United States House of Representatives

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

Hearing on "The Importance of the National Credit Reporting System to Consumers and the U.S. Economy"

May 8, 2003

Testimony:

The Impact of National Credit Reporting Under the Fair Credit Reporting Act

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Testimony: The Impact of National Credit Reporting under the FCRA

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Introduction

Good morning Mr. Chairman and members of the Committee. My name is Michael Staten. I am Professor of Management and Director of the Credit Research Center at the McDonough School of Business at Georgetown University. The Center is a non-partisan, academic research center devoted to studying the economics of consumer and mortgage credit markets. Over its 29-year history the Credit Research Center has generated over 100 research studies and papers, most of which examine the impact of public policy on credit markets. Throughout its history, the Center's research program has been supported by a mix of grants from the public sector (e.g., National Science Foundation, Federal Trade Commission) and unrestricted private sector grants from foundations and corporations made to its host University on behalf of the Center. I have served as the Center's director since 1990.

I'm pleased to be able to share with you this morning the results of two specific reports that I have recently co-authored that assess the impact of the Fair Credit Reporting Act (FCRA). I will begin by stating the general conclusion of both reports. The available evidence – economic and otherwise – suggests that the voluntary national credit reporting system that has evolved under the FCRA has generated extraordinary benefits for individual consumers and the nation as a whole, and has helped to make the United States the world leader in the development of competitive consumer and mortgage credit markets. Proposals to depart from a national reporting system by allowing states to intervene in setting new credit reporting rules run the risk of upsetting the carefully balanced interests under the FCRA, and diluting the benefits that flow from the existing system.

I. The FCRA, Federal Preemption and the National Credit Reporting System

Credit reporting in the United States evolved during the twentieth century as a market-driven response to creditors' need to determine the likelihood that borrowers would repay loans. The credit reporting industry was largely unregulated until passage of the Fair Credit Reporting Act in 1970.[1] In the FCRA Congress struck a balance that was intended to encourage more voluntary reporting of consumer borrowing and payment histories, while promoting greater accuracy in reporting and addressing consumers' privacy concerns regarding uses of credit report information.

In 1996 Congress amended the FCRA to expand the permissible uses of credit report data, further encourage the accuracy of reported information, and give consumers new opportunities to oversee the use of information about them.[2] The amendments were enacted following years of hearings and debate and continued to reflect the careful balancing of commercial and consumer interests that was the hallmark of the original statute.

However, by 1996 a rising tide of state-level privacy legislation was threatening to disrupt the balance by subjecting key elements of the increasingly *national* credit reporting system to inconsistent state standards. Thus, a critical component of the 1996 amendments that was intended to preserve the national reporting system was the preemption of state and local laws that would impact specific core elements of the credit reporting system.[3] However, in the face of ongoing, rapid, and often dramatic changes in

[1] Fair Credit Reporting Act of 1970, Pub. L. No. 91-508, 84 Stat. 1114 (codified at 15 U.S.C. §§ 1681-1681t).

[2] Consumer Credit Reporting Reform Act of 1996, enacted as title II, subtitle D, chapter 1of the Omnibus Consolidated Appropriations Act for Fiscal Year 1997, Pub. L. No. 104-208, 104th Cong., 2d Sess. §§ 2401-2422 (Sept. 30, 1996) (codified at 15 U.S.C. §§ 1681-1681t).

[3] The 1996 amendments preempted those elements of the FCRA that were considered most important for preserving a voluntary, market driven credit reporting system that protected consumer privacy but also supported widespread access to credit. Specifically, Congress prohibited state laws dealing with:

technologies and markets, Congress provided that preemption would expire on January 1, 2004. The compromise ensured that there would be both an opportunity and a need to assess the impact of imposing uniform national standards and to reevaluate the FCRA in an evolving national market.

