

The Development and Regulation of Consumer Credit Reporting in America

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The Economics of Consumer Credit:
European Experience and Lessons from the U.S.

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*: The views expressed here are my own
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Consumer Credit Markets in the US

- This is a huge market
 - Spending on credit cards alone is about \$750 billion, balances are about \$500 billion
- The consumer credit reporting industry is also huge
 - 450 million files (3+ files on every credit using American)
 - 2 million credit reports issued every day
 - 2 billion items added/changed in credit bureau files every month
 - Annual revenues of \$3 billion

Two Problems that Confront Lenders

- Adverse Selection - How well do I distinguish between borrowers of different risk?
 - If not well, what are the implications?
 - Ausubel (1999) demonstrates adverse selection through a card solicitation designed as a controlled experiment
- Moral hazard - Can I induce the borrower to repay?
 - This an important aspect of the debate over bankruptcy reform in the US (Mester 2002, CBO 2000)
 - Why consumers aren't more opportunistic? (White 1998)

Credit Bureau Data Can Help

- Scorecards based on bureau data reduce delinquencies 20-30% relative to manual evaluation
 - Sources: McCorkell (2002), Chandler and Parker (1989), Chandler and Johnson (1992)
 - This is worth \$5 billion in losses in the US credit card market
- Alternatively, scorecards generate a 20-30% gain in the acceptance rate for the same amount of risk taken
 - This is worth about \$120 billion in receivables (1% of GDP)
- Credit bureaus enable reputation effects in consumer credit markets
 - Klein (1997)

Economic Theory (briefly)

- Competition - a tradeoff
 - Increased ability to attract other lenders' customers
 - Greater competition for your existing customers
 - Models: Pagano and Jappelli (1993), Wilson (1990)
- Too much competition implies no information sharing
 - Intuition about effects of bank regulation and information sharing
 - Branching restrictions, functional restrictions
- Or more limited information sharing
 - Sharing payment history but not credit limits or utilization
 - Limiting the length of credit histories to force borrowers to signal
 - Models: Padilla and Pagano (2000), Vercammen (1995)

In the Beginning...

- In the U.S., credit bureaus first appeared around 1900
 - Often organized as non-profit joint ventures by retailers in a city
 - By 1960 the industry issued 1 million reports a week -- using filing cabinets, telephones, and mimeograph machines
- Bureaus were balkanized
 - Geographically, cities or parts of cities
 - Narrow membership -- a bureau for stores, another for finance companies, etc.
 - Bureaus serving different industry segments often did not share information.

Market Structure in the Philadelphia Area: 1950-70

Retailers

Bucks County Credit Bureau
Chester Credit Bureau
Credit Bureau of Camden
Credit Bureau of Haddonfield
Norristown Credit Bureau
Philadelphia Credit Bureau
Trenton Credit Bureau
West Chester Credit Bureau
Wilmington Credit Bureau

Banks

1st Pennsylvania Bank Soundex
Bank Credit of Wilmington
Credit Registry Association

Finance Companies

Lenders Exchange of Philadelphia
Lenders Exchange of S. Jersey

Small Installment

Retail Merchant Credit Assoc.

