For release on delivery
Expected at 11:30 a.m. (E.D.T.)
June 5, 1979

Statement by

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Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Affairs

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

June 5, 1979

I am happy to appear before this Subcommittee to address the issues raised by S. 15. This bill would amend the Equal Credit Opportunity Act to prohibit a credit card issuer from discriminating in any aspect of the issuance or use of a credit card on the basis of a person's place of residence. In part, this prohibition is directed toward those numerical credit scoring systems employed by card issuers that weight ZIP code, census tract, or a similar representation for the applicant's residence. The Equal Credit Opportunity Act prohibits discrimination on the basis of race, color, religion, national origin, sex, marital status, age, receipt of public assistance, or exercise of federally protected consumer rights. A creditor can violate the Act either by discriminating intentionally on a prohibited basis or by engaging in credit practices that have the "effect" of discriminating.

Obviously, certain uses of "place of residence" in granting credit, especially when small areas are considered, can discriminate illegally. The Board agrees that such uses are offensive and would not oppose a Congressional prohibition. However, S. 15 raises several general issues that transcend the specific proposal and it represents a significant departure from the existing prohibitions in the Act. Rather than identifying a specific group that needs protection, the proposed bill forbids the use or consideration of a particular characteristic, "place of residence." When use of "place of residence" does discriminate illegally, then the "effects test" already prohibits its use. Detection and rectification of effects tests violations, however, are presently complicated by the need for case-by-case judicial proceedings.

However, legislative remedies for "effects test" problems also raise competing considerations. First, it is not always clear when use of a particular characteristic has the effect of discriminating. Correlation with a prohibited basis is usually less than perfect. Moreover, the degree of association may vary from creditor to creditor. For example, scoring ZIP codes in New York City is more likely to have an illegally discriminatory impact than it would in a rural area.

Second, there is the problem of defining the prohibition so as not to preclude legitimate, nondiscriminatory uses. For example, identifying "place of residence" by city block probably would discriminate, whereas identifying it by state probably would not. The state in which an applicant lives might be important to a national credit card issuer since higher rate ceilings, lower cost creditor remedies, or the existence of expedited collection procedures could require different credit standards. Similarly, for the local credit card issuer, a prohibition on considering "place of residence" would preclude limiting its cards to customers that reside within its trade or market area. Like many factors used in credit decisions, the fact that the size of area considered forms a continuum makes it even more difficult to draw the line between legitimate and nonlegitimate uses of particular characteristics.

Third, limiting the legitimate, nondiscriminatory uses of characteristics will adversely affect the overall accuracy of credit decisions. This is likely to result in higher costs, less favorable terms, and fewer loans.

It may be that the use of ZIP code should be prohibited but Congress should take note of the fact that other characteristics can be called into question. For example, home ownership may correlate highly with marital status, age, and race. Bills have been introduced prohibiting the use of occupation and title. Almost anything related to financial status is likely to show some degree of correlation with one or more prohibited bases.

Although the effects tests considerations I've discussed appear most clearly in numerical credit scoring models, they also apply equally to judgmental systems. All credit analysis, whether performed by loan officers or credit scoring systems, uses the principle that past credit experience predicts future credit performance. Thus, future creditworthy applicants will resemble recent creditworthy borrowers. A judgmental system uses the experience of its credit officers to estimate the profile of past creditworthy customers. A credit scoring system uses statistics to measure the characteristics associated with repayment.

A common argument is that judgmental credit evaluation systems are preferable because credit officers personally review each application and give an applicant individual treatment. This is contrasted to numerical credit scoring systems that appear to be mechanistic and impersonal. Furthermore, they often include factors that do not obviously relate to creditworthiness and do not appear to consider each applicant individually. Interestingly, some of the information on these applications is viewed as offensive when considered explicitly in a numerical model, but is the very same information customarily used in the judgmental systems. In truth, both judgmental and numerical credit systems function in almost identical fashions.

Arguably, properly developed scoring systems offer significant advantages over judgmental systems to creditors and applicants. First, these systems have the capability of assessing creditworthiness more accurately than judgmental systems. Credit officers may recall past experience imperfectly or use the information inaccurately. More accurate credit analysis benefits applicants with fewer arbitrary decisions and creditors with lower costs. As a result, one might expect more credit or more favorable terms to be available in the long run. Second, scoring systems ensure that an applicant will be treated more evenly, both from credit officer to credit officer and from day to day, than judgmental systems. Third, scoring systems offer less opportunity for personal prejudices to influence credit decisions. Finally, from an enforcement perspective, numerical systems permit evaluation of the characteristics scored and how the analysis considered them. In contrast, each credit officer balances the available information mentally, so that a regulatory agency or a person denied credit cannot replicate the judgmental process. This makes the evaluation of judgmental systems much more difficult.

In conclusion, recognizing the problems outlined above and the precedent setting nature of the proposed legislation, the Board would not oppose a prohibition such as contained in S. 15, if limited to a census tract identification number, the last two digits of a ZIP code, or similar identifiers, and if Congress determines that explicit consideration of place of residence should be barred because its use is likely to have an illegally discriminatory effect. Thank you for the opportunity to appear here today. I will be pleased to answer any questions you may have.