THE IMPACT OF NATIONAL CREDIT REPORTING UNDER THE FAIR CREDIT REPORTING ACT: THE RISK OF NEW RESTRICTIONS AND STATE REGULATION

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The Impact of National Credit Reporting Under the Fair Credit Reporting Act: The Risk of New Restrictions and State Regulation

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Executive Summary

Since 1971 the U.S. credit reporting system has operated under the Fair Credit Reporting Act (FCRA). In 1996 Congress amended the FCRA to address a variety of concerns related to the proper uses of credit report information, its accuracy, and consumer privacy. Those amendments reflected a careful balancing of these interests. A critical component of that balance was preemption of state laws affecting those provisions of the FCRA that were considered most important for preserving a voluntary, market driven credit reporting system that supported widespread access to credit.

However, in the face of dramatic changes in technologies, commerce, and markets, Congress provided that preemption would expire on January 1, 2004. That 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, Congress is being asked to consider dropping federal preemption from the FCRA and allowing 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 benefits that flow from the existing national reporting system—the foundation for the most dynamic consumer and mortgage credit markets in the world.

Given the magnitude of this threat, preemption should not be abandoned without first assessing (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 adopting significant new restrictions on credit reporting or of subjecting that national system to state and local regulation.

All of the relevant economic analyses, case studies, policymaker statements, and government and industry reports provide a remarkably consistent response to these two inquiries. They demonstrate that the voluntary national credit reporting system that has evolved under FCRA has generated extraordinary benefits for individual consumers and the nation as a whole. National credit reporting 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

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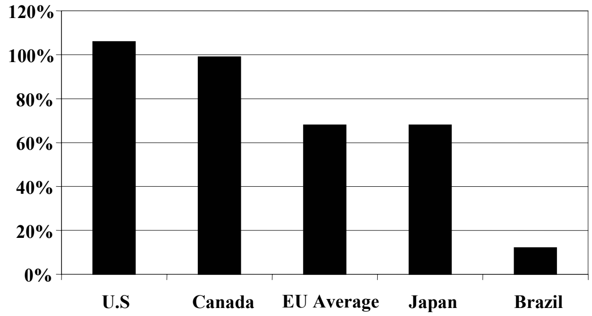
Figure 1
Total Household Credit as a Percentage of Personal Disposable Income (2000)



Source: Morgan Stanley Research, March 21, 2001.

system by allowing states to intervene run the risk of upsetting the carefully balanced interests under FCRA, and jeopardizing the benefits that flow from the existing system.

Benefits that Flow from the Existing National Credit Reporting System

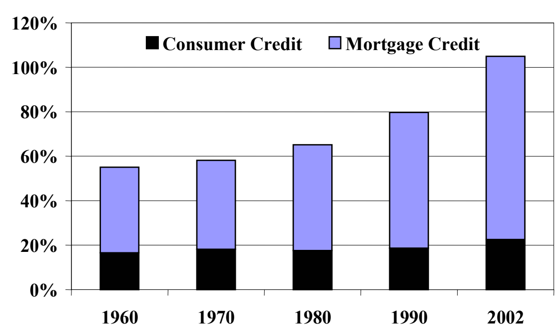
The U.S. national credit reporting system is unique in achieving a remarkable combination of (a) widespread access to credit across the age and income spectrum, (b) relatively low interest rates on secured loans (e.g., home mortgages, automobiles), (c) exceptionally broad access to open end, unsecured lines of credit (e.g., bank card products), and (d) relatively low default rates across all types of consumer loans. The following categories summarize the extraordinary benefits that consumers and the U.S. economy enjoy as a result of the national credit reporting system supported by the FCRA:

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. Mortgage credit financed the vast majority of the 516,000 single-family homes that U.S. consumers bought every month, on average, during 2001—accounting for about 14 percent of U.S. GDP. Consumer credit financed the vast majority of the 1.4 million cars, SUVs, and light trucks that U.S. consumers purchased or leased every month.

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 2
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. U.S. credit markets facilitate and extend economic expansion by reducing liquidity constraints. 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.

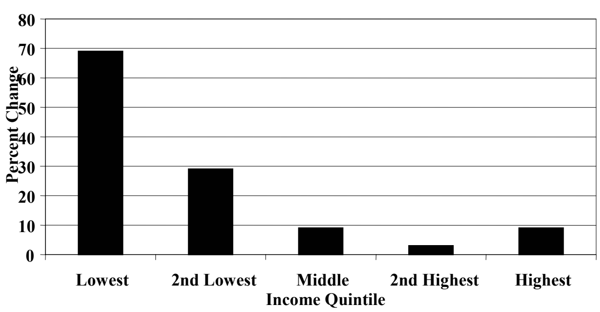
Credit provides a “bridge” to tens of millions of households that can sustain them through temporary disruptions and declines in incomes, thus helping to neutralize the macroeconomic drag associated with these events, lowering the risk of outright recession, and reducing the magnitude of downturns when they do occur.

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. A recent study of 43 countries found that total bank lending to the private sector (scaled by country GNP) is larger in countries where information sharing is more solidly established and intense.

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 3 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. By contrast, growth in the highest and second highest income quintiles averaged less than 5 percent. Accessible credit information “democratizes” financial opportunity.

Figure 3

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



Source: Federal Reserve Board, Surveys of Consumer Finances.

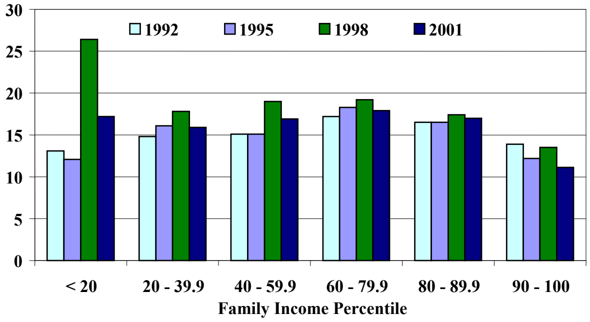
The U.S. credit reporting system helps families break the stubborn cycle of low economic status from generation to generation. Credit is essential to home ownership, which is one of the most important steps in the accumulation of wealth. Home ownership rates among younger households vary substantially 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: Chiuri and Jappelli, 2002.

Figure 4
U.S. Households: Median Ratio of Debt Payments to Family Income



Source: Federal Reserve Board, Surveys of Consumer Finances.

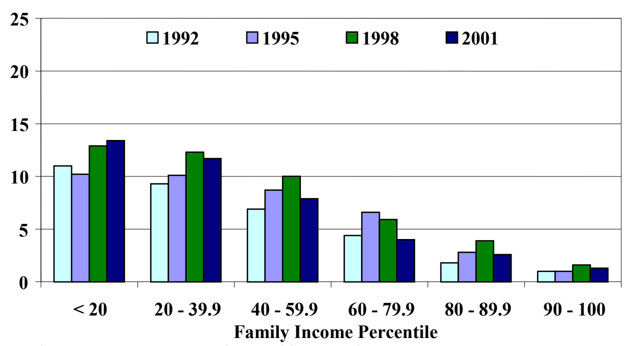
These benefits of credit reporting are especially great for minorities. Between 1989 and 1998, home ownership rates rose more sharply for African Americans, Hispanics, and lower-income families than for other groups, but only a small part of these gains were attributable to improvements in their incomes 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 antidiscrimination 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. According to one recent study, if creditors did not have access to the full range of credit information currently available in the United States, they would extend new credit to *11,000 fewer* customers for every 100,000 applicants. As Federal Reserve Board Chairman Alan Greenspan has noted, access to personal credit history data makes individual financial institutions "*more creditworthy and efficient*," and the U.S. financial services sector "*more transparent and stronger in general*."

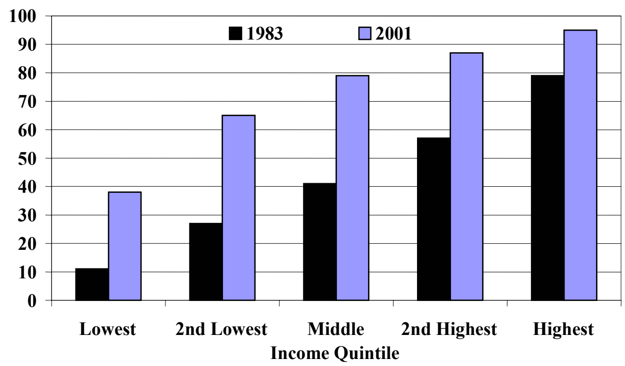
Figure 5
Percent of U.S. Households with Any Payment Past Due 60 Days or More



Source: Federal Reserve Board, Surveys of Consumer Finances.

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

Figure 6
U.S. Bankcard Ownership by Household Income



Source: Federal Reserve Board, Surveys of Consumer Finances.

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, and their burden has not significantly increased over the past decade. Similarly, there is no evidence that households in the lowest two-fifths of the income distribution experienced any greater increase in delinquency (in percentage terms) over the past decade than households in the other groupings. 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 increased 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; services such as no-fee cards and cards offering frequent traveler miles or rebates are now commonplace. Credit card 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. 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 not readily available, 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 control more than 96 percent of banking assets. The absence of comprehensive credit histories restrains competition and makes it easier to hold customers and capital captive.

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."

5. Catalyst to Productivity Growth

Portable credit "reputations" give consumers greater mobility and enhance their ability to respond to change. From a labor market perspective, the credit reporting system under FCRA has increased our mobility as a society, so that structural shifts within the economy can cause temporary disruptions but 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 not only the "foundation" of consumer credit in the United States," but also as the "secret ingredient of the U.S. economy's resilience."

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 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 gross domestic product.

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 also makes it possible to pool consumer loans and then sell them to investors. A Tower Group study concluded that U.S. mortgage rates are two full percentage points lower than in Europe because it is possible to securitize and sell mortgage loans. 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. Moreover, improved risk assessment and sharing—by spreading risks over a larger pool of capital and a larger number of investors—lowers the cost of capital, thereby making credit available to consumers more affordably.

The economic benefits of nationwide credit reporting are so great and so ubiquitous that the cost to consumers of having a less robust system could easily range into the hundreds of billions of dollars annually.

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 are an important tool in preventing financial fraud, because they provide a comprehensive picture of an individual's financial dealings. They are also becoming an increasingly potent weapon in the fight against identity theft and terrorist threats.

The Threat of New Restrictions on Credit Reporting

Proposals to abandon preemption, or to enact new federal or state restrictions on those critical aspects of credit reporting that are currently the subject of preemption, threaten the diverse array of benefits that flow from the current credit reporting system under the FCRA. While most aspects of credit reporting are vulnerable to the high costs of state or local regulation, some are especially at risk. This explains why Congress first preempted state-level regulation in these areas in 1996.

