

## A Chronological History of the Credit Industry in America

In the 1850's, Isaac Singer made significant improvements in what had been a very crude machine for sewing. However, his improvements caused the new sewing machine to be priced at \$75 – an incredibly high price at the time. To help people be able to purchase the machine, Singer came up with the “installment plan”, and credit began . . .

Credit reporting started not long after Singer created his installment plan. Until the arrival of consumer credit reporting agencies (CRAs), the very small amount of credit granted was based on the merchant's own knowledge of the customer. Groups of small retail merchants banded together to facilitate the exchange of credit information among merchants. The first CRA, The Credit Bureau, Inc. (the ancestor of today's Experian), was founded in 1899 in Atlanta, Georgia. These earliest credit agencies, which came to be self-named as “credit bureaus”, just maintained lists of customers who were considered by merchants to be poor risks.

The Associated Credit Bureaus, Inc. was founded in 1906 as these small “credit bureaus” began to multiply and sought a more efficient means by which to communicate with each other. This international trade association began to provide its members with fraud prevention and risk management products, credit and mortgage reports, tenant and employment screening services, check fraud and verification services and collection services.

The credit reporting industry experienced rapid growth just before and into the “roaring” 1920's. Following World War I, the U.S. population became more mobile and credit bureaus expanded to serve a wider audience of dispersed merchants. The bureaus provided a wider and wider base of merchants with information which was used to make decisions on whether to grant credit. Prior to the development of automated data-processing equipment and high-speed computers that could process a variety of credit data, merchants or businesses that granted credit relied on a person's employment records, information from landlords, data in public records or newspapers and direct investigations of the individual. Technology revolutionized that data gathering and storage process.

By the 1960s, controversy surfaced over the CRAs. Chris Hoofnagle of the Electronic Privacy Information Center, a public interest research group, writes that credit reports were being used to deny services and opportunities. Individuals had no right to see what was in their files. In addition, CRAs were reporting only negative financial information as well as “lifestyle” information culled from newspapers and other sources -- information such as sexual orientation, drinking habits and cleanliness.

Controversy led to a congressional inquiry, and, in 1971, Congress passed the Fair Credit Reporting Act (FCRA), which established a framework for fair information practices to protect privacy and to promote accuracy in credit reporting. Consumers

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gained the right to view, dispute and correct their records, and CRAs began to supplement the often-bleak reports with information on consumers' positive financial history.

Professor Michael Staten, director of the Credit Research Center at Georgetown University, views the FCRA and the amendments to it over the years as one of the most important in the United States. "It's fair to say that protections for consumers were tightened, and at the same time businesses have proper access to information that will benefit consumers," he says. "You can't talk about the FCRA without talking about tradeoffs. Privacy is at its core, so there's always a tension."

However, it wasn't until 2001 that consumers gained access to their credit scores, at a cost, and annual access to their credit reports at no cost. Earlier that year, *Consumer Reports* had documented the problem of credit scores being off limits to consumers in an article entitled "New Assault on Your Credit Rating." The article, combined with growing pressures from lending institutions wanting to disclose scores to consumers, finally opened credit score information to individuals. An updated version of the FCRA, signed into law in December 2003, requires CRAs to provide consumers a copy of their credit score at a "fair and reasonable" fee and annual access to their credit file for free. Consumers can obtain their FICO credit score, for a fee, at [www.myfico.com](http://www.myfico.com).

Obtaining one's credit report and credit score and correcting any mistakes is important because of score sharing. A growing number of companies having nothing to do with the business of offering credit (such as insurance companies, cellular phone companies, landlords, potential employers and affiliates of financial services firms) are now scrutinizing the data on credit reports and using this information to decide whether to do business with a consumer and how much to charge or whether to hire someone.

For example, in September 2004, *The Wall Street Journal* reported that when TXU Energy in Texas raised its rates for natural gas service, customers with the lowest credit scores had their rates raised higher than the others. According to the article, new rates were based on numeric rankings of credit-worthiness that take into account a customer's history of paying electricity, telephone and cable bills. The paper said TXU defended the use of credit information, which it gets from Experian, as an accurate predictor of future payment performance.

Employers once used credit reports to screen potential new hires without their knowing. However, today the FCRA requires that employers seek consumers' permission to pull a report and to inform the applicant if he is denied employment based on the report. Many states also have laws restricting the use of credit scoring. For example, New York's law stipulates insurers can't deny coverage based on low scores.

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Despite improvements introduced by the FCRA, many credit reports (and hence credit scores) still contain errors. According to a June 2004 study by the consumer advocacy group U.S. Public Interest Research Group (U.S. PIRG), as many as 79% of credit reports have errors -- 25 percent of which are serious enough to potentially result in a credit denial. More than half of the reports had information that was either outdated or belonged to someone else.

