



FEDERAL RESERVE BANK OF PHILADELPHIA

Update

A newsletter published by the Payment Cards Center, providing meaningful insights into developments in the payment card industry

From the Director

Peter Burns, Vice President & Director

Welcome to this third edition of *Update*, a regular publication of the Payment Cards Center intended to highlight recent Center activities and relevant industry developments. Available also on our web site, *Update* complements the broader and more robust content available at www.phil.frb.org/pcc.

The Payment Cards Center, which was established at the Federal Reserve Bank of Philadelphia in late 2000, was formed to develop insights and communicate on issues relevant to the payment cards industry. Its goal is to inform the active debates that surround many of the issues facing the industry and policymakers.

As evidenced by the varied agenda of topics addressed by the Center in these first two years, it is clear that the payment cards arena is one of the more dynamic sectors in the financial services industry. The pace of change continues to accelerate. Payments innovation, competition and industry restructuring, regulatory and legislative developments, and changing consumer behaviors all translate into new opportunities and challenges to the wide range of constituents affected by these dynamics.

Promoting and supporting dialogue among payment cards stake-

holders is central to the way the Center executes its mission. This emphasis on structured outreach and dialogue with a variety of involved parties is a defining characteristic of this Center. Industry perspectives represent a critical element of our outreach efforts and an important means to ensure that our agenda reflects current market realities. We continue to expand this dialogue by participating in industry forums as well as including industry representatives in our internal workshop series. Workshop discussions motivate written analyses, which we publish in our Discussion Paper series. As of this date, the Center has posted 18 papers to its web site. A full list of publications is featured later in this newsletter.

In developing our conference programs, we attempt to bring together a mix of industry, academic, and policy participants. One such recent event, "Innovations at the Point of Sale," included not only payment providers but also payment specialists from merchant organizations, as well as staff from a number of Reserve Banks and the Board of Governors. A brief summary of this event is included in this issue of *Update*.

The Payment Cards Center is committed to supporting original research that increases our understanding of underlying payment industry

Mission Statement

The mission of the Payment Cards Center is to provide meaningful insights into developments in the payment card industry that are of interest not only to the Federal Reserve but also to the industry, other businesses, academia, policymakers, and the public at large. The Center will carry out its mission through an agenda of research and analysis as well as forums and conferences that will encourage a dialogue that includes industry, academic, and public-sector perspectives.

In This Issue:

- 3** Privacy Experts Discuss Current Issues
- 5** "Innovation at the Point of Sale" Conference
- 7** Discussion Papers
- 8** Summary of President Santomero's Remarks
- 9** 2003 Conferences
- 10** Working Papers
- 10** Research Explores Credit Card Pricing and Disclosure
- 11** "Money in Motion"



From the Director *continued from page 1*

dynamics. Our colleagues in the Bank's Research Department help focus our efforts in this regard as does the Center's visiting scholars program. In recent months, several visitors to the Bank have participated in various Research Department and Center activities. In this issue, we highlight two recent payment-cards-related papers now in the Research Department's Working Paper series.

The Bank's Research Department has a strong tradition of banking and payments research. This spring, the department hosted its third annual conference on consumer finance and payments. This year's event, which was held in association with the *Journal of Banking and Finance*, dealt with "Retail Credit Risk Management and Measurement." The conference brought together leading researchers in the field, and discussions benefited from inclusion of industry professionals and other Payment Cards Center associates.

Consumers play a central role in any study of payment cards activity. On one level, it is ultimately consumer behavior that determines the pace of adoption and extent of use of alternative payment vehicles. On another level, laws and regulations are developed to ensure that consumers are protected from abusive practices and their behaviors are motivated by informed decisions. The Payment Cards Center strives to provide insights on both levels.

Workshops and conferences regularly include consumer perspectives. In recent months, we have hosted visitors who have addressed a number of related topics, including credit card users' exit behaviors and accuracy and fairness issues in credit bureau reporting. In the future, the Center's staff will work with colleagues in the Community Affairs Department to integrate the

topic of payment card use into the Bank's financial literacy program. The Center has built relationships with credit counseling services, interested academic researchers, and concerned issuers to better understand changing consumer payment dynamics. This spring, the Payment Cards Center worked with the Bank's Public Affairs Department to develop a cards-focused module, called "Swipe-It," in the Bank's new interactive exhibit "Money in Motion," described on page 11.

