Testimony of

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before the
House of Representatives Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

"The Role of FCRA in the Credit Granting Process"

June 12, 2003

Chairman Bachus, Ranking Member Sanders and Members of the Subcommittee. My name is Scott Hildebrand and I am appearing before you on behalf of Capital One Financial Corporation where I serve in the capacity as Vice President for Direct Marketing Services. On behalf of Capital One, let me express my thanks to you and Chairman Oxley for the leadership you have shown on this important issue. We greatly appreciate this opportunity to discuss the "Role of the Fair Credit Reporting Act (FCRA) in the Credit Granting Process." We believe that the permanent extension of the national standards contained in the FCRA is essential to the continued health of our nation's economy. Since its enactment, the FCRA has delivered extraordinary benefits to consumers, helping to fuel innovation and competition in the financial services industry that has made credit less costly and more widely available that at any time in U.S. history.

Capital One is one of the top 10 largest credit card issuers in the nation, and a diversified financial services company with over 48 million customer accounts and $68 billion in managed loans outstanding. In addition to credit cards, we are one of the nation's premier auto finance companies, and also offer our customers an array of banking and related products. We employ nearly 18,000 associates worldwide, with offices around the country and overseas.

I. An Overview of the Role of the FCRA in Creating a National Credit Granting Process

The FCRA Created a National Competitive Environment for Credit Grantors

In many ways, Capital One is a creation of the competitive environment established by the uniformity provisions of the FCRA. The primary role of the FCRA is to benefit consumers by providing a national framework of rules governing the use of credit information that does not favor any particular type of lender or corporate structure in any particular geographic location. In other words, to create a vibrant nationwide marketplace free of the old paradigm of dominant local or regional institutions which tended to stifle competition and with it, consumer choice.

That competition is alive and well today. In 2001, approximately 6800 financial institutions issued general purpose credit cards such as MasterCard and Visa, in addition to those issued by American Express, Discover and many retailers.[1] A 2002 Federal Reserve survey indicates that of the 176 largest credit card issuers, 64 distribute their cards nationally, Capital One among them.[2] Obviously, this market is not dominated by any one issuer. There are few barriers to entry and exit. Over the past year, the top 10 issuers lost market share to newcomers such as Juniper Bank and the banking arm of State Farm Insurance.[3]

[1] *The Profitability of Credit Card Operations of Depository Institutions: An Annual Report by the Board of Governors of the Federal Reserve System,* June 2001.
[2] *Ibid.*
[3] *Credit Cards, 2003,* SMR Research.

Competition remains intense, and everyday at Capital One, our associates work hard to retain our existing customers, acquire customers new to the market and, not surprisingly, to attract the customers of our competitors with better offerings. This competitive environment commenced 30 years ago with the passage of the FCRA and accelerated greatly with the amendments to the Act in 1996. It is no exaggeration to say that we would not have seen this level of competition in the balkanized, localized credit card markets of 30 years ago – markets that featured high, largely undifferentiated pricing combined with an onerous and highly subjective application process. Worse still, availability and access were greatly limited. By and large, you did not lend money to individuals that you did not "know" in a particular community, and virtually all consumer lending occurred through a "bricks and mortar" delivery system which favored location over product choice.

Beginnings of the Modern National Underwriting System

With developments in information technology, the credit granting process began to change. The FCRA was originally passed in 1974 to acknowledge the beginnings of a national consumer credit market. Credit became more widely available on a national basis, as credit bureaus developed large databases that provided lenders with a more holistic and consistent view of a particular consumer's risk characteristics. Pricing was still not highly differentiated, but access had improved significantly over the old balkanized model. Nevertheless, approximately half of the eligible U.S. population could still not qualify for a credit card.

Even as late as 1987, the credit card market was mired in a "one size fits all" approach, characterized by uniform interest rates and annual fees.

