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Chairman Capito, Ranking member Meeks, and members of the Committee, thank you very much for the opportunity to be here today. I want to make five key points.

1. Credit reporting is vital.

Consumer spending accounts for over two-thirds of U.S. gross domestic product. The wide availability of affordable credit lubricates this spending: roughly $3.2 trillion in outstanding consumer credit enables numerous transactions that would not otherwise occur.[1]

In turn, widespread credit availability depends on an efficient system for credit reporting. Lenders cannot economically make loans without understanding the potential risks they face, and credit reporting is an essential tool for objective risk assessments. Efficient credit reporting makes possible the miracle of instant credit, which enables a consumer to visit a car dealer and arrange financing for the transaction, probably in less time than it takes to negotiate the price. It enables retailers to offer on the spot discounts for consumers who agree to open a new credit account with the retailer. Such arrangements offer significant benefits to both consumers and sellers, and they facilitate economic activity.

[1] http://www.federalreserve.gov/releases/g19/current/ (August 17, 2014).

Our credit reporting system also facilitates competition among lenders, to the benefit of consumers. Using credit reports, lenders can readily identify consumers who deserve a better deal, even those in remote locations who have no direct contact with the lender. The ability to offer credit on terms that lenders find profitable, and consumers find more attractive, obviously benefits everyone. One study described credit report data as "the jet fuel for an acceleration in card offerings and competition" in the late 1980s and 1990s.[2] Aggressive competition led to declines in annual fees and interest rates, as well as the introduction of new card features such as rewards cards.

Efficient credit reporting is also important to small businesses. Decisions to lend to a small business depend on the lender's assessment of the viability of the business, but they also depend on the personal creditworthiness of the owner of the business. The adoption of commercial scoring systems based on credit report data for evaluating small business loans led to an expanded volume of loans and a net increase in lending to relatively risky borrowers.[3] Thus, credit reporting is often critical to decisions about whether to lend to the small businesses that are important job creators.

2. Risk-Based Pricing Benefits Consumers

A fundamental principle of economic efficiency requires that those who create costs must pay them. If not, they will create excessive costs that impair economic performance. This is why it is both equitable, and efficient, that teenage males pay higher auto insurance premiums than teenage females or older men – teenage males are higher risk drivers. They should, and do, pay higher insurance premiums.

[2] Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy*, Oxford University Press, 2014, at 249.

The same principles apply in credit markets. Some consumers manage their financial obligations responsibly, and pay their bills on time. Others borrow more than they can afford, and, in the end, default. There is no reason that good credit risks should be expected to subsidize the choices made by those who are less likely to repay their debts.

Risk-based pricing relies on statistically determined scores based on credit report data to assess the likelihood of default. Although many creditors rely on generic systems such as the well-known FICO score, many others develop their own risk assessment models to take into account the particular characteristics of their products or customers. A 2004 study identified 70 different generic scoring systems that were available at the time, with more than 100 different scoring models.[4] Risk assessment models based on credit bureau data have been shown to outperform assessments based on application data in the context of credit card applications.[5]

Importantly, making loans based on objective risk assessment reduces the risk of default. Some studies indicate that the delinquency risk when decisions are based on scoring algorithms from credit report data are 20 to 30 percent lower than the risk of delinquency when the lender uses "judgment" to decide which consumers deserve a

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[3] Allen N. Berger, W. Scott Frame, and Nathan H. Miller, Credit Scoring and Availability, Price and Risk of Small Business Credit, *Journal of Money, Credit, and Banking*, April, 2005.

[4] Gary G. Chandler, Generic and Customized Scoring Models: A Comparison, in *Credit Scoring for Risk Managers: The Handbook for Lenders*, Elizabeth Mays, Ed., (Mason, OH: Thomson/Southwestern, 2004).

[5] Gary G. Chandler and Lee E. Parker, Predictive Value of Credit Bureau Reports, *Journal of Retail Banking*, Winter, 1989.

loan.[6] Moreover, such judgmental decisions often rely on stereotypes about which borrowers are most likely to repay – they are, in short, discriminatory.

