ABA Staff Analysis: Risk-based Pricing Final Rule Summary
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Finally, the last of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act) regulations has been adopted. The Federal Reserve Board and the Federal Trade Commission (“Agencies”) published in the January 15, 2010 Federal Register, the final rules implementing the FACT Act provision that requires creditors to provide a “risk-based pricing notice” when they use a consumer report for purposes of risk-based pricing for consumer credit accounts. Compliance is mandatory as of January 1, 2011.

The final rule generally parallels the proposal with some clarifications. The general rule, strictly following the statute, provides that creditors must provide a risk-based pricing notice when they use a consumer report to provide credit on material terms that are materially less favorable than the most favorable terms available to a substantial proportion of consumers from or through that person.” However, recognizing that such a subjective prescription is not necessarily the best solution for consumers and is neither compliance-friendly nor necessarily feasible as a practical matter, the Agencies have chosen a more practical path by providing flexibility. In effect, the alternatives and exceptions are more important than the general rule as they are more likely to be the most practical means of compliance. The alternatives and exceptions reflect the recognition of the wide variety of credit products and creditors and of the fact that no single solution is appropriate for all circumstances.

Material term. There are a number of definitions, but the most important is “material term.” For most purposes, it means the APR. For credit cards, it means the purchase APR, excluding promotional or penalty rates. If there is no APR, for example, for a charge card, or the APR is not based on the consumer report, then the term is the one with the most impact on the consumer, such as an annual fee or deposit e.g. for a telephone account.

General rule and alternatives. Creditors may use the general rule by comparing the material terms offered to each consumer and the material terms offered to others for a specific type of credit product. The regulation provides definitions for “materially less favorable” and “substantial proportion.” However, there are other options to this rather onerous analysis.

The “alternatives” to the risk-based pricing notice take a number of forms: the credit score proxy method, the tiered pricing notice, and a special notice for credit cards. In addition, the credit score exception provides creditors an additional choice.

Credit score proxy method.

Under the credit score proxy method, if credit scores are used to determine the APR or other material term, creditors comply if they determine the credit score what represents the point where 40% of consumers to whom they have granted credit have higher scores and provide notice to everyone below the cutoff. In other words, if 40 percent of consumers have a credit score higher than X, then all consumers with a score less than X will receive a risk-based pricing notice. An alternative is to review who historically has been granted credit on the most favorable term (e.g., lowest APR). If more than 40 percent of consumers received the lowest APR, the bank may set the cutoff credit score based on the score of those in that percentage. If, for example, 80 percent of consumers received the lowest APR, and the 80 percent have a score of X, the creditor may set its cutoff as X.
The rules give guidance on how to determine the cut-off for new entrants, new or acquired products, and for creditors beginning to use risk-based pricing. In addition, if a score is not available for a particular consumer, the creditor must provide the notice. Creditors must revisit their calculations every two years.

**Tiered pricing notice.**

Creditors who use pricing tiers, based in whole or in part on a consumer report, may use the tiered pricing method. If fewer than four tiers are involved, any consumer who is not in the tier with the lowest APR receives a notice. If there are five or more tiers, anyone in the lowest three tiers, plus any tier with at least the top 30 percent but not more than forty percent of the total tiers, receives notice.

**Credit cards.**

The final rule permits but does not require credit card issuers to use a special credit card option. If the consumer is only offered one APR, no notice is required. However, if the credit card offer contained more than one APR and a consumer report is used to determine the actual APR, those consumers who did not receive the lowest APR must get the notice.

**Exceptions.**

**Credit score disclosure exception.**

In addition to the alternative to the general requirement, the final rule includes an “exception” to the risk-based pricing notice, one of which will probably be an attractive alternative to many creditors as the notice is more consumer friendly (There is no negative message to new customers that they did not receive the best terms.), may be easier to implement, and is already required for certain mortgage transactions.

Under this option, there is no need to apply a test to distinguish among consumers as the notice is provided to all consumers who receive offers. The notice must explain that a consumer report was used in the decision and contain the consumer’s credit score along with general information about consumer reports and credit scores. In addition, the notice must provide either a bar or narrative that explains where the customer ranks with other consumers as well as a notice that they are entitled to an annual free consumer report. If the creditor uses more than one score, the creditor may disclose the one it actually used, or if it averaged the scores, it may provide one more. However, the Agencies encourage creditors to provide a single score to promote short, understandable disclosures. Creditors using proprietary scores may disclose a third party score. If no score is available for a particular consumer, the creditor should provide a notice that there is no score, explain the importance of scores and how to receive a consumer report, and include a reference to the FTC’s website.

The regulation treats separately mortgage loans and non-mortgage loans. Mortgage loans already subject to the separate credit score disclosure requirements may supplement those disclosures with the additional information required for the credit score exception to the risk-based pricing notice.

**Other exceptions.**

The regulation includes other exceptions. For example, no risk-based notice is required if an adverse action is provided or if the consumer has applied for and received specific terms, unless the terms were specified by the creditor after the consumer’s application and after the creditor received a consumer report. Prescreened solicitations are also excluded.

**Account review.** The risk-based pricing notice provisions also apply to account review. Thus, creditors must provide the notice if they increase the APR of an existing account based in whole or in part on the consumer report. The credit score disclosure exception is not available for account review.

**Timing of notices.** The timing of the notice depends on whether it is a risk-based pricing notice or a credit score notice. Risk-based pricing notices for closed-end loans must be provided before...
consummation of the loan, but after the credit decision has been made. For open-end loans, the risk-based pricing notice must be made before the first transaction, but not earlier than the credit decision. For non-mortgage loans, the credit score notice must be provided “as soon as reasonably practicable” after the credit score has been obtained (e.g. within three business days), but, in any event, at or before consummation for closed-end credit and before the first transaction for open-end credit. For mortgage loans, the notice must be provided at the same time the separate Section 609(g) FCRA credit score notice is provided, but in any event at or before consummation for close-end credit and before the first transaction for open-end credit.

The rule provides some flexibility for “instant credit,” e.g. an open-end credit plan granted in person or by phone in order to finance the contemporaneous purchase of goods. In these cases, the risk-based pricing notice must be provided on either the earlier of the first mailing after the credit decision or within 30 days of the credit decision. While the regulation does not appear to include this option for credit score disclosures, our understanding is that the Agencies do intend for that option to be available for “instant credit.”

For account reviews, the notice must be provided at the time the decision to increase the APR is communicated to the consumer or if no advance notice is provided, no later than five days after the effective date of the APR change.

**Form and content of notices.** The risk-based pricing notice may be provided orally, in writing, or electronically. Conversely, the credit score notice must be provided in writing. The regulation sets forth the content for each of the notices, which include information about the consumer’s right to a free credit report.

**Who must provide the notice?** Generally, the person to whom the credit is initially payable receives the notice. Thus, brokers generally will not be providing the notice. However, there are exceptions for indirect automobile loans.

**Who gets the notice?** Creditors must provide the notice to any consumer who accepts consumer credit if they have used a consumer report in connection with the credit. Creditors must provide it to all who accept the credit, and may, but are not required to provide to all who apply. Generally, creditors may not simply provide the risk-based pricing notice to all applicants. (But see exception for providing credit scores to all consumers). Notice need not be provided to guarantors.

**Multiple applications.** Generally, the rule is one notice per transaction. Risk-based pricing notices must go to each applicant. If the applicants have the same address, a single notice addressed to both is permitted. However, for the credit score notice, a separate notice must be provided to each consumer granted credit, even if they are at the same address.

Questions? Contact Nessa Feddis or Virginia O’Neill for more information.