

## CFPB Circular On AI Credit Denials At Odds With Existing Law

By **Eric Mogilnicki and David Stein** (October 12, 2023, 5:59 PM EDT)

The Consumer Financial Protection Bureau recently issued a new circular<sup>[1]</sup> describing the adverse action notification requirements for lenders that use artificial intelligence or complex credit models in making credit denial determinations.

This small development reflects a series of larger trends at the bureau.

Like many of the bureau's recent guidance documents, the circular takes a position at odds with existing law, creates rather than resolves legal uncertainty, was developed and issued with no public input, and reflects a hostility to the deployment of new technology.

The circular explicitly addresses the question: "When using artificial intelligence or complex credit models, may creditors rely on the checklist of reasons provided in CFPB sample forms for adverse action notices even when those sample reasons do not accurately or specifically identify the reasons for the adverse action?"

The bureau's answer is no.

The circular explains that creditors may rely on the checklist of reasons in the sample forms in the CFPB's Regulation B to satisfy their Equal Credit Opportunity Act obligations only if the checked reason or reasons "specifically and accurately indicate[s] the principal reason(s) for the adverse action."

This explanation is neither surprising nor illuminating since Appendix C to Regulation B has stated for decades that "[i]f the reasons listed on the [sample] forms are not the factors actually used, a creditor will not satisfy the notice requirement by simply checking the closest identifiable factor listed."<sup>[2]</sup>

The problems arise when the bureau purports to apply this well-established standard to the use of technology to make underwriting decisions.

In the circular, the bureau concludes that "[s]pecificity is particularly important when creditors utilize complex algorithms" to make credit decisions.

The bureau takes this position "to ensure consumer understanding" because consumers "may not anticipate that certain data gathered outside of their application or credit file and fed into an algorithmic decision-making model may be a principal reason in a credit decision, particularly if the data



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are not intuitively related to their finances or financial capacity."

As an example, the CFPB asserts in the circular that "purchasing history" or "disfavored business patronage" likely is an inadequate principal reason to provide to a consumer whose credit line is closed based on a model's evaluation of their shopping behavior.

Instead, "the creditor would likely need to disclose more specific details about the consumer's purchasing history or patronage that led to the reduction or closure, such as the type of establishment, the location of the business, the type of goods purchased, or other relevant considerations, as appropriate."

There are four related problems with the CFPB's approach.

First, the circular takes a legal position that contradicts the CFPB's own official regulatory interpretations. The official bureau interpretation of Regulation B states that "[a] creditor need not describe how or why a factor adversely affected an applicant. For example, the notice may say 'length of residence' rather than 'too short a period of residence.'"[3]

However, the new circular's "purchasing history" example suggests that creditors "would likely need to disclose more specific details about the consumer's purchasing history" in a manner that effectively would require the creditor to "describe how or why a factor adversely affected an applicant."

The official interpretation also requires that "[t]he 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."[4]

Despite this official commentary, the new circular indicates that creditors using complex credit decision models must adopt a heightened standard of specificity "to ensure consumer understanding" for factors not "intuitively related to their finances." In this way, the new circular contradicts a previous circular on the same topic, in which the CFPB made clear that the requirement to provide specific and accurate adverse action reasons is the same "[w]hether a creditor is using a sophisticated machine learning algorithm or more conventional methods to evaluate an application."[5]

This effort to remake the law through guidance to other agencies repeats a mistake the bureau has made in other contexts.

The aggressiveness of the new circular is similar to the guidance provided by the bureau's recent policy statement on abusive acts and practices, which invites state attorneys general to bring abusive claims under federal law in circumstances in which the bureau itself has repeatedly declined to do so.[6]

Second, this new circular, like most of the bureau's recent guidance, is focused on emphasizing the CFPB's priorities, rather than illuminating the law.

While the CFPB circular policy states that circulars are meant to prevent "inconsistent enforcement strategies and approaches,"[7] this circular affirmatively creates inconsistencies with the official interpretations of Regulation B and may foster, rather than reduce, inconsistency in enforcement.

CFPB Director Rohit Chopra described the circular as highlighting that "[t]here is no special exemption for artificial intelligence,"[8] but no federal or state enforcement strategy or approach has ever

suggested that such an exemption exists.

The same approach is apparent in the bureau's use of advisory opinions. The CFPB's advisory opinion policy says that its primary purpose is to "facilitate the submission by interested parties of requests that the Bureau issue Advisory Opinions."<sup>[9]</sup> However, to date the bureau has posed, as well as answered, the questions addressed in its advisory opinions.

For example, the CFPB issued an advisory opinion in October 2022 "to highlight that a consumer reporting agency [must] implement reasonable internal controls to prevent the inclusion of facially false data." A July 2022 advisory opinion "reminds consumer report users that [the FCRA] strictly prohibits" the use of a consumer report without a permissible purpose.

And a June 2022 advisory opinion was "issue[d] to affirm that [the FDCPA] prohibits debt collectors from collecting pay-to-pay or 'convenience' fees ... not expressly authorized by the agreement creating the debt or expressly authorized by law."

This approach transforms the advisory opinion process from an opportunity for the bureau to understand and respond to questions to just another way for the bureau to announce its views. Such freewheeling advice is contrary to the stated purposes of the CFPB advisory opinion process, and to the practices of other federal agencies that issue opinions in response to questions from the public.

Third, the new circular reflects no public process or input. In this respect, the new circular is consistent with the bureau's insular approach to the issuance of other circulars, policy statements and advisory opinions. By moving forward without engaging with consumer and industry groups, the CFPB denies itself inputs that could inform and pressure-test the bureau's thinking.