The Special Vulnerability of Furnishers of Credit Report Data. 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.

Obsolescence Determinations. 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). State-by-state or accelerated obsolescence determinations would undermine the predictive value of credit reports.

Opt-In Consent. The 1996 amendments to the FCRA explicitly authorized the sharing of credit report data among affiliated companies and with anyone for the purpose of marketing credit or insurance opportunities to consumers, 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. Yet consumers are remarkably difficult and expensive to contact individually.

Opt-in is especially inefficient in the context of credit granting because it 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 and again to make the offer. Moreover, credit bureaus usually have no relationship or direct contact with the consumer. Individuals are less likely to pay attention or respond to requests for consent from companies with which they have no dealings. Put simply, 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.

National Credit Reporting. 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 business from across state lines. It would leave holes (potentially large ones) in credit files. Moreover, the fact that those holes *could* exist would greatly reduce the reliability of credit reports.

The cost of determining which state law or laws applied, and of complying with those laws, could easily undermine the credit reporting system. That system deals in huge volumes of data—over 2 billion trade line updates, 2 million public record items, an average of 1.2 million household address changes a month, and over 200 million individual credit files. Its viability depends on exceptional efficiency and low marginal costs of updates, which, in turn, keep the cost of providing credit reports low. Moreover, a national standard offers better and more consistent privacy protection. This undoubtedly explains why privacy advocates have historically argued for the need to replace state and local laws with a single, uniform privacy standard.

Conclusion

By limiting the term of preemption to seven years, Congress provided a specific opportunity for policymakers to determine how well the national credit reporting system under the FCRA has served the public. The available evidence—economic and otherwise—demonstrates that the voluntary national credit reporting system that has evolved under 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 run the risk of upsetting the carefully balanced interests under FCRA, and diluting the benefits that flow from the existing system.

The Impact of National Credit Reporting Under the Fair Credit Reporting Act: The Risk of New Restrictions and State Regulation

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I. Introduction

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 (FCRA) in 1970.[3] 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.[4] 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.[5] 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.

In the 1996 amendments, Congress 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:

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.[6]
5. Sharing of information—not just from credit reports—among affiliates.[7]
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

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

[4]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).

[5]The more than 3000 credit bureaus operating in 1971 had shrunk to fewer than 600 by 1996, and those were already well on the way to evolving into three national automated reporting systems—Equifax, Experian, and TransUnion.

[6]15 U.S.C. § 1681t.

[7]15 U.S.C. § 1681a(d)(2)(A)(iii). The 1996 amendments excluded two provisions of Vermont law that regulated affiliate-sharing. Vermont Stat. Ann., tit. 9, §§ 2480e(a), 2840e(c)(1).

establish and publish a toll-free telephone number that consumers can call to opt out of prescreening.[8]
7. Notices to be included with prescreened solicitations.
8. Summary of consumer rights to be provided to individuals.

States are free to regulate other aspects of the credit reporting system, and they continue to play an important role in enforcement and education, but in the eight areas specified in the statute, federal law alone has controlled since 1996.

However, in the face of ongoing, rapid, and often dramatic changes in technologies and markets, Congress provided that preemption would expire on January 1, 2004. Thus, the compromise that prohibited state-by-state regulation in the core preempted areas also ensured that there would be both an opportunity and a need to assess the impact of imposing uniform national standards, as well as to reevaluate the specific provisions of 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 or of adopting 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 this report, we seek to fill that gap, drawing on the most relevant evidence from diverse sources, including economic analyses, case studies, policymaker statements, and government and industry reports.[9]

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[8] Id. § 1681b(c)(5).

[9] This paper focuses primarily on consumer and mortgage credit markets, but it should be noted that the credit reporting system also directly benefits markets for insurance, apartment rentals, cell phones service contracts, utilities, and a variety of other types of transactions.

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

The most remarkable discovery we have made is the consistency across the wide range of material we have reviewed. Without significant exception, the evidence demonstrates that the balance struck by the FCRA has facilitated the development of the most robust credit information system in the world. In turn, that system has generated extraordinary benefits for individual consumers, businesses, and the U.S. economy. The United States 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 card products), and (d) relatively low default rates across all types of consumer loans. Below we describe categories of benefits to consumers and the U.S. economy from the credit markets supported by the FCRA.

A. Consumer Access and Usage of Credit

Broad 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. U.S. households collectively hold about $6 trillion in mortgage loans and another $1.7 trillion in auto loans, credit card balances and other personal loans.[10] Total household credit as a percent of Personal Disposable Income in 2000 was 106 percent in the United States, compared to an average of about 68 percent across the European Union and Japan (see Figure 1).[11] The greater availability of credit in the United States is no coincidence. Economists have found that the volume of consumer and mortgage lending rises as a direct result of greater information sharing within a country's credit reporting system, and the United States has the most complete, timely, and reliable credit histories of any country.[12]

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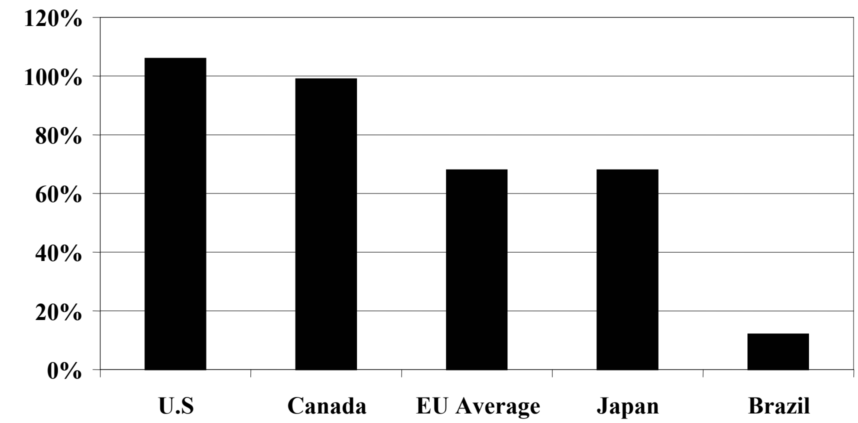
[10]Federal Reserve Board <www.federalreserve.gov>.

[11]"Global Growth, Local Challenge," Morgan Stanley Research, Mar. 21, 2001.

[12]Tullio Jappelli and Marco Pagano, "Information Sharing, lending and defaults: Cross-country evidence," *Journal of Banking and Finance*, Vol. 26, 2002, pp 2017-2045.

Figure 1

Total Household Credit as a Percentage of Personal Disposable Income (2000)



Source: Morgan Stanley Research, March 21, 2001.

In 2001, 75 percent of U.S. households participated in the consumer and mortgage credit markets and held some type of debt. Sixty-eight percent of U.S. households owned their own homes, and nearly two-thirds of these homeowners had some type of mortgage loan.[13] Those mortgages made it possible for U.S. consumers to purchase 516,000 single-family homes *every month,* on average during 2001 According to the National Association of Home Builders, the construction of housing and the value of housing services produced by the housing stock accounts for about 14 percent of U.S. GDP. Moreover, in the first twelve months after purchasing a newly built home, the new owners spend an additional $8,905 on furnishings and improvements, more than twice the amount spent in a year by non-moving homeowners.[14] These additional expenditures, most of which are financed via some type of consumer credit, help to fuel economic growth.

About 73 percent of all households owned at least one general purpose credit card (e.g., Visa, MasterCard, Discover, American Express) in 2001.[15] Consumer credit also financed the purchase or lease of 1.4 million cars, SUVs and light trucks in the average month during 2001. Nearly a third of all households had automobile loans or leases. Across 200 million individual credit reports on file with the major U.S. repositories, the average U.S. consumer-borrower had eleven open accounts (seven credit cards, four installment or real-estate-secured loans).[16] *Credit market participation is remarkably wide and deep.*

Figure 2 illustrates the striking growth in household credit in the United States as a percent of Personal Disposable Income over the past 40 years. The key point is that *the role of household*

[13]Federal Reserve Board, 2001 Survey of Consumer Finances.

[14]National Association of Home Builders <www.nahb.com>.

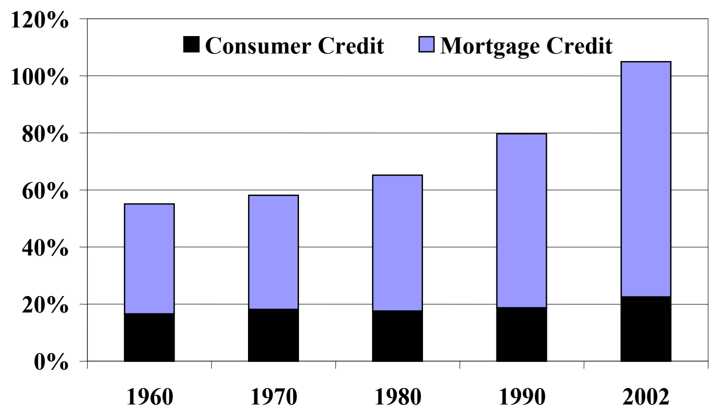
[15]Ana M. Aizcorbe, Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," *Federal Reserve Bulletin*, Jan. 2003, pp 1-32.

[16]Consumer Data Industry Association <www.cdiaonline.org>.

credit in the U.S. economy, especially mortgage credit, has grown dramatically since passage of the FCRA. To be sure, population demographics (e.g., the coming of age of the baby boomers) and other economic factors have much to do with credit growing faster than Personal Disposable Income since 1980. Nevertheless, the credit reporting system provided the essential ingredients for an innovative marketplace to respond to a burgeoning demand for credit.

Figure 2

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

For many years, growth in consumer indebtedness has been viewed negatively by both the business press and Wall Street analysts.[17] Rising debt loads are treated as warning signals of impending slowdown in consumer spending. However, academic research in the 1990s has begun to turn this viewpoint on its head. In a recent article that reviews this research, Federal Reserve Board economist Dean Maki concluded: "In stark contrast to the view that growth in consumer indebtedness is a negative force threatening future spending, a consensus seems to be emerging from recent research that consumer credit growth is positively related to consumption in future periods."[18]

[17]An interesting analysis of journalistic reporting on the impact of consumer debt trends on the macro-economy finds that it has been consistently (and inappropriately) skewed toward the negative for the past 50 years. See Thomas A. Durkin and Zachariah Jonasson, "An Empirical Evaluation of the Content and Cycle of Financial Reporting: The Case of Consumer Credit," Credit Research Center Working Paper No. 64, McDonough School of Business, Georgetown University, Apr. 2002.

