



**THE FAIR CREDIT REPORTING ACT:
ACCESS, EFFICIENCY & OPPORTUNITY**
**THE ECONOMIC IMPORTANCE OF
FAIR CREDIT REAUTHORIZATION**

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June 2003

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I. EXECUTIVE SUMMARY

I. Executive Summary

A. BACKGROUND

By most accounts, the consumer credit marketplace in the United States is the envy of the world. In 30 short years, fragmented local credit markets—characterized by undifferentiated prices on credit, highly subjective application processes, and limited access—have evolved into a national consumer credit marketplace distinguished by dynamic competition among lenders and broad participation by most American consumers. This marketplace has played a significant role in fostering consumer spending that stimulates economic growth.

Consumer credit underpins much of the consumer spending that accounts for more than two-thirds of the U.S. gross domestic product. The following are some of the features of this marketplace:

- Between 1970 and 2001, the overall share of families with general-purpose credit cards increased from 16 to 73 percent (Federal Reserve).
- Previously underserved groups have greater access to credit. The percentage of households in the lowest income quintile with a credit card has increased from 2 percent in 1970 to 28 percent in 2001. During the same period, the percentage of African American households with credit cards has more than doubled, from 23.6 percent to 55.8 percent (Federal Reserve).
- Competition, credit scoring, and technology have reduced the consumer's price for credit card credit. Assuming constant prices for credit card credit since 1997, we estimate the consumer savings from the increased competition in the credit card industry to be about \$30 billion per year from 1998 to 2002 (see endnote 51).

Trends in the mortgage market are much the same. Housing is a significant economic sector, and the percent of American families who own homes has grown to 68 percent in recent years. Credit is essential to homeownership, which is often the largest purchase a consumer ever makes.

The development of the secondary market—coupled with intense competition and the use of increasingly sophisticated technologies and risk management tools—has transformed a

fragmented, inefficient system dominated by local savings and loan associations to a highly sophisticated national market with ready access to capital throughout the world. For the U.S. economy, this spending has helped bolster economic growth. For consumers, the net result has been expanded access and lower costs. For example:

- Between 1983 and 2001, the share of families with home-secured debt rose from 36 to 45 percent. Over the same period of time, the percentage of families who own their homes increased from 60 to 68 percent (see Table 3).
- The largest gains were achieved by families who have traditionally been underserved. For example, between 1983 and 2001, the minority homeownership rate increased from 34 to 47 percent (see Table 4).
- The relative costs of a mortgage have dropped significantly. For example, if spreads today were at their early 1980s levels, the interest rate on a 30 year fixed rate mortgage would be at least one percent higher than it is today. This translates into \$54 billion in annual savings to consumers (see endnote 54).

The development of a competitive national market for consumer credit has required lenders to assess the risk associated with a particular loan based on the applicant's credit history. Lenders are able to do this today because of a national credit reporting system centered around three national credit bureaus. This system makes it possible for lenders to determine the risk associated with specific borrowers, regardless of where they live; and is, in part, responsible for enabling lenders to compete for consumers nationally. Moreover, in the United States, credit reporting is "full-file"—positive experiences with consumers are reported to bureaus as well as negative ones.

Since 1970, the Fair Credit Reporting Act (FCRA) has provided a national standard for ensuring the accuracy and security of the information contained in credit reports. Amendments to the FCRA made in 1996 strengthened this national standard by preempting state and local governments from enacting measures in several areas considered crucial to the national credit reporting system. The 1996 preemptions are due to sunset January 1, 2004.

B. RESEARCH PROGRAM

Our research suggests that the market for consumer credit has matured in interesting and important ways, largely to the benefit of consumers. However, the principal aim of our

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research is to examine whether or not a loss of the existing framework of preemption would threaten the benefits currently enjoyed by consumers. We also consider the impact on consumers of possible modifications made at the federal level to that framework, where these modifications are consistent with the state legislative proposals examined in this report.

Our quantitative analysis considers the following areas of inquiry:

- (1) Has automated underwriting contributed to the availability of home mortgage loans and increased homeownership? If so, who has been affected, and how? How would changes to the framework of preemptions enacted in 1996 affect automated underwriting practices?
- (2) Has the ability to prescreen made consumer credit markets more competitive? If so, how would restrictions on this method of customer acquisition affect the cost and availability of consumer credit? Do prescreened credit card offers contribute to identity theft? If prescreening is not essential to risk-based pricing or credit decision-making, are there other benefits that justify its preempted status?
- (3) Have uniform national standards for credit reporting contributed to the ability of credit grantors to model risk? If so, would certain types of federal or state legislative activity in areas currently preempted by the FCRA diminish the quality and quantity of data available in credit reports? And how would this affect the availability and price of credit, particularly for traditionally underserved populations?

C. KEY FINDINGS

1. HOME MORTGAGES: LOWER PRICES, INCREASED ACCESS, AND GREATER CHOICE

In the past, manual underwriters were forced to weigh the various strengths and weaknesses of an individual's loan application in making their lending decisions—an inherently subjective process that made the system vulnerable to bias, however unintended. In contrast, automated underwriting provides an objective, performance-based tool for assessing these kinds of trade-offs in a way that treats every applicant the same. If the framework of preemption created in 1996 is permitted to sunset, it is likely that the benefits arising from automated underwriting would be placed at risk. Likewise, if this framework of preemption is modified in a manner consistent with state legislative proposals, the consumer benefits stemming from AUS could be threatened. As discussed in our analysis of full-file credit reporting, deterioration in the quality and quantity of the data contained in credit reports would significantly affect the predictive power of automated underwriting models.

Based on an extensive literature review, we found that the introduction of credit scoring and automated underwriting into the mortgage market has generated sizeable benefits to both consumers and, more broadly, to others affected by this economic sector:

- (1) Automated underwriting consistently does a better job of identifying loans that ultimately “perform” – loans that do not experience a serious delinquency or default. The greater precision of automated underwriting results in higher approval rates, particularly for underserved populations. For example, a recent study found that using one of these tools resulted in approval rates improving by 29 percent for minority borrowers (Gates, Perry, and Zorn).
- (2) Automated underwriting systems permit consumers to react quickly to changes in the market, and allow underwriters to accommodate high volumes of activity during these periods. In 2002, the Federal Reserve estimates that homeowners were able to extract some \$700 billion of accumulated equity from their homes, prompted by the lowest interest rates in 35 years, according to the Federal Reserve Board.
- (3) Before the advent of automated underwriting, approving a loan application took close to three weeks; in 2002, over 75 percent of all loan applications received approval in two to three minutes (Mortech).
- (4) The introduction of automated underwriting into the mortgage market has also significantly reduced the cost of closing a loan, making homeownership more accessible to families with income and wealth constraints. Based on the number of sales of homes in 2002, automated underwriting saved consumers at least \$18.75 billion (Gates, Perry, and Zorn).

2. THE RELATIONSHIP BETWEEN FULL-FILE CREDIT REPORTING AND UNIFORM NATIONAL DATA STANDARDS

Building on an earlier generation of research on credit reporting, we constructed a case study based on six commercial scoring models that are in widespread use today. We created four different scenarios, based on either allowing the FCRA's strengthened preemption provisions to expire or modifying them in ways suggested by current state legislative proposals examined in this report. Using these four scenarios, we predicted the potential effect on the quality and quantity of information contained in consumer credit reports under each scenario.

We then examined what would happen to the performance of the six commercial scoring models under each of the different scenarios and measured the impact this would have on the availability and the cost of credit. Separately, we considered the consequences for consumers, both in the aggregate and according to various demographic attributes for one of the commercial scoring models.



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Our model yielded a number of interesting findings:

- (1) *Either acceptance rates would decline or delinquencies would increase under all four scenarios.* For example, in the “most severe” scenario, at standard acceptance rates, delinquencies would increase by about 70 percent, costing consumers about \$22 billion a year. Or, if access to credit were restricted to maintain the current delinquency rate, 30 percent of those now granted general purpose credit would be denied it under this scenario. This could prevent as many as 41 million people from receiving new credit card accounts.
- (2) *In general, the kinds of changes envisioned in our four scenarios would alter the credit scores of a high proportion of consumers.* For example, under each of the four scenarios, roughly 88 percent of all consumers would experience a change in their calculated credit score as measured by one of the commercial scoring models used.
- (3) *The predictive power of scoring models would likely decline.* The greatest impact appears to occur when there are restrictions on the kinds of negative data that can be contained in the consumer’s credit report. In the most “severe scenario” considered, the reduction in predictive power of the various scoring models would range from about 10 to 15 percent. By almost any yardstick, such changes would result in a dramatic decline in the industry’s ability to measure credit risk.

3. THE RELATIONSHIP BETWEEN PRESCREENING AND COMPETITIVE CREDIT MARKETS

Robust data on consumer credit history has enabled the development of progressively more sophisticated risk models. These models have radically improved the ability of credit issuers to identify good credit risks. Prescreening, in turn, enables issuers to compete for these desirable borrowers more effectively by permitting them to identify these good credit risks en masse and solicit their business.

In tandem, these innovations have moved the industry away from a regime of cross-subsidization toward one of risk-tiering. In the risk-tiering regime, responsibility is rewarded, access is broadened, and borrowers are extended credit in accordance with their credit capacity and credit worthiness.

This regime change has led to a dramatic increase in access to consumer credit, particularly for traditionally underserved groups. Our analysis suggests that restricting prescreening would increase the cost of credit and reduce access to credit. As recently as 12 years ago, access to credit cards was primarily for the affluent, and most borrowers paid dearly for credit. The high interest rate was the result of a system in which low-risk borrowers were forced to cross-subsidize higher-risk borrowers, and access was limited.

We surveyed major credit card providers to collect information from them on the customer acquisition channels they currently use, the costs of acquiring new customers with current channels, and the methods they would use to acquire customers in the absence of prescreening. Based on the response of five of these credit providers, which collectively issue almost half of all MasterCard and VISA accounts, we constructed a “model” issuer of credit cards.

Survey responses strongly suggest that prescreening has played a critical role in the competitiveness observed in consumer credit markets:

- (1) *Prescreening has helped to dramatically lower the interest rate on credit card balances.* Increased competition, driven in part by prescreening, has caused interest rates today to be more widely dispersed (and lower overall) than they were in 1990. In 1990, only six percent of card balances were below 6.5 percent, and 93 percent were above 16.5 percent APR. Indeed, by 2002 almost three-quarters (74 percent) of all outstanding balances were at interest rates below 18 percent, while an incredible 15 percent of balances were at interest rates under 5.5 percent. On the other end, only 24 percent of outstanding balances had interest rates above 18 percent.
- (2) *Prescreening is the most important method of acquiring new customers.* Our survey finds that prescreened offers of credit account for more than two-thirds of all new customers acquired. In contrast, the next most popular method, direct mail not prescreened, accounted for only 17 percent of the new customers acquired.
- (3) *The cost of acquiring new customers would increase, and access would decrease if prescreening is restricted.* Our model credit card issuer currently spends an average of \$57.86 to acquire a new customer. In contrast, in the absence of prescreening, this cost would increase to between \$60.78 and \$72.62 depending on the model credit card issuer’s response to the problem of customer acquisition. We estimate that in the absence of prescreening, total costs to consumers would increase between \$269 million to \$1.36 billion per year.
- (4) *Prescreened offers of credit are not driving the rise in identity theft.* In fact, prescreened offers of credit have a lower incidence of identity theft and application fraud than other forms of customer acquisition. Prescreened solicitations are subject to the same procedures for fraud detection as other forms of customer acquisition, and other fraud prevention procedures specific to prescreening.

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D. CONCLUSION

In all areas of inquiry, we find that federal preemption has contributed significantly to the benefits currently enjoyed by consumers. On the other side of the ledger, we see few quantifiable direct or indirect costs. Loss of the existing framework of preemption, or changes to that framework consistent with state legislative proposals examined in this report, would threaten the benefits currently enjoyed by consumers. Congressional action is therefore urgently recommended to reauthorize the framework of preemption that has been in place since 1996.

II. Introduction

A. BRIEF OVERVIEW OF THE FCRA

In 1970 the Congress enacted the Fair Credit Reporting Act (FCRA) to ensure the confidentiality, accuracy, and relevance of the information contained in consumer credit reports, and to define the uses for which consumer credit reports could be employed.¹ Congressional rationale is clearly stated in the FCRA:

- (1) The banking system is dependent upon fair and accurate credit reporting.
- (2) An elaborate mechanism has been developed for investigating and evaluating the credit worthiness, credit standing, credit capacity, character, and general reputation of consumers.
- (3) Consumer reporting agencies have assumed a vital role in assembling and evaluating consumer credit and other information on consumers.
- (4) There is a need to insure that consumer reporting agencies exercise their grave responsibilities with fairness, impartiality, and a respect for the consumer's right to privacy."²

The FCRA was a significant law for a number of reasons. First, in addition to being the first law to constrain the use of personal information, it also proved prescient in that it anticipated the "Code of Fair Information Practices," which the government developed three years later as an ethical guideline for fairness in personal data records keeping and use. Second, it reflected a key compromise: the need to ensure the impartiality and fairness of credit reporting methods had to be balanced with an appreciation of the "vital role"³ that consumer reporting agencies now occupied in our banking system. That is, enforcement had to be rigorous, but not so punitive as to render the system unworkable.

B. PREEMPTION AND THE CURRENT DEBATE

Since its enactment, the FCRA has contained a provision regarding the federal preemption of state laws governing the "collection, distribution, or use of information on consumers." State laws are to be upheld unless they "are inconsistent with any provision of [the FCRA], and then



II. INTRODUCTION

[preempted] only to the extent of the inconsistency.”⁴ The meaning of this provision is, of course, controversial, and some interpret this type of preemption as constituting a “regulatory floor,” whereby states are free to extend consumer protections, but not to reduce them. However, “the courts seem to agree that a state law is inconsistent with the FCRA [and therefore preempted] when it frustrates or stands as an obstacle to the accomplishment of the FCRA’s full purposes, whether or not those purposes are related to consumer protection.”⁵

A number of factors in the quarter century since the FCRA’s passage compelled Congress to amend the statute in 1996. These included an increasingly mobile labor force, advances in computing and communications technologies, the emergence of national credit markets, as well as “ambiguities in the statute.”⁶

The 1996 amendments to the FCRA strengthened consumer protections in several important ways—for example, by standardizing the period for reinvestigation procedures, and by creating limited liability for data furnishers. At the same time, the 1996 amendments were also *de jure* recognition of the existence of mature national markets for consumer credit, and of the potential hazard of “differing statutory schemes...at the state level.”⁷

These concerns prompted Congress to expand federal preemption for a number of key provisions. This strengthened preemption applies to six important sections of the Act: (i) the sharing of data among affiliates; (ii) the time by which a consumer reporting agency must take action in procedures where consumers dispute the accuracy of the information in their files; (iii) adverse action notification requirements; (iv) standards for the obsolescence of information included in consumer reports; (v) the liabilities of data furnishers; and (vi) the prescreening of consumer reports.⁸ The statutory language is quite broad and is generally understood to completely preempt state law pertaining to the enumerated provisions.⁹

This strengthened federal preemption is due to sunset January 1, 2004. Current attention to the FCRA reflects this imminent expiration date.

C. ISSUES ASSOCIATED WITH REAUTHORIZATION

The national credit reporting system has a long history and has evolved greatly over time. In a real sense, it is a product of experience, changing needs, and trial and error experimentation. Most Americans benefit daily from the national consumer credit reporting system that has developed over the last three decades. Today, the FCRA provides a uniform, understandable, national standard for an objective and unbiased evaluation of credit worthiness and for the resolution of disputes.

Our research into the contemporary consumer credit system and its regulatory framework strongly suggests that the system is: (i) remarkably fair, extending credit to increasingly wide segments of American consumers, including those who have been historically underserved; (ii) central to providing a host of consumer benefits, some of which have been profound (e.g. the effect of automated underwriting on home ownership); and (iii) efficient in that it provides credit to consumers at competitive prices.

The two previous periods during which the national credit reporting system was debated—the late 1960s and, the mid 1990s—are similar in that they shared core issues.¹⁰ In both periods, the twin imperatives for regulatory change—the emergence of a national market structure and the rapid implementation of technological innovations—were prominent features. As with the two previous major FCRA debates, the central task today remains one of balancing vital consumer protections—namely, the accuracy and privacy of the information contained in credit reports—with the efficient operation of an increasingly information-dependent advanced economy.

Each period of legislative review of the credit reporting system has had different drivers. In the 1960s, it was the unregulated nature of investigative reports; in the 1990s, it was inaccuracies on credit reports as credit bureaus adjusted to new technologies and market structures; and today, it is identity theft.

While today's core issues and goals are consistent with those of lawmakers in past decades, it is clear that a host of ancillary issues are being tied to the FCRA debate under the auspices of "privacy". *even though many of these privacy issues have nothing to do with the FCRA.*¹¹ In addition, privacy is but one of a number of consumer protections addressed by the FCRA. Others, including ensuring the accuracy of the contents of a credit report, and the structure of enforcement for violations of the FCRA are equally important to many consumers.

This section now briefly considers four of the most salient features of the current debate:

Issue 1: Marketing versus scoring. Some argue that, if Congress renews the FCRA's strengthened preemption provisions, it should include only provisions dealing exclusively with credit decision-making and risk-based pricing, and jettison provisions dealing with other issues. In particular, it is argued, Congress should not preempt the states on matters related to the sharing of consumer information for the purposes of marketing.¹² On this view, provisions that deal with the affiliate sharing of customer information and the use of prescreened solicitations for consumer credit are labeled as "marketing" provisions.

II. INTRODUCTION

Our analysis assesses whether this distinction has any policy value. We accomplish this by measuring the impact of a ban on prescreening in several different contexts, including costs to lenders, changes in access to credit for consumers, changes in the cost of credit to consumers, impact on the incidence of identity theft and fraud, and impact on consumer privacy.

Analysis from the study indicates that the marketing/scoring distinction is not as straightforward as has been presented. Indeed, our results show clear consequences for consumers in terms of access to credit, the price they will pay for credit, and their vulnerability to identity theft if prescreening is prohibited—either by allowing the strengthened preemption to lapse, or by an outright ban on prescreening at the federal level.

Issue 2: Prescreened firm offers of credit and identity theft. Many privacy advocates argue that “... consumers are being harmed by systemic deficiencies in the credit reporting system. This includes the increase in identity theft from prescreened offers of credit”¹³ According to this view, prescreened credit solicitations are stolen from mailboxes for the purpose of identity theft, and the volume and nature of these mailed solicitations make an identity thief’s job easier. To reduce the incidence of identity theft, some contend, the preemptive provision permitting prescreening should be allowed to expire.¹⁴

We have conducted structured discussions on the topic with credit card issuers, major credit card networks, and national credit bureaus in an effort to understand the putative link between prescreened firm offers of credit and the incidence of identity theft. Based on our discussions, this study finds no credible causal link between the volume of prescreened offers of credit and identity theft trends. In fact, data indicate that prescreened offers actually result in a lower incidence of identity theft than do other methods of customer acquisition.

Issue 3: The objectivity of credit scoring. Some consumer advocates argue that the current credit reporting system is biased against certain demographic groups—minorities, lower income households, etc.¹⁵ This study examines the performance of certain demographic groups (ethnic groups, age groups, income segments, and gender) in the U.S. financial markets.

Our research finds that credit has become more accessible—and for many, more affordable—irrespective of age, income, ethnicity, or gender. Based on a survey of 3.6 million randomly selected credit files, as well as data from major financial institutions and credit bureaus, advanced credit scoring techniques appear to be partially responsible for the growth in access for traditionally underserved groups.

Issue 4: Credit scoring and overextension. Some critics of the current credit reporting system suggest that credit scoring over-allocates credit among certain U.S. households. According to this somewhat paternalistic view, consumer credit is too readily available, and lenders push credit onto borrowers who are incapable of managing their finances, leading to overextension and financial ill-health.¹⁶ Credit cards are singled out as the primary cause for bankruptcy. Prescreened solicitations offering pre-approved, low-rate cards are frequently cited as the culprit for encouraging consumers to live beyond their means.¹⁷

Our analysis suggests that such a link is tenuous at best. Overall debt service burdens have not increased.¹⁸ And the extension of credit by banks has also enabled the decade-long economic expansion in the 1990s, as well as the amassing of substantial financial and non-financial wealth by American consumers during the past 15 years.¹⁹

D. OUTLINE OF THE REPORT

This report considers the degree to which the current form of the FCRA has contributed to fairness and efficiency in the market for consumer credit.

- SECTION III discusses trends in the market for consumer credit over the last three decades. We present the case that the existing consumer system is a critical factor in the health and development of the U.S. economy, and that tampering with the regulatory framework should not be taken lightly.
- SECTION IV outlines the basic structure of our quantitative research. The research agenda is addressed in this section, including a brief discussion of the models, the data, assumptions, and the process employed to define the variables used in this analysis. Here, the research objectives are also clarified.
- SECTION V describes the transformation of the market for mortgage credit by automated underwriting systems.
- SECTION VI describes in detail the statistical results of our research into preemption and full-file credit reporting.
- SECTION VII discusses the importance of prescreening as a method of new customer acquisition, and the consequences associated with restricting the practice.
- Finally, SECTION VIII concludes with our analysis of the urgency of Congressional action at this time to ensure a strong economy in the future.



III. THE FAIR CREDIT REPORTING ACT IN CONTEXT

III. The Fair Credit Reporting Act in Context

In the following section we provide statistical background and analysis of trends in consumer credit markets during the last three decades. The markets for card credit and mortgage credit are discussed. We focus on trends in consumer debt levels, access, as well as the cost of credit (including the “tiering” of credit costs since the adoption of risk-based pricing.) We also briefly discuss the use of consumer credit as a financing source for small businesses.

A. THE MATURATION OF CONSUMER CREDIT AND THE FCRA

Consumer credit is vital to the modern American economy. People use credit to purchase goods and services, acquire assets that hold value (notably, autos and houses), and invest in income-generating possessions (especially, education). It smooths consumption during cyclic periods of unemployment and reduces the effects of swings of the business cycle, thereby maintaining demand in the market. An efficient consumer credit market also smooths consumption over the life-cycles of borrowers. For new and small businesses, revolving consumer credit provides financial resources for entrepreneurial activity when business loans are more difficult to obtain.

By most accounts, the consumer credit marketplace in the United States is the envy of the world. In 30 short years, balkanized local credit card markets, characterized by high and largely undifferentiated prices on credit, very subjective application processes, and limited access, have evolved into a national consumer credit marketplace distinguished by dynamic competition among lenders and broad participation by most American consumers.

1. EARLY OBSTACLES

Credit providers have historically faced three problems. First, they lacked inexpensive access to sufficient information about the risk associated with a potential borrower. Second, they were often unable to identify potential borrowers who violated their promise to pay in the past. And third, they were unable to price loans to reflect the degree of credibility of a borrower’s promise.

The first two problems were largely addressed by the emergence of national repositories of information on borrowers—the three national credit bureaus. Up through the 1960s, credit bureaus generally focused on a specific local area, only served one type of creditor (usually local banks or retailers), and often maintained unreliable information.²⁰ Localism and incomplete reporting complicated the ability of lenders to assess the riskiness of making a loan, especially as Americans became more mobile.

Lenders need this information because unlike collateralized loans, the promise to pay is not backed by a particular asset (such as a home) that can be repossessed in the event that a borrower defaults. Likewise, sellers of goods or services in a credit-based transaction only receive from the buyer a promise to pay rather than full payment at the time of purchase. Merchants who accept credit and lenders that issue credit must therefore know that the promise to pay is credible.

Consequently, credit grantors must be able assess the risk involved in accepting this promise. A poor system of assessing credit worthiness can result in no offers of credit, or in the extension of less credit at non-competitive prices (interest rates) to both the credit worthy and the credit risky.

2. THE EMERGENCE OF RISK-BASED PRICING

The ability to extend credit at prices that accurately reflects the risk associated with the individual borrower is a relatively new phenomenon. A number of factors have made it easier for lenders to do this. These factors include the adoption of modern credit scoring techniques,²¹ advances in data technology, as well as changes in the regulatory environment. Together, these developments have made it possible for lenders to get a fairly detailed picture of how well a potential borrower has repaid the loans made to them in the past. Access to a borrower's credit history permits lenders to set the terms and price of a loan on the basis of this past behavior.

