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Report to the Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, House of Representatives

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EQUAL CREDIT OPPORTUNITY ACT

OCC Should Further Review First Chicago's Screening Test for Credit Card Holders

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The Honorable Edward J. Markey
Chairman, Subcommittee on
Telecommunications and Finance
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

This letter responds to your March 22, 1991, request that we evaluate First Chicago Corporation's actions affecting certain of its credit card holders in the Northeastern United States.[1]

Background

With about 6.8 million credit card accounts, First Chicago is the seventh largest issuer of credit cards in the country. Concerned with increasing losses due to bankruptcy of cardholders, First Chicago started a test in August 1990 to see whether it could reduce losses by reviewing credit card accounts earlier than its normal 2-year cycle. The bank also sought to determine the prudence of reducing rather than canceling lines of credit for high-risk cardholders.

First Chicago's selection of its 1.7 million cardholders in Northeast states for a test was based on internally generated bankruptcy data that showed personal bankruptcy rates were increasing most rapidly in this region.[2] Through a series of credit screening procedures, like a bankruptcy prediction test, First Chicago decided which cardholders' credit would be reduced or canceled.

As part of its routine consumer compliance examination of national banks, the Office of the Comptroller of the Currency (OCC)—First Chicago's primary regulator—requires its examiners to assess a bank's compliance with consumer protection laws, including the Equal Credit Opportunity Act (ECOA) and Regulation B, which implements the act. ECOA prohibits discrimination in any aspect of a credit transaction on a number of bases, including race, sex, and marital status.

[1] First Chicago's actions affected customers in nine states in the Middle Atlantic and New England regions. These states were Connecticut, Massachusetts, Maine, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont.

[2] First Chicago's bankruptcy data showed the Northeast states as having some of the highest rates of increase in bankruptcies between 1989 and 1990. Eight Northeast states were among the top 10; Illinois and Delaware rounded out the top 10.

Under ECOA, a credit screening procedure could be discriminatory if it includes prohibited characteristics such as race, sex, or marital status. Discrimination under ECOA may also result if a bank's credit practice has a disproportionately adverse impact on protected group members that is not reasonably related to their creditworthiness. Consequently, the design of a credit screening practice may make it discriminatory, or the practice may have the effect of being discriminatory.

As described in Regulation B and OCC examination procedures, if a particular screening practice is shown to have a disproportionate impact on an ECOA protected group, the bank must be able to demonstrate that the practice has a manifest relationship to the creditworthiness or credit performance of those affected. OCC procedures require examiners to review credit practices for possible adverse impacts on protected groups, but agency guidelines permit examiners to exercise considerable discretion in testing for adverse impacts. Appendix I provides additional details on ECOA, Regulation B, and OCC examination procedures for determining whether banks are complying with ECOA and Regulation B, including OCC's regulatory interpretation of the ECOA effects test.

ECOA does not prohibit the use of geography in screening credit card holders or applicants. However, concern over the use of geography in credit screening procedures has drawn congressional attention. In 1979, a bill was introduced in the Senate to prohibit discrimination on the basis of geography in the issuance and use of credit cards but was not enacted into law. Another bill involving geographic prohibition was introduced in the House of Representatives in 1991; it is still under consideration. Under this proposed legislation, the use of geography in screening credit card holders or applicants would be prohibited under ECOA.

Results in Brief

In response to your inquiries, OCC reviewed First Chicago's Northeast test to determine whether it violated current laws or regulations, specifically whether its use of geography as a characteristic for potential adverse actions constituted a discriminatory credit practice. OCC concluded that the credit screening process used by First Chicago was not discriminatory as defined in ECOA and Regulation B. We found that OCC based its conclusions on a description of the Northeast test provided by bank officials and on its analysis of ECOA and Regulation B provisions.