Risk-based pricing based on credit scores offers two important benefits. First, responsible borrowers – undoubtedly the vast majority – pay less for credit. The introduction of risk based pricing reduced interest rates for these borrowers by as much as 8 percentage points.[7]

Second, risk-based pricing substantially expanded credit availability. In the "one size fits all" world of standardized, plain vanilla credit products, the lender's only choice was yes or no. For marginal borrowers, the answer was often no. Risk based pricing introduces a new alternative: yes, but at a higher price, commensurate with the additional risk. The result was a substantial expansion in credit availability. In 1970, only 2% of the lowest income quintile had any credit card; by 1998, after the introduction of risk based pricing, the percentage had increased to 28%.[8] Moreover, risk-based pricing "led to a broader array of loan products available to all risk and income groups."[9]

In short, well-functioning credit markets are an essential component of economic prosperity. Consumer reporting has played a key role in providing U.S. consumers with rapid access to credit. The development of the consumer reporting system, with its sophisticated risk models and automated underwriting, has contributed greatly to making

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[6] Peter McCorkell, "The Impact of Credit Scoring and Automated Underwriting on Credit Availability," in Thomas A. Durkin and Michael E. Staten, eds., *The Impact of Public Policy on Consumer Credit (*2002).

[7] Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Federal Reserve Bank of Philadelphia (January 2003) at 8.

[8] Thomas A. Durkin, "Credit Cards: Use and Consumer Attitudes, 1970-2000," *Federal Reserve Bulletin*, September, 2000, at 626.

[9] See Durkin et al., supra note 2, at 227, citing Wendy Edelberg, Risk-Based Pricing of Interest Rates on Consumer Loans, *Journal of Monetary Economics*, November, 2006.

credit more widely, inexpensively, and rapidly available. The system also has narrowed the gap in credit availability between high and low income consumers.

3. More information in the system leads to better performance.

Information in the U.S. credit reporting system is provided voluntarily by roughly 30,000 data "furnishers," in return for access to the pooled information from other furnishers in the form of a credit report. Some furnishers provide information to all of the big three credit reporting agencies; others may only furnish to a single bureau. With more furnishers, a credit reporting agency can paint a more complete picture of a consumer's credit use decisions and obligations, enabling more accurate assessments of risk. As Durkin and his colleagues explain, "The predictive power of models built with the reported data is diminished, and the fog of uncertainty surrounding a given borrower is a little bit thicker when lenders know that the consumer may have an account (of unknown size and payment status) with a nonreporting creditor."[10]

When the stakes are high, as with decisions about mortgage loans, it is common for lenders to purchase credit reports from all three of the national CRAs. For smaller loans, lender may rely on a single credit report. Moreover, an important dimension of competition for business among CRAs is the breadth and robustness of the information about consumers in their databases. Each CRA tries to obtain as much information as possible from furnishers.

Even when furnishers participate in the system, they may not report all of the information they have about the consumer. Some, for example, may report only negative information, not a consumer's history of paying on time. Others may fear that

[10] Durkin et al., supra note 2, at 265-266.

competitors will seek to poach their best customers, and limit the information they report to minimize that risk.

An estimated 30 to 50 million consumers do not have sufficient credit information in their files to qualify for affordable mainstream credit.[11] Instead, they are left to rely on such high cost credit sources as overdraft protection, short term loans, or pawn shops. Studies have shown that adding positive payment information from utilities and telecommunications providers, in addition to the negative information that most now report, can improve the credit scores of those with thin files that otherwise do not have sufficient information to support a reliable credit score.[12] Such additional information can help to further reduce the differences in the accessibility of credit on reasonable terms.