As the January 1, 2004 deadline nears, some privacy advocates and legislators are urging Congress to drop federal preemption from the FCRA and allow states to regulate the central elements of credit reporting. Abandoning uniform national standards would mark a radical change in a credit reporting system that has evolved almost entirely without state or local regulation of its core functions. Such a step puts at risk the existing national reporting system and all of the benefits that flow from it as the foundation for the most dynamic consumer and mortgage credit markets in the world. Preemption should therefore not be abandoned without assessing carefully (1) how well the current national credit reporting system under the federal FCRA has served the American public and economy, and (2) the risks to consumers and commerce of subjecting that national system to state and local regulation that could lead to significant new restrictions on credit reporting.

There has been surprisingly little comprehensive study of the overall impact of the robust credit reporting system that has evolved in the United States. In two recent reports I teamed with my colleagues Fred Cate, Robert Litan and Peter Wallison in an effort to fill that gap.[4] I will provide both reports to the committee for its use. All of the relevant economic analyses, case studies, policymaker statements and government and industry

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1. Responsibilities of those who furnish data to be included in a credit report.
2. Responsibilities of persons who take adverse action based on a credit report.
3. Time to investigate and take appropriate action regarding disputed credit report information.
4. Time periods for which specific items of adverse information may be included in consumer credit reports.
5. Sharing of information—not just from credit reports—among affiliates.
6. Use of credit report data for "prescreening" credit information for the purpose of marketing credit or insurance opportunities to consumers, provided that credit bureaus establish and publish a toll-free telephone number that consumers can call to opt out of prescreening.
7. Notices to be included with prescreened solicitations.
8. Summary of consumer rights to be provided to individuals.

[4] Fred Cate, Robert Litan, Michael Staten and Peter Wallison, *Financial Privacy, Consumer Prosperity and the Public Good: Maintaining the Balance*, AEI-Brookings Joint Center for Regulatory Studies, April, 2003; Michael Staten and Fred Cate, "The Impact of National Credit Reporting Under the Fair Credit Reporting Act: The Risk of New Restrictions and State Regulations," mimeo, May, 2003.

reports that we examined pointed to one conclusion: The balance struck by the FCRA has facilitated the most robust credit information system in the world. That credit reporting system underpins the most competitive consumer and mortgage credit markets in the world. The system is unique in achieving a remarkable combination of (a) widespread access to credit across the age and income spectrum, (b) relatively low interest rates on secured loans (e.g., home mortgages, automobiles), (c) exceptionally broad access to open-end, unsecured lines of credit (e.g., bank credit card products) and (d) relatively low default rates across all types of consumer loans.

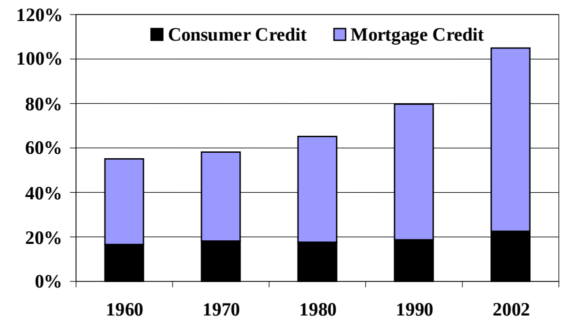
The following sections present some highlights of our findings. Although the discussion focuses primarily on consumer and mortgage credit markets, it should be noted that the credit reporting system also directly benefits markets for insurance, apartment rentals, cell phone service contracts, utilities, and a variety of other types of transactions.

II. Benefits that Flow from the Existing National Credit Reporting System

1. Consumer Access to Credit

Broader Credit Access Across the U.S. Population. Consumer and mortgage credit underpins much of the consumer spending that accounts for over two-thirds of U.S. gross domestic product and has been a key driver of U.S. economic growth. In 2001, 75 percent of U.S. households participated in the consumer and mortgage credit markets. Sixty-eight percent of U.S. households owned their own homes, and nearly two-thirds of these homeowners had some type of mortgage loan. Nearly a third of all households had automobile loans or leases. About 73 percent of all households owned at least one general purpose credit card (e.g., Visa, MasterCard, Discover, American Express) in 2001. The average U.S. consumer-borrower had eleven open accounts (seven credit cards, four installment or real-estate-secured loans). Credit market participation is remarkably wide and deep.

