GUIDELINES FOR SUPERVISION OF CREDIT REFERENCE BUREAUS

CENTRAL BANK OF KENYA

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GUIDELINES FOR THE ON AND OFF-SITE SUPERVISION OF CREDIT REFERENCE BUREAUS

CENTRAL BANK OF KENYA

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Table of Contents

BACKGROUND ON CREDIT BUREAUS

Creditors have a disadvantage versus the loan applicant to know all pertinent information on a credit application, known as moral hazard.

Credit Bureaus are information brokers. They may be set up by lenders and operated by them, or they may be for-profit institutions that provide detailed data.

In some cases, starting in central Europe and in Latin America, but now expanding to Africa and elsewhere, the central bank or another regulatory agency creates a compulsory mechanism of public credit registrars or credit risk centrals that usually provide aggregated data on mayor business borrowers.

We limit the description of credit bureaus in this Guidelines paper to the exchange of information, without analysis, on the credit history of individuals and small firms to serve the needs of lenders in consumer housing and finance, micro finance, and small business trade credits and finance.

Other specialized institutions (such as Dun & Bradstreet in the U.S.), assess the creditworthiness of firms, usually at the request of other firms considering extending trade credit. In addition, other firms (such as Standard and Poor's) conduct independent risk-rating analyses of larger firms and even of countries to support their issuance of debt instruments in national and/or international money and capital markets

An international survey of credit bureaus was sponsored by the Inter-American Development Bank (I.D.B.) to test the theory that information sharing among lenders attenuates adverse selection and moral hazard and can therefore increase lending and reduce moral hazard.[1]

The evidence reports that there are economies of scale, the larger the data base of a credit bureau, the more complete and accurate its information. In addition, that study found that:

- Credit bureaus enable lenders to lend to more and better risk clients (avoiding dead beats) and to better determine (and lower) the interest rate spread that they need to cover expected losses of extending credit to good payers.
- Credit bureaus reduce the borrowing cost to the public by forcing creditors to be more competitive for good borrowers. Those lower costs for good credit risks motivate borrowers to be more careful with repayment.
- Credit bureaus reduce moral hazard by developing a credit culture where they operate, as borrowers become aware that the credit market becomes aware of their credit history, and rewards or punishes them accordingly.

After reviewing empirical evidence, the I.D.B.-sponsored study concludes that, in competitive markets, "information sharing improves the pool of borrowers, decreases defaults and reduces interest rates."

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[1] *Information Sharing in Credit Markets: International Evidence* by Tullio Japelli and Marco Pagano, June 1999 Inter-American Development Bank Work Document R-371

Credit bureaus provide creditors with reliable, relevant and comprehensive data on the repayment habits and current debt of their credit applicants. Under reciprocity agreements, credit bureaus obtain data from creditors and other sources, consolidate and package information into individual reports, and distribute it to creditors for a fee.

The population covered by credit bureaus is mostly the middle to lower income segments of the population. In developing countries, this means the middle, lower middle and working classes, excluding the subsistence and upper classes.

Reciprocal exchanges of information by creditors on the credit history of their borrowers take various forms, usually evolutionary. A significant phase is when creditors create mechanisms. A modern credit bureau acts as the specialized information channel and is the efficient and effective way to quickly gather, file, organize and provide credit reports in a massive scale.

Data accuracy is a goal shared by all participants. The avoidance, reduction, or correction of data inaccuracies or mistakes should be designed carefully to promote a fluid and cost-effective information exchange system.

The definition of ¨credit¨ obligations to be reported by creditors to CRBs should include obligations to meet contractual payments, such as financial and real estate leases, insurance and medical coverage contracts, utility services, etc.

ROLE OF THE CENTRAL BANK

The Central Bank as a Facilitator

Given that the clear benefits of credit bureaus fall within the mandate and objectives of central banks, the CBK needs to serve as a facilitator, working with stakeholders to develop clear legal and regulatory framework and a broad credit reference system that provides: a high value product with nominal fees; operating rules that are participant-neutral; cost sensitive procedures, rules understood by all participants; a high volume of data and reports; consumer confidentiality, transparency in transactions; data accuracy; easy error correction; reasonable consumer protection; and the flexibility to broaden participation to non financial creditor and related and other stakeholders (such as employers and landlords) activities. Product innovation by individual CRBs should be welcomed and facilitated.

The Central Bank as an Honest Broker

The development of a credit reference system involves fears by the stakeholders: creditors worry that their better credit customers are going to be stolen by competitors with unauthorized access to their files; data providers fear that they are going to be sued, particularly as individuals, by disgruntled customers for invasion of privacy, slander, etc., as a result of good faith participation in the provision of credit histories; customers fear that they may be black listed and that they may be affected by mistakes; subscribers to credit reports fear that they may be sued for whatever use they make of credit reports. All participants recognize the benefits of a well functioning credit information system and look to the central bank to establish and enforce a level playing field, particularly when the law gives it ownership of the CRBs´ database.

Balance between consumer protection and allowing CRB operations. Credit bureaus face substantial technical obstacles to obtain, screen, identify, and consolidate, massive amounts of records. The prevention of mistakes, particularly by data providers, but also by the credit bureau, and the handling of credit customer complaints are a significant burden. Credit individuals identified as defaulters suffer market sanctions. A balance needs to be identified that is fair to participants.

The Central Bank and Data Protection

The European-style agencies or regulations for data protection can unnecessarily burden the work of credit bureaus, significantly limit their effectiveness, and substantially increase costs. The U.S. model of fair credit reporting, though not perfect, is a better example of best practices.

