Identifying and Measuring the Costs and Benefits of the Collection and Use of Consumer Information

Robert M. Hunt*
Federal Reserve Bank of Philadelphia

Federal Trade Commission

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FEDERAL RESERVE BANK
OF PHILADELPHIA

*: The views expressed here are my own and not necessarily those of the Federal Reserve Bank of Philadelphia or the Federal Reserve System

Two Problems that Confront Lenders

- Adverse Selection
  - How well do I distinguish between borrowers of different risk?
  - Determines who gets credit, how much, and on what terms
- Moral hazard
  - How can I induce the borrower to repay?
  - Reputation is an important tool
- Credit bureaus help to mitigate both problems
  - Information improves assessment and pricing of credit risk
  - Access to information implements reputation

Economics of Voluntary Information Sharing

- There are tradeoffs to information sharing
  - Benefit: Increased ability to attract other lenders' customers
  - Cost: Greater competition for your existing customers
- A voluntary equilibrium may not happen
  - Too much competition implies no voluntary information sharing
  - The U.S. experience is due in part to the structure of retail and credit markets 50 or 100 years ago
  - Many other countries had to legislate bureaus into existence
- Credit bureaus exhibit Network Effects
  - Joining a bureau is more attractive if it already has many members
  - Tendency towards a concentrated credit reporting industry

When Should We Expect to See Credit Bureaus?

- When there is a lot of unsecured lending
  - Amortizes fixed cost of establishing bureaus
- When lenders are small relative to their market
  - When lending markets are not highly concentrated
  - When people are mobile
- When lending markets are fragmented
  - Either geographically or functionally - both were true in the U.S.
  - Not all profits are competed away
- When people borrow from many lenders at the same time
  - Each loan I take out changes the probability I will repay any loan

The Accuracy of Credit Bureau Information

- The information is good enough to be valuable
  - Lenders pay for it and use it for automated credit decisions
- We have limited information about quality
  - Until recently there were few scientific studies
  - Must distinguish between any error and major errors that *affect decisions* about credit, insurance, employment, etc.
  - *Even a very small incidence of major errors translates into many tens of thousands of erroneous credit decisions*
- Remedies for noisy information
  - Design of the credit score, using a median score
  - Consumers can dispute information contained in their report

Incentives for Accuracy

- Borrowers typically want accurate information
  - They have a comparative advantage in detecting errors
  - A dispute process can be used to take advantage of this
- Lenders typically want accurate information
  - Especially information provided by *other* lenders
  - But they want to limit the cost of providing their own information
  - They don’t want to pay a lot to access credit bureau data
- Credit Bureaus act as a quality control mechanism
  - Pricing depends on the quality, comprehensiveness, and timeliness
  - Credit bureaus set reporting standards and audit incoming data
  - Credit bureaus process most consumer disputes

The Optimal Level of Accuracy?

- Lenders probably care more about Type I errors:
  - Making a loan on the basis of erroneous information
- Borrowers probably care more about about Type II errors:
  - Not obtaining a loan because of erroneous information
- Bureaus may be more responsive to the needs of lenders
  - Lenders are the principal source of revenues
  - May be preoccupied with Type I errors (wrong mix of mistakes?)
  - May ignore consumer losses (too many mistakes?)
- Bureaus may underfund the consumer dispute process
  - Incur most of the cost, while benefits shared with consumers
- A rationale for government intervention?
  - Intuition contained in the legislative history of FCRA

Does the Fair Credit Reporting Act Reflect Economic Intuition?

- Established a custom *negligence* rule for credit bureaus and users of credit reports
- Specified different standards of care for different parties
  - Information providers must avoid disseminating information *they know* (*or avoid knowing*) to be wrong and must respond to requests to verify their information
  - Bureaus must take *reasonable precautions* to ensure maximum possible accuracy and to avoid unauthorized disclosures
  - Users may access credit reports only for authorized purposes and must notify consumers of their rights under FCRA

Does the Fair Credit Reporting Act Reflect Economic Intuition?

- Specified different remedies for different parties
  - Civil suits by government agencies (FTC, FRB, etc.)
    - Information users, credit bureaus, and information providers
  - Civil suits by consumers:
    - Information users and credit bureaus
  - Civil suits by credit bureaus
    - Information users
  - Criminal penalties:
    - Information users and credit bureau employees

