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Briefing Report to the Honorable Charles E. Schumer, House of Representatives

April 1987

FINANCIAL MARKETS

Federal Reserve Board Opposition to Credit Card Interest Rate Limits

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April 7, 1987

The Honorable Charles E. Schumer
House of Representatives

Dear Mr. Schumer:

This briefing report responds to your December 10, 1985, request that we conduct a study of competition in the credit card industry. After subsequent discussions with your office, we agreed to evaluate the factualness and soundness of arguments in the October 29, 1985, congressional testimony of a member of the Board of Governors of the Federal Reserve System (FRS). The FRS testimony, delivered before the Subcommittee on Consumer Affairs and Coinage of the House Committee on Banking, Finance and Urban Affairs, explained the basis for FRS opposition to proposed legislation for limiting the rate of interest which may be charged on credit card accounts.

According to the testimony, FRS opposition stems from (1) its view that financial markets distribute credit more efficiently and productively when interest rates are determined in markets that are as free from artificial restraints as possible and (2) its conclusion, based on credit card cost and profit data and other market information, that reasonably competitive conditions exist, notwithstanding the lack of variation in credit card finance rates.

We found the information on credit card costs and profitability contained in the testimony to be factually accurate. While some of the data lends itself to differing interpretations and conclusions regarding the degree of competition in the credit card industry, the FRS used the data logically and rationally to support its arguments. It should be noted, however, that the annual FRS Functional Cost Analysis (FCA) surveys of banks, from which it derived most of the cost and revenue information on which it relied, were not designed to provide representative information on the banking industry as a whole. Participation by banks in those surveys is completely voluntary, and according to some studies, some operating characteristics differ between participating

banks and nonparticipating banks. We could not determine the effects of those differences on the information and conclusions in the FRS testimony. However, we believe that if the survey information is used to represent banks in general, it should be accompanied by appropriate cautions to alert the reader to its potential shortcomings. It should also be noted that the figures in the FRS testimony on credit card costs and profitability pertain only to FCA card-issuing banks (card banks); they do not include data on banks that supply credit cards to card holders through arrangements with card banks.

To evaluate the FRS testimony, we held discussions with FRS officials, reviewed FRS documents, conducted an extensive literature search, and interviewed representatives of industry and consumer groups. Appendix III contains detailed information on our scope and methodology.

In commenting on a draft of this briefing report, the FRS said the approach and conclusions of the report seem to be reasonable and well balanced and that the Federal Reserve is aware of the FCA data limitations to which we refer. FRS added that a decision has been made to implement changes designed to improve the reliability of FCA data. The FRS letter is included in appendix IV.

As arranged with your office, copies of this document are being provided to the Board of Governors of the Federal Reserve System. Copies will also be available to other interested parties. If you have any questions regarding the appended information, I can be reached on 275-8678.

Sincerely yours,

Craig A. Simmons
Senior Associate Director

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ABBREVIATIONS

AFL-CIO American Federation of Labor and Congress of Industrial Organizations

FCA Functional Cost Analysis

FRS Federal Reserve System

GAO General Accounting Office

REPRESENTATIVENESS OF THE FCA SAMPLE

The Federal Reserve System (FRS) presented several facts in its testimony regarding the importance of costs of funds to credit card loans, and regarding the profitability of the credit card function as compared with other loan functions in banks. It presented those facts in support of its key conclusions that reasonably competitive conditions exist in the credit card business and that factors other than the level of competition explain the relative stability of credit card interest rates. The FRS obtained the cost and revenue information upon which it relied for those facts from its annual Functional Cost Analysis (FCA) surveys.

However, the purpose of the surveys is to provide information which will be useful to bank management for evaluating and improving performance at individual banks. The surveys were not designed to generate information which would be projectable to the universe of banks. Bank participation in the FCA program is voluntary, and the small percentage of banks that do report are not selected at random. Therefore, the participating institutions do not provide a representative cross section of all banks. The FRS provided us with summary statistical information generated by its surveys for calendar years 1972 through 1984 in order that we might test the numeric accuracy of the numbers it cited in its testimony. We address the numeric accuracy of those numbers on pages 18 and 34. Following is a discussion of the reliability of the FCA data base for providing representative information on banks.

PURPOSE OF THE FCA PROGRAM

FRS literature describes the FCA program as a cooperative venture between the Federal Reserve Banks and participating banks which is designed to serve as a tool for bank management to evaluate its performance. Participating bankers, using uniform FCA instructions, provide information on their banks' assets, income, and expenses, segregated by bank function. In return for its participation, each bank receives a report of its own current year's operations, including profitability figures for each of the bank's functions, such as the mortgage loan function and the credit card function. It also receives, for comparison purposes, reports containing data averages by function for groups of participating banks which are similar to the subject bank in deposit size and certain other characteristics.

The FCA program has been in place since 1957. According to FRS literature, before that time the banking industry lacked a simplified uniform system of cost accounting that would require only modest data collection and would eliminate as many difficult judgments as possible. According to a recent internal FRS document, the FCA program remains the only available data source

that (1) contains directly allocated cost and revenue data for a large number of individual banking functions, (2) reports the data in a detailed line item format by function, and (3) does this within a consistent reporting framework for all participants. We did not find any other system that routinely gathers and summarizes cost and profit information on the various types of loan functions at commercial banks. However, while FCA data may be highly useful to participating bankers for evaluating performance, its reliability for considering legislation affecting all financial institutions is subject to question.

SHORTCOMINGS OF THE FCA PROGRAM

The Winter 1978 Journal of Bank Research included a study titled "On the Usefulness of Functional Cost Analysis Data" which was co-authored by an FRS official.[1] In discussing the purpose of the study, the authors state their opinion that in order for FCA data to be useful in testing hypotheses about the banking industry and in generalizing results for policy implementation, it is necessary to show that the FCA sample is representative of the banking universe. The study, which used information reported by banks for 1969 and 1970, compared characteristics of 1974 FCA-participating banks with characteristics of non-FCA banks. The authors of the study concluded that great care must be exercised in generalizing relationships estimated from FCA data to the banking industry, because FCA participants differ in several respects from the banking universe.

The FRS has, itself, recognized some shortcomings associated with the FCA program. In April 1986, an FRS staff study titled "The Effects of Proposed Credit Card Interest Rate Ceilings on Consumers and Creditors" used FCA data in its analyses.[2] It noted the criticisms in the 1978 study concerning the uncertain representativeness of FCA data. In doing so, the 1986 study cautioned that conclusions drawn from FCA data are likely to be more reliable if they are based on results for several years rather than on data for a single year that might be influenced by changes in the sample or by unusual circumstances.

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[1]Journal of Bank Research, Vol. 8, No. 4, pp. 251-256; by Arnold A. Heggestad, Chairman, Department of Finance, University of Florida and John. J. Mingo, Senior Research Division Officer, Division of Research and Statistics, Board of Governors of the Federal Reserve System.

[2]A revised version of this study, titled "The Economic Effects of Proposed Ceilings on Credit Card Interest Rates," appeared in the January 1987 Federal Reserve Bulletin, pages 1-13. Some of the statistics in this article have been updated to include 1985 data.

Recognizing that the 1978 study of 1970 bank data may no longer be relevant, we performed a simple comparative analysis to determine whether FCA-participating banks are still different from non-FCA banks. We divided each group of banks into sub-groups of small, medium, and large banks, according to asset size. We then obtained financial information which is reported by all federally insured banks on Reports of Income and Condition. Using 1984 data, we computed five commonly used operating ratios for each sub-group of banks and then compared the ratios of like-sized FCA and non-FCA banks. While our simple analysis showed us that differences do exist between the operating characteristics of FCA banks and non-FCA banks, it did not provide us a basis either for evaluating the effects of those differences on the reliability of FCA data, or for identifying likely causes of the differences.

The FRS has recently concluded its own current study aimed at evaluating whether the panel of FCA respondents is representative of all banks. In this recent study, the FRS used two methods to compare FCA participants with nonparticipants. First, the FRS used a method similar to our simple ratio comparison. Then the FRS used a method which was designed to identify factors which may represent important distinctions between the two groups being compared when other already-identified differences are simultaneously taken into account. The FRS official who conducted this study has concluded that FCA banks continue to differ from the universe of banks in a number of ways. He found that much of the difference found between FCA and non-FCA banks is due mainly to geographic distribution.

Geographic differences

To examine the difference in geographic distribution between FCA and non-FCA populations, we obtained information from the FRS on the number of banks in each state which participated in the FCA program in 1984. We compared those numbers with similar statistical information on the number of federally insured commercial banks in each state. We found that 9 states, containing a combined total of 259 banks in 1984, did not have a single bank participating in the FCA program. In addition, some geographic areas were greatly underrepresented in the program. For example, Maryland, Virginia, and the District of Columbia have a total of 283 banks within their boundaries, but had a combined representation in the FCA program of 8 banks, less than 3 percent of the total. From the states of Alabama, Florida, Georgia, and Louisiana, the FCA program attracted 16 participants, just over 1 percent of the 1,386 banks in that geographic area. The states of Nevada, California, Oregon, and Washington combined had a total of 2 FCA-participating banks, a region with 643 banks. On the other end of the spectrum and of the country, the states of Maine, New Hampshire, Connecticut, Massachusetts, and Vermont provided 54 FCA participants out of a total of 290 banks for a representation rate of about 18.6 percent.

Low participation rates

In addition to shortcomings associated with geographic distribution, the low overall participation rate may also cause some doubt about the representativeness of the FCA data. The survey of 1974 FCA banks, about which the 1978 study concluded that FCA-participating banks were not representative of the banking universe, had 905 banks participating in the program. That year only those banks which were members of the FRS were permitted to participate in the FCA program. Thus, about 15.6 percent of the 5,780 eligible member banks participated in the 1974 FCA. For 1981 and subsequent years, FRS officials opened FCA program participation to all financial institutions. On a nationwide basis, 539 out of a total of 14,483, or about 3.7 percent of the federally insured banks, provided cost information to the 1984 FCA program.

CONCLUSION

While we found that differences exist between FCA and non-FCA banks, we were unable to quantify the effects of those differences. Neither our ratio comparison nor the FRS' 1986 study provided a basis for determining the degree to which FCA data could be considered representative of all banks. Furthermore, the reliability of FCA data may well vary depending upon the item being considered. Finding detectable differences between FCA banks and all other banks does not necessarily disqualify the FCA data from use. To do that, one would need to show that the detected differences affect the particular item being considered. Nevertheless, we believe that FCA data, when used to represent all banks, should be accompanied by appropriate cautions regarding its reliability.

AGENCY COMMENTS AND OUR RESPONSE

In its comments on a draft of this report, the FRS said that it is well aware of the limitations of the FCA data and shares our view about the need for careful analysis of FCA data to avoid unreliable conclusions. The FRS added that it had alluded, during the discussion at the hearing, to shortcomings of the data and its own analytic efforts to avoid potential pitfalls. We note, however, that the hearing discussion did not include the representativeness of the sample itself. Neither did the FRS raise that topic in its prepared statement.

The FRS also said in its comments that a decision has been made to implement changes designed to improve the reliability of FCA data, particularly through broadening bank participation. The FRS comments are in appendix IV of this report.