From our review of information about First Chicago's Northeast test, obtained by OCC at our request, we found that First Chicago's bankruptcy data were, for the most part, consistent with its decision to review credit card holders in the Northeast. We also found that the characteristics First Chicago took into consideration in doing its test did not include those prohibited as discriminatory under ECOA. Thus, we do not believe First Chicago's test—on its face—discriminated against Northeast credit card holders protected under ECOA. However, the credit screening procedures could still violate the act if they have the effect of discriminating against those protected by ECOA.

Objective, Scope, and Methodology

To respond to your request, we agreed to assess First Chicago's Northeast test and OCC's review of the test. We interviewed OCC staff and examined OCC documents compiled in Washington, D.C. We also visited the OCC office located at First Chicago headquarters to interview examiners and review OCC's reports and work papers relating to its examinations of First Chicago's credit card operations. Additionally, we asked OCC to obtain more detailed information about First Chicago's Northeast test.

We reviewed First Chicago's Northeast test implementation plan and related documents, including state-by-state bankruptcy information provided to OCC by the bank. We also reviewed bank information on all its cardholders, including cardholders eligible for adverse action as a result of the Northeast test and cardholders whose credit lines were actually reduced or canceled as a result of the test. We did not verify this information against the bank's records.

We did our work between July and September 1991 using generally accepted government auditing standards.

First Chicago's Test of Its Northeast Credit Card Accounts

First Chicago chose the Northeast as a test region for two reasons: (1) an increasing level of bankruptcy among cardholders in the region and (2) the region's unfavorable economic conditions. A bank official explained to OCC examiners that a 77-percent annual growth rate in bankruptcies in the Northeast could not be ignored. Thus, instead of waiting a year to reevaluate new accounts and 2 years to reevaluate long-standing accounts, which is First Chicago's normal cycle for account review, the bank applied its standard analysis for renewing accounts to all accounts that had not been reviewed in the previous 6 to 21 months.

Characteristics of the holders of the 1.7 million Northeast credit card accounts were scored according to a model designed to predict cardholder performance. These characteristics included time at present address, number of dependents, payment patterns, credit card account history, and credit references. According to OCC, after scoring all 1.7 million Northeast accounts, First Chicago concentrated on those accounts whose holders had a history of credit problems. The bank considered an account to be at risk if it was delinquent at least once in the previous 14 months or if it was currently over its established credit limit. This screening yielded 370,000 high-risk accounts. Next, First Chicago had a credit bureau perform a bankruptcy prediction test, which identified 33,500 cardholders with high bankruptcy potential.

First Chicago assigned these accounts to 1 of 21 categories (relating to bankruptcy potential and behavioral attributes) intended to reflect the cardholders' creditworthiness. According to OCC, accounts in these categories were then randomly assigned into test and control groups. The test groups included 1,100 whose credit lines were reduced and 7,800 accounts whose credit lines were canceled. The remainder were included in a control group with unchanged credit lines. First Chicago planned to monitor the payment performance of the account holders in each of these groups to determine whether reducing, canceling, or retaining credit lines produces the best results for such high-risk accounts. First Chicago planned to use the test results to decide how best to handle high-risk accounts nationwide.

OCC Examiners Did Not Adequately Assess First Chicago's Credit Card Operations

In concluding that the test was not discriminatory, OCC examiners accepted a First Chicago official's description of its Northeast test. In evaluating the bank official's description, examiners reviewed, but did not verify, the bank's bankruptcy data for 1989 and 1990, which led to the selection of the Northeast as a test region. Examiners told us that they asked First Chicago for additional information about how the test was conducted but were told by a bank official that gathering the information would take some time. OCC examiners then accepted the bank's explanation for its selection of the Northeast as a test region. They also accepted, without verification, the bank's explanation that it used standard credit review procedures to identify high-risk accounts. Further, examiners believed the bank eliminated the possibility of discrimination, as defined in ECOA, by randomly assigning the high-risk accounts to test or control groups without regard to personal characteristics of cardholders.

