Statement by

Michael A. Turner, Ph.D.
President and Senior Scholar
The Information Policy Institute

Before the

U.S. House of Representatives
Committee on Financial Services,
Subcommittee on Financial Institutions and Consumer Credit

Concerning

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

8 May 2003
2128 Rayburn House Office Building

Introduction

Good morning Mr. Chairman and honorable members of the Subcommittee. I am grateful for the opportunity to testify before you today. I commend Chairman Bachus and Chairman Oxley, and Congressman Frank for their leadership on the complex yet crucial issue of the national credit reporting system.

My name is Michael Turner and I am President and Senior Scholar of the Information Policy Institute. The Institute is a non-profit, non-partisan research organization based in New York City – and is the only institution of its kind dedicated exclusively to issues involving the regulation of information, both domestically and globally.

In the past year alone, the Institute has taken its research findings to various federal, state, and international legislative and regulatory bodies on issues ranging from media ownership to trans-border data flows. We have worked with states' Attorneys General offices to craft a consumer survey on state do-not-call registries and shared the results with the FTC; we worked very closely with consumer groups to craft comments criticizing the FCC's proposed relaxation of media ownership rules; we participated in a task force on homeland security and information technology coordinated by the Markle Foundation, the Center for Strategic and International Studies (CSIS) and the Brookings Institution the results of which were later presented to Congress; we drafted a concept piece examining the impact of adopting an EU-style data regime on developing countries that was distributed at a recent APEC summit; Institute fellows generated a study measuring the economic impact of proposed financial services data restriction legislation in California; and personally, I am currently serving as an expert economic witness on behalf of a small firm in a pending antitrust suit against a multi-media giant. In short, during the past year the Institute has addressed information policy issues on the state, federal, and international levels and has consistently based its analysis on objective facts rather than any identifiable ideological predisposition.

Despite the significance of the issues the Institute has studied to date, perhaps none is as important to the entire population on a day-to-day basis as that of the national credit reporting system. America has long been called the land of opportunity, and more recently there has been an emphasis on <u>equal</u> opportunity. The national credit reporting system is the tool that ensures that all consumers – irrespective of their age, gender, religion, or ethnicity – are given an equal opportunity to access credit.

I am here today to share some of the preliminary results from research the Institute has recently undertaken designed to quantify the costs and benefits to consumers and the economy from the national credit reporting system, and the potential consequences should Congress decide to allow the Fair Credit Reporting Act's (FCRA's) strengthened preemptive provisions to lapse.

This research is made possible by a grant from the National Chamber Foundation. The NCF is an independent, nonprofit, public policy research organization affiliated with the U.S. Chamber of Commerce -- America's largest business federation. While the NCF is supporting the study, the research program and the analysis are entirely the product of the Institute's own independent efforts.

National Significance of the Credit Reporting System

A good place to begin is with a clear articulation of the importance of this issue. The national credit reporting system's mission is critical to the efficient functioning of the American economy. It should be classified with other vital infrastructure industries, such as the public switched telephone network and the national power grid. Like these other vital industries, consumers frequently take the benefits for granted. They expect their calls to connect every time, and their appliances to always turn on, and, when they qualify, receive credit instantly.

As with the public telephone network and the national electricity grid, the national credit reporting system has a long history and has evolved greatly over time. None of these infrastructure systems are perfect, and all three are prone to occasional errors. Telephone service can be interrupted, power failures do occur, and credit reports sometimes contain inaccuracies. Because of these imperfections, firms in these industries invest hundreds of millions of dollars annually to maintain and improve systems operations to the benefit of the consumer.

Today, just as the great majority of Americans enjoy the benefits of increasingly sophisticated telecommunications and energy distribution technologies, so, too, do most Americans benefit every day from the national consumer credit reporting system that has evolved under the protection of the current federal preemptions. And, when the system breaks down and inaccuracies occur, the law today provides a uniform, understandable, national standard for remediation. One of the key aims of the research we are undertaking is to determine whether it is the uniformity of the system which provides so many of the consumer and economic benefits, and to examine whether these benefits are threatened by the expiration of the preemptions.

