



REGULATORY COMPLIANCE OUTLOOK:

January 2011

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New Risk-Based Pricing Rules

Effective January 1, 2011



Overview

Risk-based pricing (RBP) refers to the practice of using a consumer's credit report, which reflects his or her risk of non-payment, in setting or adjusting the price and other terms of credit offered or extended to a particular consumer. The risk-based pricing rules implement Section 311 of the Fair and Accurate Credit Transactions Act of 2003 (FACTA), which amends the Fair Credit Reporting Act (FCRA).

The Federal Reserve Board (FRB) and the Federal Trade Commission (FTC) proposed regulations in May 2008 that generally would require a creditor to provide a consumer with a risk-based pricing disclosures (RBP Disclosures) when, based in whole or in part on the consumer's credit report, the creditor offers or provides credit to the consumer on terms less favorable than the terms it offers or provides to other consumers.

On Dec. 28, 2009, the FRB and FTC announced the final risk-based pricing rules, with the effective compliance date of Jan. 1, 2011. Publication in the Federal Register of the final rules took place on Jan. 15, 2010.¹

The new rules apply to mortgage brokers (if they are credit grantors), correspondents, and lenders and impact all consumers that have credit data and/or scores accessed for a risk-based pricing decision, regardless of loan approval status.

Indeed, risk-based pricing rules apply, with certain exceptions, to all creditors that engage in risk-based pricing. A risk-based pricing notice would generally be provided to the consumer after the terms of credit have been set, but before the consumer becomes contractually obligated on the credit transaction.

The rules provide a number of different approaches that creditors may use to identify the consumers to whom they must provide risk-based pricing notices.

In addition, the rules include certain exceptions to the notice requirement, the most significant being an exception that permits creditors, in lieu of providing a risk-based pricing notice to those consumers who receive less favorable terms, to provide all of their consumers with their credit scores and explanatory information.

As an alternative to providing risk-based pricing notices, the final rules permit creditors to provide consumers who apply for credit with a free credit score and information about their score. Today, most consumers must pay a fee to obtain their credit score.

Companies that use a credit report or score in connection with a credit decision must send notice, containing specified information, to a consumer when, based on a credit report or score, the company grants credit on material terms that are not the most favorable terms offered to a substantial proportion of consumers. For instance, in most cases, the rule defines material terms as the loan's annual percentage rate (APR).

What are Material Terms?

With respect to closed-end (residential real property) credit, there are two specific categories:

- 1) **Material Terms:** The Annual Percentage Rate (APR) required to be disclosed.²
- 2) **Materially Less Favorable:** The terms granted, extended or otherwise provided to a consumer differ from the terms granted, extended or otherwise provided to another consumer from or through the same person (i.e., original creditor) such that the cost of credit to the first consumer would be significantly greater than the cost of credit granted, extended, or otherwise provided to the other consumer.

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Factors relevant to determining the significance of a difference in cost: the type of credit product, the term of the credit extension, if any, and the extent of the difference between the material terms granted, extended, or otherwise provided to the two consumers.³

Who provides the RBP Disclosures?

Two-prong test

There is a two-prong test to determine the RBP compliance requirement, and both conditions must be met:

- (1) Determine that a consumer report is being used in connection with an application for, or a grant, extension or other provision of, credit (for personal, household, and family—not business—purposes) to a consumer; and
- (2) Based in whole or in part on the consumer report, determine if credit is granted, extended or otherwise provided to that consumer on “material terms” that are materially less favorable than the most favorable terms available to a substantial proportion of consumers from or through the credit grantor.

Who receives the RBP Disclosures?

A consumer must receive the RBP Disclosures by determination of the following methodologies:

Direct comparative analysis

Directly comparing the material terms offered to each consumer and the material terms offered to other consumers for a specific type of credit product.⁴

Credit score proxy⁵

- (A) Determining the credit score (cutoff score) that represents the point at which approximately 40 percent of the consumers to whom it grants, extends or provides credit have higher credit scores and approximately 60 percent of the consumers to whom it grants, extends or provides credit have lower credit scores; and
- (B) Providing a risk-based pricing notice to each consumer to whom it grants, extends or provides credit whose credit score is lower than the cutoff score.

Two or more credit scores used

Determine the cutoff score using the same method the creditor uses to evaluate multiple scores when making credit decisions. Evaluation methods may include, but are not limited to, selecting the low, median, high, most recent or average credit score of each consumer to whom it grants, extends or provides credit.

No credit scores

When using the credit score proxy method (see above) to grant, extend or provide credit to a consumer for whom a credit score is not available, an assumption is made that the consumer is receiving credit on material terms that are materially less favorable than the most favorable credit terms offered to a substantial proportion of consumers from or through that original creditor and a risk-based pricing notice to the consumer must be provided.