OCC examiners discussed among themselves the possibility that First Chicago's Northeast test may have had a discriminatory effect but concluded that discrimination under ECOA did not exist and that a review of cardholder accounts was not warranted. OCC examiners and headquarters officials offered several reasons for not further analyzing the bank's test for discrimination. Evaluating First Chicago's credit scoring procedures would require an extensive investigation of the bank's data processing systems and the workings of a complicated credit scoring model. Because geographic-based selection is not prohibited by ECOA and because they understood that the test and control groups were selected randomly, examiners dismissed as slight the possibility of discrimination. Headquarters officials further noted that if examiners verify that no ECOA-prohibited characteristics are included in the bank's credit scoring model, and the model is empirically derived and statistically valid, no further evaluation is necessary.

First Chicago officials told OCC that the test used the same credit review procedures used in the bank's normal reviews. In reviewing the Northeast test, OCC examiners also relied on their 1989 examination of First Chicago's credit card operations. OCC procedures require examiners to review credit practices as part of the consumer compliance examination.

We found, however, that OCC's 1989 examination did not closely examine the bank's credit practices. OCC examiners essentially limited their review of credit practices to consumers whose credit card applications were rejected. Examiners reviewed only 10 rejected applications from 1 state to determine whether applicants were notified within 30 days of their rejection, as required by ECOA. With essentially no review of cardholder accounts, examiners concluded that First Chicago's credit card operations were not discriminatory as defined in ECOA. Further, the 1989 examination did not include a review of First Chicago's credit scoring model.

OCC officials told us the bank's credit card scoring model had been reviewed in the 1988 compliance examination. During that examination, examiners received assurance from the bank that the model had been revalidated by the outside vendor that developed the scoring model. OCC officials also told us that OCC intends to review the results of the First Chicago Northeast test in its next compliance examination, which has been advanced from the third to the first quarter of 1992.

We discussed our analysis with OCC headquarters officials. They agreed that examiners did not fully conform to examination guidelines in either the review of First Chicago's Northeast test or the 1989 compliance examination. The officials explained that OCC's review of the Northeast test was not intended to be an examination, and, even if it had been an examination, they do not believe examiners can realistically be expected to validate a bank's credit scoring model. They stated that the examiner's responsibility is to ensure that the credit scoring model is periodically revalidated by the bank or an outside vendor.

These officials also said they do not believe there is a high likelihood of discriminatory practices resulting from credit scoring models because examiners are required to ensure that data input to the models does not include characteristics prohibited under ECOA, such as race or sex. These officials said that the prohibition against credit card issuers collecting such data makes evaluating a bank's credit screening practices impractical for determining whether it is in effect discriminatory. Further, they suggested that, even if examiners challenge a bank's credit card operations as in effect discriminatory, a bank only needs to provide a reasonable business or economic basis for its credit decisions to prevail in an administrative or judicial action. Finally, the officials noted that an effects test for a credit screening practice is unnecessary if (1) the scoring model used is empirically derived and statistically sound, (2) each factor or cardholder characteristic is manifestly related to predicting credit performance, and (3) no other factors or characteristics are known by the examiners to be as predictive while having a less adverse impact than those the bank used.

We understand that there are resource, expertise, and information constraints on examiners that may preclude them from doing extensive technical analyses of a bank's credit card scoring model. We also understand that such analyses may not be necessary for credit scoring models that have been properly validated and meet other regulatory requirements. However, First Chicago's test was not confined to a credit scoring model. First Chicago used several additional criteria to select its test group, including a credit bureau's bankruptcy prediction test. We saw no evidence that these additional criteria had been validated by First Chicago or that OCC examiners checked for validation.

Accordingly, OCC examiners did not have adequate assurance that all characteristics used in the Northeast test were related to cardholders' creditworthiness. Without such an assurance, we believe that examiners have a responsibility under ECOA to further review the bank's credit screening practices for adverse effects in accordance with OCC examination procedures.