Risk-based pricing has also enabled the development of a mature secondary market in debt. Credit card, educational and mortgage debts are bundled according to risk profiles and sold in secondary markets. The sale of securitized loans provides additional capital, which is used to extend more loans to more consumers, beginning the cycle anew. The development of a market in securitized pools of credit has made capital more easily available and the extension of credit to consumers a more economically attractive line of business.²²

3. CONCERNS ABOUT INFORMATION USE

Unsurprisingly, the core element of this system, the use of standardized records to determine eligibility for credit, prompted public concern about the content of these records. Congress began hearings on the subject in 1968.²³ The result of this inquiry was the enactment of the Fair Credit Reporting Act in 1970, the first law ever to regulate the use of personal information.

Since its enactment, the Fair Credit Reporting Act (FCRA) appears to have successfully addressed the concerns of consumers by providing a relatively uniform federal standard for ensuring the accuracy and security of the information contained in credit reports. Changes in

III. THE FAIR CREDIT REPORTING ACT IN CONTEXT

1996—largely directed at strengthening recourse for consumers—improved the act substantially. Any attempts to modify this regulatory regime should be subject to rigorous scrutiny in light of the performance of the market for consumer credit over the last three decades, and the success of the FCRA in protecting the concerns of consumers.

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

“Unless we have . . . [a] 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 . . . before they make such loans or not make those loans at all.”²⁴

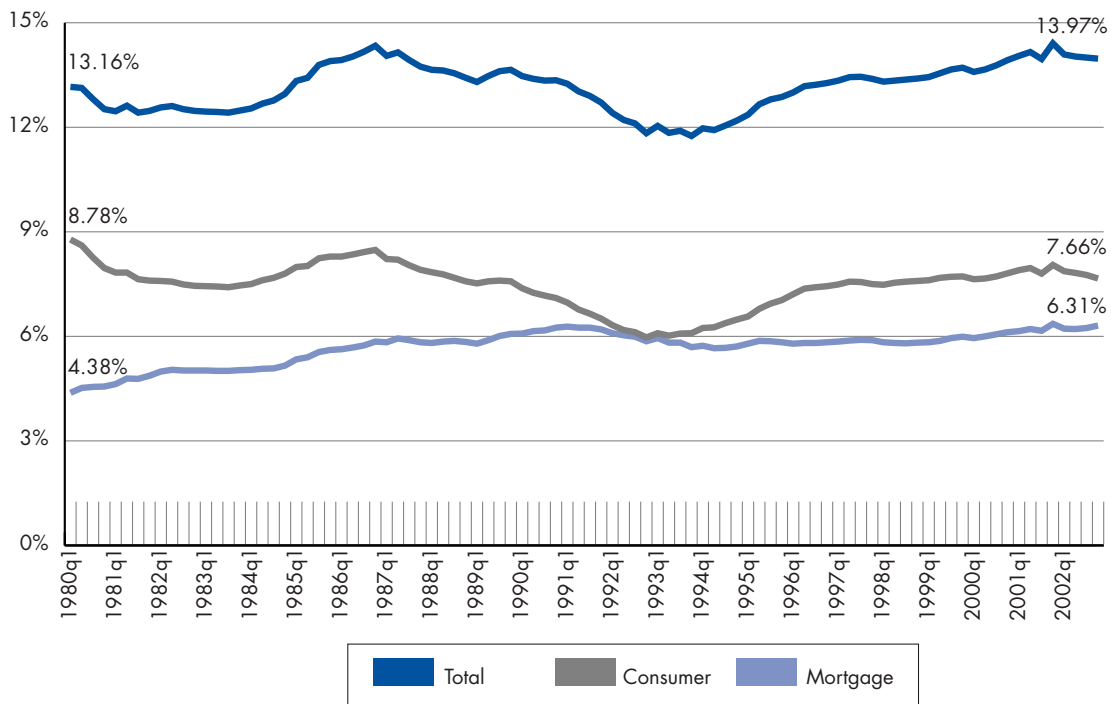
B. TRENDS IN CONSUMER CREDIT ACCESS AND USE

The recent history of the credit system can be thought of as the evolution of increasingly successful methods of reducing the risk premium caused by hidden information and moral hazard. But because of the progress described above—dramatic improvements in the ability to assess the risk of a loan—the 1990s stand in stark contrast to earlier periods. Two consequences have been greater access to credit for all consumers and the extension of credit to traditionally underserved segments.

The implications of greater access to credit for borrowing and spending patterns are debated. But two facts should be kept in mind. First, as economist Thomas Durkin notes in a Federal Reserve examination of credit card use, outstanding consumer credit (excluding real estate-secured debt) as a share of disposable personal income has remained within a band between 15 and 21 percent for the last 35 years; the share tends toward the lower end of the band during recessions and toward the upper end during booms.²⁵ In recent years, following the 1990s economic boom, it has tended toward the higher end of the band.

And second, outstanding consumer credit per household has also remained more or less the same when adjusted for inflation until the early to mid 1990s when it began to increase. But even though outstanding credit increased, debt burdens (what must be devoted to interest and principal payments to remain current) remained relatively constant (see Figure 1).

Figure 1: Household Debt-Service Burden as a Share of Personal Disposable Income (1980–2002)²⁶



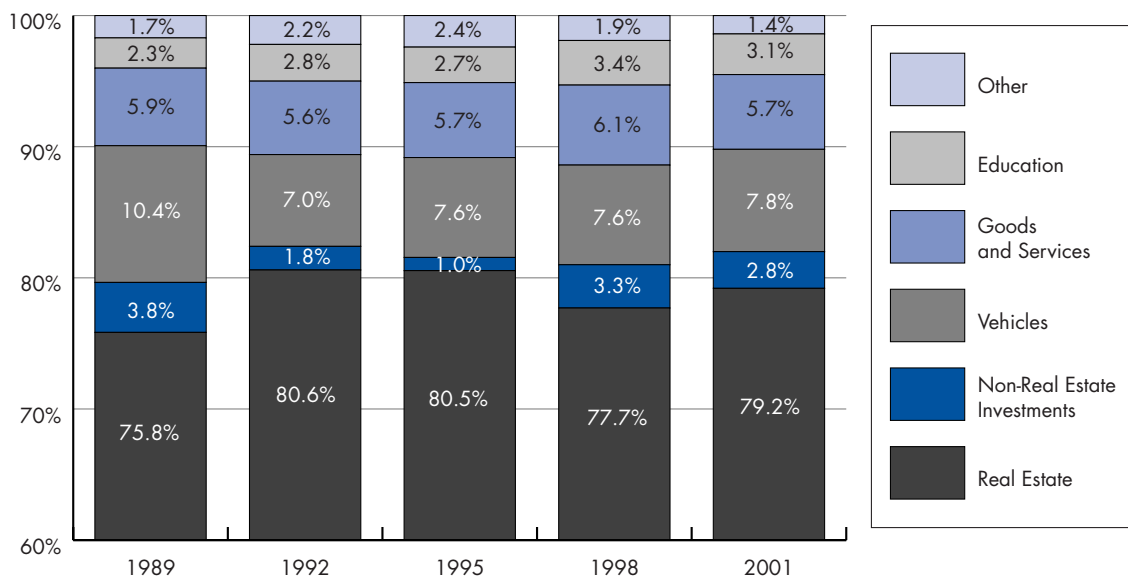
By the end of 2002 the total burden was under 14 percent of disposable income. It has fluctuated between 11.8 percent and 14.4 percent for the last 20 years, reaching relative highs in economic booms, as during the mid to late 1980s and late 1990s, and relative lows in recessions, as during the early to mid 1980s and early 1990s. While debt-service burdens as a share of personal disposable income have remained stable, mortgage payments have come to account for a larger share of the burden in recent years.

And while average household debt levels have increased since 1992,²⁷ there are reasons to believe that the most significant shift across the distribution of the uses of credit results from growing access to homeownership.²⁸ Changes in the distribution of the debt-service burden suggest that rising homeownership and the rolling in of high-interest consumer debt into low-interest home equity-backed debt has been driving this growth. Figure 2 shows the

III. THE FAIR CREDIT REPORTING ACT IN CONTEXT

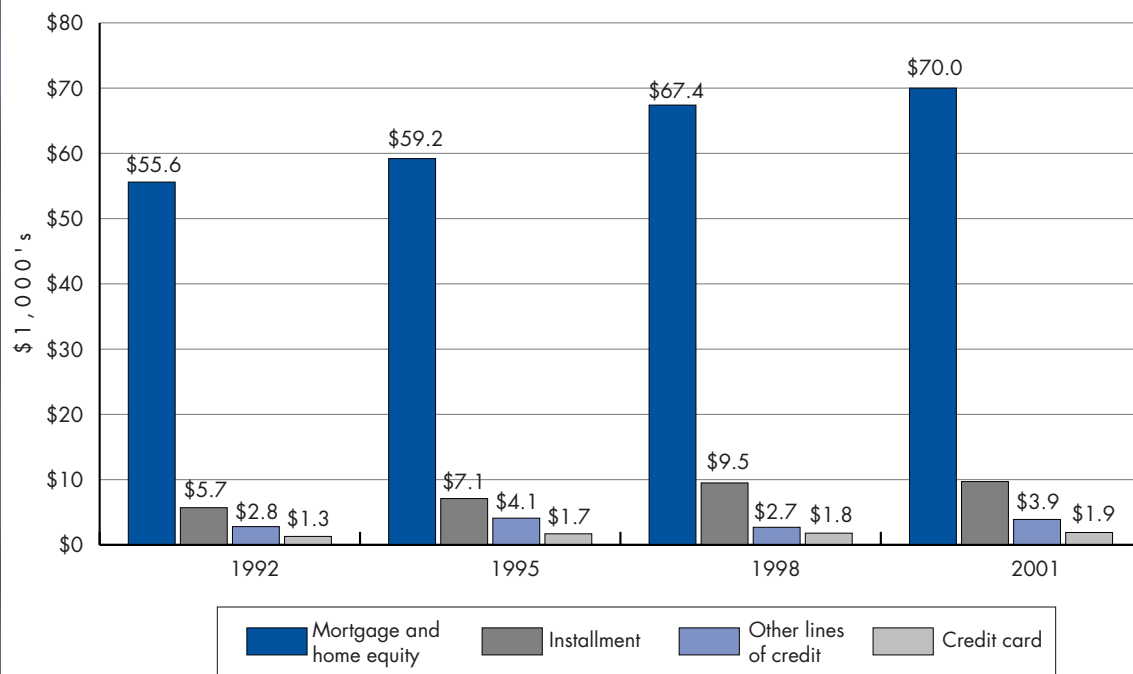
distribution of debt by purpose. Note that real-estate related debt—home purchases, home improvements and real-estate investment—as a share of total debt grew between 1989 and 1992. It is significant that the distribution of debt has not changed significantly in the last decade.

Figure 2: Distribution of Household Debt (by purpose, 1989-2001)²⁹



This shift in the composition of debt towards real-estate is also visible in changes in the value of debt by categories. The median value of mortgages and home equity loans grew by 26 percent (in constant dollars) between 1992 and 2001. The median value of credit card debts grew by more than 50 percent for the same period. (See Figure 3) Unlike the latter, the former grew on top of a substantial base, and the additional debt on mortgages constitutes a larger share of average household income than does the increased debt from credit cards.

Figure 3: Median Value of Debt for Families Holding Debt (by type, in 2001 dollars)³⁰



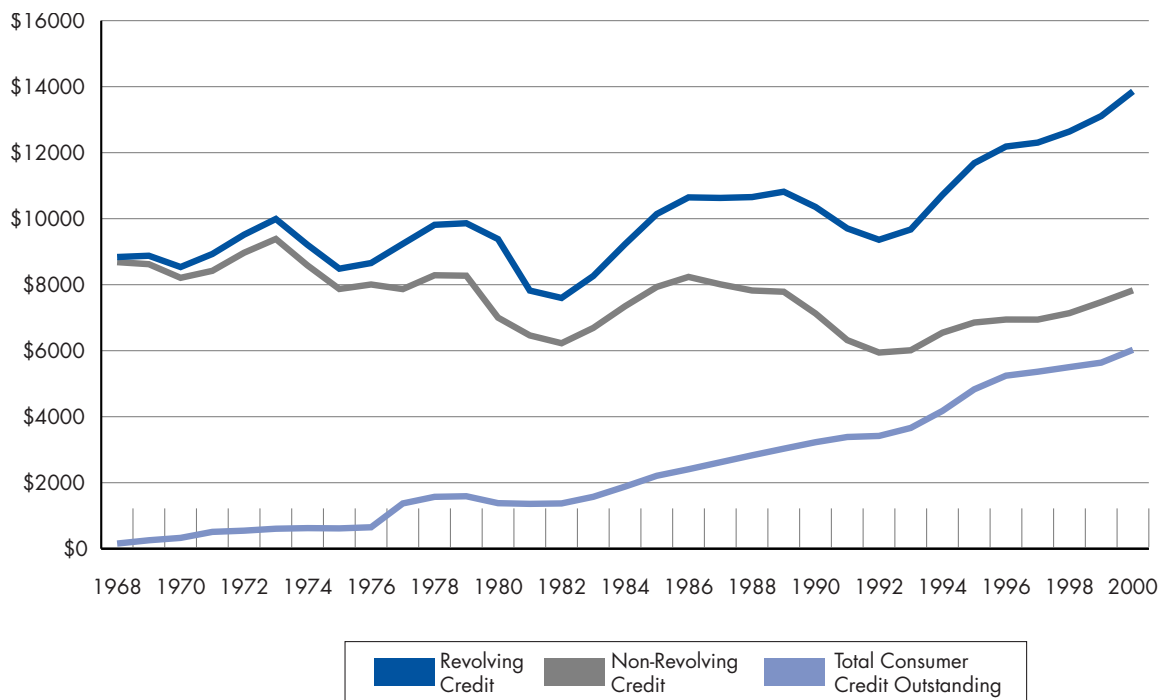
Those who argue that consumers are overextended also often cite the growth in the average balance on credit cards. Average balances have grown considerably, and the spread of credit cards has contributed to the relative growth of revolving debt as a share of total outstanding consumer credit.

Much of this growth may be the substitution of non-revolving debt by revolving debt. It is not simply that credit card debt and other forms of revolving credit have grown significantly in the aggregate when compared to non-revolving credit, but also that non-revolving debt has fallen from its mid to late 1980s peak (in absolute terms). (See Figure 4). This focus on credit card debt as evidence of growing overextension paints a partial picture.

The past few decades have been characterized by rising debt as a result of spreading homeownership and the substitution of revolving debt for the non-revolving type. Judgments about the size of debt-burden should keep this larger picture in mind. But within these changes are other, perhaps more significant shifts in the distribution and uses of credit.

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Figure 4: Consumer Credit Outstanding per Household (in 1996 constant dollars, 1968-2000)³¹



C. THE EVOLUTION OF CONSUMER CREDIT MARKETS

This section looks at the impact of changes in the consumer credit system on the distribution of consumer credit and its uses among different demographic segments of the American population.

1. CREDIT MARKETS ARE HIGHLY COMPETITIVE

Competitive markets are generally characterized by a large number of participants, with no single participant or group of participants dominating the market. Entry and exit are easy, and information for consumers is widely available. These conditions hold in markets for both credit cards and mortgages.

In 2001, more than over 6,800 depository institutions issued MasterCard and VISA credit cards.³² American Express and Discover also issue a significant number of cards.

Furthermore, many of those who issue cards do so in national markets. A 2002 Federal Reserve System survey of the 176 largest credit card issuers in the United States found that 64 of them distribute their cards nationally.³³ With so many issuers, no single firm or group of firms dominates the market. In 2002, for example, the top four MasterCard and Visa issuers of MasterCard and Visa accounted for 52.6 percent of the purchase volume of transactions for these cards and the largest 30 issuers accounted for 85.2 percent.³⁴ In contrast, in motor vehicle manufacturing, a highly concentrated industry, the top four U.S. manufacturers accounted for 82.4 percent of the value of shipments and the largest 20 accounted for 98.8 percent.³⁵

The level of competition that exists in the credit card industry is evidenced by its intense marketing efforts. Issuers must compete to attract consumers new to the marketplace, to induce others to switch, and to retain existing customers. In their quest for customers and to increase their market share, we estimate that they spend over \$5.6 billion a year on marketing.³⁶ In 2001, they not only mailed more than 5 billion solicitations to prospective new customers,³⁷ but also marketed through many other channels including print media, TV, radio, bank branches, the Internet, and the telephone. This marketing provides consumers with large amounts of information on product availability, prices, and features on which they can base their decisions.

There are few barriers to entering the market for issuing credit cards. Any bank with a federal or state charter, for example, may issue MasterCard credit cards. It is also easy to exit the market, so portfolio sales are common. For example, early in 2002, Chase announced that it would buy about 25 percent of Provident Financial's portfolio in a sale that would increase its portfolio of outstanding debt by about \$8 billion.³⁸ The ease of exit also adds to the competitive nature of the market.³⁹

The market for mortgages is also highly competitive. In 2002, the top four firms accounted for 41.9 percent of the dollar value of mortgage originations, while the top 30 firms accounted for 81.8 percent.⁴⁰ Again, since this degree of concentration is not particularly high, it underscores the competitive forces that characterize the mortgage market today. In 2001, roughly 65 percent of all mortgages were initiated by independent mortgage brokers,⁴¹ who typically dealt with between 5 and 10 different lenders. Homebuyers and owners can simply turn to the real estate section of their local paper to find a host of lenders and brokers offering competing rates on a variety of products.

The competitive credit market provides consumers with wide and flexible choice among the providers of credit cards and mortgages. In a recent survey of consumers, 86 percent of the

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respondents “strongly agreed” or “agreed somewhat” with the statement: “It is easy to get a credit card from another company if I am not treated well.”⁴² Home borrowers likewise appear to be satisfied with the terms of credit. According to a recent Freddie Mac survey, 97 percent of conventional borrowers indicated that the rates and terms of their mortgage were fair; 95 percent indicated that their lender gave them accurate information about their mortgage; and 93 percent indicated that the mortgage they ultimately received was “no different” from, or “better than” what they had expected.⁴³

In the following, we discuss in detail some of the benefits of the competitive markets for credit cards and mortgages.

2. EXPANDING AND INCREASING ACCESS TO PAYMENT CARDS

Consumers generally benefit from competitive markets since they provide wider access to goods and services. For example, general-purpose credit cards were reserved for the financially elite at their inception. However, with better systems of evaluating credit risk and greater competition, issuers realized that less affluent individuals were also often very good risks. Accordingly, as Table 1 shows, more and more people of all financial strata have been provided access to credit.

Table 1: Access to Credit by Family Income: 1970-2001 (%)

Income group	1970	1977	1983	1989	1995	1998	2001
<i>Lowest quintile</i>							
Have a card	2	11	11	17	28	28	38
<i>Second lowest quintile</i>							
Have a card	9	22	27	36	54	58	65
<i>Middle quintile</i>							
Have a card	14	36	41	62	71	72	79
<i>Second highest quintile</i>							
Have a card	22	51	57	76	83	86	87
<i>Highest quintile</i>							
Have a card	33	69	79	89	95	95	95

Between 1970 and 2001, increases in the share of families with credit cards were greatest for the lower income groups. The share of families in the lowest income quintile with a credit card increased from 2 percent in 1970 to 38 percent in 2001. In contrast, the share of families with credit cards in the highest income quintile increased by a factor of just under 3, from 33 percent in 1970 to 95 percent in 2001. Furthermore, the distribution of revolving debt “evened out.” The bottom two quintiles’ share of the balance on revolving credit grew from 11 percent of the total to 19 percent between 1970 and 2001; the top two quintiles’ share fell in measure during the same period, from 67 percent to 59 percent. (See Appendix B).

Access to credit cards has also been growing rapidly for minority populations, both in absolute terms and in comparison to whites. As shown in Table 2 below, the percentage of minority families with bank-type credit cards has more than doubled over the last 20 years, growing from 25.9 percent in 1983 to 54.3 percent in 2001. While the share of minority families with credit cards continues to be below the share for non-Hispanic whites, the racial and ethnic gap has narrowed considerably.

Table 2: Percentage of Families Having Credit Cards (by race)

RACE	YEAR							% Change 1983 to 2001
	1983	1986	1989	1992	1995	1998	2001	
All	45.1	N/A	56.0	62.4	66.5	67.5	72.7	61.1
White	46.4	N/A	63.5	70.1	72.2	73.6	78.5	69.1
Black	23.6	N/A	28.8	33.7	39.4	41.3	55.8	136.8
Hispanic	26.2	N/A	31.8	33.4	48.8	48.1	48.4	84.7
All Minority	25.9	N/A	33.8	38.7	46.5	46.4	54.3	109.6

3. EXPANDING AND INCREASING ACCESS TO CONSUMER MORTGAGE CREDIT

For the most part, trends in consumers’ growing access to mortgage credit mirror those of payment cards. Table 3 shows the percentage of families holding home-secured debt at three-year intervals from 1983 to 2001. Between 1983 and 2001, the percentage of all families holding such debt increased from 35.7 to 44.6 percent, an increase in share of over 25 percent. But as the table also shows, the percentage of minorities with such debt increased from 21.3 percent to 35.1 percent, an increase in share of 65 percent. And less affluent families, while continuing to be less likely than more affluent families to have home-secured debt at the end of the period, had a much higher growth rate in their use of mortgage debt. Between 1983 and 2001, the percentage growth in the share of families holding home-

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secured debt with incomes below \$25,000 and above \$10,000 was 30.2%, contrasting starkly with growth of 5.8% for families with incomes between \$50,000 and \$100,000 (see Table 3).

Table 3: Percentage of Families Holding Home-Secured Debt (by type)

Family Characteristic	YEAR							% Change 1983 to 2001
	1983	1986	1989	1992	1995	1998	2001	
<i>All Families</i>	35.7	38.5	39.5	39.1	41.0	43.1	44.6	25.2
<i>Income (1998 Dollars)</i>								
< \$10,000	6.7	9.9	6.5	9.0	9.0	8.6	10.3	53.8
\$10,000-\$24,999	17.7	19.9	20.6	20.9	24.5	21.4	23.1	30.2
\$25,000-\$49,999	39.8	39.8	41.7	43.9	45.3	43.7	43.6	9.8
\$50,000-\$99,999	64.9	63.4	66.6	65.7	68.2	71.1	68.7	5.8
\$100,000 +	69.2	68.3	73.8	74.2	72.0	73.1	75.8	9.5
<i>Age Of Head</i>								
Less than 35	28.9	39.3	34.8	30.9	33.0	33.2	35.7	23.8
35-44	58.3	56.4	57.9	55.5	54.3	58.7	59.6	2.2
45-54	53.5	50.2	58.3	61.4	61.8	58.8	59.8	11.7
55-64	34.0	33.5	37.0	40.9	45.2	49.3	49.0	44.0
65-74	16.0	20.4	21.8	18.6	24.7	26.0	32.0	99.9
75 +	3.1	4.1	6.3	8.6	6.8	11.6	9.5	203.8
<i>Race/Ethnicity</i>								
White non-Hispanic	39.6	41.6	43.0	42.8	44.1	46.6	47.6	20.3
Black	25.6	21.4	24.8	27.5	26.1	30.2	36.5	42.8
Hispanic	23.7	27.5	31.0	25.2	33.9	27.9	31.9	34.5
All Minority	21.3	24.3	28.9	27.8	30.2	30.7	35.1	65.0

Not surprisingly, the increasing use of mortgage debt was accompanied by a significant increase in the homeownership rate, as Table 4 shows. In 1983, 60.2 percent of all households owned a primary residence; by 2001 the percentage had increased to 67.7 percent.⁴⁴ The largest increases were again observed among lower income and minority households. For example, ownership among all minorities increased from 33.9 percent to 47.1 percent.⁴⁵ Among families with incomes between \$10,000 and \$24,999 (in 1998 dollars), home ownership increased from 48.8 percent to 54.1 percent.⁴⁶ While minority home ownership

rates continue to lag those of non-Hispanic whites—even controlling for household income and age—the gap has narrowed significantly.