[18]Dean M. Maki, "The Growth of Consumer Credit and the Household Debt Service Burden," in *The Impact of Public Policy on Consumer Credit*, eds. Thomas A. Durkin and Michael E. Staten, Kluwer Academic Publishers, 2002, pp 43-63.

Simply put, credit growth is an expression of optimistic consumer expectations regarding future income. When consumers feel good about their personal financial outlook, and credit markets do not impose liquidity constraints, consumer borrowing and spending rises. Credit markets help translate optimism into real economic activity. In this way, *smoothly functioning credit markets facilitate and extend economic expansion*.

Consumer credit allows households to transfer consumption from periods where household income is high to periods where income is low. This is particularly important for householders early in the life-cycle (ranging in age from the early 20s though their 40s) when the demand for housing, durable goods and education is relatively high, and incomes are relatively low but expected to rise over time. 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.

Because credit reports have allowed creditors to extend loans and establish lines of credit for a much wider segment of the population, as we discuss in greater detail below, tens of millions of households have access to a credit "bridge" that can sustain them through temporary disruptions and declines in incomes. Research has shown that *credit markets that make loans accessible to large segments of the population provide a cushion that neutralizes the macroeconomic drag associated with temporary declines in income, lowering the risk of outright recession and reducing the magnitude of downturns when they do occur*.[19]

Evidence from overseas markets supports the conclusion that *the United States enjoys a macroeconomic growth advantage as a consequence of its well-developed consumer credit markets.* Cross-country studies have found that credit availability and consumption fluctuations are linked. Specifically, consumer spending is more sensitive to changes in income in countries with less-developed consumer credit markets, especially during periods of tighter credit constraints.[20] In contrast, during the past two decades since financial deregulation significantly altered U.S. credit markets, credit constraints have become less of a factor in explaining shifts in household spending, because markets are making credit available to a wider range of borrowers and doing it more consistently through the business cycle.

The growing importance of consumer credit markets to the strength and resiliency of the U.S. economy is a direct consequence of the credit reporting system that provides the foundation for millions of loan decisions annually. A recent study of 43 countries found that total bank lending to the private sector (scaled by country GNP) is larger in countries where information sharing is more solidly established and intense, even after controlling for factors such as country size, growth rates and the legal environment.[21] Consequently, *the macroeconomic benefits from smoothly functioning consumer credit markets can be linked back to the establishment of a comprehensive system for sharing consumer borrowing and payment histories.*

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[19]Dirk Kreuger and Fabrizio Perri, "Does Income Inequality Lead to Consumption Inequality? Evidence and Theory," National Bureau of Economic Research Working Paper No. W9202, Sep. 2002.

[20]Tulio Japelli and Marco Pagano, "Consumption and Capital Market Imperfections: An International Comparison," *American Economic Review*, Dec. 1989; Phillipe Bacchetta and Stefan Gerlach, "Consumption and Credit Constraints: International Evidence," *Journal of Monetary Economics*, Oct. 1997.

[21]Japelli and Pagano, id.

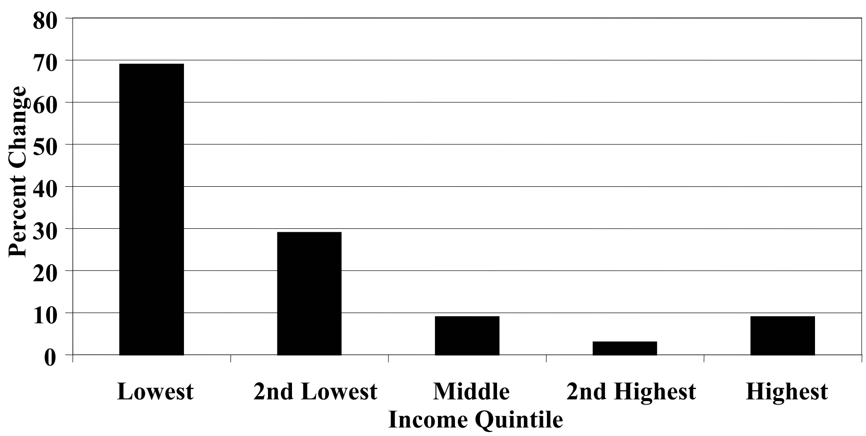
Impact of Credit Reporting on Traditionally Underserved Americans

One of the more remarkable achievements attributable to the development of comprehensive credit reporting is the increased access to credit down the household income spectrum in the U.S. over the past three decades. Recall that the FCRA was implemented in 1971. Figure 3 below displays the change in the percentage of U.S. households that had access to and used non-mortgage credit (i.e., closed-end automobile, education and other personal installment loans, plus open-end credit card accounts and lines of credit) between 1970 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. Participation by households in the second lowest income quintile rose by 29 percent. By contrast, growth in the highest and second highest income quintiles averaged less than 5 percent.

Figure 3 illustrates that the growth in the national credit reporting system under the guidance of the FCRA has facilitated an increase in the number of Americans who now qualify for credit. The intuition behind this is straightforward. Detailed and reliable information on past payment behavior gives creditors confidence in assessing the creditworthiness of new borrowers. It allows them to design products to meet the credit needs of previously underserved populations. Credit reports allow businesses from hundreds of miles away to provide credit to people they have never met who are located in small towns and rural areas and who otherwise have limited access to those opportunities.

Figure 3

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



Source: Federal Reserve Board, Surveys of Consumer Finances.

Put simply, accessible credit information "democratizes" financial opportunity: because of the underlying credit reporting network, U.S. consumers can get credit, insurance and a host of other financial services based on their individual records, not their family name or how long they have known their banker. In addition, they can rent apartments, purchase cell phones and cable television services, and rent automobiles without either large deposits or an established relationship with the service provider, all because their reputation for paying as agreed is documented through their credit reports.

The U.S. credit reporting system benefits traditionally underserved segments of the population in other ways as well. Research on U.S. income inequality has found a stubborn pass-through of low economic status from generation to generation. Studies underway at the Federal Reserve Bank of Chicago are finding that "[a]lthough the underlying factors that cause substantial (income) immobility in the United States remain poorly understood, some preliminary work suggests that borrowing constraints among families with low net worth may play a role in perpetuating income inequality." For example, the author suggests that families facing credit constraints may have neither the assets nor the ability to borrow against future income to invest properly in their children's education.[22]

Because the credit-reporting infrastructure helps to support broader access to credit it can enhance asset and wealth accumulation. This effect is most pronounced for younger households. As mentioned earlier, young households generally face tighter credit constraints. Younger borrowers have incomes that are relatively low but expected to rise, and high demand for the big-ticket purchases associated with family formation (housing, automobiles, education). Economists studying household survey data in the United States from the early 1980s found at that time that young households faced liquidity constraints (restricted access to credit) that left them with as much as 75 percent less credit than they would otherwise demand and use if credit were more widely available.[23] Two decades of expanded access to credit since then has narrowed that gap, to the benefit of young and otherwise marginal borrowers on the fringe of the market.

Home ownership is one of the most important steps in the accumulation of wealth. Economists have found that home ownership rates among younger households vary substantially across developed countries, and the reason is linked to differences in credit reporting. A study of home ownership rates in 14 countries (including eleven EU countries, Canada, the United States, and Australia) found that the cross-country variance in the required downpayment for a mortgage loan is a key determinant of differences in the timing of home purchase. The authors concluded that factors that foster the increased availability of mortgage loans and increased competition among mortgage lenders would lead to earlier home purchase behavior. In particular, the authors cited the extent of credit reporting (amount of information available in consumer credit report files) as a key factor, noting substantial variance in file content across the sampled countries. 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

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[22]See Bhash Mazumder, "Analyzing Income Mobility Over Generations," *Chicago Fed Letter*, Number 181, Sep. 2002.

[23]Donald Cox and Tullio Japelli, "The Effect of Borrowing Constraints on Consumer Liabilities," *Journal of Money, Credit and Banking*, Vol. 25, No. 2, May 1993, pp 197-213.

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.[24]

***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: Chiuri and Jappelli, 2002.

There is no question that the comprehensive borrowing and payment histories contained in U.S. credit reports have facilitated a boom in mortgage lending to "subprime" borrowers, opening the door to wealth-building through home ownership. Subprime mortgage customers are households for whom the cost of mortgage credit would be significantly higher than the prevailing "prime" rate in the conventional mortgage market. Borrowers may be deemed subprime for a variety of economic reasons, including: credit problems in the past; too much existing debt relative to income; short, thin or non-existent credit histories; self-employment income that is irregular or otherwise difficult to document; low downpayment and few liquid assets. Subprime mortgage borrowers are often younger, lower-income or minority households. These borrowers were either on the fringe or entirely outside of the U.S. mortgage market just a decade ago.

Subprime mortgage lending experienced rapid growth during the boom years of the 1990s. New lending by subprime mortgage specialists rose from less than $30 billion in 1993 to over $213 billion in 2002.[25] Subprime originations accounted for about 9 percent of all residential mortgage originations in the United States in 2002.

Why did such rapid growth occur in a previously underserved segment of the market? To a large degree it was a combination of (a) the availability of detailed credit report data, (b) the legal ability to implement risk-based pricing, and (c) the adoption of statistical risk scoring technology by the mortgage industry which allowed risk to be rapidly and consistently measured. In an analysis of home ownership trends since the late 1980s, Federal Reserve Board economists Rafael Bostic and Brian Surrette concluded that "something dramatic has taken place in the home ownership process faced by lower-income families."[26] Eight million more U.S. households became homeowners by the end of the 1990s than was the case at the start of the decade. Home ownership rates rose more sharply for African Americans, Hispanics, and lower-income families than for other groups between 1989 and 1998, but only a small part of these gains were attributable to improvements in their incomes or economic circumstances. Bostic and Surette

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

[25]*Inside B&C Lending*, Vol. 8, Issue 3, Feb. 3, 2002.

[26]Raphael W. Bostic and Brian J. Surette, "Have the Doors Opened Wider? Trends in Homeownership Rates by Race and Income," Federal Reserve Board Working Paper, Apr. 2000.

found that a substantial share of the improvement was due to changes in the ways that mortgage markets function, and cited significant innovation among mortgage lenders in terms of risk measurement and the ability to develop and tailor new products for specific population segments.

The ability of lenders to develop products to (profitably) serve new borrowers and a wider segment of the population is critically dependent on the presence of accurate and timely credit report data. It is to this critical role of credit report data to support accurate decision-making that we now turn.

