PAYMENT CARDS Center
FEDERAL RESERVE BANK OF PHILADELPHIA

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 inaugural edition of *Update* and an introduction to the Payment Cards Center of the Federal Reserve Bank of Philadelphia. This will be a regular publication highlighting Center activities and industry developments of interest to those in the payment card industry, academia, and public policy.

Rapid advances in technology, changes in regulation, and consolidation among financial firms continue to alter the landscape of the financial services industry. With these changes, new entrants into the payments system have emerged. These developments are of interest not only to the Federal Reserve but also to the broad set of industry players, academic researchers, policymakers, and the public at large.

Because the Third Federal Reserve District has a large concentration of participants in the payment card industry, the Federal Reserve Bank of Philadelphia has had a long association with these industry players. This natural association with the payment card industry and the related expertise that has developed over a number of years ultimately led to the formation of the Payment Cards Center in late 2000.

During our first year, in addition to setting up and staffing the Center, we engaged in a dialogue not only with colleagues within the Federal Reserve but also with representatives from external constituencies to help us shape a relevant agenda. We greatly value these relationships and consider such interactions critical to our strategic intent of being grounded by market realities.

These early interactions helped define our agenda and business purpose as a source of knowledge and expertise in this increasingly important segment of the financial services industry. Today, general-purpose credit cards dominate the arena, but innovations in debit cards, smart cards, and related payment vehicles represent new opportunities that have implications for the structure and efficiency of the financial system. A key element of the Center's mission statement – shown on this page – is to emphasize our intent to ensure that the work we do incorporates the perspectives of all interested parties. In this way the Center provides a forum for the points of view of not only the Federal Reserve but also industry, academia, policymakers, and the public at large.

The Center has been established as the driver of payment card studies at the Philadelphia Fed. We execute our mission through a dynamic structure of active partnerships, with both internal and external constituencies. In this issue of *Update*, we discuss our early efforts in building partnerships and provide brief summaries of several workshops held over the past year.

For more information on the Center and full reports on conferences and workshops, please visit our web site at http://www.phil.frb.org/pcc. We welcome your thoughts and suggestions as to how we might effectively shape the Center's agenda to address the needs of market participants and others interested in this important and evolving industry. U

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:

Building Capability Through Partnerships

A goal of the Payment Cards Center is to not only build expertise within the Center itself but also to leverage and expand on the Philadelphia Reserve Bank's existing competencies in the area of payment cards. Using a business model that emphasizes cross-functional initiatives allows us to expand our capabilities beyond those of the Center's core staff. We also strive to ensure that the Center's agenda is informed by market realities and recognizes the interests of external constituencies. In this sense, the Center may be seen as a forum for bringing together contributions from policymakers, industry, the academic community, and the general public.

Partnerships

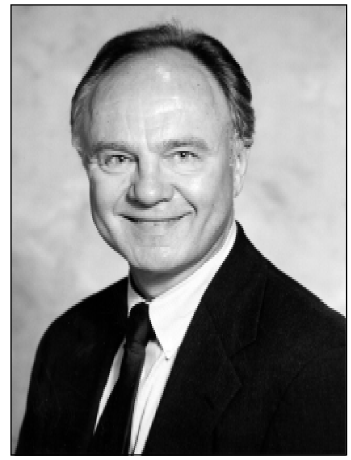
During the Center's first year, we formed key partnerships with Bank colleagues who bring expertise in a variety of relevant areas, including retail payments, risk management, legal, community and consumer affairs, and economic research. Working together and leveraging existing capabilities, we have collaborated on a range of activities. One visible result of these collaborations is the Payment Cards Center Workshop series. These half-day symposiums bring to the Center leading experts from industry, academia, and consumer groups for interactive discussions on a variety of critical issues. Following these programs, discussion summaries, along with analyses by Center staff, are published and made available on our web site (http://www.phil.frb.org/pcc). A few examples of these internal partnerships at work will serve to illustrate the natural synergies with the Center's goals.