4. Accuracy and completeness are both important.

Credit reporting agencies face a difficult task of matching incoming information to the right file when identifying information is incomplete, as it often is in a voluntary system. It is obviously a mistake to include information in my file that is not in fact about me. This is the kind of error that the FTC's 2012 report examines.[13] More subtly, it is also an error to leave out information that should be in my file simply because there is some ambiguity about the match. Such errors of omission obviously reduce the value of credit reports to lenders, because a report that does not include all of the relevant

[11] PERC, Alternative Data Initiative, available at http://perc.net/content/alternative-data-initiative-adi (May 3, 2013).

[12] Michael A. Turner and Amita Agarwal, "Using non-traditional data for underwriting loans to thin-file borrowers: Evidence, tips and precautions," 1 *Journal of Risk Management in Financial Institutions* 165 (2008).

[13] Federal Trade Commission, Report to Congress under Section 319 of the Air and Accurate Credit Transactions Act of 2003, December, 2012.

information about a particular consumer is less likely to be predictive of future behavior. In some cases, the failure to include relevant information may leave a consumer with a thin file and limited access to conventional credit. Either mistake reduces the accuracy of risk assessments, which is the ultimate goal of the credit reporting system. Moreover, the risk of a mistake depends on the quality of the information voluntarily provided by data furnishers. Even the best matching algorithms cannot overcome bad data.

As noted above, the more accurate and robust the information about an individual, the more confident the user may be in judging the risk associated with a particular transaction. However, efforts to improve accuracy and completeness must confront the fact that furnishing data is voluntary, and, if the costs and risks of providing data are too high, some furnishers may choose not to provide information at all.

As the FTC has noted, "because data furnishers provide consumer information to the CRAs on a voluntary basis, the CRAs have only limited influence."[14] In particular, their ability to enforce reporting rules "is limited by competitive pressures; if a CRA refuses to sell consumer reports to a particular lender, that lender could simply turn to another CRA."[15]

The limitations of the CRAs' ability to influence furnishers are well illustrated by issues where CRAs have a clear self-interest in obtaining information but are not fully successful in doing so. For example, the Consumer Data Industry Association (CDIA) introduced the Metro 2 data reporting format in 1997. Eight years later, the Metro 2 format was used by only 31 percent of furnishers, accounting for approximately half of

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[14] FTC Report to Congress under Sections 318 and 319 of the FACT Act of 2003, at 42 (December 2004).

[15] Id. at 13.

the data reported to the repositories.[16] Similarly, CRAs have a clear interest in obtaining consumer identifying information from furnishers, to assure that furnished data are included in the proper consumer file. Identifying information that includes a Social Security number would improve matches. The FTC reports that 5 to 10 percent of user inquiries do not include a valid SSN, and "the SSN is even less prevalent in data sent by furnishers,"[17] despite efforts to encourage provision of SSNs.[18]

To be sure, ongoing efforts to improve accuracy and completeness are essential, and there are significant competitive pressures on credit reporting agencies to do so. But all such efforts must recognize the voluntary nature of the reporting system. Regulatory requirements that reduce participation by furnishers may well be worse than the disease they are trying to cure.

5. Different risks are different.

The best prediction of risk depends on the particular risk involved. Different information may be especially valuable for certain kinds of risks. Moreover, the population of consumers attracted to particular financial products is likely to differ, leading to differences in the best risk prediction model. It is for this reason that many users of credit reports develop their own scoring models. It is also for this reason that some CRAs specialize in particular types of risks, such as the risks involved in extending short term or liquidity credit. By specializing, they can build databases that contain the right information, enabling the right risk assessment analytics, to serve particular

[16] Federal Trade Commission and Federal Reserve Board, Report to Congress on the Fair Credit Reporting Act Dispute Process, August, 2006, at 10.

[17] FTC Report to Congress under Sections 318 and 319 of the FACT Act of 2003, at 38 (December 2004).

[18] Id. at 43.

markets. Almost inevitably, however, these CRAs are significantly smaller than the big three, and regulatory compliance costs may be more significant.

Thank you again for the opportunity to testify today. I look forward to your questions.