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Financial Privacy: The Economics of Opt-In vs Opt-Out

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Summary

Rapid financial sector restructuring and accelerating technological change over the past decade have propelled the issue of financial privacy to the forefront of the legislative agenda. Recently, the 108th Congress addressed concerns regarding the sharing of consumer information among affiliates of the same corporate group with the enactment of the Fair and Accurate Credit Transactions Act of 2003 (FACT). Under the FACT Act, financial institutions are prohibited from sharing information for the purpose of marketing unless the consumer has been notified and provided an opportunity to opt out.

Economic theory suggests that there are distinct benefits to information sharing. In a perfect market, theory holds that competitive forces will deliver an economically efficient outcome. However, this conclusion is contingent upon several assumptions that underlie the theoretical model. If one or more of these assumptions are absent, then the market can be said to have "failed." In these cases, public policy can play an important role in promoting economic efficiency.

In the market for financial information, the two most relevant types of market failures are externalities and imperfect information. If externalities exist and transaction costs are zero, economic theory indicates that an efficient allocation of information sharing will occur when "property rights" over information are well defined. Opt-out effectively assigns the property rights to financial institutions, while opt-in awards ownership to consumers. In terms of economic efficiency, theory holds that it is irrelevant who owns the property rights to the information. However, if there are significant transaction costs, then an economically efficient outcome can still be achieved when costs are minimized. In this case, an opt-out policy would more likely deliver an efficient allocation of information sharing.

In a world with imperfect information, economic theory asserts that an opt-out policy will fail to produce the most efficient outcome since financial institutions will receive the economic gains from information sharing without paying consumers its true value. Therefore, theory predicts that an opt-in policy would promote a more economically efficient outcome. If financial institutions have to obtain the explicit consent of their customers, then they will have an incentive to offer some sort of compensation to their customers for the use of their information.

This report will be updated as events warrant.

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Introduction

Rapid financial sector restructuring and accelerating technological change over the past decade have propelled the issue of financial privacy to the forefront of the legislative agenda. Recently, the 108th Congress addressed concerns regarding the sharing of consumer information among affiliates of the same corporate group with the enactment of the Fair and Accurate Credit Transactions Act of 2003 (FACT).[1] Under the FACT Act, information used for marketing purposes may not be shared unless the consumer has been notified and given the opportunity to opt out.[2] Prior to the enactment of the FACT Act, which amends the Fair Credit Reporting Act (FCRA), consumers could only opt out of having non-transaction, non-experience information shared.

During the FACT Act debate, the financial industry argued that there are numerous consumer benefits to the free flow of information, thus advocating for information sharing policies to remain opt out. Meanwhile, consumer groups argued for an opt-in policy that would require financial institutions to obtain a consumer's explicit consent before sharing certain information with their affiliates. This report examines the economics of financial privacy in the context of the opt-out/opt-in debate and considers the implications of both policies.[3]

Background

According to the Federal Reserve, Americans made 71.5 billion non-cash retail payments in the year 2000.[4] Each one of those payments created valuable

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[1] P.L. 108-159.

[2] P.L. 108-159 § 214.

[3] This report will examine financial privacy in the context of economic theory. For the legal perspective, see CRS Report RS21449, *Fair Credit Reporting Act: Preemption of State Law* and CRS Report RS21427, *State Financial Privacy Laws Affecting Sharing of Customer Information Among Affiliated Financial Institutions*. Also see CRS Report RS20185, *Privacy Protection for Customer Financial Information*, and CRS Report RL31666, *Fair Credit Reporting Act: Rights and Responsibilities*, by Angie A. Welborn. For general information on privacy issues, see CRS Report RL30671, *Personal Privacy Protection: The Legislative Response*, by Harold C. Relyea.