Insurance

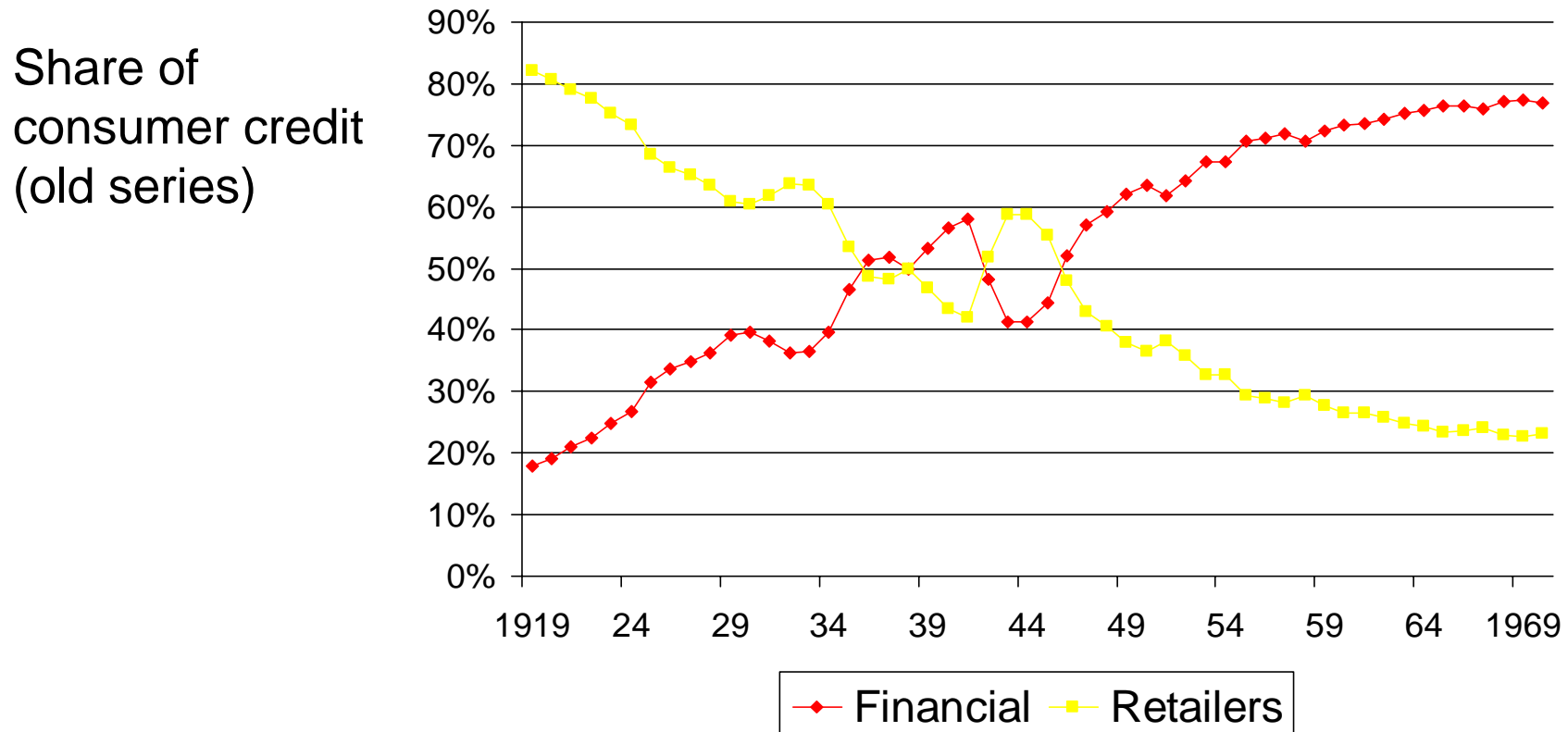
Retailers Commercial Agency

Mitigating the Coordination Problem

- Until 1970, the primary mechanism was through a trade association -- Associated Credit Bureaus Inc (ACB)
 - Started around 1905
 - At its peak it has 2,200 members
- ACB Developed standards for sharing bureau reports across the nation
- Collective coverage of the universe of borrowers by 1960

The Evolution of Consumer Credit in the U.S.