There are several approaches OCC could use to address the ECOA effects test. For example, examiners could have the bank show that each of the characteristics used in the Northeast test had been validated as predictive of cardholders' creditworthiness and/or analyze accounts selected for First Chicago's Northeast test to determine whether there were patterns of protected cardholders selected for the test. As one analytical approach, examiners could review a sample of accounts selected for the test to determine whether cardholders with the same zip code or sex were disproportionately represented in the test. Such a review may not conclusively confirm discrimination, but it could highlight unusual patterns and the need for further investigation.

Conclusions

On the basis of our review of information on First Chicago's Northeast test, we do not believe that the test—on its face—was discriminatory against Northeast credit card holders protected under ECOA. Although First Chicago did use geography in confining its test to the Northeast region, geography is not one of the prohibited characteristics under ECOA.

However, the credit screening practices could still violate ECOA if they have the effect of discriminating against those protected by ECOA. OCC did not obtain sufficient information to determine whether First Chicago's test had the effect of discriminating against cardholders whose credit was reduced or canceled.

Recommendation

We recommend that the Comptroller of the Currency direct the national bank examination staff, as part of its planned 1992 compliance examination, to review First Chicago's credit card operations to better ensure that the Northeast test did not in effect violate ECOA.

Agency Comments

In its November 15, 1991, response to our report, OCC agreed with our recommendation. OCC said that although it believes the procedures used by First Chicago preclude a finding of illegal discrimination, it plans to review the results of First Chicago's Northeast test during its next compliance examination, which is scheduled for the first quarter of 1992. OCC's written response is contained in appendix II.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days from its issue date. At that time, we will send copies to other Subcommittee members, interested congressional committees, agencies, and the public. We will also make copies available to others upon request.

Major contributors to this report are listed in appendix III. If you have any questions about this report, please call me on (202) 275-8678.

Sincerely yours,

Craig A. Simmons

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

ECOA	Equal Credit Opportunity Act
OCC	Office of the Comptroller of the Currency

The Equal Credit Opportunity Act and Related OCC Examination Guidelines

The Equal Credit Opportunity Act (ECOA), which became effective in October 1975, prohibits discrimination in any aspect of a credit transaction on the basis of race, color, religion, national origin, sex, marital status, age, receipt of income from public assistance programs, and good faith exercise of any right under the Consumer Credit Protection Act. ECOA is implemented by Federal Reserve Regulation B.

The Office of the Comptroller of the Currency's (OCC) policy and procedures for assessing compliance with Regulation B are contained in the Comptroller's Handbook for Consumer Examinations and in the Comptroller's Handbook for Compliance. OCC has two procedures for assessing compliance with Regulation B: Tier I and Tier II. Tier I procedures, according to OCC policy, represent a review of the controls, policies, and management compliance systems of banks. According to OCC policy, Tier I represents the minimum review, under which examiners are afforded discretion and flexibility in completing the procedures. Under Tier I, examiners are required to select an appropriate number of loan files and to test for differential treatment by comparing open and rejected loans.

Tier II procedures are more detailed in coverage (i.e., they require more extensive testing) and are used if the examiner is unable to reach a conclusion about a particular area or if Tier I procedures reflect significant violations, control deficiencies, or other supervisory concerns that warrant the use of additional procedures.

According to OCC policy, in addition to rules for evaluating applications, all credit practices are subject to the "effects test." According to the Comptroller's Handbook for Consumer Examinations, banks fail the effects test when their practices have a disproportionate adverse impact on ECOA protected groups and are not reasonably related to creditworthiness. Consequently, even when bank practices are not intentionally discriminatory, examiners may find that they have the effect of discriminating against ECOA protected groups.