[4] Non-cash retail payments include checks, and debit and credit card transactions. For more information, see Geoffrey R. Gerdes and Jack K. Walton II, "The Use of Checks and Other

(continued...)

information. Every financial transaction, whether withdrawing money from an ATM or settling a purchase with a credit card, generates an electronic information trail as a byproduct. These data are collected by financial institutions and may be compiled into consumer profile databases that potentially may be shared among corporate affiliates and other third parties.

In order for any non-cash financial transaction to be completed, consumers must willingly release their personal information to the other parties involved. For example, purchasing groceries with a credit card requires the release of financial information to the grocery store, the credit card company, and the financial institution. But then the critical question becomes, who owns the rights to that information once the transaction has been completed?

In this regard, there are several federal laws pertaining to a consumer's right to financial privacy, including the Fair Credit Reporting Act (FCRA), which regulates the collection, use and disclosure of consumer credit information.[5] The FCRA excludes the communication of certain types of information from the definition of a consumer report, including information shared among affiliates of the same corporate group.[6] The law distinguishes between "transactions or experiences" information and "other" information.[7] Transactions or experiences information between an institution and a consumer may be shared with affiliates. Non-transaction, non-experience information obtained from third parties or from consumer applications may not be shared unless the consumer has been notified and given the opportunity to opt out from having such information shared. The recently enacted FACT Act amends the FCRA to also prohibit the sharing of information for the purpose of

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[4] (...continued)
Noncash Payment Instruments in the United States," *Federal Reserve Bulletin*, Aug. 2002.

[5] There are five federal privacy laws that pertain to a consumer's right to financial privacy: the Electronic Fund Transfer Act (15 U.S.C. §§1693a-1693r), the Right to Financial Privacy Act (12 U.S.C. §§3401-3422), the Telephone Consumer Protection Act (47 U.S.C. §§227), the Gramm-Leach-Bliley Act (15 U.S.C. §§6801-6809), and the Fair Credit Reporting Act (15 U.S.C. §§1681-1681t).

[6] 15 U.S.C § 1681(d)(2)(A). The FCRA states that the definition of a "consumer report" excludes any "(i) report containing information solely as to transactions or experiences between the consumer and the person making the report; (ii) communication of that information among persons related by common ownership or affiliated by corporate control; or (iii) communication of other information among persons related by common ownership or affiliated by corporate control, if it is clearly and conspicuously disclosed to the consumer that the information may be communicated among such persons and the consumer is given the opportunity, before the time that the information is initially communicated, to direct that such information not be communicated among such persons."

[7] The FCRA does not provide any guidance as to what types of information may be included in the term "transactions or experiences." Furthermore, none of the federal bank regulators nor the Federal Trade Commission have promulgated regulations regarding the definition of "information solely as to transactions or experiences" or what information may be included in such.

marketing unless the consumer has been notified and given the opportunity to opt out.[8]

The financial industry favors federal privacy laws that leave the responsibility to consumers to opt out from having certain types of information shared. In support of the opt-out view, financial services providers argue that there are numerous consumer benefits to the free flow of information, including enhanced customer service and better financial product design. In addition, there is evidence to suggest that these benefits are monetary as well. In a study conducted for the Financial Services Roundtable (FSR), a prominent industry lobby group, Ernst and Young estimated that the practice of information sharing saved $17 billion per year for the customers of the FSR members.[9] Thus, the financial industry argues that an opt-out policy ensures that consumers will receive these benefits, even if they do not realize they exist.[10]

However, many consumer advocacy groups have voiced concerns about the potential erosion of financial privacy associated with information-sharing activities among corporate affiliates. In contrast, consumer advocacy groups claim that financial privacy should be protected by restricting such information-sharing activities.[11] These groups argue that advances in information technology have caused an erosion in consumer privacy, leading to more junk mail and telemarketing calls, as well an elevated risk of identity theft. Thus, consumer groups advocate an "opt-in" policy that would require financial institutions to obtain a consumer's explicit consent before sharing certain information among their affiliates.