Figure 1
U.S. Consumer and Mortgage Credit as a Percentage of Disposable Income (1960-2002)



Source: Federal Reserve Board, Statistical Release Z.1 *Flow of Funds Accounts of the United States*

Consumer Credit and the U.S. Economy. The importance of consumer credit markets to the strength and resiliency of the U.S. economy is a direct consequence of the credit reporting system. U.S. credit markets facilitate and extend economic expansion by reducing liquidity constraints. Credit markets help to translate consumer optimism into real economic activity. Consumer credit allows households to transfer consumption from periods where household income is high to periods where income is low. U.S. credit markets are the most efficient in the world at allowing households to smooth their consumption patterns over time, rather than postpone major purchases until incomes and asset holdings build to sufficient levels.

Credit also provides a "bridge" to tens of millions of households that can sustain them through temporary disruptions and declines in incomes. Credit markets that make loans accessible across large segments of the population provide a cushion that helps to neutralize the macroeconomic drag associated with these events, lowering the risk of outright recession, and reducing the magnitude of downturns when they do occur.

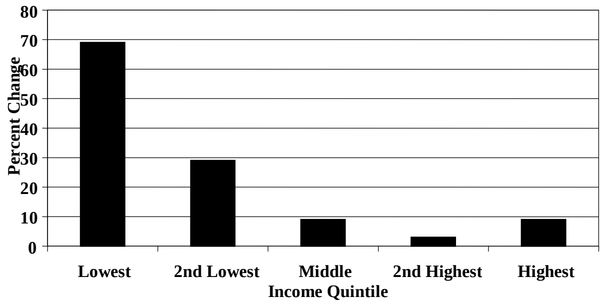
A recent study of 43 countries found that total bank lending to the private sector (scaled by country GNP) is larger in countries (and default rates are lower) where information sharing is more solidly established and intense.[5] The macroeconomic benefits from smoothly functioning credit markets can be linked back to the establishment of a comprehensive system for sharing consumer borrowing and payment histories.

[5] Tulio Japelli and Marco Pagano, "Information Sharing, Lending and Defaults: Cross-country Evidence," *Journal of Banking and Finance*, Vol. 26, 2002 pp 2017-2045.

Impact of Credit Reporting on Traditionally Underserved Americans. Equally remarkable is the increased access to credit across the income spectrum over the past three decades. Figure 2 displays the change in the percentage of U.S. households that used non-mortgage credit between 1970 (the year before the FCRA took effect) and 2001. The largest gains were in the lower end of the income spectrum. The proportion of households in the lowest fifth of the income distribution who had access to consumer credit jumped by nearly 70 percent over the period. Accessible credit information "democratizes" financial opportunity.

Figure 2

Change in the Proportion of U.S. Households Using Non-Mortgage Credit (1970 vs. 2001)



Source: Federal Reserve Board, Surveys of Consumer Finances.

The U.S. credit reporting system helps families break the stubborn cycle of low economic status from generation to generation. Credit is essential to home ownership, which is one of the most important steps in the accumulation of wealth. Home ownership rates among younger households vary substantially across developed countries, due in large part to differences in credit reporting. Lenders in the United States, Canada, and the United Kingdom can require less collateral (i.e., a lower down payment) as a hedge against the likelihood of default because borrower credit histories are more complete. These countries are among the leaders in terms of home ownership among younger households. In contrast, in countries where the exchange of credit history data is far more limited (e.g., France, Italy and Spain) down payments are higher and the degree of home ownership among younger households is significantly lower.

