Risk-Based Pricing Notice
BAI LEARNING & DEVELOPMENT WHITEPAPER

On January 15, 2010, the Federal Reserve and Federal Trade Commission (FTC) published in the Federal Register final regulations to implement the Fair Credit Reporting Act’s (FCRA, as amended by the FACT Act) risk-based pricing notice requirements. The rules were effective January 1, 2011.


Under the rules (Fed regulation V, 12 CFR 222.70 – 222.75; and FTC regulation 16 CFR 640), a notice is required to an applicant for credit if the creditor (1) “uses a consumer report in connection with an application, grant, extension, or other provision of credit” to a consumer; and (2) based in whole or in part on that consumer report, the creditor offers “material terms that are less favorable than the most favorable terms available to a substantial proportion of consumers.”

The devil is in the details, of course, and here the details of the second component above are pivotal to the requirement to provide a notice. The rule’s purpose is to provide information to a consumer that he or she did not get the best deal offered by the creditor because of information in his or her credit report. The consumer might then be motivated to take a look at the report to understand the factors that led to the creditor’s decision.

The regulators also provided model forms to utilize, which provide a safe harbor and presumption of compliance if used properly.

Who is Entitled to Receive a Notice?

Only those who are or would be borrowers. The rule provides that only those to whom credit is offered, granted, extended, or otherwise provided are entitled to a notice. Guarantors, co-signers, sureties, or endorsers are not entitled to a notice, as they are not and would not be borrowers.

A notice is not required if an application is denied, since in that case the applicant(s) has received an adverse action notice. The risk-based pricing notice is provided only in certain situations where credit is offered, not refused.
Other exceptions. The following are additional situations where a risk-based pricing notice need not be provided, even if the consumer receives less-favorable credit terms than the most favorable available:

- Non-credit products. The rules don’t apply to products that are not loans, such as deposit accounts, for example. Even if an institution utilizes a credit report in its consideration of what interest rate a customer will receive for a deposit account, the rules don’t apply;
- Commercial- or business-purpose credit. The risk-based pricing notice rules are provisions of the FCRA, and the FCRA applies only to credit primarily for personal, household, or family purposes. Even if the applicant/borrower is an individual, if the purpose of the loan is a commercial or business purpose, the rules do not apply;
- Where the consumer applies for and receives specific terms (even if those terms are not the most favorable the creditor offers). This refers to a specific set of terms received by the borrower, not a range of alternatives;
- Credit cards issued solely to access home equity lines of credit (HELOCs);
- Charge cards; and
- Preapprovals where a consumer accepts terms of a preapproved offer, despite the fact the creditor may offer more favorable terms to other consumers for the same product.

Account Review. Creditors must also provide a risk-based pricing notice to an existing accountholder under the same circumstances: (1) it uses a consumer report in connection with a review of an existing credit account; and (2) based in whole or in part on that consumer report, the creditor increases the APR on the account. However, if the APR rises due to the expiration of an introductory rate on a credit card account, no notice is required. Similar to other situations, it is also not required if an adverse action notice is provided.

Terminology

What Terms Are “Material”? Fortunately, this is simple: for purposes of the risk-based pricing notice, the “material term” is the APR required to be disclosed under applicable Reg. Z provisions:

- For non-credit card open-end plans, the material APR is the account’s normal APR and not any introductory or penalty APR;
- For credit cards, the purchase APR is the material term; if the card has no purchase APR, it is the rate that varies according to consumer report information and is has the most significant impact on the consumer;
- For closed-end credit, the APR disclosed on Truth in Lending (Reg. Z) disclosures is the material term; and
- If the credit plan has no APR, the material term is the financial term that would vary based on the person’s credit report and has the most significant financial impact (such as annual fee).

What is “Materially Less Favorable”? This is crucial to determining whether the second requirement is met: did the borrower receive an APR that is less favorable than the most favorable terms available to a substantial proportion of consumers?
“Materially less favorable” means the APR is significantly higher than the cost of credit to a substantial proportion of other consumers. There are two terms here that are critical in determining whether this is the case: “significant” and “substantial proportion.”

