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Towards a Financially Inclusive Credit Reporting Regime: Some Implementation Issues for Consideration

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GLOSSARY OF COMMONLY USED TERMS

Negative data: Adverse payment data on a consumer. It consists of late payments (usually more than 60 days or more commonly 90 days past due), liens, collections and bankruptcies.

Positive data: Information on the timeliness of payments, including whether payment was on time or was moderately late. The payment information may contain the payment date relative to the due date. Positive information often includes data on account type, lender, date opened, inquiries, debt, and can also include credit utilization rates, credit limits and account balances. It stands in contrast to negative-only reporting.

Full-file reporting: The reporting of both positive and negative data. On-time payments and late payments are reported. Delinquencies are reported at 30 days (sometimes 15 days) following the due date. Other positive information on an account, such as credit utilization, is also reported.

Negative-only reporting: The reporting of only negative data.

Segmented reporting: A system of reporting information, whether full-file or negative only, in which only data from one sector or a limited number of sectors, e.g., retail or banking, are contained in reports.

Comprehensive reporting: A system of in which payment and account information, whether full-file or negative-only, are not restricted by sector, that is, the system contains information from multiple sectors. Such a system is in contrast to segmented reporting, in which information in files is restricted to one sector such as banking or retail.

1. INTRODUCTION

A significant body of empirical work as well as actual experience has shown that full-file, comprehensive credit reporting great expands access to credit. These robust and extensive systems have been shown to enable: (1) greater access to credit; (2) fairer access to credit, in the form of making mainstream lending markets more available to lower-income and other underserved segments, especially as non-financial payment and other data are reported; and (3) improved lending performance, in the sense of lower default rates, reflecting lower levels of over-indebtedness.

While there has been considerable attention paid to demonstrating the clear benefits of full-file comprehensive reporting system, less attention has been devoted to addressing some wider problems of or *choices regarding implementation*. Discussions with policy makers suggest that these challenges often considerably retard the development of such a reporting regime. Perhaps more importantly, the side-stepping of some of these issues, or the resolution of many of these challenges in specific ways, may limit the ability of the information sharing system to expand financial access to lower-income and other excluded social segments.

While this brief cannot address all various challenges regarding implementation, it will address some important challenges faced in the transition to a full-file, comprehensive reporting system. This paper examines:

(i) different approaches to a regulatory framework;
(ii) challenges with the issue of establishing financial identities; and,
(iii) integrating non-financial payment and non-payment data, including possibly government information such as income or social grant data.

These issues are key for implementing a credit reporting system that is financially inclusive especially in emerging economies. This brief raises some issues that have been raised by stakeholders in emerging economies, and points to ways that we can begin to address them. As such, the prescriptions in this report are meant to assist in the implementation of full-file, comprehensive credit reporting standard that will increase lending to the private sector, improve systemic safety and soundness, and help serve those who have limited or no access to mainstream credit and thereby promote inclusive growth.

2. DEVELOPING A REGULATORY FRAMEWORK: CONTRASTING APPROACHES

Two regulatory issues shape the speed of development of the credit reporting system. First, whether the regulatory framework for reporting emerges through law and regulation, largely, or through contracting and industry norms, can shape the speed of implementation, depending on the legal-juridical framework of a society and the capacities of a legal system for enforcement. Second, how ownership of data is allocated, specifically, whether and to what extent lenders and data furnishers own data and to what extent the data repositories own the data, can have downstream consequences for

competition and the development of new uses for data. Each of these two factors are discussed in the sections immediately below.

Elaborating a Regulatory Framework: Common Law-Contracting Approaches vs. Civil Law

Here we can specify two ideal types with illustrations from a number of economies. The first ideal typical approach is characterized by a fully integrated regulatory regime. Laws and regulations cover privacy, permissible uses, adverse action notification requirements, redress procedures, and accuracy specifications. Such a well-elaborated system has as its complement a well developed and elaborated enforcement system.

These features are found in the robust reporting systems of the United States and Canada but also Korea and Mexico. It should be noted that these economies have well developed regulatory enforcement mechanisms, can devote resources for compliance, and capacity for regulation.