Legal

Like other segments of the financial services industry, payment card businesses are subject to a variety of regulatory and legal controls. Credit card issuers operate in a complex regulatory environment involving not only traditional bank solvency issues but also pricing strategies, consumer disclosure requirements, and with the recent passage of the Gramm-Leach-Bliley Act, a new focus on the use of customers' "personal private information."

The emergence of new, nonbank payment business models that provide card-like functionalities raises a number of issues about the legal and regulatory status of these new industry participants. The recent challenges to nonbank person-to-person payments innovators as to their status as unregulated entities illustrate the often complex legal issues surrounding this industry sector. Working with the Bank's Chief Counsel, Ed Mahon, the Payment Cards Center relies on the Legal Department to follow and advise on payment card legislation and relevant court cases. Members of the legal staff participate in Center-sponsored activities and assist in program development.

Following passage of the Gramm-Leach-Bliley Act, Ed Mahon helped organize a seminar on financial privacy led by Professor Anita L. Allen, a noted legal



Peter Burns
Vice President and Director
Payment Cards Center

Peter Burns, who joined the Federal Reserve Bank of Philadelphia in November 2000, is responsible for the development and management of the Payment Cards Center.

From 1996-2000 he was managing director of the Financial Institutions Center at the University of Pennsylvania's Wharton School and continues to serve on its advisory board of directors. Burns has an extensive background in the financial services industry, having held a number of senior management positions during a 25-year career with CoreStates Financial Corporation and its predecessor, Philadelphia National Bank.

Burns received an AB degree from Lehigh University and an MBA in Finance from the University of Chicago's Graduate School of Business.

scholar from the University of Pennsylvania's Law School. Highlights from this workshop are presented later in this newsletter. An expanded summary of the seminar was featured in the Philadelphia Fed's quarterly *Business Review* under the title "Privacy Matters: Payment Cards Center Workshop on the Right to Privacy and the Financial Services Industry."

Community & Consumer Affairs

Credit cards have increasingly become the payment vehicle of choice for many U.S. consumers. Employing sophisticated new technologies to refine underwriting techniques and develop segmented product offerings, credit card issuers have substantially broadened the base population of credit card users. This "democratization of credit" has brought benefits to many consumers who, in the past, might have been excluded from formal credit markets. However, the proliferation of credit availability has also resulted in severe financial strains for others, who find themselves overextended with heavy debt burdens. The record level of personal bankruptcy proceedings is one measure of this impact. Less understood are the causes behind these statistics and the potential remedies that might lead to more responsible use of credit at lower social cost. Consumer-related issues such as identity theft, fraudulent credit card use, and the rise in personal bankruptcies are all of concern to the Payment Cards Center.

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Dede Myers, head of the Bank's Community and Consumer Affairs Department, has helped the Center address the broad set of consumer issues related to payment cards. Working with Center staff, the Community and Consumer Affairs Department developed a workshop that brought together the heads of several regional consumer credit counseling service agencies. The workshop focused on the role these agencies play in intermediating between financially troubled consumers and credit card lenders in an effort to maintain debt service and help these individuals avoid personal bankruptcy. Highlights from this workshop are also noted later in this newsletter.

Research

Relative to the literature on corporate lending and large-dollar payment systems, the body of academic research on consumer credit and retail payment systems is substantially more limited. The Payment Cards Center is committed to supporting

the expansion of this base of study in an effort to increase understanding of underlying industry and systemic dynamics. Such research can provide the intellectual foundation for analyses of the many challenges and opportunities faced by the industry and policymakers.

Historically, the Reserve Bank's Research Department has had a strong focus on banking and on the payments system, and it is committed to enhancing its research support on issues relevant to the Payment Cards Center. Senior Vice President and Director of Research Loretta Mester has played a key role in helping to establish the Center's intellectual agenda and, along with her colleagues, has worked to support the Center's research mission. During the Center's first year, a collaborative effort resulted in a successful conference on "Consumer Transactions and Credit." Among the research papers discussed at this event was a timely study of consumer responses to changes in credit limits and interest rates based on a unique data set of several thousand credit card accounts. A summary of the conference proceedings and an article on "Perspectives and Research Issues in Consumer Behavior" by the Bank's president, Dr. Anthony Santomero, were featured in the Third Quarter 2001 issue of the *Business Review*.

