INTRODUCTION

Congress enacted the Fair Credit Reporting Act (the "FCRA") to ensure the accuracy of credit reports. The FCRA has been in effect for nearly forty-five years, but a recently completed Federal Trade Commission study estimates that about twenty percent of credit reports still contain "material errors." Credit report errors can impose significant costs on the consumers who are the subjects of the flawed reports as a bad credit report can impair a consumer's access to credit, insurance, housing, and employment.

This essay argues that the social costs of a credit report error are likely to be substantially less than the private costs that the consumer suffers. A mistake harms a consumer by making her appear to be a greater risk than she really is; she is forced to "pool" with higher-risk or otherwise less desirable consumers. But the consumer's presence in the higher-risk pool will lower the average risk in that pool and thus provide offsetting benefits to the truly high-risk consumers. If we ignore complicating factors such as misallocation, moral hazard, adverse selection, and alternative screening and signaling devices, the low-risk victim's loss is precisely offset by the
high-risk consumers' gain, and the credit reporting mistake creates no social costs.\textsuperscript{6}

The claim that credit report errors may impose no or low social costs is consistent with arguments commonly made in insurance and other risk-classification contexts. In this essay I demonstrate that, as a theoretical matter, the effect of a misstatement in a credit report is roughly equivalent to any other imperfection in a risk-classification mechanism such as an imperfect proxy used by an automobile and health insurer.\textsuperscript{7} The law sometimes mandates these imperfections. For example, federal law limits the ability of a health insurer to charge more to consumers with pre-existing conditions (higher-risk consumers),\textsuperscript{8} and the FCRA itself prohibits credit bureaus from reporting some negative information about consumers.\textsuperscript{9} Although the mistakes created by FCRA's gag rule are mistakes of omission rather than commission, they have the same basic effect as a misstatement in a credit report. These mistakes make it harder for low-risk consumers to separate themselves from high-risk consumers.\textsuperscript{10}

This essay does not claim that credit report errors have no social costs because the assumptions underlying that result are not realistic. The low-risk types may respond to the increased price that they must pay for credit or insurance by leaving the market so that only the high-risk consumers remain; mistakes can create adverse selection. Mistakes can also cause misallocation because the lower price faced by the higher-risk consumers may cause them to buy a credit or insurance product even though their willingness to pay does not exceed the cost of providing the product to them. Forced pooling lowers the reward consumers receive for investments that lower their risk, creating a form of moral hazard. Finally, firms may look for other ways to screen high-risk consumers, and low-risk consumers may look for costly ways to signal their type. The most salient example of this alternative signaling behavior is that some consumers spend considerable time and effort correcting the mistakes in their credit files.\textsuperscript{11}

Other risk-classification imperfections can also impose social costs for the very same reasons. For example, FCRA's gag rule can create misallo-

\textsuperscript{6} See infra Section II.A.

\textsuperscript{7} See infra Section III.A.

\textsuperscript{8} See 42 U.S.C. § 300gg (2012) (requiring health insurers for individuals or small group markets to vary premiums based only on several factors other than preexisting health conditions). See also 29 U.S.C. § 1182(b) (2012) & 42 U.S.C. § 300gg-4(b) (prohibiting group health plans from requiring individuals to pay higher premiums based on preexisting health conditions).

\textsuperscript{9} See 15 U.S.C. § 1681c (prohibiting the reporting of negative information that is old unless certain exemptions apply).

\textsuperscript{10} See infra Section III.B.

cation and adverse selection by lowering the cost of credit for high-risk consumers and raising the cost of credit for low-risk consumers. To the extent that this gag rule reduces the penalty that a consumer suffers from default, it can create a form of moral hazard. This gag rule can also cause lenders and low-risk consumers to turn to costly screening devices such as the use of collateral.

As a theoretical matter, imperfections in risk-classification do not necessarily impose social costs; indeed they may confer social benefits. To take one example, insurance scholars sometimes justify limits on risk-classification by arguing that these limits may reduce the price that consumers pay, on average, because the insurers would otherwise have to recover the costs of risk-categorization.\footnote{See, e.g., Ronen Avraham et al., Understanding Insurance Antidiscrimination Law, 87 S. CAL. L. REV. 195, 208-09 (2014).} Other scholars try to justify FCRA's limit on reporting negative information by suggesting that this law may mitigate a moral hazard faced by high-risk consumers by allowing them to pool with low-risk consumers.\footnote{See Ronel Elul & Piero Gottardi, Bankruptcy: Is It Enough to Forgive or Must We Also Forget, Federal Reserve Working Paper 2011, available at http://www.philadelphiafed.org/research-and-data/publications/working-papers/2011/wp11-14.pdf.} Each of these arguments can be adapted to suggest that credit report errors—or a lack of care that causes credit-report errors—can increase social welfare.\footnote{See infra Section III.}

I do not claim that there is no difference between a credit report error and a law that limits what can be placed in a credit report, and I am not arguing that the FCRA should be changed. A normative analysis of the regulation of credit reporting must account for distributional consequences as well as the incentives of the industry participants to produce accurate reports. These tasks are left to future work; this essay merely tries to take the first step along the path.