Largest Ten Issuers (1987)	APR	AMF
Citibank	19.8%	$20
Bank America	19.8%	$20
Chase Manhattan	19.8%	$20
First Chicago	19.8%	$20
Wells Fargo	19.8%	$20
First Interstate	19.8%	$20
Manufacturers Hanover	19.8%	$20
MNC Financial	19.8%	$20
Marine Midland	19.8%	$20
Security Pacific	19.8%	$20

The market was ripe for innovation, and companies like Capital One saw an opportunity to utilize the information provided by our national credit reporting system to customize product offerings to customers based on their particular needs, interests and risk profiles. Not coincidentally, the rise of Capital One, and of information based underwriting and marketing in the lending arena, really begins at the time of the 1996 amendments to the FCRA.

Our founders realized that the "one size fits all" approach made little sense in an environment where each consumer possessed vastly different needs and characteristics. While some consumers were risky, many more were not. Without the ability to differentiate one from another, however, lenders were compelled to raise prices to cover the cost of higher credit losses, or to cut back on the granting of credit to reduce the losses themselves. Either way, consumers suffered. The less risky customers were simply paying too much, and for the rest, credit was hard to come by – if available at all.

Capital One was able to utilize information within the legal framework provided by the FCRA to make significant advances in underwriting – better distinguishing the risk characteristics of our customer base. The benefits of greater access to better information went far beyond risk analysis, however. Capital One and other companies were also able to utilize information to create profound innovations in the marketing and design of credit cards. Our company led the charge with new product ideas like balance transfers, where customers could shift balances away from high priced cards to our lower priced offerings, and low introductory rates. The resulting reductions in price and penetration into traditionally underserved markets sparked a consumer revolution known as the "democratization of credit."

By 2003, the moribund competition and flat pricing structure of old was no more. In its place came fierce price competition which has produced billions of dollars in savings for consumers across the country.

Largest Ten Issuers (March 2003)	Lowest Long-Term APR	AMF
Capital One	6.90 % Fixed	$0
Chase	7.24% Variable	$0
Bank of America	7.90% Fixed	$0
MBNA	7.90% Fixed	$0
Bank One	8.90% Fixed	$0
Fleet	8.99% Variable	$0
Providian	8.99% Fixed	$0
American Express	9.24% Variable	$0
Discover	9.99% Variable	$0
Citibank	10.24% Variable	$0

Notably, these numbers actually fail to capture the true savings to consumers of increased competition, as they do not take into consideration the widespread availability of low introductory and balance transfer rates.

The last decade also saw significant developments in the pioneering of affinity cards, with benefits for consumers and the organizations they most value; rewards programs which provide consumers with value added benefits ranging from airline miles to college savings plans; and co-branded products, which allow consumer to enjoy discounts and other privileges at their favorite retail outlets.

Capital One has been able to take this market leading approach in reinventing other lending businesses, including auto finance. Through our affiliates, Capital One Auto Finance and PeopleFirst, we have pioneered innovations such as a unique auto refinance product that allows consumers to take advantage of lower rates, like they do when mortgage rates decline. Our on-line loan approval process qualifies individuals for full pre-financing of their auto loans in minutes, at industry leading rates, eliminating the lengthy, unpleasant and often costly trip to the dealer's finance desk.

The power of this heightened competition has not been lost on consumers – in just eight years as an independent company, Capital One has grown its account base from 5 million to 48 million worldwide – all without the once vital "bricks and mortar" network of branches. We can give consumers the best deals no matter where they reside – from mid-town Manhattan to the smallest farm community in Iowa.

For consumers, the tremendous benefits spurred by the FCRA are self-evident: prices continue to decline and availability to widen – most notably in the traditionally underserved low and moderate income communities.

With this broad overview of the role of the FCRA in the credit granting process, we can now examine the crucial role that key individual provisions of the Act play in ensuring that consumers enjoy the product offerings they deserve.

II. The Role of Specific Provisions of the Fair Credit Reporting Act in the National Credit Granting Process

The interdependent provisions of the FCRA can be arranged generally into three groups: (1) credit data consistency; (2) permitted uses of credit data; and (3) consumer rights.

