EXPANDING ACCESS TO FINANCE AND DEVELOPING ECONOMIES: THE FUNDAMENTAL ROLE OF CREDIT BUREAUS

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Collateralization of loans and the threat of bankruptcy are tools used to deal with market failures in credit markets. However, for many countries seizure and liquidation of collateral, and bankruptcy proceedings can be costly and time consuming. An extensive reliance on collateralization exacerbates credit constraints for small and medium size (SMEs) firms and new firms, since they may lack fixed assets to be used as collateral. One approach to facilitate lending by reducing asymmetric information in credit markets is to establish a credit reporting system – and namely, strong credit bureaus. This article focuses on the impact of well designed credit information systems on financial sector deepening and briefly describes 'good practice' in the design of a credit bureau.

Consumer and small business finance is of great significance to the International Finance Corporation (IFC) – the private sector arm of the World Bank Group - given its commitment to increasing access to financial services for the underserved. Thus support for the development of private credit bureaus through technical assistance and investment is a core part of IFC's work in the financial sector and developing countries.

The importance of Credit Bureaus in the new competitive challenge

The credit industry has been undergoing a strong change spurred by globalization and by technological development over the last years. Competition among financial institutions has been increasing fiercely everywhere and the challenge regarding the expansion of credit comes to the fore through the acquisition of new and good retail customers - individuals, sole proprietors and small and medium enterprises (SMEs). Growing retail and SME lending requires that client banks introduce adequate risk management and loan approval processes to ensure that growth remains healthy.

On the other hand, firms, globally, consider access to finance as one of the principal constraints to start-up and growth. Credit constraints are even more pronounced in middle and low-income countries, where access to commercial finance is scarce, particularly for anything other than short-term loans. Repeatedly, economic studies have linked credit rationing and the inefficient allocation of credit to market failures arising, mainly, from asymmetric information and moral hazard.[1] Information asymmetries occur when lenders have incomplete information in assessing the credit risk of borrowers, while borrowers know more about their ability to repay loans. The logical follow on is to develop institutions that reduce either one of these features in order to increase the availability of credit for productive firms.

In this scenario, good management of credit risk becomes a key factor in the competitive challenge, and it not only requires that each financial institution is well equipped with policies, procedures and experienced human resources for credit risk management, but it also requires a robust and reliable information infrastructure, which is mainly provided by private credit bureaus. The use of credit bureau information - and of value-added services the latter can provide, such as credit scoring - can significantly reduce risks of default and enable banks to lend to new segments of the market.

[1] Stiglitz and Weiss (1981) -"information asymmetries" contribute to market inefficiency and can be reduced by allowing greater access to information which should increase the quantity of lending, although the price of loans may not decrease unless the credit market is competitive and information can flow easily between institutions. Moral hazard arises when one party (lender/borrower) to a contract can change their behavior to the detriment of the other party once the contract has been concluded.

Credit Bureaus: why are they needed and what are their characteristics

Up to 25 years ago, only one third of the countries in the world had a credit bureau. Nowadays 80% do. This growth has mainly occurred in the developing world, particularly in Latin America, Asia and Eastern Europe.

Credit Bureaus ease the flow of information and access to finance constraints. Information sharing institutions have a positive impact on the amount of credit granted by the financial sector, enable a wider range of borrowers to access credit, and have reduced the level of non-performing loans and default rates in a number of countries.[2]

To summarize, credit bureaus have the potential to:

- reduce asymmetric information in credit markets and increase access to credit,
- provide financial institutions with information - with excellent predictive power - to determine the borrowers' ability to repay loans
- reduce loan default rates
- reduce the sensitivity of a firm's decision to finance investment based on cash flow/internal funds availability
- extend the terms of credit for firms and allow them not to depend on short-term (trade or suppliers credit), particularly, for small firms
- ease credit constraints in the small and new business loan market by providing standardized information on borrowers and easing the cost and time needed by banks to assess such loans[3]
- encourage borrowers to repay loans in order to build "reputation collateral" for future borrowing.

The latter point is particularly relevant, as it captures the important "educational" role that Credit Bureaus can play, as borrowers who know that their credit reports will be shared among creditors, are motivated to pay off their debts regularly.

Key Characteristics of Well-Performing Credit Bureaus

In order for a credit reporting system to have an impact on the credit market, there must be a wide range of creditors (bank and non-bank institutions, including utility companies, telecoms etc.) that exchange detailed and historical information on the payment and borrowing behavior of individual and firms through credit bureaus. The data collected by credit bureaus must facilitate creditors' ability to determine creditworthiness of a borrower and provide value added to credit risk analysis. In addition to relevant personal data on borrowers, important aspects of credit registries include the following:

- Negative data (late payments, defaults and other irregularities)
- Positive data (debt outstanding, even those paid on schedule)
- Historical data on borrowers credit activities
- Data from various sources (public or private sources-- utilities, court records, retailers)
- Allow access to data by a wide range of creditors (bank and non-bank institutions)
- Allow borrower to access their credit data and correct any discrepancies through a proper dispute resolution system

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[2] Jappelli and Pagano (1999), World Bank (2005) and others.

[3] Love and Mylenko (2003) found that 40 percent of firms were able to obtain bank credit in countries with bureaus versus 28 percent in countries without a bureau.

Historical positive and negative information on borrowers as well as wider access of data by lenders are the most important components of credit bureaus. These aspects of credit registries have been found to have significantly increased the predictability of credit risk and thus ease credit constraints in credit markets.

The importance of positive credit information

All markets with a developed consumer credit economy are supported by a credit bureau which collects and shares both positive data and data from different market sectors across. The most efficient way to accurately predict the likelihood of default is to share positive data not just within a market sector – for instance, banks - but also across different market sectors so that the full picture of the borrower can be provided. There are several countries where consumer lending is – or has been - in crisis for lack of credit bureaus sharing positive and full data.

By sharing both positive and negative information, lenders can make better lending decisions, use risk-based pricing methods more effectively, actively manage credit lines, collect debt more successfully, and reduce fraud. Consumers and firms with good credit histories can borrow to more equitable limits, receive lower interest rates, and get access to more credit products.

Conclusion

Credit registries have been around for a long time but have gained importance in the past two decades, in both developed and developing countries, due to changes in the banking system, advances in technology, and recognition of the important role they play in easing credit constraints. Also, economic crises, which have roots in financial sector distress, have encouraged countries to establish and/or fortify credit registries, e.g. the "1994 Tequila Crisis", caused by non-performing loans in the banking sector, encouraged the government of Mexico to create a private credit bureau.

Recent research shows that the private sector of countries with a well performing credit reporting system enjoy a greater access and availability to credit, and better loan pricing than those without credit registries. Credit registries do reduce information asymmetries and lead to lower default rates and to more efficient credit markets. Private credit registries play a key role, particularly, in easing access to finance for individuals, small and new firms.

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