FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 80-168
September 8, 1980

REGULATION B - EQUAL CREDIT OPPORTUNITY

Proposed Interpretations

TO ALL BANKS, OTHER CREDITORS,
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has proposed for public comment two interpretations of Regulation B, which implements the Equal Credit Opportunity Act. Comment is requested by October 20, 1980.

The first proposed interpretation sets out three basic principles which are to govern the consideration of a credit applicant's income under Regulation B and discusses the meaning of the regulatory requirement that a creditor not discount or exclude from consideration an applicant's income because it derives from alimony, child support, separate maintenance, part-time employment, retirement benefits or public assistance.

The second proposed interpretation deals with a creditor's manner of selecting and disclosing the reason or reasons for adverse action on a request for credit. The Board has proposed general principles to be followed in the selection and disclosure of reasons for adverse action.

The Board has in the case of each proposed interpretation, provided illustrations of their application and asks for comment whether the illustrative material is helpful, or whether it adds undesirable complexity to the interpretations.

Although the two interpretations are in response to questions which have arisen in the application of Regulation B to credit scoring systems, the Board notes that the basic principles as set forth in the proposed interpretations are to apply to judgmental systems as well.

Printed on the following pages is the Federal Reserve press release and material submitted for publication in the Federal Register summarizing the proposed interpretations. Questions regarding Regulation B and this circular should be directed to the Consumer Affairs Section of our Bank Supervision and Regulations Department, Ext. 6171.

Sincerely yours,

Robert H. Boykin

First Vice President

Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank: 1-800-442-7140 (intrastate) and 1-800-527-9200 (interstate). For calls placed locally, please use 651 plus the extension referred to above.

FEDERAL RESERVE press release

For immediate release August 21, 1980

The Federal Reserve Board today proposed for comment two interpretations of its Regulation B -- Equal Credit Opportunity -- concerning consideration of income and disclosure of reasons for adverse action.

The Board asked for comment by October 20, 1980.

The first proposed interpretation deals with the meaning of the requirement in Regulation B that a creditor not discount or exclude from consideration an applicant's income because it derives from alimony, child support, separate maintenance, part-time employment, retirement benefits or public assistance.

The second proposed interpretation addresses the question of how a creditor should select and disclose the principal reason or reasons for an adverse action on a request for extension of credit.

Although the questions raised -- in answer to an earlier request for comment by the Board -- were in the context of credit scoring, the Board emphasized that the provisions of Regulation B generally apply equally to all forms of analysis by creditors of the creditworthiness of consumers, whether the analysis is carried out judgmentally or through the use of credit scoring systems. The principles proposed would therefore apply equally to the use of judgmental analysis and the use of credit scoring systems.

1. Consideration of income

The Board proposed three basic principles as governing consideration of income under Regulation B:

a. If income is considered at all in a credit evaluation system, the creditor must treat income derived from alimony, child support, separate maintenance, part-time employment, retirement benefits or public assistance at least as favorably as other income.

b. Where consideration of these "protected" incomes would have no effect on the credit decision, the creditor need not consider them.

c. A creditor may consider, on a case-by-case basis, the likelihood that income of any kind will be received consistently and in a timely manner during the term of the credit extension.

The Board proposed that creditors following these rules in good faith would be considered in compliance with the requirements of Regulation B concerning consideration of income.

The Board followed the proposal of these basic principals with several illustrations of their application. The Board asked for comment whether the illustrative material is needed and helpful, or whether it adds undesirable complexity to the interpretation.

These illustrations concern the equal treatment of protected income, what income is to be considered in making credit decisions and the evaluation of the reliability of income.

2. Selection and disclosure of reasons for adverse action on a request for credit

The Board noted that here, as well as in the consideration of income, although the questions prompting the proposed interpretation have arisen in the context of credit scoring, it is the Board's view that the principles proposed apply equally to credit decisions based on credit scoring or judgmental systems of evaluation of an applicant's creditworthiness.

The Board proposed the following general principles with respect to the selection and disclosure of reasons for adverse action:

a. Regulation B (Sections 202.9(a)(2) and (b)(2)) requiresdisclosure of factors actually scored or reviewed by the creditor. No factors may be arbitrarily excluded from the pool of factors for adverse action subject to disclosure.

b. The optimal disclosure for either a judgmental or numerical system would identify the minimum adjustments an applicant would have to make to qualify for credit. Such disclosure, however, may be beyond the capabilities of many creditors. Other than the optimal disclosure there is no one best method for selecting reasons for adverse action, nor any absolute number of factors that should be disclosed.

c. Whatever method of selecting reasons for adverse actions is used, the same selection method must be used for all applications assessed under the same evaluation procedures and standards of creditworthiness (although the credit may change the method from time to time).