The FCRA Progress Report: Greater Access, Lower Prices, Better Quality

As I have already mentioned, the national credit reporting system is not without flaws. However, comparing today's national credit reporting system to some hypothetical notion of a perfect system is neither appropriate nor useful.

What is both necessary and meaningful is a dynamic analysis of the performance of the national credit reporting system -- and its governance structure -- over time. Analysis of the Survey of Consumer Finances, conducted by the Federal Reserve Board, suggests that consumer credit markets have progressed tremendously:

➢ The percentage of families with home-secured debt increased from 35.7% in 1983 to 44.6% in 2001, an increase of over 25%. The percentage of minorities with such debt increased from 21.3% to 35.1%, an increase of 65%.

➢ While increases in home ownership are a function of a variety of factors – prolonged, sustained economic growth during past two decades – preliminary findings from our study indicate that the <u>upswing in home ownership</u> in minority and low income households during the late 1980s and 1990s strongly correlates with the pervasive use of sophisticated risk models and automated underwriting.

➢ In 1983, 60.2% of all households owned a primary residence; by 2001 the total had increased to 67.7%. The largest increases were again observed among the lower income and minority households. Ownership among all minorities increased from 33.9% to 47.1%, an increase of almost 40%.

➢ Expanding access to credit not only increases the opportunity for home ownership, but also provides the <u>opportunity for wealth formation</u> through appreciation and mortgage paydowns. In fact, a recent Federal Reserve Bulletin states that "…the equity that has accumulated in homes is one of the largest components of U.S. household wealth."[1]

➢ Between 1970 and 2001 the overall share of families with credit cards increased from 16 to 73 percent. That's an increase of more than 450% in little more than one generation. This enables more consumers to use credit cards to build a credit record, enables more consumers to smooth out temporary cash flow disruptions using credit, and permits consumers to purchase goods they may want or need today against their future earnings.

➢ Credit accessibility has been extended to groups that were previously not able to obtain inexpensive credit. For households in the lowest income quintile the percent with a credit card increased from 2% in 1970 to 38% in 2001.

➢ Approximately 95% of households in the top income quintile have at least one credit card. Tentative findings from our analysis suggests that because of risk-tiering -- made possible by sophisticated credit modeling -- the gap between the top and bottom has narrowed considerably.

➢ The percentage of minority families with bank-type credit cards has more than doubled over the last 20 years, growing from 26% in 1983 to more than 54% in 2001. Growth was most pronounced among African American families, whose usage grew by 137% during this period. Full-file credit reporting, made possible by the preemptive provisions of the FCRA, enables lenders to distinguish different degrees of risk far better than older, less sophisticated techniques. For instance, if credit bureaus and lenders were forced to rely on Census track data, it is highly likely that many low-risk and better-risk borrowers from minority communities would not be extended the credit they deserve.

---

[1] Canner, Glen B., Thomas Durkin, and Charles A. Luckett. "Recent Developments in Home Equity Lending," *Federal Reserve Bulletin*, April, 1998. pg. 241.

- Despite the increased access to credit cards the median balance has remained stable. The FRB Survey of Consumer Finances showed that the median balance was unchanged between 1998 and 2001.[2]

Research Methodology and Assumptions

These findings are highly suggestive on their own of a system and a regulatory environment that functions remarkably well. However, the point of objective research is to unearth the facts behind the facts. That is, what are the key drivers of what appear to be remarkable improvements in the access, growth, and fairness of consumer credit? The Institute is currently undertaking a rigorous quantitative analysis of several possible causes:

- Has automated underwriting contributed to the availability of home mortgage loans and homeownership? Using primary and secondary research, discussed in more depth below, early results from our analysis indicates that the "mass customization" of the mortgage market has played a critical role in the recent increase in the homeownership rates, particularly for segments of the population that were previously underserved.

