FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **9388**
October 26, 1982]

EQUAL CREDIT OPPORTUNITY

Final Interpretations and Withdrawal of Proposed Amendments to Regulation B

To All Depository Institutions, and Others Concerned, in the Second Federal Reserve District:

The following is quoted from the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has adopted in final form two proposed interpretations of Regulation B — Equal Credit Opportunity — and withdrew three proposed amendments to the regulation. The interpretations will become effective April 1, 1983.

The first of the interpretations discusses the use by creditors of judgmental and credit scoring systems in the treatment of income from alimony, child support, separate maintenance, part-time employment, retirement benefits or public assistance. The regulation requires that creditors not discount or exclude such income from consideration.

The second interpretation concerns the selection and disclosure of principal reasons for adverse actions on applications for credit.

The Board at the same time withdrew, effective October 15, the proposed amendments to the business credit provisions of Regulation B. The Board proposed last June to withdraw these amendments, which were first proposed in 1978. The amendments would have affected only the mechanical requirements of the regulation and their withdrawal does not affect the substantive provisions of the regulation prohibiting discrimination in any aspect of a business credit transaction on the basis of sex, marital status, race and like provisions. The Board said that the costs and burdens associated with the proposed amendments outweighed their possible benefits, which the Board judged to be slight in view of the basic requirements of the regulation.

The Board acted after consideration of comment received on its proposals regarding the interpretations and amendments.

Enclosed is a copy of the text of the interpretations of Regulation B, effective April 1, 1983. The text of the Board's Notice withdrawing its proposed amendments to the business credit provisions of Regulation B, a summary of which is printed on the reverse side of this circular, has been published in the *Federal Register* of October 15, 1982; a copy of the full text of that Notice will be furnished upon request directed to the Circulars Division of this Bank.

Questions regarding these matters may be directed to our Consumer Affairs and Bank Regulations Department (Tel. No. 212-791-5914).

ANTHONY M. SOLOMON,
President.

(OVER)

Federal Reserve System

12 CFR Part 202

[Reg B; Docket No. R-0185]

EQUAL CREDIT OPPORTUNITY

Withdrawal of Proposed Amendments

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Withdrawal of proposed amendments.

SUMMARY: The Board is withdrawing proposed amendments to the business credit provisions of Regulation B. The proposed amendments were initially published for comment in October 1978; notice of their proposed withdrawal was published in June 1982 (47 FR 23741). The amendments to the business credit rules would have (1) eliminated the partial exemption that currently exists with respect to record keeping and adverse action notification requirements in certain loan transactions under $100,000; and (2) subjected business credit to the general bar in the regulation against asking an applicant's marital status. The proposal would also have incorporated official staff interpretation EC-0009 into the regulation to make clear that creditors must give business applicants some notice, oral or written, of action taken on an application within a reasonable time; the interpretation remains in effect.

The proposed amendments related only to the mechanical requirements of the regulation, and their withdrawal does not affect the substantive provisions of the Equal Credit Opportunity Act and Regulation B, which continue to prohibit discrimination on the basis of sex, marital status, race, etc. in any aspect of a business credit transaction.

EFFECTIVE DATE: October 15, 1982.

FOR FURTHER INFORMATION CONTACT: Claudia J. Yarus, Staff Attorney, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202-452-3667). Regarding the final regulatory flexibility analysis, contact: Robert Kurtz, Economist, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202-452-2505).

The full text of this notice may be obtained from the Board or the Federal Reserve Banks.

Board of Governors of the Federal Reserve System

EQUAL CREDIT OPPORTUNITY

INTERPRETATION OF REGULATION B

(effective April 1, 1983)

FEDERAL RESERVE SYSTEM

12 CFR Part 202

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

Equal Credit Opportunity; Final Board Interpretations; Consideration of Income and Disclosure of Reasons for Adverse Action

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final Board interpretations.

SUMMARY: The Board adopted two interpretations of Regulation B, Equal Credit Opportunity. The first interpretation discusses how users of judgmental and credit scoring systems must treat income derived from alimony, child support, separate maintenance, part-time employment, retirement benefits or public assistance to comply with the regulation's requirement that creditors not "discount or exclude from consideration" such income. The second interpretation explains how creditors should select and disclose the principal reason or reasons for adverse action. These interpretations derive from questions that have been raised about the application of Regulation B to credit scoring systems, but the basic principles apply to judgmental systems as well.