***Table 1:* Home ownership Rates Among Younger Borrowers**

Country	% Home ownership Among Population Aged 26-35	Average % Downpayment, 1991-1995
United States	49.3	11
United Kingdom	63.8	5
Spain	40.0	20
France	35.0	20
Italy	23.2	40
Germany	18.5	20

Source: Maria Concetta Chiuri and Tullio Jappelli, "Financial Market Imperfections and Home Ownership: A Comparative Study," manuscript, Department of Economics, Universita di Salerno, 2002.

These benefits of credit reporting are especially great for minorities. Between 1989 and 1998, home ownership rates rose more sharply for African Americans, Hispanics, and lower-income families than for other groups, but only a small part of these gains were attributable to improvements in their incomes or economic circumstances. Innovation among mortgage lenders in terms of risk measurement and the ability to develop and tailor new products for specific population segments accounted for much of the gains, all of which depended upon a robust credit reporting system.

2. More Accurate Decision-Making

Because credit reports are compiled over time, from a wide range of sources, and updated daily, creditors (as well as insurers, employers and other businesses with a permissible purpose) can see a far more complete picture of present *and* past credit behavior. These data, reflecting a borrower's own past payment history, replace face-to-face attempts to evaluate character and capacity (common a generation ago) with a less invasive, more accurate assessment based on documented prior behavior. Lending decisions are faster and more equitable. There is less opportunity for the loan decision to be influenced by factors other than how the borrower has handled credit in the past, and standardized credit report data make it easier for regulators to verify compliance with anti-discrimination and other lending laws.

Credit reporting thus improves the performance of the entire market, lowering the costs of making credit available and increasing the number of Americans who qualify for credit. As Federal Reserve Board Chairman Alan Greenspan has noted, "There is just no question that unless we have some major sophisticated system of credit evaluation continuously updated, we'll have very great difficulty in maintaining the level of consumer credit currently available, because clearly without the information that comes from credit bureaus and other sources, lenders would have to impose an additional risk premium – because of the uncertainty – before they make such loans. . . or not make those loans at all."[6]

Furthermore, credit reports (and the scoring models they make possible) allow lenders to be proactive in *preventing* debt problems, even for existing accountholders. By

[6] Testimony of Alan Greenspan before the U.S. House Financial Services Committee, April 30, 2003.

providing a comprehensive picture of all of the borrower's credit accounts, credit report data allow creditors to prevent overextension. Consequently, U.S. delinquency rates are remarkably low. In the fourth quarter of 2002 only 3.9 percent of all mortgage borrowers in the United States were delinquent 30 days or more. Only 4.6 percent of all credit card borrowers were delinquent 30 days or more on their accounts. Sixty percent of U.S. borrowers *never* had a payment delinquent 30 days or more in the previous seven years.

Moreover, the share of household income devoted to debt service is remarkably similar across all income groups, suggesting that previously underserved groups are not generally taking on more new credit than they can handle. As a group, households in the lower two-fifths of the income distribution do not carry greater debt burdens than higher income households. Robust, national credit reporting has thus not only made it possible for more people to have access to more credit, but to do so without a substantial increase in defaults.