Ed Mierzwinski, the consumer program director of U.S. PIRG, says credit card companies often inaccurately portray their customers to credit reporting agencies in an effort to dampen credit scores and ward off competition. If companies make consumers look like they're a bad risk, says Mierzwinski, then other companies won't try to recruit them.

Mierzwinski cites a June 2003 report by the Federal Reserve, which suggests that credit card companies may be hurting their customers -- and lowering the customers' credit scores -- by withholding certain information from the major credit bureaus. The research, based on the study of a random sample of 301,000 individuals' credit files, found that nearly half -- 46 percent -- of the consumers had files where the credit limit had been withheld at least once by a creditor.

Withholding a consumer's credit limit is a major problem, says Mierzwinski, because the limit is used to calculate the "utilization" of existing credit -- a major factor in producing a credit score. To measure utilization, scoring systems look at the ratio of a person's balance to their credit limit. If a person has a \$1,000 balance and a \$10,000 credit limit, their ratio is very low (10 percent) and their credit score increases. If the balance is high -- meaning a person is nearly maxed out -- then the ratio goes up and the credit score decreases.

However, lenders often don't include their customers' credit limits in their reports to score-generating companies. These score-generating companies, such as Fair Isaac, substitute a consumer's highest balance in place of the missing credit limit, inflating the utilization ratio and lowering the credit score.

Another problem, Mierzwinski says, is using credit scores to determine insurance risk. Insurance laws require that insurance rates be based on causation, or "actuarial evidence." This means a statistical relationship between two factors must be proved. For example, the fact that a person who has a lot of speeding tickets will have more accidents has been statistically proved, but no statistical relationship has been found between credit scoring and insurance risk. "If I miss a payment on my credit card, or am the victim of identity theft, does it mean I'm a worse driver than you," Mierzwinski asks? "Consumer advocates do not believe there is any relationship between the two."

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As credit reporting grows in importance, a cottage industry in credit-score deciphering is mushrooming. Consumers can now sign up, for a fee, to have their personal credit files monitored by companies and notified via e-mail when their score changes.

Since all creditors do not use the three major credit bureaus (CRAs) equally, monitoring one bureau does not mean monitoring the other two. Mistakes may appear on any of the three reports. Although this is a problem, Georgetown University's Michael Staten says having competing CRAs makes the credit reporting process healthier.

Although consumers can now monitor their credit ratings with the national credit reporting agencies, a new practice may be undermining the privacy and access rights Americans gained with the FCRA. Some credit card companies, like Citigroup, now develop and use their own internal credit scores. In testimony before the U.S. Senate Banking Committee in June 2003 in defense of affiliate sharing, Citigroup said it uses information collected from its affiliates to create internal scores that help determine eligibility for credit, supplementing credit reports and FICO scores.

The company said that sharing credit information and transaction histories with affiliates largely reduced errors and "the burden" on customers to provide documentation to their bank's affiliates. But critics like Evan Hendricks, editor and publisher of *Privacy Times*, a biweekly newsletter in Washington, say an error in one account would be shared by all affiliates -- and could go unfixed since the records are secret.

"The fact of the matter is, we don't know exactly what such companies are doing. This is a very murky area," Hendricks says. He says the Citigroup testimony was the first time that the sharing of "insider scores" with affiliates was acknowledged by the industry. Hendricks calls it an aggressive use of personal information that does not comport with fair information practices. "If people don't have access [to their information], that's going to breed inaccuracies."

Others, like Ed Mierzwinski of U.S. PIRG, say internal sharing of credit information can lead to the development of what he calls "black box databases."

"Sharing information with affiliates is simply not fair, because consumers have no access, knowledge of or control over the use of their information," Mierzwinski says. "Consumers should have the right to look at their file and to dispute the file. These large banks are using consumer information to create unregulated databases. It could be used to redline people -- and they wouldn't even know about it."

Despite the drawbacks, critics agree that credit scoring has dramatically improved the efficiency of credit markets. "What credit reporting does, and does especially well in the U.S., is that it improves risk assessment," says Michael Staten of Georgetown University. "It gives the lender a better picture of whether the loan will be repaid,

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based entirely on how the consumer has handled loans in the past. You could say that it takes out a lot of the factors that you would consider discriminatory."

One major advantage of credit scores, says Professor Staten, is that they allow investors who buy securities to get a more accurate assessment of the underlying risk in these loans.

Securitization is the process of bundling large pools of consumer loans (e.g. Mortgages, credit card loans or automobile loans) and selling them as securities to investors. Investors who purchase the securities buy a share of the stream of revenue that flows as loans are repaid. This allows the lender to get the loans "off their books" and shift some of the risk to outside investors.

How does that help consumers seeking credit? These investments make available huge quantities of additional funds to the lender that can then be made available in consumer credit markets. This lowers the price of loans or the interest rates to the consumer and makes credit more widely available, Staten says.

However, consumer advocates warn that until the industry is further regulated, Americans have to keep an unswerving watch of their credit scores -- or pay the price for negligence.