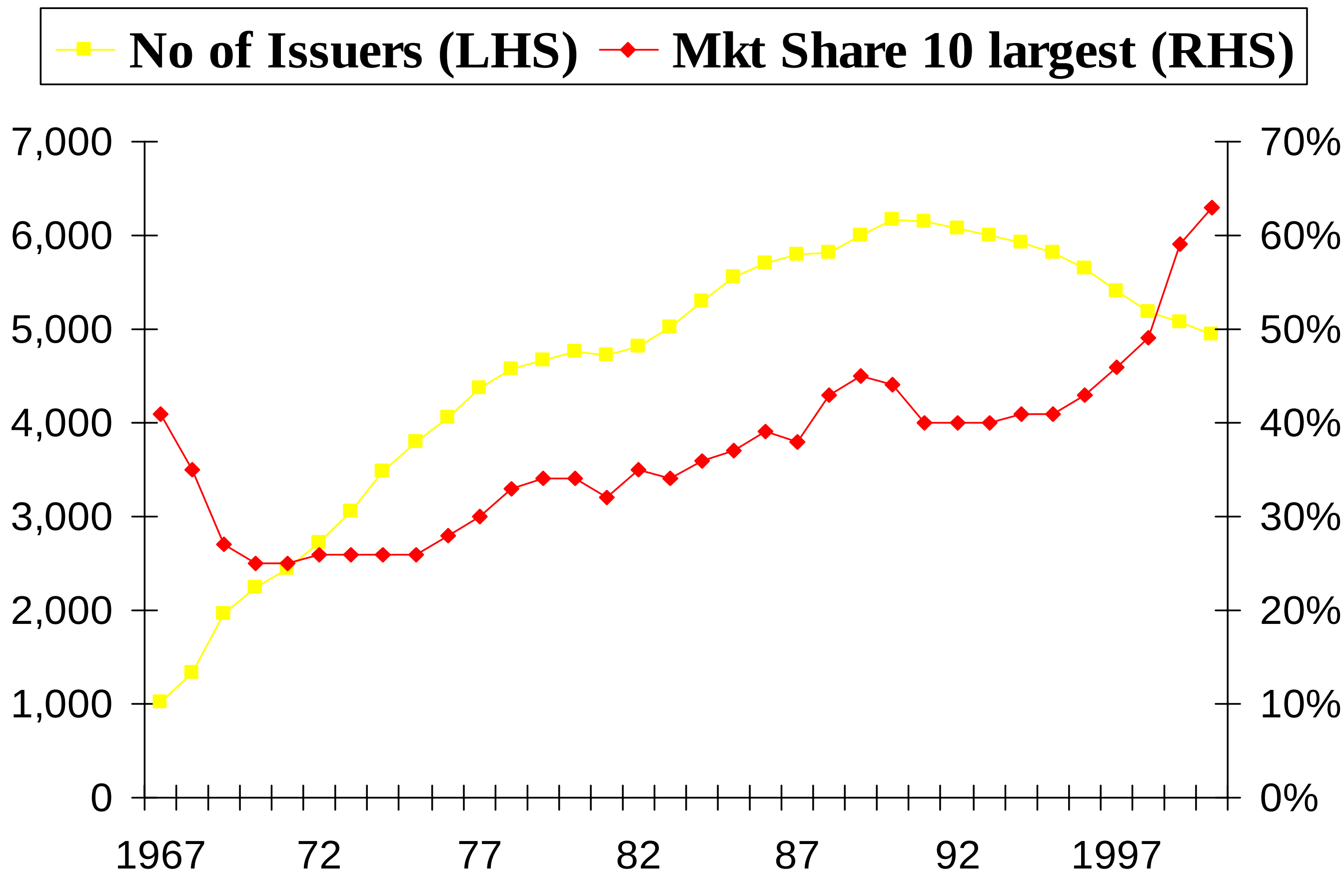
FCRA Encourages Error Correction

- Consumers' access to credit reports is subsidized
  - Prices are capped by regulation
  - Credit reports are free after an *adverse action*
- Consumers can dispute information by writing a letter
- Bureaus are subject to performance requirements
  - Information not verified within 30 days must be removed
  - Consumers must be notified if disputed information reappears
  - National bureaus must share corrected information
  - National bureaus must staff 800 lines
- N.B. The dispute process is costly for the bureaus
  - Unit costs are falling, but volume is rising even faster

Conclusion

- There are a variety of techniques for measuring the costs and benefits of information sharing
  - Some work has already been done
  - There is a lot more work to do
- This can be difficult
  - Not easy to choose the right counterfactuals
  - Not everything we're interested in is priced in a market
- It's important to understand the nature of the equilibrium
  - Institutions matter
  - Regulations matter
  - Financial market characteristics matter

The Changing Market Structure of Credit Cards



Note: Market share is calculated using credit card receivables reported in bank call report data, so this chart does not reflect card issuers that are not banks or thrifts, and does not reflect any securitized receivables.

An Example

- During late 1990s, some issuers reported less information
  - In particular, credit lines or high balances
  - Important variables for assessing and pricing credit risk
  - Affected about 1/3 of revolving credit accounts
  - Some large lenders and more likely for sub-prime accounts
- Credit bureaus and regulators responded
  - Bureaus threatened to enforce their reciprocity rules
  - These lenders began reporting more information
- Will it happen again?