B. More Accurate Decision-Making

Piercing the "Fog of Uncertainty"

It is no exaggeration to say that credit bureau data has become the cornerstone of the $7 trillion consumer lending industry in the United States. With access to the deepest, most comprehensive consumer payment histories in the world, U.S. creditors now apply statistical scoring models to estimate an individual's repayment risk on virtually every type of consumer loan transaction, including home mortgages. Creditors use scoring to set and adjust virtually every dimension of the loan relationship, including the initial application decision, pricing, collateral requirements on secured loans, size of credit line on unsecured credit cards, authorization of purchases at the point of sale, decisions to cross-sell other financial products, and the appropriate steps to collect the debt if the account becomes delinquent, or even looks like it might become delinquent.[27]

The credit report helps lenders pierce the "fog of uncertainty" that characterizes the risk assessment for a potential new borrower. Lending markets almost always display what economists call an "information asymmetry" between borrowers and lenders. Borrowers typically have more accurate information than lenders about their likelihood of repaying a loan. Lenders have an obvious incentive to evaluate the borrower's creditworthiness, and the outcome will affect whether to approve the loan as well as its price. Borrowers have an incentive to signal their true risk (if it is low) or disguise it (if it is high). Given the amount of the loan principal at stake, both parties have incentives to incur costs (often large ones) to reduce the information asymmetry, and these actions have significant consequences for the operation of credit markets. The emergence of the third-party credit bureau to compile borrower credit histories and distribute them to lenders significantly lowers the cost to all parties of measuring borrower risk.[28]

Credit reports in the United States contain factual information about consumers' current and past credit experience that is compiled over time, from a wide range of sources, and updated daily. Rather than relying on data from a single source or a snapshot of a borrower at a single moment in time, 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. In the words of

[27]Paul Demery, "How Technology Boosted Plastic," *Credit Card Management 10th Anniversary Edition,* May 1998, pp 42-45.

[28]For the seminal article on the role of credit bureaus in making credit markets more efficient see Marco Pagano and Tullio Japelli, "Information Sharing in Credit Markets," *Journal of Finance*, Dec. 1993, pp 1693-1718.

Federal Trade Commission (FTC) Chairman Timothy Muris: The extraordinary amount and variety of consumer credit available in the United States is made possible "because, without anybody's consent, very sensitive information about a person's credit history is given to the credit reporting agencies."[29] Such a complete credit report helps lenders pierce the "fog of uncertainty" surrounding new applicants. The result is a better match of borrowers to loans.

More efficient matching of loans and borrowers produces significant benefits for both consumers and the economy. Economists John Barron and Michael Staten conducted a study that simulated the effect in the United States of imposing restricted credit reporting rules such as those in Australia (which allows the reporting of negative, or default, information only) and various Latin American countries (which developed fragmented, industry-specific reporting systems).[30] An example illustrates the general conclusions. To achieve the same default rate experienced with loans made in the U.S. reporting environment, creditors that were constrained to using the sharply limited credit bureau data present under Australian rules would extend new credit to 11,000 fewer customers for every 100,000 applicants than would be the case if they were allowed to use the more complete data available under U.S. law. The reason is intuitive: when risk assessment tools have less information available to them, creditors are less effective at matching loans to creditworthy borrowers. More loans go to borrowers who will default. More borrowers are rejected who would have repaid. The negative impact on worthy borrowers is greatest for those who are young, have short time on the job or at their residence, have lower incomes, and are generally more financially vulnerable. These are precisely the borrowers for whom the ability to see successful handling of credit on the credit report is most important, to offset attributes that otherwise make them appear to be higher risk.

A statistically valid credit scoring model based on credit bureau data has become the most powerful tool for predicting and managing risk appropriately. Credit bureau data in the United States have been shown to be dramatically more predictive than application information alone, including borrower income.[31] The reason is straightforward. Past payment behavior signals both ability *and* willingness to repay. Creditworthiness can be inferred from the degree to which past and existing lines have been utilized and whether those payments were on time or late. By definition, consumers with "good" credit histories have taken the credit available to them and, subject to their available incomes and economic circumstances, found a way to meet and pay their accounts as agreed. Risk assessment based on credit bureau data rewards those consumers who find a way to make their payments. Consequently, as detailed credit reports enable lenders to do a better job of assessing and pricing borrower risk, they also have an important side effect: they reinforce borrower incentives to manage credit wisely and avoid delinquencies and defaults. In

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

[30]John M. Barron and Michael E. Staten, "The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience," in Margaret Miller, ed., *Credit Reporting Systems and the International Economy*, MIT Press, 2003.

[31]Gary G. Chandler and Lee Parker, "Predictive Value of Credit Reports," *Journal of Retail Banking*, Vol. XI, no. 4, Win. 1989; Gary G. Chandler and Robert W. Johnson, "The Benefit to Consumers from Generic Scoring Models Based on Credit Reports," *IMA Journal of Mathematics Applied in Business and Industry*, Vol. 4, No. 1, Oxford University Press, 1992, pp 61-72; R.B. Avery, R.W. Bostic, P.S. Calem and G.B. Canner, "Credit Risk, Credit Scoring and the Performance of Home Mortgages," *Federal Reserve Bulletin*, Jul. 1996, pp 621-648.

this way, credit reporting improves the performance of the entire market and lowers the costs of making credit available.[32] *All of this further lowers the cost of credit to consumers.*

Credit scoring based on a borrower's own past payment history replaces 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 antidiscrimination and other lending laws. Moreover, validation of statistical scoring models built with credit bureau data prove that these inferences are more accurate and consistent, as well. Federal Reserve Board Chairman Alan Greenspan has noted that access to personal credit history data makes individual financial institutions "*more creditworthy and efficient*," and the U.S. financial services sector "*more transparent and stronger in general*."[33]

Preventing Delinquencies and Defaults

Furthermore, an under-appreciated aspect of today's risk management technology is that it allows lenders to be proactive in *preventing* debt problems, not only in the application phase but even for existing accountholders. Credit scoring that takes into account the full breadth of a borrower's obligations (and past payment history) allows creditors to prevent overextension. Scoring is being used to determine appropriate intervention for borrowers headed for trouble, including possible recommendations for credit counseling assistance.[34] The comprehensive credit reports that have developed under FCRA give U.S. lenders a much broader base of knowledge about a borrower's financial circumstances, and more tools to serve their customers. The broader the lender participation in the voluntary reporting system, the better the information in the credit reports, to the benefit of all lenders and borrowers alike.

Consequently, U.S. delinquency rates are low, remarkably so in the face of such high penetration of credit products across all income segments of the population. In the fourth quarter of 2002 only 3.9 percent of all mortgage borrowers in the United States were delinquent 30 days or more.[35] Only 4.6 percent of all credit card borrowers were delinquent 30 days or more on their

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[32] A. Jorge Padilla and Marco Pagano, "Sharing Default Information as a Borrower Discipline Device," *European Economic Review*, Vol. 44 2000, pp 1951-1980.

[33] Remarks by Alan Greenspan at the Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, Chicago, IL (May 6, 1999) (emphasis added).

[34] For examples see: Paul Demery, "Why Risk Managers Expect More," *Credit Card Management, 10th Anniversary Issue,* May, 1998, pp 34-35; Jane Adler, "Two Faces of the Card Market," *Collections and Credit Risk*, Vol. 7, No 10, Oct., 2002, pp 48-54; Peter Lucas, "Score Updates," *Collections and Credit Risk*, Vol. 7, No 10; Oct. 2002, pp 22-25.

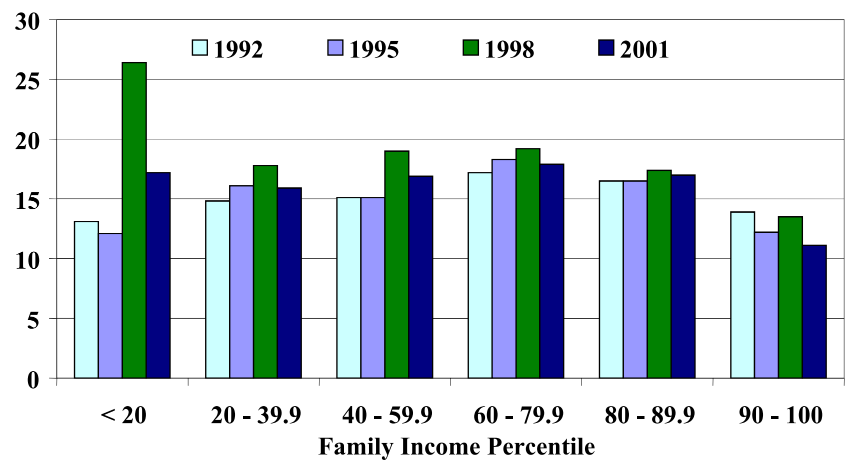
[35] Source: authors' calculations utilizing TrenData, an aggregated credit report database product of Trans Union, LLC.

accounts.[36] Indeed, a scan of 200 million credit reports revealed that 60 percent of U.S. borrowers had *never* had a payment delinquent 30 days or more in the previous seven years.[37]

Despite remarkably low average delinquency rates across all U.S. households, some observers have worried that previously underserved groups may have taken on more new credit than they could handle. If this actually occurred, it follows that we should expect to see evidence of growing household budgetary stress throughout the 1990s, the decade of most rapid gains in credit accessibility and growth in debt relative to income. This would be especially apparent among lower income households, those revealed in Figures 2 and 3 to have experienced the greatest percentage growth in participation in credit markets. However, Figures 4 and 5 provide little support for such an argument. Both figures display data from the Federal Reserve's Surveys of Consumer Finances. Figure 4 displays, by income grouping, the median ratio of households' debt payments relative to their income. With the exception of one observation (1998 for households in the lowest fifth of the income distribution), the share of household income devoted to debt service is remarkably similar across all income groups, suggesting strong self-regulating behavior on the part of both borrowers and creditors.

Figure 4

U.S. Households: Median Ratio of Debt Payments to Family Income



Source: Federal Reserve Board, Surveys of Consumer Finances.

This is not to deny that some households do find themselves with unmanageable debt loads. But, as a group, households in the lower two-fifths of the income distribution do not carry greater debt burdens (payments as a percent of monthly income) than higher income households, and their burden has not significantly increased over the past decade.