"[The Consumer Transactions and Credit] conference is just the first of many efforts we at the Federal Reserve Bank of Philadelphia plan to make to advance the consumer credit research agenda."

Anthony M. Santomero, *President*

A conference on "Innovation in Financial Services and Payments," which will be held in May 2002, will bring together a number of leading academic researchers to review new work on a variety of consumer payment issues. Another conference, "Credit Risk Modeling and Decisioning," will include experts from industry and academia who will discuss the latest advances in applying statistical modeling technologies to consumer credit risk management. This event, which will also be held in May of this year, is jointly sponsored by the Financial Institutions Center of the University of Pennsylvania's Wharton School.

Beyond supporting an active conference schedule, the Research Department and the Center collaborate on bringing scholars to the Bank for seminars and discussions of relevant payment cards research. The Center also helps support longer term visits by scholars to the Research Department during academic sabbaticals or other times when longer periods are available for research. In late 2001, the Center established a Visiting Fellows program and announced its first appointment, Professor David Humphrey from Florida State University. Under this multi-year program, Fellows visit the

Bank periodically to participate in Center activities and research discussions, serving also as advisors to Center analysts and Research Department economists. Over time, the Center will expand the Fellows program.

The Future

During its first year, the Payment Cards Center established a strong foundation of activities and began the process of realizing its goal to be "a source of knowledge and expertise on this important segment of the financial services industry." As the Center moves forward, it will continue to emphasize its partnering strategy and to work with the broad base of market participants in developing a value-added agenda.

An integral function of the Payment Cards Center is to provide a forum for the discussion of critical issues facing industry and public policy practitioners. Conferences that incorporate the unique perspectives of academia, industry, consumers, and the public sector advance the Center's mission of extending the state of knowledge and contributing to the public debate on matters of importance to the payment cards industry. Our web site contains further information on upcoming events and summaries of past conferences. Listed below are conferences sponsored by the Payment Cards Center.

March 22-23, 2001
"Consumer Transactions and Credit"
co-sponsored with the Federal Reserve Bank of Philadelphia's Research Department and the Wharton Financial Institutions Center, in association with the *Journal of Financial Intermediation*

May 16-17, 2002
"Innovation in Financial Services and Payments"
co-sponsored with the Research Department of the Federal Reserve Bank of Philadelphia

May 28-30, 2002
"Credit Risk Modeling and Decisioning"
co-sponsored with the Wharton Financial Institutions Center

Since the creation of the Payment Cards Center in late 2000, its Workshop Series has proved to be a successful forum for providing industry insights and promoting productive discussions. The workshops encourage collaboration between the Philadelphia Fed and participants from industry, academia, and the public sector to examine issues of relevance to the payment card industry. Listed below are the workshops the Payment Cards Center held during its first year.

March 5, 2001
"The Evolution of Bank Card Associations"
James Shanahan, *Principal*
Business Dynamics Consulting, Inc.

May 1, 2001
"Legal and Historical Precedents for Financial Privacy, Policy, and Regulation"
Anita L. Allen, *Professor of Law*
University of Pennsylvania Law School

May 22, 2001
"Credit Cards, Interchange, and Payment Efficiency"
David B. Humphrey, *Professor of Finance*
Fannie Wilson Smith Eminent Scholar in Banking
College of Business, Florida State University

June 15, 2001
"EFT Industry Perspective and New Secure Payment Products"
Bruce Sussman, *Director of Internal Audit*
NYCE Corporation
Paul Tomasofsky, *Vice President*
Advanced Product Group, NYCE Corporation

July 20, 2001
"A Panel Discussion on Dynamics in the Consumer Credit Counseling Services "
James Godfrey, *Executive Vice President*
CCCS of Maryland and Delaware, Inc.
Patricia Hasson, *President*
CCCS of Delaware Valley, Inc.
Jerome Johnson, *President and CEO*
CCCS of South Jersey
Ghyll Theurer, *Program Manager*
CCCS of South Jersey

