NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

April 30, 1991

Richard A. Katz, Esq.
Katz, Wolff & Caraccio
16 School Street
Rye, NY 10580

Re: Credit Applications
(Your April 9, 1991 Letter)

Dear Mr. Katz:

You requested National Credit Union Administration ("NCUA") review of a question on a federal credit union's ("FCU's") credit applications, namely "Have you been sued for debts or filed bankruptcy within seven years?" (the "credit question"). You felt that the credit question might have some effect on fair basis/discriminatory loan practices in Federal regulations. NCUA has not confronted this precise question before, but it would seem that the credit question does not violate either the Federal Credit Union Act or the Equal Credit Opportunity Act. It may, however, either fail an "effects test" or violate state requirements. Evidence is needed regarding whether discriminatory effects are produced by the credit question, whether it has business validity and necessity in making the credit decision, and whether, if the first two inquiries are affirmative, no less discriminatory alternatives are available. We also urge you to contact the appropriate state regulators for an answer regarding potential violations of state law raised by the credit question. This letter expresses no opinion on any federal laws outside of the jurisdicition of the NCUA, such as bankruptcy laws.

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ANALYSIS

Equal Credit Opportunity Act (the "ECOA")

The ECOA makes it unlawful for any creditor to discriminate against any applicant, with respect to a credit transaction:

> (1) on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract); (2) because all or part of the applicant's income derives from any public assistance program; or (3) because the applicant has in good faith exercised any right under this chapter. 15 U.S.C. §1691(a).

The question that you raise is not facially covered within the ambit of the ECOA or the applicable Regulation B. 12 C.F.R. Part 202. "[A] creditor may consider any information obtained, so long as the information is not used to discriminate against an applicant on a prohibited basis." 12 C.F.R. §202.6(a). Only if the credit question is determined to have a discriminatory effect, even though no such discrimination can be detected on the face of such question, may a possible ECOA violation occur. The "effects test" is explained in an NCUA Opinion Letter, dated September 5, 1989, the Federal Reserve Board ("FRB") Official Staff Interpretation to Regulation B, Section 202.6, §2, enclosed with said letter, and an excerpt from the FRB Consumer Compliance Handbook, Regulation B Chapter, pages 20-21, enclosed. You have not provided the statistics showing a discriminatory effect of the credit question, nor made a showing of the business validity and necessity of the credit question, nor made a showing of the availability of less discriminatory alternatives. More facts are needed to determine if the credit question violates the ECOA via the effects test.

Federal Credit Union Act ("FCU Act")

The FCU Act does not contain any provision which would prevent a credit union from asking the question you raise on credit applications. The FCU Act permits FCUs to make loans to members on certain terms. 12 U.S.C. §1757(5). Loans to individuals are to be made only to members "for provident or

productive purposes in accordance with applicable rules and regulations." Standard FCU Bylaws, Art. XII, §1. Lines of credit may be extended to members in accordance with applicable laws and regulations and within the interest rates, maximum maturity, terms of payment or amortization, security and maximum amount terms fixed by the FCU board of directors. Standard FCU Bylaws, Art. XII, §3.

Also, FCUs may not deny real estate-related loans, nor discriminate in setting or exercising its rights pursuant to the terms or conditions of such a loan, nor discourage an application of such a loan, on the basis of race, color, national origin, sex, handicap, or familial status. 12 C.F.R. §701.31(b). A "real estate-related loan" is one made to finance or refinance the purchase, construction, improvement, repair or maintenance of a dwelling. 12 C.F.R. §701.31(a)(3). You did not state whether the credit question concerned real-estate related credit, but if so Section 701.31 of the NCUA's Rules and Regulations would be applicable. However, as the question raised does not, on its face, violate Section 701.31, only if the credit question failed an "effects test," might a violation arise. Your question does not raise any issues under NCUA's Credit Practices Rules. 12 C.F.R. Part 706.