Figure 5 displays the percent of households who were delinquent on any debt payment 60 days or more during the previous year. Not surprisingly, the percentage of lower income

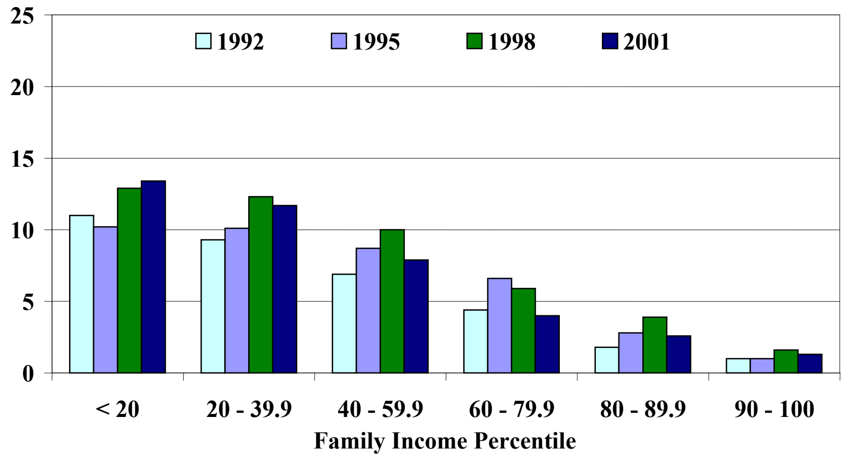
[36]Id.

[37]Consumer Data Industry Association <www.cdiaonline.org>.

households that experience payment difficulties is higher than the delinquency rate for higher income households. Relative to higher income households, those households in the lower part of the income distribution often have incomes that are more vulnerable to interruption and generally have fewer assets to function as a cushion when budgets are tight. Notice that all income groups experienced some rise in delinquencies over the course of the past decade. However, as in the previous figure, there is little evidence that households in the lowest two-fifths of the income distribution experienced any greater increase in delinquency (in percentage terms) than households in the other groupings. All of this suggests net positive benefits to wider credit access across the income spectrum.

Figure 5

Percent of U.S. Households with Any Payment Past Due 60 Days or More



Source: Federal Reserve Board, Surveys of Consumer Finances.

To summarize, in the United States, comprehensive credit reports have improved the efficiency of credit markets, led to powerful improvements in risk-management technology (like credit scoring), and brought consumers more product choices, lower prices, and more equitable treatment. Robust, national credit reporting has made it possible for more people to have access to more credit without increased defaults.

C. 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. A significant obstacle to new entry into an established loan market is the prospect that the only customers interested in the new lender's product are the ones who have been rejected by other lenders because of their higher risk. This problem that economists call "adverse selection" can sharply limit the number of competitors in a market, especially if information on borrower's past credit experience is costly to obtain.[38] Credit report information lowers those costs. It follows that the

[38] Giovanni Dell'Ariccia, Ezra Friedman and Robert Marquez, "Adverse Selection as a Barrier to Entry in the Banking Industry," *RAND Journal of Economics*, Vol. 30, No. 3, Aut. 1999, pp 515-534.

more detailed the credit history available to new entrants, the more competitive will be the market for new loans.

The credit card industry provides a prime example of the pro-competitive effects of nationwide credit reporting in the United States. Through the late 1970s, most credit cardholders acquired their cards through their local financial institutions, often by picking up applications at a branch. Choice was limited to the number of issuers in the local area who happened to offer a card product. Customers in smaller towns had fewer choices than residents of large cities. Local institutions faced little threat of entry into the market by financial institutions outside the state or region, a fact that was reflected in higher prices and little variance in card features.[39]

All of this began to change in the early 1980s. A key legal decision in 1978 gave national banks the ability to launch national credit card marketing programs at far lower cost than before.[40] The ability under the FCRA to acquire information about potential cardholder prospects, irrespective of location, made it possible for companies—both new and established—to enter new geographic markets, often with astounding speed.[41] In particular, the use of prescreening to target applicants provided the jet fuel for the acceleration in card offerings and competition. New entrants used credit reports and other externally acquired information to identify and target low-risk borrowers for their low-rate cards throughout the United States. Retailers and manufacturers introduced their own "co-branded" bank credit cards as unique alternatives to the traditional Visa and MasterCard products being offered by banks. Companies with established products and brands outside the financial services market (General Motors, General Electric, AT&T, Sears) combined data about existing customers of their corporate affiliates with information from credit reports and other external sources to identify and reach likely prospects. Many of these new products came without an annual fee and gave consumers an opportunity to earn cash rebates or free products and services each year depending upon their charge volume. Thanks to the success of those new market entrants, cards offering frequent traveler miles, rebates, and other consumer benefits have become commonplace.

The wave of new entrants to the bankcard market put great downward pressure on the finance charge rate and annual fees charged by existing issuers. Incumbent issuers were forced to make a choice: either leave their rate unchanged and risk defection of their best customers to the new, low-rate entrants or cut finance charge rates and fees. As a result, between 1991 and 1992 the proportion of all revolving bankcard balances in the United States being charged an APR greater than 18.0 percent plummeted from 70 percent to 44 percent in just twelve months.[42]

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[39]For further discussion of competitive conditions in credit card markets see Christopher R. Knittel and Victor Stango, "Price Ceilings as Focal Points for Tacit Collusion: Evidence from Credit Cards," mimeograph, Federal Reserve Bank of Chicago, Nov. 10, 2001.

[40]Marquette National Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299 (1978).

[41]Following its introduction in 1992, the General Motors MasterCard established 2 million accounts and more than $500 million of balances in its first 60 days, making it the most successful credit card launch in U.S. history. See Martin Dickson, "Record Take-Up for GM Card," *Financial Times*, Nov. 17, 1992, p 26.

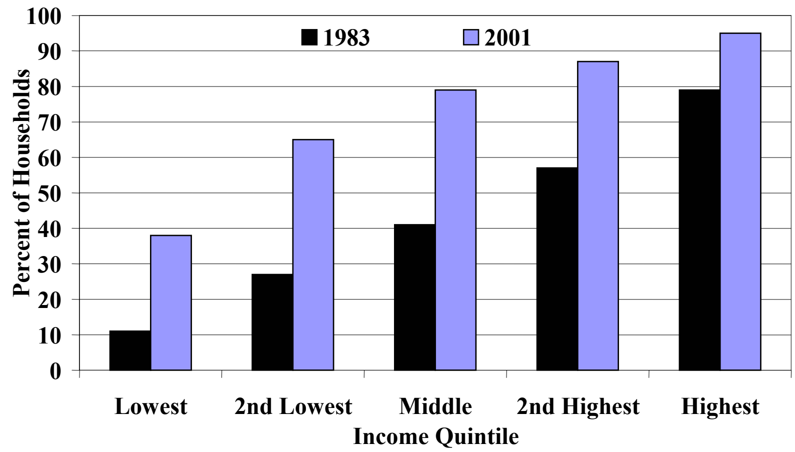
[42]RAM Research Corp., *Card Trak*, no. 28, April, 1993. To be sure, market interest rates (including the prime rate) fell by approximately 400 basis points between 1990 and 1994, but they also fell by over 200 basis points during the mid 1980s, with no comparable decline in credit card interest rates. Competitive pressures were much greater by the early 1990s, forcing issuers to develop innovative pricing strategies to prevent defection of their best customers. It

The ability of new entrants to use credit report data to establish and cultivate relationships with customers thousands of miles away has transformed the competitive landscape in the United States, injecting price and service competition into the credit card market which had not been known for either. Economists Richard Schmalensee and David Evans reinforce this point: "The industry has expanded robustly in the past 20 years. Output measured by the number of cards issued, the amount charged on cards, and the amount of charges that are financed, has risen dramatically. Prices, as measured by the average revenue issuers receive after adjusting for charge-offs, have fallen. The expansion of the industry has taken place through both the continuous entry of new issuers and the growth of existing ones."[43]

Tiered, risk-based pricing based on credit report data made it possible for any given issuer to serve a broader range of customers. In 2001 a Federal Reserve Board study noted that "Many card issuers that in the past offered programs with a single interest rate now offer a broad range of card plans with differing rates depending on credit risk and consumer usage patterns."[44]

Figure 6

U.S. Bankcard Ownership by Household Income



Source: Federal Reserve Board, Surveys of Consumer Finances.

Not surprisingly, one consequence of the explosion in credit card competition and adoption of risk-based pricing has been a dramatic increase in the percentage of U.S. households owning at least one general-purpose bank credit card, from 43 percent in 1983 to 73 percent by 2001. Figure 6 reveals substantial gains in ownership in every income group, but the gains were much larger

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is no coincidence that this was the period during which variable rate cards (with interest rates tied to the prime rate or some similar index) gained substantial market share.

[43] David Evans and Richard Schmalensee, *Paying with Plastic: The Digital Revolution in Buying and Borrowing*, MIT Press, 2000, p 246.

[44] *The Profitability of Credit Card Operations of Depository Institutions*, Board of Governors of the Federal Reserve System, Jun. 2001.

among lower income households. Overall, 30 million more U.S. households had a bankcard in 2001 than was the case in 1983.

The availability of credit report data transformed the competitive landscape of the credit card industry in the United States, intensifying price and service competition.[45] In contrast, laws that would 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. Such laws, Robert Litan, vice president and director of the Economic Studies Program and Cabot Family Chair in Economics at the Brookings Institution, has written, "raise barriers to entry by smaller, and often more innovative, firms and organizations."[46]

Ownership rates for unsecured credit cards puts the difference in access to credit across countries in sharpest perspective. Table 2 compares the number of cards owned per thousand people in the United States verses eight EU countries. Ownership rates are vastly higher in the United States. Indeed, the rankings in card ownership strongly resemble the rankings of countries by the amount of detail in credit bureau reports. This is all the more significant because unsecured, revolving lines of credit are considered to be much higher risk than secured loans because of the lack of collateral and the lender's exposure in the untapped line. Literally, the borrower's reputation (past and future) is the lender's assurance that the loan will be repaid. For this product, comprehensive credit reports are the most valuable.

Although cultural differences across country borders surely explain some of the variance in card ownership in Table 2, it is hard to avoid the conclusion that the presence of more detailed credit histories in the United States is responsible to a large extent for the much higher rate of credit card ownership. Indeed, an Industry Report on the global credit card industry prepared by Morgan Stanley Dean Witter confirms this conclusion regarding the impact of the credit reporting environment as a boon or impediment to new entrants. Of the United Kingdom, the Morgan Stanley report had this to say: "Barriers to entry are low and new companies are still entering. U.K. credit bureaus have access to almost as much data as do those in the United States, allowing companies to launch targeted direct mail campaigns."

Their assessment of competitive conditions and entry prospects in other European countries contrasts sharply. For example, "France is a difficult market to crack." In addition to a cartel-like organization that controls the nation's merchant terminal structure, "[l]ack of a central credit bureau in the country is another hindrance, since the credit information made available through the Banque de France is limited to negative or so-called black data. This information is held for only one year." The report's authors write that while "Italy is an open market," "[t]he biggest obstacle to new entrants is the lack of a centralized credit bureau." They note that "[n]ew

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[45]One card industry executive remarked in 1998, "Ten years ago, credit cards were an under-marketed business. Issuers are now more sophisticated in their approach to underwriting, pricing and targeting offers at consumers. The entry of a lot of powerful marketers like AT&T and General Motors woke people up and made them realize they were not as aggressive as they could be." See Peter Lucas, "Marketing's Long and Winding Road," *Credit Card Management 10th Anniversary Edition*, May 1998, pp 26-30.