Table 4: Percentage of Families Owning Primary Residence (by type)

Family Characteristic	YEAR							% Change 1983 to 2001
	1983	1986	1989	1992	1995	1998	2001	
<i>All Families</i>	60.2	62.8	63.9	63.9	64.7	66.3	67.7	12.4
<i>Income (1998 Dollars)</i>								
< \$10,000	29.2	41.6	31.3	36.2	36.3	35.1	34.2	17.3
\$10,000-\$24,999	48.8	52.8	51.2	54.6	55.5	51.6	54.1	10.7
\$25,000-\$49,999	63.7	60.4	66.7	67.0	67.0	68.2	66.4	4.3
\$50,000-\$99,999	85.0	80.1	84.6	82.6	84.9	85.1	85.9	1.0
\$100,000 +	91.1	91.1	94.2	90.2	90.8	93.3	94.0	3.2
<i>Age Of Head</i>								
Less than 35	34.1	42.9	39.3	36.9	37.9	38.9	39.9	17.0
35-44	68.5	62.0	66.1	64.5	64.7	67.1	67.8	-1.0
45-54	78.0	71.7	76.5	75.5	75.3	74.4	76.3	-2.2
55-64	76.4	72.1	80.1	77.5	82.0	80.3	83.2	8.9
65-74	78.1	79.6	77.8	79.3	79.5	81.5	82.5	5.7
75 +	68.0	65.1	69.9	77.3	72.8	77.0	76.2	12.1
<i>Race/Ethnicity</i>								
White non-Hispanic	67.4	66.7	70.5	70.3	70.6	71.8	74.1	9.9
Black	44.3	44.5	42.4	43.4	42.7	46.3	47.5	7.1
Hispanic	31.4	37.3	42.0	39.9	42.9	44.2	44.3	41.2
All Minority	33.9	44.6	44.3	44.4	44.3	46.8	47.1	38.9

Improving access to credit not only expands the opportunity for home ownership; it also provides the opportunity for wealth formation through appreciation and mortgage pay downs. As one report noted, “The equity that has accumulated in homes is one of the largest components of U.S. household wealth.”⁴⁷

Total equity in primary residences has grown along with access to credit. As Table 5 below shows, total equity in primary residences has almost doubled from about \$4 trillion (in

III. THE FAIR CREDIT REPORTING ACT IN CONTEXT

1998 dollars) to almost \$8 trillion (in 1998 dollars), and would have increased even more if not for refinancing. Equity for all minority households has more than doubled in this period from \$383 billion (in 1998 dollars) to \$822 billion (in 1998 dollars.)

Table 5: Total Home Equity (Primary Residence) in billions of 1998 constant dollars⁴⁸

Family Characteristic	Year						
	1983	1986	1989	1992	1995	1998	2001
All Families	4,246	4,816	6,046	5,257	5,047	5,915	7,967
<i>Income (1998 Dollars)</i>							
< 10,000	201	235	182	269	267	273	208
10,000-24,999	673	746	818	882	935	858	1,054
25,000-49,999	1,119	1,161	1,465	1,343	1,317	1,400	1,519
50,000-99,999	1,359	1,550	1,746	1,425	1,361	1,783	2,247
100,000 +	894	1,124	1,836	1,338	1,167	1,601	2,939
<i>Age Of Head</i>							
Less than 35	445	345	468	396	252	349	405
35-44	860	952	1,167	892	881	949	1,358
45-54	968	1,100	1,384	1,125	1,154	1,293	1,921
55-64	970	1,046	1,302	1,093	1,027	1,222	1,640
65-74	739	948	1,054	1,037	972	1,147	1,393
75 +	264	425	671	714	760	955	1,249
<i>Race/Ethnicity</i>							
White non-Hispanic	3,863	4,419	5,297	4,636	4,485	5,243	7,145
Black	245	257	302	262	243	252	294
Hispanic	80	86	196	152	128	213	223
All Minority	383	397	749	621	562	673	822

4. CREDIT COSTS ARE DECLINING AND BECOMING MORE RISK BASED

Competitive markets not only offer wider choices of products and services to consumers, but also restrain the prices sellers are able to charge. The data seem to indicate that what is true in theory is also true in practice for both credit cards and mortgages. While there is not a government-published series showing a price index for credit cards, economists David Evans and Richard Schmalensee have computed one for the period 1984 to 1996.⁴⁹ 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 quality of credit cards was also increasing. (See Appendix B for a discussion of ancillary services of credit cards below.) Evans and Schmalensee attribute these favorable trends to increased competition in the consumer credit card market.⁵⁰

Compared with a scenario in which the cost of credit had remained stable since 1997, consumers have reaped huge savings from this increased competition. Revenues (net of charge-offs) for bank card issuers were \$62.6 billion in 2001,⁵¹ meaning that increased competition and resulting lower costs saved consumers about \$30 billion during that one year alone.⁵²

Competition for customers, driven largely by prescreening and the ability to perform credit scoring, has resulted in interest rates on credit cards becoming more widely dispersed, better reflecting the risk of the loan. In 1990, as reported by economists John Barron and Michael Staten, almost 73 percent of all accounts had interest rates above 18 percent, 20 percent had rates of between 16.5 to 18 percent, and only 6 percent had a rate below 16.5 percent.⁵³ By collecting recent data from a number of issuers of credit cards, we have updated the work on the distribution of interest rates to show the distribution in 2002.

Our respondents account for over a \$100 billion in outstanding balances, or about 20 percent of the total MasterCard and VISA outstandings.⁵⁴ Table 6 shows interest rates today to be more widely dispersed—and lower overall—than they were in 1990. For example, today, only 26 percent of balances are at interest rates of 18 percent or above while 15 percent of balances are at interest rates under 5.5 percent. These figures contrast those in 1990, when only 6 percent of interest rates were below 6.5 percent and 93 percent were above 16.5 percent.

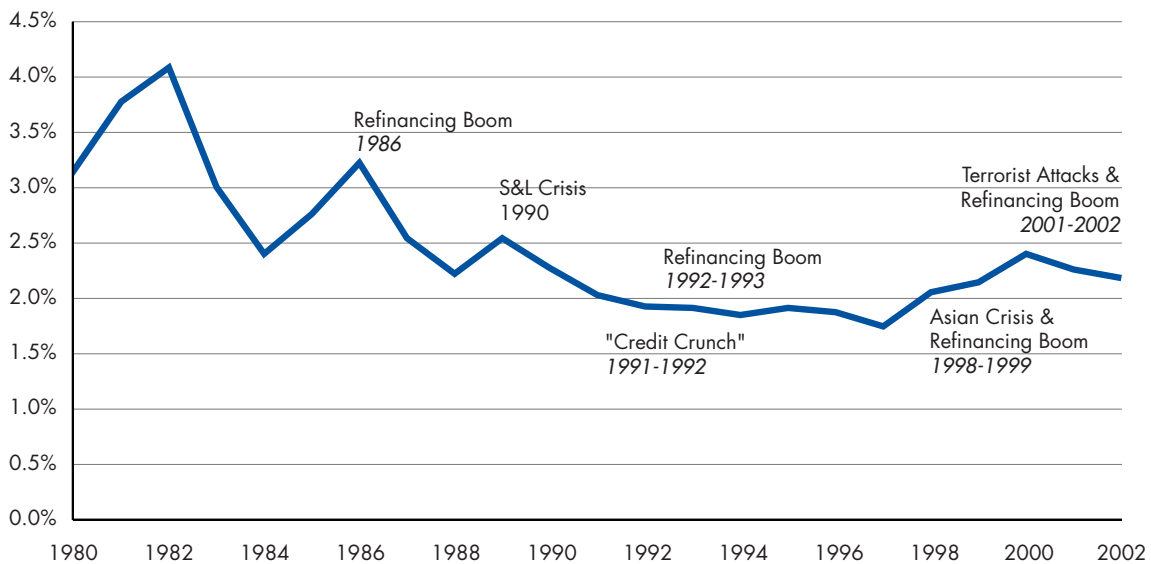
Table 6: Distribution of Account Balances by Interest Rate

Year	Interest Rate Tier				
	< 5.5 %	5.5-10.99 %	11 – 16.49 %	16.5 -17.99 %	18% and over
2002	15	31	25	3	26
1990	6			20	73

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The average cost of a mortgage has also dropped significantly over the past 20 years, fueled by intense competition and the growth of the secondary mortgage market. Figure 5 shows the spread between the average rate on a 30-year fixed-rate mortgage, and the yield on a 10-year Treasury—the benchmark typically used to measure the relative costs of mortgage funds. 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 economic stress. For example, in the early 1980s, mortgage rates were about 3.5 percentage points higher than the rates on a 10-year Treasury bill, while in the last few years, spreads have averaged about 2.5 percentage points. Thus, if spreads today were at their early 1980s levels, the interest rate on a 30-year fixed-rate mortgage would be about 1 percent higher than it is today. With a total mortgage stock of \$5.4 trillion in 2001, a 1 percent (100 basis points) savings in the cost of mortgage funds translates into \$54 billion in annual savings to consumers.⁵⁵

Figure 5: Spread Between 30-Year Fixed Effective Mortgage Rate and 10-Year Treasury Yield




Sources: Freddie Mac "We Open Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2002", March 17, 2003. Exhibit 12, p. 21

5. SMALL BUSINESSES USE CREDIT CARDS AS A FINANCING SOURCE

Credit cards also 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.⁵⁶ Among these small businesses, firms with fewer employees and lower sales have a higher prevalence of personal credit card use. Credit cards are even more important sources of financing for entrepreneurs who 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 were consistently accepted, only 45 percent used their personal credit cards.⁵⁷

The informal role of credit cards as a key source of financing for small businesses should underscore the types of secondary impacts that would occur if preemption sunset led to changes in credit approval policy. The result of tighter credit for small businesses would have a negative impact on entrepreneurial development and would result in reduced job generation.

Thus far, it has been asserted that changing the quality or the quantity of data available in credit reports would have a dramatic effect on consumer credit markets. In particular, it has been argued that such changes would jeopardize most, if not all, of the consumer and economic benefits described above. The following section outlines our approach to these issues, describing several of the possible consequences, should Congress either fail to reauthorize the FCRA's strengthened preemptive provisions or modify them in ways proposed by some state legislators. The next three sections, in turn, provide the results from our three case studies that were designed to test our hypothesis about the relationship between the FCRA and the availability and price of consumer credit.



IV. APPROACH TO THE ISSUES: FULL-FILE CREDIT REPORTING

IV. Approach to the Issues: Full-file Credit Reporting

In this section we will provide an overview of the Information Policy Institute research that is the chief contribution of this report. Research detailed in subsequent sections includes: (1) an analysis of the benefits of credit scoring; (2) an empirical estimate of the impact of changes to the existing rules governing the national credit reporting system on the ability of consumers to access credit and the price of consumer credit; and (3) a model of the role of prescreening in maintaining competitive credit markets, and analysis of the relationship between prescreening and identity theft.

A. RESEARCH PROGRAM

The Information Policy Institute designed a research program to gauge the impacts of eliminating or modifying the preemptive provisions in the Fair Credit Reporting Act.⁵⁸ While this study does not assess the consequences of changes in all of the FCRA's strengthened preemptive provisions, it does examine the likely impact of changes in three—data furnisher obligations, the contents of a consumer report, and prescreening.⁵⁹ These three have been identified as areas of focus by the states (see Appendix C) and also areas that pose potential risk to the integrity of the credit reporting system. Because of their importance, any modifications to these provisions should be subject to intense scrutiny.

In what follows, we examine the economic consequences of possible revisions to these three provisions. This is accomplished by simulating the impact of select proposed changes that are likely to result from the expiration of the preemption status of provisions that enable full-file credit reporting and prescreening.

Section V discusses the development of automated underwriting through the use of scoring models. There, we present a brief overview of the adoption of scoring models and examine the effect these techniques have had on the cost, availability, and distribution of mortgage credit. As we have argued elsewhere, these significant consumer benefits would be placed at risk were the quality of the information in credit reports to deteriorate quantitatively or qualitatively.

In Section VI, we discuss the current full-file credit reporting system. Here, we place particular emphasis on developing quantitative measures of the loss of data elements and data standards on the credit ratings of individual consumers. In other words, we explore what is likely to happen to consumer access to credit, and the price of credit, should Congress not reauthorize the strengthened preemptive provisions.

We then explore some of the economic effects of failing to reauthorize prescreened firm offers of credit as a permissible purpose. Specific attention here will be paid to the competitive effects of prescreening, and the likely impact on the credit card market should prescreening be prohibited. The relationship between prescreened credit solicitations and identity theft is also explored in Section VII.

B. IMPACT OF LOSING OR MODIFYING THE STRENGTHENED PREEMPTIONS

The end of federal preemption—or the inclusion of certain state proposals within the list of preemptions—would almost certainly change the quality and/or the quantity of data available in credit reports (See Appendix C for an overview of legislative proposals). Findings from our analysis lead to one inescapable conclusion, namely, that the resulting effect on consumer credit markets would be dramatic. Scoring models developed under a full-file reporting system would lose much of their predictive power, increasing the level of risk associated with extending consumer credit. Faced with such a scenario, lenders must either raise their fees, reduce their acceptance rates, or both. As a result, borrowers would inevitably suffer.

The end of federal preemption would most likely lead to a patchwork of state laws (and even local ordinances) that could significantly increase the costs of doing business. National lenders would have to adjust their underwriting models to accommodate the prevailing regulation in the borrower's locality. Models would need to be adjusted state by state, at a considerable cost in money and time, and with no real guarantee that the loss of predictive power could be significantly limited. Further, the cost of securitizing debt for secondary markets would rise with the end of the relatively uniform reporting standards that play a crucial role in assessing the risk associated with the debt bundle. In the end, eliminating the federal preemption would threaten, and could possibly reverse, the significant progress that has been made to date in extending affordable credit to all segments of the U.S. population.

The other possibility, continued preemption coupled with federally enacted restrictions on the content of consumer reports, restrictions on the purposes for which reports may be used, or increases in the obligation and liability of data furnishers can also result in similar losses to consumer welfare and economic efficiency. Overly restrictive national credit reporting systems can have adverse consequences similar to those associated with a sunset of preemption.

V. THE BENEFITS OF CREDIT SCORING: THE CASE FOR AUTOMATED UNDERWRITING

V. The Benefits of Credit Scoring: The Case for Automated Underwriting

The development and implementation of sophisticated consumer credit scoring models is among the most important innovations made possible by the current full-file credit reporting system. Lenders use credit scoring models to allocate credit and manage risk on an on-going basis. These models are also key to the efficient operation of secondary markets and the ability to link American consumers to the broader capital market. Removing or modifying the FCRA's strengthened preemption provisions would seriously undermine the quality of scoring models, and reduce—if not eliminate—the many benefits that have been produced by this rapidly developing technology.

Accordingly, this first case study looks at some of the benefits of credit scoring in the consumer mortgage market. As described in Section III, two important trends have characterized consumer credit markets over the past 20 years: declining costs and increasing access. Although many factors have contributed to these trends, credit scoring has undoubtedly played an important role. This case study consolidates information about credit scoring, and how it has affected the cost and availability of mortgage credit. By documenting the benefits of credit scoring, we help to set the stage for the question examined in our second case study, namely, what would happen to these benefits if the models—and the underlying data on which they are based—become less robust.

A. THE DEVELOPMENT OF SCORING MODELS

Credit scoring models are complex statistical tools that use the wealth of information contained in the consumer's credit file to predict the likelihood of repayment. Unlike manual underwriting systems—where it is difficult, if not impossible to avoid the introduction of subtle biases—scoring models provide an objective, empirically based method of assessing credit risk. *While difficult to quantify, the development of scoring models has undoubtedly played a critical role in extending credit to segments of the market that have been historically underserved.*

Though credit scoring has existed for several decades, consumer credit scoring based solely on the contents of credit bureau data was introduced in 1987. The development of scoring models permitted credit grantors to rank consumers according to their expected risk. Credit scoring rapidly spread throughout the credit card sector, and is now being used for a variety of purposes, ranging from initial underwriting, to on-going servicing, to the prescreening of credit offers.

An early study by economists Chandler and Parker⁶⁰ examined the predictive power of scoring models based on detailed information drawn from credit bureau reports. As part of their analysis, the authors developed a series of hypothetical scoring models using data that ranged from the simple information contained in a standard application—household income, age, ownership status, years at current job, etc.—to increasingly detailed information drawn from the consumers’ credit files.

Chandler and Parker found that models based on the full range of credit data did a significantly better job of predicting card performance than models based on “applications” data alone. In fact, they found that *omitting* the applications data actually improved their models’ predictive power for credit cards and revolving retail debt. More importantly, Chandler and Parker found that models based on the full range of credit data had significantly higher predictive power than models based on less complete information on the consumer’s credit profile.

B. EXTENSION TO MORTGAGE MARKETS

While the use of credit scoring spread rapidly among direct and indirect lenders of credit as well as credit card issuers, mortgage lenders took longer to adopt the technology. In 1996, Freddie Mac recommended that credit scores be used as part of the manual underwriting process. Before then, assessments were based on the underwriter’s interpretation of the detailed information contained in a consumer’s credit files. By the end of the following year, the vast majority of mortgage issuers were using credit scores to assist in underwriting loans.

At the same time, Fannie Mae, Freddie Mac, and a number of other major lenders and mortgage insurers began to use automated underwriting systems (AUS) as an alternative to manual review. These models combine information on the consumer’s credit score with other factors traditionally used in mortgage underwriting—for example, the property’s appraised value, the size of the down payment, and the relationship between the borrower’s income and the monthly costs of carrying the mortgage as well as other debt.

In less than a decade, automated underwriting has become the norm. In 1996, only 25 percent of all mortgage lenders used AUS. By 2002, over 90 percent had adopted the technology, with 75 percent of new production underwritten through AUS.⁶¹ In the process, automated underwriting has virtually transformed the mortgage market, reducing the time and costs required to originate loans, and at the same time significantly improving the industry’s ability to monitor and manage credit risk.



V. THE BENEFITS OF CREDIT SCORING: THE CASE FOR AUTOMATED UNDERWRITING

C. CONSUMER BENEFITS

The introduction of credit scoring and automated underwriting into the mortgage market has generated enormous benefits to consumers. *Before the advent of automated underwriting, approving a loan application took close to three weeks; in 2002, over 75 percent of all loan applications received approval in two to three minutes.*⁶² Such efficiencies have enabled the industry to handle the massive refinancing waves that have occurred within the last few years. In 2002, for example, some 10 million borrowers refinanced their existing mortgages, taking advantage of the lowest interest rates in more than three decades, while another 6.4 million sold their existing homes.⁶³ As a result of this unprecedented activity, the Federal Reserve estimates that homeowners were able to extract some \$700 billion of accumulated equity from their homes—a massive infusion of funds that has played a critical role in shoring up an otherwise anemic economy.⁶⁴

It is highly unlikely that this volume of activity could have been accommodated in the absence of automated underwriting. Moreover, automated underwriting—by promoting a greater understanding of credit risk—has enabled the industry to take a more flexible approach to its treatment of a cash-out refinancing. In 1993, for example, Fannie Mae’s underwriting guidelines limited the amount of cash that the borrower could withdraw to 75 percent of the property’s value. Today, the limit is 90 percent.⁶⁵

These changes have had an impact on the recent performance of our economy. In the words of Alan Greenspan:

“There can be little doubt that the availability of a ready source of home equity has reduced the costs and uncertainties associated with income volatility ... and a host of other life events that can unexpectedly draw down savings. Home equity extraction may be the household sector’s realization of the benefits of a rapidly evolving financial intermediation system.”⁶⁶

The introduction of automated underwriting into the mortgage market has also significantly reduced the cost of closing a loan, making homeownership more accessible to families with income and wealth constraints. *A recent survey by Fannie Mae found that lenders who integrated automated underwriting at point of sale reduced their origination costs by about 50%, or roughly \$1,500 per loan. Applied to the 12.5 million sales⁶⁷ of new and existing homes in 2002, this would produce savings of \$18.75 billion.*

Given the highly competitive nature of the mortgage industry, most of these savings are passed through to consumers. Since high upfront costs are a significant barrier to owning a home for many low-income families, automated underwriting in the mortgage industry has undoubtedly contributed to the significant increase in the homeownership rate that has occurred within the past few years.

When automated underwriting is combined with online originations—another emerging trend—the potential savings could be even greater. According to Microsoft estimates, online efficiencies could eliminate nearly two-thirds of the prevailing 3-percentage point origination fee.⁶⁸ Thus, on a \$150,000 mortgage, savings could run as high as \$3000. None of this would be possible without the use of mortgage scoring models.

Finally, automated underwriting has undoubtedly opened doors to families previously underserved by the mortgage market. In the past, manual underwriters were forced to weigh the various strengths and weaknesses of an individual's loan application in making their lending decision—an inherently subjective process that made the system vulnerable to bias, however unintended. In contrast, automated underwriting provides an objective, performance-based tool for assessing these kinds of trade-offs in a way that treats every applicant the same. Such objectivity is particularly important for families who do not precisely meet each individual underwriting guideline.

A recent study by Freddie Mac documents the effects of automated underwriting on low-income and minority families.⁶⁹ The study examined a sample of roughly 1000 mortgages originated in 1993 and 1994 and purchased by Freddie Mac as part of an affordable housing program with a major lender. At the time, human underwriters were asked to classify each application as an “accept” or “caution.” The Freddie Mac researchers used data drawn from the original applications to re-underwrite every loan using a simplified version of Loan Prospector, the company's automated underwriting tool.

They then compared the assessments of the human underwriters to the classifications produced by Loan Prospector. Not only did they find that automated underwriting did a better job of identifying loans that ultimately perform—that is, loans that did not experience a serious delinquency or default—but they also found that the greater precision of automated underwriting resulted in higher approval rates, particularly for underserved populations. *In particular, a 2000 version of Loan Prospector increased the share of “accepts” by 36 percentage points for all affordable loans, and by 29 percentage points for the subset of minority borrowers.*

V. THE BENEFITS OF CREDIT SCORING: THE CASE FOR AUTOMATED UNDERWRITING

D. SUMMARY

Existing evidence suggests that credit scoring has generated many benefits to consumers. In the mortgage market, for example, automated underwriting and credit scoring have lowered closing costs, expanded access for minority and lower-income families, and reduced the time it takes to get a loan. More broadly, it has enabled unprecedented numbers of existing homeowners to tap the accumulated equity in their homes. In the end, however, the potential benefits of scoring models are directly tied to the quality of the data on which they are based. Our next case study examines what would happen to these benefits if the strengthened preemption provisions enacted in 1996 were allowed to expire, or were modified by Congress to reflect the state proposals analyzed in this study.

VI. Full-File Credit Reporting and Uniform National Data Standards

A. METHODOLOGY

Building on an earlier generation of research on credit reporting, we constructed a case study based on six commercial scoring models in use today.⁷⁰ We modeled four different scenarios describing what might happen to the quality and quantity of information contained in consumer credit reports if the FCRA's strengthened preemptive provisions were allowed to expire or were modified. While these scenarios do not attempt to mimic a single specific legislative proposal, they incorporate restrictions that have actually been proposed at the state or local levels. (See Appendix C). We then examined what would happen to the performance of the commercial scoring models under each of the different scenarios, and measured the impact this would have on the availability and the cost of credit. Finally, we examined some consequences for consumers, both in the aggregate and according to various socio-demographic attributes.

1. DEFINING SCENARIOS

Based on our own analysis of pending state legislation (see Appendix C), removal of the strengthened preemptive provisions would trigger a flood of legislative initiatives at both state and local levels. If enacted, many of these initiatives would restrict both the quality and quantity of information included in consumers' credit reports. In our analysis, we classified these proposed initiatives into two broad categories:

- The first type of initiative would result in changes that reduce the quantity of data reported (increasing the liability of data furnishers, for example, might lead to a reduction in reporting rates).
- The second type of initiative would have a direct effect on the quality of data reported (for instance, eliminating the reporting of 30-day delinquencies).

The four scenarios selected for our analysis represent specific examples of what could happen under these two types of legislative actions (Table 7). Scenarios A and B represent the impact of legislation that imposes additional obligations and liabilities on data furnishers.⁷¹

Scenario A assumes that two third-party data processors drop out of the system. These third-party data processors collect information primarily from credit card issuers. These card issuers vary by size, and include large issuers as well as community banks and credit unions.



VI. FULL-FILE CREDIT REPORTING AND UNIFORM NATIONAL DATA STANDARDS

Collectively, these lenders account for about 2.5 million total trade lines in our sample of 3.5 million credit files (each credit file contains an average of 9.3 trade lines), of which more than 315,000, or 13 percent, were purged as a result of the data restrictions modeled in Scenario A.

In Scenario B, eight randomly selected major credit providers—that collectively account for more than 17.5 million trade lines in our sample of 3.5 million credit files—drop out of the system as a result of increased liability concerns. Unlike Scenario A, however, the data affected in Scenario B captures a broad swath of credit types, including revolving credit and non-revolving credit. Because the data captured in Scenario B is richer and more diverse than in Scenario A, the data restrictions modeled in Scenario B produce a 21 percent reduction in data furnished to the credit bureaus.