EFFECTIVE DATE: April 1, 1983.

FOR FURTHER INFORMATION CONTACT: Lucy Griffin, Senior Attorney, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202–452–2412).

SUPPLEMENTARY INFORMATION: (1) *Introduction.* In response to requests for clarification on how certain provisions of Regulation B (12 CFR Part 202) apply to the operation of numerical credit scoring system,* the Board asked for public comment (44 FR 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 almost 300 written comments from members of Congress, industry, academics, and others. The comments expressed a wide diversity of views about how Regulation B's rules should apply to credit scoring systems. The multiplicity of viewpoints and the 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 on that review, the Board issued for public comment (45 FR 56818, August 26, 1980) two proposed interpretations. One interpretation addressed several issues concerning consideration of income and income reliability. The second set forth several principles governing the selection and disclosure of adverse action. Both proposed interpretations affirmed the Board's conclusion, based upon an analysis of the comments and the Equal Credit Opportunity Act, that the rules in Regulation B apply to all creditors, whether they evaluate creditworthiness judgmentally or through a credit scoring system.

The Board again received approximately 300 written comments on these proposals from members of Congress, federal and state agencies, industry, consumers, and academics. Generally, creditors (retailers, oil companies, financial institutions, and trade associations) claimed that a properly designed credit scoring system is an accurate, objective mechanism for determining creditworthiness. They suggested that to preserve the empirical and statistical character of such a system, a creditor should 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 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. They were opposed to allowing creditors the degree of flexibility sought by the industry because of the belief that such flexibility might be used to mask illegally discriminatory practices.

Based on a review of the comments and a renewed analysis of the issues, in May 1982 the Board stated general endorsement for the two revised interpretations but issued them for further comment (47 FR 23738, June 1, 1982) with respect to any technical problems that creditors might encounter in complying with them.

The Board has received almost 80 written comments on these proposals from federal and state agencies, industry, and consumers. Consumers and creditors supported most of the changes in the proposed interpretations.

* Basically, credit scoring is the use of statistical techniques to assign points or weights to various applicant characteristics (e.g., income, credit history) or to identify relationships between them 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).

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Consumers observed that the interpretations maintain fundamental consumer protections without unduly burdening creditors. Generally, creditors requested a delayed effective date of six months in which to adapt existing credit scoring systems to the requirements of the interpretations. Most commenters requested that the interpretations describe more than one method for selecting reasons for adverse action.

The first interpretation (§ 202.601) addresses several issues concerning consideration of income and income reliability. The interpretation clarifies that Regulation B applies to credit scoring systems as well as to judgmental systems. The interpretation also advises that income need not be fully considered on an individual basis and should not be assigned a weight based on aggregate statistics.

The second interpretation (§ 202.901) sets forth several principles governing the selection and disclosure of reasons for adverse action. The interpretation advises creditors that the process used to select specific reasons for adverse action must identify the factors that were most significant in the applicant's failure to achieve a passing score in a credit scoring system. The interpretation also advises creditors that the reasons must be taken from those factors actually considered for that applicant. The interpretation has been modified to include a second acceptable method for selecting reasons for adverse action, based on the average scores for all applicants. The interpretation also explains that other methods that produce substantially similar results, i.e., selecting those factors for which the applicant fell furthest below a norm, are acceptable. Finally, the interpretation advises creditors on proper use of the model form for disclosing reasons for adverse action.

(2) *Regulatory Flexibility Analysis.* The two interpretations adopted by the Board clarify creditor procedures with respect to several aspects of Regulation B, Equal Credit Opportunity, dealing with treatment of income and selection and disclosure of reasons for adverse action. The economic impact of either interpretation is unlikely to be large. Since the actions taken are interpretations rather than regulations only those creditors who currently use procedures that are inconsistent with the interpretations will be forced to modify their credit processing procedures. Indications from comments received by the Board are that most of these cases will arise from creditors having taken too narrow an interpretation of the implications of Regulation B, particularly with respect to treatment of protected income. The interpretations advise creditors how they can use several different procedures for which guidance had been requested by a number of creditors. Thus, given these assurances, a number of creditors may modify their credit screening procedures.