The FCRA and National Credit Data Consistency

The provisions of the FCRA that ensure national credit data consistency include those related to furnisher responsibility and determinations of what is excluded from and included in consumer reports. The furnisher responsibility provisions strike a sensible balance by providing incentives to voluntarily report information accurately while removing disincentives to such reporting by keeping costs and liability within rational limits. The balance achieved enables companies like Capital One to construct highly accurate credit models on a nationwide basis – one of the key building blocks of a national credit underwriting process. These provisions benefit consumers by increasing the availability and reducing the price of credit, while also improving the convenience and speed of approval.

Voluntary nature of the consumer reporting system

It is worth spending a moment on the voluntary nature of the credit data reporting system. The question has been asked: why don't we just make reporting mandatory for everyone? At first glance, this approach appears logical; but in reality, you risk choking the system with inconsistent, low quality data that has little predictive value. To

illustrate, why compel a small business such as "Bob's Muffler Shop" – which may offer customers a "90 Days Same as Cash" option – to take on the significant burdens and costs of reporting into a system that they do not, in fact, use and, therefore, is irrelevant to their business? Would such a business be properly incented to take the time to report as accurately as those who depend on the system would likely choose to do?

The system works primarily because consumer reporting agencies, and the institutions that provide credit data information, share incentives to ensure that those who use the system also report into the system, and that the data reported is as consistent and accurate as reasonably possible. Our point is not to prevent Bob's Muffler Shop from reporting information into the system if that business sees value in doing so, but there is nothing to be gained by forcing them to do so.

Based on the voluntary nature of the system, it is an absurd argument that those who use the data as part of their credit granting process do not have a significant stake in the accuracy of the information provided on consumers. Put most simply, at Capital One, our models do not work if the information contained in the bureau reports is not accurate.

Permissible Uses of Credit Data

This group of provisions includes the processes of prescreening and affiliate sharing. Taken together, these provisions enable companies like Capital One to use information to reach potential customers and to make prudent credit decisions that ensure the safety and soundness of the lending institution. In terms of consumer benefits, these provisions, particularly the prescreening process, increase credit availability, reduce prices and speed access. Most significantly, they provide customers with preapproved offers of credit – virtually removing the fear of rejection that historically characterized the traditional customer-initiated credit application process.

Some have argued that prescreening and affiliate sharing constitute "marketing" rather than "underwriting" and, therefore, represent less important components of our uniform national system. As the discussion below illustrates, this distinction is inappropriate, and misunderstands the vital interdependencies of the current system as enabled by the FCRA. Stated more plainly, our current system cannot operate effectively without all of its constituent parts.

The Role of Prescreening and Affiliate Sharing in the National Credit Granting Process

Prescreening and affiliate sharing enhance the reliability of credit underwriting decisions; help reduce the cost of credit to millions of consumers; and expand the availability of credit, particularly to traditionally underserved populations in urban and rural America. Moreover, affiliate sharing and prescreening are almost certainly the single most important catalysts of the intense competition in today's consumer credit marketplace, particularly in credit cards, but also increasingly in auto finance and other lending arenas.

Prescreening greatly enhances the ability of credit grantors to accurately assess risk and avoid losses

Our experience confirms that losses from customers obtained through prescreened offers of credit are significantly lower than losses from customers obtained through non-prescreened channels (e.g., “invitation to apply” direct mail; in-store “take-one” applications; internet banner advertisements). The reason, at first blush, may appear counter-intuitive – not all customers are good customers. Unlike other retail businesses where money is paid at the time of purchase, lending involves the provision of money in exchange for the promise to pay. Prescreening permits us to obtain the necessary information to properly assess risk, and to mail an offer that best suits the needs and circumstances of particular customers. In doing so, we can make prudent determinations regarding the probability of repayment and the appropriate credit line or loan amount to be offered. Prescreening, therefore, is a vital tool in ensuring the continued safety and soundness of consumer lending institutions.