The Economics of Financial Privacy[12]

The Economic Value of Information

Economic theory suggests that there are benefits to information sharing. For example, producers might be able to expend fewer resources on marketing and product development when they have access to detailed consumer information. That translates into lower prices and enhanced consumer choices. Similarly, consumers will spend less time searching to identify products that meet their demands at a

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[8] P.L. 108-159 § 214.

[9] This estimate captures savings from both affiliate and non-affiliate information sharing. For more information, see Cynthia Glassman, "Customer Benefits from Current Information Sharing by Financial Services Companies," an Ernst and Young study conducted for the Financial Services Roundtable, Dec. 2000.

[10] For a perspective on how opt-in restrictions could affect the financial industry, go to the American Bankers Association web site, [www.aba.com/Industry+Issues/GR_PR_Opt-in.htm], visited Feb. 12, 2004.

[11] For information on the concerns voiced by consumer advocates, visit the Privacy Rights Clearinghouse web site, [www.privacyrights.org/financial.htm], visited Feb. 12, 2004.

[12] The theoretical arguments outlined in this section are applicable to both affiliate and non-affiliate information sharing.

competitive price. Therefore, information sharing can play a positive role in economic transactions.

To illustrate this point, suppose one wants to buy a new car. The dealer has many different types of cars on the lot, ranging from economy to luxury. It is in one's own interest to let the salesman know what type of car is desired. Search costs are reduced since the salesman can immediately direct the buyer to that type of car on the dealer's lot. Thus, the transaction is made more efficient by releasing detailed information about one's preferences to the salesman.

The same rationale can be applied to the market for financial services. For consumers, junk mail is equivalent to the car salesman presenting a sales pitch for every single vehicle on the lot. In other words, there exist excess search costs because a seller has too little information about the buyer's preferences. If a financial institution knows whether a customer is interested in purchasing insurance or applying for a new credit card, then the financial institution can make better decisions on whether or not to supply that customer with informational materials. Just like the car example, it is in the best interest of both parties to have the seller know the customer's preferences. Therefore, consumers have an incentive to provide this information to financial institutions, and financial institutions have an incentive to solicit this information from consumers.[13]

Economic Efficiency

Although financial information sharing can generate economic benefits, consumer valuations of these benefits might differ depending on each individual's preferences over privacy. Some consumers might not feel comfortable sharing their personal information with financial companies, either due to a concern of identity theft or a dislike of intrusive solicitation, while other consumers are less opposed to giving up a degree of financial privacy in exchange for improved products or services.

Similarly, the magnitude of economic value generated by information sharing could differ across financial institutions. Thus, it might be more costly to some financial services providers to offer a greater degree of privacy to their consumers since it means forgoing potential economic gains.

Under the traditional economic model, competitive market forces will generally deliver an economically efficient outcome. Applying this theory to the market for financial information suggests that an efficient amount of information sharing will occur up to the point where the economic benefits of information sharing are balanced against the associated costs. Specifically, if the economic value created by information sharing exceeds the value derived from financial privacy, theory maintains that the economically efficient outcome would be to share information.

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[13] For a more detailed explanation of this economic argument, see Hal R. Varian, "Theory of Markets and Privacy," in *Privacy and Self-Regulation in the Information Age* (Washington, DC: U.S. Department of Commerce, June 1997); online [www.ntia.doc.gov/reports/privacy/privacy_rpt.htm], visited Feb. 12, 2004.

In contrast, if the economic value generated by financial institutions from access to consumer information does not exceed the consumer benefit from financial privacy, then economic efficiency dictates that information not be shared.