The specific impact of the first interpretation will be focused on creditors currently using credit scoring systems which treat protected income in a manner that is inconsistent with the interpretation. These creditors will need to modify their systems. This will entail the probable expense of new statistical analysis, the retraining of those making loan evaluations, and possibly changes in application forms. One commenter stated that this could cost a creditor as much as $50,000. However, if such modifications are made as part of normal periodic updates of credit systems, these costs may be minimized. If creditors, particularly those using credit scoring vendors, were required to make such changes immediately, costs might be more substantial. Most commenters to the Board have indicated, however, that a six months delayed effective date should provide adequate time to modify systems in a cost efficient way.

The economic impact of the second interpretation, governing notice of adverse action, is likely to be more far reaching. In a 1981 Federal Reserve Board survey,[1] over one-half of the surveyed financial institutions indicated a desire to modify the notification of adverse action. Furthermore, they indicated that the largest recurring cost associated with Regulation B was the cost of providing a written notice of adverse action. Written comments received by the Board have also indicated the need for additional guidance both as to methods of selecting reasons for adverse action and for the design of adverse action forms. The second interpretation speaks directly to both these concerns. The interpretation explicitly sanctions two methods of selecting reasons for adverse action which in most cases can be done mechanically and need not require constant updating. In addition, it authorizes any other method which produces substantially similar results. The information needed to implement the methods sanctioned by the interpretation should already be available to creditors using credit scoring systems. By clarifying use of the Board's sample form, the interpretation is likely to require some expense by creditors who will have to design new forms. Creditors using systems for which use of the sample form is not appropriate will have to design and distribute new forms and discard old forms. As a temporary measure creditors may have to manually modify old forms before new ones can be developed.

Smaller creditors are unlikely to suffer significant costs from either interpretation. The largest impact is likely to be felt by creditors with large, centrally-based, credit scoring systems. Smaller institutions are much more likely to use judgmental systems which can be modified with very little cost.

To offset some of the costs, the clarifications provided by the interpretations will probably help both applicants and creditors. With more precise instructions on the proper treatment of protected income, creditors who may previously have been reluctant to use income in their credit evaluation process may now do so. By providing more explicit guidance as to the selection of reasons for adverse action, the interpretations are likley to result in rejected loan applicants receiving more useful information.

List of Subjects in 12 CFR Part 202

Banks, banking, Civil rights, Consumer protection, Credit, Federal Reserve System, Marital status discrimination, Minority groups, Penalties, Religious discrimination, Sex discrimination, Women.

PART 202—[AMENDED]

Regulatory Text. Pursuant to the authority granted in § 703(a) of the Equal Credit Opportunity Act (15 U.S.C. 1691(a)), the Board adopts the following two interpretations of Regulation B (12 CFR Part 202) to read as follows:

§ 202.601 Consideration of income.

(a) Regulation B prohibits creditors from discounting or excluding the income of an applicant (or the spouse of the applicant) from consideration because of a prohibited basis or because

[1] *Survey of Compliance Costs and Benefits of Consumer Protection Regulations,* Federal Reserve Board, 1981.

the income is derived from alimony, child support, separate maintenance, part-time employment, retirement benefits or public assistance ("protected income").[1] A creditor may consider, however, the probability of any income continuing in evaluating an applicant's credit worthiness, and may consider the extent to which alimony, child support or separate maintenance is likely to be consistently made. Regulation B applies equally to all methods of credit evaluation—whether performed judgmentally or through the use of a credit scoring system.[2]

(b) Creditors need not consider income at all. However, creditors that do consider income should consider the amount of income as required in § 202.6(b)(5). A credit scoring system [3] will not be deprived of its status as a "demonstrably and statistically sound, empirically derived" credit scoring system because it aggregates income (including a type of income which, by itself, would not be selected as a predictive characteristic).

(c) Creditors have asked whether evaluating or deriving a point score for certain types of income (such as Social Security and alimony) during the development of the system constitutes "consideration" of that income for purposes of the regulation, enabling the creditor to discount or exclude such income based upon these aggregate statistics. In the Board's view, the statute requires that evaluation of protected income be made on an individual basis, and not based upon aggregate statistical relationships such as those underlying credit scoring models. Thus, creditors may not use blanket rules which automatically deem a certain type of protected income to be unreliable and therefore a predictor of adverse credit performance. Nor may the average reliability of a particular type of protected income be used to predict the reliability of the same types of income for an individual applicant.