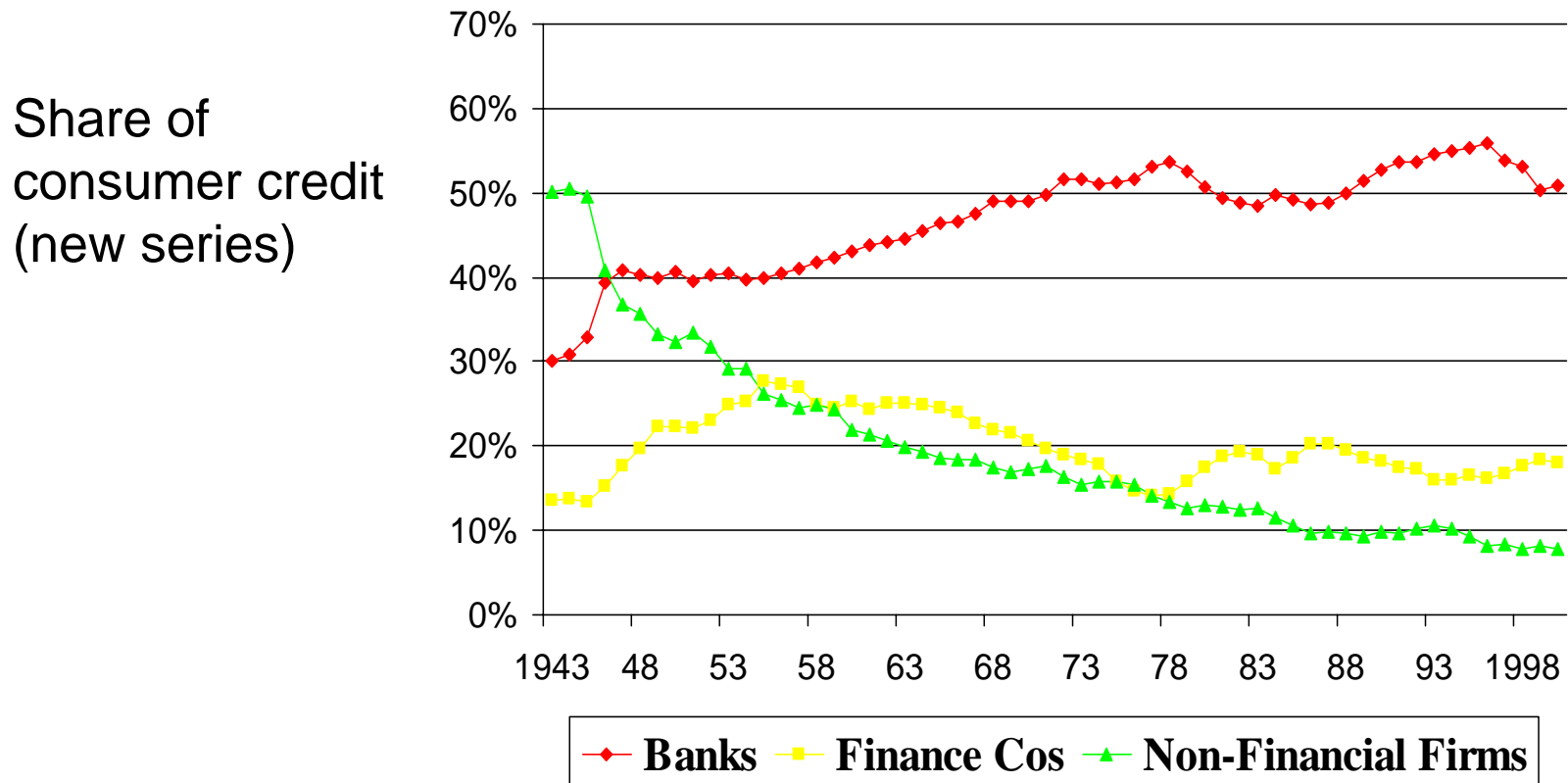
- Consumer credit was initially dominated by retailers
- This changes beginning in 1920 when consumer finance is (partially) deregulated



Note: Retailers' share excludes paper sold to or funded by finance companies

The Evolution of Consumer Credit in the U.S.