Part I of this essay provides an overview of credit reporting, its regulation, and the nature and frequency of credit report errors. Part II begins by demonstrating that the social costs of credit report errors are zero if strong assumptions are true. Part II then goes on to relax these simplifying assumptions and acknowledge that credit report errors can create significant social costs. Part III establishes the parallel between credit report errors and other risk-classification imperfections such as laws that limit the information that credit bureaus can report. Part IV concludes.
I. CREDIT REPORTING AND ITS REGULATION

Part A provides a brief overview of the credit reporting industry and the nature of credit report errors. Part B describes the current and proposed regulation of the industry.

A. An Overview of the Credit Reporting Industry

The credit reporting industry began as a series of largely regional co-operatives among retailers who shared information about their customers. However, the industry is now dominated by three national credit bureaus whose reports are used by a wide variety of entities including creditors, insurers, employers, and landlords.

This essay focuses on the reports produced by the three major credit bureaus, but the scope of the FCRA is much broader—it regulates “consumer reports” issued by “consumer reporting agencies.” A consumer report is almost any report about a consumer that is used for credit, insurance, employment, housing, or similar purposes. The FCRA therefore covers specialized consumer reports such as those produced by insurers to share information on insured events, those produced by landlords to report on tenant behavior; those used by payday lenders to report the credit history of their borrowers, and may even cover college placement offices. There is a very important exception—the FCRA does not apply if the speaker is drawing solely on its own experience with the consumer. The FCRA therefore does not regulate a reference given by an employer, but it does regulate background checks conducted by outside firms unless some other exemption applies.

Some consumer reports contain qualitative information such as summaries of interviews with a consumer’s co-workers and neighbors.

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15 The existing literature offers several excellent overviews of the credit reporting industry as well as its history and regulation. See, e.g., CFPB, Key Dimensions and Processes in the U.S. Credit Reporting System (12/2012), Robert M. Hunt, A Century of Consumer Credit Reporting in America, Federal Reserve Bank Working Paper (2005), Avery et al., Credit Reporting and Access to Credit, Federal Reserve Bulletin, 2004; Mark Furletti, An Overview and History of Credit Reporting (2002), FTC, 40 Years of Experience with the Fair Credit Reporting Act (2011).

16 See NATIONAL CONSUMER LAW CENTER, supra note 2, at 4-5.


18 Id. § 1681a(d)(1).

19 See NATIONAL CONSUMER LAW CENTER, supra note 2, at 71-75. The CFPB maintains a list of some of these consumer reporting agencies at http://files.consumerfinance.gov/f/201207_cfpb_list_consumer-reporting-agencies.pdf.


21 See NATIONAL CONSUMER LAW CENTER, supra note 2, at 51-52, 54-56, 71-75.

22 Id. at 56.
ever, this essay does not focus on these “investigative consumer reports.”

The credit reports produced by the major credit bureaus contain little if any qualitative data, focusing instead on more objective criteria such as the number and amount of debts outstanding and the debtor’s past payment history. The credit bureaus gather most of the information from creditors who purchase reports from them, but they also gather data from public records (e.g., bankruptcy filings, judgment liens, etc.). The FCRA refers to those who provide information to the consumer reporting agencies as furnishers and to those who use consumer reports as users. I will use these same terms, but it is important to remember that furnishers and users are often the same entities. For example, if a bank obtains a consumer report in connection with a loan application, it is a user. If it grants the loan and subsequently reports the consumer’s payment history, it is a furnisher.

Errors can arise at any many points in the credit reporting process. A consumer could make a mistake when filling out a loan application, or a furnisher could misread the consumer’s information, and the mistake could be transmitted to the credit bureau. A furnisher could wrongly report that a consumer has defaulted on her obligation when she has in fact paid, or the furnisher could misidentify the consumer who has defaulted. Some mistakes may not be innocent. For example, credit repair organizations sometimes report fictitious obligations and repayment histories in order to boost a consumer’s credit score. The credit bureaus try to maintain some quality by conducting initial and periodic audits of their furnishers, but such quality controls will never be perfect.

The credit bureaus receive data from a very large number of furnishers, and they make mistakes as they try to match this information to the files that they maintain on each consumer. Assume that I receive medical care while attending a conference in Cambridge, Massachusetts, but I do not pay the bill. If a credit bureau were careless, it might attribute my default to the much more eminent Professor Richard Hynes, Richard O. Hynes, the biologist from the Massachusetts Institute of Technology. The credit bureau might be able to avoid this mistake by omitting the reported default from his file unless the hospital’s report matched his file along several dimensions such as full name (including middle name or initial), social security number, home address, etc. However, the information that credit bureaus receive from furnishers may not always be complete, and furnish-

24 See NATIONAL CONSUMER LAW CENTER, supra note 2, at 71-75.
25 Id. at 4-5; CFPB, supra note 15, at 8-10.
27 Id. § 1681m.
28 See CFPB, supra note 15, at 24-25.
29 See id. at 18.
30 Id. at 18-19.
ers will sometimes make mistakes. Assume, for example, that the credit bureau receives a report of a default by a Richard O. Hynes but the reported default matches the information in my file along in all other conceivable ways (same home address, social security number, etc.). Should the credit bureau include the information in my file? If they include the information they risk one type of error—wrongly including incorrect information in my file. But if they omit the default they risk another type of error—wrongly excluding correct information from my file.

