BANKING & FINANCE

A Government Credit-Rating Monopoly?

If you like the DMV and TSA, you'll love giving government sole control of credit reporting.

BY TODD ZYWICKI

The country is engaged in an ongoing reckoning about its history of racial inequality. One way in which this sad legacy continues to manifest itself is in consumer finances. Decades after the enactment of the Equal Credit Opportunity Act (ECOA) and a battery of federal programs aimed at improving the well-being of the least well off, black families on average continue to have — relative to white families — lower credit scores, less wealth, less financial stability, and less access to mainstream credit products such as mortgages and credit cards.

Closing the racial wealth gap by enabling more minority families to access high-quality financial services is a moral and economic imperative. Remedying this gap begins with recognizing the sordid historical role of the federal government in promoting "redlining" and other discriminatory practices, and how state and federal regulation blocked efforts by private companies to provide greater choice and competition to traditionally underserved communities. Other facially race-neutral policies, such as usury ceilings and competitive barriers to the entry of new banks and credit unions, also disproportionately harmed black families relative to whites.

But instead of learning from these decades of examples of how ill-conceived federal regulation harmed the least well-off, the Biden administration and some members of Congress want to destroy the single greatest success story in American history of breaking down discrimination and promoting financial inclusion: the consumer credit reporting system. Under a proposal inspired by the left-wing activist group Demos, the current competitive system (dominated by Experian, Equifax, and TransUnion) would be replaced with a government-run monopoly operated by the Consumer Financial Protection Bureau (CFPB). This proposal

ignores the history of the credit reporting system in opening doors to minorities and others who were traditionally excluded from the financial mainstream and threatens to undo many of the beneficial consequences of that history.

RISE OF THE CREDIT BUREAUS

Easy access to quality financial services — bank accounts, credit cards, and mortgages — traditionally was limited to middle-aged white men. Lending was done according to the so-called "five Cs" of lending: character, capacity, capital, collateral, and conditions. But often more important was a sixth C: "connections." Bank offi-

TODD ZYWICKI is a George Mason University Foundation Professor of Law at the Antonin Scalia Law School and a research fellow at GMU's Law and Economics Center. He chaired the Consumer Financial Protection Bureau's Taskforce on Federal Consumer Financial Law from 2020 to 2021.

cers preferred customers with whom they played golf and went to church, usually middle-aged white men like themselves. Although a single woman could get a bank account and charge card at the local department store, her credit history was merged with her husband's when they married. Minorities and immigrants needn't bother applying because they were foreclosed from the high-class downtown department stores. Instead, they shopped for overpriced goods in local stores in their neighborhoods, primarily because those were the only merchants that would extend them credit. Once tied to this local network of retailers offering credit, financial exclusion became a self-reinforcing dynamic, blocking minority families from access to the financial mainstream.

The emergence of comprehensive credit reporting democratized financial access. For the first time, creditworthiness was based on a proven record of personal financial responsibility, not the applicant's race, sex, golf handicap, or chumminess with the bank manager or loan officer. As economic historian Louis Hyman observed in his 2012 book *Debtor Nation*, the traditional "five Cs" of lending have given rise to another: the computer. Little

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wonder that the architects of the ECOA pushed for reliance on credit reporting as the vehicle for overcoming traditional disparate lending patterns and improving access to credit for previously excluded Americans.

The results have been profound, especially for lower-income Americans, who have experienced transformative growth in access to financial services. According to Federal Reserve data, in 1970 only 16% of American households had general-purpose credit cards, but that number rose to 73% by 2001. Whereas only 2% of low-income households had credit cards in 1970, by 2001 that figure stood at 45%. Card ownership by working-class families increased from 9% to 65% of households over that same time frame. The Federal Reserve also found that, from 1983 to 2004, the prevalence and ownership of general credit cards increased by at least 25 percentage points across every racial and ethnic group, and the gap between blacks and whites for all types of credit narrowed during that period. Even more startling, by enabling more accurate and more personalized assessments of customers' risk, the adoption of credit scoring enabled private lenders to take on new customers while reducing loss rates. Credit cards not only became available to more people, the development of risk-based pricing made them less expensive: from 1990 to 1994 alone, the proportion of all revolving balances in the United States being assessed an annualized percentage rate greater than 18% fell from 70% to 44%.

ARE PERSISTENT DISPARITIES A PROBLEM?

Yet, there are calls today to abolish the traditional competitive credit reporting system and replace it with a government-run monopoly credit bureau. The justification for doing so is simply that, under the current credit reporting system, black families on average have lower credit scores and more-blemished credit reports than white families. Washington's proposed solution? To tinker with the credit reporting and credit scoring systems to make sure that the credit scores come out "right," which is to say that blacks and whites should have similar credit scores and the only reason they don't must be because of "systemic racism." Rather than serving as an unbiased prediction of an individual's creditworthiness based on economic variables and personal financial record, a government credit bureau could be harnessed to the political goal of promoting "racial equity."