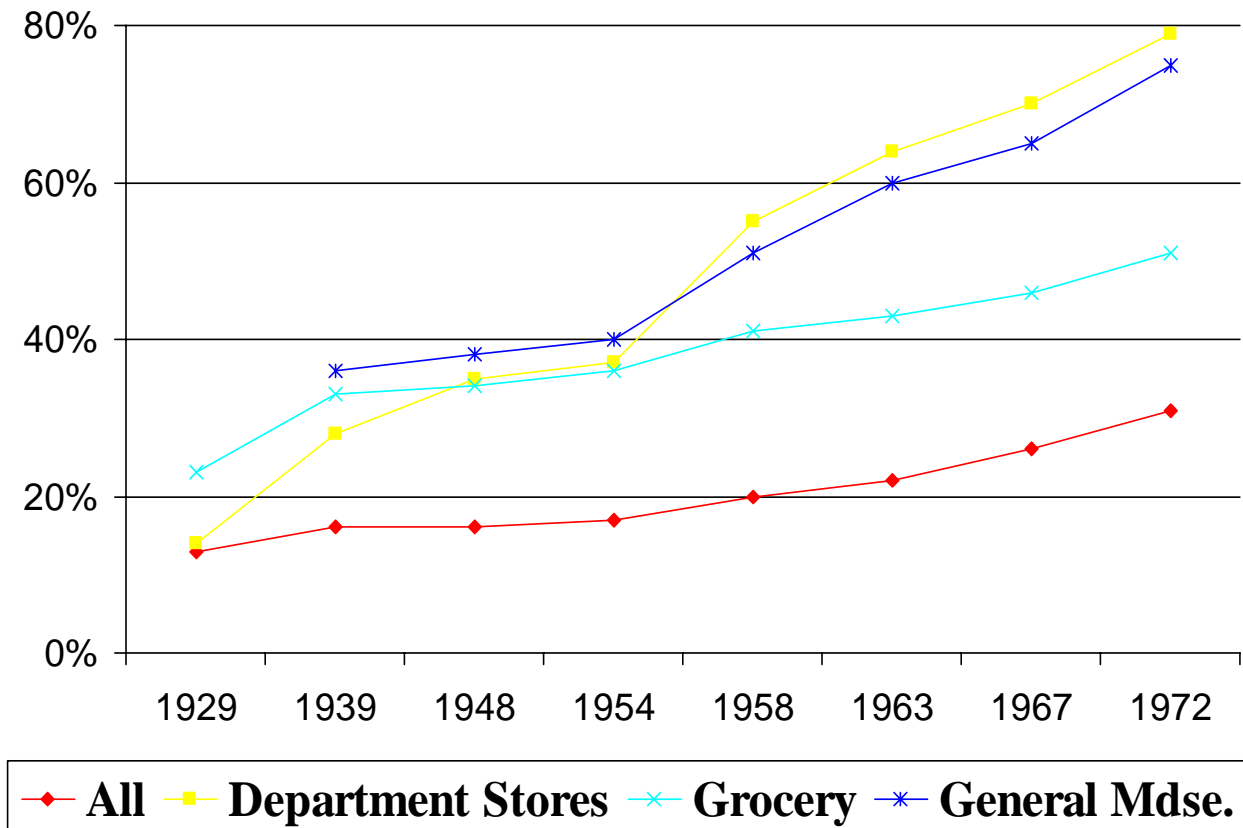
- Banks and finance companies become the dominant sources of consumer credit