In short, Scenario A is homogeneous with respect to the type of loan affected (overwhelmingly credit card loans), but is varied in terms of firm size. Scenario B, by contrast, is homogeneous with respect to firm size (all data furnishers are major institutions), but is varied with respect to the type of data captured (credit card debt, auto loans, boat loans, personal loans, non-revolving credit, and mortgage loans).

Both scenarios assume that all current, historic, and inactive trade lines provided by a data furnisher will be purged from the system once that furnisher drops out. These assumptions add extra uncertainty to the model because we do not know precisely how increased reporting liability will affect the behavior of different credit reporters.

Scenarios C and D consider restrictions on the kinds of information that can be included in the consumer's credit report. The "moderate" scenario (Scenario C) assumes that late payments can only be reported after 90 days; that all public record data must be purged after 3 years; that all negative information must be purged after 5 years; and that inquiries clustered within a 30-day period count only once.⁷²

The more "severe" scenario (Scenario D) assumes that late payments can only be reported after 120 days; that all public record data pertaining to a late payment must be purged upon settlement of debt; that all adverse information – including bankruptcy – must be purged after 4 years; and that all inquiries must be counted as one if they are less than 60 days old.⁷³

It should be noted that the results from these scenarios also apply to the case where similar restrictions are enacted at the federal level, even if the more restrictive federal law preempts state legislation.

Table 7: Scenarios

Criteria	Reductions in the Number of Data Furnishers		Restrictions to the Type of Data Reported	
	Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
<i>Limitations on Reporting of Delinquent Accounts</i>			Purge trades with 30- or 60-day delinquencies	Purge trades with 30-, 60-, or 90-day delinquencies
<i>Limitations on Reporting of Paid Public Record Items</i>			Purge at 3 years	Purge when paid
<i>Limitations on Reporting of All Adverse Information</i>			Purge All Adverse Information at 5 years	Purge All Adverse Information at 4 years
<i>Limitations on Use of Inquiries in Models</i>			All 30 day clustered inquiries count as one	Purge all but one inquiry less than 60 days
<i>Reduction of Trade-line Availability</i>	Two Third-Party Data Processors Stop Reporting	8 Major Credit Issuers stop Reporting		

2. THE MODELS

Six commercially developed scoring models were used to conduct the simulations on the overall impact of changes in data. Four are commercial scoring models used by credit bureaus to rank consumers according to risk. The other two are proprietary scoring models developed by two financial institutions that are used to determine the terms and conditions of credit card offers. Commercial Model #1, developed by TransUnion, was also used to assess the impact of the hypothetical changes in credit data on credit scores by socio-demographic groups.

The Commercial Scoring Models. One of the four commercial scoring models examined in this report was developed by Fair, Isaac and Company and used to generate the so-called “FICO score.” The other three models were developed by TransUnion.

Three of the four commercial scoring models estimate the probability that a consumer will become seriously delinquent on an account (defined as 90 days or more past due) within a

VI. FULL-FILE CREDIT REPORTING AND UNIFORM NATIONAL DATA STANDARDS

two-year period of time. The remaining model predicts the probability that the consumer will file for bankruptcy within the next 12 months. While their objectives differ somewhat, each commercial scoring model uses information from the consumer's credit report to predict the probability of a negative event within a certain period of time. Based on this assessment, each model assigns consumers a numeric credit score that reflects their predicted performance, with successively higher credit scores indicating successively lower risk. The range of scores across the different models is similar, but not identical.

While credit scores are used for a variety of purposes, commercial scoring models do not specifically generate an "accept" or "reject" decision. Even if the consumer's credit score were the only consideration, the individual credit issuer would have to determine the specific score—or cut-off—to be used in approving an application. In addition, many underwriting models—such as those employed in the mortgage industry—include other important factors that can potentially offset weak credit scores.

Credit Card Models. In contrast with the commercial scoring models, the credit card models examined in the analysis generate scores that are used to determine both the price and amount of credit offerings to consumers. Two financial institutions agreed to use their credit card models to conduct the simulations: GE Capital and JP Morgan Chase Manhattan. While JP Morgan Chase Manhattan is a bankcard issuer—accounting for about almost five percent of all MasterCard and VISA accounts on a nationwide basis⁷⁴—GE Capital is a "private label" issuer, servicing large retailers such as The Gap and J.C. Penney.

3. THE DATA

Our analysis is based on a data set constructed by TransUnion from the detailed credit reports of roughly 3.6 million randomly selected consumers at two points in time: December 2000 and December 2002. This sample was drawn from their total data file covering virtually everyone in the United States with a credit card or some other form of consumer credit. Data for December 2000 was used to simulate what credit reports would look like under each of the four scenarios depicted in Figure 4. These "hypothetical" credit files were then processed through the different scoring models to generate five different scores per model: one that was based on consumers' original (full file) records; and four that were based on the "hypothetical" credit files associated with each scenario.

To protect the proprietary nature of the different scoring models, they were not specifically identified in the data file. Rather, they were simply identified as Commercial Scoring Models 1 through 4 and Credit Card Models 1 and 2.

An extracted data set containing only Commercial Score #1 (a model developed by TransUnion) and the actual performance of each consumer (based on December 2002 data) was then sent

to an independent information service provider. The information service provider merged the credit data with information on the consumer's race, ethnicity, gender, and household income. After the two data sets were merged, all information that could be used to identify the names or addresses of individual consumers was purged from the file in order to protect their privacy.

Not a single credit file with personal identifying information was ever reviewed by an individual for purposes of this research. TransUnion did not conduct the demographic analysis, and does not have access to this sort of socio-demographic data in their credit files.

4. LIMITATIONS OF THE ANALYSIS

In interpreting the results of our simulations, it is important to recognize that our findings are based on the *current* versions of *existing* scoring models. In the real world, however, regulatory changes of the magnitude examined here would undoubtedly force companies to re-estimate their scoring models—an exercise that would be both time-consuming and extremely costly. These re-estimated models would presumably do a somewhat better job of predicting performance than our simulations would suggest. As such, our simulations can be viewed as “worst case” scenarios.

To understand the potential impact of re-estimation, it is useful to compare the results of our simulations with results from a recent study by economists John Barron and Michael Staten.⁷⁵ Their results also suggest that a loss in the quality or quantity of data can have adverse effects on consumer lending. They simulated the impact of restricted credit information on the performance of scoring models and on the cost and availability of consumer credit.⁷⁶ Credit records of roughly 300,000 randomly selected consumers were used to construct a generic scoring model predicting the probability that an account would experience a 90-day delinquency over a two-year period of time. Barron and Staten began by using a large set of credit variables similar to those employed in many commercial applications. They then re-estimated their scoring model using fewer variables in order to mimic the reporting regimes in other countries: Australia, where only negatives are reported; and Latin America, where bureau data is restricted by type of lender (e.g., banks can only access information on the consumer's performance on other bank cards).

Barron and Staten found that their generic scoring model lost much of its predictive power as the number of variables were reduced. (In other words, their model was less able to distinguish a “good” loan from a “bad,” and more mistakes were made). If lenders chose to keep acceptance rates the same, inferior scoring models in the new regime would significantly increase default rates—an outcome that would eventually cause lenders to raise their fees. Or, if lenders elected to hold the default rate constant, acceptance rates would have



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to fall in the new regime, thereby restricting access for many credit-worthy borrowers. While Barron and Staten acknowledge that their inability to use a commercial scoring model limits their findings somewhat, they conclude that moving away from a full-fill credit system would raise the cost of consumer credit and limit access to consumers, particularly for those with relatively weak credit histories.

The two approaches are complementary. Our simulations use actual credit models but do not show the impact of re-estimation, whereas Barron and Staten's use simplified simulations of credit models that do show the impact of re-estimation. A comparison of the two sets of results shows that they are in fact very similar, implying that the improved performance available from model re-estimation is unlikely to have a significant effect on our overall conclusions.

However, as part of the Institute's ongoing research efforts, one of the three national credit bureaus has agreed to re-estimate one of its commercial scoring models to account for the changes embodied in the four post-FCRA scenarios included in this analysis. This will enable comparison of the results that are presented in this report with those associated with a fully re-estimated scoring model. In addition, it will enable estimation of the compliance costs associated with the removal or modification of federal preemption, based on the costs associated with re-estimating the commercial scoring model for analytical purposes. The Institute will release the results from this analysis during the summer of 2003.

B. BASIC RESULTS OF THE RESEARCH

As described in the remainder of this section, the results of our simulations suggest that modification or removal of the strengthened preemptive provisions enacted in 1996 would have serious repercussions for consumers. While the precise effects differ across scenarios and scoring models, the basic patterns are the same. In general, reducing either the quantity or the quality of the data contained in credit reports will affect the credit scores of large numbers of consumers and reduce the predictive power of scoring models. As a result, the costs of credit would rise and acceptance rates would fall, particularly for minorities, the young, and lower-income families.

1. IMPACT ON CREDIT SCORES

Table 8 shows the percent of credit scores that would be affected under each scenario, as well as the impact that this would have on the distribution of credit scores. To simplify the presentation, we have restricted the results to Commercial Scoring Model #1, which is one of TransUnion's proprietary models. Comparable statistics for all four commercial scoring models are presented in Appendix D.

The first column in the chart shows the current distribution of credit scores based on the full-file data. The remaining columns depict what would happen to these scores if the quality or quantity of data changed. Differences between the “full-file” scores and the scores derived for the different scenarios illustrate the measurement errors that could arise if the federal preemption were allowed to expire.

Table 8: Impact on Credit Scores: Commercial Model #1

Model	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
<i>Percent of Scores Affected</i>	NA	88.3	88.3	88.3	88.4
<i>Distribution of Scores</i>					
<400	11.0	11.5	12.0	11.6	12.2
400-449	1.7	1.5	1.4	0.9	0.6
450-499	4.6	3.9	3.7	2.8	2.3
500-549	5.8	5.7	5.5	4.4	3.7
550-599	6.4	7.2	7.1	5.9	5.2
600-649	7.1	7.7	7.6	6.7	6.2
650-699	10.1	11.5	11.6	11.2	11.2
700-749	9.7	10.8	11.0	10.7	11.0
750-799	9.4	9.5	9.6	10.2	10.7
800-849	14.4	12.7	12.8	14.4	15.1
850+	19.8	18.1	17.7	21.1	21.8

In general, the kinds of changes envisioned in our four scenarios would change the credit scores of a high proportion of consumers. For example, *under each of the four scenarios, roughly 88 percent of all consumers would experience a change in their calculated credit score as measured by Commercial Model #1.* Findings for the other credit scores are much the same. Although the number of scores affected is considerably lower for the other models (ranging from about 5 to 35 percent) the results suggest that the elimination of the federal preemption would have a profound affect on consumers’ credit scores.

VI. FULL-FILE CREDIT REPORTING AND UNIFORM NATIONAL DATA STANDARDS

The impact of these changes on the measured distribution of credit risk appears to depend on the nature of the regulatory action. Under Scenarios A and B—where the number of reported trade lines is assumed to fall due to increased liabilities that are newly imposed on data furnishers—the overall distribution of credit scores would remain about the same. In other words, consumers with higher scores would be affected about as much as consumers with lower scores. This general effect is observed for each of the different commercial models.

In contrast, imposing restrictions on the kinds of negative data that can be contained in a consumer's credit file (Scenarios C and D) will cause existing commercial scoring models to underestimate the incidence of high-risk loans. This effect is particularly pronounced for Scenario D, where the percentage of consumers with scores below 620 falls from 32 to 26 percent. Again, the results are essentially the same regardless of the model used. These findings suggest that restricting the kinds of data contained in a consumer's credit file will tend to obscure important differences among consumers at the lower end of the risk distribution—differences that might otherwise enable credit issuers to distinguish a good risk from a bad.

2. IMPACT ON PREDICTIVE POWER

Table 9 shows what could happen to each model's predictive power if the strengthened preemptive provisions were either modified or allowed to expire. Predictive power is captured by the model's Kolmogorov-Smirnov, or "K-S" statistic, a commonly used measure of a model's ability to distinguish between two different groups (in this case, performing and non-performing accounts, based on the absence or presence of one delinquency of 90-days or more). To simplify the comparisons, the K-S statistics for each model have been scaled to equal 100 when the model is based on the full-file estimates. As a result, the values that are presented for the different scenarios—which are all below 100—measure the relative predictive power that would occur under each of the four regimes, with the difference from 100 showing the relative loss of predictive power.

Table 9: Impact on Predictive Power: K-S Statistics⁷⁷

Model	Current Full File Reports	Reductions in the Number of Data Furnishers		Restrictions to the Type of Data Reported	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
Commercial #1	100	99.9	97.7	92.8	85.6
Commercial #2	100	93.6	91.5	91.5	88.2
Commercial #3	100	99.0	96.3	94.7	90.8
Commercial #4	100	99.1	96.1	96.0	93.6
Card #1	100	99.8	96.7	93.7	90.3
Card #2	100	99.7	96.4	95.0	91.6

As shown in the chart above, the predictive power of each model declines under each of the four scenarios. The impact tends to be relatively small for Scenario A, with most models showing a decline in K-S score of less than one percent, and larger for Scenario B, in which declines range from 3 to 8 percent. The degradation in predictive power in Scenario B exceeds that witnessed in Scenario A for two reasons. First, a higher quantity of trade lines are purged in Scenario B (21 percent) than Scenario A (13 percent). Second, the diversity of data types is considerably greater in Scenario B.

As was the case with the quantity of scores affected, the greatest impact on predictive power appears to occur when there are restrictions to the kinds of negative data that can be contained in the consumer’s credit report—as with Scenarios C and D. Under the “moderate” scenario, the models would lose about 5 to 8 percent of their predictive power. Under the “severe scenario,” the loss would range from about 7 to 15 percent, with the largest losses experienced by Commercial Model #1. By almost any yardstick, such changes would represent in a dramatic decline in the industry’s ability to measure credit risk.

In the following section, we discuss how the model’s loss of predictive power would affect both access to and the price of credit.

3. IMPACT ON THE OVERALL COST AND AVAILABILITY OF CREDIT

Degradation in the predictive power of risk models inevitably affects both the cost and availability of consumer credit. Since credit issuers will be less able to identify how borrowers will ultimately perform on their accounts, they will confront some difficult choices.

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Lenders can either keep their acceptance rates the same—and risk letting in a higher number of non-performers—or they can attempt to control their risk by restricting access to only the most credit-worthy borrowers—thereby reducing acceptance rates. Most likely, they will do some combination of the two.

The kinds of trade-offs that credit issuers would face are illustrated in Tables 10 and 11. To simplify the presentation, we have limited the discussion to results from Commercial Model #1. However, the conclusions are essentially the same, regardless of the model used.⁷⁸

Table 10: Serious Delinquencies by Target Acceptance Rates⁷⁹: Commercial Model #1

Acceptance Rate	Current Full File Reports	Reductions in the Number of Data Furnishers		Restrictions to the Type of Data Reported	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
30 %	1.3	1.4	1.5	2.1	2.6
40 %	1.8	2.1	2.4	3.0	3.7
50 %	3.1	3.2	3.4	4.5	5.3
60 %	5.0	5.1	5.4	5.9	6.9
70 %	8.5	8.2	8.5	8.5	9.1

Table 10 shows how moving away from a full-file credit reporting system would cause the performance associated with a given acceptance rate to deteriorate. Suppose, for example, that the credit issuer wished to maintain an acceptance rate of about 50 percent, a rate that is more or less in line with the current incidence of serious delinquencies among credit card holders nationwide.⁸⁰ With this target acceptance rate, serious delinquencies would rise from 3.1 percent in the full-file regime to a high of 5.3 percent in Scenario D.

In general, the impact on the delinquency rate is lower under Scenarios A and B since the loss in the model's predictive power is not as severe as it is in the other cases. However, even under Scenario B, projected delinquencies would rise by as much as 10 percent. Not surprisingly, the impact is considerably greater under Scenarios C and D. In the “moderate” scenario, serious delinquencies would rise by about 45 percent, while in the “severe” scenario, the estimated increase would be over 70 percent. These are huge differences that would inevitably have dramatic repercussions on the overall cost of credit.

The pricing implications are admittedly complex, and will inevitably vary from issuer to issuer. However, some simple calculations suggest the likely magnitude of the effects. In 2001, the credit card industry sustained roughly \$30 billion in charge-offs. If one assumes that a 10 to 70 percent increase in serious delinquencies inevitably leads to a comparable increase in charge-offs—and that these additional costs will be passed through to consumers—the aggregate costs of credit cards could rise by as little as \$3 billion under Scenario A, and as much as \$21 billion per year under Scenario D. *For the average family, this would translate into an increased cost of between roughly \$40 and \$270 per year.*⁸¹

Table 11 takes the opposite perspective, and shows what would happen to acceptance rates if issuers wished maintain a given level of risk (as measured by the incidence of serious delinquencies.) For example, in order to maintain a delinquency rate of about 3 percent—the approximate average for credit cards—acceptance rates would have to fall from about 49 percent today to a low of 35 percent in Scenario D. Again, while the impact is relatively small for Scenario A, it is significant for the other cases. In fact, to keep delinquencies at their current levels, acceptance rates would have to fall by about 10 percent in Scenario B, 19 percent in Scenario C, and 30 percent in Scenario D.

Table 11: Acceptance Rates by Targeted Delinquency Rate⁸²: Commercial Model #1

Incidence of Serious Delinquencies	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
2 %	41.9	38.1	36.0	28.5	21.8
3 %	49.2	48.5	44.6	40.0	34.6
4 %	55.6	55.1	54.1	47.2	42.2
5 %	60.4	59.6	58.7	55.5	48.4
6 %	63.7	64.2	63.4	60.4	55.7
7 %	66.4	67.2	66.4	64.1	61.6

The consequences of these findings for a typical consumer’s access to credit depends on how the models are used. The most conservative view assumes that only applicants without credit cards will be affected. In a typical year, roughly 2 million consumers are issued MasterCard or VISA accounts for the very first time.⁸³ Thus, our conservative estimate analysis suggests that in Scenario D, roughly 600,000 individuals would be denied access to these cards.

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However, scoring models are also used on an on-going basis to qualify individuals for additional accounts and to determine the credit limits on existing cards. As a result, even consumers who currently have access to credit card accounts are likely to be affected by measures restricting the quantity or quality of data available to lenders. For example, between 2000 and 2001, the net number of MasterCard and VISA accounts increased by about 32 million. Netting out the 2 million new accounts already discussed leaves 30 million additional accounts.⁸⁴ Under Scenario D, this number would drop by about 9 million accounts. While it is difficult to estimate the ultimate impact on consumers, suffice it to say that a significant demand for consumer credit that would otherwise be met would not be satisfied were the strengthened preemptive provisions modified or allowed to expire.

Finally, many people change credit card providers, presumably because they prefer the terms of the new card over the terms of the old one. For example, a new offer may provide a consumer with a lower interest rate, a zero balance transfer, a lifetime no-annual fee, or another feature they value. As discussed in the prescreening section below, general purpose credit card issuers acquire about 170 million new accounts each year. Excluding the 32 million already accounted for, there are still 138 million of these changes each year. Under Scenario D, the number would drop by about 41 million. In other words, up to 41 million consumers who currently qualify for credit, would be denied the same credit if the strengthened preemptions sunset or are modified.

4. IMPACT ON UNDERSERVED BORROWERS

Table 12 shows how changes in acceptance rates would vary across different socio-demographic groups, assuming that the risk tolerance of lenders remains the same. We again present our results for just one model, Commercial Model #1, a model developed by TransUnion. To simplify the presentation, we use a “targeted” delinquency rate (3 percent) that approximates the average for credit cards, and scale our results so that the current full-file system has an acceptance rate of 100%. Thus, the entries in the table show the percentage of selected applicants who would be accepted in the scenario as compared to the current full file system.

Table 12: Impact on Acceptance Rates of Selected Borrowers: Commercial Model #1⁸⁵

Characteristics of the Borrower	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
<i>Race</i>					
Caucasian, Non-Hispanic	100.0	98.5	91.0	82.1	71.4
African American	100.0	99.4	89.4	78.2	66.5
Hispanic	100.0	97.6	87.1	73.1	60.2
All Minority	100.0	97.3	87.6	73.8	61.6
<i>Gender</i>					
Female	100.0	98.2	91.0	82.1	71.6
Male	100.0	97.4	90.5	81.3	70.1
<i>Age</i>					
<36	100.0	95.7	87.3	68.0	52.3
36-45	100.0	97.8	91.3	82.1	69.3
46-55	100.0	97.7	91.5	82.5	71.0
56-65	100.0	97.5	91.7	83.5	73.4
66-75	100.0	98.2	91.5	84.8	76.6
76+	100.0	101.2	88.7	83.4	77.3
<i>Household Income</i>					
< 15,000	100.0	98.8	85.9	73.6	63.0
15,000-29,000	100.0	98.9	88.1	77.1	66.4
30,000-49,000	100.0	98.5	90.5	80.5	69.5
50,000-99,000	100.0	97.7	91.6	82.9	71.7
>100,000	100.0	97.3	92.3	84.9	74.9

As shown in Table 12, under the scenarios likely to evolve following the loss of the federal preemption, acceptance rates would fall by significant amounts for virtually every demographic and ethnic group considered. For example, under Scenario D, acceptance rates for Hispanics and African Americans would fall by 40 and 33 percent, respectively, while the rates for non-Hispanic whites would decline by about 29 percent. Likewise, lower-income and younger consumers would experience larger proportionate declines than wealthier and older segments of the population.



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This general pattern reflects the decline that would occur in the industry’s ability to distinguish between “good” and “bad” credit risks as scoring models lose their predictive power. This development would inevitably have a greater impact on consumers whose credit histories are not as strong. Indeed, the results observed for minority, lower-income and younger borrowers strongly suggests that the removal of, or modifications to the strengthened preemptions would undermine recent progress in extending credit to underserved segments of the population.

5. SUMMARY OF CASE STUDY FINDINGS

The results of our simulations underscore the importance of maintaining the full-file credit reporting system. While the specific impact varies across the different models and legislative scenarios considered, our findings suggest that should the strengthened preemptions sunset or be modified, the cost of consumer credit will increase and access to consumer credit will decline. Further, sunset or modification would reverse the considerable progress that has been made in recent years in providing low-cost consumer credit to underserved segments of the population. In the end, proposals similar to those put forth by several states in recent years would hurt—not help—consumers, with minorities, the young, and lower-income families suffering the most.

VII. Prescreening and Competitive Credit Markets

A. THE ROLE OF PRESCREENING

The FCRA permits credit grantors to obtain “prescreen lists” from consumer credit bureaus. Prescreen lists generally consist of contact information for consumers who meet particular criteria (for example, all consumers who have a credit score above a particular threshold). Under the law, credit grantors and insurers who obtain such lists are required to provide all of the individuals on the list a “firm offer of credit.”⁸⁶

Prescreening improves marketing efficiency by helping credit issuers match offers to prospective borrowers through unsolicited offers of credit. In prescreening, credit issuers establish a set of specific credit criteria and request from a credit bureau a list with the names and addresses of all consumers who meet these criteria. Prescreening is also often combined with targeting of consumers on factors other than the credit criteria. Those who meet the criteria receive offers of credit tailored to their credit needs, their credit capacity, and their credit worthiness.

Prescreening enhances the efficiency of the payment card market in two ways. First, by combining prescreening with targeting, credit issuers can increase the response rate of their solicitations by mailing to those most likely to respond, while at the same time attracting consumers with the proper risk profile for the particular credit offering. Second, by prescreening, the credit issuer uses information from the credit file twice, once in selecting the population for the original offer, and once in verifying that those who accept the offer still qualify for it based on the original selection criteria. Although an individual’s credit score is reasonably stable,⁸⁷ assessing it twice provides more information than does assessing it once. Consumers benefit from improved efficiency, since the competitive nature of the market ensures that savings (as well as expenses) are passed along to consumers.

While prescreening enjoys federal preemption, several states, including California, have proposals pending before their legislature that would restrict the use of prescreened lists for prospect marketing.⁸⁸ Because California is often a leader in developing legislation, it is important to analyze the impact if other states were to follow its lead. Thus, we performed a case study to determine the effect on consumers if a loss of the federal preemption on prescreening resulted in a loss of prescreening. These findings also hold in the event that Congress acts to restrict prescreened firm offers of credit from the FCRA’s strengthened preemptions.