Although the Payment Cards Center is not responsible for defining Federal Reserve policy nor is it part of the System's supervision and regulatory functions, its mission focuses on promoting dialogue and analysis that helps inform policy debate. As such, our activities are oriented toward developing and communicating insights into a range of payment-card issues.

In this *Update*, we highlight two recent initiatives we believe have made relevant contributions to informing policy discussion. First is a summary of a discussion paper "Credit Card Pricing Developments and Disclosure," written by Center analyst Mark Furletti. The second is "Financial Privacy: Perspectives from the Payment Cards Industry," a conference that brought together a range of practitioners and legal experts for a roundtable discussion. The full text of these papers is available on the Center's web site.

We hope you enjoy this issue of *Update*, and we thank you for your continued interest in and support of our efforts. We are eager to hear from readers who have comments or suggestions as to how we can improve our efforts to deliver a meaningful agenda. ■

PCC Symposium Brings Together Industry Experts on Privacy to Discuss Current Issues



Motivated by the January 2004 expiration of a federal preemption that prohibits states and municipalities from enacting laws that conflict with the Fair Credit Reporting Act (FCRA), Washington is contemplating a number of revisions to current privacy-related statutes. To better inform the debate over payment-card-related privacy issues, the Payment Cards Center hosted a one-day symposium entitled “Financial Privacy: Perspectives from the Payment Cards Industry.”

Legal scholars, federal banking regulators, and privacy officers from the largest credit card issuers and information providers in the U.S. discussed the key privacy issues facing the industry. The symposium was structured as a roundtable discussion. Participants freely interacted with discussants and moderators. The president of the Federal Reserve Bank of Philadelphia, Anthony M. Santomero, opened the symposium by posing a series of questions for discussion. What kinds of uses and abuses of consumer information give rise to legitimate privacy concerns? How do current industry practices manage these concerns? How should market forces and prescriptive rulemaking work together to create an environment that both responds to consumer needs and protects consumer interests?

After Santomero’s introduction, Oliver Ireland of Morrison & Foerster LLP provided a brief legal history of privacy as a matter of recent public concern. He explained how Vietnam-era distrust of government and the emergence of electronic data collection systems drove Congress to pass privacy-related legislation in the 1970s. Twenty years later, the proliferation of personal computers and the growth of the Internet resulted in another wave of privacy leg-

islation, including amendments to the Fair Credit Reporting Act (FCRA) and Gramm-Leach-Bliley (GLB). Overall Congress’s various privacy initiatives, coupled with programs proposed by state legislatures and attorneys general, have, in Ireland’s view, largely created a “hodgepodge” of privacy policies. As a result, policymakers, consumer groups, and bankers have difficulty agreeing on precisely what privacy legislation should be protecting. Is it about identity theft? Businesses sharing customer information with



Pictured at the financial privacy symposium (left to right) are Oliver Ireland, Peter Swire, Andy Navarrete, and Bill Brooks.

other businesses? The secrecy of medical records? Protecting consumers from the intrusions of government, businesses, or other consumers?

In an attempt to answer some of the questions posed by Santomero and Ireland, the following experts discussed their perspectives on the issues: L. Richard Fischer, Morrison & Foerster; Peter Swire, the Moritz College of Law at Ohio State; Robert Ryan, TransUnion; Timo-

thy Spainhour, Acxiom; William Brooks, MBNA; and Andy Navarrete, Capital One.

Overall, conference participants agreed that much of the recently enacted privacy legislation has provided benefits to the credit card industry, the privacy notice provisions of GLB excepted. Participants generally concurred that GLB's privacy provisions have led to stronger data security procedures, better-documented and better-understood information flows, and much improved data management as it relates to issuers' third-party relationships.

One of the hottest issues currently being debated in Congress is the extension of the federal preemption prohibiting states and municipalities from enacting laws that conflict with the Fair Credit Reporting Act. Participants felt strongly that these preemptions should be permanently extended. Ryan explained how critical uniform national standards are to the country's rich credit reporting system. If the federal preemption is allowed to lapse, Ryan predicted that credit bureau data would lose much of its completeness and richness.

