



Financial Services Regulatory Practice

# Regulatory Practice Letter

ADVISORY

RPL Number 10-03

## Risk-Based Pricing Notices to Consumers – Final Rules

### Executive Summary

The Federal Reserve Board ("Fed") and the Federal Trade Commission ("FTC") have approved final regulations that implement the risk-based pricing provisions of Section 311 of the *Fair and Accurate Credit Transactions Act of 2003* ("FACT Act"), which amends the *Fair Credit Reporting Act* ("FCRA"). In general, the final rules require a creditor to provide a consumer with a risk-based pricing notice when, based in whole or in part on the consumer's credit report, the creditor grants, extends or otherwise provides (hereinafter "grants") credit to the consumer on material terms that are materially less favorable than the most favorable terms it grants to a substantial portion of its other consumers. Several methods are available for identifying customers that must receive the risk-based notices and some exceptions do apply. Sample notices are provided. The final rules become effective January 1, 2011.

### Background

The FACT Act generally amends the FCRA to enhance the ability of consumers to combat identity theft, increase the accuracy of consumer reports, and allow consumers to exercise greater control regarding the type and amount of solicitations they receive. Section 311 of the FACT Act adds a new Section 615(h) to the FCRA that addresses risk-based pricing and requires a person to provide a risk-based pricing notice to a consumer when the person uses a consumer report in connection with an application for, or grant of, credit to the consumer, and, based in whole or in part on the consumer report, grants credit to the consumer on material terms that are materially less favorable than the most favorable terms the person makes available to a substantial proportion of the consumers to which the person provides credit. In May 2008, the Fed and the FTC issued proposed rules to implement Section 615(h) and the final rules are substantially similar to that proposal.

### Subject:

**Final Rules to Effect Risk-Based Pricing Notices to Consumers**

### As Issued By:

**Federal Reserve Board;  
Federal Trade Commission**

### Date:

**February 4, 2010**

## Description

### General Rule

The final rules generally require that a person must provide a consumer with a risk-based pricing notice in the form and manner prescribed in the final rules if:

- That person uses a consumer report in connection with an application for, or a grant of, credit to the consumer; and
- Based in whole or in part on the consumer report, grants credit to the consumer on material terms that are materially less favorable than the most favorable material terms available to a substantial proportion of consumers "from or through" that person.

The final rules also apply to account reviews of credit that has already been extended to a consumer when, based in whole or in part on a consumer report, they result in an increase to the annual percentage rate ("APR.")

### Scope of Risk-Based Pricing Notices

The risk-based pricing notice requirement applies only in connection with credit that is primarily for a consumer's personal, household, or family purposes and not for business credit.

"Material terms" would be defined for:

- An open-end credit plan, including credit cards, as the APR that is required to be disclosed under Regulation Z in account opening disclosures, except for a temporary initial rate that is lower than the rate that would apply after the temporary rate expires, a penalty rate that would apply once a specific event occurs, or a fixed annual percentage rate option for a home equity line of credit. Further,

for credit cards, the APR would be the APR that applies to purchases;

- A closed-end credit plan, as the APR that is required to be disclosed under Regulation Z prior to consummation; and
- An extension of credit that does not have an APR, as the financial term that varies based on information in the credit report and has the most significant financial impact, such as a deposit or fee.

"Materially less favorable" is defined to mean that the terms granted to one consumer would be significantly greater than the cost of credit granted to others. Factors relevant to determining the significance of a difference in cost include: the type of credit product; the term of the credit extension; and, the extent of the difference in the material terms granted to the two consumers.

No definition is provided for "substantial proportion." The Fed and the FTC indicate that no definition could reflect the widely varying pricing practices of creditors. As in the proposal, the Fed and the FTC note they would expect creditors to consider this as more than a "*de minimis*" percentage, which may or may not represent a majority.

### Identifying Consumers

Creditors may identify consumers to whom the risk-based notices must be sent through a number of methods:

- On a case-by-case basis comparing the terms offered to one consumer to others for a specific type of credit product, which entails one or more credit products with similar features that are designed for similar purposes.

- Using the credit score proxy method - where a cutoff score is set at the point where approximately 60 percent of all of the creditor's consumers have lower credit scores and risk-based notices are sent to these consumers.
  - An alternative is provided for cases where a person has granted credit to more than 40 percent of consumers on the most favorable material terms (based on a representative sample) and permits the person to set the cutoff point at the approximate percentage of consumers that did not receive the most favorable material terms.
  - Cut-off scores must be recalculated no less than every two years.
- Using a tiered pricing method – where a discrete number of tiers with material terms are set and consumers are assigned to one, based in whole or in part, on their consumer report.
  - Where there are four or fewer tiers, notices must be sent to consumers who are not assigned to the top tier (the lowest cost).
  - Where there are five or more tiers, notices must be sent to consumers who are not assigned to the top two tiers and any other tiers that when combined with the top two tiers comprise no less than 30 percent and not more than 40 percent of the total number of tiers.
  - Different tiers may be used for different types of credit products.