A form of error can also arise from the way credit reports are used. This is most clearly seen in the form of identity theft. I could wrongly claim to be Richard O. Hynes and apply for credit from a bank. Acting on my claim, the bank could mistakenly order Richard O. Hynes's credit report, see that it is outstanding (I assume), and extend a loan to me. I will, of course, fail to pay, and then the bank may sue the real Richard O. Hynes or harass him to try to get him to pay. Even if he avoids payment, these efforts can impose real harm. This harm is likely to be magnified when the bank assumes the role of furnisher by reporting the default in his name to the credit bureaus.

Just how commonly errors appear in credit reports is the subject of debate. Studies sponsored by consumer advocates claim error rates as high as seventy-nine percent, while studies sponsored by industry groups find error rates as low as one-half of one percent. The FTC recently completed a multi-year study, and the most widely publicized finding of the study is the twenty-one percent “material error” rate quoted above. However, this twenty-one percent rate may overstate the number of errors that actually affect a consumer’s welfare as this estimate defines “material error” as any change in a credit report after a consumer investigation. When the FTC focuses solely on errors that could actually affect credit terms (defined as the terms of automobile credit offered to the consumer) the rate falls to just five percent. Still, many will find this error rate unacceptably high.

34 See National Association of State PIRGS, Mistakes Do Happen: A Look at Errors in Consumer Credit Reports at 4 (2004) (“Altogether, 79% of the credit reports surveyed contained either serious material errors or other mistakes of some kind.”).
35 PERC, U.S. Consumer Credit Reports: Measuring Accuracy and Dispute Impacts (2011) at 50 (“This material impact rate in which participants’ credit scores moved to a higher credit score tier following the resolution of their disputes was found to be 0.5% on average.”).
36 See FTC Report, supra note 4.
37 Id. at page iv.
38 Id.
B. The Regulation of Credit Reporting

Before the passage of the FCRA, the law of defamation was the primary tool used to regulate credit reports. At common law, defamation was a strict liability tort with regard to accuracy; a reasonable belief in the accuracy of the statement would not protect the speaker from liability for reporting false information. However, the Supreme Court has imposed important exceptions to this rule. For example, the Supreme Court has ruled that speech about public figures is protected by a qualified immunity that shields the speaker from liability unless she acted with malice (knowledge of the falsity of the claim or reckless indifference to the truth). Most jurisdictions applied a similar qualified immunity to the credit reporting industry and for the same reason—they feared that a contrary rule would chill socially valuable truthful speech. The credit bureaus sought further protection from liability by forcing the users of their reports to promise not to share the reports with the subjects of the reports. If the subjects could not learn of the contents, they were unlikely to bring a suit alleging a false statement.

The FCRA retains and even extends the industry’s immunity through its preemptive powers. Originally the FCRA preempted “any action or proceeding in the nature of defamation, invasion of privacy, or negligence” based on information disclosed in credit reports “except as to false information furnished with malice or willful intent to injure such consumer.” However, Congress later added additional preemptive sections, including one that appears to preempt state law regulation of many of the areas cov-

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39 The FTC completed a follow-up study on January 21, 2015. This further study did not change the main results from the study completed in December of 2012, but it did suggest that mistakes did not frequently reenter credit reports. See http://www.ftc.gov/news-events/press-releases/2015/01/ftc-issues-follow-study-credit-report-accuracy.

40 See Dan B. Dobbs, The Law of Torts §§ 401, 417, at 1120, 1169 (2000) (“So far as the prima facie case at common law was concerned, defamation was a strict liability tort except that with slander the plaintiff often had to prove actual damages.”).

41 New York Times v. Sullivan, 376 U.S. 254 (1964). The Supreme Court has also held that a state cannot impose liability for false statements about a private individual unless the speaker was at least negligent, and a state cannot impose punitive damages unless the speaker had a higher level of mens rea. See Gertz v. Robert Welch, Inc., 418 U.S. 323 (1974).

42 See Virginia R. Mauer, Common Law Defamation and the Fair Credit Reporting Act, 72 GEO. L.J. 95, 100 (1983-84); Jeremiah Smith, Confidential Privilege for Mercantile Agencies. McIntosh v. Dunn II, 14 COLUM. L. REV. 296 (1914).

43 See Mauer, supra note 42, at 99-100 (“First, because credit reporting agencies operated in almost complete secrecy, a victim was unlikely to discover the existence of the erroneous information at the root of his credit problems until the statute of limitations precluded relief.”).

erred by FCRA even if the alleged wrongdoer acted with malice. Some courts have read this new language literally while others have not.