What is “significant”? The rules generally leave it up to each creditor to determine what “significantly higher” means; however there are several factors involved to consider, including:

- The type of credit product;
- The term of the credit extension, if any; and
- The extent of the difference between the material terms. This includes consideration of the cost of the credit product, as measured by the APR.

In other words, is it a meaningful difference? If it is different enough to have separate qualification criteria, then it’s almost always enough to be significant for purposes of this rule.

What is a “substantial portion” of consumers? Things get a little gray here. The Fed and FTC decided not to define this term specifically as in their words, “no definition of ‘a substantial proportion’ could reflect the widely varying pricing practices of creditors.” But at the same time they state that it must be more than a de minimis percentage. So what is the magic number? The following is from the Federal Register announcement of the final rule:

While each creditor’s “substantial proportion” determination is an individual decision, the Agencies expect that creditors will consider “a substantial proportion” as constituting more than a de minimis percentage, but that may or may not represent a majority.

They mention that for one creditor, it may be 90% of consumers receive the most favorable terms, while for another creditor only 10% receive those terms. A third creditor may provide the most favorable terms to 1% of consumers, slightly less favorable terms to 20%, and the rest receive materially less favorable terms.

So in the end it is up to each individual creditor to determine what a “substantial proportion” is, depending on its own credit standards and product offerings. Fortunately, the regulators provided some instruction to assist with this effort.

Methods to Determine Whether Materially Less Favorable Terms Have Been Offered

Direct comparison method. The states that creditor may always determine, on a case-by-case basis, whether a consumer has received materially less favorable terms for a specific credit product. This is more of a “you know it when you see it” observation. Here, for example, creditors could compare the loan at issue with past transactions of similar type, controlling for changes in rates and other market conditions, to make the determination whether this loan is less favorable than past ones.
Sampling approach. Note that the consumer report criteria used to offer differing credit terms can be virtually anything on the report. The easiest term to differentiate, however, is the credit score, and this is the term most focused upon by the rules.

An alternative to examining each and every extension of credit to determine which is most favorable vs. less favorable is to determine what credit scores historically have been used to grant credit on differing terms. Here, the creditor uses a sampling approach to calculate a “cutoff score” ("cutoff" meaning below which credit is offered and/or granted on less favorable terms) by considering the scores of all or a representative sample of consumers to whom it has granted, extended, or provided credit for a specific type of credit product.

For example, the creditor could take a representative sample of consumers from the preceding six months and determine that approximately 80% received credit at lowest APR (most favorable terms), and 20% received credit at a higher APR. If approximately 80% of the sampled consumers had a credit score at or above 700 and 20% have a credit score below 700, 700 would be selected as the cutoff score. Consumers with scores below 700 would be provided with a risk-based pricing notice.

In this example, the number of notices required would be reduced quite a bit (since only 20% would receive a notice); the rule mandates that this method cannot be used if the result would be notices required for more than 60% of consumers.

Secondary source approach. This alternative approach may be used to determine the cutoff score in situations where sampling is not feasible, such as acquisitions, mergers, where offering new products, or otherwise where direct history is not available. Here, the creditor relies on information from a secondary source (such as a market research firm, credit bureau, or company that develops credit scores) to provide the data used in calculating the cutoff score. If this method is used, the creditor must recalculate its cutoff score within one year using a representative sample of its own data (unless it does not have sufficient data within that timeframe).

Model Form H-1 can be used for either of these above sampling approaches.

Proxy Methods

In many cases, however, it isn’t practical to compare terms offered to each consumer – it’s far too time-consuming and can be too subjective. In response to these concerns, the rule provides methods to serve as proxies for comparing terms offered to consumers.