Prescreening lowers costs both to providers and recipients of credit

Because prescreening is a highly cost-efficient and proven way to identify lower risk customers, both consumers and credit grantors enjoy enormous benefits from this system. Consumers benefit in the form of significantly lower costs for credit; and credit issuers benefit through large reductions in underwriting costs. In testimony before this committee last week, economist Robert Turner of the Information Policy Institute stated that with respect to consumer benefits, his recent study concludes that, since 1997, consumer savings in the cost of credit from the increased competition in the credit card industry – largely enabled by prescreening – <u>is about $30 billion per year</u>.[4]

Prescreening fosters competition

Prescreening is almost certainly the single most important dynamic driving competition for consumer credit**.** Because prescreening allows financial services firms to identify the credit characteristics of individuals with whom customer relationships are sought, credit issuers are able to offer their credit products with tailored terms and conditions specifically designed to “beat the competition.” The attractiveness of our offers depends on what we know – if your current card carries a 9.9 percent interest rate, it makes little sense for us to send you an offer for a 10.9 percent product.

As noted above, prescreening also foster innovation. The extraordinary ancillary benefits attached to modern credit card products are largely a function of prescreening. Airline miles, cash rebates, contributions to college savings plans, store discounts, merchandise – all of these reward programs have become commonplace to the point of being expected, if not demanded, by consumers. Lest we forget, however, few if any such programs existed just two decades ago – unless you count the ubiquitous free toaster provided by your local bank.

Such programs are naturally dependent on information about consumer preferences, but also depend largely on improved risk analysis to keep losses – and costs – down. The

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[4] Testimony of Michael Turner, The Information Policy Institute before the Subcommittee on Financial Institutions, Committee on Financial Services, U.S. House of Representatives, May 8, 2003.

importance of lower costs in this context is significant – benefits such as airline miles cost us money. These programs can only remain viable if high credit losses do not undercut their profitability.

The success of prescreening in the credit card arena has also fostered innovation in the auto finance market. Our highly successful auto refinance products, which can save consumers up to 4 percentage points on their loans, is made possible through prescreening. Bureau data allows us to determine which consumers would benefit from a reduction in their APR, and helps to ensure that our offering will, in fact, save them money.

Prescreening makes credit available to traditionally underserved populations.

Prescreening enables credit issuers to find good credit risks among traditionally underserved populations and to extend credit to them in ways that would be difficult or impossible through other credit application channels.

Prescreening reduces identity theft

Because the process of prescreening involves additional confirmation of a consumer's identity, prescreening actually works to reduce identity theft and other forms of fraud in connection with the opening of new or additional accounts. Our data demonstrates that rates of identity theft and other fraud is 5 to 15 times lower for credit generated through prescreening than from credit generated through other channels (e.g., the internet, in-store "take-ones"). Our experience is supported further by testimony from the Information Policy Institute, which concluded that prescreened credit card solicitations are significantly less likely to result in fraud than other forms of account acquisition (prescreening customer-verification procedures identify between 60% and 80% of all fraudulent applications before accounts are opened – a considerably higher rate of prevention than with other application channels). Additional fraud prevention techniques are applied when prescreened applications are accepted.[5]

Affiliate sharing of information enhances the ability of credit grantors to accurately assess risk and extend credit to traditionally underserved populations

The quality, quantity and timeliness of customer credit information available through affiliate sharing greatly increases the likelihood that a lending institution will make a prudent credit decision. Testifying before this subcommittee, the National Retail Federation put it well: "A lot of people ask what affiliate sharing has to do with the granting of credit. The answer is: a lot." Capital One uses the data and transaction histories of the customers of its two banking institutions and its auto finance company to ensure the creation of the most accurate file possible. Most importantly, this information supplements the broader information obtained through the credit reporting system to create more reliable internal credit scores and models that help determine a consumer's eligibility for credit.

[5] *Ibid.*

Because affiliate sharing permits providers of consumer credit to reduce their overall risk of loss, the cost of credit to their customers is also reduced

Like prescreening, affiliate sharing greatly enhances the safety and soundness of our lending institutions by improving our predicative capabilities and reducing losses. The savings generated by our ability to reduce losses are passed on to our customers. If the ability of lending institutions to share information among affiliates is eliminated or reduced, the cost of credit to their customers will increase.