Swire, former chief counselor for privacy in the Office of Management and Budget under President Clinton, argued that, contrary to many economists' assessments, confidentiality enhances efficiency in financial services markets. An assurance of information privacy induces consumers to trust their financial institutions with their business. Without such assurance, consumer information would likely be concealed and the quality of transactions greatly diminished.

During the day's final session, privacy experts from two credit card issuers returned to

Ireland's assertion that the multifaceted nature of privacy required a more focused debate. Privacy, explained Navarrete, means different things to different people. To improve consumers' sense of privacy in a meaningful way, policymakers, regulators, and credit card issuers

The issue [of privacy] is simply too broad, its facets too complex...to be resolved with a single piece of legislation.

need to work together to disentangle the many issues associated with the term. Overall, privacy issues are best addressed individually and with specific remedies.

It was clear from the day's discussion that the privacy debate cannot be resolved with a single piece of legislation or a single administrative agency's rule. The issue is simply too broad, its facets too complex, and the technology that gives rise to these concerns too dynamic. Instead, the questions surrounding privacy require careful dissection, extensive analysis, and tailor-made remedies. The goal of industry leaders and policymakers, therefore, should be to understand clearly the specific privacy interests that need to be protected and to implement safeguards in a way that efficiently balances relevant costs and benefit.

For a detailed summary of the day's discussion, see the conference summary entitled "Financial Privacy: Perspectives from the Payment Cards Industry" on the Center's web site. **■**

Merchants' Concerns Take Center Stage at PCC-Sponsored "Innovation at the Point of Sale" Conference

Not long ago, a merchant's decision about the kinds of payments it would accept from its customers was among its least complicated management challenges and had little strategic significance. The list of payment forms was rather short, and the decision had little impact on the merchant's overall profitability. This is no longer the case. Today, merchants are confronted with a long list of payment options, each with its own set of cost, efficiency, and usage considerations. Ultimately, the forms of payment a merchant

of the 12 Federal Reserve Banks, the OCC, the Board of Governors, institutional payment innovators, and national retailers.

T. Jack Williams, a senior vice president at National Processing Company (NPC) who helped organize the event, opened with an overview of merchant processing and various payment innovations currently in development by his firm and partner clients. Williams explained how merchant acquirers, such as NPC, serve merchants by obtaining approval and facilitating payment for their electronic transactions (e.g., credit card or debit card transactions).

The success of any new payment technology, Williams asserted, depends on its ability to provide merchants with incremental sales and lower transaction processing costs. Electronic check conversion, smart cards, prepaid debit cards, radio-frequency identification, fingerprint scans, and iris scans are some of the technologies that Williams described as competing for acceptance in merchants' real and virtual checkout lanes. "Bleeding edge" technology, he believes, does not have a chance at mass adoption by merchants unless it can present a strong business case based on incremental sales.

After Williams's introduction, representatives from three payments innovators described their alternative check-based payment solutions. Teri Hoehn from NACHA — The Electronic Payments Association; Dante Terrana of Visa POS Check Service; and Ronald Congemi of Star Systems, a Concord EFS Company (an owner-partner in SafeCHECK), participated in a panel discussion of check electrification at the point of sale.



(Left to right) Ronald Congemi, Dante Terrana, and Teri Hoehn discuss check conversion innovations at the point of sale.

accepts can be a competitive advantage, affecting sales and customer loyalty.

In an effort to understand how merchants evaluate different kinds of payment products, how merchants' banks (i.e., merchant acquirers) support these products, and how the newest of these payment products work, the Payment Cards Center sponsored a conference entitled "Innovation at the Point of Sale." The one-day event brought together more than 60 payments professionals, including representatives from six

Despite advances in card-based payments and the declining use of cash, the value of consumer purchases made by check at the point of sale is larger than the value of purchases made by card and other electronic means combined. For this reason, Visa, SafeCHECK, and NACHA are investing in technologies that “electronify” check-based transactions. Using a terminal that reads the magnetic ink on the bottom of customers’ checks, the technology allows merchants to convert checks presented at the point of sale into electronic payment messages. This “conversion” may make it possible for merchants to confirm the availability of a customer’s funds, decrease check float, and reduce fraud exposure. In describing their processes, the three panelists agreed that, despite dwindling check volumes, conversion provides check-accepting merchants with savings that more than offset the costs associated with purchasing the technology.