July 31, 2001
"Managing Consumer Credit Risk"
Jeffrey Bower, *Senior Manager*
KPM Consulting

September 25, 2001
"Innovations in Small Dollar Payments"
Richard Corl, *Director*
Ecount

November 16, 2001
"Fraud in the Credit Card Industry"
Daniel Buttafogo, *Director of Risk Management*
Juniper Bank
Larry Drexler, *General Counsel and Chief Privacy Officer*
Juniper Bank

December 14, 2001
"Retail Credit Risk Modeling and the Basel Capital Accord"
Paul S. Calem, *Senior Economist*
Division of Research and Statistics, Board of Governors of the Federal Reserve System

January 23, 2002
"Prospects for Smart Card Applications"
Joel Tolbert, *Eastern Regional Manager*
SchlumbergerSema

April 5, 2002
"Credit Bureaus"
Dan Brackle, *Vice President*
Philadelphia, TransUnion
A.C. Capaldi, *Group Vice President*
Eastern Region, TransUnion
Chet Wiermanski, *Vice President*
Analytical Services, TransUnion

Following are summaries of selected workshops from our 2001-2002 Workshop Series. Full-text versions of these summaries, summaries of workshops not included here, and all of our discussion papers are available on our web site.

Legal and Historical Precedents for Financial Privacy, Policy, & Regulation

The Gramm-Leach-Bliley Act (GLB) broke down the remaining barriers between commercial and investment banking. While this provided potential advantages to many financial services firms and their customers, it also raised new concerns over the issue of privacy.

In May 2001, Anita Allen, a professor at the University of Pennsylvania Law School, led a discussion about privacy issues, particularly the privacy provisions included in GLB. Her remarks provided a chronological timeline for these issues and a context for the passage of the privacy provisions of GLB. Professor Allen provided a detailed historical perspective on the evolution of privacy concerns in the U.S., from the Constitution's exclusion of the word "privacy," to the 1890 *Harvard Law Review* article citing privacy concerns associated with the newly invented camera and high-speed printing press, to modern-day concern over privacy on the Internet.

Legislative actions to address privacy concerns in the financial services arena did not emerge in the U.S. until the 1970s when Congress passed the Fair Credit Reporting Act, which applies to consumers and covers the allowable use of credit information. Later legislation further restricted access. For example, the 1974 Privacy Act mandated "fair information practices" and limited third-party access to personal records. That same year, the Freedom of Information Act gave the public access to government records (excluding medical and personnel files). Privacy rights were finally extended to banking and financial transactions with the Right to Financial Privacy Act in 1978.

Most recently, Congress passed GLB in 1999. The privacy provision in the act requires a financial institution to inform consumers that it may disclose "nonpublic personal information" to nonaffiliated third parties. However, consumers must be offered the opportunity to opt out of such disclosures. Professor Allen advised caution when considering the question of how much protection consumers actually derive from the privacy provisions of GLB, which specifically permit information sharing among affiliated companies. With ever-increasing information processing capabilities, the consolidation of industry players, and an increasing number of companies with global affiliates, consumers' personal information could potentially be shared far more broadly than is the case today. At the same time, it may also be argued that responsive and responsible financial institutions will use new technologies to improve the delivery of value-added services.

Inaugural Visiting Fellow

David Humphrey
Professor of Finance and the Fannie Wilson Smith Eminent Scholar in Banking, College of Business, Florida State University

Professor David Humphrey has held the Fannie Wilson Smith Eminent Scholar Chair in Banking at Florida State University since 1991. In addition to his academic appointments he has also held positions at the Federal Reserve Bank of Richmond, the Board of Governors of the Federal Reserve System, and the U.S. Department of Commerce.

Professor Humphrey was appointed a Visiting Fellow with the Payment Cards Center of the Federal Reserve Bank of Philadelphia in September 2001.

His research interests include banking, payment system issues, and international finance. His work has been broadly recognized and published in leading academic journals.

