

Statement by

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Before the

U.S. House of Representatives
Committee on Financial Services,
Subcommittee on Financial Institutions and Consumer Credit

Concerning

"Helping Consumers Obtain the Credit they Deserve."

12 May 2005
2128 Rayburn House Office Building

INTRODUCTION

Good morning Mr. Chairman and honorable members of the Subcommittee. I am grateful for the opportunity to testify before you today. I commend Chairman Bachus and Chairman Oxley, and Congressman Castle for their leadership on the complex yet crucial issue of the national credit reporting system.

My name is Michael Turner and I am President and Senior Scholar of the Information Policy Institute. The Institute is a non-profit, non-partisan research organization based in New York City – and is the only institution of its kind dedicated exclusively to issues involving the regulation of information, both domestically and globally.

Since its inception, the Institute has maintained an active focus on issues relating to consumer credit reporting, and has taken its research findings to various federal, state, and international legislative and regulatory bodies on issues ranging from the need for a uniform national law governing consumer credit reporting, to the security of trans-border flows of personal financial information. In addition to the analysis of the importance of the national credit reporting system in the U.S.—the results of which I reported to this Subcommittee two years ago.

When Congress last examined policy issues around our national credit reporting system, they acted swiftly to preserve uniform national standards for consumer credit reporting by passing the Fair and Accurate Credit Transactions Act, or “FACT Act” as it has become known. In addition to making federal preemptions in important areas permanent and also implementing measures to protect Americans from identity thieves, Congress mandated a number of studies, including one by the Federal Trade Commission on whether transactional data not currently included in consumer credit reports could help Americans outside the credit system obtain credit.¹

The FTC’s report to Congress on this topic concludes that there are several types of transactions that could be useful in evaluating a consumer’s creditworthiness, and that there are currently barriers to reporting these payments. The Institute also recently completed research designed to assess the value of including non-traditional data in consumer credit reports. We believe our report is useful because it provides an analytical framework for gauging which data sets are most likely to help bring the underserved into the credit system. We also point to courses of actions for industry, regulators and lawmakers to encourage the provision of non-traditional data.

I shall now briefly describe a number of the issues related to non-traditional data, and some of our study’s key findings.

¹ Section 318 of the FACT Act required that the FTC examine “whether there are any common financial transactions not generally reported to the CRAs that would provide useful information in determining a consumer’s credit rating.”

ISSUES TO BE CONSIDERED

Before discussing our findings, some facts about credit reporting and non-traditional information should be kept in mind.

Credit Bureau Data

Access to credit depends on the assessment of the risk level associated with a particular loan. Credit scoring has become the principal means by which credit risk, and thereby price, is assessed. Scoring is an empirical and pragmatic endeavor. Vast amounts of consumer payment information from a statistically valid sample are scoured for patterns, and the patterns are linked to probabilities with the various features of consumers. The latter set of factors can include elements such as residential tenure² and overall indebtedness. And from these factors, loans are priced and access is determined, and a decision is made which reflects the risk associated with lending to an individual.

In addition to identifying information such as name, age, and address, traditional sources of data include information on any line of credit: how long the consumer has had the line of credit; credit limit or loan amount; balance; if the account is a joint account; monthly payment; and, payment pattern. Also contained in credit reports are tax liens, bankruptcies, state and county court judgments, and, in some states, delinquencies on child support. Furthermore, credit reports also contain information on inquiries, a list of those who have obtained a consumer's credit report. Inquiries are kept for two years. Positive information is kept for seven years. Most derogatory information is maintained for seven years with some exceptions including bankruptcies and tax liens, which are kept for 10 years.

Credit Bureau Coverage, the Consequences of Exclusion, and Entry into the Credit Market

If there is little or no information on a consumer along these dimensions, then the consumer often cannot be scored, or otherwise assessed. These consumers are often described "thin-file" and have a difficult time accessing credit. And of course, paradoxically, without credit to begin with, it is difficult for such consumers to establish that they are creditworthy.