Credit card issuers may use any of the three methods (case-by-case, credit score proxy, and tiered pricing) for identifying consumers to receive risk-based notices. In addition, credit card issuers are permitted to provide a risk-based notice to a consumer on an offer-by-offer basis when:

- A consumer applies for credit in connection with an application program or a solicitation to which more than one possible purchase APR applies; and
- Based in whole or in part on the consumer report, the credit card issuer grants the consumer a credit card with a purchase APR that is greater than the lowest APR available through the program or solicitation.

#### **Content and Timing of Notice**

The notice must be clear and conspicuous and may be provided to a consumer in written, oral or electronic form. It must include statements that:

- Explain that a consumer report includes information about a consumer's credit history;
- Indicate the terms offered the consumer are based on the consumer's report;
- Indicate the terms offered may be less favorable than the terms offered to consumers with better credit histories;
- Encourage the consumer to verify the accuracy of information in the consumer report and to dispute any inaccurate information;
- Identify the consumer reporting agencies that provided a report used in the credit decision;
- Inform the consumer of their right to obtain a consumer report from the consumer reporting agencies identified in the notice at no charge

(separate from the free annual consumer report available to all consumers);

- Inform the consumer how to obtain a copy of the report (within 60 days); and
- Direct consumers to the Web site of the Fed and FTC.

Model forms are provided as part of the final rules though they are not required to be used. For closed-end credit, a risk-based pricing notice would generally be required to be provided to the consumer before consummation of the transaction. For open-end credit, a risk-based pricing notice would generally be required before the first transaction is made under the plan. For account reviews, the notice is due to the consumer at the time the increase in the APR is determined.

Other provisions specific to certain auto lending transactions and contemporaneous purchase credit (instant credit) are included in the rule.

#### **Exceptions**

Exceptions to the notice requirement are provided under the final rules, including instances when:

- A consumer applies for and receives a specific material term (e.g., an APR stated in an offer);
- A person receives a consumer report as part of a prescreened list and uses the report to make a firm offer of credit to the consumer;
- The credit applied for is secured by one-to-four family residential real estate and the creditor provides the consumer with a notice containing the credit score and additional information and disclosures; and

- Creditors provide all consumers applying for credit with their credit scores and explanatory information.

#### **Rules of Construction**

- Only one risk-based notice per extension of credit.
- The person to whom the credit is initially payable must provide the risk-based notice even if the person assigns the credit agreement to a third party, unless the person has satisfied the requirements and provided the appropriate notice under one of the exceptions.
- In a transaction involving two or more consumers, a risk-based notice must be sent to each consumer, except if they share the same address and it is addressed to all consumers at that address. However, if the notice is sent based on the credit score exception, notices must be sent to each consumer.

#### **KPMG Commentary**

While creating additional processes, systems changes and customer notifications, risk based notices are not envisioned to substantially reduce the practice of risk-based pricing. The intent of this consumer protection regulation is to provide consumers with more information about their credit so they can better understand their credit costs and the factors affecting their creditworthiness.

The result of these new rules will be to heighten consumer awareness of the importance of credit data in determining credit rates and terms. The impact of the new rules may be to make it easier for consumers to keep track of credit scores, as well as review and resolve potential inaccuracies (including

inaccuracies associated with fraud and/or identity theft). The notice must generally be provided at the time of application or the time the decision is communicated to the consumer (with the thought that the consumer still has an opportunity to use the notice to check the validity of the information being used to make the determination).

On the part of lenders, the risk-based pricing notices required under the final rule will necessitate substantial consideration as no one solution will best serve all lenders or products. Lenders may determine that different methods for identifying consumers might be applied to different types of products, and must determine whether employing multiple methods is feasible.

Lenders should note that they bear the responsibility to provide a notice to a consumer, even if they have assigned the credit agreement to a third party unless they have opted to satisfy the rule requirements and have provided the appropriate notice under one of the exceptions. The Fed and FTC note in the discussion portion of the final rule that, "Although legal responsibility for providing the notice rests with the person to whom the obligation is initially payable, the various parties involved in a credit extension may determine by contract which party will send the notice. Generally, purchasers or assignees of credit contracts are not subject to the risk-based pricing notice requirements, except in the case of a notice provided in connection with an account review."

Though the effective date is not until January 1, 2011, some lenders may begin phasing in the new notice this year. Lenders should have procedures,

training and testing in place for consistency in the application of these notices, as well as related customer inquiries..

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