Market Failures

The conclusion that competitive markets will produce an efficient allocation of information sharing is contingent upon the assumptions that underlie the theoretical model. The conditions for a market to deliver an efficient outcome include freedom of entry and exit of producers, the absence of external effects, or "externalities," and perfect information. However, economists agree that these conditions often do not exist in practice. For instance, economic actors usually do not share symmetrical and complete understanding about the market, including the economic impact of law or the market value of financial information. The absence of one or more of these conditions is said to result in a "market failure," that is, the market fails to deliver an economically efficient outcome. In these cases, a prudent mix of government legislation and market-oriented policies can approximate the forces necessary to produce an efficient allocation of information sharing. In the market for financial information, the two most relevant types of market failures are externalities and imperfect information.[14]

Externalities. An externality occurs when transactions impact third parties without due compensation. For example, when your neighbor paints the exterior of his or her house, this action in turn raises the property value of your own home. This is an example of a favorable externality to you since you incur an economic gain without having to compensate your neighbor for the expense of the improvements.

Some economists have argued that there are no externalities in the market for financial privacy since the information sharing that occurs between consumers and financial institutions does not affect other parties.[15] However, this view does not consider the benefit financial institutions receive from accessing the information that is shared between consumers and non-financial companies. Recall the example of a consumer purchasing groceries with a credit card. In order to settle the grocery bill, the consumer must share credit card information with the store clerk. But in today's technology-driven world, every financial transaction generates an electronic information trail. Financial information is a byproduct of non-cash transactions, and, when compiled into databases, generates value for financial institutions when shared among their affiliates. Therefore, the economic benefit accrued to financial institutions is analogous to the benefit you receive when a neighbor paints his or her house. Since financial institutions do not purchase this information, they are

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[14] Public goods and imperfect competition are also often referred to in economics literature as market failures. However, financial information is "excludable" so it cannot be considered a public good. Furthermore, since there are few regulatory restrictions on entry and geographic expansion, the financial services industry is often considered to be competitive.

[15] For more information on this view, see Jeffrey M. Lacker, "The Economics of Financial Privacy: To Opt Out or Opt In?," *Economic Quarterly*, Federal Reserve Bank of Richmond, Volume 88/3, Summer 2002.

receiving a favorable externality from being able to access and use the financial information.

When market externalities exist, economic theory dictates that an efficient allocation can still be reached when "property rights" are well defined.[16] Public policy effectively assigns the property rights over information through the choice of opt out or opt in. Under the current opt-out policy, financial institutions have the right to share certain types of information about a consumer with their affiliates. Consumers will choose to opt out when the value of their financial privacy exceeds the value derived from information sharing. In this case, competitive financial institutions will have an incentive to compete for those depositors by bidding up compensation for the use of their information. Similarly, under the alternative opt-in policy, consumers effectively hold the property rights to their information. In this event, financial institutions will have an incentive to purchase this information up to the point where the economic gain to them equals the cost of compensating consumers. Therefore, regardless of how property rights are assigned, the market can still deliver an economically efficient outcome.[17]

Imperfect Information. Under the Gramm-Leach-Bliley Act, all financial institutions are required to send customers an annual privacy policy statement.[18] This document includes a detailed description of a financial company's policies related to information sharing among affiliates.[19] Therefore, many economists would argue that all parties have full and complete information.

But some consumers claim that privacy notices are confusing and complex, and consumers might therefore be inadequately informed about their financial privacy rights. Further, it is possible that consumers do not fully understand the potential market value of their financial information to the same extent as financial institutions. That may explain why surveys reveal that a majority of consumers place a high value on their financial privacy, yet banking industry estimates show that opting-out rates "hover around 5 percent."[20]

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[16] The economics literature commonly refers to this result as the Coase theorem, named after the Nobel Prize-winning economist Ronald H. Coase, who first proposed this idea. The term "property rights" is a general concept used in economics to represent ownership or control over a good, and should not be interpreted literally as a legal definition of an individual's property rights.

[17] Note that this argument depends upon the assumption that transaction costs are zero. The next section will show how the existence of transaction costs could affect the assignment of property rights.

[18] P.L. 106-102, Title V; 113 Stat. 1436-1450; 15 U.S.C. §§6801-6809. For more information, see CRS Report RS20185, *Privacy Protection for Customer Financial Information.*

[19] The statements also describe an institution's policy about sharing financial information with other non-affiliated third parties.