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B. METHODOLOGY

1. DEFINING THE SCENARIO

For the case study, we constructed a survey of major general-purpose credit card issuers to collect information pertaining to their number of accounts, how many were newly acquired in 2002, what channels they used to acquire their new accounts, the costs of acquiring accounts in the various channels, and how they would acquire accounts if prescreening were not permitted. (See Appendix E to review the questionnaire).

We received seven responses to our survey.⁸⁹ Although our data do not provide a random sample of all credit card issuers, we believe they are broadly representative of the industry. We received responses from credit issuers that are major users of prescreening, as well as from others that do not rely heavily on prescreening. Our responses on prescreening include bank type credit card issuers representing six of the top 13 bank issuers, and account for over half (or about 153 million of the 281 million)⁹⁰ of all active MasterCard and VISA accounts. Five of the responses contained sufficient cost information for use in the cost analysis, and these issuers comprise over more than 130 million of the active MasterCard and VISA accounts.

Part of our analysis of prescreening entailed an examination of the alleged relationship between prescreened firm offers of credit and identity theft and other types of fraud. We performed a literature review and conducted structured interviews with experts on credit card fraud and identity theft at credit issuers, financial institutions, and credit bureaus to provide insights on the relationship between prescreening and identity theft. We used information from the literature review and our discussion to construct a flow chart describing the authentication and identity verification procedures used by a vast majority of credit card issuers. (See Appendix F). We also examined other measures used by credit bureaus to reduce the incidence of identity theft and fraud.

2. THE MODEL

For the case study, we constructed a “model” credit card issuer by averaging the responses to each of the questions in our questionnaire. We did so by weighting for each respondent the current acquisition methods, and those that would be used if prescreening were not permitted, by the number of new customers acquired in 2002, and by the unit cost of the acquisition method. Thus, for the model credit card issuer, we determined the current cost of customer acquisition through prescreening, and then estimated the cost of acquisition if prescreening were eliminated. We used the model approach due to of the sensitive nature of the underlying data; because the market is so competitive, firms are unwilling to allow their competitors access to the proprietary data used in our model.

C. THE RESULTS

Our analysis shows that prescreening is by far the most important method of acquiring new customers, accounting for over two-thirds of all acquisitions. It also shows that costs would increase in the absence of prescreening. Finally, it suggests that prescreening does not substantially contribute to the incidence of identity theft.

1. IMPACT ON ACQUISITION COSTS, THE COST OF CREDIT, & AND CONSUMER ACCESS TO CREDIT

Table 13 presents the results for our model credit card issuer. As it shows, responses to our survey confirm that prescreening is the most important marketing channel for acquiring new customers. For those who responded to the survey, prescreened offers of credit by direct mail and telephone were the source of 68 percent (or nearly 7 out of ten) of all new customers acquired. In contrast, the next most popular single method, direct mail not prescreened, accounted for only 17 percent of the new customers acquired.

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Table 13: Unit Cost, Total Cost and Overall Share of Marketing Expenditure by Channel (Current and Hypothetical)⁹¹

Acquisition Channel	Unit Cost	Share (%)			Cost		
		Current Mix	Scenario I	Scenario II	Current Mix	Scenario I	Scenario II
Direct Mail: <i>Prescreened</i>	\$48.69	53	N/A	N/A	\$26.01	N/A	N/A
Direct Mail: <i>Not Prescreened</i>	\$81.18	17	63	85	\$13.72	\$40.11	\$63.87
Outbound Phone: <i>Prescreened</i>	\$56.13	8	N/A	N/A	\$4.24	N/A	N/A
Outbound Phone: <i>Not Prescreened</i>	\$51.61	0	1	0	\$0.04	\$0.36	\$0.04
TV	\$12.00	0	0	0	\$0.00	\$0.00	\$0.00
Print	\$12.00	0	0	0	\$0.00	\$0.52	\$0.00
E Mail	\$42.60	2	5	2	\$0.85	\$2.01	\$0.85
Bank Web Sites	\$50.65	0	1	0	\$0.20	\$0.62	\$0.20
Internet Banner	\$43.65	3	6	3	\$1.25	\$2.70	\$1.25
Inbound Phone: <i>Prescreened</i>	\$74.35	7	N/A	N/A	\$5.13	N/A	N/A
Events	\$66.52	1	2	1	\$0.50	\$1.14	\$0.50
Take Ones	\$59.53	1	1	1	\$0.40	\$0.59	\$0.40
Other	\$65.13	8	21	8	\$5.52	\$12.73	\$5.52
<i>Total</i>	\$57.86	100	100	100	\$57.86	\$60.78	\$72.62

Survey responses also indicated that new account acquisition costs would increase in the absence of prescreening. As Table 13 shows, our model credit card issuer currently spends an average of \$57.86 to acquire a new customer. In contrast, in the absence of prescreening, this cost would increase to between \$60.78 and \$72.62, depending on the model credit card issuer's response to the problem of customer acquisition.

In Scenario I—the lower cost scenario—\$60.78 per customer acquired is the unit cost if firms were able to switch to acquiring all new customers in their next most cost-effective way. In

this scenario, we calculated the acquisition cost using the channels the respondents indicated they would first try to use if prescreening were not allowed. This represents a short run, lower bound on the unit cost of acquiring new customers. Because many of our respondents indicated that they would acquire a different kind of customer through these channels, and many indicated that they would not be able to acquire a sufficient number of new customers using these channels, we also calculated the cost under a scenario where all customers currently acquired with prescreening are acquired through direct mail that is not prescreened. Under this scenario, (Scenario II) the unit cost of acquiring a new customer increased 26 percent to \$72.62 per customer acquired.

Although the difference in the unit cost between the current mix of channels for acquiring a new customer and mix that would be used in the absence of prescreening is relatively small, there would still be a major economic effect from the loss of prescreening since the small unit cost would be applied to the large number of new customers acquired each year. In fact, respondents to our survey indicated that approximately 29 percent of their active accounts were newly acquired during the year. Applying this 29 percent newly acquired account estimate to the roughly 585 million MasterCard, Discover, Visa, and American Express accounts in 2001 would result in about 170 million new accounts. *With a unit cost difference of \$2.92 in our lower bound scenario and \$14.76 in our upper bound scenario, total costs to consumers would increase between \$269 million to \$1.36 billion. Given the competitive nature of the market, it is likely that these costs will be passed along to consumers.*

The above analysis describing the effects on consumers from a loss of prescreening assumes that financial institutions, faced with a loss of prescreening, would still try to acquire the same number of new accounts each year. This would increase the cost of credit to consumers. But another outcome is also likely: one where access to credit is restricted. We describe this below.

In determining the optimal number of new accounts to acquire each year, credit issuers balance the lifetime value of the account against its acquisition cost. As new account acquisition costs increase, credit issuers will acquire fewer of them. When prescreening is allowed, the model credit issuer in our case study will acquire customers so long as their lifetime value is greater than their cost of acquisition: \$57.86. When prescreening is not allowed, the model credit issuer will acquire customers only so long as their lifetime value is above the new acquisition cost: between \$60.78 and 72.62. Clearly, there are more customers with a lifetime value of \$57.86 than there are with the higher values, so credit issuers will likely respond by issuing fewer new accounts.

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While a large portion of the new accounts issued each year are simply a replacement of one general purpose card for another, some of the new accounts each year are new accounts for existing account holders, and others are new accounts issued to new cardholders. Between 2000 and 2001 there was an increase of more than 32 million MasterCard and VISA credit card accounts; of these over more than 2 million were genuinely new cardholders.⁹² If prescreening were not allowed, some new holders of additional accounts and some new cardholders would have been denied access to credit.

Although data are not available to perform the kind of distributional analysis that we performed for full file credit reporting, it is logical to assume that any restriction in access would have the same types of distributional effects. Prescreening enables credit issuers to find good credit risks among underserved populations and to extend credit offers to them in ways that other marketing channels do not. It is likely prescreening has been one factor responsible for the widening access to credit, and that restricting it would reverse the progress that has been achieved. Further, results from our analysis suggest that restrictions in prescreening would affect underserved populations disproportionately.

2. PRESCREENED FIRM OFFERS OF CREDIT AND IDENTITY THEFT

The contention that identity theft has been driven by the greater flows of information has not been subject to scrutiny. The evidence is often anecdotal or relies on spectacular but single events. Comprehensive studies remain to be done, but in our literature review and interviews we explored elements of this contention.

Identity theft is defined as “the use of personal information to (1) make unauthorized use of existing credit or other financial accounts [referred to as “account takeover”] or (2) establish new accounts, apply for loans, etc.”⁹³ While there is no comprehensive data source on its cost and prevalence, the data available indicate that identity theft is a growing problem. Consumer reporting agencies have reported to GAO that the number of fraud alerts in their files has grown. The Federal Trade Commission has also noted an increase in the number of complaints made to its Identity Theft Data Clearinghouse.⁹⁴ Furthermore, based upon an analysis of multiple sources, Celent Communications estimates that the number of identity theft cases has increased from around 50,000 cases per year in 1996 to more than 150,000 in 2002.⁹⁵

While victims frequently did not know the method that was used to obtain their personal information, the two primary methods reported to the FTC are (i) access through relationship to victim (52.5 percent) and (ii) lost or stolen wallet or purse (34.4 percent). The most commonly identified relationships to victims were family members, roommates, neighbors, and co-workers. Mail theft, or fraudulent address changes, accounted for 13.4 percent of

cases, and telephone or mail solicitations or purchases accounted for less than one 1 percent.⁹⁶ In fact, as shown in Table 14 below, other forms of credit card fraud (particularly use of lost and stolen cards, which comprise about half of fraud)⁹⁷ are substantially more significant than false applications.⁹⁸

Table 14: Cost of Credit-Card Fraud

Type	Year 2000 Cost (Millions)	% of Credit Card Fraud	% of Sales Volume
False Applications	\$46.1	4.5	0.004
Other Fraud	\$976.1	95.5	0.078
Total	\$1,013.2	100.0	0.082

Note: Includes data from VISA and Mastercard, which account for approximately 75 percent of charge card sales volume.

Despite these statistics, many observers believe that prescreened credit card offers are responsible for a significant share of identity theft and insist that eliminating these offers would substantially reduce the problem.⁹⁹ This is not the case. Prescreened credit card offers do not contain any personal information other than name and address, and none of the other prerequisite personal information needed in order to apply for credit.¹⁰⁰ This fact presumably explains why information obtained from prescreened solicitations is rarely used to commit identity theft.

Credit card issuers also have authentication procedures in place at many stages of the process to limit the ability of criminals to open fraudulent credit card accounts. The vast majority of credit card issuers (if not all of them) review the application, using a variety of automated tools (Appendix F) based upon credit file data to authenticate the identity of the applicant.¹⁰¹ In some cases, if the lender has any degree of uncertainty about the applicant's identity, additional documentation (such as a state-issued driver's license, or a utility bill) is requested before approval is granted. Even after the card has been physically delivered to the applicant, the account is not activated until the applicant again verifies his or her identity, usually by calling from his or her home phone.

Issuers undertake these procedures because they are generally liable for the cost of fraudulent charges. MasterCard and VISA, for example, have zero liability policies that significantly limit the consumer's responsibility for fraudulent charges.¹⁰² Issuers will soon legally be required to authenticate identity when opening accounts as well.¹⁰³ Given the cost to issuers, it's no surprise that losses from fraudulent applications account for significantly less than one-hundredth of one percent of credit card sales volume and less than five 5 percent of *all* credit card fraud.¹⁰⁴



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The vast majority of credit card issuers further review the application using a variety of sophisticated automated tools. These authentication tools check the applications for inconsistencies, compare information from the application to that in credit files and other national databases, and check applications against databases on known fraud. If inconsistencies are detected, or if the application is identified as being high risk for fraud, the tools instruct the issuer to decline the application or perform a thorough manual review.

For example, if the applicant attempts to change the address and the new address is different than in these databases, the products indicate the possibility that the application is fraudulent and that an identity thief is trying to open an account and divert mail away from the victim's address to avoid being detected. *These products are very successful, identifying the majority, from 60 to 80 percent, of fraudulent applications before the accounts are ever opened.*¹⁰⁵ The success of these tools also serves as a powerful deterrent to potential identity thieves.

Finally, prescreened credit card offers simply have a low incidence of fraud. For instance, prescreened credit card solicitations are significantly less likely to result in fraud than other forms of new account acquisition.¹⁰⁶ Based on results from a structured interview conducted with one major issuer, prescreening has the lowest incidence rate of application fraud versus other origination channels.

According to this issuer, it accounts for less than 20% of their identity theft losses, which in turn constitute only a small fraction of their total fraud losses. The issuer reports that the majority of application fraud that does originate from prescreened offers is committed by someone familiar to the victim.

The reasons why prescreened solicitations are unattractive to "identity thieves" is obvious. If a solicitation is intercepted and submitted by an "identity thief" with a change of address, it would trigger an alert and be routed to a fraud analyst for verification.

While prescreened credit card offers are relatively unproblematic, we do believe that credit card applications through the Internet – which are routinely between two and five times more likely to result in fraud than accounts acquired through other media – deserves further scrutiny.¹⁰⁷

Undeniably, true identity theft is a nightmare for the victim, the costs of which cannot be quantified. Consumers are increasingly aware of this growing crime and are vocalizing their concerns to policymakers on every level. Indeed, the Federal Trade Commission recently indicated that identity theft now rates as the single most common consumer complaint.¹⁰⁸ As such, it is incumbent upon government and industry to take additional steps to empower consumers with the tools necessary to protect themselves against identity theft.

While there is a growing consensus that more needs to be done, there is little agreement about how to go about it. Given the markedly greater frequency of identity theft online, we recommend that lenders' authentication and fraud prevention procedures for online credit applications be thoroughly examined. If fraud prevention measures that are common in other media are absent from Web-based application platforms, we would encourage industry to explore whether these could be usefully applied to the Internet.

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. As recommended by AEI-Brookings, “target[ing] the fraudulent activity itself—through stiffer penalties, more vigorous enforcement, greater coordination among enforcement agencies, and improved consumer education” is a better approach to combating identity theft.¹⁰⁹

VIII. CONCLUSION

VIII. Conclusion

A. ANALYSIS: CURRENT SYSTEM BENEFITS VS. ID THEFT RISK

The research results presented here demonstrate many of the significant ways in which the strengthened preemptive provisions of the FCRA have benefited consumers. In particular, consumers today enjoy a competitive credit marketplace characterized by a wide selection of products and services. Consumers enjoy increased access to affordable credit and greater opportunities for home ownership across all demographic groups, with the most notable gains occurring among minority, low-income, and otherwise previously underserved populations. The report also has demonstrated how such benefits to millions of individual consumers combine to keep the American economy strong. The volume of consumer and mortgage lending rises as a direct result of the information shared through our national consumer credit system. The credit card and consumer mortgage credit, in turn, helps fuel economic growth.

We began this study by noting that the debates around FCRA “reauthorization” have been driven by rising fears of identity theft and a popular belief that the relatively free flow of personal data renders consumers more vulnerable. Opponents of FCRA renewal may grant much of what we have shown above. They may acknowledge that credit has become available to wider segments of the American population than ever before, and that it has become available to Americans who have traditionally been underserved by credit markets—notably minority and low-income groups.

Critics of the regime may further grant that the American credit market under the FCRA has contributed to historically unprecedented levels of homeownership, especially among underserved populations. They may even grant that it has not led to appreciable over-indebtedness or “irresponsible” borrowing, but that consumer debt has instead followed the movements in disposable income and business cycles. But these critics will still contend that the harm done to some, especially in the form of identity theft, outweighs the benefits to consumers yielded by the current system.

Our analysis of identity theft is somewhat mixed. On one hand, we find the claim advanced by some that prescreened firm offers of credit contributes significantly to identity theft to be totally devoid of any merit whatsoever. Indeed, prescreening is substantially less vulnerable to identity theft and fraud than new accounts acquired through other channels, particularly online. On the other hand, and for reasons that are neither readily understood nor fully explored in this analysis, the incidence of fraudulent applications online is relatively greater than on other media.

B. CONSUMERS GENERALLY SATISFIED WITH CURRENT SYSTEM

Whether consumers are satisfied with the widening access to credit, and the price of credit, is of course a complicated matter. Certainly, if behavior reveals preferences, consumers want greater access to credit and do, in fact, acquire more credit when it is offered to them. 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 a wide variety of segments of the population. 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 to see this greater access threatened.

However, surveys of credit card users paint a mixed picture. Nine out of 10 consumers simultaneously believe both that credit card companies make too much credit available (88%)¹¹⁰ and that overspending is the fault of the consumer (90%).¹¹¹ and yet they also are satisfied in their dealings with credit card issuers (91%), believing that they provide a useful service (92%).¹¹² What has changed significantly is the satisfaction that consumers have in their dealings with credit card companies; whereas only 17% of cardholders reported being satisfied in 1977, a vast majority (91%) reported being satisfied in 2000.¹¹³

Reducing access to credit in order to prevent overextension by borrowers, of course, risks reorienting policy towards the paternalistic. Moreover, a recent Federal Reserve survey indicates that the majority of credit card users consider overextension to be a problem related mostly to other people's credit habits, as opposed to a result of self-evaluation.

C. AMERICAN CONSUMERS BENEFIT FROM THE FCRA PREEMPTIONS

The report found several ways in which the FCRA's strengthened preemptive provisions make home mortgages and other types of credit more available and affordable for American consumers.

- *Automated underwriting not only lowers mortgage rates and closing costs; it actually increases the amount of mortgage money available.* Nationally uniform—and complete—credit reports form the basis of consumer credit scores, which make automated underwriting possible, increasing the speed and efficiency, and reducing the costs, of evaluating mortgage applications. They also provide greater confidence in the quality of the borrowers and their ability to repay, making it possible to pool multiple mortgages and sell the to investors, increasing the availability of capital.



VIII. CONCLUSION

- *Before the advent of automated underwriting, approving a loan application took close to three weeks; in 2002, over 75 percent of all loan applications received approval in two to three minutes.*
- *Full-file credit reporting makes scoring models much more predictive, resulting in broader access and lower prices for consumers.* With more information, lenders are better able to differentiate between borrowers that are more and less likely to repay their debts fully and on time. Fewer defaults mean that lenders need to build less “risk protection” into their interest rates, which makes credit more affordable.
- *Prescreening rewards creditworthy consumers with lower rates and reduces the costs of acquiring customers, keeping cardholders’ costs down.* Mailing lists obtained from consumer reporting agencies, based on lender-specified credit scores and other criteria, enable credit grantors to reach qualified consumers more efficiently and economically. The resulting savings in marketing costs helps issuers keep fees and interest rates down.
- *Prescreening has helped to dramatically lower the interest rate on credit card balances.* Increased competition, driven in part by prescreening, has caused interest rates today to be more widely dispersed (and lower overall) than they were in 1990. In 1990, only six percent of interest rates were below 6.5 percent, and 93 percent were above 16.5 percent APR. Indeed, by 2002 almost three-quarters (74 percent) of all outstanding balances were at interest rates below 18 percent, while an incredible 15 percent of balances are at interest rates under 5.5 percent. On the other end, only 24 percent of balances carry an APR above 18 percent, even with the dramatic rise in the number of new cardholders.

D. NATIONAL CREDIT REPORTING SYSTEM NOT PERFECT, BUT WORKS VERY WELL

A key takeaway point from this report is that the national credit reporting system that has crystallized under the FCRA, particularly after the addition of the 1996 strengthened preemptive provisions, works exceedingly well. The consumer and economic benefits, as documented and quantitatively demonstrated in this research, are pervasive and substantial.

As is the case with the public telephone network and the national power grid, the national credit reporting system is an essential facility to the American economic infrastructure. None of these systems is perfect, yet all play a vital role in the day-to-day lives 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.

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 FCRA's current strengthened preemptive provisions.

E. FORTHCOMING ANALYSIS

As part of this research effort, one of the three national credit bureaus has agreed to retool one of its commercial scoring models to account for the changes embodied in the four post-FCRA scenarios included in this analysis. This will enable us to compare the results that are presented in this report with those associated with a fully re-estimated scoring model. In addition, it will enable us to estimate the compliance costs that might arise with the removal of the federal preemption, based on the costs associated with retooling the scoring model for analytical purposes. The Institute will release the results of this experiment in the summer of 2003.

F. POLICY PRESCRIPTIONS

- 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 FCRA's current strengthened preemptive provisions. Failure to do so would place the benefits currently enjoyed by consumers at risk and would jeopardize the health of the U.S. economy.
- We believe the online credit application process deserves further scrutiny. Specifically, we recommend that authentication and fraud detection procedures with respect to online credit applications be closely examined, and if deficiencies are identified, steps be taken by industry to address them.

APPENDIX A: KEY PROVISIONS OF THE FCRA

The rationale behind the design of our research is found in the structure of the FCRA. In this section we summarize the key provisions of the Fair Credit Reporting Act (FCRA) in a series of brief discussions that cover the following broad categories:

- *Definitions and requirements* (what entities qualify as “consumer reporting agencies,” what can be kept in a consumer’s file, and standards for the obsolescence of information contained in a consumer’s file);
- *Permissible purposes* (the purposes for which a consumer report may be obtained from a consumer reporting agency);
- *Consumer rights* (consumer access to credit report information and to remedy in the event of a dispute);
- *Enforcement and liabilities*
- *Preemption and relation to state law*

Definitions and Requirements: The FCRA defines a consumer report as consisting of information “bearing on a consumer’s creditworthiness, credit standing, credit capacity, character, reputation, personal characteristics, or mode of living” which is used or expected to be used for the purpose of establishing the consumer’s eligibility for: “(A) credit or insurance to be used primarily for personal family, or household purposes; (B) employment purposes; or (C) [other authorized purposes].”¹¹⁴ A report comprised entirely of publicly available information, even one devoid of any past borrowing behavior, can qualify as a consumer report if it is used to determine eligibility for credit or insurance or other permissible purposes.

A “Consumer Reporting Agency” (CRA) is defined as any organization which “assembles or evaluates” credit information or other information on consumers for the purpose of regularly furnishing “consumer reports” to third parties by any means.¹¹⁵ The definition is broad: “private investigators, detective agencies, collection agencies, and even college placement offices can be CRAs under the law.”¹¹⁶

The FCRA also sets standards for how long certain types of negative information can be maintained in a consumer’s file. For example, the law holds that negative data about a consumer’s credit accounts or public record data such as liens is to be purged after seven

years. Chapter 13 bankruptcies can only be maintained in a consumer's file for seven years, while Chapter 7 bankruptcies persist for ten years.¹¹⁷

Under the 1996 amendments to the FCRA, what is known as "affiliate sharing" is not considered to be a case of "consumer reporting." Firms affiliated by "common corporate control" can share certain types of consumer information (notably about its own experiences with a consumer) without incurring the legal obligations of a CRA. These amendments also give companies the ability to share "other"¹¹⁸ data with affiliates.