ANALYSIS OF FEDERAL RESERVE SYSTEM TESTIMONY

On October 29, 1985, Martha R. Seger, a Member of the Board of Governors of the Federal Reserve System (FRS), testified on behalf of the FRS at a hearing before the Subcommittee on Consumer Affairs and Coinage of the Committee on Banking, Finance and Urban Affairs, of the House of Representatives. The focus of that hearing was two legislative proposals, H.R. 1197 and H.R. 3408, each of which would have limited the rate of interest which may be charged on credit card accounts. The FRS said that a premise that underlies both bills is that the market for credit card lending is not competitive, as evidenced by the resistance of credit card rates to downward movement at a time when market rates, which represent funding costs, have fallen substantially.

FRS OPPOSES FEDERAL CEILING FOR CREDIT CARD INTEREST RATES

In the testimony Ms. Seger said that the Board of Governors of the Federal Reserve System opposes the legislative proposals which would impose a federal ceiling on interest rates applied to credit card accounts. The FRS opposition to a federal ceiling is based on its views that:

1. In the credit card business, reasonably competitive conditions exist, notwithstanding the lack of variation in finance rates.

2. Factors other than the level of competition explain the relative stability of credit card interest rates.

3. Financial markets distribute credit most efficiently and productively when interest rates are determined in markets that are as free from artificial restraints as possible.

4. Efforts to constrain credit card rates through federal regulation are likely to have undesirable side-effects in the form of reduced credit availability or less efficient means of recapturing credit costs.

5. The establishment of interest rate ceilings has long been a state prerogative that should not be preempted lightly.

6. It would be undesirable to use the Federal Reserve discount rate for computing federal ceilings on interest rates.

Following is a discussion of each of the FRS views and the facts presented in the FRS statement to support the views and our evaluation.

COMPETITION IN CREDIT CARD BUSINESS

In examining the merits of imposing a federal ceiling on credit card interest rates, the FRS first discussed the purpose of such a ceiling. The FRS stated that a premise that underlies both bills is that the resistance of rates to downward pressure is an indication that the market for credit card lending is not competitive, allowing card issuers to avoid lowering finance rates at a time when market rates, which represent funding costs, have fallen substantially. The FRS then marshalled evidence which, it concluded, demonstrates the existence of reasonably competitive conditions and explains the resistance of credit card interest rates to downward pressures, thus discounting the need for any federally mandated limits.

Key sponsors of the proposed bills have pointed prominently to the lack of a lowering of credit card interest rates while other rates have dropped in discussing the need for a federal ceiling. In addition, a provision of one legislative proposal would task the FRS with determining if prevailing credit card loan rates reflect the cost of funds to creditors and competition for credit card accounts. If such were found to be the case, no federal ceiling would be imposed by that legislative proposal.

Extent of current competition

The FRS concludes that reasonably competitive conditions exist in the credit card business. It cites the following six facts or circumstances which it contends are indicative of a competitive environment:

- A diverse array of businesses participate as suppliers.
- A large number of suppliers exists.
- Suppliers employ aggressive marketing practices.
- Profits have not been out of line with other types of lending.
- Suppliers engage in non-rate competition.
- Signs of finance rate competition have begun to emerge.

While each of the six statements seems to be factually accurate, there is room for differing interpretations as to the degree of competition which they indicate.

Types of suppliers diverse

The FRS states that what used to be known as "bank" credit cards are now issued by a growing number of credit unions, finance companies, savings and loan associations, and others.

Several types of business entities do offer credit cards. National retail store chains, such as Sears, Montgomery Ward, and J.C. Penney, issue credit cards in their own names. Likewise, many major oil companies issue credit cards in their names. Such credit cards are referred to as proprietary cards. Banks offer credit cards, usually MasterCard and/or Visa cards, although some offer proprietary cards. The MasterCard and Visa organizations provide services for settling interbank accounts involving their respective cards; they do not control the terms of service, such as levels of fees or interest rates, to cardholders. Some of the banks which supply credit cards are "issuing banks" which set the interest rates and fees for the MasterCards, Visa cards, or proprietary cards they provide to customers. Others are "participating banks" which offer credit cards through contractual arrangements with issuing banks. Participating banks do not set the interest rates or other fees to be charged on the cards they offer, but follow those set by the issuing banks.

Other types of financial institutions, such as credit unions and savings and loan associations, also offer credit cards. Like banks, they usually offer MasterCard and/or Visa credit cards, rather than proprietary cards. Savings and loan associations have only recently become suppliers of credit cards. They received authority to offer credit cards in 1980 with passage of the Depository Institutions Deregulation and Monetary Control Act (Public Law 96-221).

Some car rental firms and some airlines offer credit cards, as does the American Telephone and Telegraph Company. In addition, some organizations with large memberships, such as the American Automobile Association and the AFL-CIO, are offering credit cards to their members through special arrangements which the organizations have made with financial institutions that are suppliers.

Many suppliers of cards

The FRS points to the large number of credit card suppliers as another indication that competitive conditions exist. There does seem to be a large number of suppliers of credit cards. A study performed by Lexecon, Inc., an economic consulting firm, estimated that about 3,000 depository institutions are issuing (card) institutions and approximately 12,000 more are participating

institutions.[3] Of 503 banks which responded to the 1985 FRS Functional Cost Analysis program, 306 were suppliers of credit cards; 85 were issuing banks and 221 were participating banks. In addition, according to the Nilson Report (issue 347, Jan. 1985), a twice-monthly newsletter which reports information on the credit card industry, at least 18 retail store chains and at least 12 oil companies had issued more than one million credit cards each by January 1985.

While a number of types of business entities offer credit cards and a large number of suppliers exist, there is some evidence that not all of these suppliers' credit cards are in direct competition with each other. Retailers and oil companies typically offer credit cards which can be used only for purchases made from the issuing company. That is, a card issued by one retail store could not be used to make purchases from a rival retail store, nor could it usually be used to purchase gasoline at a service station. Even banks, which supply cards that are used by the cardholder to make purchases from providers of goods and services other than the bank, do not always compete directly. For example, not all banks compete in all geographic areas of the United States. Also, some banks will supply cards only to individuals who are already bank customers. In addition, participating banks are limited in the ways in which they may compete for credit card customers because they must adopt the rates and terms of their associated issuing bank.

Competition through marketing techniques

According to the FRS, one evidence of competition in the credit card market is the aggressive marketing practices employed by suppliers of credit cards. Indications of this behavior cited by the FRS are the heavy volume of solicitations for new accounts made by credit card suppliers, and solicitations often directed to residents who live outside of market areas typically serviced.

While we could find no quantitative information, some studies and news articles have suggested that increased solicitations by credit card suppliers are taking place both within and outside of the suppliers' states. Thrift institutions were advised in January 1986 by The Kaplan Smith Report, a thrift industry monthly newsletter published by Kaplan, Smith & Associates, Inc., that marketing is a key ingredient in the credit card business. The newsletter cautioned that large money center banks could be expected to engage in mass mailings in the tens of millions of

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[3]Interest Rate Controls on Credit Cards -- An Economic Analysis, by Lexecon, Inc., October 1985, 84 pages, prepared for the American Bankers Association, MasterCard International Inc., and Visa U.S.A., Inc.

credit cards with preapproved lines of credit. The American Banker, on May 19, 1986, reported on marketing techniques employed by Manufacturers Hanover Trust Company, one of the Nation's largest banks. According to that news article, since lowering its interest rate on credit cards in the second half of 1985, Manufacturers had promoted its credit cards in print advertising, television and radio ads, 8 to 10 million pieces of direct mail, and unsolicited telephone calls, known as telemarketing.

However, additional factors may influence some banks' choice of marketing techniques, such as use of out-of-state solicitations. Since credit card markets are not confined by state boundaries and national banks may charge out-of-state credit customers the rate permitted by the bank's home state rather than the customer's home state, some lenders may find it attractive to extend credit across state lines to borrowers who cannot qualify for cards from banks in their states because of the states' constraining usury laws. Thus, credit may be offered across state lines because of the availability in those states of applicants who have been refused credit by in-state banks but who represent lower risk to the out-of-state bank than card applicants in that bank's state who do not already have credit cards. However, it should be noted that restrictive usury ceilings have become less of a factor in recent years, as many states have changed their usury laws.

Another likely reason for some out-of-state solicitations is the desire of some financial institutions to position themselves advantageously for benefiting from any future banking deregulation. That is, they wish to create a potential customer base in other states for other financial products and services they offer in anticipation of the further relaxing of restrictions on interstate banking.

Comparisons of profitability

The FRS said that over the longer term, returns on credit card plans have not been out of line with other types of lending and that profits actually have been substantially lower on average in the credit card area than for commercial or mortgage lending. FRS bases this statement on statistical information developed through the FCA surveys of banks for calendar years 1972 through 1984. We discuss the reliability of using data developed from those FCA surveys in appendix I; here we focus on the numbers which the surveys produced.

We obtained summary data from FCA surveys on banks' costs and revenues for calendar years 1972 through 1984. We noted that a distinction was made in the FCA data between banks that actually administer their own card plans or are the primary regional agents of national credit card plans (issuing banks) and those banks that operate under the authority of regional card banks (participating

banks). In its testimony, the FRS provided cost and profitability data for the former type only. Likewise, we limited our analysis to these banks. It should also be noted that, while data for the credit card function was limited to FCA participant issuing banks, data for the commercial loan function[4] and the mortgage loan function pertain to all FCA participant banks that reported those functions.

Table II.1 shows average profitability for the credit card, mortgage loan, and commercial loan functions for those reporting banks with deposits of $50 million or more. Similar data for smaller banks were not available for 1983 and 1984. All revenues attributable to the three loan functions under the FCA program were included in our profitability computations, not just revenues from interest payments on outstanding balances. For example, for the credit card function, some revenue is generated from discounts allowed by merchants to the issuing banks for the banks' handling of the merchants' sales slips. These merchant discounts, along with other credit card revenues, were added to interest charged on outstanding balances in computing total credit card function revenues. Likewise, all revenue offsets attributable to the three loan functions under the FCA program were subtracted from revenues to determine net earnings. Net earnings for the three functions were then divided by average balances outstanding during the year for each respective function to determine that function's profitability for the subject year.

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[4]In comparing costs and profits for the credit card function at banks with data for other bank functions, the FRS testimony refers to both the commercial lending function and commercial lending. The actual heading for the tables in FCA program reports from which the FRS took the numbers it cited is "Commercial and Other Loan Function." According to the FCA reports, this category is composed of leased equipment loans, agricultural loans (except real estate and installment loans), construction loans, and commercial and other loans not shown elsewhere in the FCA report. For convenience, we refer in the text to this category as commercial loans also.

