For release ON DELIVERY
Expected AT 2:00 p.m. (EST)

Statement by

Nancy H. Teeters

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Affairs

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

February 18, 1981

I am pleased to appear before you this morning to present the views of the Board of Governors on the proposed "Cash Discount Act." Unlike the current law, the proposal provides that a discount -- in whatever amount -- which is offered by a seller to a customer to induce payment by cash, check or other means other than an open-end credit plan or credit card is not a disclosable finance charge under the Truth in Lending Act. The bill would also extend the current ban on the imposition of a credit card surcharge for another three years.

The Board has testified previously in favor of omitting these discounts from the finance charge as a way of encouraging them, and I do so again this morning. Also, as I have done previously, I must express the Board's uncertainty about the wisdom of prohibiting surcharges in view of their economic similarity to discounts. Their permissibility might in fact help assure that cash customers are not forced to subsidize credit card users.

In our view, it is time to take a fresh look at the cash discount issue. During the six years since the Truth in Lending Act was first amended to encourage the offering of cash discounts, the Congress has repeatedly considered the discount/surcharge issue. Testimony has been delivered at length. The Federal Reserve, meanwhile, has carefully constructed regulations to carry out the statutory provisions regarding availability and notice to consumers of discounts. Despite these Congressional and regulatory efforts, what we haven't seen is merchants offering discounts -- at least not to any appreciable degree. If we believe that encouraging merchants to reward cash buyers is a goal worthy of diligent pursuit, then we must try to identify the impediments which have, in fact, discouraged the concept.

Our guess is that the current 5 percent limit on the size of the discount is not the culprit. Rather, it seems to us that this may, once again, be a case of government regulation creating part of the problem -- regulation which is grounded on a set of well-intentioned arguments, but which introduces such friction into otherwise simple transactions, that compliance is simply not worth the merchant's risk or effort.

If this analysis is correct, there are two features in the current regulation that are probably most significant in discouraging the development of cash-paying incentive plans. First is the obvious difficulty in drawing a clear economic distinction between a permitted discount and a prohibited surcharge. It is true that discounts and surcharges may not be as identical in practice as, say, a half empty glass of water is to a half full one. Nevertheless, it is difficult to quarrel with the fact that the distinction is, at best, uncertain.

If a seller wants to impose a surcharge it could probably be done without running afoul of the surcharge prohibition. The seller could simply raise the price of an item by the amount the seller wants to impose as a surcharge, making this new price the "regular price," and then offer a lower price to cash customers as a permitted discount.

Second, the well-intentioned protections in the statute to insure equitable treatment of consumers have, once again, led to the seemingly complicated regulatory provisions attached to my statement. The current statute and the proposed bill specify that any discount must be offered to "all prospective buyers." Its availability must be disclosed to all of them "clearly and conspicuously in accordance with regulations of the Board." But who are "all prospective buyers"? Those who present credit cards, or all those who enter the merchant's door? What signs meet the test of "clear and

conspicuous" disclosure when there are several store entrances, and numerous independent cash registers? How do you disclose to customers who purchase by phone? May the discount be limited to certain types of property? How about to certain branches of stores? We have sought to provide answers to these questions in our regulations.

Unfortunately, by issuing rules beyond the basic provision we have again probably made simple things so complicated that the public throws up its hands in frustration. Although in our current proposals to simplify Regulation Z we have proposed trimming back these regulations, the obvious way for any merchant to avoid regulatory burden is simply not to offer discounts. And that, apparently, is what has happened.

I therefore would recommend for Subcommittee consideration a very simple rule: that one-time discounts or surcharges offered by the seller for the purpose of inducing payment by cash, check or means other than use of an open-end credit card plan shall not constitute a finance charge, and that the availability of the discount or surcharge be disclosed to customers. This would leave out the specific requirement that "all" customers be notified and that any disclosure be "clear and conspicuous" --not because we favor hidden plans but because of the uncertainties this standard produces with the inevitable need for clarification.

Of course, it is possible that authorizing discounts and surcharges without calling them finance charges opens up a potential loophole in the blanket embrace of Truth in Lending. Not only are discounts essentially equivalent to surcharges, but both are essentially equivalent to finance charges. They do represent a cost of using credit.

Therefore, if we are right that the 5 percent limit has not itself been the impediment to merchants offering discounts, this limit might be retained to insure that the exclusion of discounts and surcharges does not

become a vehicle which could be used to defeat the basic Truth in Lending protections. In our view, the best chance of accomplishing the goals Congress began pursuing six years ago would be to retain this limit, but allow discounts and surcharges to be used with minimal further government interference.