The Board provided several proposed illustrations of the application of these principles and here also asked for comment whether the inclusion of the illustrations would be helpful or whether they add unnecessary complexity to the proposed interpretation.

The illustrations concerned disclosure of reasons where adverse action is automatic, relationship of reasons for adverse action to factors in the applicant's record and selection of reasons for adverse action.

The proposed interpretation also addresses the use of the sample form in Regulation B (Section 202.9(b)(2)) to disclose reasons for adverse action when the factors considered in making the decision do not correspond exactly to the reasons stated in the sample form. In such instances, the Board said, the sample form would have to be modified.

The proposed interpretations, including proposed illustrative material, are attached.

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Proposed Rule

FEDERAL RESERVE SYSTEM

12 CFR Part 202

[Reg. B; Docket No. R-0203]

Equal Credit Opportunity; Proposed Board Interpretations; Consideration of Income; Disclosure of Reasons for Adverse Action.

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed Board interpretations.

SUMMARY: The Board is proposing for public comment two interpretations of its Regulation B, which implements the Equal Credit Opportunity Act. The first proposed interpretation discusses the meaning of the regulatory requirement that a creditor not "discount or exclude from consideration" an applicant's income because it derives from alimony, child support, separate maintenance, part-time employment, retirement benefits, or public assistance. The second proposed interpretation addresses the issue of how a creditor should select and disclose the principal reason or reasons for an adverse credit decision. These interpretations derive from questions that have been raised about the application of Regulation B to credit scoring systems, but the basic principles apply as well to judgmental systems.

DATE: Comments must be received on or before October 20, 1980.

ADDRESS: Comments (which should refer to Docket No. R-0203) may be mailed to the Secretary, Board of Governors of the Federal Reserve System, Washington. D.C. 20551, or may be delivered to Room B-2223 in the Board Building, 20th Street and Constitution Avenue, N.W., Washington, D.C., between 8:45 a.m. and 5:15 p.m. on business days. Comments may be reviewed in Room B-1122 of the Board Building during those same hours.

FOR FURTHER INFORMATION CONTACT Stanley D. Mabbitt, Attorney, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202-452-3867).

SUPPLEMENTARY INFORMATION: Last year the Board received several requests for clarification of how certain provisions of its Regulation B apply to the operation of numerical credit scoring systems. */ In response to these requests, the Board asked for public comment (44 Federal Register 23865, April 23, 1979) on four questions about Regulation B's application to credit scoring systems:

- May a credit scoring system score the fact that an applicant has more than one job or multiple sources of income, and may it score secondary income differently from primary income?

- How must a scoring system consider the amount of an applicant's income derived from part-time employment, pension, or alimony?

- How must a creditor using a scoring system select the specific reasons for adverse action?

- Under what circumstances may a creditor employing a credit scoring system use the reasons for adverse action contained in Regulation B's model statement?

The Board received nearly 300 written comments from members of the Congress, federal and state agencies, industry, and academics. The comments expressed a wide diversity of views about how Regulation B's rules should apply to credit scoring systems. Generally, creditors (retailers, oil companies, banks, and trade associations) claimed that a properly designed credit scoring system is an accurate, objective mechanism for determining creditworthiness. In order to preserve the empirical and statistical character of such a system, they suggested that a creditor be allowed wide latitude to include in or exclude from a particular system the amount and sources of an applicant's income depending on whether those factors were related in a statistically significant way to creditworthiness as established by the creditor developing the system. They also advocated that wide latitude be given to determining the most appropriate way for selecting and disclosing the principal reason or reasons for an adverse credit decision.

Consumer commenters (including several members of the Congress and a number of individual consumers) generally were concerned that the Board not reduce or eliminate what they perceived as the basic protections already afforded by the law. Thus, they were opposed to allowing creditors the degree of flexibility sought by the industry because of the concern that that flexibility might be used to mask illegally discriminatory practices.

*/ Basically, credit scoring is the use of statistical techniques to assign points or weights to various applicant characteristics (e.g. income, credit history) or other factors relevant to the transaction (e.g. type of security) in order to predict the likelihood that the applicant will satisfactorily repay the credit. In Regulation B, an empirically and statistically derived credit scoring system is contrasted with the judgmental evaluation performed by a credit officer or committee; compare the definition of "a demonstrably and statistically sound, empirically derived credit system" in § 202.2(p) with the definition of "judgmental system of evaluating applicants" in § 202.2(t).