A second panel examined point-of-sale innovations from the perspective of an important but often overlooked party—the merchant. Donald Roddy of Sonic, a quick-service restaurant (QSR) chain that operates in south-central states; Henry Bray of ExxonMobil; and Daniel Olstad of Best Buy discussed how payment systems have become an integral part of their consumer marketing strategies and how merchants evaluate new payment technologies. All three merchants agreed that the most successful payment technologies can increase customer loyalty, customer traffic, the average amount a customer spends, and overall sales. It is also important to merchants that the technologies reduce costs, make checkout easier and faster, and be easily understood by customers.

Roddy explained how Sonic’s adoption of credit cards increased transaction amounts more than 50 percent. Best Buy’s Olstad argued that PIN-based debit represents a huge opportunity for merchants. At one-third the cost of credit and one-half the cost of check, debit is the payment medium that Best Buy wants its customers to use the most. Bray indicated that the ExxonMobil Speedpass, a payment form that incorporates radio-frequency identification technology, is a comparatively expensive payment option. ExxonMobil, however, has been aggressive in marketing the technology because of its ability to simplify buying and build customer loyalty.

From the merchants’ perspective, innovators need to be mindful of the substantial investments that new payment technologies require and make certain that new technologies offer merchants a compelling value proposition.

The conference closed with a brief discussion of the importance of bringing *all* participants in the payments chain, including merchants, together to discuss emerging issues. The interdependencies inherent in consumer payments systems require that any successful payment-facilitating or payment-accepting entity understand how technologies benefit and burden others in the chain.

For a more detailed summary of the day’s discussion, please see the conference summary entitled “Innovation at the Point of Sale” on the Center’s web site. **U**

Discussion Papers

In addition to supporting original academic research in the area of payment cards and related issues, the Center also emphasizes the development of more generally accessible industry analyses. Academic research papers are included in the Bank's Research Department Working Paper series and less theoretical industry analyses are published as Discussion Papers. These papers, prepared by Center staff and Bank colleagues, may be motivated by topics from workshops and forums or by other industry developments of interest to the authors.

The Discussion Paper series is available in pdf format on the Center's web site. A chronological listing of programs posted to the site to date follows:

2003

- 03-1 Credit Card Pricing Developments and Their Disclosure
- 03-2 Voting With Your Feet: Consumers' Problems with Credit Cards and Exit Behaviors
- 03-3 Financial Privacy: Perspectives from the Payment Cards Industry

2002

- 02-1 Is the Personal Bankruptcy System Bankrupt?
(also an FRBP *Business Review* article)
- 02-2 An Overview and History of Credit Reporting
- 02-3 Managing Global Privacy
- 02-4 Arbitration: Alternative Dispute Resolution in the Credit Card Industry
- 02-5 Update on Securitization: Credit Cards and Other ABS Markets
- 02-6 What's in the File? The Economics and Law of Consumer Credit Bureaus
(also an FRBP *Business Review* article)

2001

- 01-1 Privacy Matters: The Right to Privacy and the Financial Services Industry (also an FRBP *Business Review* article)
- 01-2 Summary of Conference on Consumer Transactions and Credit (also an FRBP *Business Review* article)
- 01-3 Credit Cards and Payment Efficiency
- 01-4 The Evolution of EFT Networks from ATMs to New On-Line Debit Payment Products
- 01-5 A Panel Discussion on Dynamics in the Consumer Credit Counseling Services
- 01-6 Managing Consumer Credit Risk
- 01-7 Innovations in Small Dollar Payments
- 01-8 Fraud Management in the Credit Card Industry
- 01-9 Retail Credit Risk Modeling and the Basel Capital Accord

Retail Credit Risk Management and Measurement

This is a summary of the opening remarks made by Philadelphia Fed President Anthony Santomero at the retail credit risk conference on April 24, 2003.

Over the past several decades there has been a sea change in the Federal Reserve's approach to regulation. The Fed's emphasis has shifted from portfolio restrictions and crude leverage ratios to a much more subtle approach to risk regulation.

While banks are indeed increasing their risk-modeling efforts, it should come as no surprise that historically the focus has been on the commercial side. However, despite this emphasis, retail credit is a substantial and increasing part of the risk borne by the banking industry. Recognizing this, the industry has begun to develop more sophisticated credit-scoring models for measuring retail risk. While the sophistication of automated credit scoring has increased, only recently have some institutions put resources into advanced methods of retail portfolio credit risk modeling.