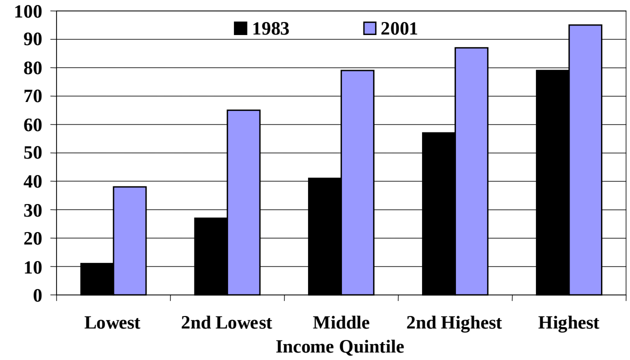
3. Enhanced Competition

Because it dramatically reduces the cost of assessing the risk of new borrowers, credit report information encourages entry by new lenders and greater competition. Access to national credit report data and the ability to use them to "prescreen" applicants, for example, has transformed the credit card market by facilitating efficient national competition. In the face of that competition, consumer choice has increased dramatically; no-fee cards and cards offering frequent traveler miles or cash-back rebates are now commonplace. Credit card interest rates have plummeted, relative to the late 1980s. The number of Americans with access to credit cards has soared. The percentage of U.S. households owning at least one general-purpose bank credit card has increased from 43 percent in 1983 to 73 percent by 2001 (Figure 3). Overall, 30 million more U.S. households had a bankcard in 2001 than in 1983.

Laws that inhibit the assembly of comprehensive credit reports act as a barrier to competition by giving the dominant incumbent lender a monopoly over the information it possesses about its customers, and denying new market entrants the information needed to provide and market competitive services. In Europe, where comprehensive credit reports are unavailable in several countries, financial services are provided by far fewer institutions—*one-tenth* the number that serve U.S. customers. In France, the European Union country with some of the strictest financial privacy laws, seven banks controlled more than 96 percent of banking assets in the late 1990s. The absence of comprehensive credit histories restrains competition and makes it easier to hold customers and capital captive.

Figure 3

U.S. Bankcard Ownership by Household Income



Source: Federal Reserve Board, Surveys of Consumer Finances.

Ownership rates of unsecured credit cards are vastly higher in the United States than in Europe. A Morgan Stanley Dean Witter report highlights the critical difference that available credit histories make, noting that "[t]he biggest obstacle to new entrants" in many European countries "is the lack of a centralized credit bureau."

***Table 2:* Credit Card Ownership, 1997 (per 1000 people in population)**

Country	Superpremium + Premium	Corporate	Standard	Total
United States	650.4	20.9	945.0	1616.3
U.K.	91.3	22.5	546.7	660.5
Belgium	53.0	6.9	197.4	257.3
Netherlands	38.3	9.4	195.9	243.5
Spain	26.5	4.3	212.0	242.8
Sweden	44.2	46.4	85.8	176.4
Germany	39.7	4.6	127.8	172.0
Italy	18.2	9.7	109.1	137.0
France	25.1	3.1	68.3	96.6

Source: Lyn C. Thomas, David B. Edelman, and Jonathan N. Crook, *Credit Scoring and its Applications*, Society for Industrial and Applied Mathematics, Philadelphia, 2002, p 212.

4. Speed and Convenience

The depth of information in U.S. credit reports enhances the speed of credit and other financial service decisions. Even very significant decisions about financing a college education or a new home or writing automobile or homeowners insurance are often made in a matter of hours or minutes, instead of days and weeks as is the case in most other countries, because credit history data is readily accessible. In 2001, 84 percent of automobile loan applicants in the United States received a decision within an hour; 23 percent of applicants received a decision in less than 10 minutes. Many retailers open new charge accounts for customers at the point of sale in less than two minutes. According to Federal Trade Commission Chairman Muris: "Many fail to appreciate that the average American today enjoys access to credit and financial services, shopping choices, and educational resources that earlier Americans could never have imagined. . . . What I personally find most astounding is . . . the 'miracle of instant credit.'" Muris concluded: "This 'miracle' is only possible because of our credit reporting system."[7]

5. Catalyst to Productivity Growth

Portable credit "reputations" give consumers greater mobility and enhance their ability to respond to change. By increasing our mobility as a society, the credit reporting system under the FCRA has improved the efficiency of U.S. labor markets, so that structural shifts within the economy can cause temporary disruptions without crippling long-term effects. There is less risk associated with severing old relationships and starting new ones, because objective information is available that helps us to establish and build trust in new locations more quickly. Economist Walter Kitchenman has described the "almost universal reporting" of personal information about consumers as the "secret ingredient of the U.S. economy's resilience."[8]

In contrast, more restrictive, and inconsistent, credit reporting laws prevent European consumers from taking full advantage of their complete credit histories. The fact that credit *information* is not mobile restricts the mobility of *consumers*, because of

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[7] Timothy J. Muris, *Protecting Consumers' Privacy: 2002 and Beyond*, Privacy 2001 Conference, October 4, 2001.