Most of the provisions in FCRA are targeted at the CRAs. To protect consumer privacy, the law insists that CRAs take steps to ensure that users of credit reports have a permitted purpose, but the law defines permitted purpose broadly so that the reports can be used by creditors, insurers, employers, landlords, governments that are granting a license and others with a business purpose. The FCRA prohibits CRAs from reporting most negative information once it is seven to ten years old, though this limit does not apply if the consumer has applied for a loan or a life insurance policy above $150,000 or a job paying more than $75,000, and prohibits the reporting of some medical information to creditors or property and casualty insurers.

Several provisions of the FCRA are designed to reduce the number of misstatements in credit reports. The FCRA insists that CRAs adopt "reasonable procedures to ensure maximum possible accuracy" and insists that CRAs take reasonable steps to investigate consumer claims of errors in their reports. The FCRA has granted consumers access to their credit reports since its enactment, and in 2003 Congress amended the FCRA to force the CRAs to provide consumers with one free copy of their credit report each year. These provisions allow attentive consumers to identify and thereby reduce the number of misstatements in their credit reports. The FCRA tries to further protect consumers against identity theft by allowing them to include initial or extended alerts in their files.

The FCRA regulates the users of credit reports as well. As noted above, users must have a permitted purpose to view a report. Users also play an important role in ensuring the accuracy of credit reports. If a user rejects a consumer's application for credit, insurance, housing, etc. based on his or her credit report (an "adverse action"), it must provide the consumer

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46 See NATIONAL CONSUMER LAW CENTER, supra note 2, at 459-68 (for an extended discussion of this conflict).
48 15 U.S.C.A. § 1681b (noting, however, that state laws sometimes ban the use of credit reports for some purposes, such as for employment purposes, see infra notes 72-73, or for insurance purposes, see Avraham et al., supra note 12, at 265).
51 Id.
with a notice designed to encourage the consumer to check her report,\footnote{15 U.S.C.A. § 1681m (West 1997); see also 15 U.S.C. §§ 1681g, 1681j (West 1997) (noting that the FCRA also gives the consumer a free credit report after he or she has suffered an adverse event).} and, if the user is a creditor, the Equal Credit Opportunity Act insists that the user provide the consumer with a reason for the adverse action.\footnote{15 U.S.C.A. § 1691d (West 1997).}

In 2003 Congress amended the FCRA to adapt this notice system to a world of risk-based pricing. Under the FCRA and the accompanying regulations, creditors must provide a notice if the terms offered to the consumer are materially worse than those offered to many other customers (usually around sixty percent).\footnote{12 C.F.R. §§ 222.72-.74, 16 C.F.R. §§ 640.3-.5.} These regulations do not apply to insurers or employers.\footnote{In Safeco Insurance Co. of America, the Supreme Court held that an insurer need only provide a notice of an adverse action if the consumer would have received better terms had the firm never checked the credit report. 127 S.Ct. 2201 (2007). }

Until 1996 the FCRA imposed no duties on furnishers,\footnote{See NATIONAL CONSUMER LAW CENTER, supra note 2, at 17-21.} and even today the obligations placed on furnishers are relatively weak. Furnishers are prohibited from reporting information that they have reasonable cause to believe to be inaccurate,\footnote{15 U.S.C.A. § 1681s-2.} but they can discharge this duty by simply posting an address where the consumer can send complaints.\footnote{Id. § 1681s-2(a)(1)(B).} In addition, consumers cannot sue furnishers for a breach of this duty,\footnote{Id. § 1681s-2(c).} and the government can only impose liability if it first obtains an injunction and the furnisher subsequently breaches this injunction.\footnote{Id. § 1681s(c)(5).} Furnishers have an independent duty to investigate alleged errors that CRAs bring to their attention,\footnote{Id. § 1681s-2.} and consumers do have a cause of action to enforce this obligation.\footnote{Id. §§ 1681n, 1681o.}

Perhaps the most significant recent development in credit reporting is the fact that the Consumer Financial Protection Bureau has begun regular examinations of the major credit bureaus.\footnote{See http://www.consumerfinance.gov/guidance/supervision/manual/.} These examinations will, among other things, examine the procedures that the credit bureaus use to minimize the number of errors that they make themselves\footnote{Id at 10-15.} and examine the procedures that they use to ensure that their furnisher are reliable.\footnote{Id.} Scholars and consumer advocates have advanced a number of proposed reforms to the FCRA. The current FCRA prohibits credit bureaus from reporting adverse events that are many years old as well as certain...
details about medical debt. Scholars and advocates have proposed new gag rules. The proposed gag rule with the greatest potential impact would prohibit the use of credit reports for employment except in limited circumstances. Ten states already limit the use of credit reports in employment, and Elizabeth Warren and other members of Congress have introduced legislation that would do the same on a national level.

Some countries require that creditors report a consumer’s payment history to a central registry, but the United States does not. A second major category of proposed reforms would impose reporting requirements on certain creditors and the credit bureaus. For example, Richard Brooks has proposed such a requirement for subprime lenders like payday lenders.