The multiplicity of viewpoints, lack of consensus, and underlying technical complexity of the questions raised in the comment process led to a thorough reconsideration of the issues and the policy options available. Based upon that review, the Board has decided to issue for public comment two proposed interpretations. Both proposed interpretations affirm the Board's conclusion, based upon an analysis of the comments and the Equal Credit Opportunity Act, that the rules in Regulation B generally apply uniformly to all creditors, whether evaluating creditworthiness judgmentally or through a credit scoring system.

The first proposal (Interpretation § 202.601) addresses several issues concerning consideration of income and income reliability. Three general principles are stated at the outset in the proposed interpretation, and the proposal then elaborates on how those principles apply in several different factual situations where guidance was sought from the Board. In issuing the interpretation for comment, the Board is particularly interested in knowing whether the explanation of how the basic principles apply in different contexts is needed to provide the necessary guidance, or whether the specificity adds an undesirable degree of complexity or is otherwise unnecessary.

The second proposal (Interpretation § 202.901) sets forth several principles governing the selection and disclosure of reasons for adverse action. The proposal then explains how those principles are applied. Again, the Board invites comment on whether the additional explanatory material in the proposal is desirable. In addition to the interpretation in the second proposal, the Board is considering the desirability of encouraging or requiring creditors to indicate to the applicant the type of credit evaluation system used--whether judgmental or credit scoring--and to describe briefly the method of selecting the principal reason or reasons for adverse action. These explanations might further the congressional purpose of educating consumers about why they were denied credit and how they might improve their creditworthiness. On the other hand, requiring or even encouraging these additional disclosures, however brief, would increase compliance costs and burdens. Therefore the Board specifically asks for comment on the merits of these possible disclosures.

For these reasons and under the authority granted in § 703(a) of the Equal Credit Opportunity Act (15 U.S.C. 1691(a)), the Board issues for public comment the following two proposed interpretations of Regulation B (12 C.F.R. Part 202):

§ 202.601 Consideration of income.

(a) Introduction. Questions have arisen about the rules in Regulation B governing consideration of income--particularly as those rules apply to the operation of a credit scoring system.[1]/ In resolving those issues, the Board wishes to make clear that the provisions of Regulation B generally apply equally to all forms of credit analysis--whether performed judgmentally or through the use of a credit scoring system.[2]/

(b) Basic principles. There are three basic principles that govern consideration of income under Regulation B. First, the regulation does not require consideration of income by a credit evaluation system. But, if income is considered at all by a credit system, a creditor must treat income relied upon by an applicant that is derived from alimony, child support, separate maintenance, part-time employment retirement benefits, or public assistance at least as favorably as income from any other source.[3]/ Second, where consideration of protected income would have no effect on the credit decision, the creditor is not required to consider it. Third, a creditor may consider, evaluating the circumstances of each case, the likelihood that any income relied upon--regardless of its source--will be received consistently and in a timely manner during the term of the credit extension. If a creditor follows these principles in good faith, it will be acting in compliance with the income consideration rules in Regulation B. The remainder of this interpretation explains how these principles apply in different contexts.

1/ Section 202.6(b)(5) states in relevant part:

> A creditor shall not discount or exclude from consideration the income of an applicant or the spouse of the applicant because of a prohibited basis or because the income is derived from part-time employment, or from an annuity, pension, or other retirement benefit but a creditor may consider the amount and probable continuance of any income in evaluating an applicant's creditworthiness. Where an applicant relies on alimony, child support, or separate maintenance payments in applying for credit, a creditor shall consider such payments as income to the extent that they are likely to be consistently made. Factors that a creditor may consider in determining the likelihood of consistent payments include, but are not limited to, whether the payments are received pursuant to a written agreement or court decree; the length of time that the payments have been received; the regularity of receipt; the availability of procedures to compel payment; and the creditworthiness of the payor . . . .

2/ The only differences in evaluation procedures for the two methods of judging creditworthiness that are sanctioned by the law relate to consideration of age and receipt of public assistance (see § 202.6(b)(2)(ii) and (iii)).

3/ For the purpose of this interpretation, income derived from any source mentioned in § 202.6(b)(5)--alimony, child support, separate maintenance, part-time employment, retirement benefits, or public assistance--is referred to as "protected income."

Paragraphs (c)-(e) - Illustration of the Application of General Principles

(c) Equal treatment of protected income. (1) As long as protected income is treated at least as favorably as the amount of income from any other source, a creditor using a credit scoring system may comply with the income consideration rule of Regulation B (i) by scoring the amount of any protected income as one or more characteristics in the system, (ii) by adding it to the amount of other income scored, or (iii) by judgmentally considering it outside of the system. A credit scoring system will not be deprived of its status as a demonstrably and statistically sound, empirically derived credit system because it aggregates protected income, which by itself would not be selected as a predictive characteristic, with other income Similarly, the fact that a creditor using a credit scoring system might consider protected income outside the system would not change the status of the system for Regulation B purposes.

