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before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

COMMITTEE ON FINANCIAL SERVICES

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Good morning. Mr. Chairman and Members of the Committee. Thank you for inviting me here today to discuss the Fair Credit Reporting Act (FCRA) and the importance of uniform national standards for sharing financial information. Citizens for a Sound Economy is a nonprofit, nonpartisan organization with approximately 280,000 members. Our mission is to educate citizens on, and to promote the adoption of, free-market policies, which we believe inure to the benefit of consumers and citizens generally. Within the framework of FCRA, the United States economy has developed an efficient and highly integrated system of sharing information that allows businesses to provide consumers a wide array of financial services and products at competitive prices. On behalf of the members and supporters of Citizens for a Sound Economy, I urge Congress not to ignore the importance of the national uniform standards and the need to extend FCRA amendments adopted in 1996.

That there are economic benefits for both producers and consumers from efficient information sharing cannot be disputed. However, that same information sharing raises important concerns about privacy. FCRA establishes a framework to address these concerns while acknowledging the benefits of information sharing. As markets changed and technology improved, FCRA was revised to address new concerns. The 1996 amendments provided new opportunities in the marketplace while establishing guidelines to protect the privacy of individual consumers.

Advances in technology only make these protections more important. In the last decade we have witnessed an enormous explosion in the amount of information and tracking of individuals in the United States, due mainly to two factors: technology and the commercialization of data. The explosion of computers, cameras, location-sensors, wireless communication, biometrics, and other technologies is making it much easier to track, store, and analyze information about individuals' activities. In addition, corporations have discovered that detailed information about consumers is extremely valuable, and are in the process of identifying ways to use this information profitably. Consumers, on the other hand, benefit from increased access to financial services and products**.** FCRA attempts to strike a balance between these competing interests. Ultimately, the power of choice rests with every consumer—the power to shop, the power to ignore, and the power to purchase based on individual needs.

FCRA History

From its origins in 1970, the role of FCRA has been to facilitate the exchange of information among businesses while protecting consumer privacy. Importantly, the goal was not to abolish the flow of information, because it was widely recognized that the use of this information provided benefits to consumers and to the economy as a whole. FCRA created uniform standards and practices for the credit reporting industry and established parameters for the growing market for credit. Prior to its enactment, credit reporting was developing in an ad hoc manner where consumers had little control or knowledge of how their credit information was being used.

Along with providing consumer protections, FCRA also allowed a national market for credit to emerge, which generated real benefits for consumers. Previously, consumers were limited in their options when seeking credit. The market was highly localized and the independent evaluations by loan officers drove the decision-making process. By standardizing and facilitating the exchange of information, FCRA allowed consumers to access a wider array of financial services and products while at the same time increasing competition among providers of those products.

Advances in technology only made the process more competitive, with consumers now having access to everything from instant credit to mortgages through the Internet. As noted by the Federal Trade Commission, today's credit reporting market is dominated by three credit bureaus, which have data on 190 million individuals and 1.5 billion credit accounts. These credit bureaus use this data to compile a credit score for individuals who are seeking loans and other financial services.

In light of the growing importance attached to these credit scores and the exponential increase in consumer information amassed in these databases, FCRA was amended in 1996 to include additional provisions clarifying the use of this information. Again, the role was not to limit the flow of information; it was to ensure uniform standards while safeguarding individual privacy. The allowed uses of credit information were expanded, and safeguards were included to increase the accuracy of this information. Finally, consumers were granted the ability to limit certain uses of the information by opting out of certain transactions.

Information Sharing in the Private Sector

In the private sector, companies with an incentive to generate profits collect information. To generate profits, firms in a competitive market must compete to provide better services and products to individual consumers. Better information offers a way for firms to better meet the needs of individuals. In fact, information is a critical component of a dynamic marketplace that serves consumers well. Beyond the "mass customization" that better information allows, it also reduces fraud, lowers costs to consumers, and reduces marketing costs through more specialized information that allows more targeted marketing.

In addition, consumers have a choice in the private sector. Whether on the Internet or dealing with a private company, consumers can choose to do business based on privacy policies. Privacy is valued by consumers, which forces firms in the marketplace to compete for customers by offering the appropriate privacy policy. Markets tend to create incentives that constrain the role of data mining and incursions into individual privacy.

Even in those instances where markets are not competitive or are heavily regulated, actors in the private sector are constrained by legislation and regulation with respect to privacy policy and information sharing. Laws have been established to protect individual privacy. Congress has examined the issue with respect to financial services deregulation, and policies have been established to protect individual privacy.

In the end, it is consumers who protect individual privacy by exercising choice. Federal attempts to constrain private sector information practices should consider the benefits consumers enjoy through information sharing. Laws and regulations that restrict the flow of information can have detrimental effects on consumers. In fact, FCRA was enacted not to stop the flow of information, but to facilitate information sharing while establishing safeguards for to protect the privacy of consumers.

Under the framework of FCRA, the United States has developed one of the most sophisticated credit markets in the world. One study estimates that 75 percent of all households participate in consumer credit or mortgage markets. The ability to share information and determine potential risks has increased consumer access to credit, while increasing competition.