Two other categories of reforms are more relevant for this essay because their goal is to reduce the number of mistakes in credit reports. One category would mandate specific matching procedures that the credit bureaus must use, perhaps the CFPB examinations are a de facto version of this. A second category of reforms would make it easier for consumers to sue the credit bureaus and their furnishers. As noted above, credit bureaus are only liable for their misstatements if they behaved negligently, and the FCRA effectively imposes no liability on furnishers at all for the initial misstatement. Furnishers may face some state law liability if they acted maliciously, but even then the FCRA may preempt state law. Commentators have proposed reforms that would increase the liability of the credit reporting industry, though these take various forms. Some call for a narrow reading of the FCRA’s preemption provisions to allow for liability under state law. Others call for strict liability for the credit bureaus or the furnishers. The basic logic of these reforms is to force the industry to internalize the harm that their mistakes cause to consumers.

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76 For a summary of proposed matching requirements, see Sovem, supra note 33, at 369-371.
78 See supra notes 62-67, and the accompanying text.
79 See supra notes 44-46, and the accompanying text.
80 See, e.g. Elizabeth De Armond, Preventing Preemption: Finding Space for States to Regulate Consumers’ Credit Reports, working paper; Elizabeth De Armond, A Dearth of Remedies, 113 PENN STATE L. REV. (2008).
II. THE SOCIAL COSTS OF CREDIT REPORT ERRORS

The argument for strict liability for credit report errors is superficially attractive as it appears to be a simple extension of the economic analysis of tort law. This analysis suggests that if we are not concerned with the victim's incentive to take care (e.g. contributory negligence), then strict liability is likely to lead to efficient outcomes by forcing the tortfeasor to internalize the harm that her actions cause.82 A properly set negligence standard can also cause the tortfeasor to take efficient precautions,83 but courts must discern the efficient level of precautions, and victims may have difficulty proving that the tortfeasor failed to take these precautions. Moreover, the efficient level of precautions rarely eliminates the risk of injury. Once the tortfeasor takes this level of care, she no longer bears the risk of loss, and she will engage in too much of the activity.84 One can reasonably argue that consumers cannot easily protect themselves against mistakes in their credit reports. It would therefore seem that holding the credit reporting industry liable for the harm that their mistakes impose on consumers would provide the industry with the incentive necessary to take a socially optimal level of care.85

This essay does not attempt a full analysis of the proper scope of liability for credit report errors. Rather, it notes that there is a fundamental problem with the above logic that makes the analysis much harder. Strict liability causes the tortfeasor to take care by forcing her to internalize the private harm suffered by the victim, and in tort law this private harm is usually equal to the social harm. However, a consumer's loss from a credit report error is likely to substantially exceed the social cost of the mistake because the mistake will confer benefits on third parties. Part A uses an example to show that, if we make some simplifying assumptions, credit report errors impose no social costs at all; they merely transfer wealth from some consumers to others. Holding the industry strictly liable for the private loss of credit report errors could thus cause the industry to take an excessive level of precaution or chill the reporting of information. Part B discusses some likely consequences of relaxing the simplifying assumptions.

83 Id.
84 Id.
85 This is essentially the argument set forth by those who favor strict liability for credit bureaus. See, e.g., Sovem, supra note 33, at 373.
A. A Simple Example

To see why the harm that a consumer’s private costs of credit report errors are likely to exceed the social costs, assume that one hundred consumers each borrow $100 for one year in a competitive market. To make the math easier, assume that $100 in the future is worth $100 today, there is no time value of money, and that lenders are risk-neutral. Eighty of the consumers are low-risk; they will repay the debt with certainty. Twenty consumers are high-risk; they will repay the debt eighty percent of the time, and they will repay nothing the other twenty percent of the time. If credit reports allow lenders to perfectly distinguish between low and high-risk consumers, lenders will demand a promise of $100 from the low-risk consumers and a promise of $125 from the high-risk consumers so that the expected payment for each consumer is $100. Lenders cannot charge less than these amounts or they would lose money and go out of business. They cannot charge more or a competitor would undercut them.

Now assume that the credit reports are imperfect. Because consumer groups typically complain about errors that lower a consumer’s credit score, assume that credit reports only contain one type of error. The credit reports correctly identify every high-risk consumer as high-risk. However, the credit reports also misidentify nine of the eighty low-risk consumers as high-risk. Consumers with a clean (low-risk) credit report will continue to get loans for a promised repayment of $100. Lenders may initially demand $125 from the consumers with a bad (high-risk) credit report. If they did, they would find that their average repayment would be a little more than $107.75 because the actual rate of default in the pool of consumers who appear to be high-risk is about fourteen percent, not twenty percent. This is because nine of the twenty-nine members of this risk-pool never default (they are actually low-risk consumers). If the industry consistently misclassifies some low-risk consumers as high-risk, other lenders would see that those who lend to the high-risk pool earn an abnormally large profit. They would enter the high-risk market and drive the price down. If the actual default rate for those with bad credit reports is a little less than fourteen percent, competition should drive the required repayment down to $116.