In most cases there are mechanisms by which thin-file consumers or those who lack credit history altogether may enter the credit market fairly painlessly. For example, parent-child joint accounts for bankcards help many of the young enter the system. Others, by contrast, do not transition so easily into the system or at all. Uncovering the full set of causes why some do and others do not awaits research. Whatever the causes, the consequences can be significant for living standards, opportunities, and asset formation. The last deserves a special mention.

For most American households, the bulk of savings takes the form of homeownership. Rent is turned into equity through ownership and goes to a large extent into savings in the form of real estate assets. The irony is that because of this feature of savings in the U.S., most Americans

² One CRA we interviewed found that residential tenure was a useful predictor of likelihood of repay.

need to have access to credit in order to build up substantial savings. This is especially true for poorer households, as the Survey of Consumer Finances regularly shows. For the whole of the American population, home equity accounted for 42% of all assets of those who owned their homes. This share increases as we go down the income ladder. For the bottom 20% on the income ladder (for the homeowner population) home equity accounts for 80% of their assets.

A second and equally pressing dilemma that stems from no files and unscorable files is the lack of access to revolving credit. The issue of revolving credit is thornier, as it raises fears of rising debt burdens. The other face of revolving credit is its use in small business activity. Many small businesses use credit cards—personal credit cards—to finance much of their activity especially in moments where there are bottlenecks in cash flow. (The Federal Reserve’s survey of small businesses found this to be increasingly true in the 1990s; the share of small businesses using personal credit cards increased nearly 10% from 41% in 1993 to 45% in 1998.)³ This is particularly true for the smaller and younger of the small businesses.

Lack of access to credit may help explain lower levels of entrepreneurial activity among poorer segments of the population. Lack of information about credit risk, in turn, helps to partly explain the lack of credit for these consumers. It’s clear that low levels of capital act as a hurdle to acquiring credit, as lack of access to credit also acts as a hurdle to building assets. From the perspective of addressing the problem of helping consumers build assets, the proximate issue is how to help them enter the credit system.

The structure described above creates a “catch-22” for many with thin or no files, though low income levels may explain the exclusion of many from the credit reporting system. Briefly, without a credit history, consumers cannot be scored, and without a credit score, they cannot access credit necessary to build a credit history. Building up a credit history initially is not especially difficult for most consumers, but for some consumers, particularly those lacking an understanding of the credit system or with few financial resources, it can be a significant obstacle.

³ “Financial Services Used by Small Businesses: Evidence from the 1998 Survey of Small Business Finances.” *Bulletin*. April 2001. www.federalreserve.gov/pubs/oss/oss3/ssbf98/april2001bulletin.pdf, p. 192

THE PROMISE OF NON-TRADITIONAL DATA

What is Alternative Data?

Data on transactions that are currently excluded from traditional consumer credit reports comprises what is referred to as “non-traditional” or “alternative” data. Though this information is potentially predictive of an individual’s credit risk, it rarely reaches the credit reporting agencies.⁴

Categories of “Alternative Data” include:

- Energy payments (water, electric, gas);
- Telecommunications (landline, cellular, internet, cable television);
- Auto liability insurance;
- Homeowner’s insurance
- Rental payments;
- Child care payments;
- Payday loans;
- Healthcare payments;
- And, certain types of retail payments (e.g. furniture rental data).

What Can Be Done to Break the Thin-file Catch-22?

The majority of those with unscorable thin-files or without files at all do in fact engage in activities that can be thought of as “credit-like”--that is, they receive goods or services in advance of making a payment. They also make payments that precede services, but whose expected regularity may provide a basis for evaluating responsibility (for example, auto insurance). The regularity and amount of these payments is often one indicator of how risky the prospect of lending to a prospective borrower happens to be. In other words, the vast majority of lower-income Americans reveals their sense of responsibility in whether or not they pay their rent and utility bills on time.

The successful use of alternative data may help move “thin-file” and “no-file” consumers into spheres where traditional data furnishers would also have information on them. In short, it promises a means to help some of the underserved escape the “catch-22” described above and enter into the mainstream credit market.