Table II.1

COMPARISON OF AVERAGE PROFITABILITY OF CERTAIN LOAN FUNCTIONS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS OF $50 MILLION OR MORE FOR CALENDAR YEARS 1972 THROUGH 1984

	CREDIT CARD FUNCTION			COMMERCIAL AND OTHER LOAN FUNCTION			REAL ESTATE MORTGAGE LOAN FUNCTION		
YEAR	NET EARNINGS OR (LOSS)	AVERAGE BALANCE OUTSTANDING DURING YEAR	EARNINGS AS PERCENT OF OUTSTANDINGS	NET EARNINGS OR (LOSS)	AVERAGE BALANCE OUTSTANDING DURING YEAR	EARNINGS AS PERCENT OF OUTSTANDINGS	NET EARNINGS OR (LOSS)	AVERAGE BALANCE OUTSTANDING DURING YEAR	EARNINGS AS PERCENT OF OUTSTANDINGS
1972[a]	$ 8,059	$ 3,806,525	0.21	$1,247,053	$66,910,297	1.86	1,261,196	$39,707,336	3.18
1973	39,878	5,182,515	0.77	1,916,224	75,090,011	2.55	1,146,776	43,040,155	2.66
1974	55,904	6,879,962	0.81	2,499,456	71,894,734	3.48	1,016,996	46,114,037	2.21
1975	126,424	7,720,506	1.64	1,651,882	63,165,458	2.62	1,077,604	39,889,175	2.70
1976	217,278	7,783,497	2.79	1,167,881	62,106,304	1.88	1,106,433	39,069,377	2.83
1977	289,788	9,321,972	3.11	1,236,747	64,858,025	1.91	1,298,353	41,461,034	3.13
1978	225,275	9,075,020	2.48	1,753,187	62,193,021	2.82	1,070,518	39,318,388	2.72
1979	188,560	11,572,966	1.63	2,547,957	63,941,161	3.98	947,086	44,352,529	2.14
1980	(138,029)	9,116,359	-1.51	2,601,876	56,938,166	4.57	654,229	39,850,504	1.64
1981	103,644	10,135,373	1.02	2,725,901	50,252,330	5.42	230,159	38,005,837	0.61
1982	282,854	11,655,050	2.43	1,830,810	55,565,959	3.29	397,901	42,766,938	0.93
1983	198,463	8,378,028	2.37	840,800	55,555,643	1.51	841,354	38,408,148	2.19
1984	227,985	6,610,646	3.45	1,057,995	54,613,538	1.94	802,580	37,011,982	2.17
AVERAGE PERCENT[b]			1.63			2.91			2.24

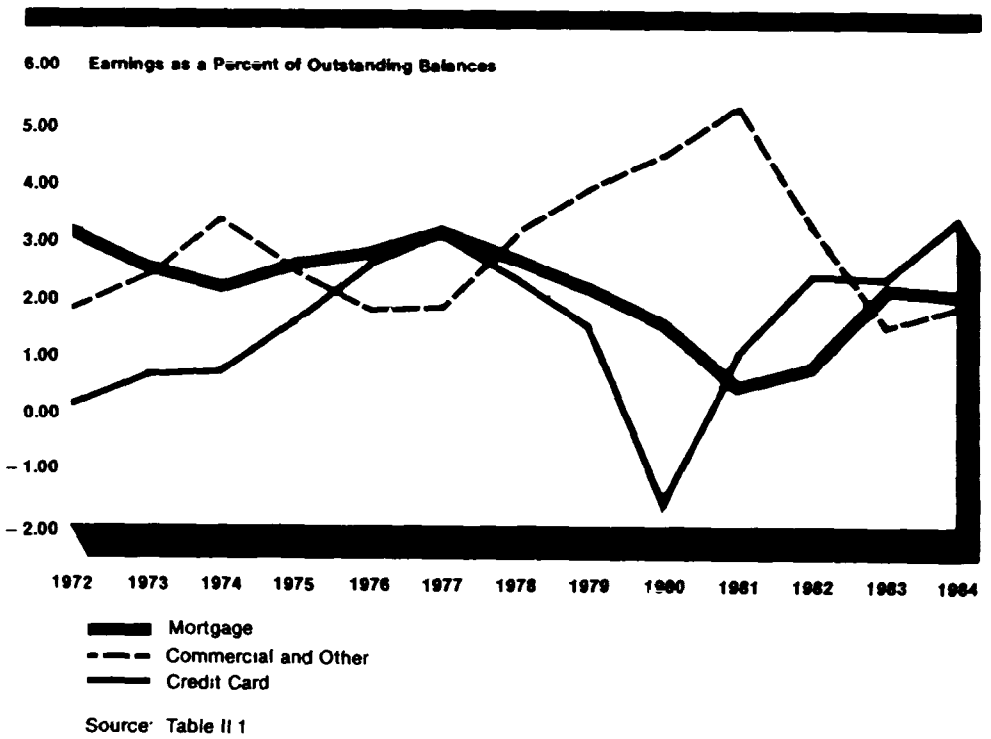
[a]We include 1972 FCA data in this table because the FRS referred to the time period 1972 through 1984 in discussing profitability in its testimony. It should be noted, however, that 1972 data for the credit card function, as obtained from the FCA report, pertain to both issuing and participating FCA banks, whereas credit card data for 1973 through 1984 pertain to only issuing FCA banks.

[b]Average percents for the 13-year period were computed by adding the percents listed in a column and dividing the sum by 13.

SOURCE: COMPUTED BY GAO FROM DATA CONTAINED IN FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1972 THROUGH 1984.

APPENDIX II

Figure II.1: Profitability by Bank Function for FCA Banks with Deposits of $50 Million or More



Source: Table II 1

APPENDIX II

As can be seen from table II.1, average profitability for the 13-year period for the credit card function (1.63 percent) is lower than that for each of the other two loan functions (2.24 percent for mortgages and 2.91 percent for commercial loans). However, credit cards were not less profitable for every year of the 13 years. Figure II.1 illustrates that credit card profitability exceeded the profitability of both mortgages and commercial loans in 1983 and 1984. Additionally, profits as a percent of outstanding balances were greater for credit cards in 1981 and in 1982 than they were for mortgage lending, and were greater for credit cards in 1976 and in 1977 than they were for commercial loans.

In addition, certain factors may have affected the profitability of credit cards in years when profits were low without having the same effect on the profitability of the other two loan functions. Those factors are (1) credit controls imposed in 1980, (2) changes in state usury limits, and (3) the entrance and exit of banks from the credit card industry.

Profitability of credit cards at FCA issuing banks was relatively low for the years 1979, 1980, and 1981. In fact, in 1980 issuing banks that participated in the FCA program, on average, incurred a net loss on credit card operations. Profits on credit cards may have been adversely affected during that 3-year period by state usury limits which prevented many credit card issuers from continuing to raise rates as the cost of funds rose dramatically. Additionally, in March 1980, the FRS, in cooperation with the overall anti-inflation program announced by President Carter, instituted consumer credit restraint measures designed to, among other things, limit the growth of all open-end credit such as credit card debt. According to an FRS interim report on that program, many banks lowered maximum borrowing limits on credit cards or stopped issuing cards altogether in the first few weeks after controls were announced. Mortgage loans, on the other hand, were not covered by the credit restraint program.

During the 1973-1975 period, low profitability of the credit card function may have been influenced by heavy start-up costs for banks initiating credit card programs. However, we could not determine from FCA reports the number of banks entering and exiting the field.

Non-rate competition

The FRS said that since credit card programs generally have once again become profitable, many credit card suppliers have engaged in non-rate competition. They have intensified their efforts to attract new credit card accounts and to encourage account usage, according to the FRS, by easing credit standards and by offering non-rate inducements. The FRS also includes in the category of non-rate competition various banks' adopting of floating finance rates, often paired with annual fees, and

experimentation by those banks with different combinations of rates and fees.

While we found no available statistical information on which to evaluate this statement, it appears that some credit card suppliers have eased credit standards for card applicants. Some banks are soliciting new cardholders among groups which may be considered riskier, such as students and individuals with no credit history, according to an October 1985 paper prepared by Lexecon, Inc., for the American Bankers Association, MasterCard International Inc., and Visa U.S.A., Inc.[5]

Besides the apparent easing of credit standards, some card suppliers are offering various card enhancements to lure potential cardholders and to foster account usage of current cardholders. These card enhancements, according to the Nilson Report (issue 380, May 1986), include car rental discounts, airline trip insurance, and hotel/motel discounts.

Signs of emerging rate competition

The FRS said that as a result of existing competitive conditions some credit card issuers have already begun to lower finance rates on their cards, and others have adopted floating finance rates.

Some banks are lowering the finance rate they charge on their cards. According to an article which appeared in the Wall Street Journal on October 9, 1985, just before the FRS testified, Manufacturers Hanover Trust Company announced that it had lowered the interest rate it charges on credit cards to 17.8 percent from 19.8 percent. Other institutions have also acted to lower credit card rates. An April 1986 Nilson Report (issue 378) listed 23 banks that had lowered their credit card interest rates in the most recent 12-month period. Further, lowered interest rates had been successful in attracting some customers, according to a news article in the May 15, 1986, American Banker. It indicated that Manufacturers Hanover Company had opened nearly 1 million new card accounts in the 7 months since lowering its interest rate.

Some banks have also adopted a floating finance rate for their credit cards. For example, Chevy Chase Federal Savings Bank of Maryland was recently offering a credit card with a rate that is adjusted quarterly to 4.5 percentage points over the prime rate with a minimum finance rate of 14 percent.

Although we have noted some decline in credit card finance charges and the emergence of floating rates, caution should be used in assessing the importance of these events. It is difficult to

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[5]See Interest Rate Controls, p. 52.

say how available these "low rate" cards will be to consumers in all geographic areas, whether a trend is developing, and what the reaction of issuers will be if the cost of funds begins to rise again.

FACTORS OTHER THAN THE DEGREE OF COMPETITION AFFECT RATES

The FRS testimony concludes that factors other than the level of competition explain the relative stability of credit card interest rates. Those factors are (1) the uncertainty about future financing costs, (2) a lack of consumer pressure to lower rates, (3) the lesser role of funding costs in determining total costs for credit cards, (4) the past effects of state-imposed statutory ceilings, and (5) the behavior of cardholders both in using credit cards and repaying credit card debt.

Uncertainty over future rates

The FRS contends that until actions are taken that curtail federal budget deficits and thereby reduce uncertainty about the likely future course of financing costs, many credit card issuers may remain reluctant to cut finance rates much if at all, especially in view of their experience with intense cost pressure in previous years. We did not find any evidence from studies, interviews or other sources which supported or refuted this FRS contention. Uncertainty over future events is a generally recognized reason for demanding a higher return on any investment, with higher returns generally demanded for longer-term commitments. The FRS did not address the relative duration of credit card outstanding balances and other types of loans, such as commercial loans.

However, the FRS argument that issuers keep credit card rates high because of uncertainty over future financing costs seems weakened by another of the statements in the FRS testimony. The FRS said also that funding costs seem to be much less important for credit card lending than they are for other types of loans. To the extent that this latter statement is valid (and tables II.10 and II.11 show it to be valid for FCA participant banks from 1974 through 1984), creditors should be even more reluctant to lower rates on other types of loans than on credit cards.

Card suppliers have not felt pressure from consumers

Another of the factors to which the FRS attributes the relative stability of credit card interest rates is a lack of pressure to lower rates from seemingly unconcerned consumers. The FRS suggested that the explanation for this perceived apathy differs according to the situation of the consumer. The FRS reasons that the approximately 50 percent of cardholders who pay their total credit card bills each month pay no interest; those who

use credit cards infrequently pay little interest in terms of dollar amounts; and those who roll over balances seem to view cards as desirable sources of short-term financing. The FRS points to the rapid expansion of credit card debt over the past 2 years as a sign that consumers generally find credit cards sufficiently attractive for short-term financing to outweigh any rate disadvantages.