Attached to my statement is an appendix discussing certain technical problems which our staff has identified with the current language of the bill. Although I have not referred to these issues in my testimony, we would of course be happy to answer any questions you may have on these points.

With regard to Title III, the technical amendment to the Truth in Lending Act, I have no hesitation in recommending adoption. In the course of our efforts to revise and simplify Regulation Z to conform with the Truth in Lending Simplification and Reform Act of 1980, we have received numerous questions regarding the status of the civil liability provisions. The statute gives creditors the option of complying with the new rules beginning on April 1, 1981, or waiting until April 1, 1982, when compliance becomes mandatory. However, uncertainty has arisen as to whether creditors are protected by the new civil liability provisions of the statute if they elect to follow the new rules before April 1, 1982. Title III makes it clear that the civil liability provisions take effect this April.

Absent such protection, creditors will not have the incentive they otherwise would have to comply with the new regulations at an early date. This outcome would seem to be contrary to what we believe was Congress' intent. Both consumers and creditors will benefit from the new and simpler disclosure scheme. It would be unfortunate if a technical problem turned out to be an impediment to voluntary early compliance with the new provisions during the transition year. Thus, we wholeheartedly support this portion of the bill.

Technical Problems in S. 414

1. Section 103 of the bill provides that current Federal Reserve Board regulations implementing the basic cash discount provision now in the statute (§ 167(b)) become null and void when the new Act is enacted. Section 167(b) of the current statute provides as follows:

> With respect to any sales transaction, any discount not in excess of 5 per centum offered by the seller for the purpose of inducing payment by cash, check, or other means not involving the use of a credit card shall not constitute a finance charge as determined under § 106, <u>if such discount is offered to all prospective buyers and its availability is disclosed to all prospective buyers clearly and conspicuously in accordance with regulations of the Board</u>. (emphasis added)

The regulations issued by the Board in § 226.4(i) of Regulation Z were adopted to resolve ambiguities as to who "all prospective buyers" may be, and when disclosures meet the "clearly and conspicuously" statutory test.

The objective is to bring certainty to merchants so that they can confidently comply with the statute without fear of misinterpreting the law. In clarifying the requirement that discounts be offered to "all" prospective buyers, the regulations answer such obvious questions as whether the seller may legally limit the discounts to certain types of property or certain outlets. In amplifying the "clear and conspicuous" disclosure requirement, the regulations cover such questions as whether signs must be posted at each department store entrance and each cash register.

In making these existing regulations null and void, § 103 of the bill seems to carry with it the implication that the Board should not issue new regulations on these subjects. However, § 101 of the bill restates the old § 167(b) directive to the Board to issue regulations. It provides as follows:

> With respect to any sales transaction, any discount from the regular price offered by the seller for the purpose of inducing payment by cash, checks, or other means not involving the use of an open-end credit plan or a credit card shall not constitute a finance charge as determined under § 106 <u>if such discount is offered to all prospective buyers and its availability is disclosed to all prospective buyers clearly and conspicuously in accordance with regulations of the Board.</u> (emphasis added)

Retaining the requirement that disclosure must be made to "all prospective buyers," that they be made "clearly and conspicuously," and that they be made" in accordance with regulations of the Board" seems to direct the Board in § 101 to reissue the very type of regulations which § 103 has concurrently made null and void. If the intent of § 103 is to prohibit the Board from issuing regulations, at least the wording "in accordance with regulations of the Board" should be dropped in § 101.

2. Currently, § 167(b) exempts discounts from being considered finance charges if offered for payment "not involving the use of a credit card." The statute is not specifically limited to "open-end credit." By its literal terms, closed-end installment credit might conceivably be covered if it

involved use of a credit card. However, because the legislative history of this provision suggested that Congress simply had in mind encouraging merchants to give cash purchasers the savings from avoiding the merchant discount to third-party open-end credit card issuers, the Board's regulation is more specific than the statute. It specifies that § 167 applies to discounts involving cash rather than use of an "open-end credit card account" (emphasis added). In contrast, the current bill would cover cash discounts not involving use of "an open-end credit plan or a credit card." The effect is that discounts would be available, without limit, not only in the following types of credit arrangements where a 5 percent discount is allowed under the present statute:

1. A merchant honoring a third party credit card for an open-end credit plan.
2. A merchant honoring its own open-end credit card.

But also in the following additional situations:

1. A merchant with an open-end credit plan not involving any credit card.
2. A merchant with a closed-end credit plan involving a credit card.