Furthermore, the FCU Act requires the FCU's credit committee or loan officers to consider applications for member loans and lines of credit. 12 U.S.C. §1761c(a). Loan application forms are to be prepared and furnished by the credit committee or loan officer and set forth the security, if any, and <u>any such other data as may be required</u> by applicable law and regulations. Standard FCU Bylaws, Art. XII, §7. The credit committee or loan officer is required to inquire into the character and financial condition of each applicant for a loan or line of credit and his/her sureties, if any, to ascertain their ability to repay fully and promptly the obligations incurred by them and to determine whether the loan or line of credit will be of probable benefit to the borrower. Standard FCU Bylaws, Art. IX, §6. FCUs, within the bounds of

compliance of applicable laws and regulations, generally have broad discretion in the range of questions asked on a credit application.

Sincerely,

Hattie M. Ulan

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Associate General Counsel

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NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

September 5, 1989

Office of General Counsel

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89-0719

Jacques G. Tessier, Manager
Boulevard Federal Credit Union
2479 Niagara Falls Blvd.
Tonawanda, New York 14150

Re: Regulation B (Your Letter of July 10, 1989)

Dear Mr. Tessier:

You have inquired whether your proposed credit policy will be in violation of the Equal Credit Opportunity Act or Regulation B. Boulevard Federal Credit Union ("Boulevard FCU") would like to amend its current policy for a preferred line of credit. The proposed policy requires a member to be a home owner, have a minimum annual income of $12,000, and be continually employed for a period of two years before qualifying for the preferred line of credit. The policy does not violate the Equal Credit Opportunity Act or Regulation B on its face; however, it may have a discriminatory effect.

Applicable Law

Regulation B (12 C.F.R. Part 202) is the implementing regulation for the Equal Credit Oppurtunity Act. It is issued by the Federal Reserve Board.

Section 202.4 of Regulation B (12 C.F.R. §202.4) provides:

> A creditor shall not discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction.

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"Prohibited basis" is defined in Section 202.2(z) (12 C.F.R. §202.2(z)) as:

> [r]ace, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); the fact that all or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted by the [Federal Reserve] Board.

Section 202.5(a) of Regulation B (12 C.F.R. §202.5(a)) provides:

> A creditor shall not make any oral or written statement, in advertising or otherwise, to applicants that would discourage on a prohibited basis a reasonable person from making or pursuing an application.

Analysis

The requirements you intend to add to your preferred line of credit program (home owner, $12,000 in annual income, and continual employment for a period of two years) do not, on their face, violate any proscription of Regulation B or the Equal Credit Opportunity Act. However, the credit policies may have a discriminatory effect, even though they appear neutral. The "effects test" is a judicial doctrine which, in essence, holds that policies may be described as discriminatory if the policy has a negative impact on persons intended to be protected by law, even if there is no intent to discriminate. The Federal Reserve Board issues Official Staff Interpretations to Regulation B. Enclosed is the section of the Official Staff Interpretations which concerns the "effects test" (paragraph 2. to Section 202.6).

In light of the "effects test" and good business practice, the loan risk assumptions underlining your new requirements should be regularly reviewed in order to determine whether they, in fact, relate to credit losses and whether they have the effect of discriminating against one of the protected classes of individuals included in Section 202.2(z) of Regulation B. For example, depending upon the statistics in your area, your

requirement of home ownership may have the effect of discrimination against a protected class in violation of Regulation B. Also, we note that the requirement of two years continual employment may have the effect of discrimination if a large portion of a protected class participates in seasonal or migratory work in your area. We suggest that you obtain the opinion of local counsel concerning these matters and other applicable state laws governing discrimination.

We also note Section 701.31 of the NCUA's Rules and Regulations (12 C.F.R. §701.31) which prohibits discriminatory practices relating to real estate-related loans. A "real estate-related loan" is defined in the regulation as "any loan for which application is made to finance or refinance the purchase, construction, improvements, repair, or maintenance of a dwelling." Your letter did not indicate whether your preferred line of credit program involves real estate-related credit. If it does, you must comply with Section 701.31 of the NCUA's Rules and Regulations. This section summarizes the prohibitions on discrimination in real estate lending activities contained in the Federal Fair Housing Act and certain provisions of Regulation B.