In its April 1986 staff study on the effects of proposed credit card interest rate ceilings on consumers and creditors, the FRS cites information from surveys of consumer finances by the University of Michigan in 1977 and in 1983 on the card use and payment patterns of cardholders. For the earlier survey of respondents who used credit cards, 49 percent reported that they nearly always paid their credit card balances in full. Similarly, in the later survey, 47 percent of such respondents said they nearly always paid in full. We did not find any organization that routinely collects such information from card suppliers. However, the Nilson Report in April 1986 estimated that 51.2 percent of cardholders pay in full during the normally free grace period. It should be kept in mind that even those cardholders who always pay card balances in full have some incentive to do comparison-shopping for the card which best fits their needs. However, since their primary aim may be to minimize annual fees and other non-rate charges, they may purposely select cards which have high interest rates (which they will not have to pay) and low annual fees. Thus, the actions of these consumers should not be interpreted as reflecting a lack of concern over rates by cardholders overall.

Also in the 1983 Michigan survey, 28 percent of the surveyed cardholders said they hardly ever use their bank cards. These cardholders may indeed pay a low dollar amount of interest annually, regardless of the annual percentage interest rate.

Concerning the rapid expansion of credit card debt over the past 2 years, we found that credit card debt as reported in the monthly Federal Reserve Bulletin had grown about 58 percent from October 1983 through September 1985, while total consumer debt had expanded 36 percent over that same period. Thus, credit card debt as a percent of total consumer debt had actually grown from 19 percent to 22 percent over the most recent 2 years before the FRS testimony, perhaps showing a lack of overriding concern by consumers about the interest rates. However, there have been some indications from news articles that when a card issuer lowers its finance charge, and consumers are made aware of the lowered rate, many consumers will respond to the lowered rate.

The lesser role of funding costs

The FRS said that the relative stability of credit card rates also reflects the lesser role of financing costs in the overall cost function. According to the FRS, this lesser role can be

examined both in absolute terms by comparing financing costs to the total of other costs associated with credit cards, and in relative terms by comparing the cost of funds for credit cards as a percent of total credit card costs with similar ratios for other types of loans.

Other costs outweigh funding costs for credit cards

The FRS said that implicit in the idea that variations in credit card finance rates should correspond closely to changes in market rates is the premise that the cost of funds is a dominant cost factor in providing credit card services. However, according to the FRS, the bulk of total costs for credit card plans is composed of operating costs incurred for processing transactions, monthly billing, and evaluating credit applications, along with costs associated with delinquent accounts and credit losses. Funding costs, according to the FRS, comprised only about three-tenths of total expenses before taxes of a credit card operation. In addition, the FRS maintains that those other cost factors vary in ways that usually differ from the pattern followed by changes in market costs of funds.

We used summary cost information gathered by the FRS through its FCA program to determine what percentage of total credit card costs was made up of funding costs over the 11-year period to which the FRS had referred in its testimony. We used FCA data in this instance because (1) it was the data cited by FRS officials to support their statement and (2) it was the only data we found available which contained the necessary detailed costs for the desired time period. (See app. I for a discussion of the limitations of using FCA data for this purpose.)

In discussing the importance of funding costs in its testimony, the FRS referred to FCA-participating, medium- and large-size banks that issue credit cards. Table II.2 shows the relative importance of the various offsets to credit card income at those banks. The offsets to income are in three categories: the cost of funds which represents the cost to the banks of obtaining money to lend; operating expenses which include amounts for data services, publicity and advertising, credit card activity and franchise fees, salaries, fringe benefits, furniture, equipment, occupancy, and other operating expenses; and credit and fraud losses. Tables II.3, II.4, and II.5 show how the relative importance of the three offset categories changes with the size of the FCA-participant, issuing bank. Figure II.2 illustrates the differing importance of financing costs to total credit card costs for the 3 sizes of FCA banks. Data were not available for 1983 and 1984 for banks with deposits of under $50 million.

Table II.2

COST OF FUNDS AND OTHER CREDIT CARD COSTS SHOWN AS A PERCENT OF TOTAL CREDIT CARD COSTS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS OF $50 MILLION OR MORE, 1974-1984[a]

	COST OF FUNDS		OPERATING EXPENSES		CREDIT AND FRAUD LOSSES[b]		
Year	Amount	Percent of Total Costs	Amount	Percent of Total Costs	Amount	Percent of Total Costs	Total Costs
1974	$367,142	28.8	$790,702	62.0	$117,611	9.2	$1,275,455
1975	355,208	26.7	843,566	63.5	129,990	9.8	1,328,764
1976	359,503	27.5	834,674	63.8	114,804	8.8	1,308,981
1977	433,263	28.0	982,337	63.5	131,505	8.5	1,547,105
1978	480,371	31.3	904,121	58.9	150,984	9.8	1,535,476
1979	749,359	36.2	1,097,196	53.0	221,948	10.7	2,068,503
1980	711,492	35.0	1,090,557	53.6	231,878	11.4	2,033,927
1981	959,825	42.8	1,054,260	47.0	227,887	10.2	2,241,972
1982	1,080,986	41.8	1,280,082	49.5	224,880	8.7	2,585,948
1983	648,136	35.6	1,041,347	57.2	132,505	7.3	1,821,988
1984	545,642	39.2	764,913	54.9	82,217	5.9	1,392,772
AVERAGE PERCENT FOR 11-YEAR PERIOD[c]		33.9		57.0		9.1	

NOTE: Adding percents across a line for a given year may not equal 100.0, due to rounding.

[a]All dollar amounts are averages of amounts reported by FCA participants of this size.

[b]For 1974 through 1978, FCA-participant banks reported their banks' 5-year average for credit and fraud losses. Figures for 1979 through 1984 represent each designated year's experience only.

[c]Average percents for the 11-year period were computed by totaling the percents listed in a column and dividing the total by eleven.

SOURCE: DOLLAR AMOUNTS AND PERCENTAGES WERE COMPUTED BY GAO FROM FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984.

APPENDIX II

Table II.3

COST OF FUNDS AND OTHER CREDIT CARD COSTS SHOWN AS A PERCENT OF TOTAL CREDIT CARD COSTS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS UP TO $50 MILLION, 1974-1984[a]

Year	COST OF FUNDS		OPERATING EXPENSES		CREDIT AND FRAUD LOSSES[b]		Total Costs
	Amount	Percent of Total Costs	Amount	Percent of Total Costs	Amount	Percent of Total Costs	
1974	$19,272	23.4	$56,196	68.3	$6,780	8.2	$82,248
1975	20,268	24.0	57,696	68.4	6,400	7.6	84,364
1976	18,918	23.0	56,640	68.9	6,632	8.1	82,190
1977	20,558	25.6	55,294	68.8	4,575	5.7	80,427
1978	26,680	24.9	73,018	68.2	7,339	6.9	107,037
1979	25,356	26.1	62,714	64.5	9,210	9.5	97,280
1980	32,149	27.6	76,371	65.5	8,146	7.0	116,666
1981	49,042	32.8	88,217	59.0	12,325	8.2	149,584
1982	51,692	30.1	110,758	64.5	9,231	5.4	171,681
1983	a	a	a	a	a	a	a
1984	a	a	a	a	a	a	a
AVERAGE PERCENT FOR 9-YEAR PERIOD[c]		26.4		66.2		7.4	

NOTE: Adding percents across a line for a given year may not equal 100.0, due to rounding.

[a]All dollar amounts are averages of amounts reported by FCA participants of this size. Due to the low participation rate in the FCA program by banks of this size in 1983 and 1984, comparable figures for those years were not available.

[b]For 1974 through 1978, FCA-participant banks reported their banks' 5-year average for credit and fraud losses. Figures for 1979 through 1984 represent each designated year's experience only.

[c]Average percents for the 9-year period 1974-1982 were computed by totaling the percents listed in a column and dividing the total by nine.

SOURCE: DOLLAR AMOUNTS ARE FROM FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984; PERCENTAGES WERE COMPUTED FROM THE DOLLAR AMOUNTS BY GAO.

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Table II.4

COST OF FUNDS AND OTHER CREDIT CARD COSTS SHOWN AS A PERCENT OF TOTAL CREDIT CARD COSTS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS FROM $50 MILLION TO $200 MILLION, 1974-1984[a]

	COST OF FUNDS		OPERATING EXPENSES		CREDIT AND FRAUD LOSSES[b]		
Year	Amount	Percent of Total Costs	Amount	Percent of Total Costs	Amount	Percent of Total Costs	Total Costs
1974	$89,735	26.7	$218,501	65.1	$27,446	8.2	$335,682
1975	93,303	25.5	237,357	64.8	35,757	9.8	366,417
1976	82,161	24.8	224,632	67.7	25,005	7.5	331,798
1977	95,155	24.9	261,594	68.5	25,353	6.6	382,102
1978	126,527	26.3	320,069	66.6	34,274	7.1	480,870
1979	134,099	30.6	270,137	61.7	33,708	7.7	437,944
1980	187,556	33.4	324,018	57.7	50,077	8.9	561,651
1981	199,043	38.7	282,098	54.8	33,787	6.6	514,928
1982	270,437	39.0	368,356	53.1	54,339	7.8	693,132
1983	254,671	36.6	372,788	53.6	68,233	9.8	695,692
1984	210,202	36.1	341,820	58.7	30,289	5.2	582,311
AVERAGE PERCENT FOR 11-YEAR PERIOD[c]		31.1		61.1		7.7	

NOTE: Adding percents across a line for a given year may not equal 100.0, due to rounding.

[a]All dollar amounts are averages of amounts reported by FCA participants of this size.

[b]For 1974 through 1978, FCA-participant banks reported their banks' 5-year average for credit and fraud losses. Figures for 1979 through 1984 represent each designated year's experience only.

[c]Average percents for the 11-year period were computed by totaling the percents listed in a column and dividing the total by eleven.

SOURCE: DOLLAR AMOUNTS ARE FROM FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984; PERCENTAGES WERE COMPUTED FROM THE DOLLAR AMOUNTS BY GAO.

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Table II.5

COST OF FUNDS AND OTHER CREDIT CARD COSTS SHOWN AS A PERCENT OF TOTAL CREDIT CARD COSTS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS OVER $200 MILLION, 1974-1984[a]

	COST OF FUNDS		OPERATING EXPENSES		CREDIT AND FRAUD LOSSES[b]		
Year	Amount	Percent of Total Costs	Amount	Percent of Total Costs	Amount	Percent of Total Costs	Total Costs
1974	$757,120	29.2	$1,595,100	61.4	$244,365	9.4	$2,596,585
1975	674,887	27.0	1,583,498	63.3	245,009	9.8	2,503,394
1976	700,037	27.9	1,583,713	63.1	225,064	9.0	2,508,814
1977	890,166	28.5	1,956,314	62.7	274,954	8.8	3,121,434
1978	1,078,689	32.5	1,891,700	57.0	348,329	10.5	3,318,718
1979	1,647,033	37.0	2,303,888	51.8	496,593	11.2	4,447,514
1980	1,526,503	35.3	2,282,952	52.8	514,680	11.9	4,324,135
1981	2,049,127	43.5	2,159,855	45.8	505,802	10.7	4,714,784
1982	1,932,062	42.2	2,237,395	48.9	403,948	8.8	4,573,405
1983	997,882	35.3	1,635,622	57.9	189,635	6.7	2,823,139
1984	842,377	39.9	1,139,188	54.0	128,154	6.1	2,109,719
AVERAGE PERCENT FOR 11-YEAR PERIOD[c]		34.4		56.2		9.4	

NOTE: Adding percents across a line for a given year may not equal 100.0, due to rounding.

[a]All dollar amounts are averages of amounts reported by FCA participants of this size.