(d) For creditors that do consider income, there are several acceptable methods under § 202.6(b)(5) which creditors using credit scoring systems may use for this purpose. First, creditors can score the amount of all income stated by the applicant without taking steps to evaluate the income. This method could be used in a system which is based on the income the applicant states; the creditor need not actually verify the amount. Second, based on an individual evaluation of each component of the applicant's income, the creditor may score reliable income separately from income that is not reliable. Alternatively, the creditor may include a portion or disregard a portion of income to the extent that it is not reliable, before aggregating and scoring all reliable income. Third, if the creditor does not evaluate all income components, any component of protected income that is not evaluated must be treated as reliable. In considering the separate components of an applicant's income, the creditor may not automatically discount or exclude from consideration any income of a type protected by § 202.6(b)(5).

(e) Creditors have asked whether credit scoring systems may place values on the number of sources from which earned income is received without violating the regulation's prohibition against discounting income. Although creditors may not take into account the number of sources for any applicant of income that is not earned, e.g., retirement income, social security, or alimony, the regulation does not prohibit consideration of the number of earned income sources for an individual applicant. For example, a creditor may take into account the fact that an individual applicant has more than one source of *earned income*—a full-time and a part-time job, or two part-time jobs. Alternatively, a creditor might score an individual applicant's earned income from a secondary source differently than the applicant's earned income from a primary source. Creditors may not, however, treat as an adverse factor the fact that an individual applicant's only source of earned income is derived from a part-time job.

§ 202.901 Disclosure of reasons for adverse action.

(a) 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 [1] where a credit scoring system [2] is used, alone or in conjunction with a judgmental evaluation. Although the issue has arisen in the context of credit scoring, as a general principle the provisions of Regulation B apply equally to both judgmental and credit scoring systems of credit evaluation. The reasons for adverse action disclosed under § 202.9 (a)(2) and (b)(2) must relate to factors actually scored or considered by the creditor. The creditor must disclose the specific reason or reasons for the adverse action.

(b) Many credit decision methods contain features that call for automatic adverse action because of one or more negative factors in the applicant's record (such as the applicant's previous bad credit history with that creditor, a declaration of bankruptcy, or the fact that the applicant is a minor) that cannot be offset by other factors. When a creditor takes adverse action because of an automatic factor, the creditor must disclose that specific factor.

(c) If the creditor does not automatically reject the application, and bases the decision on a credit scoring system, the reasons disclosed must

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[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 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 purposes of this interpretation, "credit scoring system" refers to any mechanical method of making a credit decision that is developed using statistical methods and empirical data.

[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 check list 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."

[2] For the purposes of this interpretation, "credit scoring system" refers to any mechanical method of making a credit decision that is developed using statistical methods and empirical data.

relate only to those factors actually scored in the system, not to factors that are not included in the credit scoring system. Similarly, in a judgmental system, the reasons disclosed must relate to the factors in the applicant's record actually reviewed by the person making the decision and must accurately describe the reasons for adverse action. If the credit evaluation system employs both judgmental and credit scoring components, the reasons to be disclosed will be determined by whether the final decision resulted from the judgmental or the scoring system assessment of the application. Thus, if the creditor initially credit scores an application and takes adverse action as a result of that scoring, the reasons for adverse action must relate only to the factors actually scored in the system. If the application passes the credit scoring stage successfully but the creditor then takes adverse action based on the judgmental assessment, one or more of the reasons disclosed must relate to the factors in the applicant's record that were reviewed judgmentally.

(d) The regulation does not require that any one method be used for selecting reasons for the adverse credit decision, nor does it mandate that a specific number of reasons be disclosed. However, disclosure of more than four reasons is not likely to be helpful to the applicant. The Board recognizes that there may be a number of valid methods for selection of reasons for denial which meet the requirements of Regulation B. One method, for example, would be to identify those factors for which the applicant's score fell furthest below the average score for each of those factors achieved by applicants whose total score was at or slightly above the minimum passing score.[3] Another method would be to identify those factors for which the applicant's score fell furthest below the average score for each of those factors achieved by all applicants. These average scores could be developed periodically during the use of the system or during the development of the system. Any other method that produces results substantially similar to either of these methods would be acceptable under the regulation.

