AI Adverse-Action Requirements

Cite

CFPB, Consumer Financial Protection Bureau Circular 2022-03;
Adverse action notification requirements in connection with credit decisions based on complex algorithms

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Impact Assessment

- Lenders using AI or other complex underwriting methodologies must determine how to issue compliant adverse action notices as quickly as possible, repairing any opacity impeding issuance to ensure that notices are clear and allow consumers can dispute errors to gain rapid remediation and regulators to enhance anti-discrimination enforcement.
- Lenders have this same responsibility even if their AI models are provided by third-party vendors, GSEs, or "partner" institutions.
- Traditional underwriting and credit scores may regain market share with possible adverse implications for inclusion and efficiency.
- Credit discrimination may be easier to identify not only with regard to applications, but also existing credit.

Overview

Continuing its use of novel rulings that preclude public notice and comment, the CFPB has issued a landmark ruling on artificial intelligence (AI) and other forms of algorithmic underwriting stipulating lender responsibility for sending out the adverse action notices required under the Equal Credit Opportunity Act (ECOA). The CFPB recently added a broader range of credit decisions on outstanding loans (e.g., granting or reducing lines), to these notice requirements, making the reach of this new policy still broader. Lenders are responsible for adherence to these requirements even if their underwriting models are provided by third parties or credit decisions are made by third parties such as fintechs or auto dealers. However, when these nonbanks are the lender, they are then subject to CFPB enforcement even if the Bureau does not have formal supervisory power over them under another recent CFPB ruling. The press release accompanying the circular also includes more sweeping statements about broader fair-lending compliance obligations when using these underwriting systems.

Impact

In 2021, the federal banking agencies took a tentative step towards addressing AI-related risks, issuing a request for information (RFI) on numerous prudential and consumer-protection issues.[1] The RFI notes challenges to ensuring fair-lending compliance and issuing adverse action notices but expresses no opinion on the extent of these challenges nor on how they might be addressed.

Now, the CFPB's sweeping action essentially answers the RFI's questions and, by virtue of the agency's interpretation of its authority over nonbanks[2] and the reach of its UDAAP standards[3] has also made it clear that immediate steps to adhere to its edicts are essential to avoid legal and reputational risk. Lenders might ultimately prevail in such cases due to the unusual nature of the CFPB's rulings, but considerable damage to them could be done along the way.

However, it is likely to prove difficult for lenders to implement new underwriting methodologies quickly to comply with the CFPB's requirements. As detailed below, the circular essentially prohibits use of any underwriting system that does not permit a lender to generate a meaningful adverse action notice. Some AI-user creditors do issue these notices, but the Bureau believes many are "ad hoc" and cannot be rigorously validated. Adverse-action notices may now also not meet the CFPB's standards if lenders depend on GSE automated-underwriting models that are not always transparent to lenders.

The circular also states that a creditor's inability to understand an underwriting methodology is no excuse for failure to provide adverse action notices. This is meant to ensure that lenders who deploy third-party underwriting systems take responsibility for models or methodologies even if these are not their own. The banking agencies have proposed a rule that would holds banks responsible for consumer compliance regardless of the extent to which they otherwise rely on a third-party vendor or "partner".[4] The CFPB's circular applies this standard now not only to banks, but also to all creditors under both its direct jurisdiction and its view of the reach of its enforcement powers. As a result, creditors may now demand far more of third-party providers, forcing these vendors to enhance model transparency, improve validation, and perhaps also release information now deemed proprietary.

The reach of these new requirements is also broader than many lenders may anticipate. Under another recent Bureau action, notices are now required not only with regard to application denials, but also to changes to existing credit obligations (e.g., lines) that are costly to the borrower.

One of the reasons Congress initially enacted the adverse notice requirement is the view that underwriting clarity improves market competition by enhancing the ability

[1] See **AI,** *Financial Services Management***,** April 5, 2021.

[2] See **CONSUMER41,** *Financial Services Management*, April 27, 2022.

[3] See **CONSUMER39,** *Financial Services Management*, March 22, 2022.

[4] See **VENDOR9,** *Financial Services Management*, July 21, 2021.

of borrowers to protect themselves against discrimination and improve their own creditworthiness. This may be among the Bureau's objectives with this new policy based on Director Chopra's focus on fair competition, with the new approach making it easier for lenders using more traditional underwriting that generate compliant adverse action notices to compete against fintech or other lenders whose systems appear to offer credit on more attractive terms or conditions. This may enhance not only the competitiveness of traditional lenders, but also of longstanding credit scores that may adversely affect access to credit for under-served borrowers. The Bureau appears to believe that the harm of this effect, should it occur, is offset by market transparency, reduced discrimination, and greater equity.

Another result of this policy could be reduced innovation in an area many believe could ultimately increase financial inclusion by virtue of the rigorous objectivity AI is said to bring to credit underwriting and the cost savings its efficiency also affords. Critics of these claims believe that this cannot be achieved without AI transparency because of proven instances in which AI inputs or assumptions have had clear discriminatory effect. As noted, the Bureau clearly prefers to err on the side of caution, allowing AI-related innovation to ensure transparency, consumer rights, and effective fair-lending enforcement.

What's Next

This circular was issued on May 26. It is effective immediately, with the Bureau giving no indication that it will counsel lenders rather than issue enforcement actions if good-faith compliance efforts take time to introduce.

Analysis

The circular lays out the CFPB's interpretation of the ECOA and the extent to which it covers algorithmic or other complex underwriting methodologies with particular regard to adverse action notices. It states that the law and current rule require a statement of "specific" and "actual" reasons for credit denial or other adverse action related to applications or outstanding obligations. The Bureau asserts that simply stating that a borrower failed to satisfy internal ratings standards will not suffice, nor does checking the factor nearest to the one for which an adverse action was taken. Here, the Bureau notes that simply disclosing an external credit score (e.g., FICO) does not currently constitute sufficient reason and including it in internal scoring systems would be thus incompatible with longstanding practice.