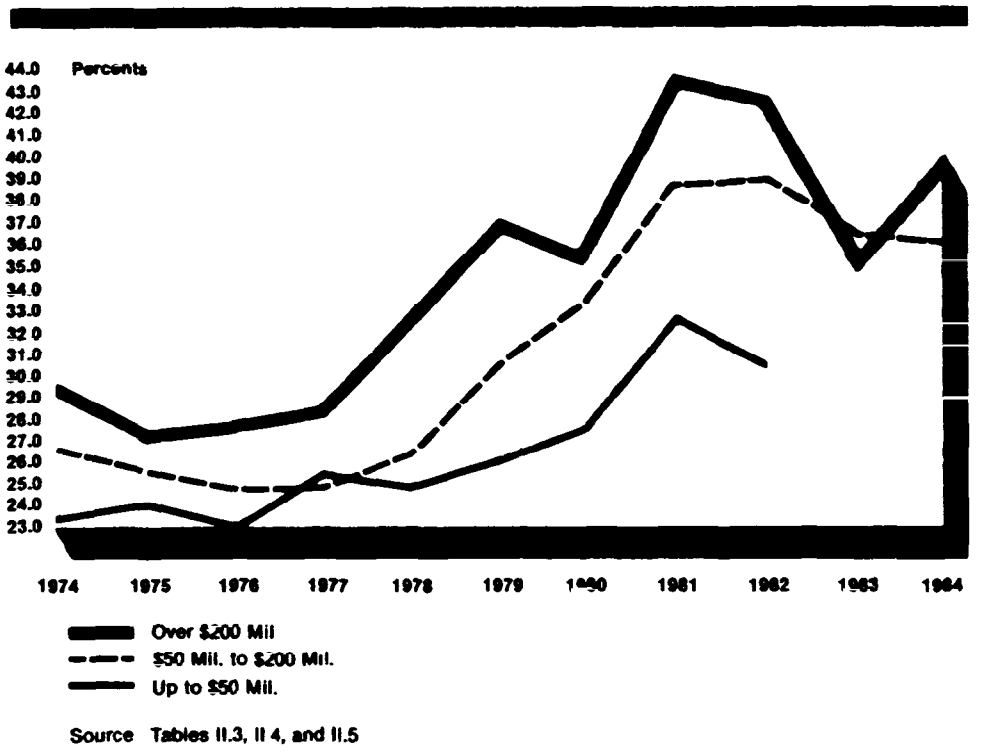
[b]For 1974 through 1978, FCA-participant banks reported their banks' 5-year average for credit and fraud losses. Figures for 1979 through 1984 represent each designated year's experience only.

[c]Average percents for the 11-year period were computed by totaling the percents listed in a column and dividing the total by eleven.

SOURCE: DOLLAR AMOUNTS ARE FROM FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984; PERCENTAGES WERE COMPUTED FROM THE DOLLAR AMOUNTS BY GAO.

APPENDIX II

Figure II.2: Credit Card Function Financing Costs as a Percent of Total Credit Card Costs, by Bank Deposit Size



Source Tables II.3, II.4, and II.5

APPENDIX II

As can be seen in tables II.3, II.4, and II.5, and as graphically shown by figure II.2, funding costs as a percent of the total costs for the credit card function at FCA issuing banks has varied somewhat according to the size of the bank. Generally, the larger the bank, the greater has been the cost of funds relative to other credit card costs. The relationship between size of bank and significance of funding costs to the credit card operation may be explained in part by economies of scale. We note that for the FCA issuing banks, which are grouped by amounts of deposits, each group has a far greater average amount of average outstanding balance for credit cards than does the group of next smaller-deposit sized banks. Because of the nature of credit cards, the balance outstanding on credit card loans may increase without causing a proportional increase in operating expenses to issuers. Only the cost-of-funds expense need rise proportionately with outstanding credit card balances. Thus, as total operating costs are spread over larger outstanding balances, they become less significant relative to funding costs which increase at the same rate as outstanding balances.

The relative significance of the cost of funds compared with other function costs has also generally been greater in more recent years than it was in the early and mid-1970s. For example, the cost of funds was most significant during this 11-year period in 1981 when it made up, on average, 43 percent of total credit card costs for large banks, that is, those with deposits of more than $200 million. Conversely, the cost of funds was least significant in 1976 when it averaged 23 percent of credit card costs for the smallest banks, those with deposits of less than $50 million.

The FRS said that operating costs and credit losses vary in ways that usually differ from the pattern followed by changes in market costs of funds. It cited this fact as one of the reasons why variations in credit card interest rates may not closely correspond to changes in market rates. Table II.6 shows the three categories of revenue offsets for credit card functions as percents of average outstanding balances for FCA-participant issuing banks with deposits of $50 million or more, the banks to which the FRS referred. Figure II.3, which depicts this information graphically, shows that operating costs and credit losses, as percentages of credit card balances outstanding, have behaved differently from the costs of funds over the period 1974 through 1984. Tables II.7, II.8, and II.9 provide additional detail on the three categories of revenue offsets, showing the trends for each of three deposit-size groups for which FCA data is available.

Table II.6

COST OF FUNDS AND OTHER CREDIT CARD COSTS SHOWN AS A PERCENT OF AVERAGE OUTSTANDING BALANCE FOR CREDIT CARDS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS OF $50 MILLION OR MORE, 1974-1984[a]

	COST OF FUNDS		OPERATING EXPENSES		CREDIT AND FRAUD LOSSES[b]		
Year	Amount	Percent of Outstanding	Amount	Percent of Outstanding	Amount	Percent of Outstanding	Average Outstanding Balance
1974	$367,142	5.3	$790,702	11.5	$117,611	1.7	$6,879,962
1975	355,208	4.6	843,566	10.9	129,990	1.7	7,720,506
1976	359,503	4.6	834,674	10.7	114,804	1.5	7,783,497
1977	433,263	4.6	982,337	10.5	131,505	1.4	9,321,972
1978	480,371	5.3	904,121	10.0	150,984	1.7	9,075,020
1979	749,359	6.5	1,097,196	9.5	221,948	1.9	11,572,966
1980	711,492	7.8	1,090,557	12.0	231,878	2.5	9,116,359
1981	959,825	9.5	1,054,260	10.4	227,887	2.2	10,135,373
1982	1,080,986	9.3	1,280,082	11.0	224,880	1.9	11,655,050
1983	648,136	7.7	1,041,347	12.4	132,505	1.6	8,378,028
1984	545,642	8.3	764,913	11.6	82,217	1.2	6,610,646
AVERAGE PERCENT FOR 11-YEAR PERIOD[c]		6.7		11.0		1.8	

[a]All dollar amounts are averages of amounts reported by FCA participants of this size.

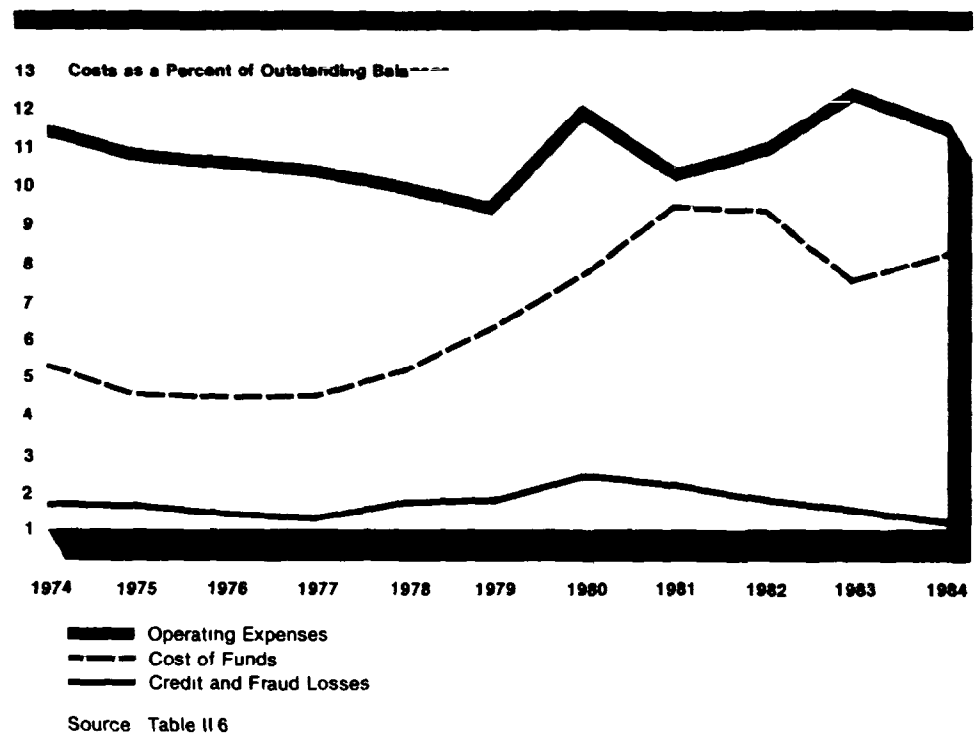
[b]For 1974 through 1978, FCA-participant banks reported their banks' 5-year average for credit and fraud losses. Figures for 1979 through 1984 represent each designated year's experience only.

[c]Average percents for the 11-year period were computed by totaling the percents listed in a column and dividing the total by eleven.

SOURCE: DOLLAR AMOUNTS ARE FROM FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984; PERCENTAGES WERE COMPUTED FROM THE DOLLAR AMOUNTS BY GAO.

APPENDIX II

Figure II.3: Credit Card Function Cost Components for FCA Banks with Deposits of $50 Million or More



Source Table II 6

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Table II.7

COST OF FUNDS AND OTHER CREDIT CARD COSTS SHOWN AS A PERCENT OF THE AVERAGE OUTSTANDING BALANCE FOR CREDIT CARDS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS UP TO $50 MILLION, 1974-1984[a]

	COST OF FUNDS		OPERATING EXPENSES		CREDIT AND FRAUD LOSSES[b]		
Year	Amount	Percent of Outstanding	Amount	Percent of Outstanding	Amount	Percent of Outstanding	Average Outstanding Balance
1974	$19,272	4.8	$56,196	14.1	$6,780	1.7	$399,197
1975	20,268	4.8	57,696	13.6	6,400	1.5	422,756
1976	18,918	4.8	56,640	14.5	6,632	1.7	390,412
1977	20,558	5.0	55,294	13.4	4,575	1.1	413,820
1978	26,680	5.2	73,018	14.3	7,339	1.4	511,267
1979	25,356	5.8	62,714	14.3	9,210	2.1	437,110
1980	32,149	6.9	76,371	16.4	8,146	1.7	466,285
1981	49,042	8.5	88,217	15.3	12,325	2.1	577,621
1982	51,692	8.0	110,758	17.2	9,231	1.4	644,281
1983	a	a	a	a	a	a	a
1984	a	a	a	a	a	a	a
AVERAGE PERCENT FOR 9-YEAR PERIOD[c]		6.0		14.8		1.6	

[a]All dollar amounts are averages of amounts reported by FCA participants of this size. Due to the low participation rate in the FCA program by banks of this size in 1983 and 1984, comparable figures for those years were not available.

[b]For 1974 through 1978, FCA-participant banks reported their banks' 5-year average for credit and fraud losses. Figures for 1979 through 1984 represent each designated year's experience only.