[46]Robert E. Litan, *Balancing Costs and Benefits of New Privacy Mandates*, AEI-Brookings Joint Center for Regulatory Studies Working Paper 99-3, p 11 (1999).

entrants in Spain's revolving credit market face some challenges. The lack of availability of credit information on consumers is one problem, as the country does not have centralized credit bureaus to collect and exchange credit information."[47]

***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.

Other evidence from Europe provides additional confirmation of the relationship between robust credit reporting and competition. New service providers in financial services markets require access to credit data to thrive and the presence of comprehensive, accurate, and up-to-date credit reports facilitates new competition. Restrictive or inefficient credit reporting laws act as a barrier to competition by giving the dominant incumbent a monopoly over the information it possesses about its customers and denying new market entrants the information needed to provide and market financial services. In Europe, where comprehensive credit reports are not readily available, financial services are provided by far fewer institutions—*one-tenth* the number that serve U.S. customers—despite the fact that the pan-European market has almost one and one-half times as many households.[48] This means that European consumers have fewer choices of companies and services, fewer locations at which they can obtain financial services, and fewer ATMs—one-third the number in the United States—at which they can obtain and deposit funds.[49]

In France, for example, the EU country with some of the strictest financial privacy laws, seven banks control more than 96 percent of banking assets.[50] Laws that restrict the availability of complete, reliable credit histories help facilitate this type of concentration. The seven dominant French banks, each with assets over $100 billion, already own extensive databases; they have no need to share information about their customers with anyone. In fact, they don't want to share information about their customers. The fact that this system restrains innovation, hurts customer

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[47]Kenneth A. Posner, Athina Meehan and Geula Daniel, *Industry Report: Global Credit Cards*, Morgan Stanley Dean Witter Equity Research, Mar. 21, 2001, pp 75, 78-79, 81, 83.

[48]Walter F. Kitchenman, *The European Union Directive on Privacy as a Barrier to Trade* 6 (The Tower Group, 2000).

[49]Id.

[50]In particular, France does not allow "positive" credit reporting, i.e., delinquent accounts may be reported, but lenders may not share information about accounts in good standing. Consequently, unless a borrower has had past payment difficulties, he has no credit history at all.

choice, and increases price is not a great concern to those banks because the same system also restrains competition and makes it easier to hold customers and capital captive.

D. Speed and Convenience

The depth of information in U.S. credit reports enhances the speed of credit, insurance, 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. A survey of auto lenders in the United States revealed that in 2001, 84 percent of automobile loan applicants received a decision within an hour; 23 percent of applicants received a decision in less than 10 minutes.[51] Many retailers open new charge accounts for customers at the point of sale in less than two minutes. According to FTC 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. Today, we can check our credit card and bank balances over the phone 24 hours a day, we can order books, clothes, or gifts online while we are having our first cup of coffee in the morning, or we can review our finances in a convenient consolidated statement whenever we like. What I personally find most astounding is what occurs all over America at auto dealers every day. If consumers have good credit, they can borrow $10,000 or more from a complete stranger, and actually drive away in a new car in an hour or less. I call this the "miracle of instant credit."[52]

The variety and speed of such services are unheard of in most other countries where restrictive laws often prevent credit bureaus from storing sufficient information on consumer borrowing and payment behavior to support rapid and accurate decision-making. "When you think about it," Muris concluded, "this event is extraordinary. This 'miracle' is only possible because of our credit reporting system."[53]

E. Catalyst to Productivity Growth

The availability of comprehensive and timely credit report data contributes to the mobility of both labor and capital in the U.S. economy. As a result, credit reporting is arguably one of the key elements of the U.S. infrastructure that underpins the remarkable productivity growth of the past decade.

A number of economic studies have now concluded that the proliferation of computer and information technology was largely responsible for the productivity surge in the United States.

[51]Consumer Bankers Association, 2002 Automobile Financing Survey.

[52]Muris, supra.

[53]Id.

However, what was remarkable about this development was that the same factors were available worldwide, but for the most part we did not witness similar productivity growth elsewhere. Economists who study productivity growth are increasingly conceding that the secret to the flexibility and resiliency of the U.S. economy lies in the underlying institutions that promote efficiency in capital and labor markets. These institutions allow both capital and labor to reallocate to their highest valued uses.[54]

A good example of such an institution is the U.S. regulatory framework that facilitates the transfer of personal credit history data for permissible purposes. Portable credit "reputations" give consumers greater mobility, and make us more open to change. From a labor market perspective, the credit reporting system under FCRA has increased our mobility as a society, so that structural shifts within the economy can cause temporary disruptions but 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.

In contrast, more restrictive, and inconsistent, credit reporting laws in Europe 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 the resulting difficulty of obtaining credit from new institutions. As a result, economist Walter Kitchenman writes that consumer lending in Europe "where it exists, is concentrated among a few major banks in each country, each of which has its own large databases."[55] In fact, European consumers, although they outnumber their U.S. counterparts, have access to *one-third* less credit as a percentage of Gross Domestic Product.

A developed credit reporting system makes capital more mobile as well. There is growing, cross-country empirical evidence that the increased efficiency of capital markets is a powerful determinant of growth. Improved risk sharing—by spreading risks over a larger pool of capital and a larger number of investors—lowers the cost of capital, and leads to greater investment.[56] This is why Walter Kitchenman has described the "almost universal reporting" of personal information about consumers as not only the "foundation" of consumer credit in the United States," but also as the "secret ingredient of the U.S. economy's resilience."[57]

Investment in financing small business startups is a prime example. Small business formation in the United States has benefited directly over the past decade from the underlying

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[54]For example, see Christopher Gust and Jaime Marquez, "International Comparisons of Productivity Growth: The Role of Information Technology and Regulatory Practices," International Finance Discussion Papers, No. 727, Board of Governors of the Federal Reserve System, May 2002.

[55]Kitchenman, *European Union Directive*, supra, at 3; Geert Bekaert, Campbell Harvey and Christian Lundlbad, "Does Financial Liberalization Spur Growth?" National Bureau of Economic Research Working Paper No. 8245, Apr. 2001.

[56]Geert Bekaert, Campbell Harvey and Christian Lundlbad, "Does Financial Liberalization Spur Growth?" National Bureau of Economic Research Working Paper No. 8245, National Bureau of Economic Research, Apr. 2001.

[57]Walter F. Kitchenman, *U.S. Credit Reporting: Perceived Benefits Outweigh Privacy Concerns* 1 (The Tower Group 1999).

credit reporting system. According to the National Federation of Independent Businesses, seven out of ten small-business owners start their businesses with less than $20,000.[58] By the early 1990s, credit analysts had determined that personal credit reports for small business owners and partners were highly predictive of the success of the business. Commercial scorecards for evaluating small business loans were introduced to the market in 1995. Since then, research has shown that small business credit scoring is associated with "a net increase in lending to relatively risky marginal borrowers, that would otherwise not receive credit."[59] Other research has shown that, much like the case in consumer credit markets, small businesses are increasingly dealing with banks and other lenders located far away. The authors conclude that "greater, and more timely, availability of borrower credit records, as well as the greater ease of processing these may explain the increased lending at a distance. Consistent with such an explanation, distant firms no longer have to be observably the highest quality credits, suggesting that a wider cross-section of firms can now obtain funding from a particular lender."[60] These findings have great significance for economic growth in the United States. Small businesses represent over 99 percent of all employers in the United States, create 80 percent of all new jobs, and account for about 38 percent of Gross Domestic Product.[61]

As we have seen, credit reporting allows lenders to cut through the "fog of uncertainty" to better evaluate potential borrowers. The transparency of risk in single loans enables creditors to document that risk, and subsequently pool loans of similar risk and sell them to investors. This ability to securitize and resell consumer and mortgage loans in secondary markets brings huge amounts of loanable funds into consumer credit and mortgage markets, making credit cheaper and more readily available.

The enormous growth and new entry into the U.S. credit card market was fueled in part by the influx of loanable funds during the 1990s made possible through securitization. At the end of 1990, there were $1 billion of securitized credit card balances in the United States, less than 1 percent of all outstanding card balances. By the end of 1996, securitized card balances totaled $178 billion, about 45 percent of total outstanding card balances. As of the end of 2002, securitized receivables comprised nearly 56 percent of over $700 billion in revolving credit outstanding. According to Richard C. Drason, associate director at ratings agency Fitch IBCA, securitization "played a major role for smaller players, for players just getting into the business, and for regional players trying to grow nationally. It gave them access to cheaper funds that they might not have been able to obtain."[62] Securitization has been especially helpful to non-depository credit card companies that did not have access to consumer deposits to use to make card loans. The transparency of risk in the accounts that underpin credit card-backed securities gives even distant investors such confidence that MBNA's chief financial officer remarked "Our (card-

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[58]National Federation of Independent Businesses <www.nfib.com>.

[59]Allen N. Berger, W. Scott Frame and Nathan H. Miller, "Credit Scoring and the Availability, Price and Risk of Small Business Credit," Federal Reserve Board Working Paper, April 2002.

[60]Mitchell A. Petersen and Raghuram G. Rajan, "Does Distance Still Matter? The Information Revolution in Small Business Lending," National Bureau of Economic Research Working Paper 7685, May 2000.

[61]National Federation of Independent Businesses <www.nfib.com>.

[62]Linda Punch, "The Legacy of Card Bonds," *Credit Card Management 10th Anniversary Issue*, May 1998, pp 36-38.

backed) securities are well-received in all corners of the globe, from England to the Far East to Australia. Many times the deals are oversubscribed."[63]

Again, the European Union provides a contrast. Cross-border competition has benefited the corporate lending market over the past decade, but consumer loan markets remain fragmented. Conversion to a common currency within the European Union has not been enough to remove persistent cross-border differences in consumer loan interest rates. Adjustments to changing market interest rates conditions are faster in some countries but lag far behind in other countries. Economists have concluded that to lower the cost of consumer loans it will be necessary to encourage cross-border penetration by retail lenders to bring loan rates into closer alignment across countries.[64] Of course, as was noted above, one of the impediments to cross-border consumer lending to some countries is the lack of information about borrowers, a direct result of lack of harmonization of credit reporting rules across EU countries.