THE USE OF CREDIT IN INSURANCE MARKETS

Information contained in credit reports is also used by insurance companies as a risk characteristic. Insurers have begun using credit histories in their scoring models to help them predict the costs of future losses. Insurance companies classify risk and price coverage accordingly in order to stay in business. Accurately classifying risk allows companies to cover their costs while providing a wide array of insurance products. Risk classification allows insurers to divide individuals into groups with similar anticipated claims so coverage can be priced based on probability of future loss. Insurers rely on a wide variety of characteristics when classifying risk, such as driving history, age, gender, and so forth. Increasingly, insurance scores have been found to be a more reliable predictor of future risk. Insurers take these scores under consideration and factor them into the underwriting process.

The exact reasons for the correlation between credit history and loss is unclear. Some suggest that that a strong credit score indicates risk adverse behavior that translates into safer driving habits. While there are many theories as to why credit scores correlate with loss, no specific causal link has been identified. Nonetheless, a strong statistically significant correlation exists, making credit history a useful tool when classifying risk. The Risk Classification Subcommittee of the American Academy of Actuaries, in its review of recent studies on this topic noted, “the subcommittee believes that credit history can be used effectively to differentiate between groups of policyholders and therefore it is an effective tool” (The Use of Credit History for Personal Lines of Insurance: Report to the National Association of Insurance Commissioners, November 15, 2002). Moreover a rating variable does not require a causal link; statistical correlation can make its use valid. If insurers ignore or abandon variables that can accurately assess risk, consumers are harmed because the costs of insurance are unnecessarily higher than they otherwise would be.

Moreover, when consumer credit histories are used as an underwriting criterion, they tend to increase the fairness and accuracy of risk classification. This means credit reports can help people acquire insurance policies when they might otherwise be denied. With the ability to classify risk more accurately, insurers gain the ability to provide a wider array of products that can be offered to customers they otherwise could not serve. Ultimately, the competitive forces of the market will do a far more effective job than regulators in determining whether credit reports are an efficient means of selecting and classifying risk.

Opponents of the use of credit reports in underwriting believe they are a suspect tool for selecting and classifying risks. They do not believe a correlation between credit history and the risk of loss has been adequately established. However, in an open and competitive market, insurers would abandon any risk classifiers that were poor predictors of future loss. Critics also claim that the information that comprises the credit score is often erroneous. However, if the data were that poor, it is unlikely that the strong statistical correlation would continue to exist over time. Finally, some critics contend that the use of credit reports in underwriting may have a disparate impact on certain protected classes. However, to date, no statistical studies have conclusively proved such an effect.

Imposing restrictions upon the use of risk classifications, such as credit history, can have a significant impact on the ability of insurers to operate within a given market. Risk classification restrictions impose limits on the information insurers can use to assess the risk of loss for different consumers. For example, there may be restrictions that prohibit distinctions between young and old drivers, or distinctions between urban and rural customers. From an economic perspective, such restrictions are clearly inefficient. To be competitive, insurers must determine loss ratios as accurately as possible, based upon as much information as possible. Limiting the use of information hampers the ability of insurers to make the best decision. Ultimately, it will be consumers who bear the costs of these mistakes.

If there are concerns over the price of insurance, the best solution is competition, not restrictions on the flow of information. A more open and competitive market would help state insurance regulators achieve their goal of "adequate, not excessive, and not unfairly discriminatory" rates. If insurance regulators focused more directly on questions of adequacy to address concerns of insolvency, competition would provide consumers rates that are neither excessive nor unfairly discriminatory. By definition, insurance that is priced based upon a careful assessment of all information generated in the market cannot be discriminatory. Loss ratios would accurately depict the risk. In this case, competition between insurers would enhance the accuracy of the information used to forecast loss ratios, while at the same time eliminating excess profit. Regulatory barriers that make transactions less efficient offer little assistance to consumers.

CONCLUSION

FCRA has provided important policies that govern the flow of private consumer information between businesses in our economy. These rules have created a strong market for credit and established the foundation for risk-based lending in the United States. Consumers have benefited from these guidelines due to reduced risk premiums and increased availability of financial services and products. From short-term retail credit to long-term mortgages, consumers have seen the benefits of FCRA. The ability to share information more efficiently also provides benefits in others markets. Consumers of insurance are also beneficiaries of the 1996 amendments to FCRA.

Consumers can benefit from credit scoring and other cost effective tools used by insurance companies to lower the price of premiums or facilitate the inclusion of consumers who otherwise would be too expensive to underwrite.

Legislators and regulators should not be skeptical of the development of better and more efficient underwriting tools, nor should they create barriers for their use. This is especially true of credit reports, which have passed the test of time and competition and have been shown to be a cost-effective, accurate underwriting tool for insurance companies. Restricting credit history information as an underwriting tool would result in higher costs for insurers and higher premiums for policyholders.

If consumers, legislators and regulators want to improve the affordability and availability of insurance, they should encourage the use of instruments that help insurers make more accurate underwriting decisions. The use of credit history in insurance underwriting is one such tool. State-level legislation addressing privacy and credit scoring threaten to balkanize insurance practices, raising costs and harming consumers in the process.