The goal of each is to determine who is likely to receive materially less favorable terms. There are two principal proxy methods provided by the rule: the credit score proxy method and the tiered pricing method.
Credit Score Proxy Method. This is available for creditors that use the consumer’s credit score to set material terms of credit. Creditors utilizing this method must determine the “cutoff score,” defined here as the score at which approximately 40% of consumers have higher credit scores and 60% have lower credit scores. A risk-based pricing notice is then provided to all consumers having a credit score lower than the cutoff score (the 60% category).

The creditor’s cutoff score must be re-calculated at least every 2 years.

If the creditor uses two or more different scores to set material credit terms (such as from a tri-merge report), it would determine the appropriate cutoff score based on how multiple credit scores are typically evaluated by the creditor when setting terms. This could be an average score, high score of those provided, and so forth. If different methods than these are used, using the average score is a safe harbor.

Tiered Pricing Method. This method is available to creditors that set material terms of credit by placing the consumer within one of a discrete number of pricing tiers for a specific type of credit product. For example, a creditor may offer credit card plans at 9, 10 or 11% APR depending on credit score and/or other information from a consumer report. A risk-based pricing notice is provided to consumers who are not placed into the top tier or tiers (Model Form H-1 can be used in this scenario). Denied consumers do not constitute a tier.

Who exactly is entitled to a notice depends on the number of tiers for the credit product, as follows:

- If the creditor has 4 or fewer pricing tiers, a risk-based pricing notice is required for each consumer who is not placed in the top (lowest-priced) tier;
- If the creditor has 5 or more pricing tiers, consumers who do not qualify for the top 2 tiers and any other tier that represents no less than the top 30% but no more than the top 40% of the total number of tiers must receive a risk-based pricing notice. For example, if a creditor has 9 pricing tiers, the top 3 tiers (33%) comprise no less than the top 30% but no more than the top 40% of the tiers. In this scenario, a risk-based pricing notice would be required for all consumers placed within the lower 6 tiers.

Credit card special test. For credit card lenders that utilize the tiered pricing method, if a consumer applies for a credit card program that has more than one purchase APR, the creditor should assume the consumer was applying for the best rate. If the consumer does not receive the best pricing available (lowest APR), a risk-based pricing notice is required. If there is no purchase APR, the creditor should consider the APR that varies according to the consumer’s credit qualifications.
A credit card issuer is **not** required to provide a risk-based pricing notice to a consumer if:

- The consumer applies for a credit card for which a single APR (excluding a teaser rate) is offered, or
- The creditor offers the consumer the lowest APR available under the credit card plan for which the consumer applied, even if a lower APR available under a different offer or plan from the issuer. That’s pretty confusing, so here’s an example: say a consumer applies for the “standard” plan, which has rates from 10 to 12% APR. The consumer is given an APR of 10%. No risk-based pricing notice is required, despite the fact that the creditor also offers a “preferred” plan that has a 7% APR.

Credit card issuers may always use the credit score proxy or tiered pricing methods if they wish.

**Credit Score Disclosure Exceptions: Alternative Methods**

There are additional, flexible alternatives available to either the credit score proxy or tiered pricing methods. With these alternative methods, a creditor **does not need to determine if approved applicants received an offer of materially less favorable terms**. This eliminates the requirements above to analyze cutoff scores, tiers, or otherwise.

However, use of these methods doesn’t come without strings attached: if these alternatives are utilized, the creditor is **required to deliver the alternative disclosure to all applicants to whom it makes an offer** of credit (except for those for which one of the obvious exceptions applies, such as where the consumer applied for a specific rate or accepted a prescreened offer, etc.)

*Credit score disclosure exception for loans secured by 1 to 4 units of residential real property.* This allows creditors making consumer-purpose loans secured by residential real property (including purchase, home equity/improvement, refinance, HELOCs, etc.) to meet the requirement by **adding information regarding the use of consumer reports to the credit score disclosure** (Notice to Home Loan Applicant) it already provides to consumers.