Tiered-pricing method

Tiered-pricing occurs when the creditor places the consumer within one of a discrete number of pricing tiers for a specific type of credit product, based in whole or in part on a consumer report. If the consumer is not placed within the top pricing tier or tiers, the RBP Disclosures compliance are met, as follows:

- ❖ **Four or fewer pricing tiers:** Providing a risk-based pricing notice to each consumer who does not qualify for the top tier (that is, the lowest-priced tier). Example: A creditor that uses a tiered pricing structure with annual percentage rates of eight, 10, 12 and 14 percent would provide the risk-based pricing notice to each consumer to whom it grants, extends, or provides credit at annual percentage rates of 10, 12, and 14 percent.⁶
- ❖ **Five or more pricing tiers:** Providing a risk-based pricing notice to each consumer who does not qualify for the top two tiers (that is, the two lowest-priced tiers) and any other tier that, together with the top tiers, comprise no less than the top 30 percent, but no more than the top 40 percent of the total number of tiers. Each consumer placed within the remaining tiers must receive a risk-based pricing notice. Example: If a creditor has nine pricing tiers, the top three tiers (that is, the three lowest priced tiers) comprise no less than the top 30 percent, but no more than the top 40 percent of the tiers; therefore, a creditor using this method would provide a risk-based pricing notice to each consumer to whom it grants, extends, or provides credit who is placed within the bottom six tiers.⁷

When are the RBP Disclosures sent?

With respect to close-end (residential real property) credit:

- ❖ The RBP Disclosures are provided before consummation of the transaction, but not earlier than the time the decision to approve an application for, or a grant, extension or other provision of, credit, is communicated to the consumer by the creditor.⁸
- ❖ RBP Disclosures are required to be sent individually and separately. These disclosures cannot be combined with any other non-FACTA documents and/or required disclosures.

What are the Model Forms?

With respect to closed-end (residential real property) credit, there are four Model Forms provided. Technical modifications to the language of the forms are permitted, providing a "safe harbor," as long as the substance of the model forms is not modified.⁹

1. Model Form for Risk-Based Pricing Notice
2. Model Form for Account Review Risk-Based Pricing Notice
3. Model Form for Credit Score Disclosure Exception for Loans Secured by One to Four Units of Residential Real Property
4. Model Form for Loans Where Credit Score is Not Available

Are there exceptions?

There are five exceptions to the RBP Disclosure compliance requirements.

1) Application for specific terms: A creditor is not required to provide a risk-based pricing notice if the consumer¹⁰ applies for specific material terms¹¹ and is granted those terms, unless those terms were specified by the creditor using a consumer report after the consumer applied for or requested credit and after the creditor obtained the consumer report.

2) Adverse action notice: A creditor is not required to provide a risk-based pricing notice to a consumer¹² if the creditor provides an adverse action notice to the consumer under section 615(a) of the FCRA.¹³

3) Prescreened solicitations: A creditor is not required to provide a risk-based pricing notice to a consumer¹⁴ if the creditor:

- (i) Obtains a consumer report that is a prescreened list as described in section 604(c)(2) of the FCRA; and
- (ii) Uses the consumer report for the purpose of making a firm offer of credit to the consumer; or, provides more favorable material terms.

This exception applies to any Firm Offer of Credit offered by a creditor to a consumer, even if the creditor makes other Firm Offers of Credit to other consumers on more favorable material terms.

4) Loans secured by residential real property—credit score disclosure: A creditor is not required to provide a risk-based pricing notice to a consumer¹⁵ if:

- (i) The consumer requests from the creditor an extension of credit that is or will be secured by one to four units of residential real property; and
- (ii) The creditor provides a notice to each consumer containing the following:
 - A. A statement that a consumer report (or credit 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;
 - B. A statement that a credit score is a number that takes into account information in a consumer report and that a credit score can change over time to reflect changes in the consumer's credit history;
 - C. 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;
 - D. The information required to be disclosed to the consumer pursuant to section 609(g) of the FCRA;¹⁶
 - E. The distribution of credit scores among consumers who are scored under the same scoring model that is used to generate the consumer's credit score using the same scale as that of the credit score that is provided to the consumer, presented in the form of a bar graph containing a minimum of six bars that illustrates the percentage of consumers with credit scores within the range of scores reflected in each bar or by other clear and readily understandable graphical means, or a clear and readily understandable statement informing the consumer how his or her credit score compares to the scores of other consumers. (See Model Form # 3, hereinabove.)

- F. A statement that the consumer is encouraged to verify the accuracy of the information contained in the consumer report and has the right to dispute any inaccurate information in the report;
- G. A statement that federal law gives the consumer the right to obtain copies of his or her consumer reports directly from the consumer reporting agencies, including a free report from each of the nationwide consumer reporting agencies once during any 12-month period;
- H. Contact information for the centralized source from which consumers may obtain their free annual consumer reports; and
- I. A statement directing consumers to the Web sites of the Federal Reserve Board and Federal Trade Commission to obtain more information about consumer reports.