[8] Walter Kitchenman, *U.S. Credit Reporting: Perceived Benefits Outweigh Privacy Concerns*, The Tower Group, 1999.

the resulting difficulty of obtaining credit from new institutions. In fact, European consumers, although they outnumber their U.S. counterparts, have access to *one-third* less credit as a percentage of aggregate personal income.

6. Reduced Costs

Comprehensive credit reports have improved the competitiveness and efficiency of credit markets, led to powerful improvements in risk-management technology (like credit scoring), and created more product choices and better tools for assessing and managing risks, thereby avoiding delinquencies and defaults. *All of this ultimately lowers the cost of credit to consumers.*

Reliable, centralized, and standardized consumer credit information makes it possible to pool consumer loans and then sell them to investors. Such securitization of home mortgages, auto loans and credit card balances has made hundreds of billions of dollars of additional funds available to loan to consumers. A Tower Group study concluded that U.S. mortgage rates are two full percentage points lower than in Europe because of securitization in the mortgage loan market. Consequently, American consumers save as much as *$120 billion* a year on $6 trillion of outstanding mortgages because of the efficiency and liquidity that credit report data make possible. By making refinancing easy and fast, the U.S. credit reporting system also allowed eleven million homeowners to refinance their home mortgages to take advantage of lower interest rates during just a 15-month period in 2001 and early 2002, thereby saving an estimated $3.2 billion *annually* in mortgage payments.

7. Public Safety and Security

Credit reports have long proved a useful and convenient way to check for past criminal convictions when employing school bus drivers, child-care workers, security guards, and people to fill other sensitive positions. They provide an increasingly important tool for preventing financial fraud, because they contain a comprehensive picture of an individual's financial dealings, information that can be used to cross-check and verify identities. They are also becoming an increasingly potent weapon in the fight against identity theft and terrorist threats.

III. The Risk of a Balkanized, State-level System of Credit Reporting

Proposals to abandon preemption threaten the diverse array of benefits that flow from the current credit reporting system under the FCRA. Virtually all of the benefits to individuals and the economy from the current U.S. reporting system result from its national character. National credit reporting made possible national competition in the market for credit and other financial services. Moreover, U.S. consumers are remarkably mobile, thanks in part to the ubiquitous availability of credit reports. Regulating credit histories state-by-state would ill serve consumers as they move, commute, and deal with businesses across state lines. It would leave holes (potentially large ones) in credit files, which would greatly reduce the reliability of credit reports. A balkanized credit reporting system would make a consumer's creditworthiness and credit opportunities depend on the state in which he/she lived.

While most aspects of credit reporting are vulnerable to the higher costs of inconsistent state or local regulations, some are especially at risk. I list three particularly sensitive areas below.

Voluntary Reporting is Vulnerable: Because no one is *required* to provide information to credit bureaus, if furnishers of information faced significant compliance burdens or liability, as would be the case if complying with separate and even inconsistent state laws, they would be more likely to stop contributing the information. Imposing liability for errors or significant additional burdens on the furnishers of consumer data to credit bureaus would discourage firms from reporting. Even the absence of a small amount of relevant information from credit reports could dramatically reduce their usefulness and lead to less accurate credit decisions and less access to credit for people who need it most.

Limits on Reporting of Adverse Information Dilute the Value of the Credit File: The 1996 amendments also precluded states from regulating when data would be considered "obsolete" and therefore could not be included in credit reports. Currently, derogatory information must be excluded from credit reports after seven years (with the exception of a notice of bankruptcy, which may remain for ten years). Attempts to accelerate obsolescence determinations, or modify the range of adverse information that could be reported would undermine the predictive value of credit reports.

