Understanding credit markets for Europe

Credit reporting: Towards better access to credit and protection for consumers

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Credit reporting addresses the fundamental problem of credit markets: information asymmetry between borrowers and lenders. By providing an efficient mechanism for evaluating risk, accurate credit information enables credit markets to function more effectively and at a lower cost than would otherwise be possible. Regulators and financial market actors therefore increasingly recognise the value of credit-reporting systems for the improved management of credit risk and as a tool to enhance access to credit, thereby contributing to sustainable economic growth and financial sector stability. When assessing the need for more regulation, however, it should be noted that credit-reporting systems are networks combining different industries for the benefit of more efficiency and security, and excessive regulation can work against the very objective of stable and efficient financial markets.

Introduction

European policy-makers are working towards more stable, secure and efficient financial markets. From the perspective of retail financial markets, this means financial inclusion, responsible lending and the transparent pricing of financial services. To facilitate this development, retail financial markets need to be safe and competitive. One important attribute for competition is the access to and availability of credit data. Consumers may face higher prices or be denied access to financial services because of a service provider's lack of access to comprehensive information about the consumer. This inefficiency not only creates barriers to entry but also reduces customer mobility and choice. Accordingly, European policy-makers want to encourage the smooth flow of credit data, while taking into account the need for data protection.

Since the European Commission-led Expert Group on Credit Histories (EGCH) pointed out in 2009 that there is no need for a pan-European credit-reporting scheme,[1] the general focus of the

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[1] See EGCH, *Report of the Expert Group on Credit Histories*, DG Market and Internal Services, European Commission, Brussels, May 2009 (http://ec.europa.eu/internal_market/consultations/docs/2009/credit_histories/egch_report_en.pdf).

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rather quiet EU-level discussion on the issue has been to ensure that consumers of any EU nationality would enjoy equal protection and efficiency. In this quest, the first concrete step has been the review of the EU Data Protection Directive (95/46/EC). In January 2012, the European Commission proposed a comprehensive reform[2] of the EU's 1995 data protection rules, aimed at ensuring the fundamental rights of natural persons to data protection, as well as the free flow of data. The rules are to be adopted in legislation that will be directly applicable in all member states, to put an end to the cumulative and simultaneous application of different national laws on data protection.

The protection of data and data security are issues of crucial importance, but from the perspective of the credit-reporting systems as a whole, it is only one of the concerns. Other aspects of credit reporting, such as efficiency and competition, need to be assessed in order to promote a stable playing field for different players – again for them to be able to provide credit reporting that is secure and which respects the rights of consumers. A supportive legal framework should be designed to balance the interests of consumers on the one hand, and to promote the flows of credit information and innovation in the credit-reporting system on the other.

Level playing field for the benefit of consumers

The current emphasis in the legislative processes of European financial services on the responsibility of service providers is without doubt a fair approach, given the information asymmetries and moral hazard problems that arise when the money of less informed consumers is at stake. Creditors are urged to practise responsible lending, and the prices of basic financial products should be transparent and not excessive. At the same time, consumers should be able to switch service providers without undue costs and financial inclusion should be promoted everywhere in the EU.

In this discussion, however, less emphasis is placed on the tools and resources that the financial service providers need to enable them to keep up with this development. To lend responsibly and at costs that are proportional to the profile of the consumer, creditors need timely and relevant information about the consumer. To compete for potential customers and also make financial services accessible to unbanked consumers, service providers need better access to information about them. Service providers also need information for identity checking and fraud prevention.

All of this comes down to access to credit data – in particular which kinds of data should be used for credit reporting and which parties should have access to this data. If more relevant credit data are available for financial service providers, the providers are able to make more accurate assessments of a consumer's creditworthiness, provide financial services that are more accurately priced and make financial services available to a wider group of consumers. Also, efficient mechanisms for sharing credit information are important for efficient and competitive

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[2] As the proposal has since been passed on to the European Parliament and the EU member states for discussion, the European Commission is planning to reach an agreement on the EU's new data protection framework by the end of 2012. The new rules will take effect two years after adoption. See European Commission, *Proposal for a Directive on the protection of individuals with regard to the processing of personal data by competent authorities for the purposes of prevention, investigation, detection or prosecution of criminal offences or the execution of criminal penalties, and the free movement of such data*, COM(2012) 10 final, Brussels, 25 January 2012.

credit-reporting systems. The more that financial service providers can gain access to all the relevant information about potential customers, the greater will be the number of providers able to present consumers with competitive offers, thereby increasing customer mobility and choice. This is especially the case for specialised and non-bank credit providers, which have no banking data in their possession. For them, access to credit data is critically important to making responsible credit decisions and to competing with banks.