Using Alternative Data in Consumer Credit Risk Models

While it is very difficult to assess the predictive value of non-traditional data without collecting the information, constructing models, and assessing its performance, it is possible to make some

⁴ Interviews with the national consumer reporting agencies (CRAs) confirms that information on auto insurance, rents, positive information on payday loans, and the like are not generally reported. Positive information on utility payments exists in some regions, but it is not a nationwide practice. Interviews with insurance and utility industry associations confirm that reporting to the CRAs is infrequent in much of the country.

reasoned speculations as to which types of data offer the most promise of reaching the underserved.

Here it is important to note that a history of positive information is what allows modelers to fully assess a consumer's likelihood of repayment. That is, it is not the reporting of negatives so much as the presence of negatives and positives that enables models to score information. In many sectors that do not currently report regularly, some negatives such as defaults are reported to credit bureaus.

The problem for those outside of the credit system is less the access to negative information on them than the absence of positive information on credit files. Concerns that reporting by utilities may lead to negative consequences overlooks the fact that most serious negatives are either already reported directly to the bureaus, or via collection agencies.

What most candidates for viable types of non-traditional data share is the character of obligation—there is an agreement of payment for a service of some kind. The relationship may be regular, and is ideally regular, though notably payday loans are not regular for the most part. In some instances, payment is received prior to the receipt of services, such as rent, in which payment is for the month following, but the failure to receive payment does not automatically terminate the receipt of service. In other instances, such as utilities and telecommunications, payday loans, payment is received after services are offered. And in others still, payment must be made before services are extended, such as insurance or tuition. In all instances, information about these relations is likely to offer some insights into an individual's ability and willingness to repay a loan and a general sense of their credit risk.

OUR RESEARCH

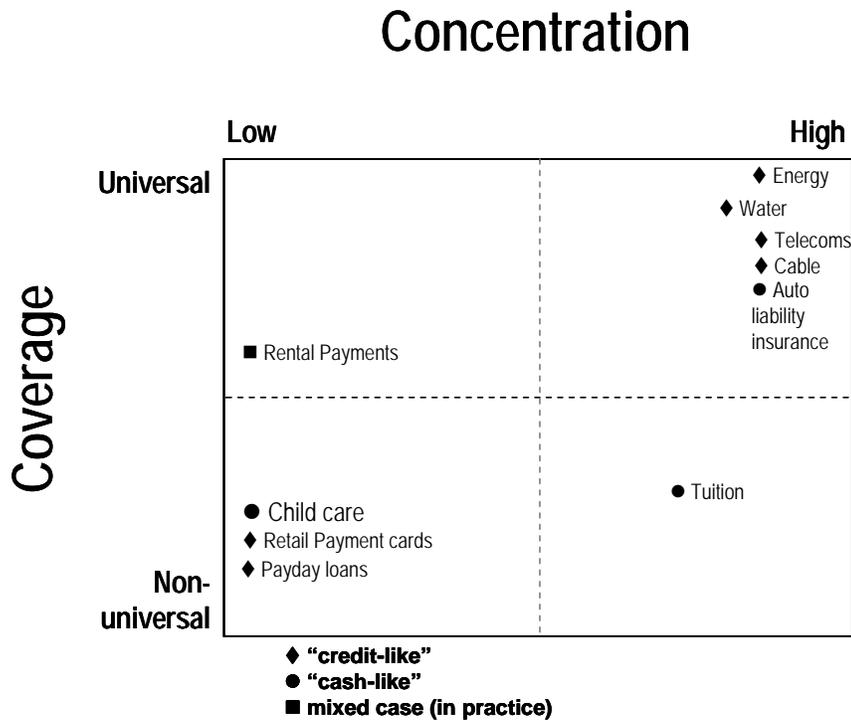
The Information Policy Institute recently completed the first stage of an analysis examining the potential costs and benefits of including alternative data in consumer credit reports. The study provides an analytical framework for assessing the potential usefulness of including various non-traditional data for different populations with an emphasis on low to moderate income Americans. The report also includes an examination of existing technological, regulatory, and economic barriers that may impede alternative data flows. This paper will be forthcoming shortly. We describe the research program used in the first phase of our analysis below.

