

Legal and regulatory framework for credit reporting.

International experience.

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International practices in regulation of credit reporting vary greatly around the world. This note aims to summarize briefly key aspects in regulation of credit reporting and its implications for development of credit markets and consumer protection.

I. General Issues.

- 1. Goals of credit reporting.** Existence of formal information exchange mechanisms, such as credit bureaus is an essential prerequisite for development of well functioning credit market. Information from a credit bureau serves two main purposes: a) improving risk management by financial institutions and lowering default rates; b) decreasing information asymmetries and allowing banks to increase lending volume and provide loans to new categories of customers.
- 2. Importance of credit reporting for lending to individuals and SMEs.** While lending to large companies requires a thorough analysis of financial standing of the potential borrower, payment history information is found to be a sufficiently good predictor of the probability of default for smaller loans. This fact makes a credit bureau especially useful when lending to individuals and small and medium enterprises and allows credit reporting to be one of the major tools supporting wider access to credit.
- 3. Information on individuals versus information on firms.** Sharing of information must be balanced with protecting individual's privacy. In countries around the world there are laws limiting information exchange to protect individual's right for privacy. Usual mechanisms include permissible purposes and mechanisms for notification and authorization for issuing a credit report. It is essential to point out however, that these procedures only apply to individuals (physical persons). Sharing of information on firms usually is not restricted by such laws.
- 4. Balancing privacy protection and effective information sharing.** The purpose of a law regulating credit reporting is to allow sharing of credit information while protecting the rights of individual or firm with regard to the information collected in the credit bureau. Overly restricting information sharing, for example through unnecessarily severe penalties and sanctions or complicated and expensive procedures for information exchange, may discourage firms to enter the business of credit reporting and will result in a higher cost of credit report that will be passed on to a borrower through higher lending rates.

II. Regulating credit bureaus. International experience.

- 5. Legal framework for credit reporting.** Legal framework for credit reporting varies greatly around the world. Usually there are several laws in a country which would be relevant to operations of credit reporting registry. These laws include:
- regulations concerning bank secrecy
 - data protection law
 - consumer protection
 - fair credit granting and consumer credit regulations
 - provisions regarding privacy and personal or corporate secret in existing laws
- Several countries chose to pass a specific law regulating credit reporting entities. Examples: USA, Peru, Israel, Mexico, Sweden, Thailand, Korea, Russia (draft), Kazakhstan (draft), Ukraine(draft). In almost all European countries, as well as in Australia, New Zealand, Hong Kong, Taiwan, Argentina, the focus is on regulating data management process rather than credit reporting agencies as institutions. In these countries major law governing operation of credit registry is a Data Protection Law.
- 6. Scope of the law: institutions participating in credit reporting.** Economic research shows that the registries are most effective when they are able to collect information from a wide number of sources, including bank and non-bank financial institutions as well as firms selling goods in credit. Legal framework should be able to support such a system and should not restrict ability of some creditors to participate in a credit bureau. Fair Credit Reporting Act (FCRA) in the US, as well as Data Protection laws in Europe allow information exchange among all types of creditors. There are usually no restrictions on collection of information from public sources such as court records, bankruptcy filings etc. Credit bureaus create added value by merging information from public sources with the information collected by the credit bureau and allowing automated access to such records.
- 7. Limits on the time period information is stored and distributed.** International best practice is to establish time limits on the length of the credit history record available to a lender. Economic research shows that mostly recent credit payment record is relevant for predicting future default. Moreover, the fact that after a certain period of time information, especially regarding defaults, will not be distributed to lenders creates additional incentives for the borrower to improve credit repayment behavior and to “clean up” the record. For example, records are available only for 5 years in Australia, Brazil, Germany, Ireland, Peru, Spain, for 7 years in the US, Mexico. It is essential that all information in the file is kept for this set period. For example, if the debt is paid information on it should stay in the registry for the period prescribed. Deleting records, or parts of records significantly lowers predictive power of the data in the registry and weakens repayment incentive stimulating effect that the bureau has.

- 8. Data processing systems and data safety.** In most countries there is a tendency to rely on industry self-regulation for ensuring data safety. Credit bureaus as well as their members have strong incentives to establish proper mechanisms for data processing and data protection. In general development of mechanisms for data processing is driven by competition within the industry and developments in technology, while data security standards are set high to avoid significant costs a loss of data or an unauthorized access may cause. In some European countries, for example in Germany, data protection act requires credit bureaus to register with the data protection authority and to appoint an officer in charge of compliance with the data protection law. Due to the high level of sophistication of the systems used in data processing by modern credit bureaus and given limited resources of data protection authorities, they usually are not able to directly monitor and audit quality of the systems used by a data processor, but rather react to misdoings by a credit bureau or its members. For this purpose Supervisory Authority usually is required to log customer complains and assist in resolution of conflicts. Data protection authority may require a credit bureau to present the results of an independent audit of data security systems to certify compliance with the standards set by the law.
- 9. Data collection – notification.** In several European countries data protection law requires notification of data subjects regarding the information transfer to a credit registry. It is important to point out that such notification is only required in case of information related to individuals (physical persons) and not firms. Notification is only required for initial data transfer and not for repeated transmission of data. It is a standard practice to include a notification statement into a loan application and into a loan agreement. Such notification would usually inform the borrower that information on him/her will be sent to certain credit bureaus stating their names, specify the purpose for the use of such information in the credit registry (the record will be available upon request to an institution considering granting a credit, collecting on a loan, etc), describe information that will be sent to the bureau (identifying information, information on amount of loan outstanding, information on the status of payment on the loans, etc). With the development of technology the use of electronic signature becomes standard practice for such procedures. It is common to require compliance with the notification cause only for the records originated after the law is enacted, e.g. it is not necessary to notify borrowers whose records are already in the registry, since this would constitute prohibitively high costs for credit bureaus and their members. Time frame for keeping the records of loan applications and loan agreements as well as notification records is usually determined by the laws existing in the country and the standard practices in financial institutions, but may also be included in the specific regulation for credit registries to ensure compliance.
- 10. Disclosure of credit report – purposes.** Defining a set of legitimate purposes is the key aspect in ensuring privacy and authorized access to the data. This set of purposes in international practice usually include not only consideration for granting credit, but also monitoring of existing credit, collecting on a credit, etc.

