CREDIT INFORMATION SYSTEMS

[Principle B1]

Credit Information Systems

A modern credit-based economy requires access to complete, accurate and reliable information concerning borrowers’ payment histories. Key features of a credit information system should address the following:

B1.1 Legal framework. The legal environment should not impede and, ideally, should provide the framework for, the creation and operation of effective credit information systems. Libel and similar laws have the potential of chilling good faith reporting by credit information systems. While the accuracy of information reported is an important value, credit information systems should be afforded legal protection sufficient to encourage their activities without eliminating incentives to maintain high levels of accuracy.

B1.2 Operations. Permissible uses of information from credit information systems should be clearly circumscribed, especially regarding information about individuals. Measures should be employed to safeguard information contained in the credit information system. Incentives should exist to maintain the integrity of the database. The legal system should create incentives for credit information services to collect and maintain a broad range of information on a significant part of the population.

B1.3 Public policy. Legal controls on the type of information collected and distributed by credit information systems can be used to advance public policies. Legal controls on the type of information collected and distributed by credit information systems may be used to combat certain types of societal discrimination, such as discrimination based on race, gender, national origin, marital status, political affiliation, or union membership. There may be public policy reasons to restrict the ability of credit information services to report negative information beyond a certain period of time, e.g., five or seven years.

B1.4 Privacy. Subjects of information in credit information systems should be made aware of the existence of such systems and, in particular, should be notified when information from such systems is used to make adverse decisions about them. Subjects of information in credit information systems should be able to access information maintained in the credit information service about them. Subjects of information in credit information systems should be able to dispute inaccurate or incomplete information and mechanisms should exist to have such disputes investigated and have errors corrected.

B1.5 Enforcement/Supervision. One benefit of the establishment of a credit information system is to permit regulators to assess an institution’s risk exposure, thus giving the institution the tools and incentives to do so itself. Enforcement systems should provide efficient, inexpensive, transparent and predictable methods for resolving disputes concerning the operation of credit information systems. Both non-judicial and judicial enforcement methods should be considered. Sanctions for violations of laws regulating credit information systems should be sufficiently stringent to encourage compliance but not so stringent as to discourage operations of such systems.
1. A modern credit-based economy requires access to complete, accurate and reliable information concerning borrowers’ payment history. Key features of a credit information system should address the following. An effective credit information system can be integral to the operation of modern financial systems. Credit information systems can include a number of functions, including collecting, analyzing, and distributing information about how consumers and businesses, large and small, handle their credit obligations. This type of information has proven to be an effective tool for a variety of purposes, including assessing the risk faced by creditors, as past payment experience is a strong predictor of future performance. Credit information systems also make it possible to empirically assess, in the form of credit scoring tools, which factors are most predictive, permitting finely tuned credit decisions. As a result, creditors can more intelligently assess consumer and business lending decisions, thus promoting the extension of credit and economic development in the countries in which they operate. Also, creditors are in a better position to develop numerous credit offerings tailored to the risk presented by borrowers’ unique credit histories. Credit information systems promote competition among lenders, thus reducing the cost of credit. In fact, such systems can also increase the ability to attract foreign investment capital by providing foreign creditors a rational basis on which to evaluate credit risk. This regionalization and globalization of credit granting is further enhanced if consistent or at least transparent information collection standards are employed.

Legal Framework

2. **Basis for Operation of Credit Information Systems.** The legal environment should not impede and, ideally should provide the framework for, the creation and operation of effective credit information systems. Establishment and operation of credit information systems may be impeded or prevented by legal prohibitions or uncertainties concerning the application of laws relating to the collection, disclosure and use of financial information. For instance, bank secrecy laws may be perceived to prohibit banks from sharing information about their customers’ accounts and payment history with a credit information system. The existence of such laws can chill the creation or operation of credit information systems.

3. Enabling legislation is not required for the development of credit information systems. Many credit information systems have developed organically so long as laws did not prevent their operation. Nonetheless, concerns about fair use of information have led to passage of legislation authorizing and regulating the existence of credit information systems. Passage of such legislation removes doubt about the legal viability of such entities and by creating greater regulatory certainty may encourage entrants into the credit information systems marketplace.

