percent, because of the effect of the grace period as well as the tendency for balances to be paid off to avoid charges. Nevertheless, a person who stays continuously in debt is paying interest charges approaching an 18-percent annual rate.

Banks and cardholders

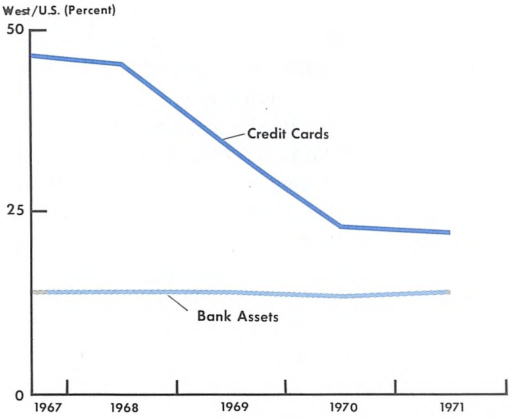
With credit cards as with other forms of credit, banks try to ensure proper utilization on the part of consumers. Banks typically issue new cards with an initial credit limit of $300, and raise the limit only after satisfactory experience. In mid-1971, the average balance per active account was only $227, and not all of this was subject to current interest charges.

In addition, the average cardholder generally has the education and the income to handle credit successfully. In a 1970 Federal Reserve survey, about 30 percent of all surveyed households possessed credit cards, but card usage increased sharply with income and education. About 44 percent of the college educated and 44 percent of households with over $10,000 in income utilized credit cards, and those groups also showed the most rapid expansion of card usage over time.

Some abuses have occurred, but mostly because of the mass mailing of unsolicited cards, especially during the rapid expansion of 1968-69. At that time, most banks starting new plans resorted to mass mailings to obtain enough cardholders to make their plans acceptable to merchants, and also to match the plans of competitor banks. But in the aftermath, many of these banks had to absorb heavy credit and fraud losses because of their overemphasis of marketing objectives and their underemphasis of normal cost controls.

Unsolicited mass mailings were made illegal by Congress in 1970, but the practice had already decreased in importance because of the sharp reduction in the number of new plans. Cards are currently issued by application only, and are sub-

Western banks still maintain predominance, despite falling share



ject to the usual credit standards. The 1970 legislation also set $50 as the maximum legal liability of a cardholder in the case of loss or theft, and thus removed one concern of cardholders, although most (but not all) banks had been absorbing such losses all along.

What merchants get

Banks are just as active in signing up merchants as they are in signing up cardholders. The two national interchange systems had over one million merchant members on their rolls in mid-1971. The total, although containing some duplications, indicates the broad coverage of bank plans.

Merchants find bank cards advantageous because of their relatively low cost in relation to retailers' plans. Nationally, banks charge an average 3 1/2-percent discount on credit-card sales, and they also shoulder bad debt and fraud losses. Some merchants, especially travel-oriented merchants, find the honoring of bank cards to be a useful way of attracting customers. Most airlines and oil companies accept bank cards as well as their own, simply because of the number of cardholders who are potential customers.

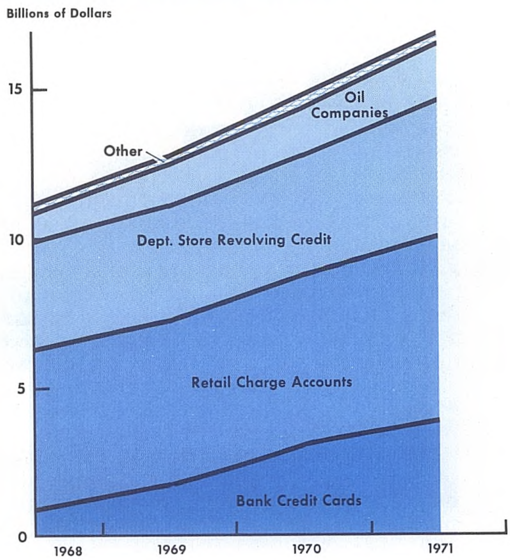
As in the case of many other competitive devices, some merchants encounter higher net costs when they are forced by competitive pressures to enroll in bank-card plans, where the extra business generated fails to compensate for the cost of discounted sales drafts. More typically, however, merchants are happy enough to replace their own credit with bank credit offered at a 3 1/2-percent average discount, particularly since most bank-card transactions occur in lines where credit has been traditionally available.