- Have uniform national standards for credit reporting contributed to a robust consumer credit market? How would the sunset of the preemptive provisions affect the ability of lenders to extend credit to borrowers? Based on an extensive review of recent state legislative proposals, the Institute has created a number of possible post-FCRA sunset scenarios. The Institute is working with credit grantors and credit bureaus to examine the impact of the sunset of the preemptive provisions enacted in 1996 on their ability to model risk, and how this would affect the accessibility and price of credit. The research examines existing state proposals, and models their likely impact on the ability of credit bureaus and financial institutions to model risk based on a sample size of 4.5 million credit files.

- Has the ability to prescreen made consumer credit markets more competitive? How would restrictions on this method of customer acquisition affect the cost and availability of consumer credit? While our results on this component are thus far incomplete, we do have some preliminary findings. Based on responses from 6 of the top 13 bank issuers, prescreening is undoubtedly an important method of customer acquisition. Our preliminary responses suggest that the cost of customer acquisition via prescreening is, on average, less than of other methods of customer acquisition. Moreover, increases in the cost of customer acquisition as a result of restrictions on prescreening, would lead issuers to acquire fewer customers.

---

[2] Aizcorbe, Ann etc. "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances", Federal Reserve Bulletin, January 2003, page 24.

Home Mortgages: Lower Prices, Increased Access and Greater Choice

The cost of a mortgage has dropped significantly over the past 20 years, fueled by intense competition and the growth of the secondary mortgage market. While spreads are affected by broad market forces, relative mortgage rates have, for the most part, trended downward and have remained relatively low even in periods of significant stress—including the collapse of the thrifts in the early 1990s, the international financial crisis of 1998, and the unprecedented refinancing booms of 1992, 1998, and 2002. If spreads today were at their early 1980s levels, the interest rate on a 30 year fixed rate mortgage would be over 7 percent, compared to the 6 percent rate available today. With a total mortgage stock of $5.4 trillion in 2001, **a one percent (100 basis points) savings in the cost of mortgage funds translates into $54 billion in annual savings to consumers.**[3]

The mortgage market is also characterized by a wide array of low-cost products increasingly tailored to the individual borrower's needs. Consumers can now chose among a mix of fixed- and adjustable-rate products which differ with respect to the term of the loan, the frequency of the rate adjustment, and the size of the required down payment. In addition, the industry has created a host of products and programs designed to meet the specific needs of lower income and minority families. This "mass customization" of the mortgage market has undoubtedly played a critical role in the recent increase in the homeownership rate, particularly for segments of the population that were previously underserved.

Uniform National Data Standards and the Safety and Soundness of Consumer Credit Markets

Summarizing his view of federal credit information sharing laws, Federal Reserve Board Chairman Alan Greenspan recently said:

"There is just no question that unless we have some major sophisticated system of credit evaluation continuously updated, we'll have very great difficulty in maintaining the level of consumer credit currently available because clearly without the information that comes from credit bureaus and other sources, lenders would have to impose an additional risk premium – because of the uncertainty – before they make such loans or not make those loans at all."[4]

The question Greenspan's statement begs is whether or not the preemption of state law undertaken in the 1996 amendments to the FCRA have been responsible for maintaining the quality of information available to lenders. As explained above, we are currently

[3] Calculation of mortgage savings: **Step A.** If spreads today were at their early 1980s levels, the interest rate on a 30 year fixed rate mortgage would be over 7 percent, compared to the 6 percent rate available today. **Step B.** The total mortgage stock is $5.4 trillion in 2001. **Step C.** From A., mortgages are 1 percent less expensive. One percent times $5.4 trillion (see B) = $54 billion in annual savings to consumers.

[4] April 30, 2003 report to the Committee on Financial Services by Federal Reserve Chairman Alan Greenspan, in response to a question by Representative Gillmor. Cited from article by Reuters, April 30, 2003. Available at http://www.cardforum.com/html/ccmissue/may02cov1.htm.

conducting a quantitative analysis that seeks to model the effects of FCRA-relevant state proposals on the quality of credit report information. For example, changes to the obsolescence rate of the data contained in credit reports – a component of the Act that currently enjoys federal preemption -- would undoubtedly have an effect on the ability of lenders to model risk.