4. **Liability Protections.** Libel and similar laws have the potential of chilling good faith reporting by credit information systems. While the accuracy of information reported is an important value, credit information systems should be afforded legal protection sufficient to encourage their activities without eliminating incentives to maintain high levels of accuracy. There are a number of potential legal impediments to the development of credit information systems. One of the most significant is the existence of libel laws, laws that permit legal actions based on false publications that damage a person's reputation. The information maintained in a credit information system is of the type likely to damage a person's or
company’s reputation if publicly known. This may include failure to pay bills or filing bankruptcy. While credit information systems should be encouraged to maintain high standards of accuracy, potential exposure to libel actions -- even as a result of inadvertent mistakes -- could discourage their operation or make them unwilling to report information unless there was no question about its accuracy. Even with the best intentions, it can be difficult to develop certainty concerning the accuracy of information being reported. Accordingly, some protection from libel or similar actions can be critical to the existence of comprehensive credit information systems. Such protections should not relieve credit information systems from the responsibility to provide reasonably accurate information. Instead, standards more geared to the challenges of operating a credit information system should be substituted.

Operations

5. Use Restrictions. Permissible uses of information from credit information systems should be clearly circumscribed, especially regarding information about individuals. Credit information systems collect a wealth of information about individuals and businesses. Much of that information could have a serious impact on reputations and financial standing. The information could be used in negative and potentially harmful ways, such as for purposes of blackmail or referrals to criminal authorities for tax evasion. On the other hand, if the information is used for legitimate, beneficial purposes, the existence of the credit information system is likely to receive public acceptance. Legally imposed use restrictions can address these concerns.

6. Data Security. Measures should be employed to safeguard information contained in the credit information system. To the extent information in credit information systems is sensitive, and to avoid undermining use restrictions, such systems should employ reasonable methods to protect the security of such information. As appropriate, these methods may include physical, electronic and procedural safeguards to protect against improper data access.

7. Credit information services can provide valuable information for assessing repayment risk, likely profitability of accounts, debt collection, marketing, employment screening, tenant screening, claims analysis, insurance underwriting, market research, and economic trends. A sound environment for managing credit and insolvency risk requires reasonable access to accurate, reliable and current credit information on borrowers that affords adequate protection and safeguards for the privacy of borrowers and that is governed by general rules of due process.

8. The legal environment should provide a transparent procedure that contains incentives for gathering and dispensing information. Access should be provided to firms engaged in credit activities and not limited to particular types of entities, e.g., banks. While there may be arguments to limit access to firms that furnish information to the credit information service, this could unduly limit potentially beneficial users, especially firms that are just starting up and may not yet have significant amounts of information to contribute.
9. Transparency and good corporate governance are the cornerstones of a strong lending system and corporate sector. Transparency exists when information is assembled and made readily available to other parties and, when combined with the good behavior of “corporate citizens,” creates an informed and communicative environment conducive to greater cooperation among all parties. Transparency and corporate governance are especially important in emerging markets, which are more sensitive to volatility from external factors. Without transparency, there is a greater likelihood that loan pricing will not reflect underlying risks, leading to higher interest rates and other charges.

10. **Data Integrity.** *Incentives should exist to maintain the integrity of the database.* Credit information systems can be used in a variety of ways. Some uses, such as evaluating credit risk, rely on a database containing historical data on as large a number of potential borrowers as possible. Other uses may not require that data be maintained for extended periods of time. One such use can be as a means of collecting past due obligations by encouraging repayment to have one’s name removed from the list. In that context, it might make sense to remove a debtor’s name from the database when the obligation has been satisfied. However, if the database is also to be used to make future risk assessments, removal of that information might encourage payment of the particular debt at issue, but it would undermine the ability to identify borrowers who have fallen behind in their payments in the past. If a database is to be used, even in part for credit risk assessment, there should be incentives in place to keep data in the system even after that particular creditor’s loans have been repaid.

11. **Scope of Data.** *The legal system should create incentives for credit information services to collect and maintain a broad range of information on a significant part of the population.* Credit information systems are most effective and enhance risk prediction if they contain data on a large segment of the population. The more ubiquitous their coverage, the better they can serve financial institutions in evaluating applicants for credit. Many existing credit systems work effectively through voluntary contribution of data by creditors who recognize it is in their self-interest to contribute information on their customers. If voluntary contributions are ineffective in creating a robust credit information system, legal requirements to report information could be imposed on creditors. Such requirements could avoid the problem that large incumbent creditors may choose not to contribute information due to the concern that reporting will facilitate creditors’ competing for their existing customers.

12. There is strong empirical evidence that systems that collect both positive and negative payment histories permit more accurate risk assessments. Those same systems present the potential of financial institutions identifying their best customers to competitors, thus discouraging participation in the system. Alternatives exist to reduce the risk of losing customers, such as not allowing credit information systems to be used to target specific financial institution’s customers. However, it should be noted that these alternatives do potentially reduce some of the beneficial competition that results from increased access to credit information.