Opt-In Rules Dampen Competition: The 1996 amendments to the FCRA explicitly authorized the use of credit report data for prescreening offers of credit and the sharing of data across affiliated companies, provided that consumers are given an opportunity to opt out of that sharing. Proposals to move to an *opt-in* system are certain to impose new costs on consumers because opt-in requires each company to gain explicit consent from each consumer prior to using personal information to target its marketing efforts. Opt-in is especially inefficient in the context of credit granting because is requires that every consumer be contacted, even though only a portion will qualify for an offer of credit. Those who do qualify will have to be contacted twice – once for permission to use the data to evaluate them, and again to make the offer. The consensus of studies and company experience is that *conditioning the use of information on opt-in consent is tantamount to banning the use outright.*

This makes an opt-in system for prescreening and sharing credit report data among affiliated companies an especially great impediment to the emergence of new market entrants and the development of innovative products and services, which, in turn, threatens the lower prices and enhanced choice that competition facilitates. Opt-in for prescreening and affiliate-sharing restrains competition and the benefits that flow from it.

Conclusion

Continued preemption of state and local credit reporting rules will preserve a truly national credit reporting system. As Congress deliberates whether to reauthorize the federal preemption, the threat of unraveling the remarkable gains to individual consumers achieved under our existing national reporting system should give policymakers pause. Compared to most other developed countries, the U.S. national credit reporting system has helped make it possible for a higher proportion of Americans to live in their own homes, drive their own cars, and afford college educations. It has greatly increased the number of Americans who now qualify for credit, insurance, and other financial services, and increased the confidence of providers in meeting the needs of previously underserved populations. The credit reporting system, undergirded by the FCRA, has helped to break down geographic and economic barriers, so that virtually all Americans can choose from financial services provided by competing businesses without regard for location. Credit reporting has had a literally transforming effect on the lives of less well-off individuals, young adults, and those located in small towns and rural areas. "Democratization" describes a broad and beneficial social effect, but the greatest measure of the impact of robust, national credit reporting is measured in the millions of individual lives improved.

I thank you for the opportunity to appear today and would be happy to answer questions.

Biography

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As director of the Credit Research Center since 1990, Prof. Staten has designed and conducted projects on a wide range of policy-oriented issues involving markets for consumer credit and financial services. His most recent research projects have examined the causes and consequences of personal bankruptcy, the role of comprehensive credit bureau data in expanding access to credit, the economics of subprime loan markets, and the impact of privacy regulations on the products and customer service offered by retail financial services firms.

Since its founding at Purdue University in 1974, the Credit Research Center has built a national reputation for its analysis of the economics of consumer credit markets. The Center's research product is used by the U.S. Congress, regulatory agencies, legislatures, the credit industry, consumer groups and the court system. The Center moved to the McDonough School of Business at Georgetown University in 1997. More information is available on the Center's website at www.msb.edu/prog/crc.

Prof. Staten has presented expert testimony on credit and insurance issues before committees of the U.S. House and Senate and various state legislatures. He has published numerous articles in various professional journals. In 1997 his book *Consumer Attitudes Toward Credit Insurance* (with John M. Barron) won the American Risk and Insurance Association's Elizur Wright Award for its contribution to the risk management and insurance literature.

Recent Publications Relevant to Credit Reporting:

John Barron and Michael Staten, "The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience," forthcoming in *Credit Reporting Systems and the International Economy*, edited by Margaret Miller, MIT Press, spring 2003.

Michael Staten and Fred Cate, "The Impact of Opt-in Rules on Retail Credit Markets: A Case Study of MBNA," forthcoming, *Duke Law Journal*, 2003.

Fred Cate, Robert Litan, Michael Staten and Peter Wallison, "Financial Privacy, Consumer Prosperity and the Public Good: Maintaining the Balance," AEI-Brookings Joint Center for Regulatory Studies, April, 2003.