The level of credit reporting differs substantially among EU member states, creating varying needs for reform. In some countries the absence of a credit-reporting system significantly impedes financial inclusion, while in other countries the inadequate sharing of credit information hinders consumer mobility and choice, also inhibiting technological innovations. Different layers of information are relevant in different countries, but the overall playing field and level of protection should be equal throughout the EU to facilitate integrated, European credit markets. This calls for a cross-sectional analysis of the functioning of national credit-reporting systems.

What can be done to promote better efficiency?

What then is the level of relevant information needed for credit reporting? A report by a Task Force coordinated by the World Bank[3] calls for the use of all relevant information for credit reporting, with relevant information referring to both negative and positive data, as well as any other information deemed appropriate by the credit-reporting system. Empirical evidence has shown that the use of positive data is associated with better retail credit decisions,[4] but in practice its benefits continue to provoke debate throughout the EU. The report by the World Bank warns that in countries where positive credit reporting is prohibited by the legal or regulatory framework or simply not performed for other reasons, a debtor's ability to access new financing following an adverse event may be severely impaired. The use of utility payment data should also be considered in the making of more efficient credit-reporting systems. These alternative sources of data are especially important in developing countries that have considerable numbers of consumers with no banking data. Therefore, the use of utility data might provide a solution also from the perspective of financial inclusion.

The question of what level of information sharing is needed for efficient credit-reporting systems is also a topic of debate. The World Bank report says that data providers should share data widely and equitably across all credit-reporting service providers, because it is beneficial for the credit-reporting system as a whole. If significant market frictions in credit reporting exist, financial service providers do not have access to the same information, hindering competition. This leads to less consumer choice and the non-transparent pricing of financial products. In virtually all of the more mature credit-reporting systems, more and more participants from different industries are joining the networks. Therefore, it is important to assess the national credit-reporting systems from a competitive point of view to avoid any

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[3] See *General Principles for Credit Reporting*, the report by the Task Force coordinated by the World Bank, with support from the Bank for International Settlements (World Bank, Washington, D.C., May 2011, http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTFINANCIALSECTOR/0,,contentMDK:22912648~pagePK:148956~piPK:216618~theSitePK:282885,00.html).

[4] See J.M. Barron and M. Staten, "The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience", Purdue University and Georgetown University, West Lafayette, IN and Washington, D.C., 2000.

abuse on the part of banks and credit bureaus, thereby ensuring transparency and promoting consumer confidence. To encourage competition among credit-reporting service providers, barriers to entering the market should not be excessively high and regulation should not pose a barrier because of the costs of compliance. Jentzch (2007) points out that trying to regulate credit-reporting agencies as an industry would be counter-productive, and that it is better to regard credit bureaus as networks, where information providers and users take part in the information sharing under standardised conditions.[5]

In summary, instead of being perceived as something to be simply regulated for the sake of consumer protection, credit reporting could be considered a tool for promoting responsible lending, the fair pricing of financial services and financial inclusion. To facilitate this development, the sharing of all relevant credit information should be promoted and country-specific analysis of market frictions in this respect should be undertaken. An important milestone to reach is a consensus among both lenders and borrowers about the merits of a robust mechanism for sharing credit information. Both the providers and users of credit information as well as consumer associations should be consulted to identify any inconsistencies in safety and efficiency and to resolve them in a way that reflects a country's overall priorities, yet also works for the benefit of equal rights in more integrated markets. When assessing the need for regulations or amendments, however, regulators should carefully weigh the intended benefits against the potential negative consequences that such new rules may have on the credit-reporting system as a whole. Excessive regulation should be carefully avoided to prevent disruption of the information networks that are at the heart of efficient credit-reporting systems.

[5] See N. Jentzsch, *Do we need a European Directive for credit reporting?,* CESifo DICE Report 2/2007, CESifo, Munich, 2007.

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