The ECOA's guiding principle of basing lending decisions on economic and financial variables that accurately predict ability and willingness to repay is sound. A congressionally mandated comprehensive study by the Federal Reserve in 2007 definitively found that the use of credit scores in underwriting and pricing consumer credit is not a subterfuge for discrimination. Asian-Americans, on average, have higher credit scores and more access to credit than whites. Indeed, despite differences in average income, men and women have virtually identical credit scores.

Persistent disparities in credit scores among different races reflect a variety of factors, including the unfortunate legacy of government policies such as redlining and usury ceilings that blocked minority access to mainstream financial products for decades. But replacing the objective system of credit underwriting with a race-based one treats the symptoms of decades of financial exclusion but ignores the underlying cause. And if we learned anything from the 2008 financial crisis, it is that helping people obtain access to more credit than they can afford will not help them in the long run. Closing the gap in credit scores among different subgroups in American society requires well-conceived policies to build individual capability (such as better-designed financial literacy programs) and wealth, not counterproductive fixes such as political manipulation of credit reporting.

Subordinating credit reports to politics will harm those it is intended to help. Information is the currency of credit, and corrupting the relevance and accuracy of information contained in credit reports raises the costs to providers of discerning a customer's creditworthiness. "Connections" or other proxies for creditworthiness will once again become an important part of credit when objective creditworthiness is difficult to ascertain. This echoes the effects of the well-intentioned "Ban the Box" policy of striking questions about criminal records from employment applications: it has actually exacerbated racial disparities in hiring. Simply put, degrading the accuracy of credit reports would be likely to increase the cost of credit for everyone, but especially for lower-income and minority borrowers.

Underwriting and pricing loans require very nuanced estimations of borrower risk. Absent the ability to drill down into particular borrowers' finances at low cost, lenders will either eschew certain categories of consumers entirely (such as higher-risk consumers) or increase prices in order to compensate for the inability to accurately estimate risk. While this might increase the amount of lending capital available to lower-risk borrowers, enabling them to get lower prices than they otherwise would, this windfall will be subsidized by higher-risk borrowers. Of course, lower-risk borrowers demographically are more likely to be upper-class — and therefore typically white — families than higher-risk borrowers. And many consumers will pay higher prices for credit to offset the increased loss rates that would result from not being able to estimate risk accurately.

GOVERNMENT VS. PRIVATE CREDIT BUREAUS

This is not to ignore that the consumer credit reporting market is imperfect (like any market). Studies have identified that some consumers (about 5%, according to a Federal Trade Commission study) have material errors on their credit reports that can be detrimental to credit access and the prices people pay. (Naturally, consumers care only about errors that harm their credit records, not errors that improve them.) In part, these problems arise from the unusual structure of the market for credit bureaus: while they collect information on individual consumers, their "customers" are banks and other credit providers, not the individuals themselves.

Although providers of financial services value accuracy in credit reporting, their concern is not as intense as an individual consumer's. As a result, credit bureaus and the banks to whom they sell their services lack sufficient incentives to monitor an individual person's credit report to ensure that inaccuracies are corrected and stale information removed. Federal law provides various mechanisms to facilitate the correction of errors, such as notifying consumers of adverse credit decisions. Still, these mechanisms put the responsibility back on consumers to pursue the tedious, time-consuming, and sometimes frustrating process of correcting errors on their credit reports. The final report of the 2020–2021 Consumer Financial Protection Taskforce on Federal Consumer Financial Law (which I chaired) provides several additional recommendations on ways to promote credit reporting accuracy and ease the burdens on consumers for correcting errors.

Whatever the defects in the current system, the relevant policy issue is not whether it is imperfect, but whether a government monopoly is likely to improve the system. As state departments of motor vehicles demonstrate, government-run monopolies are not distinguished by their reputation for efficient and customer-friendly service. Unlike a government-run monopoly, credit bureaus have at least *some* incentive to provide accurate information to potential credit providers. If consumers find it frustrating to deal with private credit bureaus operating in a competitive market — and who doesn't at times? — they should consider what their customer service experience would be like with a DMV-style government monopoly credit-reporting bureau. Or, another example, the government has shown a remarkable inability to effectively correct errors on the Transportation Security Administration's "No-Fly List," even for celebrities and members of Congress. Does anybody think that accuracy, innovation, and customer service will be responsive to consumer demands once credit reporting on every American citizen is subject to government rather than market incentives?