[c]Average percents for the 9-year period 1974-1982 were computed by totaling the percents listed in a column and dividing the total by nine.

SOURCE: DOLLAR AMOUNTS ARE FROM FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984; PERCENTAGES WERE COMPUTED FROM THE DOLLAR AMOUNTS BY GAO.

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Table II.8

COST OF FUNDS AND OTHER CREDIT CARD COSTS SHOWN AS A PERCENT OF AVERAGE OUTSTANDING BALANCE FOR CREDIT CARDS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS FROM $50 MILLION TO $200 MILLION, 1974-1984[a]

	COST OF FUNDS		OPERATING EXPENSES		CREDIT AND FRAUD LOSSES[b]		
Year	Amount	Percent of Outstanding	Amount	Percent of Outstanding	Amount	Percent of Outstanding	Average Outstanding Balance
1974	$89,735	5.1	$218,501	12.5	$27,446	1.6	$1,748,199
1975	93,303	4.8	237,357	12.1	35,757	1.8	1,958,145
1976	82,161	4.7	224,632	12.8	25,005	1.4	1,760,388
1977	95,155	4.8	261,594	13.1	25,353	1.3	1,994,281
1978	126,527	5.2	320,069	13.1	34,274	1.4	2,435,636
1979	134,099	6.1	270,137	12.3	33,708	1.5	2,200,114
1980	187,556	7.1	324,018	12.3	50,077	1.9	2,633,344
1981	199,043	9.1	282,098	12.8	33,787	1.5	2,198,843
1982	270,437	9.2	368,356	12.5	54,339	1.8	2,937,271
1983	254,671	7.9	372,788	11.6	68,233	2.1	3,204,965
1984	210,202	8.3	341,820	13.6	30,289	1.2	2,519,786
AVERAGE PERCENT FOR 11-YEAR PERIOD[c]		6.6		12.6		1.6	

[a]All dollar amounts are averages of amounts reported by FCA participants of this size.

[b]For 1974 through 1978, FCA-participant banks reported their banks' 5-year average for credit and fraud losses. Figures for 1979 through 1984 represent each designated year's experience only.

[c]Average percents for the 11-year period were computed by totaling the percents listed in a column and dividing the total by eleven.

SOURCE: DOLLAR AMOUNTS ARE FROM FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984; PERCENTAGES WERE COMPUTED FROM THE DOLLAR AMOUNTS BY GAO.

APPENDIX II

Table II.9

COST OF FUNDS AND OTHER CREDIT CARD COSTS SHOWN AS A PERCENT OF AVERAGE OUTSTANDING BALANCE FOR CREDIT CARDS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS OVER $200 MILLION, 1974-1984[a]

	COST OF FUNDS		OPERATING EXPENSES		CREDIT AND FRAUD LOSSES[b]		
Year	Amount	Percent of Outstanding	Amount	Percent of Outstanding	Amount	Percent of Outstanding	Average Outstanding Balance
1974	$757,120	5.4	$1,595,100	11.3	$244,365	1.7	$14,094,179
1975	674,887	4.6	1,583,498	10.7	245,009	1.7	14,753,977
1976	700,037	4.6	1,583,713	10.4	225,064	1.5	15,178,959
1977	890,166	4.6	1,956,314	10.2	274,954	1.4	19,224,257
1978	1,078,689	5.3	1,891,700	9.3	348,329	1.7	20,301,614
1979	1,647,033	6.5	2,303,888	9.1	496,593	2.0	25,248,110
1980	1,526,503	8.0	2,282,952	11.9	514,680	2.7	19,201,049
1981	2,049,127	9.5	2,159,855	10.0	505,802	2.4	21,499,041
1982	1,932,062	9.3	2,237,395	10.8	403,948	1.9	20,808,717
1983	997,882	7.7	1,635,622	12.6	189,635	1.5	12,976,307
1984	842,377	8.2	1,139,188	11.1	128,154	1.3	10,229,483
AVERAGE PERCENT FOR 11-YEAR PERIOD[c]		6.7		10.7		1.8	

[a]All amounts are averages of amounts reported by FCA participants of this size.

[b]For 1974 through 1978, FCA-participant banks reported their banks' 5-year average for credit and fraud losses. Figures for 1979 through 1984 represent each designated year's experience only.

[c]Average percents for the 11-year period were computed by totaling the percents listed in a column and dividing the total by eleven.

SOURCE: DOLLAR AMOUNTS ARE FROM FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984; PERCENTAGES WERE COMPUTED FROM THE DOLLAR AMOUNTS BY GAO.

APPENDIX II

Comparison of funding costs among types of lending

The FRS said that funding costs averaged only about three-tenths of total expenses, before taxes, for the credit card function at medium- and large-sized banks which participated in its FCA surveys during the period 1974 through 1984. Table II.2 shows the summary cost information to which the FRS referred. The funding costs for the 11-year period for all FCA-participant issuing banks with $50 million or more in deposits averaged 33.9 percent of total costs, which approximates the three-tenths figure cited by the FRS. However, as pointed out earlier, the funding costs' share of total costs increases with the size of the bank and seems to be greater in more recent years than in earlier years. Thus, the use of a single average figure for the 11-year period may not be as informative for considering the behavior of credit card interest rates as the detailed information in tables II.2 through II.5. In this regard, had the FRS chosen to include banks with less than $50 million in its computation for the years for which complete data were available, the average percent of total costs accounted for by funding costs would have been even lower. Figure II.2 graphically depicts the changing significance over time of the cost of funds to credit card functions, by size of bank for FCA-participant issuing banks.

Additionally, the FRS said that the cost of funds seems to be much less important in credit card lending than in other types of credit. According to the FRS, during the period 1974 through 1984, funding costs averaged only about three-tenths of total expenses, before taxes, for the credit card function at medium- and large-sized banks that issue credit cards. By comparison, funding costs at medium-sized and large-size banks accounted for more than three-quarters of total costs of the commercial lending function, and for nearly nine-tenths of total costs of mortgage lending.

Table II.10 shows the relative importance of funding costs to the three loan functions for FCA-participating banks with deposits of $50 million or more. Table II.11 provides more detailed information, showing the relative importance of funding costs for the three loan functions for each of the three size groups of FCA participants.

Table II.10

COST OF FUNDS SHOWN AS A PERCENT OF TOTAL FUNCTION COSTS FOR CERTAIN LOAN FUNCTIONS FOR FCA-PARTICIPANT BANKS WITH DEPOSITS OF $50 MILLION OR MORE, 1974-1984

Year	Credit Card Function	Real Estate Mortgage Loan Function	Commercial and Other Loan Function
	(percent)	(percent)	(percent)
1974	29	87	79
1975	27	85	73
1976	28	84	72
1977	28	84	73
1978	31	85	77
1979	36	88	80
1980	35	91	81
1981	43	91	82
1982	42	91	78
1983	36	88	74
1984	39	88	76
AVERAGE PERCENT FOR 11-YEAR PERIOD[a]	34	87	77

[a]Average percents for the 11-year period were computed by totaling each column and dividing each column total by eleven.

SOURCE: THE PERCENTAGES WERE COMPUTED BY GAO FROM THE DOLLAR AMOUNTS CONTAINED IN FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984.

Table II.11

COST OF FUNDS SHOWN AS A PERCENT OF TOTAL FUNCTION COSTS FOR CERTAIN LOAN FUNCTIONS FOR FCA-PARTICIPANT BANKS, 1974-1984[a]

	BANKS WITH DEPOSITS UP TO $50 MILLION			BANKS WITH DEPOSITS FROM $50 MILLION TO $200 MILLION			BANKS WITH DEPOSITS OVER $200 MILLION		
Year	Credit Card	Real Estate Mortgage	Commercial and Other	Credit Card	Real Estate Mortgage	Commercial and Other	Credit Card	Real Estate Mortgage	Commercial and Other
1974	23	85	73	27	87	78	29	87	79
1975	24	85	72	25	86	75	27	85	73
1976	23	84	71	25	86	74	28	83	71
1977	26	84	72	25	85	75	29	83	73
1978	25	85	74	26	86	76	33	85	78
1979	26	87	75	31	89	79	37	87	81
1980	28	89	76	33	90	79	35	91	83
1981	33	90	78	39	92	82	43	91	83
1982	30	89	76	39	91	78	42	91	78
1983	b	87	73	37	87	73	35	88	75
1984	b	87	73	36	88	74	40	88	77
11-YEAR AVERAGE[c]	26	87	74	31	88	77	34	88	78

[a]Total function costs consist of operating expenses, funding costs for the function, and losses attributable to the function.

[b]Due to the low participation rate in the FCA program by banks of this size with credit card operations for 1983 and 1984, comparable figures for those years were not available.

[c]The average is for nine years for the credit card function for banks with deposits up to $50 million. See footnote b for the reason.

SOURCE: THE PERCENTAGES WERE COMPUTED BY GAO FROM THE DOLLAR AMOUNTS CONTAINED IN FEDERAL RESERVE SYSTEM, FUNCTIONAL COST ANALYSIS, ANNUAL ISSUES 1974 THROUGH 1984.

APPENDIX II

The effects of state-imposed rate ceilings

The FRS concluded that much of the inertia in credit card interest rates may be attributable to the influence of restrictive rate ceilings imposed by the states. It explained that when the market costs of funds rose sharply between 1979 and 1981 while credit card rates were restrained in all but a few states by state-imposed ceilings, net returns on credit cards were adversely affected to the point of prompting several fundamental realignments by lenders. These actions included, in some cases, relocating credit card operations to states with less restrictive rate ceilings, tightening lending standards, deemphasizing credit card business in favor of other types of lending, instituting annual fees on credit card accounts, and refusing to accept any new accounts. The FRS further explained that more recently, as the market costs of funds have dropped, card issuers have reacted to the return to profitability by reversing some of their earlier realignment actions rather than by lowering rates. That is, they have increased the availability of credit cards and intensified their efforts to market new credit card accounts and encourage card usage. Thus, according to the FRS, state-imposed rate ceilings did not allow credit card interest rates to increase as steeply as other market rates in previous years when costs were rising, so credit availability was curtailed. Now as market rates move lower, actions have been taken to broaden the customer base at existing rates, instead of continuing to lend more selectively and lowering rates.

We did find some evidence of the actions in the 1979 to 1981 time period to which the FRS referred. For example, the 1982 Retail Bank Credit Report by the American Bankers Association indicates that, of survey respondents who responded to credit card questions, over 5 percent of banks with deposits of less than $100 million and over 1 percent of larger banks discontinued credit card plans during 1981.[6] Also, according to some news accounts, certain banks were influenced by state usury ceilings in deciding to move their credit card operations from one state to another. Furthermore, as mentioned on page 13, we have seen some empirical evidence of a recent intensifying of marketing efforts by card suppliers.

However, while we have no basis for disagreeing with the FRS, we did not find any studies which indicate the motivations of issuers in undertaking these actions. As discussed on page 18, FCA data do show that profits on credit card operations were well below those for some other types of loan operations for participating

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[6] 1982 Retail Bank Credit Report, by American Bankers Association, p. 74.

financial institutions for 1980 when net losses were incurred on average. However, FCA data also show credit card profitability rebounded in 1981 to surpass profits on mortgage loans, and in 1983 and 1984 it exceeded profits from mortgages and commercial loans.