The other ideal typical approach can be described as a system that evolves largely out of contracting between key parties of a system and consumer protection laws. In such a system the rules that govern the collection and use of data are develop through reciprocal arrangements and lending industry norms on information sharing. The laws on data protection and prevention of consumer harm provide a basis for enforcement and for intervention in defense of consumer interests. The best known and most elaborated of these systems is the credit-reporting regime found in the United Kingdom, in which the EU privacy directive provides guidelines for consumer rights and protections over data. (Regulatory guidelines in both systems often specify consumer rights that comport with the OECD Fair Information Principles.[1])

It should be noted that these ideal-types are inexact. Actual credit information sharing systems include elements of both in different degrees. These idealizations refer, as such, to general approaches that can be followed in implementation. The possibility of mixture provides policy makers with flexibility in bringing full-file, comprehensive credit reporting into being.

While a system in which well-elaborated regulations that enable and undergird credit reporting can be found in both common law and civil law societies, contracting, industry norms and case law play a greater role in regulation in common law systems. Where regulation does not extensively specify the roles and responsibilities of data furnishers and data companies such as credit bureaus, legal precedent will have to play a considerable role.

Each system evolves in relationship to the legal-juridical framework in which it is embedded. But it is useful to note that for societies in which regulatory capacity is limited and developing, an evolutionary approach in which legal precedent develops in

[1] See OECD, "OECD Guidelines on the Protection of Privacy and Transborder Flows of Personal Data." http://www.oecd.org/document/18/0,3343,en_2649_34255_1815186_1_1_1_1,00.html

tandem with the credit reporting systems assist stability. The choice of which approach to follow depends on the legal-juridical framework. The fact of different approaches also provides flexibility in the development of credit reporting regimes.

Here, one key aspect of the larger framework is creditor rights regime (creditor rights in bankruptcy and collateral). Information sharing and creditor rights are to some extent substitutes and to another extent complementary. They are substitutes to the extent that each presents a sanctioning mechanism over delinquent borrowers. They are complements in that information sharing may provide a lower cost sanctioning system for loans that are of small value, while creditor rights come into play with larger loans. For some emerging economies, the issue may strongly depend on the robustness of the legal system. As with credit reporting, creditor rights presuppose extensive enforcement powers by legal authority. Information sharing born of private contracting may be the most effect approach to building a credit reporting system in societies with poorly functioning legal-juridical systems. The choice again may be shaped by the wider juridical framework, notably regarding creditor rights.

There is little systematic investigation into the best methods to develop and implement. A systematic inquiry can help with implementation, as lessons learned for different economies can help to identify which elements of law must be specified early on, which regulatory issues can be developed as challenges emerge, and how these may vary according to the legal and regulatory framework, including enforcement capacity.

The Issue of Ownership of the Data

A core element of the credit reporting system that, while related to the question of what approaches are available to implementation of a full-file, comprehensive reporting regime, remains crucially important in the development of a credit reporting system is ownership of the data. The data can be owned by the data furnishers and managed by the credit bureau, or it can be owned by the credit bureau with parameters for use specified by law and/or standard contracts. Each approach can converge on the other, but they may also lead to very different outcomes that have significant consequences for the structure of lending. These distinctions also map very much onto whether the credit bureau is independent or is owned by lenders.

Systems in which data is owned by banks—largely, but not always, where the bureau is itself owned by the lenders—are often characterized by more restricted uses of the data. The ownership of data has consequences for the scope and pace of the development of value added services. Systems, such as those found in Mexico and the UK, where data is owned by lenders, have witnessed frictions in the use of information for score development and/or the use of data for purposes other than risk assessment. Scores by major lenders, for example, are or are not easily available for score development depending on the ownership structure. In some systems, the inability of new entrants into the market to use the data of large incumbents for score development becomes in effect a competitive disadvantage. To be sure, many systems in which the data is owned by lender do overcome these competitive problems; Schufa, in Germany, is notably such a

system. In other systems, the development and deployment of other uses for the data—for example, the use of credit reports to validate the valuation of collateralized securities—take longer than in systems where the data is owned by bureaus, but the parameters of its uses is limited by agreements and industry norms.

How ownership is specified either by regulation or by agreement in early part of the development of a system has consequences for how value added services are innovated and perhaps even how competitive the financial system becomes.