Permissible Purposes: A CRA may provide a consumer report to a firm or an individual "it has reason to believe" intends to use the report for one of the following "permissible purposes": the extension of credit, or for the review or collection of an existing credit obligation; to determine eligibility for employment; in connection with underwriting for insurance; eligibility for a license or other benefit granted by a governmental entity, as required by law to consider that applicant's financial responsibility or status; or otherwise has a legitimate business need for the information in connection with a business transaction *that is initiated by the consumer.*¹¹⁹

The law also permits credit grantors and insurers to obtain "prescreen lists" from CRAs. Prescreen lists generally consist of contact information for consumers who meet particular criteria (for example, all consumers who have a credit score above a particular threshold.) Under the law, credit grantors and insurers who obtain such lists are required to provide all of the individuals on the list a "firm offer of credit or insurance."¹²⁰

The FCRA restricts the content of prescreen lists to: "(A) the name and address of a consumer; (B) an identifier that is not unique to the consumer and that is used by the person solely for the purpose of verifying the identity of the consumer; and (C) other information pertaining to a consumer that does not identify the relationship or experience of the consumer with respect to a particular creditor or other entity."¹²¹

Consumer Rights: Consumers have a number of basic rights with respect to their consumer reports. The FCRA requires that a consumer be provided a free copy of their consumer report if it has been the basis of an unfavorable decision (known as an "adverse action").¹²² The FCRA also requires a consumer-reporting agency to make trained personnel available upon request to explain the content of the report to a consumer.¹²³ If adverse action is taken, consumers are to be provided a list of their rights that includes an explanation of how to dispute any information contained in their report.¹²⁴ Consumers have the right to have information they believe to be inaccurate promptly investigated. A consumer reporting agency is required to

provide the consumer, within 30 days of the date when they receive the dispute, a report reflecting the results of the investigation. Furthermore, if the investigation does not resolve the dispute to a consumer's satisfaction, the consumer may add a statement to their report.¹²⁵

Consumers may also choose not to have certain types of information shared. They may have their name removed from prescreen lists for unsolicited credit and insurance offers. Also, certain permissible purposes of consumer reports require explicit consent. A CRA may not give out information about a consumer to an employer, or a prospective employer, without written consent.¹²⁶ Likewise, a CRA may not report a consumer's medical information without his/her explicit permission.¹²⁷

Enforcement: The FCRA provides for tripartite enforcement: administrative enforcement through specified federal and state agencies; civil enforcement through private rights of action against CRAs and users of consumer reports; and criminal liability for knowing and willful violations of the FCRA.¹²⁸

Administrative enforcement is primarily the purview of the Federal Trade Commission. The FTC does not have the authority to create binding regulations regarding the FCRA,¹²⁹ but the Commissioners do publicly address inquiries and publish guidelines. The FCRA also provides for enforcement by federal bank regulatory agencies including the Comptroller of the Currency, the Federal Reserve Board, the FDIC, and the Office of Thrift Supervision.¹³⁰ Since 2000, these agencies have been empowered to conduct regular examinations to assess compliance. State attorneys general may also bring action to enjoin a violation of the FCRA.¹³¹

Civil liabilities are generally limited to CRAs and users of consumer reports. Individuals may sue a CRA or a user of consumer reports for negligent or willful noncompliance with the FCRA.¹³² However, no civil penalties may be sought for the noncompliance of a furnisher of data to the bureau, unless the data furnisher has been enjoined from committing the violation or otherwise ordered not to commit the violation.¹³³ Criminal liability is also a possibility under the FCRA. The FCRA prohibits the "knowing and willful" acquisition of information on a consumer from a consumer-reporting agency under false pretenses.¹³⁴ This prohibition applies to any information obtained under such circumstances, not just consumer reports.

Preemption: Since its enactment, the FCRA has contained a provision regarding the federal preemption of state laws governing the "collection, distribution, or use of information on consumers."¹³⁵ The proscription reads that state laws are to be upheld unless they "are inconsistent with any provision of [the FCRA], and then only to the extent of the inconsistency."¹³⁶ The meaning of this provision is, of course, controversial. According to a legal treatise that

discusses the subject, “the courts seem to agree that a state law is inconsistent with the FCRA [and therefore preempted] when it frustrates or stands as an obstacle to the accomplishment of the FCRA’s full purposes, whether or not those purposes are related to consumer protection.”¹³⁷

The 1996 amendments to the Fair Credit Reporting Act substantially expand federal preemption for a number of key provisions. This strengthened preemption applies to the sections of the FCRA that govern the following: the prescreening of consumer reports; the time by which a consumer reporting agency must take action in a procedure where a consumer disputes the accuracy of the information in their file; adverse action notification requirements; standards for the obsolescence of information included in consumer reports; the liabilities of data furnishers; and the sharing of data among affiliates.¹³⁸

The scope of the expanded preemption in the areas specified above is unambiguous. The FCRA states: “No requirement or prohibition may be imposed under the laws of any State...with respect to any subject matter regulated under [the specified subsections].”¹³⁹ In other words, any state law pertaining to the enumerated provisions, regardless of its intent, is completely preempted.

APPENDIX B: GENERAL PURPOSE CREDIT CARDS, ANCILLARY BENEFITS AND THE DISTRIBUTION OF BALANCE BY INCOME

In the not so distant past, payment cards all featured the same interest rate (19.8 percent) and yearly fee (\$20)¹⁴⁰ and had no ancillary benefits attached to the general purpose credit cards as reported by the Federal Reserve Board. (See <http://www.federalreserve.gov/pubs/shop/tablbw.pdf>).

Appendix Table A: Credit Card Features

Description	Count (N=110)	Frequency Of Institutions That Reported
Travel accident insurance	85	77.3%
Automobile rental insurance	36	32.7%
Reduced introductory interest rate available	33	30.0%
Travel-related discounts	22	20.0%
Purchase protection/security	17	15.5%
Extension of manufacturer's warranty	16	14.5%
Non-travel-related goods and services	15	13.6%
Credit card registration	13	11.8%
Rebates on purchases	5	4.5%
Other, not specified	33	30.0%

Appendix Table B illustrates the share of households possessing at least one general purpose credit card, carrying a balance, the mean and median values of the balance and the share of total revolving balance by income quintile.

Appendix Table B: Use of Credit Cards by Family Income: 1970-2001

Income group	1970	1977	1983	1989	1995	1998	2001
<i>Lowest quintile</i>							
Have a card	2	11	11	17	28	28	38
Carrying a balance	27	40	40	43	57	59	61
Mean balance (\$)	896	731	1147	784	2,386	2,240	1,794
Median balance (\$)	336	538	818	592	995	700	847
Share of total revolving balance	2	4	4	1	6	5	6
<i>Second lowest quintile</i>							
Have a card	9	22	27	36	54	58	65
Carrying a balance	39	42	49	46	57	58	59
Mean balance (\$)	659	1,055	906	1,712	2,622	3,028	2,379
Median balance (\$)	504	565	655	1,315	1,605	1,400	1,012
Share of total revolving balance	9	13	8	8	14	13	13
<i>Middle quintile</i>							
Have a card	14	36	41	62	71	72	79
Carrying a balance	47	45	58	56	58	58	61
Mean balance (\$)	820	883	1,161	2,159	2,952	4,129	3,102
Median balance (\$)	630	672	736	1,262	1,605	1,900	1,841
Share of total revolving balance	22	19	19	21	21	23	22
<i>Second highest quintile</i>							
Have a card	22	51	57	76	83	86	87
Carrying a balance	39	52	56	62	60	60	55
Mean balance (\$)	1,010	846	1,259	2,212	2,687	4,334	3,718
Median balance (\$)	840	753	818	1,183	1,605	2,000	1,841
Share of total revolving balance	37	30	28	30	23	29	25

Chart continued on next page

Appendix Table B: Use of Credit Cards by Family Income: 1970-2001
(continued)

Income group	1970	1977	1983	1989	1995	1998	2001
<i>Highest quintile</i>							
Have a card	33	69	79	89	95	95	95
Carrying a balance	30	39	47	46	50	45	40
Mean balance (\$)	761	898	1,531	3,417	4,460	5,232	6,207
Median balance (\$)	630	672	916	2,630	2,246	2,500	2,761
Share of total revolving balance	30	33	40	40	36	29	34
<i>All quintiles</i>							
Have a card	16	38	43	56	66	68	73
Carrying a balance	37	44	51	52	56	55	54
Mean balance (\$)	839	889	1,282	2,404	3,160	4,073	3,559
Median balance (\$)	630	672	818	1,315	1,605	1,900	1,657
Share of total revolving balance	100	100	100	100	100	100	100

Note: In 1970, families were asked about using cards; in all other years, they were asked about having cards. Proportions that “have a card” are percentages of families; proportions “carrying a balance” are percentages of holders of bank-type cards with an outstanding balance after the most recent payment. Mean and median balances are for cardholders with outstanding balances after the most recent payment and are in 1998 dollars, adjusted using the Consumer Price Index for All Urban Consumers, all items. Shares may not sum to 100 percent because of rounding.

Source: Updated from Thomas Durkin, “Credit Cards: Use and Consumer Attitudes, 1970-2000,” *Federal Reserve Bulletin*, September 2000, p. 626. U.S. Surveys of Consumer Finances.

APPENDIX C: ANALYSIS OF STATE ACTIVITY ON FCRA MATTERS

Opponents of the current national credit reporting system place great confidence in state legislators. The rationale for their confidence that states will do the right thing is based on the belief that “State legislators are closer to their constituents, and are more likely to tailor a law to a particular problem.”¹⁴¹ Congress, by contrast, is accused of intentionally enacting flawed legislation and offloading it onto the states. This sort of thinking is evident in a “fact sheet” published by advocacy group the U.S. Public Interest Research Group (USPIRG):

“The 1999 Gramm-Leach-Bliley Financial Services Modernization Act (GLB) privacy protection section was flawed and Congress knew it. So, Congress gave states the explicit right to pass stronger laws governing the sharing of information by financial firms.”¹⁴²

Those who favor state regulation of the credit reporting system advocate Congressional legislative restraint. “Privacy law gets better if Congress does nothing [about FCRA]”, letting preemption lapse and thereby opening the door to states to regulate.¹⁴³ Opponents of federal standards clearly favor that state legislators introduce bills extending FCRA provisions that are not covered by the strengthened preemptions introduced in 1996—for instance, by limiting the use of credit reports for employment purposes.¹⁴⁴ According to some state government affairs insiders, state legislators are also being encouraged to introduce bills that are currently preempted in an effort to shape the tone of the debate in Congress.

Despite claims by proponents of state-level activism that “... the states are rational actors; they will not balkanize our financial system,” evidence suggests that balkanization cannot be so easily written off as a possible outcome.¹⁴⁵ During the current legislative session, there have been nearly 250 FCRA-related bills introduced in 46 states (see Appendix Figure A).¹⁴⁶ While the two largest categories of pending FCRA state legislation either concern components not preempted by the FCRA (e.g. free credit reports), or are not explicitly addressed in the FCRA (e.g. the use of credit scores), the fact that there is currently legislative activity in 11 broad categories strongly suggests that a post-preemption world may not be characterized by legislative harmony among states as opponents of FCRA renewal suggest.¹⁴⁷

A. METHODOLOGY FOR SELECTING STATE BILLS

Our methodology uses as a starting point a catalog of existing state legislation relevant to the current FCRA debate. To develop this catalog of pending state proposals, a list of search terms were selected and run through a state legislation database maintained by state legislatures in all 50 states.¹⁴⁸ These terms were selected on the basis of their likelihood of yielding search

results germane to the provisions enjoying strengthened preemption under the 1996 amendments to the FCRA.¹⁴⁹

The keywords and /phrases used to identify FCRA-related bills are as follows:

(credit near/1 (fair OR accurate OR report* OR score* OR rate* OR history OR information OR data or bureau) OR credit near/5 (prescreen* OR underwrit* OR repository OR derogatory) OR “firm offer” OR “data furnisher”)

The keywords and /phrases used to capture GLB related bills are as follows:

(financial adj priva*) or “gramm leach bliley” or “modernization act” or (disclose near/10 affiliat*)

After receiving an initial list of pending state bills, Institute staff analyzed text from each bill to determine the germaneness of the bill to the strengthened preemptive provisions of the FCRA. Bills that had no apparent bearing on any aspect of the FCRA were winnowed out, in order to ensure that the final list tallied only those bills that are reasonably germane to the FCRA. In some cases, although a particular bill does not directly address a strengthened preemptive provision, it was included because the Institute staff determined that it could reasonably serve as a vehicle for FCRA-related legislation and therefore met the “germaneness” standard.

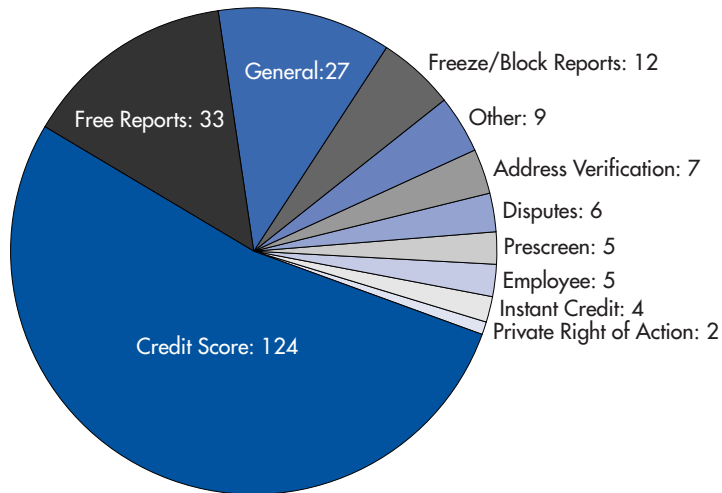
The results were subsequently classified into 11 categories. While these categories reflect the primary intent of the proposals, they are necessarily broad and subject to some degree of interpretation. In some cases, legislation could be coded across several categories (e.g. “credit reporting” and “private right of action”). Coding decisions were made by Institute staff working in conjunction with state government affairs experts.¹⁵⁰ The sum figure of bills does *not* double count proposals that could be coded in multiple categories.

There are caveats to this approach. For example, it is likely the quantity and the diversity of FCRA state legislation would increase exponentially should Congress fail to reauthorize the FCRA’s preemptive provisions. Clearly, many legislators have refrained from proposing bills where they understand them to be preempted by federal law. Additionally, it is safe to presume that some state legislators have introduced legislation that would be preempted, ostensibly with an eye toward influencing the course of the debate inside the Beltway, while many have been reluctant to do so, preferring to first see how things unfold in Congress.

B. ACTIONS BY STATE LEGISLATORS

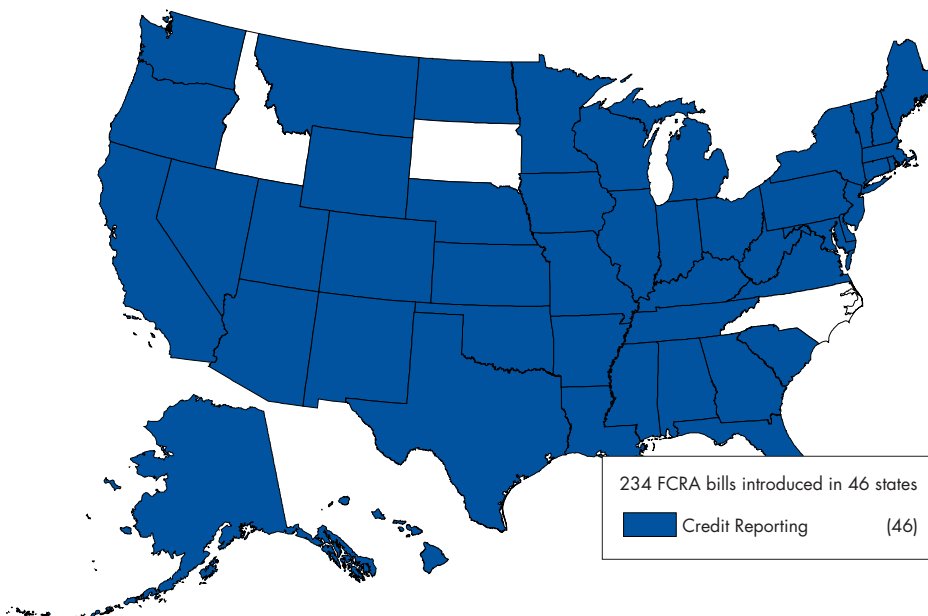
State legislators have introduced, moved, and enacted a diverse range of FCRA legislation. As the figure below shows, as of mid-April, 2003, lawmakers in 46 states have introduced 234 bills germane to different provisions of the FCRA, and an additional 154 concerning elements of the Gramm-Leach-Bliley Act (GLBA) that could easily encompass FCRA provisions.¹⁵¹

Appendix Figure A: FCRA Bills Introduced in 2003 (by type, N = 234)

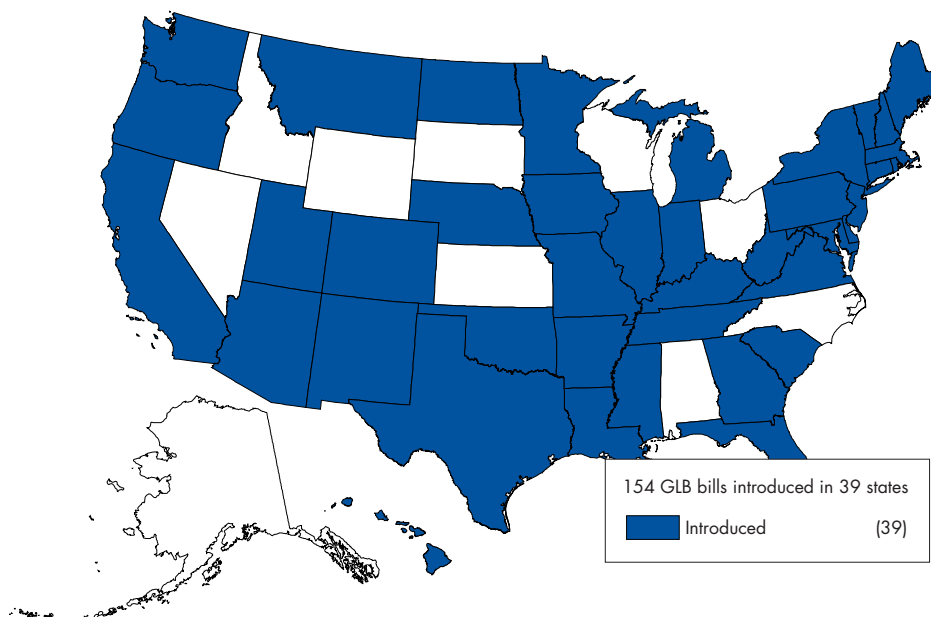


C. REVIEW OF STATE PROPOSALS

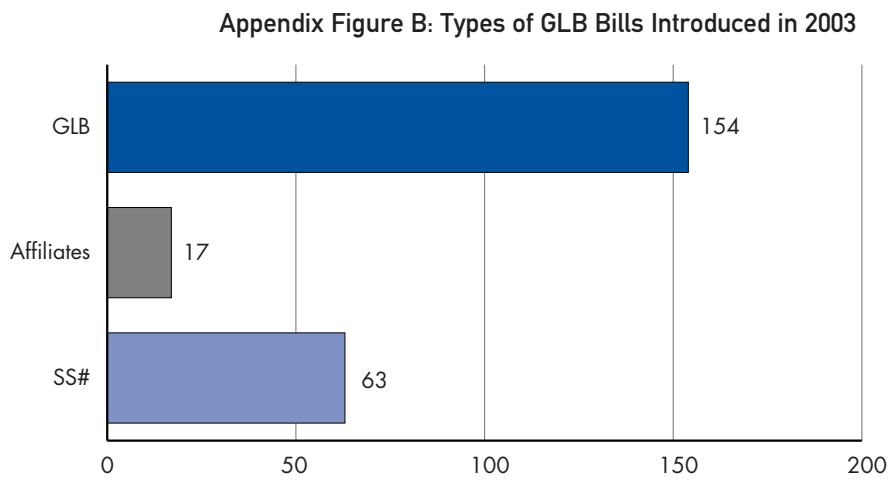
In 1996, the Fair Credit Reporting Act (FCRA) was amended to allow the financial industry to pool credit history information collected from affiliates into a central database as long as consumers were first given the option to opt-out of the data collection. The FCRA amendments preempted any state legislation affecting the content of credit reports, the sharing of information across affiliates, and their use for permissible purposes. These amendments took effect on September 30, 1997 and are slated to expire on December 31, 2003. The prospect that state lawmakers will enact a patchwork of FCRA legislation now looms large.



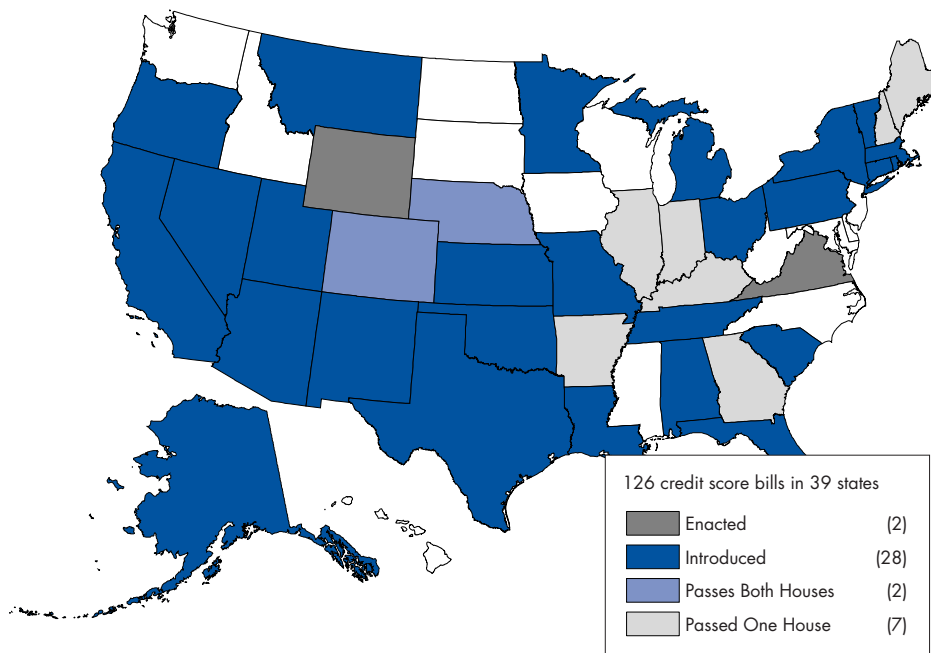
Industry and advocates alike generally agree that obtaining an extension or permanent federal preemption of FCRA will not be automatic. Complicating the issue is a strong push from privacy advocates to tighten restrictions related to the sharing of personal information under the Gramm-Leach-Bliley Act (GLBA). Some 39 states are considering 154 GLB-related bills.



Affiliate sharing is generally not addressed in the GLBA, except to state that the affiliate sharing provisions of the FCRA obtain. Despite deference to the FCRA, Gramm-Leach-Bliley does not prohibit states from passing tougher restrictions. As a result, some parties are actively championing a more restrictive “opt-in” financial data regime for both third-party and affiliate sharing. Proposals reflecting these views have been making considerable headway in states like California and North Dakota. Success in the states has emboldened some opponents of the FCRA to try to get tougher federal legislation enacted. Depicted below are additional figures showing the distribution of GLB bills related to affiliate sharing and restricting the use of Social Security Numbers. These impact the very same issues covered by the FCRA.



States have been recently adopting privacy laws that are stricter than the federal rules. There is little doubt that states will move to adopt their own versions of FCRA if the federal preemption expires. Some 46 states are considering 234 bills targeting the use of credit reports for insurance purposes. Nearly half of all FCRA-related bills (124 of them) would restrict the use of a person's credit score for purposes of insurance underwriting. (Appendix Figure A.) Other legislation, like SB 356 in New York, is more specific. This bill would reduce the amount of time that a credit reporting agency could maintain a negative record on a consumer report from seven years to just three years. California AB 800 requires the data supplier – referred to as a “data furnisher” in the FCRA – to correct inaccurate information within 30 days of the dispute and makes validation of inaccurate information after an investigation a violation of the law. Confronted with an ambiguous standard of “accuracy,” and the potentially severe liability imposed under AB 800, data furnishers, seeking to minimize their exposure to damaging litigation, may elect to reduce the quantity or quality of data they provide.



Still another possibility that worries lenders is laws such as the one proposed in New Jersey. SB 1018 authorizes a person or enterprise, damaged by credit card fraud, to sue and recover damages. Industry is concerned that this could impose increased liability on creditors and could raise the costs of participating in the credit system.

These examples are meant to be illustrative. Yet, it is clear that the data reporting regime will most likely be radically altered and balkanized if the strengthened preemption provisions of the FCRA are allowed to expire. It is far from the case that the matter is simply one of who enacts the most effective and balanced legislation. Without the wider picture of the functioning of a truly *national* consumer credit market, states are likely to pass bills that reflect more the balance of local politics than that of consumer needs. Hanging in this balance is nothing short of the fairness and efficiency of the consumer credit market itself.