(e) Creditors may identify reasons for adverse action by mathematical or manual selection. No factor or factors may be arbitrarily excluded from the pool of factors subject to disclosure. The creditor must disclose reasons actually considered (such as "age of automobile") even if the relationship of that factor to predicting creditworthiness may not be clear to the applicant.

[3] For example, if a scoring system with a maximum score of 300 points has a cut-off score of 200 points, the creditor could use applicants whose total scores fall between 200 and, for example, 205 points to determine the average score for those factors.

(f) Creditors have also asked about proper use of the sample form set forth in § 202.9(b)(2) when providing reasons for adverse action. The sample form is illustrative and may not be appropriate for all creditors. It was designed to disclose those factors which creditors most commonly consider. Some of the reasons listed on the form could be misleading when compared to the factors actually scored. In such cases, it is improper to complete the form by simply checking the closest identifiable factor listed. For example, a creditor that considers only bank references (and disregards finance company references altogether) should disclose "insufficient bank references" (not "insufficient credit references"). Similarly, a creditor that considers bank references and other credit references as separate factors should treat the two factors separately in disclosing reasons. The creditor should either add those other factors to the form or check "other" and include the appropriate explanation. In providing reasons for adverse action, creditors 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."

By order of the Board of Governors of the Federal Reserve System, October 8, 1982.

William W. Wiles,

Secretary of the Board.

[FR Doc. 82-28357 Filed 10-14-82; 8:45 am]

FEDERAL RESERVE SYSTEM

12 CFR Part 202

[Reg B; Docket No. R-0185]

Equal Credit Opportunity; Withdrawal of Proposed Amendments

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Withdrawal of proposed amendments.

SUMMARY: The Board is withdrawing proposed amendments to the business credit provisions of Regulation B. The proposed amendments were initially published for comment in October 1978; notice of their proposed withdrawal was published in June 1982 (47 FR 23741). The amendments to the business credit rules would have (1) eliminated the partial exemption that currently exists with respect to record keeping and adverse action notification requirements in certain loan transactions under $100,000; and (2) subjected business credit to the general bar in the regulation against asking an applicant's martial status. The proposal would also have incorporated official staff interpretation EC–0009 into the regulation to make clear that creditors must give business applicants some notice, oral or written, of action taken on an application within a reasonable time; the interpretation remains in effect.

The proposed amendments related only to the mechanical requirements of the regulation, and their withdrawal does not affect the substantive provisions of the Equal Credit Opportunity Act and Regulation B, which continue to prohibit discrimination on the basis of sex, marital status, race, etc. in any aspect of a business credit transaction.

FOR FURTHER INFORMATION CONTACT: Claudia J. Yarus, Staff Attorney, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202–452–3667). Regarding the final regulatory flexibility analysis, contact: Robert Kurtz, Economist, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, D.C 20551 (202–452–2505).

SUPPLEMENTARY INFORMATION: (1) *Introduction.* Regulation B (12 CFR Part 202) prohibits discrimination, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, age, receipt of public assistance, or the exercise of rights under the Consumer Credit Protection Act. The regulation applies to all credit transactions, including business credit.

The regulation sets certain mechanical requirements that creditors must follow with regard to applications that they receive. Sections 202.9 and 202.12(b) of Regulation B provide, respectively, that a creditor must give the applicant notice of the action taken on an application and retain, for 25 months, the records regarding the application. When the creditor rejects a credit application it must give an "adverse action" notice consisting of a written statement of reasons (or of the right to request the reasons) for the credit denial, together with a short summary of the applicant's rights under the Equal Credit Opportunity Act.

Because of the specialized nature of the business credit application process, § 202.3(e) of Regulation B provides a partial exemption for business credit transactions from these notification and record keeping requirements. An applicant for business credit may *request* written notice of reasons for adverse action, but does not receive the written notice automatically. The business applicant may also *request* to have records of the application retained for 25 months. If there is no such request, the creditor may discard its records of the application 90 days after it rejects the credit request.

On October 26, 1978 the Board published for comment proposed changes to these business credit provisions (43 FR 49987). The proposed amendments would have applied to direct loan applications for amounts under $100,000. Creditors would have been required in such cases to give written notification of adverse action to the applicant, and to retain the records of the application for 25 months.