If those consumers who appear to be high-risk must promise to pay $116, each of the nine misidentified consumers will suffer a very real $16 loss – they are paying $16 more than they would have had they been correctly identified. However, their aggregate $144 loss (9 * $16) is exactly offset by the gain experienced by the twenty consumers who are truly high-risk. Each of the twenty high-risk consumers sees her promised payment fall by about $9, but they will only make this payment twenty percent of the time so that their expected aggregate gain from the mistake is $144

\[ P = 0.2 \times \frac{20}{29} = 0.1379. \]
(20*$9*0.8). From a social perspective, the credit report error may be no more damaging than a lottery operator misreading the number of a winning ticket, causing Alice to win the prize instead of Alan.

B. Why Credit Report Errors May Create Costs

The simple example presented in Part A ignored complicating factors that could cause credit report errors to create social costs. First, the example assumed that the high-risk consumers would borrow at a rate that reflected their true probability of default. However, they may be unwilling to borrow at this price because they place a value on receiving the loan that exceeds the cost of providing it to them. If this is true, it is not socially efficient for them to receive credit, and the pooling created by credit report error misallocates resources. Second, the example in Part A assumed that the misidentified consumers would borrow at a required repayment of $116. Even if the high-risk consumers are willing to pay this amount, the low-risk consumers may refuse because they will have to pay the price more often (they do not default). As a result, the low-risk consumers may be more likely to leave the market; this is the problem of adverse selection. If they do leave, the high-risk consumers will continue to have to promise $125; there is no offsetting benefit to the high-risk consumers. Third, credit report errors reduce the penalty for default and thus reduce the consumer's incentive to repay. Credit report errors can create a form of moral hazard. Finally, lenders and the misidentified consumers have a strong incentive to find alternative screening or signaling mechanisms to identify those who are, in fact, low-risk. Most obviously, many consumers will spend substantial time and effort to correct errors in their credit file. These efforts are especially burdensome for victims of identity theft.

87 Note that this analysis ignores distributional questions. While providing the high-risk consumers with credit may reduce aggregate wealth, it may still increase the wealth of the high-risk consumers. A full analysis of the distributional consequences of credit report errors is left for future work. For now, note that society might be able to achieve the same distributional results with less loss of efficiency through the tax and transfer system. See, e.g., LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002).

88 There may be still other forms of misallocation, especially in other contexts. For example, a lender may want to adopt different precautions or procedures for the different types of borrowers. If the borrowers are misidentified, the lender will apply the wrong procedures.

89 As noted below, however, other forms of moral hazard can actually imply that credit report errors raise social welfare. See infra notes 105-108 and the accompanying text.

90 As noted below, however, lenders have other screening devices available to them.

91 See supra note 33.
III. CREDIT REPORT ERRORS, GAG RULES AND POOR PROXIES FOR RISK

Section III demonstrates that the social costs of a credit report error are likely to exceed the private costs to the victim because these mistakes confer benefits on those consumers who are not subject to the mistake.Offsetting benefits are a general problem for the law, but the problem is particularly acute in the risk-categorization context. Part A demonstrates that a credit report with mistakes can be thought of as a poor proxy for risk and that the insurance literature on risk-categorization is likely to offer important insights for the regulation of credit reporting. Part B draws an analogy between credit report errors and the FCRA rules that prohibit credit bureaus from reporting useful information that allows users to predict consumer behavior.

A. Analogy to Insurance Proxies

Insurance companies can rarely measure risk directly or can only measure it at an unacceptable cost. As a result, they classify individuals based on some proxy for risk. Consider automobile insurance. Insurers would like to classify individuals based on their recklessness, but it may be impossible to precisely define a measure of recklessness much less test drivers for this. Insurers may therefore charge young males more than other drivers because they believe that this group behaves more recklessly than others. They do not have complete discretion in the choice of these proxies as the government regulates the proxies that insurance companies can use to sort individuals into risk categories.

Econometricians think of proxies as the true variable of interest measured with error. If we think of it in this way, the link between credit report errors and risk-classification errors becomes obvious. We can think of a perfectly accurate credit score as the true variable of interest and a credit score constructed from a set of imperfect credit reports as a proxy.

To further illustrate this parallel, note that in Section II we considered an example in which a perfect credit report would have perfectly identified a consumer’s risk level but that some credit reports contained errors. But we could just as easily frame the problem as one in which even a perfect