Sincerely,

Hattie M. Ulan

HATTIE M. ULAN
Assistant General Counsel

Enclosure

• The applicant's obligation to pay alimony, child support, or separate maintenance.
• The source of income to be used as the basis for repaying the credit requested, which could disclose that it is the income of a spouse.
• Whether any obligation disclosed by the applicant has a co-obligor, which could disclose that the co-obligor is a spouse or former spouse.
• The ownership of assets, which could disclose the interest of a spouse.

Paragraph 5(d)(2)

1. *Disclosure about income.* The sample application forms in Appendix B to the regulation illustrate how a creditor may inform an applicant of the right not to disclose alimony, child support, or separate maintenance income.

2. *General inquiry about source of income.* Since a general inquiry about the source of income may lead an applicant to disclose alimony, child support, or separate maintenance, a creditor may not make such an inquiry on an application form without prefacing the request with the disclosure required by this paragraph.

3. *Specific inquiry about sources of income.* A creditor need not give the disclosure if the inquiry about income is specific and worded in a way that is unlikely to lead the applicant to disclose the fact that income is derived from alimony, child support or separate maintenance payments. For example, an application form that asks about specific types of income such as salary, wages, or investment income need not include the disclosure.

5(e) *Written applications.*

1. *Requirement for written applications.* The requirement of written applications for certain types of dwelling-related loans is intended to assist the federal supervisory agencies in monitoring compliance with the ECOA and the Fair Housing Act. Model application forms are provided in Appendix B to the regulation, although use of a printed form of any kind is not required. A creditor will satisfy the requirement by writing down the information that it normally considers in making a credit decision. The creditor may complete the application on behalf of an applicant and need not require the applicant to sign the application.

2. *Telephone applications.* A creditor that accepts applications by telephone for dwelling-related credit covered by section 202.13 can meet the requirements for written applications by writing down pertinent information that is provided by the applicant(s).

3. *Computerized entry.* Information entered directly into and retained by a computerized system qualifies as a written application under this paragraph. (See the commentary to § 202.13(b).)

Section 202.6—Rules Concerning Evaluation of Applications

6(a) *General rule concerning use of information.*

1. *General.* When evaluating an application for credit, a creditor generally may consider any information obtained. However, a creditor may not consider in its evaluation of creditworthiness any information that it is barred by § 202.5 from obtaining.

2. *Effects test.* The effects test is a judicial doctrine that was developed in a series of employment cases decided by the Supreme Court under Title VII of the Civil Rights Act of 1964 (42 U.S.C. 2000e *et seq.*). Congressional intent that this doctrine apply to the credit area is documented in the Senate Report that accompanied H.R. 6516, No. 94-589, pp. 4-5; and in the House Report that accompanied H.R. 6516, No. 94-210, p. 5. The act and regulation may prohibit a creditor practice that is discriminatory in effect because it has a disproportionately negative impact on a prohibited basis, even though the creditor has no intent to discriminate and the practice appears neutral on is face, unless the creditor practice meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact. For example, requiring that applicants have incomes in excess of a certain amount to qualify for an overdraft line of credit could mean that women and minority applicants will be rejected at a higher rate than men and nonminority applicants. If there is a demonstrable relationship between the income requirement and creditworthiness for the level of credit involved, however, use of the income standard would likely be permissible.

6(b) *Specific rules concerning use of information.*

Paragraph 6(b)(1)

1. *Prohibited basis—marital status.* A creditor may not use marital status as a basis for determining the applicant's creditworthiness. However, a creditor may consider an applicant's marital status for the purpose of ascertaining the creditor's rights and remedies applicable to the particular extension of credit. For example, in a secured transaction involving real property, a creditor could take into account whether state law gives the applicant's spouse an interest in the property being offered as collateral.

2. *Prohibited basis—special purpose credit.* In a special purpose credit program, a creditor may consider a prohibited basis to determine whether the applicant possesses a characteristic needed for eligibility. (See § 202.8.)

Enclosure

It is not even necessary that an institution itself be consciously aware that it is engaged in a discriminatory practice if the discrimination is reasonably apparent from objective analysis. Lack of awareness, or insufficient but "good faith" efforts to comply will not excuse a violation. To avoid charges of "purposeful" discrimination a lender must exercise a reasonable degree of precaution and self-examination.