5) Credit score not available: a creditor is not required to provide a risk-based pricing notice to a consumer¹⁷ if the creditor:

- I. Regularly obtains credit scores from a consumer reporting agency and provides credit score disclosures to consumers in accordance with the final rule, but a credit score is not available from the consumer reporting agency from which the creditor regularly obtains credit scores for a consumer to whom the creditor grants, extends, or provides credit;
- II. Does not obtain a credit score from another consumer reporting agency in connection with granting, extending, or providing credit to the consumer; and
- III. Provides to the consumer a notice that contains the following:
 - A statement that a consumer report (or credit report) includes information about the consumer's credit history and the type of information included in that history;
 - A statement that a credit score is a number that takes into account information in a consumer report and that a credit score 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 about the consumer was not available from

- a consumer reporting agency, 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 the information contained in the consumer report and has the right to dispute any inaccurate information in the consumer report;
- A statement that federal law gives the consumer the right to obtain copies of his or her consumer reports directly from the consumer reporting agencies, including a free consumer report from each of the nationwide consumer reporting agencies once during any 12-month period;
- The contact information for the centralized source from which consumers may obtain their free annual consumer reports; and
- A statement directing consumers to the web sites of the Board and Federal Trade Commission to obtain more information about consumer reports.

The following documents may be downloaded from the FCRA/FACTA section of our firm's Web site Library (<http://lenderscompliancegroup.com>):

- Fair Credit Reporting Risk-Based Pricing Regulations, Final Rule, FR 75/10 (01/15/10)
- Fair Credit Reporting Risk-Based Pricing Regulations - Agency Notice (12/28/09)
- Model Forms—Risk-Based Pricing, Agency Notice (12/28/09)
- Fair Credit Reporting Risk-Based Pricing Regulations: Correction, FR 73/104 (05/29/08)
- Fair Credit Reporting Risk-Based Pricing Regulations, Proposed Rule, FR 73/97 (05/19/08)

Submit your questions ...

Do you have a regulatory compliance issue that you'd like to see addressed in the Regulatory Compliance Outlook Column? If so, e-mail your issue or concern to Jonathan Foxx at jfoxx@lenderscompliancegroup.com.

Jonathan Foxx, former chief compliance officer for two of the country's top publicly-traded residential mortgage loan originators, is the president and managing director of Lenders Compliance Group, a mortgage risk management firm devoted to providing regulatory compliance advice and counsel to the mortgage industry. He may be contacted at (516) 442-3456 or by e-mail at jfoxx@lenderscompliancegroup.com.

Footnotes

- 1—This outline is based on information provided in "Fair Credit Reporting Risk-Based Pricing Regulations," Federal Register, 75/10, 01/15/2010, Rules and Regulations, pp. 2724-2784. The FTC is placing the final regulations and guidelines in the part of its regulations implementing the FCRA, specifically 16 CFR Part 640. This is the source document used herein for citations.
- 2—See 12 CFR 226.17(c) and 226.18(e).
- 3—Op. cit. 1, p. 2753.
- 4—That is, one or more credit products with similar features that are designed for similar purposes.
- 5—The credit score proxy method must be used to recalculate the cutoff score(s) no less than every two years, by considering the credit scores of all or a representative sample of the consumers to whom it has granted, extended, or provided credit for a specific type of credit product, or within one year after using a cutoff score derived from market research, third-party data, or information from a party which it acquired, with which it merged, or from which it acquired the portfolio.
- 6—Op. Cit. 1, p 2754. Actual example is in the Federal Register.
- 7—Idem, Actual example is in the Federal Register.
- 8—RBP Disclosures are provided before the first transaction is made under the HELOC plan, but not earlier than the time the creditor communicates to the borrower its approval decision.
- 9—Op. Cit. 1, Part 698-Model Forms and Disclosures, Appendix B(3), p 2776. Any rearrangement or modification of the language of the model forms "may not be so extensive as to materially affect the substance, clarity, comprehensibility, or meaningful sequence of the forms."
- 10—Pursuant to § 640.3(a) or (c).
- 11—"Specific material terms" means a single material term, or set of material terms, such as an annual percentage rate of 10 percent, and not a range of alternatives, such as an annual percentage rate that may be eight percent, 10 percent, or 12 percent, or between eight percent and 12 percent.
- 12—Pursuant to § 640.3(a), (c), or (d).
- 13—FCRA § 615. Requirements on users of consumer reports (15 U.S.C. § 1681m), (a) Duties of users taking adverse actions on the basis of information contained in consumer reports.
- 14—Pursuant to § 640.3(a) or (c).
- 15—Pursuant to § 640.3(a) or (c).
- 16—FCRA § 609. Disclosures to consumers (15 U.S.C. § 1681g), (g) Disclosure of Credit Scores by Certain Mortgage Lenders.
- 17—Pursuant to § 640.3(a) or (c).