The Geographic Scope of the Retail Sector Increases

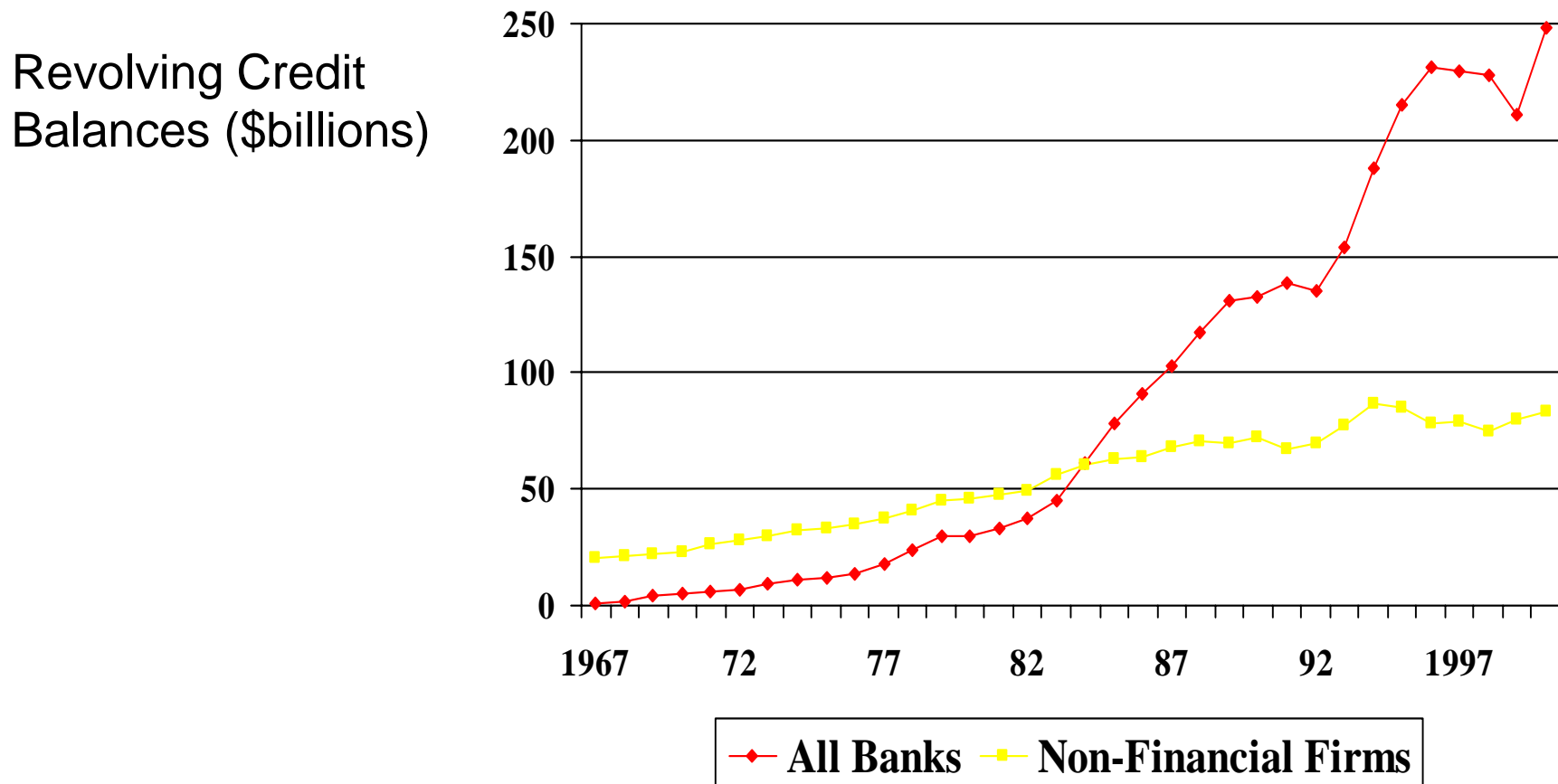
- Regional and national chains dominate certain retail segments
- Concentration of credit departments at headquarters
- They require data on a regional or national basis

Share of
Retail Sales
by Regional or
National
Chains



Geographic Scope of Consumer Credit Also Increases

- Bank issued credit cards replace store credit
- Many banks compete for customers across the country
- They require data on a regional or national basis



Consumer Credit Changes and Bureaus Respond

- The industry becomes capital intensive
 - Financial institutions adopted mainframe computing during the 1960s. Especially important for credit cards.
 - TRW begins automating its bureaus in large cities in 1965
 - Most smaller bureaus could not afford to automate; instead they formed affiliations with a large bureau, or were bought out
- Market structure changed.
 - The number of firms declined 50 percent between 1972 and 1997
 - The top 4 firms account for 50% of industry revenues in 1997
 - The 3 largest bureaus (Trans Union, Experian, and Equifax) attain universal coverage by the early 1980s
- Impressive productivity growth
 - Since 1970 industry output has increased twice as fast as GDP and yet industry employment has not changed

Consolidation in the Philadelphia Area: 1970-80

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Policy Issues in the U.S.

- Privacy
 - Who should have access to credit bureau data and for what purposes?
 - How much protection of privacy should we expect from credit bureaus?
- Accuracy
 - How good is credit bureau data?
 - Do credit bureaus have the right incentives w.r.t. accuracy?
 - Do credit bureaus have the right incentives w.r.t. responding to consumer disputes?