(2) Generally, a creditor may consider the nature and number of any income sources, as long as protected income is treated at least as favorably as income from other sources [4/] A creditor may consider, for example, that an applicant has two sources of income--employment and investments--and may consider what those sources are. If the applicant also relies upon alimony and retirement payments, the creditor could not consider the alimony and retirement income less favorably than the employment or investment income because of the type of income or the number of sources. Similarly, a creditor could not consider employment income less favorably than other income because it was derived from several part-time jobs.

(d) Consideration of protected income. (1) The rule prohibiting the discounting or exclusion of protected income does not require consideration of that income where its consideration would have no effect on the credit decision. Thus, if a creditor would approve an application without considering any income at all, it would not have to consider protected income. If income is considered but the amount of protected income is not needed for approval, the protected income need not be considered. Also, if a portion of any protected income would be sufficient to support approval, then any portion or type of that income not needed for approval would not have to be considered. In each case, the creditor's practice would be permissible because no adverse action would have been taken.

(2) Similarly, if a creditor would take adverse action without considering income at all, then the creditor need not consider the applicant's income regardless of its source because consideration of income would not change the result. For example, a creditor might reject an application because of the applicant's credit history, notwithstanding the amount or sources of the applicant's income.

4/ Under § 202.6(b)(1) a creditor may never consider that income is derived from public assistance unless, in a judgmental evaluation, it is considered under § 202.6(b)(2)(iii) for the purpose of determining a pertinent element of creditworthiness.

(3) If, on the other hand, a creditor considers any portion of the income relied upon in an application, it would have to consider any protected income relied upon before it could take adverse action. For example, if an applicant's employment income were not sufficient to repay the credit, the creditor would have to consider, at least as favorably as the applicant's employment income, any alimony, retirement, or public assistance income relied upon by the applicant. In addition, the creditor may not discourage the applicant from disclosing the existence of protected income if the applicant chooses to rely on that income.

(e) Considering reliability of income. A creditor may consider the likelihood that any income relied upon--regardless of its source--will be received consistently and in a timely manner during the term of the credit extension. In considering the reliability of any protected income, a creditor must make its evaluation on an individual basis, taking into account the circumstances of each case.

(f) Prospective effect. This interpretation shall have prospective effect only after being promulgated in final form

§ 202.901 Disclosure of reasons for adverse action.

(a) Introduction. The Board has been asked for an interpretation of § 202.9 of Regulation B regarding the selection and disclosure of the reasons for adverse action where a credit scoring system is used alone or in conjunction with a judgmental evaluation.[1]/ Although the issue has arisen in the context of credit scoring, the Board wishes to make clear that, as a general principle, the provisions of Regulation B apply equally to both judgmental and credit scoring systems of credit evaluation.

(b) Basic principles. The reasons for adverse action disclosed under §§202.9(a)(2) and (b)(2) must relate to those factors actually scored or reviewed by the creditor, and no factor or factors may be arbitrarily excluded from the pool of factors subject to disclosure. While the optimal disclosure for either a judgmental or numerical system would identify the minimum adjustments that the applicant would have to make in order to be approved for credit, that disclosure may be beyond the capability of many credit scoring and judgmental systems. Moving away from the optimal disclosure, there is no one best method for selecting the reason for the adverse decision, nor is there an absolute number of reasons that should be disclosed. Whatever method of selection is used, the creditor must use the same selection method for all applications that are evaluated under the same credit evaluation procedures and standards of creditworthiness, although the creditor may change the method from time to time.

1/ Section 202.9(a)(2) states in relevant part:

> Any notification given to an applicant against whom adverse action is taken shall be in writing and shall contain...a statement of specific reasons for the action taken.

Section 202.9(b)(2) states in relevant part:

> A statement of reasons for adverse action shall be sufficient if it is specific and indicates the principal reason(s) for the adverse action. A creditor may formulate its own statement of reasons in checklist or letter form or may use all or a portion of the sample form printed [in this subsection], which, if properly completed, satisfies the requirements of subsection (a)(2)(i). Statements that the adverse action was based on the creditor's internal standards or policies or that the applicant failed to achieve the qualifying score on the creditor's credit scoring system are insufficient.