In the US for example, a broader set of purposes is allowed including access to credit report for employment purposes.

- 11. Credit report disclosure – consent.** In many countries, for example in Germany, Thailand, and Australia, law requires consent of an individual to authorize issuance of a credit report by a credit registry. Countries differ in the requirement of consent depending on the purpose of the credit report. In case of application for a credit, standard practice is to include a statement into the loan application requesting a consent of a borrower for a credit registry to issue a credit report. The text of consent specifies that the individual agrees that the lender will request a credit report from a credit registry (registries) with the purpose of using such information in making decision regarding granting of a credit. Letter of consent is usually kept on record at the lending institution for a set period of time, while credit bureaus can access such records upon request. Development of technology and electronic signature allows to obtain and store consent in electronic form. Usually no additional consent is required for a lender to access a credit report on a borrower once credit is granted as long as the lender has a legitimate purpose, such as reconsidering terms of a loan, collection, etc. International best practice suggests that access to the registry by tax authorities should be limited.
- 12. Consumer protection. Notice of refusal of credit.** Credit reporting and data protection laws internationally are in large part self-enforcing. One of the key provisions in the laws is the ability by the information subject to view his/her own record. One of the most effective mechanisms for maintaining quality and accuracy of information in the database is ensured via provision of a notice to the borrower when credit is refused. The notice informs borrower that decision to refuse credit was in whole or in part based on the information obtained from a credit registry specifying its name. The notice should also state that according to the law the borrower can obtain a record from the credit bureau and to provide contact information for this bureau. In most countries consumer is entitled to obtain a free report if he/she has received such notice. Alternatively the price for report may be set at some low level. Notice of refusal of credit also serves as a good educational tool informing consumer of the importance of building good credit history and improving payment discipline.
- 13. Consumer protection. Information on who has accessed the credit report.** The object of the credit report, whether an individual or a firm, is in the best position to know who has a valid reason for accessing their report. They know where they have requested credit or employment and whether other firms or individuals have a valid reason to request the information. Therefore, one of the best ways to limit unauthorized use of credit information is to develop systems which record all queries for an individual's report. Consumers can review this information if they think their data has been used in an inappropriate manner. This simple reporting tool can greatly help to detect misuse of the data, by lenders and others who may request this information as well as by staff of the credit reporting firm.

14. Consumer protection. A mechanism for non-judicial dispute resolution.

Procedures should be in place to facilitate challenges to erroneous data. Again, the consumer or firm who is the object of the credit report is in the best position to know if data in the report is correct or flawed. At the same time, they have an incentive to challenge negative information in their report, even if they know it to be accurate. These two facts should be balanced in regulations on dispute resolution in credit reporting. Providing access to credit reporting firms via the internet and by phone can encourage consumers to review their reports and identify reporting errors. As stated above, it is particularly important that consumers have access to reports when an adverse action has been taken. Clear procedures should be established in regulations specifying the steps in the dispute resolution process and the time that credit reporting firms have to verify and respond to complaints. These regulations may include requirements that credit reporting firms operate toll-free phone numbers to take complaints or otherwise facilitate consumer access. If the credit reporting firm and consumer differ over the validity of the information, the consumer should be able to add a comment to this effect on their report. However, consumers should not be able to effectively hamper the functioning of the system by their interaction with the credit reporting firm(s). For example, requirements that all consumers get a free copy of their credit report every year, even if they haven't requested it, can add great cost to the system. Similarly, allowing consumers to obtain unlimited numbers of free credit reports on themselves can lead to abuse.

15. Consumer outreach and education. The role of credit reports is often misunderstood by consumers. People seldom think about or review their credit report until they have a problem so the association they have with credit reports is often a negative one. Consumers are unlikely to fully appreciate the role that credit reports have in facilitating access to credit or how they may contribute to a more competitive credit market. When there is a problem, consumers may not know the laws and regulations pertaining to this activity or their rights and responsibilities under these statutes. An important role for the regulator is outreach and education to consumers, both so as to ensure that consumers are able to exercise their basic rights and to encourage the development of the industry. The regulator can accomplish this function in many ways including making available the laws and regulations pertaining to credit reporting in easy-to-understand formats and via multiple media (websites, in writing, information distributed at banks, etc.) and by sponsoring or encouraging public service ads and announcements related to credit reporting. The regulator can also require that notices of an adverse action based on a credit report include information about the consumer's rights under the law. The public outreach function for regulators may be particularly important when a credit reporting system is first established in order to gain the public's confidence and maximize participation in the system.

We hope that this brief overview will be helpful in your work. Please do not hesitate to contact us at

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For more information on our work and for links to the texts of some of the laws relevant for credit reporting in countries around the world, please refer to our website:

http://econ.worldbank.org/programs/credit_reporting

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