

CONSUMER FINANCIAL PROTECTION CIRCULAR

Consumer Financial Protection Circular 2022-03

Adverse action notification requirements in connection with credit decisions based on complex algorithms

Question presented

When creditors make credit decisions based on complex algorithms that prevent creditors from accurately identifying the specific reasons for denying credit or taking other adverse actions, do these creditors need to comply with the Equal Credit Opportunity Act's requirement to provide a statement of specific reasons to applicants against whom adverse action is taken?

Response

Yes. ECOA and Regulation B require creditors to provide statements of specific reasons to applicants against whom adverse action is taken. Some creditors may make credit decisions based on certain complex algorithms, sometimes referred to as uninterpretable or "black-box" models, that make it difficult—if not impossible—to accurately identify the specific reasons for denying credit or taking other adverse actions.¹ The adverse action notice requirements of ECOA and Regulation B, however, apply equally to all credit decisions, regardless of the technology used to make them. Thus, ECOA and Regulation B do not permit creditors to use complex algorithms when doing so means they cannot provide the specific and accurate reasons for adverse actions.

Analysis

ECOA makes it unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex or marital status, age (provided the applicant has the capacity to contract), because all or part of the applicant's income derives from any public assistance program, or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act.²

In addition, ECOA provides that a creditor must provide a statement of specific reasons in writing to applicants against whom adverse action is taken.³ “Adverse action[s]” include denying an application for credit, terminating an existing credit account, making unfavorable changes to the terms of an existing account, and refusing to increase a credit limit.⁴

Pursuant to Regulation B, a statement of reasons for adverse action taken “must be specific and indicate the principal reason(s) for the adverse action.”⁵ Regulation B explains that “[s]tatements that the adverse action was based on the creditor’s internal standards or policies or that the applicant, joint applicant, or similar party failed to achieve a qualifying score on the creditor’s credit scoring system are insufficient.”⁶ The Official Interpretations to Regulation B explain that “[t]he specific reasons disclosed . . . must relate to and accurately describe the factors actually considered or scored by a creditor.”⁷ Moreover, while Appendix C of Regulation B includes sample forms intended for use in notifying an applicant that adverse action has been taken, “[i]f the reasons listed on the forms are not the factors actually used, a creditor will not satisfy the notice requirement by simply checking the closest identifiable factor listed.”⁸ With respect to adverse actions based on a credit scoring system specifically, the Official Interpretations explain that—

the reasons disclosed must relate only to those factors actually scored in the system. Moreover, no factor that was a principal reason for adverse action may be excluded from disclosure. The creditor must disclose the actual reasons for denial (for example, “age of automobile”) even if the relationship of that factor to predicting creditworthiness may not be clear to the applicant.⁹

ECOA’s notice requirements “were designed to fulfill the twin goals of consumer protection and education.”¹⁰ In terms of consumer protection, “the notice requirement is intended to prevent discrimination ex ante because ‘if creditors know they must explain their decisions . . . they [will] effectively be discouraged’ from discriminatory practices.”¹¹ The notice requirement “fulfills a broader need” as well by educating consumers about the reasons for the creditor’s action.¹² As a result of being informed of the specific reasons for the adverse action, consumers can take steps to try to improve their credit status or, in cases “where the creditor may have acted on misinformation or inadequate information[,] . . . to rectify the mistake.”¹³ In addition, Congress also believed ECOA’s notice requirement would have “a beneficial competitive effect on the credit marketplace.”¹⁴

Creditors who use complex algorithms, including artificial intelligence or machine learning, in any aspect of their credit decisions must still provide a notice that discloses the specific principal reasons for taking an adverse action. Whether a creditor is using a sophisticated machine learning algorithm or more conventional methods to evaluate an application, the legal requirement is the same: Creditors must be able to provide applicants against whom adverse action is taken with an accurate statement of reasons.¹⁵ The statement of reasons “must be specific and indicate the principal reason(s) for the adverse action.”¹⁶ A creditor cannot justify noncompliance with ECOA and Regulation B’s requirements based on the mere fact that the technology it employs to evaluate applications is too complicated or opaque to understand. A creditor’s lack of understanding of its own methods is therefore not a cognizable defense against liability for violating ECOA and Regulation B’s requirements.

Endnotes

1. While some creditors may rely upon various post-hoc explanation methods, such explanations approximate models and creditors must still be able to validate the accuracy of those approximations, which may not be possible with less interpretable models. ↩
2. 15 U.S.C. 1691(a). ↩
3. 15 U.S.C. 1691(d)(2)(A), (B); *see also* 15 U.S.C. 1691(d)(3). A creditor may either provide the notice or follow certain requirements to inform consumers on how to obtain such notice. 15 U.S.C. 1691(d)(2)(B). ↩
4. 12 CFR 1002.2(c). ↩
5. 12 CFR 1002.9(b)(2) (emphasis added); *see also* 12 CFR Part 1002 (Supp. I), sec. 1002.9, para. 9(b)(2)-9 (“The Fair Credit Reporting Act (FCRA) requires a creditor to disclose when it has based its decision in whole or in part on information from a source other than the applicant or its own files. . . . The FCRA also requires a creditor to disclose, as applicable, a credit score it used in taking adverse action along with related information, including up to four key factors that adversely affected the consumer’s credit score (or up to five factors if the number of inquiries made with respect to that consumer report is a key factor). Disclosing the key factors that adversely affected the consumer’s credit score does not satisfy the ECOA requirement to disclose specific reasons for denying or taking other adverse action on an application or extension of credit.”). ↩
6. 12 CFR 1002.9(b)(2). ↩
7. 12 CFR Part 1002 (Supp. I), sec. 1002.9, para. 9(b)(1)-2. A creditor, however, “need not describe how or why a factor adversely affected an applicant.” 12 CFR Part 1002 (Supp. I), sec. 1002.9, para. 9(b)(1)-3. ↩
8. 12 CFR Part 1002 (App. C), comment 4 (emphasis added). The sample forms are illustrative and may not be appropriate for all creditors. If a creditor chooses to use the checklist of reasons provided in one of the sample forms and if reasons commonly used by the creditor are not provided on the form, the creditor should modify the checklist by substituting or adding other reasons. 12 CFR Part 1002 (App. C), comment 3. ↩
9. 12 CFR Part 1002 (Supp. I), sec. 1002.9, para. 9(b)(1)-4. ↩
10. *Fischl v. Gen. Motors Acceptance Corp.*, 708 F.2d 143, 146 (5th Cir. 1983); *see also id.* (calling these provisions “[p]erhaps the most significant of the 1976 amendments to the ECOA”). ↩
11. *Treadway v. Gateway Chevrolet Oldsmobile Inc.*, 362 F.3d 971, 977-78 (7th Cir. 2004) (quoting *Fischl*, 708 F.2d at 146); *see also* S. Rep. 94-589, 94th Cong., 2d Sess., at 4, *reprinted in* 1976 U.S.S.C.A.N. 403, 406 (calling the notice requirement “a strong and necessary adjunct to the antidiscrimination purpose of the legislation”). ↩
12. S. Rep. 94-589, 94th Cong., 2d Sess., at 4, *reprinted in* 1976 U.S.S.C.A.N. 403, 406. ↩
13. *Id.* ↩
14. S. Rep. No. 94-589, at 4, 7 (1976). ↩
15. 15 U.S.C. 1691(d)(2)(A), (B); 12 CFR 1002.9(a)(2)(i), (ii). ↩
16. 12 CFR 1002.9(b)(2). ↩


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