Credit Cards, Interchange, and Payment Efficiency

Not very long ago, almost all consumer purchases were paid for with cash or checks. The introduction of the general-purpose credit card in 1966 changed the payments landscape. Since then, credit cards have become the preferred means of payment for many consumers' retail purchases, travel and entertainment expenditures, and even bill remittance.

Major credit cards, issued under the bankcard association brands of Visa and MasterCard, operate through an "open-loop" system. All transactions are processed through a centralized system, which must effectively authorize, transfer, and settle each transaction. Each transaction is part of a four-party system, which includes the merchant, the merchant's bank, the card-issuing bank, and the consumer or cardholder. In "closed-loop" systems, such as American Express and Discover Card, card issuing and the merchant-settlement processes are conducted by the same entity.

Interchange fees, which allocate costs and revenues between the issuing bank and the merchant's bank, were established by bankcard associations to provide a balanced incentive arrangement to encourage banks to issue cards to their retail customers and for merchants to agree to accept the cards. When merchants process a cardholder's purchase through their bank, they receive the purchase price less a discount. The acquiring bank then passes back a portion of this merchant discount, as an interchange fee, to the card-issuing bank.

Controversy and legal challenges have long surrounded interchange fees. Some critics have argued that cash and check payment mechanisms subsidize credit card users who do not pay an explicit price for transacting in the more costly medium. Others allege that interchange fees are anti-competitive because they encourage bankcard associations to exercise market power through the collective actions of their members.

This debate sparked the May 2001 workshop focusing on "Credit Cards, Interchange, and Payment Efficiency," led by Professor David Humphrey of Flordia State University. He noted the many reasons consumers use credit cards: convenience, acceptability, delayed billing, perhaps even frequent flyer miles. But he questioned whether cardholders would continue to favor credit cards to the same extent if they – rather than the merchants – were explicitly charged the interchange fee used to compensate the issuing bank. Or in a world of explicit charges for the cost of payment vehicles – whether checks or debit and credit cards – would the market shift to a different and more efficient mix?

There is general agreement that interchange fees provided a very effective mechanism for establishing bankcard networks by providing an important balanced incentive to encourage early acceptance by all four parties in the "open-loop" bank card environments. The emerging debate in the U.S. and in several international markets is whether the interchange system will continue in the same form now that the bankcard network has matured and whether potential changes in pricing schemes will lead to a more efficient system overall.

EFT Industry Perspective & New Secure Payment Products

In June 2001, Paul Tomasofsky and Bruce Sussman of NYCE, the New York-based EFT network, led a workshop discussing the evolution of debit card applications and emerging Internet payment mechanisms.

The payment card industry has been a catalyst for innovation and the development of alternative payment mechanisms. One area that has been a major contributor to innovation is the electronic funds transfer (EFT) industry. As consumers' needs evolve and technology advances, the EFT industry continues to adapt and grow. From its early successes with ATMs to debit applications at the point of sale, the EFT industry has played an integral role in the payment card industry.

EFT networks such as NYCE provide support to issuers of online ATM and debit-card products. Transactions over these networks require the use of a PIN at the point of sale or at the ATM. This is in contrast to signature-based debit transactions that authorized and settled across the Visa or MasterCard networks in much the same way as a credit card transaction. The use of debit cards at the point of sale has grown rapidly in recent years as consumers have come to appreciate the convenience and sense of control over their finances that this product provides.

With over 40 percent of adults making online purchases in 2001, the Internet has become a viable market for developing payment vehicles. While the credit card is the payment mechanism of choice for Internet transactions, an absence of authentication capabilities exposes online retailers to increased risk of fraud.

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One result has been the emergence of fraud detection services. While these services provide protection against fraud, they also increase the cost of doing business on the Internet. Accordingly, companies that sell over the Internet are looking for safer and cheaper payment mechanisms. At the same time, Tomasofsky noted that many consumers are concerned about the security limitations of credit card use on the Internet and have been reticent to shop through this medium, inhibiting sales growth. A number of innovative solutions to this problem are emerging in various sectors of the payment cards industry, including debit-card providers.