The effects of cardholder behavior

The FRS suggested that the behavior of credit card rates cannot be properly evaluated solely by comparing a credit card rate with a market interest rate due, at least in part, to the flexibility of the repayment terms of credit card accounts. The FRS pointed out that the terms of repayment are at the discretion of the account holders, and that, excluding cash advances which typically earn finance charges from the transaction date, most credit card plans charge interest only if cardholders pay less than the full amount billed during the period. The FRS said that, because of this repayment flexibility, the way the cardholder uses the account determines how much, and, indeed, whether interest revenue is earned from the account. The FRS cited cardholders who do not use their cards and those who usually pay off the entire balance when billed as examples where considering only stated finance charges can be misleading for judging the behavior of credit card rates. According to the FRS, such customers pay little or no interest to offset processing, financing, and billing costs. On pages 20 and 21 we discuss these aspects of cardholder behavior in another context, which concerns whether issuers have felt any pressure from cardholders to lower rates. The point addressed here is the effects of that behavior on translating the stated annual percentage rate on credit cards into interest revenue from all cardholders as a group, regardless of card usage and payment patterns. However, that does not change the rate paid by cardholders who do use their cards and pay only the minimum amount due each month. Additionally, some card issuers charge annual fees which serve to offset to some extent the difference between stated and effective interest rates.

FREE MARKETS AND ARTIFICIAL RESTRAINTS

The FRS said that financial markets distribute credit most efficiently and productively when interest rates are determined in markets that are as free from artificial restraints as possible. It expressed concern that rate ceilings can have an adverse impact on the availability of funds in local credit markets. It offered as evidence of this adverse impact the behavior of credit card suppliers from 1979 to the present, which we discuss on page 37. In its April 1986 staff study, the FRS devoted an entire chapter to this topic. It cited several empirical investigations to support its conclusions on the effects of state-imposed rate ceilings on consumer access to and use of consumer credit. We did not test the validity of those studies.

POTENTIAL EFFECTS OF A FEDERAL CEILING

The FRS said that an effort to establish a federally mandated ceiling on credit card interest rates can be expected to encounter difficulties. It cited experience with the imposition of credit controls in 1980 and the sharp, unexpected contraction in consumer spending that accompanied them as evidence that regulatory measures can have unpredictable and unwanted consequences. According to the FRS, setting a federal ceiling rate of interest on credit card debt below those that currently prevail in many states would likely reduce the amount of credit made available. Moreover, such a curtailment would likely fall most heavily on less affluent borrowers with relatively limited access to other sources of credit. Furthermore, the FRS speculated that imposition of stringent rate ceilings might be countered by adjustments in nonrate credit card terms such as increased annual fees, processing charges levied on each purchase or cash advance, and penalties for late payments or for exceeding the authorized credit limit. Some card issuers also might begin applying the reduced finance charges from the date of purchase, where permitted, rather than after the grace period expires, and might seek to increase merchant discount fees. We agree with the FRS that these options are available to card issuers and there is some likelihood of an increase in their use if credit card profits decline sufficiently due to a federal ceiling on finance rates.

The FRS added that based on recent levels of 3-month Treasury bill rates and the Federal Reserve discount rate, the ceiling for credit card rates under either of the proposed bills would be 12-1/2 to 13-1/2 percent, well below the finance rates that have been typical since credit cards emerged in the early 1960s as a major method of consumer financing. The FRS is correct that the rates in effect at the time of its testimony would have called for a credit card rate ceiling of 12-1/2 to 13-1/2 percent under either of the formulas of the proposed bills. Furthermore, both the discount rate and 3-month Treasury bill yields have moved lower since that time. On February 28, 1987, the ceiling under the two proposals would have been between 10-1/2 and 11-1/2 percent.

In addition, there is evidence that credit card interest rates charged by commercial banks have, since at least February 1972, been higher than the current proposed ceilings would allow. The FRS periodically publishes financial and business statistics, including consumer installment credit terms. For the months of February, May, August, and November of each year, the FRS publishes a rate which represents, on an annual percentage rate basis, finance rates charged by commercial banks on credit card plans. The FRS derives the published rate from data provided by a panel of banks, which were asked to provide the "most common rate" they charged during the first week of each month. An examination of issues of the FRS Annual Statistical Digest for 1970 through 1982

and of the monthly Federal Reserve Bulletin for July 1983 through March 1987, shows that the published rate has been above 16.8 percent since February 1972, the first month for which the FRS reported the rate. The published rate for February 1972 was 17.13 percent. The highest reported published rate during the past 14-1/2 years was 18.85 percent for February 1985, and the lowest published rate was 16.86 percent for August 1977. The most current published rate was 18.09 percent for November 1986.

Turning to the central provisions of the two bills being considered at the hearing, the FRS said that credit cards are issued by a broad variety of retail merchants and financial institutions that differ both as to their sources of funding and their liability structures. Under these circumstances, according to the FRS, a single index rate would be unlikely to mirror changes in either marginal or average costs for such a diverse array of card issuers. The FRS also said that in any case, short-term rates, such as on Treasury bills, fluctuate a good deal more widely than do the costs of funds of most lenders. They do so because a lender's overall average cost of funds at any point is partly determined by previously issued liabilities, and because market rates on longer-term liabilities--which make up part of the cost of funds--typically vary less than do shorter-term rates.

We did not find any statistical information on the costs of funds to retail merchants or other issuers of credit cards besides banks. We obtained information on the costs of funds for issuing banks' credit card operations and on the overall costs of those operations, including operating expenses, and credit and fraud losses, from the FRS Functional Cost Analysis program. (See app. I for a discussion of the appropriateness of using FCA data for this purpose.) In order to examine the trends of the funding costs and of the overall credit card costs for FCA-participant, issuing banks, we divided those costs for each of the years 1973 through 1985 by the banks' average outstanding credit card balances for each of those years. Table II.12 shows the trends of overall credit card costs, and of the costs of funds, for FCA-participant issuing banks. It also shows the trends of two market rates proposed for use in setting a federal interest rate ceiling.

We believe that the banks' overall credit card costs for a given year divided by the banks' average outstanding credit card balance for that year approximates the percentage of return the banks would have needed to recover from interest charges on outstanding credit card balances and from other credit card income such as merchant discounts and annual card holder fees to break even. As such, it is a useful figure for comparing to market rates which might be used for setting interest rate ceilings. Figures II.4 and II.5, which illustrate the trends of the credit card costs and of the two market rates, seem to support the FRS contention that there is somewhat wider fluctuation in the market rates than in card issuers' costs of funds.

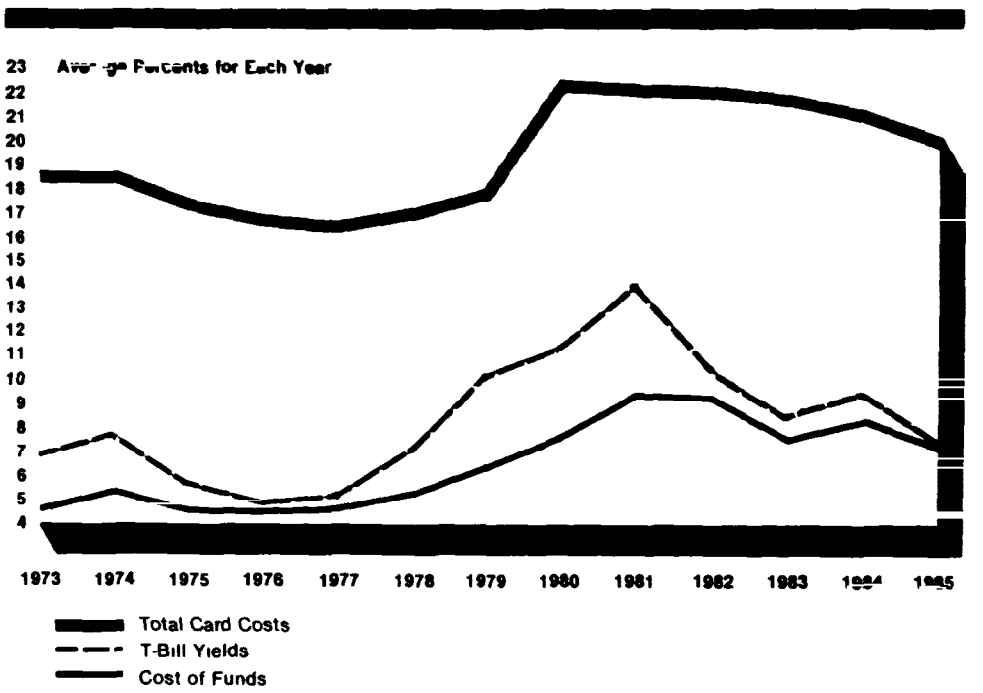
Table II.12

COMPARISON OF TRENDS OF AVERAGE CREDIT CARD COSTS FOR ALL FCA-PARTICIPANT BANKS WITH TRENDS OF TREASURY BILL YIELDS AND THE FEDERAL RESERVE DISCOUNT RATE 1973 - 1985

Year	Yearly average of market yields on three-month Treasury bills	Yearly average of the discount rate of New York Federal Reserve Bank	Cost of funds as a percent of credit card balances outstanding for FCA banks	Total credit card costs as a percent of credit card balances outstanding for FCA banks
	(percent)	(percent)	(percent)	(percent)
1973	7.0	6.4	4.6	18.6
1974	7.8	7.8	5.3	18.6
1975	5.8	6.2	4.6	17.3
1976	5.0	5.5	4.6	16.9
1977	5.3	5.5	4.7	16.6
1978	7.2	7.5	5.3	17.0
1979	10.1	10.3	6.5	17.9
1980	11.4	11.8	7.8	22.3
1981	14.0	13.4	9.5	22.2
1982	10.6	11.0	9.3	22.2
1983	8.6	8.5	7.7	21.7
1984	9.5	8.8	8.3	21.1
1985	7.5	7.7	7.4	20.2

SOURCE: GAO computed the annual averages for Treasury bill yields and the annual average for the discount rate from monthly averages provided by the FRS. Costs of funds and total credit card costs percentages were computed by GAO from FRS' FUNCTIONAL COST ANALYSIS, annual issues for 1973 - 1985.