The result would be that a merchant could develop a credit plan involving substantial finance charges without making Truth in Lending disclosures, since the proposed bill also removes the 5 percent limit.

This potential "loophole" seems all the more serious in view of § 171(c) of the Act which provides as follows:

> Notwithstanding any of the provisions of this title, any discount offered under § 167(b) of this title shall not be considered a finance charge or other charge for credit under the usury laws of any state or under the laws of any state relating to disclosure of information in connection with credit transactions, or relating to the types, amounts or rates of charges, or to any element or elements of charges permissible under such laws in connection with the extension or use of credit. (emphasis added)

Thus, any "loophole" which would allow very large differentials between a cash and credit price to be imposed, without Truth in Lending disclosures, would also allow them to escape state usury ceilings.

Two solutions to this possible major loophole would be to either (1) define more narrowly the type of transaction to which the discount exemption will apply (say restricting it to open-end credit plans involving use of a credit card), or (2) retain the 5 percent limit, which itself has probably not been the impediment to merchants offering discounts.

(uu) **"Discount,"** as used in §§ 226.4(i) and 226.13(*l*), means a reduction made from the "regular price," as defined in § 226.2(tt).

(vv) **"Surcharge,"** as used in § 226.4(i), means any amount added at the point of sale to the "regular price," as defined in § 226.2(tt), as a condition or consequence of payment being made by use of an open end credit card account. For purposes of this definition, payment by check, draft, or other negotiable instrument which may result in the debiting of a cardholder's open end account shall not be considered payment made by use of that account.

* * * * *

4. Effective July 20, 1977, § 226.4(i) is amended to read as follows:

SECTION 226.4—DETERMINATION OF FINANCE CHARGE

* * * * *

(i) **Discounts for payments in cash.** (1) Notwithstanding any other provision of this section, a discount which a creditor offers, allows, or otherwise makes available for the purpose of inducing payments for a purchase by cash, check, or similar means rather than by use of an open end credit card account, whether or not a credit card is physically used,[5a] is not a finance charge, Provided that:

(i) Such discount does not exceed 5 per cent when computed or expressed as a percentage of the regular price of the property or services which are the subject of the transaction,

(ii) Such discount is available to all prospective buyers, whether or not they are cardholders, and such fact is clearly and conspicuously disclosed by a sign or display posted at or near each public entrance to the seller's place of business wherein such discount is offered, and at all locations within the place of business where a purchase may be paid for, and

(iii) If an offer of property or services is advertised in any medium or if offers are invited or accepted through the mail, over the telephone, or by means other than personal contact between the customer and the creditor offering such a discount, and if customers are allowed to pay by use of a credit card or its underlying account and such fact is disclosed in the advertisement, telephone contact, or in other correspondence, the availability of such a discount must be clearly and conspicuously disclosed in any advertisement for such offerings and, in any case, before the transaction has been completed by use of the credit card or its underlying account. If a price other than the regular price, as defined in § 226.2(tt), is disclosed in an advertisement, telephone contact, or other correspondence promoting goods or services for which such a discount is offered, then the advertisement, telephone contact, or other correspondence shall also indicate that such price is not available to credit card purchasers.

(2) With respect to any such discount which is greater than 5 per cent, the total amount of such discount shall constitute a finance charge under § 226.4(a) to be disclosed in accordance with § 226.7(e).

(3) The availability of any discount may be limited by the creditor offering such discount to certain types of property or services or to certain outlets maintained by that creditor provided that such limitations are clearly and conspicuously disclosed.

† (4) No creditor in any sales transaction may impose a surcharge. This paragraph shall cease to be effective on February 27, 1979.

(5) Notwithstanding any other provisions of this Part, any discount which, pursuant to paragraph (1), is not a finance charge for purposes of this Part shall not be considered a finance charge or other charge for credit under the laws of any State relating to:

(i) usury; or

(ii) disclosure of information in connection with credit extensions; or

(iii) the types, amounts, or rates of charges, or the element or elements of charges permissible in connection with the extension or use of credit.

5. Effective July 20, 1977, footnote 5[a] to § 226.5(a)(3)(ii) is redesignated footnote 5[b].

6. Effective July 20, 1977, section 226.13(*l*)(1)(i) is amended by deleting the word "cash" which appears immediately before the word "discounts."

[5a] For purposes of this section, payment by check, draft, or other negotiable instrument which may result in the debiting of a cardholder's open end account shall not be considered payment made by use of that account.

† Prohibition on imposition of surcharges extended to February 1981 on March 5, 1979. See no. 19 on page 8.