Most large national and regional department-store chains still are holdouts against bank cards. These chains are usually large enough to maintain their own revolving-credit plans, with appropriate computer installations and the like. Furthermore, they wish to retain the marketing advantages provided by charge-customer mailing lists as well as control over their own credit policy—not to mention the income from interest on such plans. Supermarkets also remain holdouts, partly because of banker reluctance to encourage credit purchases of food, but mainly because of their own small-sized markups, which are usually too low to bear the cost of discounted sales drafts.

Two systems

One of the most striking features of the credit-card scene is the consolidation of most bank-card plans into two nationwide systems—National BankAmericard Inc. (NBI) and Interbank Inc. Until 1966, almost all card plans operated independently of each other. But in that year, Bank

Bank cards now account for one-fourth of total revolving credit



of America announced plans for the national licensing of its BankAmericard, which hitherto had been limited to California. In response, several other large banks announced the formation of a second coast-to-coast card system, Interbank.

With national interchange, the cardholder can use his card for purchasing goods in areas served by other banks. The interchange arrangement provides a means of transfering sales drafts from the merchant's bank to the cardholder's bank for collection, and thus of transforming local cards into national cards. The interchange arrangement increases the usefulness of cards to customers, and the greater number of potential users makes cards more attractive to merchants. Also, it encourages the formation of new plans and increases competitive pressures on individual banks to hasten the introduction of new plans of their own. The development of national card systems thus has helped bring about the sharp upsurge in card usage.

The form of the two interchange systems has stabilized in the last two years, and has centered around the use of two national cards, BankAmericard and Master Charge. In the process the two systems have grown to parallel each other, with BankAmericard adopting a cooperative form of organization similar to Interbank, and Interbank in effect adopting a standard card design.

Similarities

NBI, the corporation owned by the various BankAmericard issuers, was established in 1970 to replace Bank of America in the licensing and coordinating role for BankAmericard. In the first years after 1966, Bank of America had the expertise lacked by the new licensees and thus dominated BankAmericard. But this situation was temporary. Licensees soon began to operate on their own, and several large banks with fully operational plans adopted BankAmericard as a response to competitors' Master Charge cards, so that Bank of America eventually relinquished its central role and NBI took over its organizational responsibilities. Consequently, NBI and Interbank are now organized along the same corporate lines, except that NBI remains a somewhat more closely coordinated system.

Meanwhile, the Master Charge name and design were adopted by most Interbank members to ensure the increased nationwide acceptability of that

Role for Small Banks?

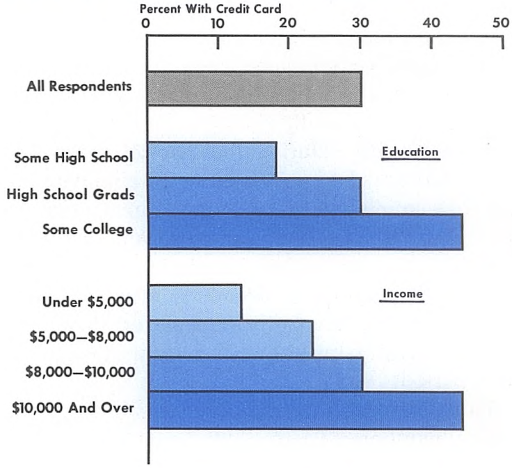
Large banks have dominated the credit-card industry from the outset. Nonetheless, small banks are now playing an increasing (and profitable) role, both as operators of their own plans or as agents for larger plans. Banks with less than $100 million in deposits accounted for less than 5 percent of credit-card outstandings in 1967, but between 1967 and 1971 their share of the total increased to over 10 percent. More than 1,000 banks in this category operate plans—and according to a recent Federal Reserve survey, the smaller plans of this type (with outstandings under $1 million) frequently are more profitable than the larger ones.

The present organization of the industry offers considerable scope for the entry of small banks with their own plans, principally because national interchange removes geographic barriers previously limiting small banks to local markets. In addition, the association form of organization provides small banks with access to computer and related systems on an equal basis with other banks, with costs allocated in proportion to card activity. A large bank frequently will offer a card system to a smaller bank on a fee basis, providing central accounting and billing services and issuing cards in the smaller bank's name.