While we have yet to complete the quantitative component of this portion of our discussion, a survey of state bills is suggestive on its own. During the current legislative session, there have been nearly 250 FCRA-related bills introduced in 46 states.[5] The diversity of these bills – the Institute's own analysis has identified 12 separate categories of such bills – strongly suggests that a post-preemption world will not be characterized by legislative coordination and harmony among the states.

Should the preemptions sunset, one possible near-term result is horizontal preemption – as is likely to occur should a single large state like California enact data restrictions inconsistent with the current FCRA regime. In a very real sense, then, Congress must decide whether it wishes to have its current authority over credit reporting usurped by lawmakers in a single state.

The Relationship between Prescreening and Competitive Credit Markets

In theory, not only do competitive markets offer wide choices of products and service to consumers, but competition in the marketplace also restrains both the prices sellers are able to charge and the profitability of their operations. The data seem to indicate that what is true in theory is also true in practice for both credit cards and mortgages.

For example, in the not so distant past, payment cards nearly all featured the same interest rate (19.8 percent) and yearly fee ($20)[6] and had no ancillary benefits. Likewise, the conventional mortgage market was dominated by 30 year fixed rate mortgages requiring a minimum of 20 percent down. Continuing competition and growing innovation in the marketplace has provided consumers with far more choices today.

While there is not a government-published series showing a price index for credit cards, economists David Evans and Richard Schmalansee have computed one for the period 1984 to 1996.[7] According to their index — which incorporates changes in fees as well as interest rates-- prices declined by almost 35 percent between the first quarter of 1984 and the fourth quarter of 1996. This price decline is particularly significant, given that the

---

5 Data from Information Policy Institute research, in conjunction with Kimbell, Sherman & Ellis. April 2003. Bills included according to criteria for germaneness. Criteria and methodology discussed in forthcoming study by the Information Policy Institute.

6 "Capital One Financial Corporation," Harvard Business School Case Study 9-700-124, Rev. May 1, 2001, Christopher H. Paige.

7 David Evans and Richard Schmalansee, Paying with Plastic: The Digital Revolution in Buying and Borrowing, The MIT Press, 1999, p 238-240.

quality of credit cards was also increasing. Evans and Schmalansee attribute these favorable trends to increased competition in the market.
If the index has remained stable since 1997, consumers will have reaped huge savings from this increased competition. With revenues (net of charge-offs) for bank card issuers of $62.6 billion in 2001, [8] **consumer savings from the increased competition would be about $30 billion per year.** [9]

Consumers also enjoy continual increases in the quality of credit cards. Many credit cards today not only provide credit and ease of transactions, but also additional features and benefits, ranging from insurance to purchase protection to rebates and discounts. The Federal Reserve Board collected data on the frequency of such additional features in its most recent survey of the largest credit card issuers.[10] According to this survey, the average card had two or more added features. As shown in Figure 1 below, the most common added feature was travel accident insurance, followed by automobile rental insurance and a reduced introductory rate.

Figure 1: Credit Card Features

DESCRIPTION	COUNT	FREQUENCY OF INSTITUTIONS THAT REPORTED
Rebates on purchases	5	4.5%
Extension of manufacturer's warranty	16	14.5%
Purchase protection/security	17	15.5%
Travel accident insurance	85	77.3%
Travel-related discounts	22	20.0%
Automobile rental insurance	36	32.7%
Non-travel-related goods and services	15	13.6%
Credit card registration	13	11.8%
Reduced introductory interest rate available	33	30.0%
Other, not specified	33	30.0%
Reporting Firms	110	

Finally, not only do payment cards offer additional services, but they have become more convenient to use over the years. For example, a recent advertisement on a United Mileage Plus Visa card noted that the consumer has online access to the account, zero

[8] Calculated from figures in Credit Card Management, A Little Help From UNCLE SAM, James J. Daly,
[9] **Calculation of credit card savings: Step A.** According to Evans and Schmalansee, index prices declined by almost 35 percent between the first quarter of 1984 and the fourth quarter of 1996. **Step B.** If prices have gone down by 35 percent and stayed there, prices are about 65 percent of what they would have been. **Step C.** To return price to the levels of where they would have been, they would increase by 35 percent divided by 65 percent or by 53.8 percent. **Step D**. 53.8 percent of 62.6 billion of revenues (net of charge-offs) is $33.7 billion, which is about $30 billion.
[10] Op. Cit. 2

liability for fraudulent purchases, an option to change the payment due date, and the ability to pay by phone.