When examiners find that a bank's credit practice has the effect of being discriminatory, examiners are to encourage the bank to determine whether there is an alternative credit practice that would serve the same business need but would be less discriminatory. For example, a bank credit practice that requires applicants to have an extensive credit history in order to receive credit may have the effect of being discriminatory against married women. When examiners find such a practice, they are to encourage bank management and directors to review the practice and implement an alternative credit practice that serves their business need without having the effect of being discriminatory.

The following example of how the effects test may be applied to credit discrimination is provided in an appendix to the Comptroller's Handbook for Consumer Examinations:

- In step 1, the consumer would attempt to show that although a particular credit standard—home ownership, for instance—does not appear on its face to discriminate on the basis of sex, reliance on this standard of creditworthiness, in whole or part, results in the rejection of the credit applications of women. The consumer would further attempt to show that such rejections of women occur at a significantly higher rate than rejections of men. Such a showing would present a prima facie case of illegal discrimination by the bank.
- In step 2, the bank would attempt to rebut the consumer's prima facie case by showing that this credit standard is customarily applied to all applicants and that the standard has a manifest relationship to creditworthiness. To have that relationship to creditworthiness, the standard must have significant predictive ability.
- In step 3, the consumer would attempt to prove that an alternative credit standard exists that would have a lesser adverse impact on women and that the alternative would serve the bank's legitimate business interest at least as well as the standard of home ownership. If the consumer made such a showing, the bank—to prevail—would have to demonstrate that the alternative practice would not have a lesser adverse impact or that it would not serve the bank's interests at least as well as the consideration of home ownership.

The following excerpts from the appendix further describe how the effects test could apply to banks' credit systems:

"Without guidelines, banks and their lawyers are justifiably concerned about the prospect of the effects test being applied in credit discrimination cases, and they question what they can do to protect themselves. Any advice on this subject has to be prefaced with the warning that the courts may apply the effects test to credit discrimination cases differently from the way it is applied in employment discrimination, and the Supreme Court may re-interpret the test.

"Some preliminary observations can be made. Banks that use demonstrably and statistically sound, empirically derived credit systems should not have difficulty in successfully rebutting the consumer's prima facie case of discrimination, since such a credit system may only contain factors that have a manifest relationship to creditworthiness.

"For banks that rely on judgmental systems, building a credit system that will withstand an attack based on the effects test is by no means an easy task. The credit manager, the lending officers or the management should identify the factors considered in making credit decisions. They should examine each one to see whether there is a rational relationship between the factor and the goal of identifying acceptable credit risks. Although most traditional standards of creditworthiness (income, own or rent, length of time on job, and so on) can have a disproportionate adverse impact on women or minorities, a bank may not have to abandon those standards in evaluating creditworthiness. The bank probably can show that the factors have a manifest relationship to creditworthiness.

"Whether a bank uses a demonstrably and statistically sound, empirically derived credit system, or a judgmental one, it is desirable for the bank to examine alternative factors that might be less discriminatory than those which have been identified as being vulnerable under the effects test. Alternative factors that are less discriminatory and that serve the same business purpose of existing credit criteria can, if they are substituted, lessen a bank's exposure to civil liability, provide a larger pool of qualified applicants, and strengthen competition."

Comments From the Office of the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

November 15, 1991

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

We have received and reviewed your draft report titled "Equal Credit Opportunity Act: OCC Should Further Review First Chicago's Screening Test for Credit Card Holders."

See p. 7.

The draft report recommends that, during the 1992 compliance examination, the OCC review First Chicago's credit card operation to better ensure that the Northeast test did not violate the Equal Credit Opportunity Act. We believe the procedures used by First Chicago in performing the Northeast test preclude a finding of illegal discrimination. However, we intend and had previously planned to review the results of First Chicago's Northeast test during our upcoming compliance examination. As your draft report states, we rescheduled the start of the examination from the third quarter to the first quarter of 1992.

Thank you for the opportunity to comment.

Sincerely,

Judith A. Walter
Senior Deputy Comptroller for Administration

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