APPENDIX D: COMPLETE STATISTICAL RESULTS OF FULL-FILE CASE STUDY

Appendix Table C: Impact on Credit Scores: Commercial Model #2

Model	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
<i>Percent of Scores Affected</i>	NA	88.2	88.3	88.3	88.3
<i>Distribution of Scores</i>					
<400	20.7	18.3	18.7	17.1	17.2
400-449	2.8	3.4	3.3	2.6	2.2
450-499	5.1	4.7	4.5	3.8	3.2
500-549	4.3	5.8	5.7	5.0	4.4
550-599	5.8	7.3	7.3	6.5	6.1
600-649	6.3	8.7	8.7	7.8	7.7
650-699	8.1	7.8	7.7	7.2	7.5
700-749	7.4	8.6	8.4	8.9	9.3
750-799	13.0	10.5	10.5	12.3	12.9
800-849	19.5	16.5	16.6	19.3	19.9
850+	7.2	8.5	8.8	9.5	9.7

Appendix Table D: Serious Delinquencies by Target Acceptance Rates¹⁵²: Commercial Model #2

Acceptance Rate	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
30 %	0.9	1.0	1.1	1.4	1.7
40 %	1.3	1.5	1.6	1.9	2.3
50 %	2.0	2.5	2.8	2.9	3.4
60 %	3.7	4.7	5.0	5.0	5.4
70 %	7.3	8.2	8.7	8.8	9.3

Appendix Table E: Acceptance Rates by Targeted Delinquency Rate¹⁵³: Commercial Model #2

Incidence of Serious Delinquencies	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
2 %	49.7	45.9	44.2	40.7	35.5
3 %	56.6	52.9	51.4	50.6	47.2
4 %	61.2	57.4	56.2	56.2	53.8
5 %	64.4	61.1	59.8	60.0	58.5
6 %	67.2	64.3	63.1	63.2	61.8
7 %	69.4	67.0	65.8	65.9	64.5

Appendix Table F: Impact on Credit Scores: Commercial Model #3

Model	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
<i>Percent of Scores Affected</i>	NA	4.9	36.9	22.5	28.1
<i>Distribution of Scores</i>					
<400	33.5	33.5	32.9	30.3	29.0
400-449	3.0	3.0	3.0	3.1	3.1
450-499	2.4	2.4	2.3	2.5	2.6
500-549	2.9	2.9	2.9	3.1	3.2
550-599	3.1	3.1	3.1	3.3	3.5
600-649	4.0	4.0	4.1	4.4	4.5
650-699	5.4	5.4	5.5	5.8	6.0
700-749	8.9	8.9	8.8	9.3	9.5
750-799	8.4	8.4	8.6	8.9	9.1
800-849	3.5	3.5	3.8	3.6	3.7
850+	25.1	25.1	25.1	25.7	26.0

APPENDICES

Appendix Table G: Serious Delinquencies by Target Acceptance Rates¹⁵⁵: Commercial Model #3

Acceptance Rate	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
30 %	2.6	2.7	3.0	3.0	3.4
40 %	2.8	2.9	3.2	3.3	3.8
50 %	3.4	3.5	3.9	4.1	4.5
60 %	5.2	5.3	5.6	5.8	6.4
70 %	7.8	7.9	8.3	8.6	9.3

Appendix Table H: Acceptance Rates by Targeted Delinquency Rate¹⁵⁶: Commercial Model #3

Incidence of Serious Delinquencies	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
2 %	24.6	24.0	19.8	20.5	18.6
3 %	45.0	42.9	31.4	29.7	27.5
4 %	54.0	53.2	51.2	49.6	44.6
5 %	59.3	58.8	57.1	56.1	53.6
6 %	63.3	62.9	61.6	60.7	58.5
7 %	67.4	67.0	65.0	64.4	62.4

Appendix Table I: Impact on Credit Scores: Commercial model #4

Model	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
<i>Percent of Scores Affected</i>	NA	8.9	36.6	35.8	39.4
<i>Distribution of Scores</i>					
<400	15.2	15.5	16.9	15.9	16.4
400-449	0.2	0.2	0.2	0.1	0.1
450-499	2.3	2.3	2.1	1.3	0.9
500-549	5.9	5.8	5.4	3.7	2.9
550-599	7.0	6.9	6.7	5.1	4.4
600-649	8.2	8.1	7.9	7.2	7.0
650-699	11.1	11.1	10.9	10.7	10.5
700-749	15.0	15.0	14.8	16.1	16.6
750-799	25.4	25.3	25.1	29.1	30.1
800-849	9.9	9.9	10.0	11.0	11.2
850+	0.0	0.0	0.0	0.0	0.0

Appendix Table J: Serious Delinquencies by Target Acceptance Rates¹⁵⁸: Commercial Model #4

Acceptance Rate	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
30 %	0.8	0.9	1.0	1.2	1.4
40 %	1.2	1.3	1.4	1.6	1.9
50 %	2.1	2.2	2.4	2.5	2.8
60 %	4.0	4.2	4.7	4.6	4.9
70 %	8.4	8.6	9.5	8.8	9.2

Appendix Table K: Acceptance Rates by Targeted Delinquency Rate¹⁵⁹: Commercial Model #4

Incidence of Serious Delinquencies	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
2 %	49.6	48.7	46.6	45.3	41.8
3 %	55.8	55.2	53.4	53.0	51.2
4 %	59.9	59.4	57.7	57.8	56.4
5 %	62.9	62.5	61.0	61.4	60.2
6 %	65.4	65.0	63.5	64.2	63.2
7 %	67.5	67.1	65.6	66.5	65.7

Appendix Table L: Impact on Credit Scores: Card Model #1

Model	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
<i>Percent of Scores Affected</i>	NA	3.5	36.7	32.2	37.5
<i>Distribution of Scores</i>					
<400	15.6	15.6	16.3	14.3	14.2
400-449	13.4	13.4	13.3	11.5	10.3
450-499	23.6	23.6	23.9	23.8	24.0
500-549	25.3	25.4	26.3	25.4	25.8
550-599	21.8	21.7	20.0	24.8	25.4
600-649	0.3	0.3	0.2	0.3	0.3
650-699	0.0	0.0	0.0	0.0	0.0
700-749	0.0	0.0	0.0	0.0	0.0
750-799	0.0	0.0	0.0	0.0	0.0
800-849	0.0	0.0	0.0	0.0	0.0
850+	0.0	0.0	0.0	0.0	0.0

Appendix Table M: Serious Delinquencies by Target Acceptance Rates¹⁶¹: Card Model #1

Acceptance Rate	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
30 %	1.4	1.4	1.6	1.8	2.0
40 %	2.0	2.1	2.3	2.5	2.8
50 %	3.2	3.2	3.5	3.8	4.2
60 %	4.8	4.8	5.1	5.5	5.9
70 %	7.3	7.4	7.8	7.9	8.2

Appendix Table N: Acceptance Rates by Targeted Delinquency Rate¹⁶²: Card Model #1

Incidence of Serious Delinquencies	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
2 %	39.4	39.1	36.6	33.3	29.3
3 %	48.7	48.4	46.3	44.3	41.7
4 %	56.1	55.9	53.6	51.0	49.0
5 %	61.2	61.1	59.2	57.2	54.6
6 %	65.9	65.8	64.2	62.0	60.3
7 %	69.1	69.0	67.6	66.6	64.6

APPENDICES

Appendix Table O: Impact on Credit Scores: Card Model #2

Model	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
<i>Percent of Scores Affected</i>	NA	3.1	32.0	20.0	26.8
<i>Distribution of Scores</i>					
<400	15.5	15.6	17.1	16.0	16.6
400-449	0.5	0.5	0.4	0.4	0.4
450-499	3.3	3.3	2.9	2.8	2.4
500-549	5.5	5.5	5.1	4.4	3.6
550-599	5.4	5.4	5.4	4.3	3.9
600-649	7.8	7.8	7.8	6.9	6.6
650-699	12.1	12.1	12.1	12.9	13.4
700-749	19.5	19.5	19.9	20.8	21.4
750-799	22.4	22.4	22.3	23.2	23.5
800-849	7.9	7.8	6.9	8.3	8.3
850+	0.0	0.0	0.0	0.0	0.0

Appendix Table P: Serious Delinquencies by Target Acceptance Rates¹⁶⁴: Card Model #2

Acceptance Rate	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
30 %	1.5	1.5	1.6	1.8	2.0
40 %	1.9	1.9	2.1	2.3	2.6
50 %	2.5	2.5	2.8	3.1	3.5
60 %	4.2	4.3	4.8	4.9	5.4
70 %	8.4	8.5	9.5	8.7	9.1

Appendix Table Q: Acceptance Rates by Targeted Delinquency Rate¹⁶⁵: Card Model #2

Incidence of Serious Delinquencies	Current Full File Reports (%)	Reductions in the Number of Data Furnishers (%)		Restrictions to the Type of Data Reported (%)	
		Scenario A	Scenario B	Scenario C (Moderate)	Scenario D (Severe)
2 %	43.2	43.0	38.1	34.3	30.2
3 %	53.8	53.7	51.3	49.1	45.4
4 %	59.0	58.9	56.8	55.9	53.5
5 %	62.6	62.5	60.7	60.3	58.4
6 %	65.2	65.0	63.4	63.8	62.1
7 %	67.3	67.2	65.6	66.5	65.3

APPENDIX E: SURVEY INSTRUMENT FOR PRESREEN CASE STUDY

Please respond for your business activities in the United States only.

A. CONTACT INFORMATION

- 1 Company _____
- 2 Contact First Name _____
- 3 Contact Last Name _____
- 4 Contact Telephone Number _____
- 5 Contact Email _____

B. CARD INFORMATION

- 6 How many statement active CREDIT CARD accounts did your company have during 2002? (average monthly figure) _____
- 7 How many CREDIT CARD accounts were newly acquired in 2002? _____
- 8 How many CREDIT CARD accounts were lost either by charge off or attrition (at least six months of inactivity) in 2002? (combined number) _____

- 9 How many DIRECT MAIL PRESREENED SOLICITATIONS for credit cards did your company make in 2002? _____
- 10 Of the total number of DIRECT MAIL PRESREENED SOLICITATIONS, how many ultimately resulted in new accounts? _____
- 11 Of the total number of DIRECT MAIL PRESREENED SOLICITATIONS, how many had APRs with risk-based pricing? _____
- 12 Of the total number of DIRECT MAIL PRESREENED SOLICITATIONS, how many had only one APR on the solicitation? _____
Note: the sum of line 11 plus line 12 should equal line 9.
- 13 Of the total of DIRECT MAIL PRESREENED SOLICITATIONS shown on line 12 which ultimately resulted in new accounts, what percentage of these accounts were issued credit at the APR in the initial offer? _____
- 14 What percentage of DIRECT MAIL PRESREENED SOLICITATIONS ultimately result in new accounts? _____

- 15 How many OUTBOUND PHONE PRESREENED SOLICITATIONS for credit cards did your company make in 2002? Please count only those solicitations that were a stand alone channel. _____
- 16 Of these OUTBOUND PHONE PRESREENED SOLICITATIONS, how many ultimately resulted in new accounts? _____
- 17 Of these OUTBOUND PHONE SOLICITATIONS which ultimately resulted in new accounts, what percentage of these accounts were issued credit at the APR in the initial offer? _____

- 18 How many DIRECT MAIL SOLICITATIONS that were NOT PRESREENED for credit cards did your company make in 2002? _____
- 19 What percentage of these DIRECT MAIL SOLICITATIONS ultimately resulted in new accounts? _____

- 20 Do DIRECT MAIL PRESREENED SOLICITATIONS for credit cards include any personally-identifying information other than name and address? _____
- 21 If YES, what personally-identifying information is included? _____
- 22 (additional line for personally-identifying information) _____
- 23 (additional line for personally-identifying information) _____

- 24 Do DIRECT MAIL SOLICITATIONS for credit cards that are NOT PRESREENED include any personally-identifying information other than name and address? _____
- 25 If YES, what personally-identifying information is included? _____
- 26 (additional line for personally-identifying information) _____
- 27 (additional line for personally-identifying information) _____

- 28 What PROCESS does your company use to AUTHENTICATE the applicant's identity before opening the account and activating the card? _____
- 29 How does this process differ based upon whether the solicitation was prescreened or not? _____

- 30 What PERCENTAGE of TOTAL CREDIT CARD APPLICATIONS are responses to direct mail prescreened credit card solicitations? _____

- 31 What PERCENTAGE of FRAUDULENT CREDIT CARD ACCOUNTS are responses to direct mail prescreened credit card solicitations? _____

PLEASE CONTINUE SURVEY -- GO TO NEXT WORKSHEET ("SURVEY PAGE TWO") ----->

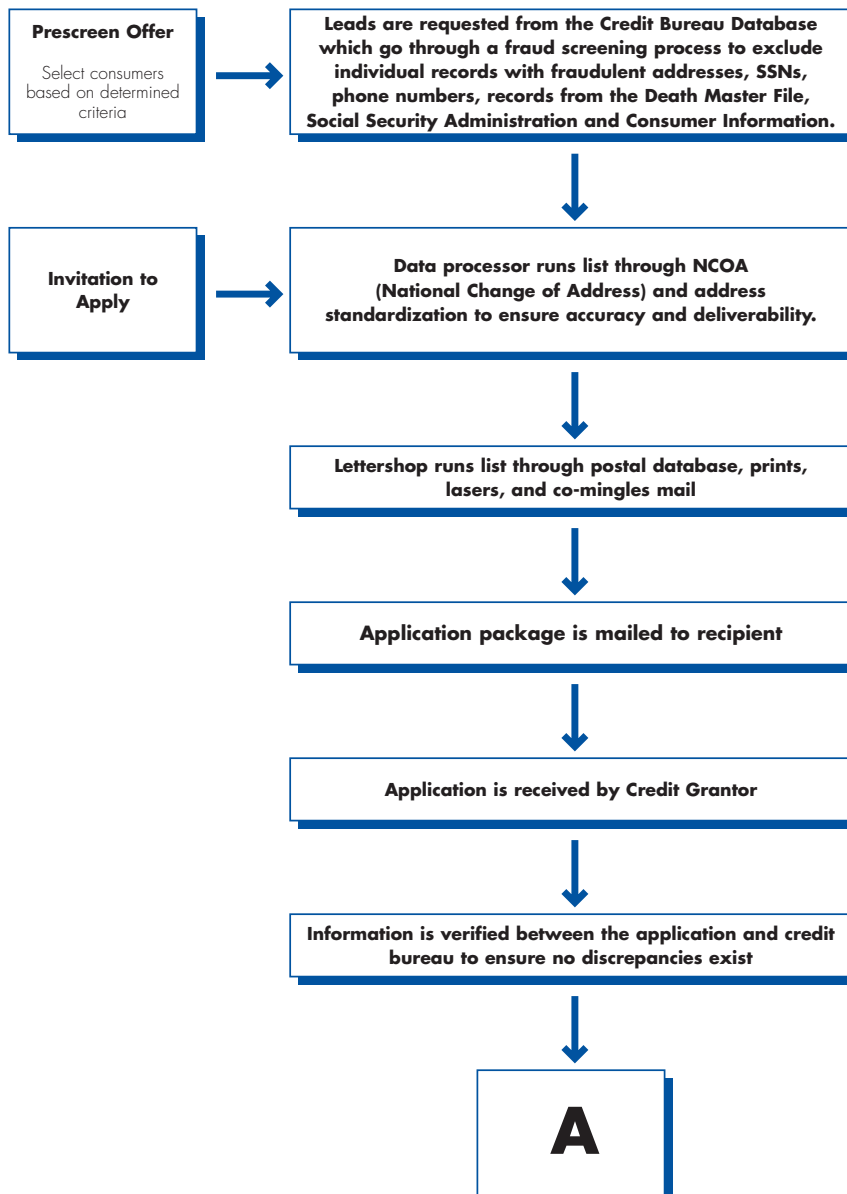
GO TO PAGE TWO

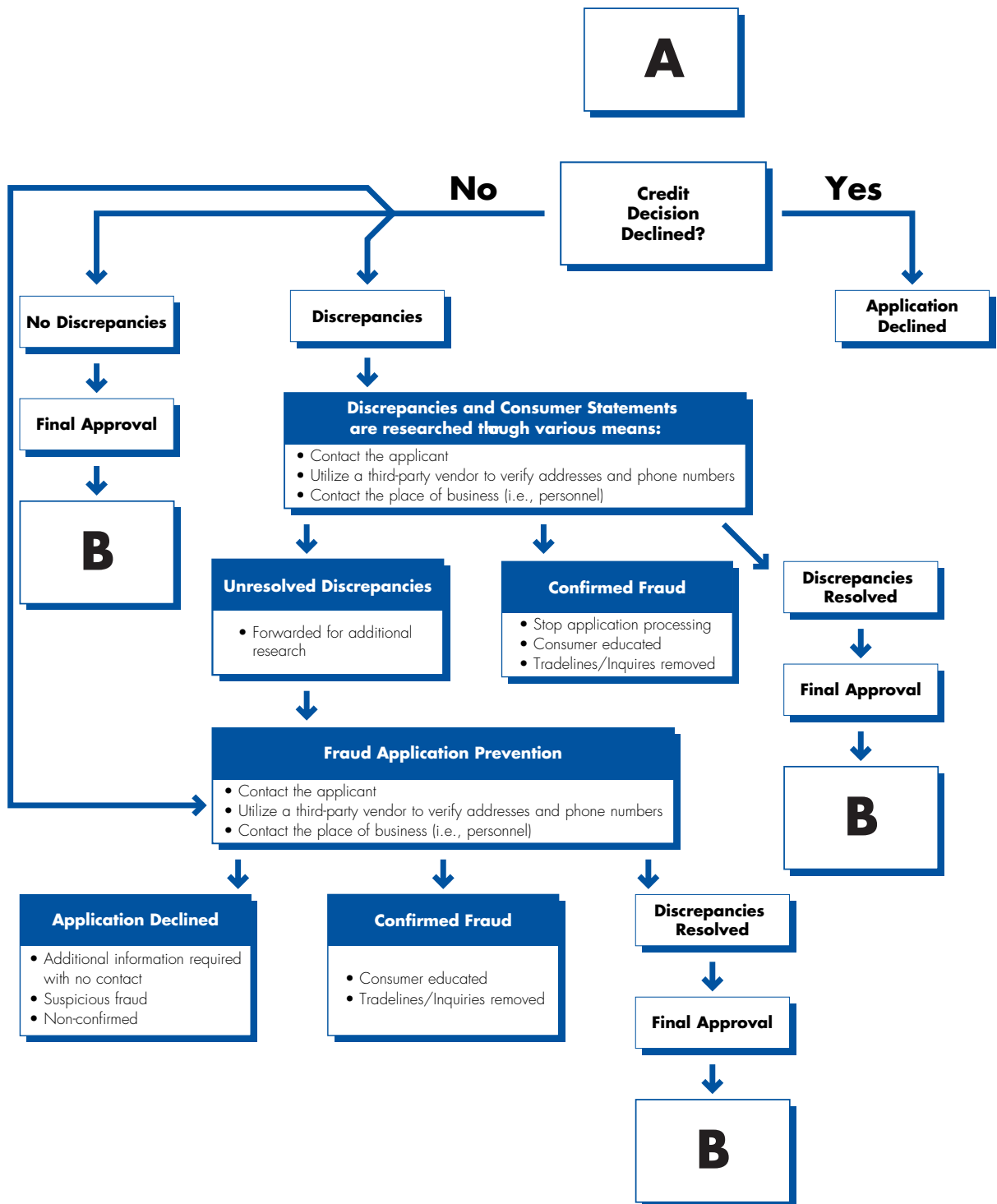
C. CUSTOMER ACQUISITION INFORMATION

	32	33	34	35	36
		Did you use this channel to acquire customers in 2002?	What % of acquired customers did this channel account for in 2002?	What is the cost of acquiring one additional customer using this channel?	If prescreening were not allowed, what % of acquired customers would each channel account for?
MARKETING CHANNEL		(YES or NO)	(Note: The column should add to 100%.)		(Note: The column should add to 100%.)
(a) Direct Mail (Prescreened)					N/A
(b) Direct Mail (NOT Prescreened)					N/A
(c) Telemarketing Outbound Phone Call (Prescreened)					N/A
(d) Telemarketing Outbound Phone Call (NOT Prescreened)					N/A
(e) TV Ads					
(f) Radio					
(g) Print					
(h) Email					
(i) Bank Web Sites					
(j) Internet Banner					
(k) Other Channel : SPECIFY ----->					
(l) Other Channel : SPECIFY ----->					
(m) Other Channel : SPECIFY ----->					
			0%		0%

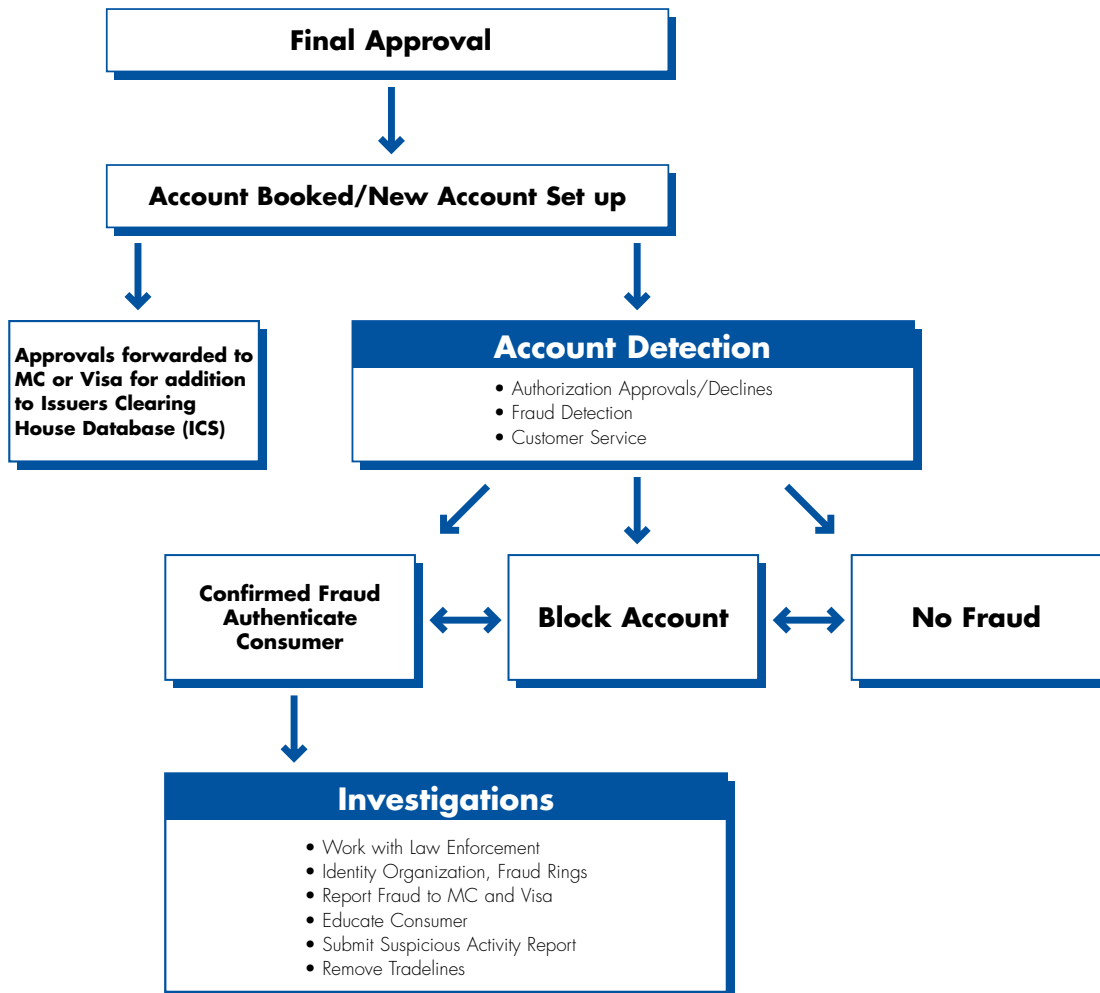
APPENDIX F: PRESscreen FRAUD DETECTION FLOWCHART

Appendix Figure C: Credit Card Application and Identity Verification Procedure





B



APPENDIX G: DERIVATION OF CREDIT CARD ISSUERS' DIRECT MARKETING COST

Appendix Table R: Credit Card Survey Respondents' Marketing Expenditures

(A) Line Item	(B) Company	(C) Marketing Expense (Millions)	(D) Outstandings (Millions)
1	Capital One	\$1,100.0	\$43,500.0
2	MBNA	\$315.4	\$75,845.0
3	Provident Financial	\$404.9	\$19,907.0
4	Metris Companies	\$190.3	\$11,691.5
5	Advanta	\$10.6	\$2,188.0
6	Household Bank	\$156.1	\$15,373.4
7	Bank One/First USA	\$488.4	\$66,800.0
8	Total—Sample	\$2,665.6	\$235,304.9
9	Top 100 Banks Outstandings		\$496,490.0
10	Inflator		2.11
11	Total Direct Marketing Cost—Population	\$5,624.4	
Sources:			
(D)	The Nilson Report, #769. August 2002.		
1	2002 Annual Report, p. 22.		
2	2002 Annual Report, p. 72.		
3	2002 Annual Report, p. 55.		
4	2002 Form 10-K.		
5	2001 Annual Report, p. 15.		
6	Household International, Inc 2001 Annual Report, pp. 40 & 96. Distributed marketing expense based upon credit card revenue share.		
7	Bank One 2002 Annual Report, p. 81. Distributed marketing expense based upon credit card revenue share.		
8	Sum of rows 1 through 7.		
9	The Nilson Report, #769. August 2002.		
10	= 9 / 8.		
11	= 8 * 10.		