These consumer benefits are sizeable and real -- and would be put at risk should Congress fail to reauthorize the strengthened preemptive provision that includes prescreening among the permissible purposes. A number of states, including several large ones, have already proposed to prohibit the dissemination of prescreened firm offers of credit.[11] While well-intended, it is unlikely that these legislators fully understand the causal link between prescreening, competition in the credit card industry, and the full range of consumer benefits described above.

Prescreening Does Not Drive Identity Theft

Undeniably, identity theft is a serious and growing crime. One recent study estimated that the incidence of identity theft has increased from around 50,000 cases per year in 1996 to more than 150,000 in 2002.[12] While most victims generally don't know how their personal information was stolen, the two primary methods reported by the FTC were access through relationship with the victim (52.5%) and lost or stolen wallet (34.4%).[13]

Some seeking to change the FCRA's strengthened preemptive provisions have argued that prescreening is harmful as it affords identity thieves an easy opportunity to fraudulently open a line of credit in another person's name.

Preliminary results from our study offer several reasons why prescreened credit card offers do not drive identity theft. First, prescreened credit card offers do not include the prerequisite personal information needed to commit identity theft.[14] Second, as part of the prescreen process, credit bureaus routinely filter out accounts identified as being at a high risk for fraud. Third, when applying for a card, an individual must provide personal and financial information that must be authenticated by a credit card issuer. Credit card applications, resulting from prescreened solicitations, are not any less rigorous in their requirements that the applicant provide information verifying their identity than other types of credit applications.

---

[11] As of the first week of April, 2003 there were proposals pending in 5 states that would restrict the ability of lenders to offer prescreened firm offers of credit. States with such a proposal include California, Connecticut, Massachusetts, New York, and Pennsylvania.

[12] Beckett, Paul and Jathon Sapsford. "As Credit Card Theft Grows, A Tussle Over Paying to Stop It." *The Wall Street* Journal. 1 May 2003. Page 1. Source of data is Celent Communications.

[13] GAO 02-363 at 27-28.

[14] Prescreened offers of credit contain only name and address, which is available on virtually every other piece of mail.

The vast majority of credit card issuers review the application using a variety of sophisticated automated tools. Inconsistencies, such as newly-changed addresses, raise red flags and initiate a barrage of additional questions. **These products are very successful, identifying as much as 80% of fraudulent applications before the accounts are ever opened**.[15]

Finally, prescreened credit card offers simply have a low incidence of fraud. For instance, preliminary data from our survey of credit card issuers indicates that prescreened credit card solicitations are significantly less likely to result in fraud than other forms of new account acquisition.[16] In some cases, this number is substantially higher. While prescreened credit card offers are unproblematic, we do believe that credit card applications through the Internet – which are routinely between 2 and 5 times more likely to result in fraud than accounts acquired through other media – deserve further scrutiny. It makes some sense that the incidence of identity theft and fraud are higher on the Internet, as identity thieves are more likely to utilize the most anonymous medium. Further, unlike prescreened firm offers of credit through the mail, which are almost always checked against fraud databases, applicants on the Internet are self-selected, so there is no preliminary fraud screen.

Ultimately, however, should Congress permit the preemptive provision on prescreening to expire, and states, in turn, move to prohibit prescreened credit card offers, issuers will have to reach consumers through other, riskier channels. Oddly, a ban on prescreening would likely result in an increase in fraud and identity theft – precisely the opposite of the intended effect.

