

# Regulators' Focus On AI Highlights Risks For Lenders

By **Moorari Shah, A.J. Dhaliwal and Matt Benz** (October 16, 202)

As the capabilities of predictive decision-making technologies continue to grow, lenders are turning to complex algorithms and artificial intelligence, including generative AI, as the foundation of their underwriting models at increasing rates.

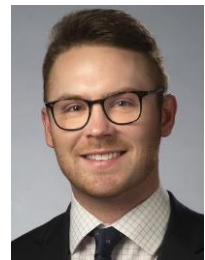
The expanding role of AI in consumer credit transactions has accordingly triggered heightened attention from consumer finance regulators in recent months. In particular, the Consumer Financial Protection Bureau has made regulating the intersection of AI technologies and fair lending one of its top priorities.

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On Sept. 19, the CFPB issued its Circular 2023-03,[1] which addressed whether, when using AI or complex credit models, lenders may rely on the checklist of reasons provided in CFPB sample forms, as currently codified in Regulation B, for adverse action notices even when those sample reasons do not accurately or specifically identify the reasons for the adverse action.[2]

The circular answered this question with a resounding no, explaining that lenders that rely on the checklist in CFPB sample forms do not satisfy their obligations under the Equal Credit Opportunity Act if those reasons do not specifically and accurately indicate the principal reason or reasons for the adverse action.

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The circular further announced that, as a general rule, reliance on overly broad or vague rationales that obscure the specific and accurate reasons for an adverse action represents a failure to comply with the ECOA.

The circular is an important resource for financial institutions that engage in credit transactions with consumers. The circular also reinforces prior CFPB guidance clarifying that lenders that rely on AI-based underwriting models in making credit decisions have adverse action notice obligations under the ECOA.[3]

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Beyond the CFPB, recent actions and guidance from other regulatory authorities suggest that companies using AI in the context of consumer credit transactions should tread lightly.

## Circular 2023-03

The purpose of the CFPB's latest circular is to provide lenders and other market participants with guidance regarding how the use of AI and complex algorithms affects adverse action notice obligations under the ECOA.

The ECOA, implemented by Regulation B, makes it unlawful for any lender to discriminate against any applicant with respect to any aspect of a credit transaction on the basis of race; color; religion; national origin; sex, including sexual orientation and gender identity; 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.[4]

The ECOA and Regulation B require that, when taking adverse action against an applicant, a lender must provide the applicant with a statement of reasons for the action taken.[5] This statement of reasons must be specific and indicate the "principal reason(s) for the adverse action." [6] In addition, the specific reasons disclosed must "relate to and accurately describe the factors actually considered or scored by a lender." [7]

In today's marketplace, lenders are increasingly using AI in their underwriting models, and lenders often supply these complex algorithms with large datasets, sometimes including data that may be harvested from consumer surveillance.

As a result of the automated, algorithm-based analysis of these datasets commonly employed by lenders, regulators contend that consumers may be denied credit for reasons they may not consider particularly relevant to their finances.

Moreover, AI systems can result in denials, according to regulators, based on combinations of general indicators and patterns rather than specific indicia of credit unworthiness. Such denials pose a problem for lenders when it comes to maintaining compliance with adverse action notice requirements under the ECOA.

According to the CFPB's circular, lenders faced with this issue have resorted to relying on a checklist of reasons provided in CFPB sample forms when issuing AI-based credit denials to consumers. However, the circular makes clear that lenders cannot simply conduct check-the-box exercises when delivering notices of adverse action if doing so fails to accurately inform consumers why adverse actions were taken.

Specifically, the circular explains that the use of AI and complex algorithms in issuing credit denials does not excuse lenders of their obligation to provide consumers with the specific reasons that a given denial was issued. That is to say, simply pointing to a broad and unspecific bucket of reasons for a denial does not satisfy the requirements of the ECOA.

Lenders must instead disclose the specific reasons for credit denials, even if such disclosures relate to data that may not intuitively relate to a consumer's finances — in this case, to either modify the sample form or check "other" and include the appropriate explanation.

The circular cites the following example from Appendix C of Regulation B:

[A] creditor should disclose "insufficient bank references" and not "insufficient credit references," which is listed on the CFPB's sample form, if the creditor considers only references from banks and other depository institutions and not from other institutions.

To be sure, the circular acknowledges in a footnote that Appendix C also limits how much specificity is actually required, i.e., "[t]he creditor need not, however, describe how or why a factor adversely affected the application. For example, the notice may say 'length of residence' rather than 'too short a period of residence.'"