92 For example, if a public firm misstates its earnings, it may cause a buyer to pay too much for a share of stock, but it will correspondingly allow a seller to sell the share for more. For a more general discussion of the consequences of offsetting benefits, see Ariel Porat & Eric Posner, Offseting Benefits, 100 Va. L. Rev. 1165 (2014).
93 See, e.g., Ken Abraham, Efficiency and Fairness in Insurance Risk Classification, 71 Va. L. Rev. 403 (1985); Avraham, et al., supra note 12.
94 See, e.g., WILLIAM H. GREENE, ECONOMETRIC ANALYSIS 221 (7th ed. 2012).
credit report is an imperfect proxy for risk. For example, assume that the credit reports contain perfectly accurate records of past bankruptcy filings. Assume further that those debtors who have never filed for bankruptcy are certain to repay their debts in full. There are seventy-one of these debtors. Twenty-nine debtors have filed for bankruptcy previously. Twenty of these twenty-nine debtors are, in fact, high-risk and would default on a loan twenty percent of the time. However, nine of the twenty-nine debtors with a prior bankruptcy are actually low-risk; they will never default. They may have suffered some unavoidable medical shock that caused them to file for bankruptcy but from which they have fully recovered. The numbers chosen are, of course, precisely the same as those in Section II. The fact that nine of the low-risk debtors are misclassified as high-risk raises each of their required repayment by $16 so that their private costs are costs are $144 (9* $16). However, the misclassification lowers the required repayment of each of the twenty low-risk debtors by $9, and since each of them repays eighty percent of the time their collective benefit is also $144.

One may object that the mistake in the credit report is different because it can be corrected. We should not underestimate the difficulty of correcting these errors. Indeed, consumers themselves may have difficulty determining the accuracy of the information in their files. After all, in January of 2015 the FTC completed a study that followed consumers with unresolved disputes from a prior FTC study, and they found that nearly a third (thirty-one percent) of consumers accepted the original information as correct.96 But credit bureaus could almost certainly reduce the number of mistakes if they were willing to invest more money doing so. One study found that credit bureaus spent an average of just fifty cents investigating each disputed claim.97

Note, however, that insurers and lenders could also likely improve the precision of their proxies if they were willing to spend more. Consider the above example. Lenders could interview the debtor to determine the reason for the bankruptcy filing. They may be dissuaded from doing so if these interviews were very costly. Some debtors may misrepresent their reason for filing for bankruptcy, just as some consumers wrongly claim that information in their file is incorrect.

If we consider the cost of accurately sorting between low and high-risks, society may not actually want greater accuracy. Scholars sometimes use this argument to justify limits on risk-classification.98 The intuition is

that insurers or lenders must expend resources to sort between low and high-risk consumers, and they must recover these costs through the fees that they charge consumers. If the categorization just lowers costs for low-risk consumers and raises costs for high-risk consumers, then a ban may actually reduce average costs by an amount that reflects the cost of categorization.

Note that this same logic applies to credit report errors if one views the problem at a higher level of abstraction. Instead of considering the cost of a mistake, consider the social cost of the industry’s failure to take sufficient care to avoid the mistake. To the extent that this care is costly, the industry must find a way to recover the costs through the charges passed on to consumers. If the errors merely raise the rates that some low-risk consumers must pay and lower the rates that truly high-risk consumers must pay, then society may be able to lower rates on average by accepting a lower level of care and a higher rate of error. In other words, a lower level of care that leads to a greater rate of error may be socially desirable.

B. Analogy to FCRA's Gag Rule

The FCRA instructs credit bureaus to make “reasonable efforts to ensure maximum possible accuracy,” but it also contains provisions that make credit reports less accurate, at least if we interpret accuracy to mean reports that enable users to predict consumer success or failure. The FCRA prohibits credit bureaus from reporting old negative information even though studies have shown that this information is relevant for predicting repayment. This gag rule creates a form of credit report error, but it is an error of omission rather than commission. If we make the same simplifying assumptions that we used in Section II, then this gag rule merely transfers wealth from some consumers (truly low-risk consumers) to others (those who have the negative information removed from their files).

To see this, assume again that one hundred consumers will each borrow $100 in a competitive market and that eighty consumers are low-risk and repay with certainty while twenty consumers are high-risk and default twenty percent of the time. Now assume that the law mandates that the credit bureaus delete the information that identifies nine of the twenty as high-risk. The eleven consumers correctly identified as high risk will continue to have to promise to pay $125 so that they pay $100 on average and the lenders break even. Naïve lenders may initially require a promise of just $100 from the eighty-nine consumers with a clean credit report because

99 See 15 U.S.C. § 1681c (prohibiting the reporting of negative information that is old unless certain exemptions apply).
they think that the clean report means that they will be repaid with certainty. If they do so, however, they will lose an average of a little more than two dollars on each loan because the average rate of repayment for consumers with a clean report is now a little under ninety-eight percent. In a competitive market lenders will raise the price until they break even, charging about $102.06. Collectively, the nine high-risk debtors who have their prior bankruptcy deleted receive a benefit of about $165 as each of the nine sees a drop in the required repayment of about $23 and each makes this payment eighty percent of the time. However, the eighty low-risk consumers see a corresponding $165 loss as each of the eighty sees their required repayment go up by a little more than $2 and they make this payment with certainty.