The supplemental information requirement can be met by providing **Model Form H-3** (which is a safe harbor form where notice is deemed to be in compliance), and contains:

- A statement that a consumer report is a record of the consumer’s credit history and includes information about whether the consumer pays his or her obligations on time and how much the consumer owes to creditors;
- A statement that a credit score is a number that takes into account information in a consumer report and it can change over time to reflect changes in the consumer’s credit history;
- A statement that the consumer’s credit score can affect whether the consumer can obtain credit and what the cost of that credit will be;
- A distribution of credit scores (represented by a bar graph) containing at least 6 bars illustrating the dispersion of applicants among credit score ranges. These bar graphs typically are provided to creditors by the credit bureaus, which are required to update the information “as necessary.” As an alternative to the bar graph, a clear statement describing how the applicant’s credit score compares to the scores of other consumers may be provided;
• A statement that the consumer is encouraged to verify the accuracy of consumer report information and has the right to dispute any inaccurate information;
• A statement that federal law gives the consumer the right to obtain copies of his or her consumer report directly from the credit bureau, including a free report from each of the nationwide bureaus once every 12 months;
• Contact information for the credit bureau where consumers may obtain their free annual consumer reports; and
• A statement directing consumers to the Fed’s and FTC’s websites to obtain more information about consumer reports.

This information (Model Form H-3 or in a form the creditor creates) is provided with the Notice to the Home Loan Applicant, which must be provided in all situations where a credit score is utilized in consideration of a consumer loan secured by 1 to 4 units of residential real estate. Both must be provided before loan closing or when the first transaction is conducted under an open-ended credit line.

Other Extensions of Credit. This operates in much the same way as the method above, meaning cutoff scores, tiers, and so on need not be calculated, but disclosures must be provided to all to whom offers are extended. This method, however, covers applications for loans other than credit that to be secured by 1 to 4 units of residential real property, such as credit cards, student loans, auto loans, and so forth. This method includes disclosing the consumer’s credit score along with additional information.

The information required in these situations can be met by providing Model Form H-4 (again a safe harbor form), and contains:

• A statement that a consumer report is a record of the consumer’s credit history and includes information about whether the consumer pays his or her obligations on time and how much the consumer owes to creditors;
• A statement that a credit score is a number that takes into account information in a consumer report and it can change over time to reflect changes in the consumer’s credit history;
• A statement that the consumer’s credit score can affect whether the consumer can obtain credit and what the cost of that credit will be;
• The consumer’s current or most recent credit score;
• The range of possible credit scores under the model used to generate the score;
• A distribution of credit scores (represented by a bar graph) containing at least 6 bars illustrating the dispersion of applicants among credit score ranges. These bar graphs typically are provided to creditors by the credit bureaus. As an alternative to the bar graph, a clear statement describing how the applicant’s credit score compares to the scores of other consumers may be provided;
• The date the credit score was created;
• The name of the credit bureau or other person who provided the credit score;
• A statement that the consumer is encouraged to verify the accuracy of consumer report information and has the right to dispute any inaccurate information;
• A statement that federal law gives the consumer the right to obtain copies of his or her consumer report directly from the credit bureau, including a free report from each of the nationwide bureaus once every 12 months;
• Contact information for the credit bureau where consumers may obtain their free annual consumer reports; and
• A statement directing consumers to the Fed’s and FTC’s websites to obtain more information about consumer reports.

The notice (Model Form H-4 or a form the creditor creates) must be provided as soon as practicable after the creditor has obtained the credit score, but in any case it must be provided before loan closing or when the first transaction is conducted under an open-ended credit line.

No credit score. This method is available to creditors that normally utilized credit scores during underwriting, but for some reason a score is not available for a particular consumer(s). When a credit score is not available (and the creditor does not obtain one from another source), to use the alternative method the creditor must assume the consumer receives credit on material terms that are materially less favorable; thus it will be provided to all consumers to whom offers have been extended.