More commonly, however, small banks act only as agents of other banks or of card associations; indeed, almost 90 percent of the 9,400 banks involved in credit-card operations fit into this category. The agent-bank status permits smaller banks to offer credit-card services to merchant customers, accepting their sales slips but not carrying their outstanding credit. This removes any exposure to credit losses, although it also removes any possibility of profit on revolving-credit balances. In addition, many agent banks, especially in the unit-banking states of the Midwest, offer both BankAmericard and Master Charge to participating merchants.

The agent-bank arrangement has allowed the interchange systems to expand their coverage both geographically and numerically in many areas. In unit-banking or limited-branching states, a card-issuing bank otherwise would find it difficult to expand beyond its immediate market.

Bank credit-card usage increases sharply with income and education



plan. Originally, many Interbank members issued their own cards, each with a distinctive design but with only a small lowercase "i" within a circle to identify the card as an Interbank card. However, this feature was not distinctive enough to ensure the ready acceptability of such cards everywhere. Relatively quickly, most Interbank members adopted the Master Charge name and design for their cards. BankAmericard, having a standard design from the beginning, avoided the recognition problem.

The Master Charge card was developed by the Western States Bankcard Association, which began operations in 1967. Four large California banks—the Bank of California, the present Crocker National Bank, United California Bank and Wells Fargo—organized WSBA as a cooperative association open to others as well as to the four founders.

WSBA adopted the Master Charge design to avoid identification with a single bank or region and thus the design became readily acceptable by other banks in Interbank. Moreover, through the development of the association form of organization, WSBA provided a model for similar organizations in other regions. The association format permitted the sharing of costs, and made it easier for new entrants to issue cards. Since all but one of these associations joined Interbank, the example of WSBA turned out to be a key element in the spread of Interbank.

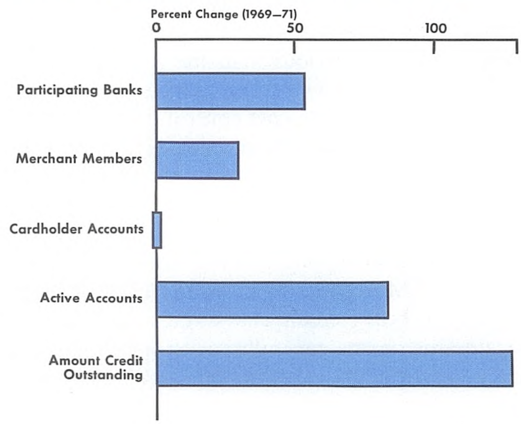
WSBA now services banks in seven Western states from its San Francisco operations center. The association provides the centralized computer-accounting system essential for large card operations, and it supplies or contracts for other services which individual banks would have difficulty supplying themselves. The member banks—not the association—retain control over credit approvals and the rates charged to consumers, but all customer transactions flow through the association's central accounting system. National interchange is then obtained through the association's membership in Interbank.

Independents

Independent bank plans without interchange features are now quite rare, especially after the recent linkup of the largest such plan (Chase Manhattan's Unicard) with NBI. Two Western banks still offer independent plans, First National of San Jose—which boasts the West's oldest such plan (1953)—and Walker Bank and Trust of Salt Lake City. Most banks that formerly offered independent plans have now joined in one or the other of the two national systems, so as to obtain the marketing advantage of national acceptance. However, the few remaining independents have special marketing situations where interchange is not essential, or they wish to avoid the increased credit risks involved with interchange facilities.

With the nation now blanketed by NBI and Interbank, the next logical step is an international

Despite expansion, banks control costs by reducing inactive accounts



spread of interchange systems. At present, both BankAmericard and Interbank have reciprocal arrangements with foreign banks to accept cards. Foreign banks associated with BankAmericard issue their cards with their own plan name at the top, but with a BankAmericard blue-white-gold overlay. Foreign banks associated with Interbank usually issue cards with their own design for domestic use but provide Master Charge for customers travelling to this country.

How profitable?

For most banks credit cards are now a profitable operation, but this was not always so. Until 1971, losses were more common than profits, largely because of unexpectedly heavy startup costs, but also because of overestimated revenues.