Consumer Credit Helps Finance Small and New Businesses

Credit cards represent an important source of financing for small businesses. In 1998 about 45 percent of all small businesses (defined as those with fewer than 500 employees) used personal credit cards as a financing source.[17] Among these small businesses, firms with a smaller number of employees and smaller sales, have a higher prevalence of personal credit card use. Credit cards are even more important sources of financing for those firms that have been rejected for other sources of financing. Among those who had sometimes or always been denied loans, 65 percent used their personal cards to finance their business, while among those who had not been denied, only 45 percent uses their personal credit cards.[18]

---

15 Preliminary finding based upon April 2003 survey of major financial institutions and credit reporting agencies. Final figures will be included in forthcoming study by Information Policy Institute.
16 Op. Cit.
17 Financial Services Used by Small Business: Evidence from the 1998 Survey of Small Business Finances, Marianne P. Bitler, Alicia M. Robb, and John D. Wolken, Federal Reserve Bulletin, April 2001, p 192.
18 Calculated from data in the 1998 Survey of Small Business Finances

Consumers Generally Satisfied with Current System

Whether consumers are satisfied with the widening access to credit is of course a complicated matter. Certainly, if behavior reveals preferences, consumers want access to greater credit and do in fact acquire more credit when approved and offered. The answer is in many ways a plural one made so by the fact that the extension of credit comprises vast areas of consumption, from homes and education to travel, restaurants and books, by wider segments of the population for a diversity of purposes. Homeownership certainly seems to meet the aspirations of many households. And it is unlikely that historically underserved populations who now have greater access to the possibility of owning a home would want a return to the earlier credit regime.

However, surveys of credit card users paint a mixed picture. Majorities of consumers simultaneously believe that credit card companies make too much credit available[19], that overspending is the fault of the consumer[20], and yet also are satisfied in their dealings with credit card issuers, believing that they provide a useful service[21]. What has changed significantly is the satisfaction that consumers have in their dealings with credit card companies; whereas a majority report being satisfied in 2000, in 1977 only 17% did so.[22] Reduction of access to credit as a means to prevent overextension by borrowers, of course, risks reorienting policy towards the paternalistic. But the fear of general overextension appears, if the survey results are right, to be a fear of the other peoples' credit habits as opposed to self-evaluation for the majority of credit card users.

National Credit Reporting System Not Perfect, But Works Very Well

If I can leave you with one takeaway point, it is that the national credit reporting system that has crystallized under the FCRA, works exceedingly well. The consumer and economic benefits, as I have briefly documented in this testimony and as our forthcoming research will quantitatively demonstrate, are pervasive and substantial.

The national credit reporting system, as with the public telephone network and the national power grid, is an essential facility to the American economic infrastructure. None of these systems are perfect, yet all play a vital role in the day-to-day economic behavior of millions of consumers. New regulations have never prevented power outages or disruptions in phone service, nor are they likely to solve the systems maintenance issues in the national credit reporting system.

---

[19] Durkin reports that 68% 'strongly agree' and 20% 'agree somewhat' with the statement "Credit card companies make too much credit available to most people". Thomas Durkin, . p. 629

[20] Durkin reports that 63% 'strongly agree' and 27% 'agree somewhat' with the statement "Overspending is the fault of consumers, not the credit card companies".

[21] Durkin reports that 51% 'strongly agree' and 40% 'agree somewhat' with the statement "I am generally satisfied with my dealings with the credit card company." 44% 'strongly agree' and 48% 'agree somewhat' with the statement that "Credit card companies provide a useful service to consumers."

[22] That is, only 17% strongly agreed with the statement that they were satisfied in their dealing with credit card companies.

Given the vital economic role played by the national credit reporting system, the ubiquitous economic and consumer benefits evidenced by data from the past 30 years, and the overwhelming consumer satisfaction with the current system, we strongly encourage Congress to make permanent the preemptive provision of the FCRA.

By taking this step, Congress is ensuring that all Americans -- regardless of their age, income, ethnicity, and gender – are given equal access to the opportunities that access to credit provides.