Methodology

Our examination of the potential sources of non-traditional information relied on interviews that were structured by an analytic typology. The typology took into consideration three factors or dimension: (i) the number of consumers that purchased services from the sector (or **coverage** in the figure below); (ii) the ratio of consumers to the providers of the service (or **concentration** in the figure below); and (iii) the extent to which a service was cash-like and the degree to which it was credit-like. Coverage provides an indication of how likely a source of information is to reach the underserved. Concentration offers an idea of the costs or effort that would be necessary to reach

potential data furnishers, as well as the costs of furnishing for each consumer. Whether a service is cash-like or credit-like gives some indication as to the incentives that a source of non-traditional data has for furnishing data.

The following figure illustrates the configurations. We structured our interviews accordingly. We did not interview anyone in the sectors that occupy the lower right quadrant. No sector in that quadrant has, to our knowledge, either examined furnishing data or has had an interested party such as a credit bureau attempt to organize it to furnish.



In addition to potential providers in these sectors and/or those who have organized the provision of information by this sector, we also discussed the issue with some end users, prospective lenders who are seeking information on underserved segments, and the credit bureaus.

Findings

We expect that most parties will be affected positively by the reporting of non-traditional data.

Consumers: For the estimated 35 to 50 million American borrowers who don't have credit scores, bank accounts, or whose files have too little information to be used in allocating credit, the use of alternative data about individuals could potentially enable them to access credit from mainstream lenders. The use of non-traditional data may also have an impact on borrowers who are already part of the credit reporting system, optimizing risk

assessment and reducing inefficient cross-subsidies from responsible borrowers to higher risk borrowers.

Creditors would also benefit from an increased ability to assess risk, which results in a reduction in bad loans, an increased ability to price loans to match risk, and higher performance rates for their entire portfolio of loans.

Furnishers of non-traditional data would also benefit from the disciplining effect of reporting, including fewer delinquent payments and reduced charge-offs.

There are impediments to this type of information sharing. Two economic barriers and two regulatory barriers may deter many prospective data furnishers from reporting.

1. Would-be data furnishers that are unfamiliar with the reporting systems and some of the practices that mitigate poaching don't want to share customer data for fear that sharing will enable competitors to steal their customers.
2. Some firms may have complex and incompatible legacy IT systems in place that would make the cost of reporting greater than any perceived benefits.
3. At least two states have statutory prohibitions on the onward transfer of customer data by regulated utility companies. In those states, no customer data from telephone companies, electric, gas, or water companies can be shared with credit reporting agencies as a matter of law.
4. In many states, regulatory uncertainty acts as a soft barrier on the provision of non-traditional information. This is especially true for utility providers which are often unsure of the permissibility of reporting. As a result, without clarification from state legislators or regulators, the fear of potential legal liability and public relations fall-out acts to block the sharing of customer data with credit bureaus.

Some key findings from our forthcoming analysis include:

- *Utility and telecom data is likely to be most useful for thin-file and no-filed Americans.* Data from utility companies, especially telecommunications firms and energy companies cover nearly all Americans including large segments of the underprivileged. Furthermore, these sectors are concentrated and have incentives to furnish data.
- *Non-traditional data is very unlikely to negatively affect the credit scores of most Americans.* Serious negative information is already reported by utilities, telecommunication firms, and many other sources of non-traditional data. What is not reported is positive information, i.e., on time payments. Inclusion of positive information stands to reward most consumers by positively improving their credit scores, or by generating a score where it was previously impossible to do so owing to insufficient information.
- *Prospective data furnishers need regulatory clarity.* Among those firms with customer data with the greatest potential to help enable access to credit to the unbanked and thin-filed, many are public service companies such as utility providers. Such firms confront great

regulatory uncertainty concerning data sharing, and would benefit from affirmative clarification from regulators and legislators.

