

June 3, 2022

On May 26, 2022, the Consumer Financial Protection Bureau warned via <u>Consumer Financial Protection Circular 2022-03</u> that creditors using complex algorithmic credit evaluation models are not shielded from complying with the Equal Credit Opportunity Act (ECOA) requirement that consumers receive notice of the reasons why a lender took adverse action on an application or existing credit account. If a model is complex to the point that the creditor cannot articulate the reason a consumer was denied credit, use of the model may violate ECOA.

Circular 2022-03

ECOA has long required that creditors who take adverse action on a consumer's application for credit, such as denying an application for credit or terminating an existing account, provide to consumers a notice of that action. Where the adverse action notice contains a statement of reasons for the adverse action taken, the statement must "be specific and indicate the principal reason(s) for the adverse action." When the adverse action is based on a credit scoring system, "no factor that was the principal reason for adverse action may be excluded from disclosure." General statements that the adverse action was based on the creditor's internal standards or policies, or that the applicant failed to achieve a qualifying score on the creditor's credit scoring system, are insufficient to comply with ECOA and Regulation B.

The circular does not provide creditors with guidance regarding how to comply with the requirements of ECOA and Regulation B. Rather, the circular explains that the use of algorithmic models in credit decisioning violates ECOA and Regulation B if creditors are unable to articulate a specific reason for taking adverse action. The CFPB also warns that a creditor cannot justify noncompliance with these requirements based on the mere fact that the technology it employs to evaluate applications is too complicated or opaque to understand. All creditors, even those using algorithmic credit decision systems, must provide clear statements to consumers when taking adverse action, either in the notice itself or when the consumer requests information regarding the reasons for the adverse action. These statements must identify the principal reason(s) the consumer was denied credit and must be drafted clearly so that consumers understand why they received an adverse action. Thus, a creditor's lack of understanding of its own methods is not a defense against liability for violating ECOA and Regulation B's requirements.

What does this mean for you?

When the CFPB <u>released its annual fair lending report on May 6, 2022,</u> Director Rohit Chopra said "the CFPB will be sharpening its focus on digital redlining and algorithmic bias. As more technology platforms, including Big Tech firms, influence the financial services marketplace, the CFPB will be working to identify emerging risks and to develop appropriate policy responses." Circular 2022-03 is the latest concrete example of how the CFPB will scrutinize creditors utilizing advanced credit evaluation techniques.

Creditors that leverage their own complex algorithmic systems in credit decisioning should ensure that they sufficiently understand how these models operate so they can provide consumers with clear and accurate reasons for taking an adverse action. Creditors utilizing third-party models are not absolved from compliance with ECOA, and they should engage with their vendors to ensure they understand the factors driving the credit decision – and can communicate those factors to consumers in a clear and effective manner.

Notes

- 1. 12 CFR § 1002.9(b)(2).
- 2. 12 CFR Part 1002 (Supp. I), § 1002.9, para. 9(b)(1)-2.

This content is provided for general informational purposes only, and your access or use of the content does not create an attorney-client relationship between you or your organization and Cooley LLP, Cooley (UK) LLP, or any other affiliated practice or entity (collectively referred to as "Cooley"). By accessing this content, you agree that the information provided does not constitute legal or other professional advice. This content is not a substitute for obtaining legal advice from a qualified attorney licensed in your jurisdiction, and you should not act

or refrain from acting based on this content. This content may be changed without notice. It is not guaranteed to be complete, correct or up to date, and it may not reflect the most current legal developments. Prior results do not guarantee a similar outcome. Do not send any confidential information to Cooley, as we do not have any duty to keep any information you provide to us confidential. When advising companies, our attorney-client relationship is with the company, not with any individual. This content may have been generated with the assistance of artificial intelligence (Al) in accordance with our Al Principles, may be considered Attorney Advertising and is subject to our <u>legal notices</u>.

Key Contacts

Michelle L. Rogers Washington, DC

mrogers@cooley.com +1 202 776 2227

This information is a general description of the law; it is not intended to provide specific legal advice nor is it intended to create an attorney-client relationship with Cooley LLP. Before taking any action on this information you should seek professional counsel.

Copyright © 2023 Cooley LLP, 3175 Hanover Street, Palo Alto, CA 94304; Cooley (UK) LLP, 22 Bishopsgate, London, UK EC2N 4BQ. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley LLP as the author. All other rights reserved.