[20] W.A. Lee, "Opt-Out Notices Give No One a Thrill," *American Banker*, July 10, 2001.

Federal Reserve economist Jeffrey Lacker dismisses this view. He suggests that the reason for the inconsistencies between consumer privacy preferences, as identified in surveys, and their opt-out rates is because "the value they place on financial privacy does not exceed the inconvenience of exercising their right to opt out."[21]

Lacker's argument raises an interesting point, but it remains possible that not all consumers are fully aware of their right to opt out. Therefore, financial institutions could be benefitting from asymmetric information about the "rules of the game," as well as the market value of consumers' financial information. In either case, the economically efficient outcome would not be realized. If consumers do not fully understand the market value of their financial information, then they might not opt out even when given the opportunity, and financial institutions could be receiving economic gains from sharing this information without paying consumers its true value.

If there is imperfect information, public policy might promote an efficient allocation of information sharing by assigning property rights to the consumer through an opt-in policy. Competitive financial institutions would presumably compete for depositors' information by bidding up the compensation for financial information to its true economic value. In this environment, an opt-in policy largely obviates the need for consumers to understand the actual market value of their information. Simply put, if a financial institution has to obtain the explicit consent of its customers, then it will have an incentive to offer compensation to its customers for the use of their information.

Thin Margins and Transaction Costs

Although it is important to identify the types of market failures that may prevent an efficient allocation of information sharing, there are other important factors to consider when deciding upon the optimal policy solution. For example, if thin margins exist between the economic benefit to financial institutions from sharing information and the cost of doing so, then an opt-in policy will cause the market for financial information to unravel. The additional cost required by financial institutions to compensate consumers might eliminate the economic surplus from collecting and sharing financial information. As a result, value would be lost as financial institutions ceased to share information. That would be a detriment to financial sector profits, as well as to consumers who might not receive the benefits of better choice in financial products and services. In this event, the effective control of financial information would more efficiently remain with the financial institutions by retaining the opt-out restriction as provided in the current law.

Another example is transaction costs. In the previous section on externalities, it was shown that in terms of economic efficiency, the assignment of property rights is irrelevant. However, this conclusion assumes that negotiation and transaction costs are zero, which might not always be true in practice. There could be costs, in terms of inconvenience and time, to consumers who want to opt out. Similarly,

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[21] Lacker, "The Economics of Financial Privacy: To Opt Out or Opt In?," p. 11.

financial institutions could find it costly to solicit permission from every customer in order to use their information. If there are significant transaction costs, then economic theory suggests that an efficient allocation would be one in which the costs are minimized. If transaction costs are likely to be greater for financial institutions than consumers in this case, theory holds that the current opt-out policy would deliver the most economically efficient outcome.

Conclusion

Economic theory suggests that there are distinct benefits to information sharing. In a perfect market, competitive forces will generally deliver an economically efficient outcome. However, this conclusion is contingent upon several conditions that underlie the theoretical model. If one or more of these conditions are absent, then the market will fail to deliver an economically efficient outcome. In these cases, public policy plays an important role to promote an efficient outcome.

In the market for financial information, the two most relevant types of market failures are externalities and imperfect information. If externalities exist and transaction costs are zero, then economic theory indicates that an efficient allocation of information sharing will occur when property rights are well defined. Opt-out effectively assigns the property rights over information to financial institutions, while opt-in awards ownership to consumers. In terms of economic efficiency, it is irrelevant who owns the property rights to the information. However, if there are significant transaction costs, then an economically efficient outcome can still be achieved when costs are minimized. In this case, economic theory suggests that the opt-out policy would more likely deliver an efficient allocation of information sharing.

In a world with imperfect information, an opt-out policy will fail to produce an economically efficient outcome since financial institutions will receive the economic gains from information sharing without paying consumers its true value. Therefore, an opt-in policy could promote a more economically efficient outcome. If financial institutions have to obtain the explicit consent of their customers, then they will have the incentive to offer compensation to their customers for the use of their information.