Sector Specific Considerations

Utilities: As the analysis above suggests, consumer information furnished by utility providers offers the best promise for expanding credit access to the underserved. Utility payments are practically universal, and the sector is heavily concentrated, so relatively few potential data furnishers would have to be convinced of the merits of reporting. Some utility companies, however, have expressed reluctance to begin reporting, and few utility companies report both positive and negative data to the national repositories. In some cases negatives are only received by bureaus indirectly, specifically, those accounts that have been remanded to collections.

The reason why utilities have been reluctant to report may have something to do with the history of the sector and its heavily regulated character. Interviews with utility companies revealed that a hurdle to reporting was the absence of a clear authorization from state regulators that they can report on consumers. As public service companies that are more subject than others to political pressure; their response is understandable.

It should be recalled that the consumer credit reporting system is voluntary. Experimentation, lessons from other firms, affirmative consent from state regulators, and the development of industry practices may be necessary before utilities begin reporting data in meaningful numbers.

Auto liability insurance: As with utility data, auto insurance is also subject to considerable scrutiny and regulation. But here the limitation appears to be more a market based rationale for non-reporting. Insurance carriers can quickly discipline those who are delinquent with their installments. As a result, policyholder knowledge that late payments are being reported may have a marginal disciplining effect, but not likely of the same magnitude as the expected effect in other industries with a weaker disciplining mechanism. Auto liability insurers may further benefit from richer and more robust consumer credit reports, particularly those that include non-traditional data, as they rely heavily on data from consumer credit reports to build their own underwriting scores.

Rental: Our report notes some of the advantages and problems of including rental data in credit reports. The principal issue with rental data is the large number of landlords in the US rental market. The largest landlords still only account for a small fraction of the market. Of course, these limitations may be outweighed by the benefits of having whatever data that is available reported to the bureaus. The responsiveness of the market to an opportunity to improve the quality of its product clearly mitigates the need for government intervention to achieve the same objective.

There may be room for public policy on the issue of rental payment data on the underserved. For example, those who use public housing are more likely to have thin-files or be unbanked than the average American.

Objections

The reporting of non-traditional data is not without its critics. There are three common objections.

First, there are fears that the use of this information will negatively impact consumers, notably in the form of risk based pricing. Some worry that additional negative information will dynamically raise the price of credit on existing credit lines. response. This objection is based on a misunderstanding. Most of these sectors considered here report negatives already. Collection agencies report delinquent accounts, and, likewise, landlord tenant disputes are included in credit reports. That information already makes it into pricing models. What is not currently considered are the positives, which have the effect of lowering price and improving access for consumers, especially the underserved.

Second, others fear that the inclusion of certain data sets—notably data about payday loans—will do more harm than good for low to moderate income Americans. The concern about including payday loan data stems from the high APR on such loans, and the belief that payday lenders contribute to borrowers' financial duress. Normative judgments about the practice aside, should the inclusion of payday loan data prove to be an accurate predictor of default, then those un-banked or thin-filed who make use of such services, and make prompt payments could stand to benefit.

Third, there are those who are opposed to sharing the financial and transactional data that comprise the core of a consumer credit report. Note here that this concern comes at a high price for the underserved. As noted above, access to credit is crucial for households that wish to develop assets, given that households save primarily in the form of houses. This is particularly true of households further down the income ladder. The ostensible protection of the privacy of the underserved thus involves reducing their opportunities to create assets and wealth.

FUTURE RESEARCH

Whether or not any data from the identified universe of potentially useful non-traditional data has any predictive power in consumer credit scoring is purely an empirical matter. Towards this end, The Information Policy Institute is currently developing a project to assess the predictive power of various data sets and measure the potential impact of the reporting of non-traditional data on consumer access to credit. In addition, further research will measure the full range of potential benefits from this information exchange, including benefits to prospective data furnishers, borrowers, and creditors. The project will involve the direct participation of credit bureaus, prospective data furnishers, and creditors. This research is expected to be completed during the second half of 2005.