Another proposal related to marital status inquiries. Regulation B generally prohibits creditors from inquiring about an applicant's marital status except in the case of applications for secured credit. Section 202.3(e)(1) of Regulation B provides, however, that an application for business credit is not subject to this restriction. The proposed amendment would have eliminated the exemption, making business credit subject to the general information bar against marital status inquiries.

On June 1, 1982, the Board published a notice regarding its planned withdrawal of the proposed amendments (47 FR 23741). The Board specifically solicited comment, however, on whether there have been intervening developments which suggest that creditors should be required to give business credit applicants a written notice of adverse action for certain direct loans.

Based on a review of the comments received (which did not raise evidence of intervening developments) and its own analysis, the Board is withdrawing the proposed amendments. In light of the costs and burdens that would be associated with the implementation of these amendments, their adoption appears unwarranted. The regulation already provides that business credit applicants may receive written notice and have records retained on request. The likely benefits of prohibiting inquiry about an applicant's marital status also appear to the Board to be rather limited. Because most applications for business credit are for secured credit, under the regulation creditors would in most cases continue to be able to inquire about marital status.

The proposal published by the Board also would have codified within the text of the regulation an official staff interpretation, EC–0009, which was issued on November 2, 1977. That staff interpretation makes it clear that creditors must give business applicants oral or written notice, within a reasonable time, of action taken on an

application. The interpretation remains in effect.

The Board reminds creditors once again that the proposed amendments which the Board is withdrawing related only to the mechanical requirements of the regulation. The substantive provisions of the Equal Credit Opportunity Act and Regulation B continue to prohibit discrimination on the basis of sex, marital status, race, etc. in any aspect of a business credit transaction.

(2) *Final Regulatory Flexibility Analysis.* In October 1978, the Board proposed amendments to Regulation B which would eliminate certain business credit exemptions for direct loan applications in which the aggregate of any amount already owed to a creditor and the amount applied for is less than $100,000. Adoption of the amendments would require creditors to give the business applicant notice of the action it takes and retain its records regarding the credit application for 25 months. When adverse action occurs, creditors would have to provide written notice about an applicant's ECOA rights, together with a statement of the reasons or of the right to request the reasons for denial.

In June 1982, the Board published for public comment a proposal to withdraw the proposed amendments. The comments received by the Board have been considered in this memo which discusses the potential economic impact of the proposed amendments.

Potential Economic Impacts

In 1981, the denial rate at commercial banks for business credit applicants desiring to start a new business was estimated to be approximately 50 percent. The denial rate estimated for existing businesses was 27 percent.[1] Many of the more than two million denials would have required written "adverse action" notifications and record retention for 25 months under the proposed amendments. At the 1981 level of denials, the aggregate annual compliance cost of the proposed amendments to the industry as a whole could be substantial, although the impact on after-tax profits would likely be minimal for most individual creditors. While the impact of the proposed amendments on creditor's cost per loan would be small in most instances, it could be large enough to affect creditors' decisions on applications for low denomination loans. Many relatively small short-term loans currently available to small business could become unprofitable. Creditors find it difficult to provide affordable credit to their small business customers during periods of high interest rates. The proposed amendments would aggravate the credit problem of small businesses, because the cost of compliance would ultimately be passed on to borrowers as increased cost of credit and reduced credit availability. The amendments could also encourage more creditors to prescreen small business applicants in order to avoid the compliance costs.

One-time costs would be incurred by creditors for legal counsel to review, interpret, and advise on implementation of the amendments; for the development and implementation of a system to provide written adverse action notification; for additional equipment to maintain applicant files; and for the initial retraining of clerks and loan officers.

The efforts to maintain files on denied applications and the time necessary to provide written adverse action notification would result in costs recurring with each additional credit denial. The magnitude and relative importance of these costs per denial would vary among creditors, depending primarily on the filing system technology employed and decisions about the cost effectiveness of providing all denied applicants with written reasons for adverse action rather than only responding to requests for written reasons. In a 1981 Federal Reserve Survey,[2] financial institutions reported that the most burdensome recurring cost associated with Regulation B was the cost of providing a written adverse action notice to applicants denied consumer credit. In the case of business credit, the cost is likely to be even greater because the process of granting or denying credit is more complex. A checklist of reasons for business credit denial, similar to the checklist given to consumers, may be inadequate in some cases to provide a business credit applicant meaningful information about why credit was denied. The alternative to a checklist is costly. A significant level of effort is needed by a creditor to compose and produce a detailed report explaining the denial of credit. Good business strategy, however, might indicate that a creditor make this extra effort and bear the expense when there is a prospect for future business and profit. There is the danger that the denied applicant might be offended by a short checklist type of response following a long and personal negotiating process.