13. One means of increasing demand for credit information services would be if creditors, both consumer and commercial, were expected as part of due diligence on extending credit to
consider the borrower’s credit history. This would serve the dual purpose of improving those firm’s risk controls and creating a necessary market for credit information systems.

Public policy

14. **Collection and Use Restrictions.** Legal controls on the type of information collected and distributed by credit information systems can be used to advance public policies. Control of the use of information collected by credit information systems, or even controls over the type of information such systems are permitted to collect, can be used to advance public policy goals. These public policy goals may often be in tension with the risk assessment functions of credit information systems. In theory, those systems collect the maximum information they can efficiently collect and use it to predict risk. If they were not permitted to use certain types of information, due to public policy concerns, the ability to predict risk based on the available data could be diminished. There are often public policy judgments made to sacrifice the predictive value of the data in favor of advancing other social or economic goals.

15. **Anti-discrimination.** Legal controls on the type of information collected and distributed by credit information systems may be used to combat certain types of societal discrimination, such as discrimination based on race, gender, national origin, marital status, political affiliation, or union membership. There are often legitimate societal values that call for assessment of credit risk, either individual or business, based solely on prior credit experience, as a method of equalizing treatment of borrowers. In some cases, this could result in a prohibition on collecting certain types of information, such as demographic or other data about borrowers that goes beyond their prior loan payment experience, including gender, marital status, or race. The absence of such data collection and use restrictions might well enhance the ability to predict risk, such as by concluding that men pose a greater credit risk than women, or foreigners are more credit worthy than citizens of a country. However, there may be strongly held societal values calling for equal treatment regardless of certain characteristics. These values may be deemed worth the economic costs of reducing the ability to predict risk based on credit information system data. This may result in prohibitions on collecting or using certain information about borrowers, e.g., race, gender, etc.

16. Ironically, there is another approach to combating discrimination that is directly at odds with reducing the collection of information. Rather than excluding information concerning protected characteristics, in some cases, lenders may be required to collect such data. The data is collected not for its predictive value but instead to use as a basis for evaluating whether the financial institution is making decisions based on prohibited characteristics.

17. **Obsolescence.** There may be public policy reasons to restrict the ability of credit information services to report negative information beyond a certain period of time, e.g., five or seven years. Certain types of information in a credit file have the potential of seriously impeding a business’ or individual’s ability to get credit. One such example is the filing of a bankruptcy petition; another is a series of loan defaults. The knowledge that an individual or company was forced to resort to bankruptcy because their obligations exceeded their assets could lead future creditors to decline to extend them credit. While this is quite rational, the
consequence can be the lifetime of economic destruction for an individual or company. In such cases, the government might find itself burdened with providing assistance.

18. Yet, in many cases, late payments or even bankruptcy filings are precipitated by causes beyond an individual’s control, such as a natural disaster, unexpected medical costs, or loss of employment or a contract. It may not signify a permanent inability to manage financial affairs. As a result, there can be a desire to allow borrowers who have at one time failed to fulfill their financial obligation to rebuild their credit histories through subsequent good behavior. A credit information service could undermine this goal by continuing to report the existence of the negative information indefinitely. As a result, there may be important policy reasons to prevent the reporting of certain types of negative information, e.g., late payments, court judgments, tax liens and bankruptcies, beyond a reasonable period of time, such as five to seven years. By contrast, there might be other types of negative information, e.g., convictions of serious crimes, that are in society’s interest to report for longer periods of time or even indefinitely. It is possible to craft regulation of reporting practices by credit information services to address and balance these policy concerns.

Privacy

19. Notice. Subjects of information in credit information systems should be made aware of the existence of such systems and, in particular, should be notified when information from such systems is used to make adverse decisions about them. Citizens in a country are often troubled by the existence of secret, hidden databases that contain information about them, regardless of whether those databases are maintained by the government or private firms. The legitimacy of credit information systems will be enhanced, and public apprehension reduced, if there is transparency concerning their existence and operations.

20. Aside from a general awareness of the existence of such systems, it can be critical to inform data subjects that information from those systems was used to make adverse decisions about the subject. It is impossible for databases containing thousands, if not millions, of files from numerous sources, public and private, to maintain current accurate information about a population that may have similar or identical identifiers, who do not use their personal identifiers in a consistent manner in all their interactions, who change identifiers over time (e.g., by getting married), and who move frequently. If erroneous data from those systems is used to make adverse decisions about individuals or companies, and the subject is not notified of the source of the data that led to the adverse decision, the subject will have no opportunity to correct the misinformation. As a result, the subject will continue to face rejections based on incorrect credit information system data. Not only is that unfair to the subject, it cast doubts on the operation of the system. It also means that users of the system will continue to be provided inaccurate data that will lead to incorrect risk assessments.