The courts have developed a rule that a principal is responsible for the discriminatory conduct of its agent. A lender may regularly deal with many people in addition to the applicant in the course of extending credit. The lender may rely upon information supplied by brokers, appraisers, credit bureaus, and others. The lender's own employees may also contribute substantially to a final decision about the applicant's creditworthiness.

The lender, as an institution, will be liable for any discrimination by its employees. This applies even if the employee's unlawful conduct violates the lender's own nondiscriminatory standards and instructions. With respect to persons who are independent of the lender, such as real estate brokers, the degree of lender responsibility for those participants in a transaction depends upon the nature of the lender-third party business relationship.

The Effects Test

The effects test was first articulated by the United States Supreme Court in *Griggs* v. *Duke Power Company*, 401 U.S. 423 (1971), and later referred to in *Albermarle Paper Company* v. *Moody*, 422 U.S. 405 (1975). In Griggs there was a challenge to the use of a high school diploma requirement and an intelligence test as qualification criteria for certain jobs which had previously been held only by whites. Although the Supreme Court noted the existence of prior discrimination by the company, and discrimination by society in general, it found no purposeful discrimination in the application of the diploma and test requirements. The Court nevertheless invalidated these standards because they had a "discriminatory effect," that is, the Court found that their use resulted in a disproportionate number of black applicants being rejected. The Court found that the broad remedial purpose of the Equal Employment Opportunity Act expressed a Congressional intent to remove "artificial, arbitrary and unnecessary barriers" which present "built-in headwinds" for minority groups regardless of the motivation or purpose behind the standards.

As amplified by Albermarle, the effects test can be expressed as follows:

- When it can be shown that a practice, even though neutral on its face and adopted without a discriminatory purpose, has a statistically disproportionate impact on a protected group (has a greater adverse impact on blacks than whites, or women than men), a prima facie case of discrimination has been made, and the burden shifts to the proponent of the practice to justify it.
- To justify the practice, it must be shown to serve a genuine business need. This includes proof that the practice has a demonstrable or manifest relationship to the business goal for which it was adopted, and that the goal fulfills the stated business need.
- If it is shown that the practice is a business necessity, as defined above, those challenging the practice still can prevail if they can demonstrate the availability of other devices which serve the same legitimate business goals equally well, but which have a less discriminatory impact.

While the two cases cited above deal with employment discrimination, the effects test is equally applicable to credit and housing. It is specifically incorporated into Regulation B, and courts have used the effects test analysis to detect discrimination under the Fair Housing Act.

Detecting a possible violation of the effects test involves two elements. First, the statistics are developed that will show whether a protected class is fairly represented among the bank's credit customers. If an unexpect-

edly low level of lending to women, for example, appears, gather any additional data necessary to determine what particular bank practice or policy is responsible for this effect. A finding of unlawful discrimination cannot be predicated on statistical evidence of a disparate impact alone. Once the practice is identified, however, it cannot be retained unless its validity and necessity are established. The practice must relate to a significant business goal, and not merely serve some convenience. Finally, if the practice is justifiable as a business necessity, it must be concluded that no equally serviceable and less discriminatory alternatives are available before permitting the practice to continue. There is very little specific judicial guidance on this last step in the effects test.

Examples of types of bank practices that may be susceptible to an effects test analysis include the use of criteria such as prior home ownership or type of occupation in evaluating credit applications. Other such criteria might include considering the age, size, or price of individual homes for which real estate lending will be considered. Setting minimum criteria on these bases may have the effect of disproportionately excluding blacks in smaller, older, less expensive inner city housing from consideration for a real estate loan, in favor of residents of newer, larger, more expensive suburban homes. Considering neighborhood criteria, such as average family income or the average age of homes may have similar effects and may have implications under the Community Reinvestment Act (discussed elsewhere in this handbook), as well. If such criteria correlate closely and adversely to the rejection rate for minorities or women, the bank must show not only the "predictiveness" of the factor, but also the genuine business need to use that factor to the exclusion of others. Credit scoring systems, separately discussed elsewhere in the handbook, may involve unique problems when analyzed for their impact upon protected classes.