Model Form H-5 can be used for this situation, which contains the following:

• A statement that a consumer report is a record of the consumer’s credit history and includes information about whether the consumer pays his or her obligations on time and how much the consumer owes to creditors;
• A statement that a credit score is a number that takes into account consumer report information and that it can change over time in response to changes in the consumer’s credit history;
• A statement that credit scores are important because consumers with higher credit scores generally obtain more favorable credit terms;
• A statement that not having a credit score can affect whether the consumer can obtain credit and what the cost of that credit will be;
• A statement that a credit score was not available from a credit bureau (which must be identified by name), generally due to insufficient information regarding the consumer’s credit history;
• A statement that the consumer is encouraged to verify the accuracy of consumer report information and has the right to dispute any inaccurate information;
• A statement that federal law gives the consumer the right to obtain copies of his or her consumer report directly from the credit bureau, including a free report from each of the nationwide bureaus once every 12 months;
• Contact information for the credit bureau where consumers may obtain their free annual consumer reports; and
• A statement directing consumers to the Fed’s and FTC’s websites to obtain more information about consumer reports.

The notice (Model Form H-5 or a form the creditor creates) must be provided as soon as practicable after the creditor has requested a credit score (and finds out there is none), but in any case it must be provided before loan closing or when the first transaction is conducted under an open-ended credit line.
Notice Delivery Standards

Only **one notice is necessary per credit extension**, but once an account is established, the rules for account review apply (meaning additional notices may be required if a later decision requiring notices is made). It may be provided in writing, orally, or electronically, and there is no acknowledgment or signature requirement. Use of the model forms is not required, but as mentioned above, they are a safe harbor.

**Who must provide the notice or disclosure?** Risk-based pricing notices (or one of the exception disclosures) **must be provided by the creditor**, not by a broker or other intermediary. There is an exception for auto loans, where the notice or disclosure may be delivered by auto dealer if it is timely and the creditor verifies that the dealer is delivering notices in a timely manner. The creditor is defined as the party to whom the obligation is initially payable, even if that creditor immediately transfers the agreement to another party.

**When must a notice or disclosure be provided?** As mentioned above, for closed-end credit, the required information must be delivered **before consummation** of the transaction, but not earlier than when approval is communicated. As a practical matter this will be after terms have been set, but before the consumer becomes contractually obligated (by signing a promissory note, for instance).

For open-end credit, the information must be delivered **before the first transaction is made** under the plan, but again not earlier than when approval is communicated.

In account review situations, the information must be delivered at the time the decision is made to increase the APR (excluding promotional or introductory rate expirations). If no notice of the APR increase is provided before the effective date of the change (if permitted), the creditor must notify the consumer no later than 5 days **after** the effective date of the APR change.

In so-called “instant credit” situations, where a purchase is made and credit is granted contemporaneously, the credit must provide the notice at the earlier of either the time of the first mailing to the consumer after the decision is made to approve (such as in a mailing containing the account agreement or a credit card); or within 30 days after the decision to approve the credit.
Multiple consumers. In joint credit scenarios, where 2 or more consumer are involved and the creditor obtains consumer report information on each, generally each consumer is entitled to a separate disclosure with the following conditions:

- **For risk-based pricing notices:** If each consumer has the same address, a single notice addressed to both is acceptable. If the consumer have separate addresses, a separate notice is required to each;
- **If the proxy method or tiered pricing method is used:** If each consumer has the same address, a single notice addressed to both is acceptable. If the consumer have separate addresses, a separate notice is required to each;
- **If an alternate method is used:** (meaning the creditor uses Model Form H-3 or H-4), or if a credit score is not available (Model Form H-5), a separate notice to each is required, whether or not the consumers have the same address.

When separate notices are delivered, they must contain **only** the credit score information for the individual consumer addressed.

### Additional Resources

The regulatory agencies have issued supplementary information on the rules and notices which may be helpful (note that the rules are same for all bank, thrifts and credit unions, regardless of regulator; therefore all may be helpful for all institutions):

- **Federal Reserve:**
- **Interagency Exam Procedures:**
- **OTS:**
- **NCUA:**