ENDNOTES

¹ 15 U.S.C. §1681. A full discussion of the act appears in Appendix A.

² Ibid.

³ Ibid.

⁴ Ibid.

⁵ Fischer, Richard L. "The Law of Financial Privacy." Thomson.

⁶ Economic Growth and Regulatory Paperwork Reduction Act of 1995: Report of the Committee on Banking, Housing, and Urban Affairs: United States Senate [Report 104-185] U.S. Government Printing Office. December 14, 1995. pp. 18-19.

⁷ Ibid.

⁸ 15 U.S.C. §1681t.

⁹ The Act states: "No requirement or prohibition may be imposed under the laws of any State...with respect to any subject matter regulated under [the specified subsections]." Ibid.

¹⁰ For an excellent discussion of the primary drivers that led to the enactment of the FCRA, see Alan Westin's seminal work *Privacy and Freedom*, especially pages pp. 158 – 169. Antheum, New York, 1967. For a brief description of the key issues surrounding the enactment of the FCRA, and the amendments to the FCRA, see Smith, Robert Ellis. *Ben Franklin's Web Site: Privacy and Curiosity from Plymouth Rock to the Internet*. Privacy Journal, Providence, RI. 2000.

¹¹ See Hinojosa, Ruben. "Opening Remarks For House Financial Services Committee Subcommittee On Financial Institutions 'The Importance of the National Credit Reporting System.'" P.2. 8 May, 2003. <<http://financialservices.house.gov/media/pdf/050803hi.pdf>>

¹² See for example, "Recommendations for Future Action" nos. 1 and 2 of Reidenberg, Joel R. "Testimony before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives." 8 May, 2003. <<http://financialservices.house.gov/media/pdf/050803jr.pdf>>.

¹³ Hoofnagle, Chris. "FCRA: Congress Should Allow Preemption to Expire," March, 2003. Submitted to the ABA US Banking 2003 Conference. <<http://www.epic.org/epic/staff/hoofnagle/abausbankfcra.html>>

¹⁴ Reidenberg, Joel R. "Testimony before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives." 8 May, 2003. <<http://financialservices.house.gov/media/pdf/050803jr.pdf>>

¹⁵ They argue that "... no law prevents financial institutions from using data to choose between desirable borrowers and less profitable consumers the institutions may want to avoid.." Torres. U.S. House of Representatives, 107th Congress. April 3, 2001. Serial No. 107-22.

¹⁶ Two such consumer groups remarked that "... another strategy pursued by card issuers is to increase indebtedness. They pursue this strategy through aggressive marketing ... and through aggressive credit extension." "Card Issuers Hike Fees and Rates to Bolster Profits,"

Joint press release from Consumer Action and Consumer Federation of America. November 5, 1998. Similar sentiments are echoed in "The Power of Plastic," posted on CBSNEWS.com on January 23, 2001.

<<http://www.cbsnews.com/stories/2001/01/19/6011/printable265630.shtml>> See also, Credit Card Debts Escalate in 1997, Burdening Many Xmas Shoppers: Aggressive Marketing and Credit Extension a Key Reason." Press release by Consumer Federation of America. December 16, 1997

¹⁷ Durkin, Sarah. "Bankruptcy – Are Credit Cards to Blame?" Consumer Alert's *Commonsense Consumer Column*. Vol. I, Number 9, August, 1997.

¹⁸ Durkin, Thomas. "Credit Cards: Use and Consumer Attitudes, 1970-2000." *Federal Reserve Bulletin*. September 2000. pp. 623-634.

¹⁹ For an excellent discussion of the consumption effects from increases in financial and non-financial wealth, see Case, Karl E., John M. Quigley, and Robert J. Sheller. "Comparing Wealth Effects: The Stock Market Versus the Housing Market," Cowles Foundation Discussion Paper No. 1335. October 2001. <<http://papers.ssrn.com/abstract=289664>>.

²⁰ Furletti, Mark. "An Overview and History of Credit Reporting." Federal Reserve Bank of Philadelphia. June 2002. www.phil.frb.org. p. 4.

²¹ Commercial credit scoring techniques have existed since the 1970s.

²² Revolving credit backed securities as a share of total revolving credit grew from 5.7 percent in 1989 to 56.8 percent in 2003. Source: Federal Reserve, Federal Reserve Statistical Release, Consumer Credit, Table G. 19.

www.federalreserve.gov/releases/g19/hist/cc_hist_r.html

²³ Smith, Robert Ellis. *Ben Franklin's Web Site: Privacy and Curiosity from Plymouth Rock to the Internet*. Publisher, Privacy Journal, Providence, RI. 2000.

²⁴ Greenspan, Alan. "Greenspan's Testimony to House Financial Services Committee" United States. Congress. House of Representatives. Response to Representative Paul Gilmore. 30 April, 2003. Transcript.

²⁵ Durkin, Thomas. "Credit Cards: Use and Consumer Attitudes, 1970-2000." *Federal Reserve Bulletin*. September 2000. pp. 623-634.

²⁶ Federal Reserve Board, www.federalreserve.gov/Releases/housedebt/default.htm. Updated May 26, 2003. The Federal Reserve does warn that the data is derived from aggregates using estimation techniques that may limit the reliability of the figures, but it notes that the value of the measure lies in offering some understanding of the changes in the debt-service burden by type over time. See

<www.federalreserve.gov/Releases/housedebt/about.htm>.

²⁷ Ibid. In the period between 1968 and 1992, personal savings as a share of disposable income reached a trough of 7.3 percent in 1987. In 1992, it held at 8.7 percent falling to 7.1 percent in the next year. By decades end it had fallen to 2.8 percent.

- ²⁸ And the impact of homeownership on consumption patterns appears to be wider than merely assets in residence. See Karl E. Case, John M. Quigley and Robert J. Shiller, "Comparing Wealth Effects: The Stock Market Versus the Housing Market."
- ²⁹ Calculated from Surveys of Consumer Finance, various years.
- ³⁰ Statistical Abstract of the United States, various years
- ³¹ Federal Reserve, Bureau of the Census
- ³² "The Profitability of Credit Card Operations of Depository Institutions: An Annual Report by the Board of Governors of the Federal Reserve System," June 2001 accessed at www.federalreserve.gov/boarddocs/rptcongress/creditcard/2001/ccprofit.pdf.
- ³³ See www.federalreserve.gov/pubs/shop/tablw.pdf.
- ³⁴ Calculated using data from *The Nilson Report*, Numbers 669 and 770, August 2002.
- ³⁵ 1997 Economic Census, Manufacturing Subject Series, Concentration Ratios in Manufacturing, US Census Bureau, June 2001, Table 2. Share of Value of Shipment Accounted for by the 4, 8, 20, and 50 Largest Companies in Each of the 3-, 4-, 5-, and 6-Digit NAICS Industries: 1997, p. 16.
- ³⁶ Information Policy Institute estimate. A detailed description of this derivation is presented in Appendix G.
- ³⁷ The Direct Marketing Association's *Statistical Fact Book, 2002*, p. 201
- ³⁸ *The Nilson Report*, Number 756, January 2002.
- ³⁹ Since the mid 1990s "financial institutions have completed divestitures of VISA and MasterCard branded credit card portfolios totaling well over \$100 billion in cardholder balances, or more than one quarter of the U.S. credit card industry." *The Price of Plastic: The Cost of Credit Card Portfolios*, Frank B. Mariten, First Annapolis Navigator, July 2002, accessed at http://www.1st-annapolis.com/html/body_m_news.htm, 4/22/2003.
- ⁴⁰ *The 2003 Mortgage Market Statistical Annual*, Volume 1, "The Primary Mortgage Market," Inside Mortgage Finance Publications, Inc, p 39.
- ⁴¹ Prepared Statement of Mr. David Olson before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Hearings on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums", January 8, 2002
- ⁴² Thomas A. Durkin, Thomas A. "Credit Cards: Use and Consumer Attitudes, 1970-2000," *Federal Reserve Bulletin*, September 2000, Table 4.
- ⁴³ Lax, et. al. "Subprime Lending: An Investigation of Economic Efficiency," February 25, 2000.
- ⁴⁴ Ibid.
- ⁴⁵ Ibid.
- ⁴⁶ Ibid.
- ⁴⁷ Glenn B. Canner, Glenn B., Durkin, Thomas A. Durkin, and Lockett, Charles A. Lockett, "Recent Developments in Home Equity Lending," *Federal Reserve Bulletin*, April, 1998, p 241.

- ⁴⁸ Source: Federal Reserve Survey of Consumer Finance. Selected Years.
- ⁴⁹ Evans, David and Schmalensee, Richard. *Paying with Plastic: The Digital Revolution in Buying and Borrowing*. The MIT Press, 1999, p 238-240.
- ⁵⁰ Ibid.
- ⁵¹ Calculated from figures in Revenue figure derived from *Credit Card Management*, "A Little Help From UNCLE SAM." Published by Thomson Financial. Article shows 2001 revenues of \$92.47 billion and charge-offs of \$29.87 billion. Thus, revenues net of charge-offs are \$62.6 billion.
- ⁵² If prices have declined by 35 percent, they are 65 percent of what they would have been. To return to where they would have been, they would increase by 35 percent divided by 65 percent or by 53.8 percent. 53.8 percent of \$62.6 billion is \$33.7 billion.
- ⁵³ The Value of Comprehensive Credit Report: Lessons from the U.S. Experience, John Barron and Michael Staten, p 31.
- ⁵⁴ Derived from "Outstanding" figure of \$523.21 billion, *The Nilson Report*, Number 760, March 2002, pages pp. 6-7.6 and 7.
- ⁵⁵ 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.
- ⁵⁶ Marianne P. Bitler, Marianne P., Robb, Alicia M., Robb, and Wolken, John D. Wolken, "Financial Services Used by Small Business: Evidence from the 1998 Survey of Small Business Finances." *Federal Reserve Bulletin*, April 2001, p 192.
- ⁵⁷ Calculated from data in the 1998 Survey of Small Business Finances
- ⁵⁸ See Appendix A.
- ⁵⁹ Ibid.
- ⁶⁰ Chandler, Gary G. Chandler and Parker, Lee E. Parker, "Predictive Value of Credit Bureau Reports," *Journal of Retail Banking*, Vol. XI, No. 4. Winter 1989.
- ⁶¹ Mortech 2002/03. Management Analysis-March 12, 2003.
- ⁶² Op. cit.
- ⁶³ Greenspan, Alan. "Remarks by Chairman Alan Greenspan at the Annual Convention of the Independent Community Bankers of America." 4 March, 2003. Transcript.
- ⁶⁴ \$200 billion came from cash-out refinancings; \$350 billion came from homes that turned over; and \$130 billion was drawn from a net increase in home equity loans. Op. Cit., p.1-2.
- ⁶⁵ Fannie Mae. *Fannie Mae Underwriting Selling Guide*, Part 7, Ch. 1, Exhibit 2.
- ⁶⁶ Op. Cit., p.5. Davis, Terri. Davis, "Technology Pays Off in 2001," *Mortgage Banking*, October 2002.
- ⁶⁸ Danford, David P. Danford, "Online Mortgage Business Puts Consumers in Driver's Seat," 1999 Mortgage Market Trends.

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- ⁶⁹ Susan Wharton Gates, Susan Wharton, Perry, Vanessa Gail Perry, and Zorn, Peter M. Zorn, "Automated Underwriting in Mortgage Lending: Good News for the Underserved," *Housing Policy Debate*, Volume 13, Issue 2, 2002.
- ⁷⁰ Barron, John M. and Michael Staten, Michael. "The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience," May, 2000.
- ⁷¹ Proposals of this kind have been proposed in both California and Illinois. (CA AB 800, IL HB 3334).
- ⁷² Restrictions of this sort have been proposed in a variety of states, including New York, Rhode Island and North Dakota. (ND SCR 4019, NY SB 356, and RI HB 5820)
- ⁷³ These kinds of restrictions have been proposed in California and New York. (NY SB 1530, CA AB 3).
- ⁷⁴ Calculated from numbers in the Nilson Report, Number 756, January, 2002, p 8 and Number 760, March 2002, page 6.
- ⁷⁵ Barron and Staten, Op. cit.
- ⁷⁶ Op. cit.
- ⁷⁷ K-S statistics for each model have been scaled to equal 100 for the full-file data. Values below 100 indicate that the model has experienced a loss of predictive power.
- ⁷⁸ See Appendix D for the complete set of results.
- ⁷⁹ Defined as one incidence of 90 days or more past due within a two year period.
- ⁸⁰ *The Nilson Report*, Number 760, March 2002, pages 6 and 7pp. 6-7.
- ⁸¹ Calculation is based on the number of families with credit cards in 2002.
- ⁸² Defined as one incidence of 90 days or more past due within a two year period.
- ⁸³ Nilson Report, Number 760, March 2002, p.6.
- ⁸⁴ Op. Cit., p.7
- ⁸⁵ Assumes a serious delinquency rate of 3 percent.
- ⁸⁶ The permissibility of prescreening under the FCRA has been the subject of much discussion. Because of this, the Federal Financial Institutions Examinations Council (FFIEC) developed a policy statement on the permissibility of prescreening under the FCRA. Regarding what constitutes a "firm" offer of credit, the policy statement clarifies that the offer of credit provided to consumers whose names appear on prescreen lists cannot be conditional. Furthermore, the terms of the offer cannot be changed between the time of the prescreen and the consumer's acceptance of the offer, except in "specified, rare situations." See "Federal Financial Institutions Examination Council Policy Statement on Prescreening." The permissibility of prescreened offers of credit and insurance was firmly established by the 1996 amendments to the FCRA as was a prohibition of state legislation regulating prescreening. See 15 U.S.C. 1681
- ⁸⁷ Derived from figures on number of cardholders for MasterCard and VISA as reported in *The Nilson Report*, Number 760, March 2002, pp 6-7.

⁸⁸ As of April 2003, the following prescreening bills were still pending before various state legislatures: CA AB 1175, CT HB 5079, MA HB 0856, and NY AB 4831.

⁸⁹ The Institute surveyed the member firms of the Partnership to Protect Consumer Credit, an industry group of financial service providers with business operations governed by the FCRA. Among the membership, only 8 firms were eligible for our survey, of which 6 firms responded. In addition, the Institute approached 4 other credit card issuers in order to increase the sample size and the representativeness of the sample, of which one firm responded.

⁹⁰ Derived from figures on number of cardholders for MasterCard and VISA as reported in The Nilson Report, Number 760. March 2002, pp 6-7

⁹¹ Information Policy Institute Prescreen Survey results

⁹² Derived from figures on number of cardholders for MasterCard and VISA as reported in The Nilson Report, Number 760. March 2002, pp 6-7

⁹³ GAO-02-363 at 35

⁹⁴ GAO-02-363 at 4. As noted by GAO, some of this increase may be due to increased consumer awareness. GAO-02-363 at 5.

⁹⁵ Beckett, Paul and Sapsford, Jathon. "As Credit-Card Theft Grows, A Tussle Over Paying to Stop It", Wall Street Journal, Thursday, May 1, 2003 (Vol., CCXLI No. 85) page 1.

⁹⁶ GAO-02-363 at 27-28.

⁹⁷ American Banker. Fraud Keeps On Increasing as Thieves Romp on the Web. January 31, 2003.

⁹⁸ There exists little agreement, even among financial institutions, about what constitutes identity theft. Many do not consider a lost or stolen wallet/purse to be true identity theft unless the thief uses the contents to take over an existing account, or establish a new account using the stolen identity. Similarly, many do not consider the unauthorized use of a credit card by a family member, friend, co-worker, or any other person with privileged access to constitute an act of identity theft. Rather, such acts are usually classified as credit card fraud or some other form of fraud. It stands to reason that defining the parameters of the problem would greatly assist with the development of meaningful solutions.

⁹⁹ See oral testimony of Joel Reidenberg before the House Financial Services Committee, 8 May 2003.

¹⁰⁰ Once the recipient of the offer decides to apply for the credit card, he completes the application, which does require him to provide personal and financial information (e.g., birth date, telephone number, address, employer, salary, account balances). This information allows the issuer to confirm that the applicant indeed qualifies for the offer and also to authenticate the applicant's identity.

¹⁰¹ Results from Information Policy Institute interviews of credit card issuers fielded during April – May, 2003.

¹⁰² GAO-02-363 at 7.

¹⁰³ The USA Patriot Act requires the “Secretary of the Treasury (‘Treasury’) to prescribe regulations establishing minimum standards for the identification and verification of financial institution customers in connection with the opening of an account.” Department of the Treasury. A Report To Congress in Accordance With Section 326(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act). October 21, 2002. Page 1. Final rules were issued April 30, 2003. <<http://www.treas.gov/press/releases/js336.htm>>

¹⁰⁴ GAO-02-363 at 43. These efforts are also why despite the increasing use of credit cards over the internet, “[o]ver the past few years, card providers and financial institutions...have actually reduced fraud rates.” Celent Communications, Page 13.

¹⁰⁵ Findings based upon interviews of major financial institutions and credit reporting agencies fielded by Information Policy Institute.

¹⁰⁶ Edgar, Dunn, and Company. Growing Application Fraud: What the Credit Card Industry Can Do About It. March 2003. Page 10. This is at least partially because the prescreening process often includes filtering out potential applicants identified as having a high risk for fraud.

¹⁰⁷ *Ibid.* 128, Page 13. It should be emphasized that our study does not analyze why the Internet is disproportionately utilized by identity thieves. In all likelihood, it is a function of a number of factors that make this medium uniquely appealing to identity thieves. For instance, such criminals may prefer the relative anonymity of the Internet to other media. In addition, the online credit approval process, which is heavily oriented toward speed and convenience, may not include the full range of fraud protections that are commonly applied across other media, such as prescreened firm offers of credit through the mail.

¹⁰⁸ “FTC Releases Top 10 Consumer Complaint Categories for 2002: As in 2000 and 2001, Identity Theft Tops the List,” Press release of the Federal Trade Commission, accessed online from <<http://www.ftc.gov/opa/2003/01/top10.htm>>.

¹⁰⁹ Cate, Fred H., et al. Financial Privacy, Consumer Prosperity, and the Public Good: Maintaining the Balance. March 2003. AEI-Brookings Joint Center for Regulatory Studies. Page 27.

¹¹⁰ 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

¹¹¹ Durkin reports that 63% ‘strongly agree’ and 27% ‘agree somewhat’ with the statement “Overspending is the fault of consumers, not the credit card companies”.

112 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."

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

114 15 U.S.C. §1681a(d)(1). These "other authorized purposes" include restricted uses by landlords and law enforcement.

115 15 U.S.C. §1681a(f) Non-credit bureau examples of "consumer reporting agencies" upheld by the courts include a subscription service that provided a list of consumers who had written bad checks to its members. *Greenway v. Information Dynamics, Ltd.*, 399 F. Supp. 1092 (D.Ariz. 1974), *aff'd per curiam*, 524 F.2d 1145 (9th Cir. 1975), cert. Dismissed, 424 US 936 (1976). Similarly, a landlord reporting service was also held to be CRA. *Cotto v. Jenney*, 721 F. Supp. 5 (D. Mass. 1989).

116 <<http://www.epic.org/privacy/fcra/>>

117 15 U.S.C. §1681c(a)

118 "Other" data refers to data acquired as a result of something other than a company's direct relationship with a consumer. Consumers must be given notice that such information may be shared and is given the choice to not have that information shared. 15 U.S.C. §1681a(d)(2)

119 15 U.S.C. §1681b(a)(3)

120 The permissibility of prescreening under the FCRA has been the subject of much discussion. Because of this, the Federal Financial Institutions Examinations Council (FFIEC) developed a policy statement on the permissibility of prescreening under the FCRA. Regarding what constitutes a "firm" offer of credit, the policy statement clarifies that the offer of credit provided to consumers whose names appear on prescreen lists cannot be conditional. Furthermore, the terms of the offer cannot be changed between the time of the prescreen and the consumer's acceptance of the offer, except in "specified, rare situations." See "Federal Financial Institutions Examination Council Policy Statement on Prescreening."

121 15 U.S.C. §1681b(c)

122 Consumers are also able to purchase their report at a reasonable price. 15 U.S.C. §1681j. The ceiling on allowable charges was \$9.00 in 2002. See Federal Register Doc. 01-30355 Filed 12-6-01

123 15 U.S.C. §1681h

124 15 U.S.C. §1681g (c).

125 15 U.S.C. §1681i

126 15 U.S.C. §1681b(b)

127 15 U.S.C. §1681b(g)

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- 128 15 U.S.C.1681s, 15 U.S.C. 1681n; 15 U.S.C. 1681o, 15 U.S.C. 1681q; 15 U.S.C. 1681r
- 129 15 U.S.C.1681s(a)
- 130 15 U.S.C.1681s(b)
- 131 15 USC 1681s(c)
- 132 15 U.S.C. 1681n; 15 U.S.C. 1681o
- 133 15 U.S.C. 1681s-2. Some parties may regard the inability of individuals to sue furnishers a weakness in the Act. It is instructive to note that furnishers were not liable under Federal law prior to the 1996 amendments to the Act. The rationale for limiting the liability of data furnishers is obvious: in a credit reporting system where firms are not legally compelled to furnish data to consumer reporting agencies and do so voluntarily, private rights of action against furnishers would significantly reduce the quantity and quality of the data provided. An extensive discussion of this argument can be found in — appropriate full-file section # —
- 134 15 U.S.C. 1681q.
- 135 15 U.S.C. 1681t.
- 136 Ibid.
- 137 Fischer, Richard L. The Law of Financial Privacy. Volume 1. A.S. Pratt & Sons, Thomson Financial. 2002.
- 138 15 U.S.C. 1681t.
- 139 Ibid.
- 140 Paige, Christopher H. "Capital One Financial Corporation," Harvard Business School Case Study 9-700-124, Rev. May 1, 2001., Christopher H. Paige.
- 141 Op. Cit.
- 142 U.S. PIRG. "Identity Theft, Credit Reports, Credit Scores, and Social Security Numbers." *Financial Privacy Fact Sheet*. Retrieved from the U.S. PIRG Web site on April 10, 2003 at <<http://www.pirg.org/consumer/credit/stopbiglie.htm>>
- 143 Op. Cit. See also: U.S. PIRG. "Identity Theft, Credit Reports, Credit Scores, and Social Security Numbers." *Financial Privacy Fact Sheet*. Retrieved from the U.S. PIRG Web site on April 10, 2003 at <<http://www.pirg.org/consumer/credit/stopbiglie.htm>>.
- 144 Hoofnagle, Chris. "FCRA: Congress Should Allow Preemption to Expire," March, 2003. Submitted to the ABA US Banking 2003 Conference. <<http://www.epic.org/epic/staff/hoofnagle/abausbankfcra.html>> In this, Hoofnagle points out that the FCRA is only partially preemptive, meaning that except in a few narrow circumstances, state legislatures may pass laws to supplement the protections made by the FCRA. The 1996 amendments to the FCRA preempt all state laws enacted before 1 January 2004, except for limited extant laws in Vermont, California, and Massachusetts. Currently, employers must receive affirmative written consent from an applicant before pulling their credit report.

145 U.S. PIRG. Press Briefing On Threats to State Financial Privacy Efforts: Statement of Edmund Mierzwinski, U.S. PIRG Consumer Program Director. 13 March, 2003.

<<http://www.pirg.org/consumer/credit/stopbiglie.htm>>

146 Data on state legislation compiled in April 2003 by Kimbell, Sherman, and Ellis under the direction of the Information Policy Institute. KSE is a Vermont-based government and public affairs firm.

147 As a credit score is not part of a consumer report, and is never specifically referenced in the text of the Fair Credit Reporting Act, many states have been actively regulating the use of credit scores for a variety of purposes, but overwhelming the context has been insurance underwriting.

148 Only 46 state legislatures are in session during the 2003 calendar year.

149 15 U.S.C 1681

150 Information Policy Institute state legislative analysis

151 Data on state legislation compiled during first two weeks of April 2003 by Kimbell, Sherman & Ellis — a government affairs firm based in Montpelier, Vermont — under the direction of the Information Policy Institute.

152 Defined as one incidence of 90 days or more past due within a two year period.

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165 Defined as one incidence of 90 days or more past due within a two year period.

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