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On May 26, 2022, the Consumer Financial Protection Bureau warned via Consumer Financial Protection Circular 2022-03 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."[1] 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."[2] 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 released its annual fair lending report on May 6, 2022, 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.

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