On the other hand, the wish by creditors to rely on credit scoring for credit decisions (as compared with portfolio credit risk management) may impose unfair and arbitrary limitations to credit by individuals merged into risk groups by credit bureaus on the basis of debatable statistical analyses. Additionally, creditors relying on credit scores for credit decisions may relax or abandon the use of prudent credit principles. Since the *Banking (Credit Reference Bureau) Regulations* permit credit bureaus to ¨assess¨ the credit worthiness of credit customers, the CBK needs to be especially vigilant regarding the provision and use of credit scores. Credit scores should only be allowed after the methodology used by the CRBs (not their proprietary algorithm) is reviewed by the CBK and also, more importantly, after the proposed users receive guidance on the proper and the incorrect uses of credit scores in credit decisions.

Certain instructions by regulators or data protection agencies can reduce many disputes without affecting the integrity of the system. For instance, eliminating the tracking, by credit bureaus, and the inclusion in credit reports, of arrears or unpaid fees below a certain minimum (US $10) in many places has lowered the amount of disputes and increased acceptance by the public of the credit reference system.

The CBK should maintain a log book with queries from CRBS and participants, by topic, and recording the corresponding CBK replies and CBK resolutions.

The CBK should require that its approval of the formats of the data provision and credit report subscription agreements between the CRBs and participants. These agreements, to the maximum extent possible, should require participants to have a copy of the requirements, their undertaking to comply with them, and their acceptance of the right of the CRB and of the CBK to conduct inspections to supervise compliance.

The on-site inspection by the CBK of banks and other financial institutions should include verification that credit reports are: obtained only after the customer authorizes it in writing; used for the authorized purposes; and, stored as confidential information with restricted access. Results of these verifications should be communicated by the CBK bank and other financial institution auditors to the CBK manager in charge of credit bureau supervision.

The CBK should, as it proposes, works with financial industry and/or commerce or better business associations to delegate to a committee the resolution by arbitration of customer complaints not solved by the CRBs. This committee may include or be composed of retired CBK and bank officers, as was established in Nigeria. The CBK would, of course, either confirm committee determinations, or a least retain the right to monitor and supervise the process of resolving consumer disputes, including the avoidance of repetitive causes, through amendments in the CBK guidelines or instructions to CRBs. The CBK should require CRBs to allow customers who are still unsatisfied, after creditors review their data submissions, to ask the CRB to insert a brief statement by the consumer on the disputed credit transaction. Financial institutions should be required by the CBK to consider those consumer statements in their credit decisions based on the credit report. As much as possible, simple alternatives for obtaining credit reports, and for asking and following up on the investigation and resolution of disputes, should be offered to consumers located outside of Nairobi, without burdening the CRBs. For instance, the use by CRBs of authorized agents to dispense mandatory credit reports to individuals and to receive notification of disputes, and regional sub committees.

OFF-SITE SUPERVISION OF CREDIT REFERENCE BUREAUS

The off-site supervision by the CBK of CRBS should consist of the examination of a comprehensive periodic (monthly) report to be submitted by licensed CRBs, to include:

- Identification of any problems identified by the CRB, or reported to the CRBs by participants.
- Description of internal, participant, and third-party, data security incidents.
- Compliance with the use of CBK-approved agreements for data provision and subscription to credit reports
- Actions, if any, undertaken by the CRBs to ensuring that all participants comply with regulations, including subscribers.
- Report that all required procedures were adhered to, with exceptions and corrections noted.
- Report on the number of consumer complaints, presented and resolved within the required dates, and with date brackets for complaints not resolved in time.
- Statistical registry of the number of regular and occasional data providers, type and number of subscribers.
- Fees charged – the CBK should allow the market to decide the fees whenever feasible, but should monitor them to avoid collusion or distortions.
- Report giving the breakdown of the services provided by CRBs to subscribers.
- Specific report on the participants and volume of any service to assess the credit worthiness of customers.
- The CBK should require financial institutions, and as possible, all data providers to provide to CRBs data on all credit, and not to selectively report some credit records and not others. Allowance must be made for cases where records are incomplete, or there is doubt by the CRB that the data is accurate or useful.

The cooperation of the Bank Supervision Department and the ICT Department should continue as planned. The monthly reports received by the CBK from the CRBs should be reviewed for technical and logical consistency by the ICT Department.

ON-SITE SUPERVISION OF CREDIT REFERENCE BUREAUS

- Determine that the primary and alternate premises are still suitable for operations.
- Verify that monthly reports submitted to the CBK by a CRB are validated by the internal records of the CRB.
- Verify using the check list for the physical inspection carried out at the time of licensing, that the CRB´s systems, procedures, and facilities, are valid.
- Verify that the CRB staffers know and follow their assigned specified procedures.
- Verify that the security and control protocols are relevant, and implemented.
- Verify that the protocols for updating and maintaining information are still valid and that are followed.
- Verify that the business continuity provisions are in place and are still valid.
- Verify that data providers and subscribers of credit reports are aware of the required procedures, and that the CRB has on file signed agreements for each participant.
- Verify that consumer complaints are handled as required and that logs and records are maintained and updated.
- Verify that audit trails in the system are valid, and that protocols for internal and external user access, including passwords and logs, are adhered to.
- Verify that the restrictions on the nature of information to be shared are adhered to.
- Verify that any service to assess the credit worthiness of customers is based on sound statistical methodology.
- Verify that information sharing restrictions are adhered to, such as the limitations between credit reference reporting and credit collections.