At the Philadelphia Fed, we are leading a System-wide effort to develop a supervisory framework to evaluate bank practices in retail credit risk management, including internal risk rating systems. This project, which will enhance the Federal Reserve's ability to assess banking organizations' retail credit risk quantification methods, responds to gaps in the Basel II framework.

We have three main goals: First, we are documenting existing policies and practices among institutions capable of effectively measuring retail credit risk. Second, we are analyzing the reliability of current practices and assessing their weaknesses or gaps. Third, we want to identify major analytical issues in quantifying retail credit risk and to generate relevant research. Through 2003 and beyond, Philadelphia will continue to develop its ongoing research agenda on retail credit risk quantification.

However, the efforts of our Bank are not the last word on retail credit risk. Each new development works to encourage industry and regulators toward better risk management practices. With more experience and better data, risk parameters will change and models will get stronger. Rather than a uniform regulatory standard, financial institutions will develop their own assessments and procedures that accurately capture retail credit risk. In this way, the industry itself can lead the evolution of risk management—as ultimately it should.

We can take pride in the fact that we have come such a long way in a relatively short time. Yet, we don't have all the answers, which is why we had better keep working. This conference is an integral part of our work. ■

E-mail Notification

You can receive notification by e-mail when a new **Payment Cards Center Update**, discussion paper, or other publication is added to our web site. Sign up for this service on the **Payment Cards Center main home page** <http://www.phil.frb.org/pcc/>.

2003 Conferences

The Future of E-Commerce Payments **June 17-18, 2003**

The Payment Cards Center co-hosted a forum with the Electronic Funds Transfer Association's (EFTA) eCommerce Payments Council. The meeting provided an opportunity for participants to explore e-commerce payment products and issues. The event combined Federal Reserve and industry perspectives on a variety of current issues, including check electrification at the point of sale and the implications for mobile commerce transactions.

Retail Credit Risk Management and Measurement **April 24-25, 2003**

The Philadelphia Fed's Research Department sponsored a conference on retail credit risk management and measurement. The conference topic acknowledges important developments in retail credit markets and, in turn, the retail credit portfolios of financial institutions. Recent changes in the regulatory landscape and the introduction of the Basel II Accord have underscored the importance of risk management and measurement systems used by financial institutions. Selected papers presented at the conference will be published in a special issue of the *Journal of Banking and Finance*.

Financial Privacy: Perspectives from the Payment Cards Industry **March 21, 2003**

The financial privacy debate is particularly relevant to the information-intensive credit card industry. Recent work by academic researchers

and legal scholars has helped to better frame many of the underlying principles. Policy debate at both the federal and state levels has added new information and better-defined positions. Of course, the experiences of industry participants and consumers have provided practical clarification on a number of implementation issues for privacy rules. At the same time, the upcoming sunset of the 1996 FCRA preemption amendment has heightened debate and introduced new legislative dynamics that seem certain to result in some change to the status quo.

Innovation at the Point of Sale **February 26-27, 2003**

The days of "cash-and-carry" are long gone, and consumers find themselves with an ever-increasing array of payment options. Many of these new developments emanate from networks and payment processors working together with merchant and banking partners. This event included participants from the industry, representatives from merchants' organizations, and Federal Reserve payment professionals. The discussions especially benefited from the merchants' perspectives on the need for alignment among all payment participants in the quest for productive innovation.



Research Working Papers

The Bank's Research Department publishes a working paper series of original research produced by resident economists and visiting scholars. The Payment Cards Center is committed to supporting such efforts, particularly research that focuses on payment-card-related issues. Links to these relevant Research working papers are maintained on the Center's web site.