Ultimately, the circular appears to fashion a test for greater specificity in reasons given for credit denials that are based on data gathered outside of their application or credit file, "particularly if the data are not intuitively related to their finances or financial capacity."

## Other Recent Regulatory Actions

The CFPB's latest circular further reinforces recent guidance issued by the CFPB and other consumer finance regulators.

The CFPB has previously issued guidance affirming that lenders are not excused from their adverse action notice obligations under the ECOA simply because they rely on complex algorithmic underwriting models in making credit decisions.[8]

Building on that previous guidance, the CFPB's latest circular focuses on the accuracy and specificity requirements of those notices, even when such models, driven by data gathered outside of traditional credit reports or applications, are utilized.

Moreover, the rapid rise of AI used with advertising, marketing and other consumer-facing applications has caused the Federal Trade Commission to continue to take notice and issue its own guidance.

While the FTC has issued similar AI-related guidance in the past,[9] the agency has reiterated its concerns about false or unsubstantiated claims about an AI product's efficacy.[10]

At the very least, the fact that it is being reiterated should be a signal that the FTC continues to focus on this area. Indeed, most recently, the FTC instituted an investigation into the generative AI practices of OpenAI through a 20-page civil investigative demand.[11] The apparent subjects of the investigation involve allegations of unfair or deceptive practices related to the use of OpenAI's large language model.

Finally, on April 25, the CFPB, FTC, U.S. Equal Employment Opportunity Commission and Civil Rights Division of the U.S. Department of Justice issued a joint statement outlining the agencies' collective commitment to monitor the development and use of automated systems and artificial intelligence and enforce their respective authorities where such systems produce outcomes that result in unlawful discrimination.

The joint statement explained that potential discrimination in automated systems can come from different sources, including unrepresentative or imbalanced datasets, datasets that incorporate historical bias or datasets that contain other types of errors; automated systems or black boxes with internal workings that are not clear to most people and, in some cases, even the developer of the tool; and systems designed on the basis of flawed assumptions about its users, relevant context, or the underlying practices or procedures.

## Takeaways

The CFPB's circular, along with other recent actions by consumer finance regulators, highlight that financial institutions and other market participants that use AI tools in issuing credit denials must develop policies for ensuring their use is done in a fashion that complies with federal consumer protection and other laws.

It may also be necessary for companies to review their audit processes for adverse action explanations and assess whether such explanations are sufficiently specific to satisfy the requirements of the ECOA.

In light of the heightening regulatory scrutiny of AI systems and complex algorithms in the

financial services industry more broadly, lenders and other companies that leverage AI-based technologies in consumer credit transactions should review the circular and other recent guidance issued by consumer finance regulators in order to ensure that their practices are compliant with federal law.

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[1] See Consumer Fin. Prot. Bureau, Consumer Financial Protections Circular 2023-03 (Sept. 19, 2023), <https://www.consumerfinance.gov/compliance/circulars/circular-2023-03-adverse-action-notification-requirements-and-the-proper-use-of-the-cfpbs-sample-forms-provided-in-regulation-b/>.

[2] 12 CFR Part 1002, (App. C), comment 3.

[3] See Consumer Fin. Prot. Bureau, Consumer Financial Protection Circular 2022-03: Adverse action notification requirements in connection with credit decisions based on complex algorithms, (May 26, 2022) ("Consumer Financial Protection Circular 2022-03"), <https://www.consumerfinance.gov/compliance/circulars/circular-2022-03-adverse-action-notification-requirements-in-connection-with-credit-decisions-based-on-complex-algorithms/>.

[4] See 15 U.S.C. § 1691(a).

[5] See 15 U.S.C. 1691(d)(2); 12 CFR 1002.9(a)(2)(i); see also 12 CFR 1002.9(a)(2)(ii) (affording lenders the option of providing notice or following certain requirements to inform consumers of how to obtain such notice).

[6] 15 U.S.C. § 1691(d)(3); 12 CFR § 1002.9(b)(2).

[7] 12 CFR Part 1002 (Supp. I), sec. 1002.9, para. 9(b)(2)-2.

[8] See Circular 2022-03.

[9] See Elisa Jillson, Aiming for Truth, Fairness, and Equity in Your Company's Use of AI, FTC (Apr. 19, 2021), <https://www.ftc.gov/business-guidance/blog/2021/04/aiming-truth-fairness-equity-your-companys-use-ai>.

[10] See Michael Atleson, Keep your AI claims in check, FTC, (February 27, 2023), <https://www.ftc.gov/business-guidance/blog/2023/02/keep-your-ai-claims-check>.

[11] See <https://www.washingtonpost.com/documents/67a7081c-c770-4f05-a39e-9d02117e50e8.pdf>.