F. Public Safety and Security

Credit reports have long played an important role in protecting public safety. For example, one of the "permissible purposes" for which the FCRA permits credit reports to be used is to screen applicants for employment. Because credit reports include public record data, past addresses, and prior names, they have 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.

Credit reports are an important tool in preventing financial fraud, because they provide a comprehensive picture of an individual's financial dealings. They are also becoming an increasingly potent weapon in the fight against identity theft, because they provide a reliable source of dynamic information that can be used to identify applicants for credit and other financial services. Rather than rely on an easily forged document like a driver's license or static information like mother's maiden name, businesses can verify the identity of customers or employees against an array of often-changing data points, such as outstanding mortgage balance or open credit lines.

The federal government has recognized the unique resource that credit reports provide for identity verification and has begun exploring using them as an efficient, cost-effective tool for identifying passengers boarding airplanes, visitors entering government buildings, and in other settings where positive identification is necessary to protect public safety. Moreover, the Transportation Security Administration is exploring an expanded use of credit reports to identify potential terrorists and security threats by analyzing credit report data. To be certain, credit reports are only one of many tools for responding to terrorist threats, and some of these proposed uses pose important policy and legal issues, but these proposals highlight the importance to individual

[63]Id., p 38.

[64]Friedrich Heinemann and Martin Schuler, "Integration Benefits on EU Retail Credit Markets—Evidence from Interest Rate Pass-through," manuscript, Zentrum fur Europaische Wirtschanftsforschung, Mannheim, Germany, Nov. 2001, available at www.ecri.be; Kleimer and Sander, "Consumer Credit Rates in the Eurozone: Evidence on the Emergence of a Single Retail Banking Market," European Credit Research Institute Research Report No. 2, Jan. 2002.

safety and public security of accessible credit reports as sources of comprehensive, nationwide, accurate, and up-to-date information.

G. Reduced Costs

In the United States, comprehensive credit reports have improved the competitiveness and efficiency of credit markets, led to powerful improvements in risk-management technology (like credit scoring), and brought consumers more product choices, lower prices and more equitable treatment. To the extent credit reports enable lenders to do a better job of assessing and pricing borrower risk, they reinforce borrower incentives to manage credit wisely and avoid delinquencies and defaults. *All of this ultimately lowers the cost of credit to consumers.*

Reliable, centralized, and standardized consumer credit information also makes it possible to pool consumer loans and then sell them to investors. Securitization, as already noted, makes more capital available to consumers and greatly reduces the cost of credit. A Tower Group consulting study concluded that U.S. mortgage rates are two full percentage points lower than in Europe because it is possible to securitize and sell mortgage loans.[65] *Consequently, American consumers save as much as $120 billion a year on nearly $6 trillion of outstanding mortgages because of the efficiency and liquidity that credit report data make possible*.[66]

Robust credit reporting contributes to saving consumers money in other ways as well. For example, by making refinancing easy and fast, credit reports allowed eleven million U.S. homeowners to refinance their home mortgages to take advantage of lower interest rates during just a 15-month period in 2001 and early 2002. Doing so allowed them to collectively save an estimated $3.2 billion *annually* in mortgage payments.[67] U.S. lenders are also increasingly taking advantage of accessible credit reports to allow consumers to refinance auto loans. We have also already seen how improved risk sharing—by spreading risks over a larger pool of capital and a larger number of investors—lowers the cost of capital, thereby making credit available to consumers more affordably.

H. Summary

The U.S. credit reporting system has benefited all consumers by facilitating access to more credit and financial services, especially for traditionally underserved populations. It has improved the accuracy of financial decision-making, generating substantial benefits for individual consumers as well as the entire economy. Ubiquitous credit information has significantly enhanced competition and lowered prices by making it possible for existing financial institutions to compete for customers nationally, by enabling businesses other than financial institutions to begin offering competitive products and services, and by leveling the playing field so that new entrants could overcome the advantage of established lenders in assessing new customers. The

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[65]Kitchenman, *U.S. Credit Reporting*.

[66]If mortgage interest rates are 2 percent lower as a result of securitization, 2 percent of $6 trillion in outstanding mortgages equals a $120 billion savings in interest each year.

[67]Glenn Canner, Karen Dynan and Wayne Passmore, "Mortgage Refinancing in 2001 and early 2002," *Federal Reserve Bulletin*, Dec. 2002, pp 469-481.

credit reporting system has significantly reduced costs for mortgages, credit card, and other financial services, saving U.S. consumers hundreds of billions of dollars each year. Accessible credit information has dramatically improved consumer convenience, making possible the "miracle" of instant credit; consumers can even apply for a mortgage or auto loan by phone or via the Internet and get a decision within seconds. The U.S. system of credit reporting greatly enhances consumer mobility and choice, as well as public safety and security.

III. The Threat of New Restrictions on Credit Reporting

Proposals to abandon uniform national standards by eliminating federal preemption for the eight core areas currently protected under FCRA threaten the diverse array of benefits that flow from the current credit reporting system under the FCRA. While most aspects of credit reporting are vulnerable to the high costs of state or local regulation, some are especially at risk. This explains why Congress first preempted state-level regulation in these areas in 1996. There are many examples, but the following three illustrate the risk.

A. Voluntary Reporting

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. Recognizing the special vulnerability of the entire credit reporting system, in 1996 Congress excluded the states from regulating the responsibilities of furnishers of credit information.

Voluntary reporting has already proved fragile as some financial institutions have reportedly withheld information about their best customers out of concern that it might be used by competitors to try to attract those customers. Some credit grantors, for example, choose to report derogatory information only (e.g., delinquencies, charge-offs), but not accounts in good standing. Some choose not to report at all. The industry and regulators have long fought this practice, because 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.[68]

Imposing liability for errors or significant additional burdens on the furnishers of consumer data to credit bureaus would encourage some (perhaps many) firms to curtail or cease reporting. In particular, liability for errors could discourage the reporting of negative events regarding a consumer's account (e.g., delinquency). They would no longer enhance the quality and depth of the bureau information by contributing their portfolio experience. The predictive accuracy of scoring models would quickly deteriorate if non-participation became commonplace. Increased or disparate standards of furnisher liability would be inconsistent with current regulatory initiatives to encourage robust reporting, and could easily undermine the value of credit reporting.

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[68]"It's Essential That Lenders Report Credit Data," *The Commercial Appeal* (Memphis, TN), Jan. 23, 2000, p C2.

B. Obsolescence Determinations

The 1996 amendments also precluded states from regulating when adverse data would be considered "obsolete" and therefore could not be included in credit reports. Currently, information on delinquencies, accounts placed with collection agencies, tax liens and similar events must be excluded from credit reports after seven years (with the exception of a notice of bankruptcy, which may remain for ten years). Proponents of accelerated deletion argue that the old information is "stale" and therefore may no longer be relevant to determining an individual's creditworthiness.

The available evidence, however, suggests that these arguments are wrong. Derogatory information continues to distinguish levels of credit risk "even as the information ages."[69] The results of one 1990 study are particularly interesting. The study found that "significantly more people who declare bankruptcy have older public record derogatory information but none in recent years, than do all people. As a result, if creditors are not allowed to know of public record derogatory information that is four years old or older, they may lose an important predictor of future bankruptcy."[70]

Since storage of old information entails positive costs, simple economics suggests that bureaus will retain data only so long as its value (enhanced prediction of risk) exceeds the storage cost. If creditors find old derogatory information is useful, then they will pay more for files that have it (or purchase reports more frequently). Laws that prohibit the use of such information degrade the reporting system's value for predicting risk.

C. Opt-In Consent

The 1996 amendments to the FCRA explicitly authorized the sharing of personally identifiable information among affiliated companies and with anyone for the purpose of marketing credit or insurance opportunities to consumers, provided that consumers are given an opportunity to opt out of that sharing.[71] Congress thought these activities too important to subject them to divergent state regulation. Some privacy advocates propose allowing states to alter the balance struck in 1996 by shifting to an opt-in regime for using credit report data to market credit products to their residents. Some of these opt-in proposals would require companies to obtain explicit consumer consent prior to using personally identifiable information for prescreening or before sharing such information among affiliates.

An opt-in system for giving consumers choice over information usage is always more expensive than opt-out because it requires each company that wishes to use personal information to target its marketing efforts gain explicit consent from each consumer prior to making any offers. In contrast, opt-out is less costly because it infers permission if consumers don't explicitly object.

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[69]Fair, Isaac Companies, *The Associated Credit Bureaus, Inc. Study on Adverse Information Obsolescence Phase 1*, Sep. 1990, p 3.

[70]Fran Lyons and Lee Allen, "Importance of Aged Public Record Derogatory Information," *Dialogue*, MDS Group, Fall 1990, p 6.

[71]15 U.S.C. §§ 1681a(d)(2)(A)(iii), 1681b(c)(5).

Based on the studies and company experience to date it appears that conditioning the use of information on opt-in consent is tantamount to banning the use outright.[72]

This makes an opt-in system for permissible use an especially great impediment to new and smaller credit market entrants, who lack extensive customer lists of their own or the resources to engage in mass marketing to reach consumers likely to be interested in their products or services. If information for targeting offers is unavailable because the cost of soliciting opt-in consent is too great or because too few customers have received and responded to opt-in requests, new competitors may be unable to market their products and services at all. A proliferation of opt-in requirements across multiple states would balkanize credit marketing. Credit availability would be uneven across the country, but independent of either the creditworthiness of borrowers or underlying economic conditions. Such a trend would erode the consumer benefits from national competition that were highlighted in the previous sections.

IV. National Credit Reporting

Credit reporting in the United States today is inherently national. The value of the entire system depends upon data being collected about borrowers who travel and use credit nationwide, and collected from creditors who are located throughout the country and deal with customers nationwide. This is why credit bureaus have undergone such consolidation and integration during the past half-century. Indeed, credit reporting has contributed to consumer mobility by breaking down entry barriers and opening up markets to national and global competition.

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 has made possible national competition in the market for credit and other financial services. That competition depends on the ability of banks and other card issuers to enter distant markets and provide customer service across state lines. Capturing credit data on a state-by-state basis provides little value because the vast majority of consumers deal with creditors from out of state.[73]

Consumers in the U.S. are remarkably mobile, thanks in part to the ubiquitous availability of credit reports. Forty-two million Americans—approximately 16 percent of the U.S. population—move each year. As of 1998, there were 6 million vacation or second homes in the United States, often in states different than the owners' primary homes.[74] A growing number of

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[72]For a more detailed discussion and results from case studies see Michael E. Staten and Fred Cate, "The Impact of Opt-In Privacy Rules on Retail Credit Markets: A Case Study of MBNA," 52 *Duke Law Journal* (forthcoming 2003).