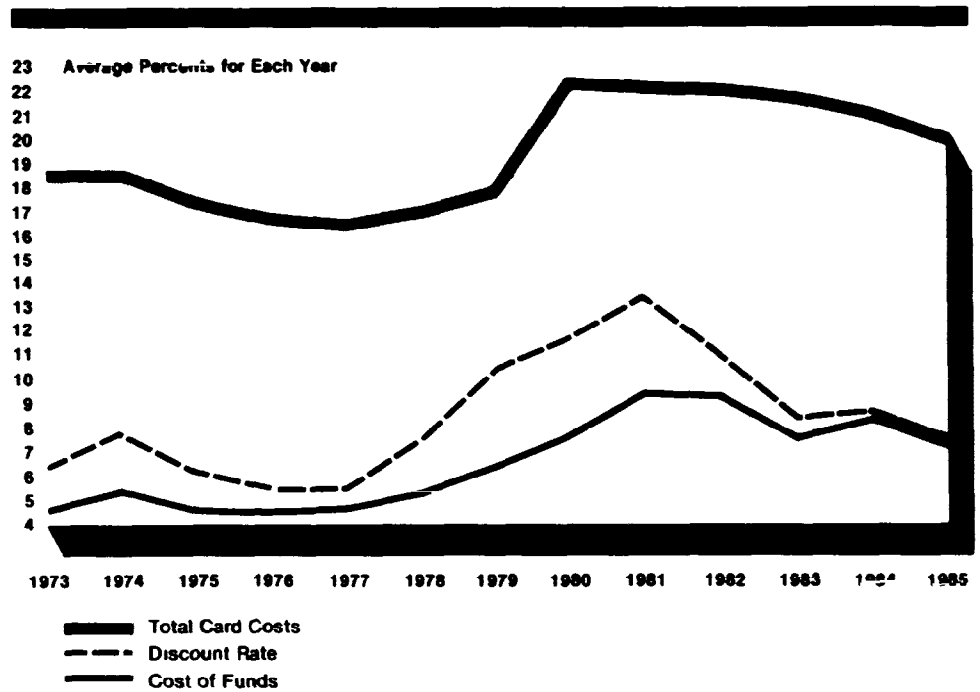
Figure II.4: Comparison of Trends of T-Bill Yields, Card Funding Costs, and Total Card Costs



Source Table II 12

APPENDIX II

Figure II.5: Comparison of Trends of Discount Rate, Card Funding Costs, and Total Card Costs



Source Table II 12

APPENDIX II

STATE GOVERNMENTS AND INTEREST RATE CEILINGS

The FRS pointed out that the establishment of interest rate ceilings has long been a state prerogative and it raised a question as to whether it is an appropriate matter for federal intervention. According to the FRS, in recent years, virtually every state has reviewed and overhauled its laws regulating consumer interest rates. After studying the situation in their own jurisdictions, many of these states opted to raise or remove interest rate ceilings for credit card borrowings. The FRS then noted that the states retain the authority to lower the ceilings if convincing evidence of noncompetitive rate determination appeared.

Since the late 1970s many states have acted to raise or remove credit card interest rate ceilings. According to The Cost of Personal Borrowing in the United States, which is periodically published by the Financial Publishing Company, at least 10 states had no statutory ceiling on credit card interest rates on January 1, 1985.[7] However, we note that since the FRS testimony in October 1985, at least one state has acted to lower its mandated ceiling, and according to news accounts, several other states have considered such action.

THE DISCOUNT RATE AS AN INDEX FOR SETTING CEILINGS

If Congress should decide to enact legislation, the Federal Reserve strongly recommends against designating the discount rate as an index for setting ceilings on credit card rates. The discount rate, the FRS explained, is the interest rate charged by the Federal Reserve Banks on extensions of short-term credit to depository institutions, such as banks. Because it typically applies to very short-term loans, the discount rate is an inexact measure of either marginal or average costs of loanable funds, which may reflect borrowing at a wide range of maturities, according to the FRS. Furthermore, the discount rate is a tool of monetary policy. As such, it reflects broad policy considerations that frequently are complex, and so may deviate from other market rates, even those for instruments of comparable maturity. Thus, it would be wrong, in the FRS view, to use the discount rate for setting credit card interest rate ceilings.

We do not disagree with the FRS that the discount rate is a tool of monetary policy and as such may reflect broad policy considerations. Also, table II.12 shows that the discount rate has fluctuated more widely than credit card costs of issuing FCA banks

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[7]The Cost of Personal Borrowing in the United States, 1985 ed., prepared by the Financial Publishing Company.

from 1973 through 1985. However, figures II.4 and II.5 show that the discount rate trend seems to more closely resemble the trend of credit card costs than does the trend of 3-month Treasury bill yields, the alternative proposal.

AGENCY COMMENTS

We provided a draft of this briefing report to the FRS for comment. The FRS said the approach and conclusions of the report seem to be reasonable and well balanced. (See app. IV.)

OBJECTIVE, SCOPE AND METHODOLOGY

The objective of our review, as requested by Representative Schumer, was to evaluate the validity of facts and the soundness of arguments contained in an October 1985 prepared statement presented at a congressional hearing by a Member of the Board of Governors of the Federal Reserve System. (See p. 1.) The focus of that hearing was proposed legislation to limit the rate of interest which may be charged on credit card accounts.

In its prepared statement, the FRS opposed the legislative initiatives. To support its position, the FRS compared the costs and profits of credit card functions and two other lending functions at banks, and gave its opinions on the reasons for current interest rate levels, the appropriateness of the proposed legislation, and its likely effects. As agreed with Representative Schumer's office, we limited our work to evaluating the facts and arguments presented by the FRS. Consequently, our review did not include determining the degree of competition in the credit card industry, or independently evaluating the need for legislation.

The time period we considered relevant for analysis varied for different facts contained in the FRS statement and was dependent upon the time period to which the FRS referred in presenting each fact. For example, the FRS referred to the time period 1974 through 1984 in discussing the costs of credit card operations, and referred to the time period 1972 through 1984 in comparing the net return of credit card functions at banks with the net returns of two other bank lending functions. Likewise, we focused on those respective time periods when evaluating the validity of the FRS statements regarding those areas. In instances where the FRS did not refer to a definite time period, such as when commenting on the trends of the two interest rates contained in the legislative proposals, we considered the relevant time period to be from 1972 through the most current date for which data were available.

We held discussions with four FRS officials to determine the sources of information in the FRS prepared statement and to obtain information on the FRS Functional Cost Analysis program, the source of the statistical data on which the FRS officials had relied for discussing the costs and profitability of the credit card function at banks and two other bank lending functions. We also had discussions with representatives of industry and relevant consumer groups to learn if there were alternative information sources which could be used to either support or refute facts presented by the FRS in its testimony. In addition, we performed a comprehensive literature search for the period January 1, 1980, through February 28, 1986, to learn of any published studies or commentaries on the credit card industry which might refer to existing data bases that could be useful in evaluating the FRS testimony.

In April 1986, the FRS issued a staff study titled The Effects of Proposed Credit Card Interest Rate Ceilings on Consumers and Creditors.[8] Whereas the October 1985 FRS testimony focused primarily on historical credit card cost and profit information to show that federal rate ceilings are unnecessary due to the presence of competition, its April 1986 study emphasized the potential adverse effects of rate ceilings on different groups of consumers in terms of diminished credit availability and increased non-rate prices for credit card services. There is some overlap between the topics discussed in the two documents, and where overlap exists, the April 1986 document contains the greater amount of detail, especially concerning the origins of statistics on which the FRS relied. While we did not evaluate the accuracy and reliability of the information in the April 1986 FRS staff report, we often used it as a guide for determining the origin of facts presented in the October 1985 testimony and, where appropriate, we refer to the April 1986 FRS staff report in this report.

Much of the FRS information regarding costs and profitability of bank credit cards was obtained from annual surveys of financial institutions conducted through the FRS Functional Cost Analysis program. The FRS provided us with summary information from each of the surveys it performed from 1972 through 1984. We used that statistical information along with information contained in monthly Federal Reserve Bulletins to confirm the sources of the cost and profit figures in the FRS testimony. (The FRS FUNCTIONAL COST ANALYSIS - 1985 AVERAGE BANKS became available in September 1986. We used 1985 information where it provided additional insight.) However, we did not validate the information contained in, nor evaluate the methodology used for gathering the data of, annual FCA surveys or Bulletins. Otherwise, our evaluation was conducted in accordance with generally accepted government auditing standards.

Because the FRS relied on its Functional Cost Analysis program for the cost and profit information presented in its testimony, we focused somewhat on the reliability of that program for producing data representative of all banks. We searched for any studies or scholarly critiques of the program. We also reviewed the FRS instructions to FCA participants and other FRS documents which describe the program, its methodology, reliability, and usefulness. In addition, we performed a simple comparative analysis to determine whether FCA-participating banks differed from non-FCA banks for 1984, the most current year for which FCA results were available at the time. We divided each group of banks into

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[8]A revised version of this study, titled "The Economic Effects of Proposed Ceilings on Credit Card Interest Rates," appeared in the January 1987 Federal Reserve Bulletin, pages 1-13. Some of the statistics in this article have been updated to include 1985 data.

sub-groups of small, medium and large banks, according to asset size. We then obtained financial information which is reported by all federally insured banks on Reports of Condition and Income. Using 1984 data, we computed five commonly used operating ratios for each sub-group of banks and then compared the ratios of like-sized FCA and non-FCA banks. The five operating ratios were (1) net income to total assets, (2) total capital to total assets, (3) net income to total capital, (4) total revenue to total assets, and (5) total expenses to total assets. We also analyzed the geographic representativeness of 1984 FCA participants by comparing the number of FCA participants from each of the 50 states and the District of Columbia with the number of federally-insured banks in each. Our discussion of the representativeness of the FCA-participating banks is in appendix I.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON D C 20551

MARTHA R SEGER
MEMBER OF THE BOARD

January 28, 1987

Mr. Craig A. Simmons
Senior Associate Director
U.S. General Accounting Office
Room 3858-A
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Simmons:

Thank you for providing the Federal Reserve Board with an opportunity to comment on the General Accounting Office report entitled "Federal Reserve Board Opposition to Credit Card Interest Rate Limits." The report focuses on testimony that I presented for the Board on the issue of placing federal limits on credit card interest rates. Both the approach and the conclusions of the GAO report seem to be reasonable and well balanced.

Now on pp. 6-9.

One topic that received prominent consideration in the report (pages 6-11) is the quality and reliability of data from the Federal Reserve System's annual Functional Cost Analysis (FCA) reports. Of course, the Federal Reserve is well aware of the limitations of the FCA data. We share the view expressed in the GAO report about the need for careful analysis of FCA data to avoid unreliable conclusions. During the discussion at the hearing, I alluded to the shortcomings of the FCA data and described how our analysis had attempted to avoid these potential pitfalls.

The Federal Reserve System sees the desirability of improving the quality of FCA data for addressing a variety of important issues. Therefore, the Conference of First Vice-Presidents of the Federal Reserve Banks has decided to implement changes designed to improve the reliability of FCA data, particularly through broadening bank participation. These steps are detailed in correspondence that I have received from an officer at the Federal Reserve Bank of Dallas, a copy of which is enclosed. I am hopeful that these steps will significantly improve the FCA data, because--as the GAO report states--they provide the only source of information that is sufficiently detailed to permit cost and revenue comparisons for particular bank functions.

I thank you again for the courtesy of providing a draft copy of the GAO report for our review.

Sincerely,

Martha R. Seger

Enclosure

FEDERAL RESERVE BANK
OF DALLAS

ROBERT SMITH III
SENIOR VICE PRESIDENT

DALLAS, TEXAS 75222

January 20, 1987

Governor Martha R. Seger
Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

Dear Governor Seger:

This is just a follow-up to our conversation concerning the Functional Cost Analysis program in the Federal Reserve System. Pursuant to your interest and that of others, Reserve Banks, through the efforts of the First Vice Presidents, have revitalized and augmented the resources devoted to the FCA program.

Specifically, actions are underway to perform major surgery on the program to achieve improvements in data validity, sample size, and usage by large bank customers and others. In addition, substantial developmental efforts are in progress with the Bank Administration Institute to increase participation in FCA; and moreover, the Reserve Banks have committed the necessary resources to administer the program. For your information, a study group is presently being formed primarily from the private sector with particular expertise in bank cost accounting to address the apparent program weaknesses in addition to exploring the potential for other improvements.

We deeply appreciate your continued interest in the program, and we will keep you informed on the more substantive aspects of this effort. If I can be of further assistance, please give me a call.

Best personal regards.

Sincerely,

cc: Mr. William H. Wallace

(233154)

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