21. Notifying subjects that adverse action was taken based on credit information service data can also be a tool in policing anti-discrimination laws. If data subjects are permitted access to their information (see below), they can assess whether there are legitimate, non-discriminatory grounds for the denial. For example, if they have comparable credit standing to other borrowers who were granted credit, and the only difference between the applicants is gender or race, they might be able to establish that discrimination has occurred.
22. It would also be possible to structure a credit information system to only collect or use information with the consent of the data subject. However, giving data subjects control over their inclusion in the database, as opposed to process rights over the use of their data, risks allowing individuals or businesses with poor credit to exclude themselves or limit access to their complete credit history. These are the very people or entities creditors most need risk information about.

23. **Access.** Subjects of information in credit information systems should be able to access information maintained in the credit information service about them. Access to data by subjects can serve a number of important purposes. First, greater transparency about how the database operates and the type of information maintained can enhance public confidence. Second, only with access can data subjects who have had adverse action taken against them based on data in the service, determine whether that data is erroneous. Third, in the case of distressed enterprises, it can be helpful to have clear laws and procedures that require disclosure of, or access to, timely and accurate financial information on the distressed enterprise. This can encourage lending to, investment in or recapitalization of viable distressed enterprises. It also helps support a broad range of restructuring activities, such as debt write-offs, reschedulings, restructurings and debt-equity conversions; and provide favorable or neutral tax treatment for restructurings.

24. In addition, the Principles and Guidelines for Effective Insolvency and Creditor Rights Systems call for laws that require the provision of relevant information on the debtor that could be accomplished by a credit information service. In addition, those Principles state that corporate workouts and restructurings should be supported by an enabling environment that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An enabling environment includes laws and procedures that require disclosure of, or ensure access to, timely, reliable and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable financially distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, reschedulings, restructurings and debt-equity conversions; and provide favorable or neutral tax treatment for restructurings. A viable credit information service can advance these goals.

25. **Dispute Rights.** Subjects of information in credit information systems should be able to dispute inaccurate or incomplete information and mechanisms should exist to have such disputes investigated and have errors corrected. It is of limited value to simply make data subjects aware that erroneous information from a credit information service served as the basis for an adverse action concerning them. In order to make that information useful, there must be mechanisms in place, either voluntary or mandated, to have such disputes investigated and, if information turns out to be erroneous, have the information corrected.

26. There are often timeliness concerns about resolving information disputes, perhaps because a business needs a financial commitment in order to sign a lease or a consumer wishes to purchase a new home that will go to another potential buyer if funding cannot be arranged. Thus, some requirement of timely consideration of disputes may often be critical to making the dispute right meaningful.
27. Similarly, a cursory review of a dispute, with no real effort to investigate and learn the correct information, can serve to make dispute rights meaningless. In some cases, the error may be apparent on its face, such as a date of birth of an infant belonging to a senior citizen. In others, there may be a need to contact the furnisher of the information to verify its accuracy. Oftentimes the extent of the investigation will be determined by the nature of the dispute.

**Enforcement/Supervision**

28. **Supervisory Function.** *One benefit of the establishment of a credit information system is to permit regulators to assess an institution’s risk exposure, thus giving the institution the tools and incentives to do it itself.* While the principle focus of credit information systems is to permit financial institutions to gauge the risk posed by borrowers, those systems provide valuable tools for regulatory agencies to supervise institutions under their jurisdiction. Credit information systems permit efficient systematic analysis of a financial institution’s loan portfolio, including its size, diversity, and risk levels over time.

29. **Effective Enforcement Systems.** *Enforcement systems should provide efficient, inexpensive, transparent and predictable methods for resolving disputes concerning the operation of credit information systems. Both non-judicial and judicial enforcement methods should be considered.* In light of the important financial and privacy interests involved in reporting credit information, there is a need for a mechanism to resolve disputes relating to accuracy and proper disclosure. This mechanism can exist in the courts, through administrative processes, government oversight, or self-regulatory organizations.

30. **Proportional Penalties.** *Sanctions for violations of laws regulating credit information systems should be sufficiently stringent to encourage compliance but not so stringent as to discourage operations of such systems.* While compliance incentives serve a valuable role in maintaining the integrity of a credit information system, there is a risk of over-deterring conduct by making the penalties for violations too costly. At the extreme, this could deter operations of such services.