What Do We Know About Accuracy?

- Available data is old (from early 1990s)
- ACB-Anderson study based on 15,000 rejected applications for credit
 - 8% of the sample (1,200) requested a copy of their reports
 - 25% of those requesting copies of their report (300) disputed something in their report
 - In 13% of disputed reports (36 instances) the resulting changes to the report would have resulted in a reversal of the credit decision
- Significance of errors?
 - 36 in 15,000 rejections is a trivial reversal rate (0.2% of rejections)
 - But a 13% reversal rate of 3 million disputed reports in 1989 suggests several hundred thousand of erroneous credit decisions

Private vs. Social Objectives

- Kinds of mistakes:
 - Type I error - making a loan on the basis of erroneous information
 - Type II error - not making a loan because of erroneous information
- Credit Bureaus as arbiters of quality
 - They internalize quality control on behalf of lenders
- But they likely reflect the loss function of lenders
 - Ignore consumer losses (too many mistakes?)
 - Preoccupied with Type I errors (wrong mix of mistakes?)
- A rationale for regulating standards of accuracy?

Consumers' Disputing Their Files

- An efficient way to increase accuracy
 - Consumers have an interest and a comparative advantage
 - Bureaus do subsidize consumer dispute resolution process
- But the process may be under-funded
 - Lenders pay the cost, but share the benefits with consumers
 - The costs are significant (tens of \$millions in the U.S.) and rising
 - The process is vulnerable to signal jamming by unscrupulous businesses
- A rationale for regulating the dispute process?

Overview of the Fair Credit Reporting Act

- Enacted in 1970, most recently amended in 1996
- An obvious example of a balancing act
 - On the one hand, Congress did not wish to discourage lenders from sharing information
 - On the other hand, Congress felt it could increase welfare by addressing issues of privacy and accuracy
- Except for gross violations of the Act, FCRA protects credit bureaus, users of credit bureau reports, and information providers (lenders) from lawsuits for
 - defamation
 - negligence under state law
 - invasion of privacy

FCRA Duties w.r.t. to Privacy

- Reports only issued for purposes authorized in the law (decisions about credit, insurance, employment, etc.) or with written permission of the consumer
- Bureaus must take *reasonable* precautions to avoid unauthorized disclosures
 - Damages awarded for negligent non-compliance, punitive damages for willful non-compliance
- There are criminal penalties for those who obtain credit reports under false pretenses (since 1996)
 - Also applies to credit bureau employees who help them

FCRA Specifies Duties w.r.t. Accuracy

- Credit bureaus must use procedures a reasonably prudent person would use under the circumstances
 - The goal is *maximum possible accuracy*
 - Court cases suggest *reasonable procedures* evolves with technology
- Lenders may not provide *information known to be inaccurate* to a credit bureau
 - Prohibition applies to information a lender consciously avoids discovering to be inaccurate.
 - lenders can be sued for failing to properly reinvestigate data it provides to a credit bureau at the request of the consumer
 - These are minimal standards

