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Subcommittee on Consumer Protection
Senate Committee On Commerce, Science, and Transportation
Hearing on "Credit Reports: What Accuracy and Errors Mean for Consumers"

May 7, 2013

Thank you very much for the opportunity to be here today. In my limited time, 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 2.8 billion in outstanding consumer credit enables numerous transactions that would not otherwise occur.

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 retailers, and they facilitate economic activity.

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. The ability to offer credit on terms that lenders find profitable, and consumers find more attractive, obviously benefits everyone.

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 the also depend on the personal creditworthiness of the owner of the business. Thus, credit reporting is often critical to decisions about whether to lend to the small businesses that are important elements of job creation.

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.

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.

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 loan.[1] Moreover, such judgmental decisions often rely on stereotypes about which borrowers are most likely to repay – they are, in short, discriminatory.

1 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).

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.[2]

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 generally 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%.[3]

Thus, 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 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.

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

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

An estimated 30 to 50 million consumers do not have sufficient credit information in their files to qualify for affordable mainstream credit.[4] 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, instead of only 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.[5] 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 recent FTC report examines. 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 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 system. Moreover, the risk of a

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

5 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).

mistake depends on the quality of the information voluntarily provided by data furnishers. Even the best matching algorithms cannot overcome bad data.

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, if not most, 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, and the right risk assessment analytics, to serve particular 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.