Potential Impact on Small Entities

Small banks are likely to be affected more than other banks by the amendments. Their business loans tend to be exclusively to small business.[3] Small banks' loan portfolios contain relatively few loans over $100,000, and their average loan size is less than that for other banks.[4] Therefore, the amendments would likely result in a greater cost per dollar of loan for small banks and their customers.

The potential negative impact of the proposed amendments on cost and availability of low denomination, short-term business loans would affect all creditors subject to the ECOA, not only commercial banks. However, recent evidence indicates that the commercial bank sector continues to be the major institutional supplier of credit to small business.[5]

Potential Benefits

The potential benefits of the proposed amendments appear to be limited. Survey evidence shows that small business credit may be more costly and less accessible to some groups protected by the ECOA,[6] but evidence suggesting that the disparity is caused by unlawful discrimination rather than a legitimate evaluation of risk is meager.

It is unlikely that the proposed amendments would substantially improve the detection of unlawful discrimination. Unlawful discrimination can be easily masked by the multitude of factors considered in approving or denying business credit. The written reasons for rejecting a particular

[1] *Survey of Commercial Bank Lending to Small Business*, February 1982, Cynthia Glassman and Peter Struck. The denial rate is an estimate of the proportion of written credit applications turned down by all federally insured commercial banks that had at least $1 million in commercial and industrial loans in their portfolios on December 31, 1980. These figures do not include informal applications and may reflect unusually weak credit demand caused by high interest rates. Thus, the number of applications subject to the proposed amendments may be much larger. Estimates in the survey reflect banks' perceptions of their small business lending, not the perceptions of the small business community.

[2] *Survey of Compliance Costs and Benefits of Consumer Protection Regulations*, Federal Reserve Board, 1981.

[3] *Federal Monetary Policy and Its Effect on Small Business*, H.R. Report of the Committee on Small Business, September 1980.

[4] *Survey of Commercial Bank Lending to Small Business*, February 1982, Cynthia Glassman and Peter Struck.

[5] National Federation of Independent Businesses, survey, April 1980. The survey results relating to numbers of loans show that 83 percent of small businesses reporting a source for their most recent loan said that the source was a bank.

[6] *Federal Monetary Policy and Its Effect on Small Business*, H.R. Report of the Committee on Small Business, September 1980.

consumer or business loan can be useful to an examiner looking for unlawful discrimination, if it is possible for the examiner to determine that (1) the reasons are untruthful or (2) the reasons are not consistent with a creditor's articulated guidelines to loan officers.

The loan officer's decision on an application depends on many factors which are unique to the particular business under consideration. Consequently, it would be a very rare even where the creditor's reasons for rejecting a business loan application were patently false and contestable.

An examiner would be suspicious if the exceptions to the articulated guidelines were less frequent for a protected group than for other groups. The guidelines to loan officers are usually much more flexible for business loan applications than for consumer loan applications, because of the greater need to negotiate in the business credit market. Therefore, the detection of differences in frequency of exceptions to the guidelines granted to various groups is less likely in the case of business credit applications.

A comparison for enforcement purposes of loan rejection rates or loan terms between members of protected groups and individuals in other groups requires information about race, sex, and other appropriate characteristics of all individuals whose applications have been rejected or approved by a creditor. In order to obtain this information about applicants for business credit, either creditors must be required to observe and record the information or applicants must be asked to make voluntary disclosures. The first approach can lead to inaccuracies, and raises the issue of invasions of privacy. Both approaches would involve additional record keeping requirements, and training expenditures for creditors. Currently, no provision for obtaining this information is contained in the proposed amendments.

List of Subjects in 12 CFR Part 202

Banks, banking, Civil rights, Consumer protection, Credit, Federal Reserve System, Marital status discrimination, Minority groups, Penalties, Religious discrimination, Sex discrimination, Women.

(15 U.S.C. 1691)

By order of the Board of Governors of the Federal Reserve System, October 8, 1982.

William W. Wiles,

Secretary of the Board

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