NYCE's SafeDebit™ was created to address these issues. This PIN-secured Internet debit payment product allows consumers to pay for purchases on the Internet with funds drawn directly from their checking accounts.

The Payment Cards Center continues to monitor these and other new developments, since we believe the creative application of payment cards to the Internet is an important means to improving the efficiency and effectiveness of the payments system.

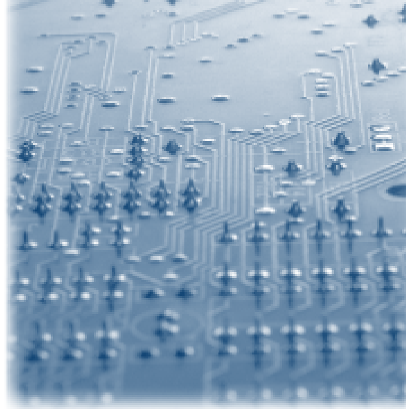
Dynamics in the Consumer Credit Counseling Services

In July 2001, an expert panel led a discussion on the role of credit counseling firms mediating between financially troubled consumers and their unsecured credit card lenders. The workshop highlighted the activities of counseling services and the structure of their relationships with lending institutions.

The consumer credit counseling service (CCCS) firms represented at the workshop are part of a national association of nonprofit organizations that provide consumers with confidential money-management, homeowner-counseling, and education services. Jerome Johnson, president and CEO of CCCS of South Jersey, opened the discussion with a historical perspective of the credit counseling industry. He also described the agencies' economic model, which is based on "fair share" payments from creditors to the agencies in recognition of the agencies' work with creditors' borrowing customers. Since credit counseling is often an alternative to bankruptcy for financially strapped consumers, these agencies provide a clear benefit to creditors.

Since credit counseling is often an alternative to bankruptcy for financially strapped consumers, these agencies provide a clear benefit to creditors.

Panelists Ghyll Theurer, program manager of CCCS of South Jersey, and James Godfrey, executive vice president of CCCS of Maryland, shared insights on the changing dynamics lead-



ing to lower reimbursement rates paid to CCCS by the creditors they serve. According to Theurer and Godfrey, the greatest contributing factor to this change has been the rapid emergence of new, for-profit agencies.

The new entrants, focusing primarily on debt-management plans, tend to be more efficient and technologically advanced than their nonprofit counterparts. Moreover, their willingness to negotiate reduced reimbursement rates with issuers has enhanced their appeal. While this increased competition has had the positive result of forcing industry improvements in service and productivity, it has had negative ramifications as well. Unfortunately, in addition to legitimate new industry entrants, some organizations have set up dubious operations known as "debt mills." Unlike the nonprofit CCCS organizations and the for-profit agencies that take a holistic approach and emphasize education and behavioral changes, debt mills focus exclusively on profitable debt-management programs that often require consumers to pay high program set-up fees. Creditors have responded not only by lowering the level of payments to credit counseling agencies but also by enforcing stringent restrictions on applicants and tight concession terms. The panelists argued that a history of trust between creditors and counseling services has been eroded, increasing costs to both parties.

Patricia Hasson, president of CCCS of Delaware Valley, led the final segment of the workshop. She discussed proposed new bankruptcy legislation, which would require consumers to complete a financial education course before being allowed to declare bankruptcy. The immediate impact would provide CCCS agencies with more opportunities and the potential for a more proactive role in the industry, given these agencies' historic role in providing financial education.

Research Bibliography Available on the Web

The Federal Reserve Bank of Philadelphia's Research Department has developed for the Payment Cards Center a bibliography of articles on payment cards and related research. The bibliography is broken down into the following categories: Credit Cards; ATM, Debit, and POS Networks; New Consumer Payment Methods; Miscellaneous Consumer Payments; Bankruptcy; Antitrust in Consumer Payments; and Privacy. You can find the bibliography at www.phil.frb.org/pcc/research/index.html.

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Update

Payment Cards Center Newsletter

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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.