Affiliate sharing allows financial services companies to provide to offer their customer of wider array of products and services to their customers on a customized basis

In the absence of affiliate-sharing, financial services companies would know decidedly less about their customers financial and other needs than they currently do, making it far more difficult to address those needs on an individualized basis. Capital One has created significant value for its card customers by offering reduced rates on auto loans through its affiliated auto finance company. These reduced rates are a direct by-product of our ability to assess the payment history and other credit characteristics of our customers – and to reward our customers for their strong performance.

Affiliate sharing is beneficial in combating identity theft and other fraud

Because the exchange of information among affiliates permits financial services companies to monitor customer activities on a company-wide basis, the likelihood of detecting identity theft and other fraud activity is greatly increased.

Affiliate sharing enhances efficiencies and allows lenders to reduce the time and costs of providing their products and services to customers

Affiliate sharing also helps companies to achieve operational efficiencies which further reduce costs and customer hassle. Such sharing allows for the creation of centralized databases to minimize account-management and administrative burdens, including customer service centers capable of handling calls relating to multiple entities and product lines.

The FCRA and Consumer Rights

To ensure healthy competition, the FCRA enacted a number of important consumer protections, including adverse action notice, dispute resolution and consumer disclosure requirements. These protections provided a carefully crafted balance to ensure an efficient and uniform national credit reporting system, while preserving significant consumer rights regardless of where they or the credit grantor is located. An orderly uniform process promotes speed of notice and resolution for consumers.

Balkanized requirements in this area would result in variations in the number of institutions reporting and erosions in credit file quality, with dire consequences for such advances as automated underwriting. If many creditors stop reporting in a jurisdiction or the time frames for resolution are unreasonably compressed to the point where creditors

have to drop any challenged information, then the effectiveness of the national system is degraded or harmed irreparably. Ultimately, the losers in this equation will be the consumers, who will pay the price of higher credit costs, reduced availability and less attractive products.

III. Conclusion

Our credit system is the envy of the world. Consistent national credit data is the foundation of this system, ensuring that Americans have more access to credit at lower prices than their counterparts around the globe. It is difficult for many of us to remember what the loan process was like 30, 20 or even 10 years ago. For those lucky enough to get credit cards, you would be guaranteed a flat rate of 19.8 percent and a $20 annual fee. Your card offered no airline miles or other rewards, no affinity programs to benefit your alma mater or favorite charitable organization, no cobranding arrangements to provide you discounts at the retail outlets you visit most often. In the auto world, once you completed the grueling process of negotiating a "fair price" on your new car, you were left to experience the joys of a visit to the dealer's finance desk to negotiate a "fair price" on your loan. In many cases, the dealer was able to recoup his concessions to you on the sale price of the car through a higher APR or hidden fees.

Today, our best credit card customers can enjoy a fixed rate as low as 6.9 percent with no annual fee. The variety of programs and rewards simply boggle the mind. Our auto finance company, PeopleFirst, provides rates as low as 3.89 percent – among the lowest in the nation – online and literally in minutes. The result? Our customers can walk into a dealership fully pre-approved and pre-financed. The dollars you save in your negotiation of the price of your car are yours to keep, and the hours spent waiting (and hoping) for loan approval is a relic of the past.

These tremendous innovations have saved borrowers billions, and Capital One is proud to have played a role in our nation's consumer revolution. Without a doubt, none of these extraordinary developments would have been possible without the FCRA. The FCRA is a vital instrument in preserving the vitality of our credit granting system, and, equally, a vital instrument in preserving the vitality of our modern economy. We urge you to reauthorize these provisions and to extend permanently our national uniform system of credit reporting.

Mr. Chairman, Ranking Member Sanders and Members of the Subcommittee, thank you again for the opportunity to testify before you. I would be happy to answer any questions you may have.