This simplified analysis is just a first approximation, and the gag rule could reduce average social welfare for the same reasons that credit report errors can reduce average social welfare. First, the omission of the negative information can cause misallocation by bringing some high-risk consumers back into the market. Unless one makes additional assumptions, it is not efficient for high-risk consumers to obtain credit if the value they place on receiving this credit is lower than the cost of providing it to them. Second, the omission causes an increase in the price faced by the low-risk consumers, and this could lead to adverse selection by driving the good types from the market. Third, the omissions reduce the penalty for defaulting on a debt and thus create a form of moral hazard. Finally, the omissions could cause lenders and low-risk consumers to look for other screening and signaling devices. For example, lenders could demand collateral as this is more expensive for high-risk borrowers (they default more often), or they could collect their own data on bankruptcy filings.

At least in theory, the gag rule could actually increase social welfare; the social cost of the error by omission could be negative. There are various theories for why this may be true, but consider a recent paper by Elul

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101 Nine of the eighty-nine consumers with a clean report are actually high-risk so that the average rate of default is (9/89)*0.2=0.0202.

102 This is $100/0.97978.

103 See infra note 105, and the accompanying text.

104 See, e.g., Helmut Bester, Screening vs. Rationing in Credit Markets with Imperfect Information, 75 AMER. ECON. REV. 850 (1985).

105 Two other papers, one by Vercammen and another by Moav and Neeman, can also be used to support this claim. See James A. Vercammen, Credit Bureau Policy and Sustainable Reputation Effects in Credit Markets, 62 ECONOMICA 461 (1995); Omer Moav & Zvika Neeman, The Quality of Information and Incentives for Effort, 43 J. INDUS. ECON. 62 (2010). These papers differ from Elul and Gottardi in that the gag rule improves efficiency by preserving asymmetric information so that borrowers have an incentive to work hard to develop a reputation for good quality, thereby mitigating the moral hazard problem.
& Gottardi. Their paper presents a complicated model, but the basic intuition is straightforward. The primary subjects of their model are entrepreneurs who would be able to get a loan if they were able to commit to exerting a high level of effort. However, limited liability creates a form of moral hazard so that they will not exert a high level of effort if they are charged a rate that reflects their probability of default. A gag rule that allows these entrepreneurs to pool with lower-risk entrepreneurs (who don't have to exert effort to succeed) can reduce the interest rate on their loans just enough to cause the higher-risk entrepreneurs to exert enough effort to make loans to them profitable and efficient.

The key to the Elul & Gottardi model is that the gag rule creates an error by omission that allows the high-risk entrepreneurs to pool with the low-risk entrepreneurs. However, one can create pooling by either adding stars to the bellies of the plain-bellied Sneetches or by removing the stars from the star-bellied Sneetches. That is, one could also create pooling by adding (mistaken) negative information to the low-risk consumers, and so, in theory, credit report errors could actually improve social welfare in the same manner.

IV. CONCLUSION AND EXTENSIONS

In this essay I argue that a theoretical analysis of the effects of credit report errors is basically the same as a theoretical analysis of imperfect risk-categorization in insurance or laws that prohibit lenders from considering some negative information about debtors. Under simplifying assumptions, the social costs of these errors, imperfections and omissions are zero; they merely transfer wealth from some consumers to others. In reality, however, these errors, imperfections and omissions are likely to impose social costs (though they could also provide social benefits) because of misallocation, adverse selection, moral hazard and signaling or screening costs.

I do not claim that credit report errors always have the same practical effect as imperfections in risk-categorization or omissions of negative information. Context matters and one must make strong empirical assump-

106 See Elul & Gottardi, supra note 13. Elul & Gottardi present a model of successive loans to an entrepreneur, but the FCRA's gag rule is unlikely to apply to such a loan. First, the gag rule does not apply if the credit report is used for high-dollar loans. See 15 U.S.C. § 1681c(b). Second, while the FCRA does apply to consumer reports that are used for business purposes, it would not apply to a report that only recorded a repayment history of business loans and was used for business purposes. See 15 U.S.C. § 1681b; NATIONAL CONSUMER LAW CENTER, supra note 2, at 30 ("A report on an individual's business history (as opposed to personal credit or employment history) is also not a consumer report if it was collected, used and expected to be used to evaluate business credit or insurance eligibility."). However, the basic intuition of the model can be applied to the consumer setting.

107 This is also true of the models in Vercammen and Moav & Neeman. See supra note 104.

tions to predict the effect of a government intervention. Depending on the assumptions one makes, an inability of good types to identify themselves can cause markets to collapse entirely or improve everyone's welfare. Moreover, the distributional effects of misstatements in a credit report are likely to be very different than those of the FCRA's gag rules.

I also make no claims about whether or how the FCRA should be reformed, or at least I do not do so in this essay. A normative analysis of the regulation of the credit reporting industry would require a careful analysis of the market structure of credit reporting and whether industry participants internalize the social costs of their mistakes. I expect to conduct this analysis in future research; this essay is just the first step.


110 See, Phillipe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J. L. ECON. & ORG. 381 (1990). The basic intuition is that a pooling equilibrium is unstable without regulation because the good types have an incentive to signal and thus get better contracts. However, the bad types will begin to mimic their signals, and the good types will end up spending so much on signaling that they would have been better off with a pooling equilibrium and no signaling.