3. IDENTITY AND MATCHING

Lack of financial identity is a major obstacle for many people to effectively access financial services. Verifying that consumer X on one account for a creditor is also consumer X on another account of a separate creditor is a prerequisite for building credit files. That is, establishing a borrower's identity is necessary for the creation of financial identity that enables the construction of shared database and thereby risk assessment.

Creating financial identities involves a number of issues. There is the issue of how financial identities can be created in economies in which there is no national identity number or in which a national identity number is not legally usable. It should be noted that even in countries with national identity numbers, this identifier is never the only one relied upon, but is one among several ones used to establish an identity.

In some economies where national identification numbers cannot be used legally, as is the case in Germany, matching is conducted on several data points including name, date of birth, street address, national ration card number, employer data, etc. Other economies have begun to use biometric data such as fingerprints to establish identities. There is no common solution across all economies. For example, some economies lack stable address systems; as such, addresses cannot be used to establish identity. Regulations or social norms in yet others prevent the use of biometric information in ways that can be used to build credit files.

While the private sector will develop the full ensemble of methods to establish and verify identity, policy makers are in a position to push the market in specific directions that can help the development and adoption of some core approaches. The problem remains one of coordination. While the data for better off consumers in the form of name, stable address and employers is likely to be evident, the dilemmas are found in establishing the identity of lower income, rural and other underserved social segments.

There are no simple answers to overcome the question of establishing financial identity. What policy makers and practitioners can benefit from is a list of approaches and a knowledge base of lessons in identity matching. Some systems are paralyzed by the question of how to establish a financial identity. A broader understanding of how the problem of establishing identity in an information sharing system is addressed, either at local levels, national ones, or in-between, can help overcome these challenges.

4. CAPTURING NON-FINANCIAL DATA: SOME CONSIDERATIONS FOR IMPLEMENTATION

Extensive evidence strongly suggests that the inclusion of non-financial information in credit reports for risk decisioning can greatly expand access to credit especially for lower income social segment that are unlikely to have any easily accessible credit history for risk assessment. Information on, for example, payments on municipal and utility services, telecommunications, and rent, perhaps even prepayment patterns on telecoms, unemployment insurance data, and social grant information can serve this function.

There are a few implementation questions that remain around the gathering and inclusion of this data. First, there is the issue of how this information can be provided to lenders. Second, there is the issue of whether the data sources should be engaged as the credit reporting system is being developed or whether these data sources should be incorporated gradually.

Models of Information Gathering for Different Types of Data

Inclusion of payment information in credit files is of course the easiest method to have this data accessed by credit providers. However, some types of data that may not be easily and efficiently reported today to a third party, for reasons of privacy, technical limits, or regulation, may be able to be reported in the near future. In addition, there is not a single best approach to collecting all types of data. While it may be optimal to have all types of payment and credit data in databases so there is not a segmented or fragmented information sharing system, the exact way in which data gets reported may vary. There are a few models of information collection. The method of data sharing can shape the incentives for and willingness to share data.

The standard and most efficient method of sharing data is the reporting of information to a licensed credit reporting agency. Lenders and other data furnishers periodically report identifier, account, and payment information to the licensed bureau. Several accounts are reported in a unified report. Interfaces between lender and credit files also mean that the data is disseminated to the credit market very quickly.

While reporting to a credit reporting bureau for the inclusion of information into a credit files is the most effective means of brings actionable information to a lender—as the systems and format are set up to permit easy statistical scoring—the nature of some data makes it hard to integrate into a credit file owning to regulatory or technical issues.

These data types comprise sensitive information, notably from the public sector. Data collected by may be useful for extending credit: for example payments for utility services, employment and income, and tax information. Interviews with lenders suggest that for lower income segments and for those in the informal economy, proxies that can measure the stability of income can greatly assist in making lending decisions that are calibrated to individual risk, rather than credit rationing for a social segment. Data such as regularity of utility and telecom payment or even prepayment, social transfers, income data via unemployment insurance databases can greatly assist in this task.

Traditionally collecting some of this data, such as payments for utility services, is straight forward as the data be easily accommodated into credit files. Collecting other types of data, such as income or employment reported to a government tax, unemployment insurance or retirement authority, can be problematic owing to sensitivity to privacy. Income, tax, employment, social grant and other such data shared with governments are expected to be kept confidential. But the potential of these data source to expand lending is significant.