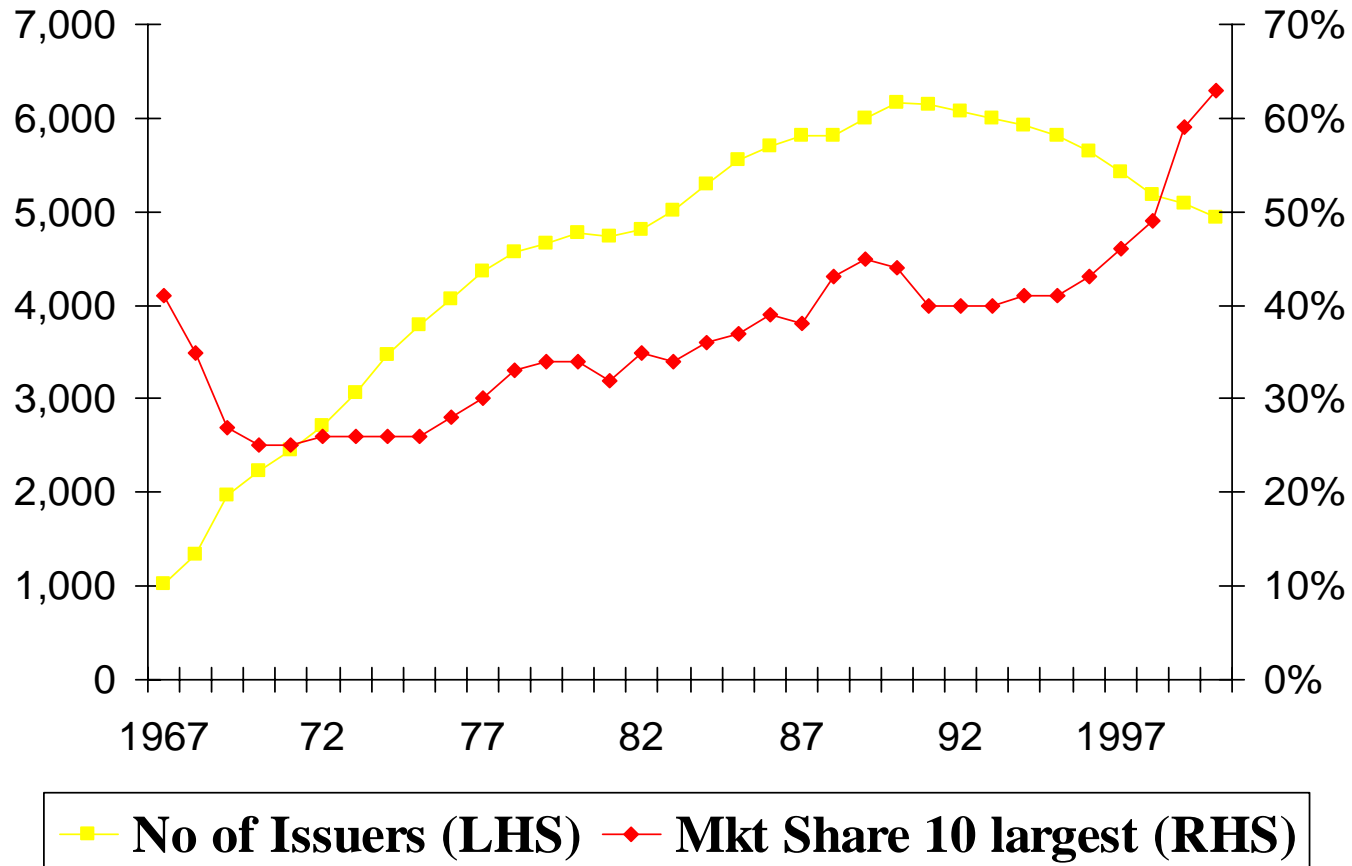
Dispute Resolution Procedures under FCRA

- Users of credit bureau information must tell consumers if it is the basis of a negative decision
 - Users must disclose where the data came from
 - The consumer is entitled to a free copy of his or her report
- Consumers can dispute a credit report a consumer need only explain, in writing, why the information in question is inaccurate
 - The bureau must verify the disputed information within 30 days or remove it from the file

Regulatory Challenges

- Until 2004, states are preempted from enforcing laws more strict than FCRA w.r.t.
 - The amount of time information may be retained in a credit file
 - The amount of time credit bureaus are allowed to respond to a consumer dispute
 - The duties of information providers (e.g. lenders)
- This also applies to *prescreening*
 - Bureaus provide names and addresses of consumers that meet underwriting criteria specified by a lender
 - The lender must make a firm offer of credit to all consumers on the list, and maintain certain records
 - Consumers may opt out of prescreening if they choose

The Challenge of Competition



Note: This data does not include securitized receivables

Is Voluntary Information Sharing Unstable?

- In 1999, some lenders briefly stopped reporting information on sub-prime accounts
 - The lenders accounted for 1/2 of all consumer credit balances
 - Omitted information included credit limits and utilization
 - Action by regulators and the bureaus ended the episode
- What will happen in the future?
 - If competition is too severe, lenders may share less information than in the past
 - New regulatory requirements might also affect these incentives