Consumer Financial Protection Bureau

1700 G Street NW, Washington, D.C. 20552

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

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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

[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.

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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

[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.

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

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[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).

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.

About *Consumer Financial Protection Circulars*

Consumer Financial Protection Circulars are issued to all parties with authority to enforce federal consumer financial law. The Consumer Financial Protection Bureau (CFPB) is the principal federal regulator responsible for administering federal consumer financial law, *see* 12 U.S.C. 5511, including the Consumer Financial Protection Act's prohibition on unfair, deceptive, and abusive acts or practices, 12 U.S.C. 5536(a)(1)(B), and 18 other "enumerated consumer laws," 12 U.S.C. 5481(12). However, these laws are also enforced by state attorneys general and state regulators, 12 U.S.C. 5552, and prudential regulators including the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the National Credit Union Administration. *See, e.g.*, 12 U.S.C. 5516(d), 5581(c)(2) (exclusive enforcement authority for banks and credit unions with $10 billion or less in assets). Some federal consumer financial laws are also enforceable by other federal agencies, including the Department of Justice and the Federal Trade Commission, the Farm Credit Administration, the Department of Transportation, and the Department of Agriculture. In addition, some of these laws provide for private enforcement.

Consumer Financial Protection Circulars are intended to promote consistency in approach across the various enforcement agencies and parties, pursuant to the CFPB's statutory objective to ensure federal consumer financial law is enforced consistently. 12 U.S.C. 5511(b)(4). *Consumer Financial Protection Circulars* are also intended to provide transparency to partner agencies regarding the CFPB's intended approach when cooperating in enforcement actions. *See*, *e.g.*, 12 U.S.C. 5552(b) (consultation with CFPB by state attorneys general and regulators); 12 U.S.C. 5562(a) (joint investigatory work between CFPB and other agencies).

Consumer Financial Protection Circulars are general statements of policy under the Administrative Procedure Act. 5 U.S.C. 553(b). They provide background information about applicable law, articulate considerations relevant to the Bureau's exercise of its authorities, and, in the interest of maintaining consistency, advise other parties with authority to enforce federal consumer financial law. They do not restrict the Bureau's exercise of its authorities, impose any legal requirements on external parties, or create or confer any rights on external parties that could be enforceable in any administrative or civil proceeding. The CFPB Director is instructing CFPB staff as described herein, and the CFPB will then make final decisions on individual matters based on an assessment of the factual record, applicable law, and factors relevant to prosecutorial discretion.