Another model of information sharing may be appropriate in these cases. This model has data transferred to a lender only with the explicit permission of the consumer. In this approach, as a borrower applies for credit, a request is sent to not a credit reporting agency, but to the data provider, either by the consumer or, more commonly, by an agent, usually a data company such as a credit reporting agency. The information is sent to the lender.

This model, like the credit reporting bureau model, can be automated. It should be noted that provision of this data transfer service by a credit bureau also enables dispute and verification systems that credit bureaus maintain to be deployed for this information as well. In terms of a model of data access, dedicated encrypted and secure data 'pipelines' would facilitate easy retrieval of the data. The agent (for example, credit reporting bureau) facilitates the transfer after authorization by the consumer is obtained at the point of the lender. The access to the data is effectively opt-in, that is, dependent on the consent of the consumer. Once set up, data retrieval is low-cost and quick.

Gradualism vs. A Rapid Approach to Non-Financial Data

In the creation of full-file, comprehensive reporting to a bureau, gradual and rapid implementation can apply to at least two dimensions. First, it can refer to the information that is collected. What counts as "positive data" is extensive: the loan amount; outstanding balance; timeliness of payment; the interest rate; maturity; loan type; the type of collateral; the value of collateral; and the loan rating. The list indicates the fact that there is considerable "positive" data associated with a line of credit. There are very few economies in which the bureau collects all these fields. For example, interest rate information in very rarely collected, especially in systems with private bureaus. Thus "rapid" implementation of positive data collection should be understood in relative terms. Most commonly, the inclusion of the timeliness of payment data is customarily considered to constitute "full-file".

Second, rapid vs. gradual implementation can also refer to the inclusion of non-bank sectors, that is, how data from non-bank sectors, especially, non-financial sectors is added to the database. In many instances of less than comprehensive reporting by sectors, or of loan instruments, or non-credit obligations, there have been moves towards inclusion and integration of payment data.

In one sense, the implementation of credit reporting is largely a gradual enterprise. Larger, more technically sophisticated players report first, with others included over time. In terms of regulatory and institutional gradualism, it should be noted that the pros and cons are largely found in cultural, political or competitive issues. With regards to non-financial data for credit reporting, the question of whether the reporting system should expand quickly at its beginnings to capture this information or wait until financial sectors have been brought into the reporting fold is less clear. Financial sectors tend to be more data driven and tend to be clearer on the logic for reporting, and thus easier to engage in reporting. However, in emerging economies, non-financial data plays a key role in financial inclusion. The early capture of this data also helps to develop norms and practices of using it in decision-making, for example in incorporating non-financial information in scoring models.

How these sectors can be best considered in credit reporting regulation and/or contracting—depending on what regulatory path is selected—remains to be systematically explored. A through examination of the role of alternative, non-financial data in the early development of credit reporting can greatly assist in orienting an information sharing system towards financial inclusion.

5. CONCLUSION

Each of the implementation issues raised above—(i) what path to the development of a regulatory framework works best for differing types of economies, (ii) which avenues to establishing a financial identity are most effective for a given reporting system, and (iii) how and when non-financial data should be engaged in the early development of a credit reporting regime—would benefit from systematic examination. Certain lessons for the development a well-functioning credit reporting system have been established by earlier generations of research. These lessons are that a full-file, comprehensive information sharing system owned by the private sector expands lending to the private sector. However, many economies, especially emerging economies face challenges in the implementation of such as system and may also need to consider factors, such as alternative data, upfront and in ways that developed economies have not had to consider. Examination of these issues can help assure that the well-established lessons can be acted upon effectively as these issues go to the heart of many implementation questions.

APEC would benefit from a number of steps that would help better address some of these outstanding issues and help policy makers engage implementation of credit reporting reform. The steps comprise research and educational efforts targeting senior financial ministry officials, including:

- Workshops on including non-financial information, including public and governmental data
- A survey and policy dialogue on approaches to establishing financial identity, especially in ways that assist financial inclusion, and
- Training seminars on approaches to developing a regulatory framework

These issues should also be and have been of interest to a number of development agencies, including the Department for International Development (DFID), the International Finance Corporation (IFC), and Alliance for Financial Inclusion. Engaging these organizations in policymaker education and research efforts would help bring mainstream financial markets to the underserved via information sharing.