Paragraphs (c)-(e) - Illustrations of the Application of General Principles

(c) Disclosure of reasons where adverse action is automatic. Many credit systems contain features that call for automatic adverse action on an application because one or more factors in the applicant's record are so adverse that they cannot be offset by other factors. Examples of automatic adverse action factors might be the applicant's previous declaration of bankruptcy or the fact that the applicant is a minor. When an application is declined because of an automatic adverse action factor, the creditor must disclose the specific factor or factors that resulted in the adverse decision.

(d) Relationship of reasons for adverse action to factors in the applicant's record. (1) If an application is not automatically declined but is evaluated and rejected, the question arises as to what information from the applicant's record must be included in the pool from which the reason for the adverse decision is selected. Generally, the reason for the adverse decision must relate to the factors actually scored or evaluated by the creditor, and no factors may be arbitrarily excluded from the pool.

(2) Thus, in a judgmental system, the reason disclosed must relate to the factors in the applicant's record actually reviewed by the person or persons making the decision. If the creditor's policies or procedures limit the specific factors considered, only those specific factors should be included in the pool. If the creditor's decision is based exclusively on a credit scoring system, the reason disclosed must relate to only those factors actually scored or weighted in the system. The reason may not relate to factors not processed by the credit scoring system. If the credit evaluation system employs both judgmental and credit scoring elements, the factors to which the reason must relate will be determined by whether the adverse action resulted from the judgmental or numerical assessment of the application. Thus, if the creditor scores an application in the initial stage of evaluation and the application is rejected, the reason for adverse action must relate to only those factors scored or weighted in the system. If the application is approved in the initial credit scoring stage and is then considered judgmentally and rejected, the reason disclosed must relate to the factors judgmentally reviewed in the applicant's record.

(e) Selecting the reason for the adverse decision. (1) The question arises as to how the reason for adverse action should be selected. In many circumstances, whether the creditor uses a judgmental or credit scoring system, an adverse decision results because the combination of factors being considered indicates that extending credit would be too risky or not sufficiently profitable given current economic conditions. Because it is the combination of factors, when considered together, that led to the adverse action, it is often difficult and perhaps impossible to infer that any single factor "caused" the creditor to take the adverse action.

(2) The optimal disclosure for either a judgmental or numerical system would identify the minimum adjustments that the applicant would have to make in order to be approved for credit. It would also include full consideration of all interactions among factors that might follow from any change in an applicant's characteristics. While the optimal disclosure may be beyond the

capability of many credit scoring and judgmental systems, it is the goal that creditors should attempt to achieve in developing specific disclosure policies and procedures.

(3) Moving away from the optimal disclosure, there is no one best method for selecting the reason for the adverse decision, nor is there an absolute number of reasons that should be disclosed. Whatever method of selection is used, the creditor must use the same selection method for all applications that are evaluated under the same credit evaluation procedures and standards of creditworthiness, although the creditor may change the method from time to time.

(4) One acceptable method of selecting the factors would be to select the factor, holding all others constant, that would require the smallest degree of change (in terms of its contribution to the overall assessment of the application) in order for the applicant's request to be approved. The creditor would advise the applicant of the type of change required, though not necessarily the degree. Specifically, in a credit scoring system, the creditor would select the factor requiring the smallest degree of change that would enable the applicant to achieve the minimally acceptable score. No specific number of factors need be selected; but, if more than one are selected and disclosed, they should be listed in ascending order, beginning with the factor that requires the least amount of change. The creditor should also advise the consumer that, if the factor were changed sufficiently and no other aspects of the applicant's profile relevant to the credit decision changed, the applicant would meet the creditor's minimum standards for credit or for further processing of the application (e.g. a credit history check). The implicit assumption underlying this method is that the factors requiring the least amount of change are more mutable and, therefore, easier for the applicant to modify than factors requiring a greater amount of change.

(f) Use of sample disclosure form. Finally, the question arises as to the extent to which creditors may use the sample form in § 202.9(b)(2) to disclose the reasons for an adverse decision when the factors considered do not correspond exactly to the checklist of reasons on the sample form. If the sample notice does not clearly and accurately state the reason for the adverse decision with sufficient specificity, it must be modified. For example in a system that scores the number of credit references from banks, an applicant with references from department stores, finance companies, and thrift institutions receives no points for them. Checking "insufficient credit references" on the adverse action notice is not specific enough. Disclosing "no bank references" would suffice. Thus, if the sample notice does not provide a clear and accurate statement of the reason or reasons for the adverse decision, its use by a creditor does not comply with the regulation.

(g) Prospective effect. This interpretation shall have prospective effect only after being promulgated in final form.

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By order of the Board of Governors, August 20, 1980

(signed) Theodore E. Allison
Theodore E. Allison
Secretary of the Board

[SEAL]