[73]A simple example illustrates the point. Not a single one of the ten largest bank card issuers is located in Texas, the second-most populous state in the U.S. Those top ten issuers held 83 percent of all bank card receivables at the end of 2001. Consequently, it is quite likely that 80 percent or more of Texans with bank cards are borrowing from and making payments to one or more out-of-state financial institutions. This is the rule rather than the exception, and reflects the national character of U.S. credit markets. *Card Industry Directory*, 2003 Edition, Thomson Media, New York, 2002, p 17.

[74]*Use and Misuse of Social Security Numbers*, Hearings before the Subcomm. on Social Security of the House Comm. on Ways and Means, May 11, 2000 (statement of Stuart K. Pratt).

consumers live in one state and work in another. This is especially true in major urban centers, such as New York, New Jersey, and Connecticut, or Virginia, Maryland, and the District of Columbia, where population is most concentrated.

Compartmentalizing credit histories state-by-state would ill serve consumers as they move, commute, and travel across state lines. It would leave holes (potentially large ones) in a consumer's credit file. Moreover, even if it did not in the case of a particular borrower, the fact that it *could* would greatly reduce the reliability of credit reports. How is a lender to know whether the picture of the consumer that the report presents is complete or not?

The cost of determining which state law or laws applied, and of complying with those laws, could easily undermine the credit reporting system. That system deals in huge volumes of data—over 2 billion trade line updates, 2 million public record items, an average of 1.2 million household address changes a month, and over 200 million individual credit files. Its viability depends on achieving exceptional efficiency in matching and processing updates so that files can be maintained at low marginal cost. In turn, this keeps the cost of providing credit reports low. In the face of greater centralization and unification of markets, and the increased mobility of both consumers and the goods that they desire, crafting, implementing, complying with, and enforcing 51 separate laws governing credit reporting will always be more expensive than is the case with a single law.[75] If state and local laws are inconsistent, compliance costs are greatly exacerbated.

Worse still, it may be impossible for a business to comply with the conflicting provisions of state credit reporting laws in all of the states in which it operates. This is especially true online. The Internet crosses state boundaries and has facilitated truly national (in many cases, global) markets. Yet the technologies of the Internet make it impossible to identify automatically in which state users are located. Even offline, however, businesses face a significant compliance challenge when faced with inconsistent state requirements.[76]

Historically, privacy advocates have argued for the need to replace state and local laws with a single, uniform privacy standard. A national standard offers better and more consistent privacy protection. In regard to the privacy of medical records, Helena Gail Rubenstein, from the Massachusetts Group Insurance Commission, has written that "normatively, privacy advocates

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[75]That number could go far higher: already Daly City, Contra Costa County, San Mateo County, and San Francisco have adopted their own ordinances regulating the sharing of financial information with affiliates and third parties—four separate laws, in addition to applicable federal and state laws, within one 20-mile area. Daly City Ordinance No. 1295 (Sep. 9, 2002), as amended by Ordinance No. 1297 (Nov. 12, 2002); Contra Costa County Ordinance No. 2002-30 (Sep. 24, 2002), as amended by Ordinance No. 2002-44 (Nov. 5, 2002); San Mateo County Ordinance No. 4126 (Aug. 6, 2002), as amended by Ordinance No, 4144 (Nov. 5, 2002); San Francisco City Ordinance No. 237-02 (Dec. 20, 2002).

[76]An ironic example comes from the recent experience of gourmet ice cream manufacturer Ben & Jerry's with food labeling. Although a vocal opponent of genetically altered milk, and one of the first U.S. companies to voluntarily label its products as containing only milk from untreated herds, the company had to abandon this practice—even though it and its customers desired it—"because of the difficulty of complying with multiple state labeling requirements." Dan L. Burk, "The Milk Free Zone: Federal and Local Interests in Regulating RecombinantbST," 22 *Columbia Journal of Environmental Law* 227, 299 (1997).

and data users agree that any health information system that must operate within the confines of fifty different sets of ground rules cannot operate efficiently."[77]

The absence of preemption, Professor Larry Gostin has written, "is self-defeating. It simply pushes the privacy battle into state legislatures and redirects the resources of the provider and research communities to costly lobbying efforts in the fifty state capitals. What will result is a patchwork of rules, as each state makes its own peace with the various interest groups." The absence of preemption, he concluded, in a world in which "data needs do not recognize state boundaries" and businesses "operate in multiple states," is to "increase the cost" to everyone who pays for goods and services in the modern economy.[78]

It is not clear why credit reporting should be different—why consumer privacy would be enhanced by "a patchwork of rules," rather than a uniform national law. How are consumers served, for example, by receiving different notices of their rights under the FCRA or by waiting different amounts of time for reinvestigations of disputed data to be completed, depending upon the state or county or city in which they are located?

The need for a single standard in the core areas of credit reporting is so great that if Congress fails to maintain one through federal legislation, it will likely emerge from the states. When the costs and complexity of complying with state-by-state legislation are high, then in the face of multiple legal standards, the most restrictive tends to dictate business practices. By complying with the most restrictive law, a business hopes to comply with the less restrictive ones as well.

In the case of credit information, states that adopt the most restrictive laws (and that are too populous or important for a business to simply cease to operate in), will set the de facto privacy standard for all other states. In the absence of express federal preemption, the most restrictive state privacy regime will ultimately effectively preempt both the privacy laws of other states and the federal standard as well. This is the irony of the current preemption debate. The question isn't whether there will be de facto preemption, but rather from what source it will come: Congress or one state legislature imposing its laws on the entire country.

Howard Beales, head of the FTC Bureau of Consumer Protection, noted this point when he was a professor at George Washington University. Addressing the specific subject of product advertising, which is similar to credit reporting in terms of its national reach and high cost of entry, Beales wrote that "[t]he high costs of developing advertising and the lack of any marketing reason to distinguish between consumers based on their state of residence mean that, as a practical matter, actions by individual states will determine the content of advertising for consumers nationwide." As with credit reporting, "it is the most restrictive judgment, rather than the most accurate, that will effectively govern," Beales noted. "If the most restrictive judgment" prevails, Beales concluded, "consumers are the likely losers. . . . Indeed, it is hard to imagine a system that

[77]Helena Gail Rubenstein, "If I am Only for Myself, What Am I? A Communitarian Look at the Privacy Stalemate," 25 *American Journal of Law and Medicine* 203 (1999).

[78]Lawrence O. Gostin, "Health Information Privacy," 80 *Cornell Law Review* 451 (1995).

is more likely to encourage advertisers"—or credit bureaus, he might have added—"to avoid altogether the kinds of objective product information that are most valuable to consumers."[79]

V. Conclusion

In 1996 Congress amended the FCRA to ensure that individuals would have the same substantive rights regarding collection and use of their credit histories irrespective of the state in which they live. Congress also guaranteed that the content of credit reports would be consistent across the country and the fundamental unfairness to both consumers and creditors of relevant information being reported under one state's laws but withheld under another's would be avoided. The 1996 amendments guarded against driving furnishers of credit information from the voluntary reporting system by overly burdensome compliance requirements or the threat of liability from separate or even inconsistent state laws. They also ensured that affiliated companies—whether or not dealing with credit information—would be able to share information freely, pursuant to federal law, without having to contend with regulatory barriers erected by state and local governments.

By limiting the term of preemption to seven years, Congress provided a specific opportunity for policymakers to determine how well uniform national reporting standards have served the public. The consistent, overwhelming answer to this question provided based on all of the available evidence we have examined is that the national credit reporting system operating under the amended FCRA has generated extraordinary benefits for individual consumers and for the nation as a whole. Proposals to alter the 1996 framework by allowing the states to intervene in the protected core areas threaten to erode the benefits of robust, national credit reporting that consumers enjoy today.

The economic scope of that threat is impossible to measure in advance, because it depends on the type and severity of adjustments to the existing reporting system and because the benefits of the U.S. credit reporting system are felt so broadly and are intertwined with so many areas of commerce. Nevertheless, a few examples make it clear that the magnitude of the threat posed by new restrictions on credit reporting could easily be in the hundreds of billions of dollars annually.

For example, recall that a Tower Group consulting study calculated that U.S. mortgage rates are two full percentage points lower than in Europe because standardized credit information facilitate the sale and securitization of mortgage loans.[80] That amounts to a $120 billion savings every year on nearly $6 trillion of outstanding mortgages outstanding at the end of 2002. New regulations that would raise the cost and consequently inhibit voluntary reporting by creditors would move the U.S. system closer to the restricted files common in many EU countries, impairing the portfolio risk assessment that is at the heart of securitization. This would lead to higher costs for investors, a reduced supply of loanable funds available in the mortgage markets, and higher mortgage interest rates.

[79]J. Howard Beales, III, "What State Regulators Should Learn From FTC Experience in Regulating Advertising," *Journal of Public Policy & Marketing*, vol. 10, no. 1, Spr. 1991, p 101.

[80]Kitchenman, *U.S. Credit Reporting*.

We have also discussed how less comprehensive credit reports would raise the cost of entry into new markets by all lenders. Recall that competitive pressures in the credit card market in the late 1980s and early 1990s led to a dramatic decline in credit card interest rates. Less competition for new customers would begin to ease the downward pressure on credit card pricing. With over $700 billion in revolving credit outstanding in the U.S. at the end of 2002, every percentage point rise in average credit card interest rates would cost consumers an additional $7 billion annually. Extending this example, since comprehensive credit reports and prescreening enhance competition across all types of consumer credit, every percentage point rise in average consumer loan rates would cost consumers $17 billion in additional finance charges annually.[81]

The economic impact of declining access to credit is difficult to estimate. Certainly, some portion of the 516,000 homes that Americans purchased every month during 2001 would not have been sold had mortgage credit been more expensive and the underwriting standards for loan acceptance been higher. The same is true for some fraction of the 1.4 million cars, SUVs, and light trucks purchased in the average month, the majority of which were financed with loans or leases. Clearly, a reduction in consumer spending on housing and durable goods resulting from tighter credit markets would impose a drag on U.S. economic activity.

All quantitative estimates of the costs of moving to a less comprehensive reporting system are necessarily speculative because they anticipate changes to the U.S. credit reporting system that we have fortunately never endured. Regardless of the magnitude of such dollar cost estimates, the threat of unraveling the gains to individual consumers should give policymakers the greatest 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 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.

In sum, it appears that all of the available evidence—economic and otherwise—suggests that the national reporting system that has evolved under FCRA has helped make the United States the world leader in the development of competitive consumer and mortgage credit markets.

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[81]Based on $1.72 trillion in outstanding (non-mortgage) consumer credit, as was the case at the end of 2002.

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