Here, for example, a more robust process might have helped the bureau identify and avoid the conflict between the new circular and the official commentary to Regulation B.

Moreover, the bureau's go-it-alone approach contributes to an environment in which each successive bureau administration feels entirely comfortable rescinding — as this administration has done — the guidance issued by its predecessor: "A more inclusive process could lead to more considered outcomes, greater consistency in enforcement, and a more durable legacy of Bureau action to advance consumer protection."<sup>[10]</sup>

Fourth, the bureau's adverse action circular is a small part of a steady drumbeat of CFPB warnings and criticisms of the use of technological advances in consumer financial services. In the new circular, the CFPB's drumbeat of criticism of AI has been expanded to encompass all "complex credit models."

The current administration of the bureau has largely turned its back on the efforts by former directors to foster innovation. This has included ending the no-action letter policy first championed by former CFPB Director Richard Cordray, to canceling the compliance assistance sandbox process created by former CFPB Director Kathy Kraninger.<sup>[11]</sup>

At the same time, the bureau has issued guidance discouraging the use of artificial intelligence in everything from credit underwriting<sup>[12]</sup> to home appraisal<sup>[13]</sup> to customer service.<sup>[14]</sup>

The supposed faults of AI include faults that apply with at least equal force to human intelligence: Chatbots are faulted because "their effectiveness wanes as problems become more complex," and

algorithms are criticized because they "can embed the very human bias they are meant to correct."

Like those pronouncements, the new circular takes no notice of the substantial contributions and widespread use of automated credit decision models in the financial services industry.

The new circular — and the bureau — generally does not seem to recognize the opportunities posed by the use of artificial intelligence, nor does it invite a dialogue about how the regulatory framework might be responsibly recalibrated to adapt to new technologies.

In time, this circular and the bureau's dire warnings about technology seem likely to take their place in history beside the 1908 New York Times essay by former U.S. Supreme Court Justice H.B. Brown, titled "The Horseless Carriage Means Trouble."<sup>[15]</sup>

At the end of the day, the CFPB's new circular on adverse action notices is profoundly flawed. The circular simply asserts that creditors must meet a new, heightened standard of explanation and description when using certain types of models.

This guidance is at odds with existing law, creates rather than resolves legal uncertainty, and reflects a hostility to technological advances that have the potential to significantly improve consumer outcomes. Unfortunately, the approach taken in this new circular reveals more about the current bureau than it does about the law.

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[1] Consumer Financial Protection Circular 2023-03, Adverse action notification requirements and the proper use of the CFPB's sample forms provided in Regulation B, available at <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/> (September 19, 2023).

[2] 12 C.F.R. Part 1002, Appendix C.

[3] 12 C.F.R. Part 1002, supp. I, § 1002.9(b)(2)-3.

[4] 12 C.F.R. Part 1002, supp. I, § 1002.9(b)(2)-4.

[5] CFPB Circular 2022-03, Adverse action notification requirements in connection with credit decisions based on complex algorithms, available at [https://files.consumerfinance.gov/f/documents/cfpb\\_2022-03\\_circular\\_2022-05.pdf](https://files.consumerfinance.gov/f/documents/cfpb_2022-03_circular_2022-05.pdf) (May 26, 2022); see also Ficklin, Pahl, and Watkins, CFPB Blog, Innovation spotlight: Providing adverse action notices when using AI/ML models (July 7, 2020).

[6] See Eric Mogilnicki, The Consumer Financial Protection Bureau's Abusive Policy Statement, *The Banking Law Journal*, Volume 140, Number 8, 377-396 (September 2023).

[7] See About Consumer Financial Protection Circulars, available at <https://www.consumerfinance.gov/compliance/circulars/about/>.

[8] CFPB Issues Guidance on Credit Denials by Lenders Using Artificial Intelligence, available at <https://www.consumerfinance.gov/about-us/newsroom/cfpb-issues-guidance-on-credit-denials-by-lenders-using-artificial-intelligence/> (September 19, 2023).

[9] Advisory Opinions Policy, 85 Fed. Reg. 77987 (Dec. 3, 2020).

[10] See 12 U.S.C. 5511 (the purposes of the CFPB include to "enforce Federal consumer financial law consistently").

[11] CFPB Statement on Competition and Innovation, 87 Fed. Reg. 58439 (Sept. 27, 2022).

[12] Director Chopra's Prepared Remarks on the Interagency Enforcement Policy Statement on "Artificial Intelligence," available at <https://www.consumerfinance.gov/about-us/newsroom/director-chopra-prepared-remarks-on-interagency-enforcement-policy-statement-artificial-intelligence/> (April 25, 2029).

[13] Algorithms, artificial intelligence, and fairness in home appraisals, available at <https://www.consumerfinance.gov/about-us/blog/algorithms-artificial-intelligence-fairness-in-home-appraisals/> (June 1, 2023).

[14] Chatbots in consumer finance, available at <https://www.consumerfinance.gov/data-research/research-reports/chatbots-in-consumer-finance/chatbots-in-consumer-finance/> (June 6, 2023).

[15] Brown, H.B., The Horseless Carriage Means Trouble, New York Times (February 1908), available at <https://www.nytimes.com/1973/03/25/archives/the-horseless-carriage-means-troublele.html>. Justice Brown is better known as the author of the majority opinion in Plessy v. Ferguson, 163 U.S. 537 (1896) which upheld racial segregation in public transportation.