Two new Research working papers were recently posted to the site. The first of these was written by Bob Hunt, a Bank economist who works closely with the Center. His paper, "The Development and Regulation of Consumer Credit Reporting in America," examines the evo-

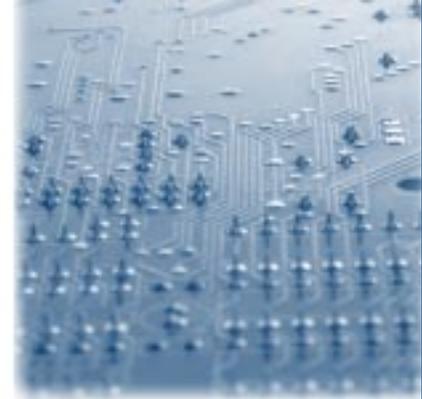
lution of the consumer credit reporting industry and the role of the Fair Credit Reporting Act in balancing the benefits of voluntary information sharing against the cost of any resulting mistakes.

The second paper was co-authored by Joe Mason, assistant professor of finance at Drexel University and a Payment Cards Center visiting scholar. Mason's paper, "Credit Card Securitization and Regulatory Arbitrage," explores the motivations that drive off-balance-sheet financing of credit card receivables by banks and addresses underlying risk transfer implications. ■

Research Explores Credit Card Pricing and Disclosure

Earlier this year, Mark Furletti, the Payment Cards Center's credit card industry specialist, completed research for a paper entitled "Credit Card Pricing Developments and Their Disclosure." In the paper, Furletti examines the history and dynamics of credit card pricing over the past 10 years. Analyzing proprietary issuer pricing data and 150 lender-borrower contracts from the largest credit card issuers in the U.S., he explains how new technologies, increasing competition, and consumer awareness have influenced card pricing.

Overall, he observes that increasingly complex fee structures and computational techniques have accompanied the record-low annual percentage rates that many low-risk consumers currently enjoy. Furletti also examines how these price-related developments are addressed by the current regulatory disclosure requirements embodied in Regulation Z (Truth in Lending). A copy of his paper is available on the Center's web site.



“Money in Motion”

July 4, 2003 marked the opening of Philadelphia’s new Constitution Center. The Federal Reserve Bank of Philadelphia is located across the street from this new facility and is near a number of other historic destinations, including Independence Hall. Coinciding with the opening of the Constitution Center was the opening of the Federal Reserve Bank of Philadelphia’s new exhibit “Money in Motion.” A year in the making, “Money in Motion” is dedicated to the story of money and central banking in the United States. It focuses on the Federal Reserve System, with special attention to Philadelphia’s Third District. The exhibit occupies 4,500 square feet on the Bank’s ground floor.

The exhibit employs the latest in interactive and presentation technology intended to make the visitor’s experience entertaining while offering rich story content in its examination of the evolution of money and central banking in the United States. Major sections of the exhibit tell the story of monetary policy, bank supervision and regulation, and the payments system. A historical timeline illustrates the history of central banking in the U.S.

Of special interest to the Payment Cards Center is the section of the exhibit devoted to payment cards. Called “Swipe It,” this interactive display is designed to educate the public about the use of payment cards. “Questions on Credit Cards” provides consumer-friendly answers to somewhat technical issues such as interest rate calculations, balance transfer fees, and credit reports. A “Debt Calculator” allows visi-

tors to determine the length of time it will take to pay off their own credit card balances based on minimum or specific payment amounts. Using touch-screen displays, visitors can find use-



“Swipe It,” part of the Philadelphia Fed’s new “Money in Motion” exhibit, tells visitors everything they’ve always wanted to know about payment cards, identity theft, and credit card fraud.

ful information on how to protect themselves against credit card fraud and identity theft.

The Payment Cards Center hopes “Swipe It” will be entertaining as well as educational and will provide real benefit to the public. 



FEDERAL RESERVE BANK OF PHILADELPHIA

Update

Payment Cards Center Newsletter

Federal Reserve Bank of Philadelphia
Ten Independence Mall
Philadelphia, PA 19106-1574
215-574-7220
215-574-7101 (fax)
www.phil.frb.org/pcc/

Peter Burns

Vice President and Director

Stan Sienkiewicz

Manager

The Payment Cards Center was established to serve as a source of knowledge and expertise on this important segment of the financial system, which includes credit cards, debit cards, smart cards, stored-value cards, and similar payment vehicles. Consumers' and businesses' evolving use of various types of payment cards to effect transactions in the economy has potential implications for the structure of the financial system, for the way that monetary policy affects the economy, and for the efficiency of the payments system.

"The Philadelphia Reserve Bank will be broadly recognized as an important center of central bank knowledge and capability."

*Anthony M. Santomero
President*