In many cases, the original revenue from card plans was somewhat lower than anticipated, because planners failed to realize that new cardholders frequently pay bills within the grace period to avoid interest charges. Revenue experience gradually improved over time, however, as cardholders built up both their balances and the percentage of those balances on revolving credit.

In addition, earnings were hurt in a few states by legislation reducing interest ceilings to 12 percent from the more common 18 percent. In such cases, banks tried to make up for the loss of revolving-credit charges by raising the merchant discount. This approach was not completely successful, however, because competitive pressures tended to force merchant discounts down rather than up. The average discount, now 3 1/2 percent nationally (and 3 percent in California), compares with the 5- to 6-percent rate commonly charged on local credit-card plans as late as 1967.

Still, the cost problems of the early card plans were much more serious than the revenue problems, largely because of the emphasis on merchandising rather than cost control in those early days. With the mass issuance of cards and the mass sign-up of merchant members, a heavy volume of work was generated. This justified the use of expensive computer facilities for handling all the new paperwork, but it also created high operating costs. Moreover, the mass approach opened the way to heavy credit and fraud losses, partly because merchants generally are more willing to accept plastic credit cards than paper checks, with the bank (not the customer) absorbing losses.

Controlling costs

By now, however, the majority of banks have brought costs under control, and have begun to earn profits on their credit-card operations. Better operating procedures have been instituted, computer systems have been debugged—and in particular, obvious credit risks have been removed from bank files. During the last several years, banks have made a strong effort to eliminate inactive accounts, so as to reduce direct costs as well as fraud exposure. Between mid-1969 and mid-1971, the two national card plans showed no increase in number of accounts, although their active accounts rose by 83 percent and their outstanding credit jumped by 128 percent in the same time period.

Banks have also taken many steps to curb the use of unauthorized cards. Merchants have always been required to obtain bank authorization for sales over a specified limit. But authorization systems now operate on a 24-hour basis in most areas, and the newer systems are "online" to computers to provide more accurate and faster information on the status of card accounts. In addition, banks are strengthening their arrangements for obtaining authorization between banks in interchange systems. These new procedures are important in reducing the major problem of charge-off losses, which for Federal Reserve members reached a peak of $116 million (3.4 percent of outstandings) during 1970.

Mature—and profitable

A growing trend towards profitability has resulted from greater operating experience, improved equipment, and more effective fraud controls. In a 1971 Federal Reserve survey, three-fourths of the reporting banks expected higher profits from credit-card operations during the year. In addition, 58 percent of the banks with long-established plans reported profitable operations in 1970, as against only 17 percent with newly established plans. Both NBI and Interbank reported a similar improvement in their members' profitability during 1971.

Consequently, with the gradual maturing of credit-card plans nationwide, increased profitability should be the norm. Even so, profits will not be produced without effective management, which means close control of both credit risks and operating costs on a day-to-day basis.

The future control of costs—which means future profitability—may well depend on the speed of automating the credit-card industry. Originally, credit cards were thought of as a step toward a paperless electronic-transfer system, although in one sense they were initially a step in the other direction, since they generated more paper for banks to handle. But the costs of handling the expanded flow of paper and the costs of reducing fraud created pressures pushing in the direction of an electronic payments system.

Authorization centers for many banks are now online through computers to cardholder accounts, and a national online authorization system probably is not far behind. In addition, some banks are adding to their cards machine-readable magnetic strips containing information on cardholders' accounts, so as to make cards more secure against misuse. In several recent experiments, the two features—a magnetic identification system and an online authorization system—have been brought together to approximate a cashless transfer system. Tests also have been made of electronic terminals installed at merchant locations and tied directly to bank authorization centers, in a one-step process involving credit authorization and charges to a customer's account.

At this point, the credit-card industry is moving from adolescence into maturity. The initial problems have been largely overcome, as consumers, merchants and banks throughout the nation have become integrated into a far-ranging payments system. Recent developments may well hasten the arrival of a general electronic-payments system, which would speed payments and reduce the flow of paper through the banks. But whatever the future may bring, bank credit cards now represent one of the most remarkable innovations in the contemporary banking scene.

Robert Johnston