Data security / There is also the concern of placing more private financial data in government hands. As one law firm observed after a 2015 Internal Revenue Service breach that resulted in the theft of personal information of more than 700,000 taxpayers (including Social Security numbers, birth dates, and other personal data), which was then used to claim over $50 million in fraudulent tax refunds, "Taxpayer data security has been an IRS problem for years." Just think what a juicy target a single government-run trove of personal financial information would provide for identity thieves. I was a victim of both the 2015 IRS data breach and the recent breach of the Office of Personnel Management (OPM) database, and the prospect of entrusting my personal financial information to still more government bureaucrats is not reassuring. In 2021 it was revealed that the IRS leaked the tax records of many of the country's wealthiest individuals, which suggests that government security standards have improved little since 2015. The fact that a 2014 Government Accountability Office study reprimanded the CFPB underscores the risk to government-held private financial information. Although the CFPB has tightened up its security since then, one centralized government-run trove of consumer financial data presents an inviting target for hackers and identity thieves.

Of course, the private credit bureaus do not have flawless data security histories. But they do have strong incentives to improve their security. Experian's data breach a few years ago resulted in massive liability and the payment of millions of dollars of compensation to injured consumers. By contrast, I have yet to receive a penny from the IRS or OPM for the harm I suffered from their negligence. Moreover, the fact that there are three different credit bureaus today provides resilience against data breaches and identity theft, as competition between them makes it more likely that anomalous behavior will be identified more readily than information swiped from a single provider.

INNOVATIONS IN THE PRIVATE MARKET

Instead of creating a lumbering new government-run public utility, a better way forward would be to start by eliminating existing barriers to competition and unleash the forces of competition and innovation. For instance, make it easier for financial services providers to use new models and alternative data to underwrite credit. Whereas traditional credit reporting models rest on narrow but reliable data sources such as whether a person is paying his current debts, alternative data models consider a wider array of potentially predictive variables, such as verified cash-flow data (such as whether you maintain positive balances in your checking account over time) or payments on bills such as utilities, rent, cell phone, and other non-debt obligations. Use of alternative data is a particular boon to so-called "thin file" consumers who lack sufficient depth or duration of credit experience to have an established credit rating and credit score. For example, a 2020 study by the Department of Housing and Urban Development found that reporting rent payments of HUD-assisted families would increase the number of these families with credit scores above 620 from 54% to 65% percent.

Alternative data proved its mettle during the pandemic when traditional debt payment obligations and collections on accounts such as mortgages, student loans, and auto loans were suspended. During that period, there were many households that needed short-term credit to bridge the time until they received government stimulus checks or state unemployment insurance. Reliance on alternative data provided a means to identify creditworthy households and get them the short-term funds they needed to make ends meet, especially by new and nimble "fintech" lenders that use these models.

Economic studies have found that the entry of fintech lenders into a market dramatically increases competition and reduces disparities in the pricing of credit between black and white borrowers. This is to be expected: if minority, younger, and immigrant consumers have less of the traditional markers of creditworthiness than established white borrowers, the use of additional reliable information that provides a fuller picture of a consumer's financial condition would tend to benefit the former disproportionately. Competition once again seems to be an effective means for promoting inclusion and breaking down remaining unjustified demographic disparities in access and terms.

The primary obstacles to still greater use of alternative data for underwriting are regulatory uncertainty and fear of litigation, particularly for alleged violations of anti-discrimination laws. One explanation for the continued market dominance of the traditional credit reporting models is that they have been verified by regulators and judges as nondiscriminatory. Risk-averse lenders seeking to avoid the legal and public relations opprobrium of being labeled "predatory lenders" can thus rely on those time-tested models without fear of adverse consequences. Fintechs, by contrast, must survive a thicket of regulatory scrutiny and potential liability to prove that their models do not have a discriminatory effect — risks that existing credit reporting models don't face.

Another source of regulatory uncertainty involves risks to so-called "furnishers" of the raw material that comprises credit reporting models. In the United States, furnishing information to credit bureaus is voluntary. While traditional financial services providers are familiar with the ins and outs of providing information to credit bureaus, furnishers of information that is not traditionally used as part of credit underwriting (such as information from landlords) are not. Furnishing information makes the overall credit reporting system more accurate and useful, but that benefit is shared among all users of the credit reporting system. Providing this information to credit bureaus, however, can bring the furnisher under CFPB scrutiny and increase regulatory and litigation risk — a risk for which the furnisher bears all the costs. Given this asymmetry between costs and benefits, the incentives for furnishers to participate in the system are tenuous already. Additional cost or scrutiny, such as increased regulatory costs or litigation risks, could further deter potential furnishers from providing information or cause current furnishers to reduce their participation.

CONCLUSION

Historically, the federal government has been a primary obstacle to greater financial inclusion and wealth building by black families in America. Sometimes this discrimination was intentional, as with the government's policy of racial redlining in housing markets in the post–World War II era. Sometimes such policies were well-intentioned, but they still ended up harming those they were supposed help — often the financially most vulnerable.

Politicizing the country's consumer credit reporting system and returning race to the center of the credit underwriting decision in the name of progressive politics may seem like a way of closing the racial wealth gap. In practice, however, it is almost certain to backfire. More competition, not a government monopoly, is the remedy for financial exclusion. R

READINGS

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