PRINCIPLES ON CREDITWORTHINESS ASSESSMENTS

A perspective from the credit reference industry

6 November 2018

Introduction

a) Creditworthiness assessment requirement

Access to finance is the ability of individuals or businesses to obtain financial services, including credit. It plays, therefore, a vital role in consumers' economic and social life. Access to finance also supports the EU Member States' economic growth.

Credit should not, however, be granted to everyone, but only to those who can afford to repay it. Otherwise, a consumer's financial wellbeing and, ultimately, the stability of the financial system could be undermined. The ongoing financial crisis has demonstrated the adverse effects that inappropriate lending can have on individuals, banks and, even, countries.

The final decision to grant credit resides entirely on a lender. This does not mean that such a decision can be taken in disregard of the interests of the consumer and of the wider economy: to ensure that consumers are protected against over-indebtedness and that markets operate efficiently, lenders are obliged to assess a borrower´s creditworthiness before concluding a credit agreement. The obligation to assess the creditworthiness of individuals is one of the regulatory tools usually considered a duty of 'responsible lending' and is included in two European Directives[1].

In meeting the obligation to assess creditworthiness, a lender's own data and processes generally play an important role, which complements the data supplied by the borrower in the credit application. But, as recognised by the World Bank[2], lenders use the information (and services) provided by credit reporting systems as an important 'primary factor' when they evaluate the creditworthiness of potential borrowers.

b) Creditworthiness assessments and CRAs

Private Credit Reference Agencies (CRAs) - as well as public credit registers - are key actors in credit reporting systems[3].

CRAs hold information on consumer's past credit and current payment behaviour. This information is supplied by different types of lenders and other organisations. Relevant information is also collected from public sources. CRAs also add value to the information they receive or collect by merging and analysing it.

[1] Mortgage Credit and Consumer Credit Directives.

[2] General Principles for Credit Reporting, September 2011 – Foreword.

[3] Public registers and CRAs fulfil different roles and have different and complementary information, with CRAs generally having more information, collected from more sources (i.e. beyond the financial sector) and also providing other services such as scoring or fraud prevention. For example, in Spain, the CIRBE (public register) only includes debts worth EUR 9,000 or more with a single lender whereas no minimum threshold applies in the local CRAs.

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CRAs make information available to lenders prior to their lending decision-making processes.[4] In addition, CRAs provide lenders with analytics and scoring tools to support these processes. It is important to underline that CRAs are not involved in how all these information solutions are used by lenders - this is for them to decide, in the context of a consumer's credit application.

When it comes to consumers, CRAs make the data available to them, first, as part of their data protection rights and, second, as part of specific services[5].

As third parties between the interest of lenders and consumers, CRAs are called to play a role towards the fulfilment of public policy objectives e.g. responsible lending, credit risk reduction, avoidance of financial distress, financial inclusion, fight against over-indebtedness, etc.

As processors and / or controllers of personal data, CRAs are subject to requirements arising from data privacy regulations, in particular from the General Data Protection Regulation (GDPR) and relevant national legislation.

Based on that background, CRAs would like to share their views on creditworthiness assessments, views that are articulated around five principles.

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Principle 1. Creditworthiness assessments should meet two interconnected, primary policy objectives: reduction of financial distress and promotion of sound credit risk management practices in compliance with responsible lending requirements.

Creditworthiness assessments includes credit risk (to the lender) and affordability risk (for the borrower). Through the performance of creditworthiness assessments:

- Consumers / borrowers are prevented from the negative impacts on their wider financial situation that may arise from a debt that they cannot afford to repay. Creditworthiness assessments should, therefore, help reduce consumers' financial distress.

- Lenders can better predict future repayment prospects based on what a consumer's past and current payment behaviour as well as the present levels of indebtedness, income and expenditure are. Lenders, therefore, can better assess the credit risk associated with lending money or providing goods and services on credit. Creditworthiness assessments should, therefore, help ensure sound credit risk management practices.

By protecting both the consumers and the lenders, creditworthiness assessments also reinforce financial stability of national economies and promote access to finance.

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Principle 2. Creditworthiness assessments should be based on all data that is relevant, accurate and necessary for each specific credit application and deriving from all relevant data sources

Lenders need to ensure that creditworthiness assessments are based on all data that is relevant, accurate and necessary for each credit situation.

[4] CRAs hold data for uses other than for creditworthiness assessment purposes, including fraud and money laundering prevention (not covered in this paper).
[5] Direct -to- consumer services are only available in certain countries.

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Relevant data is data that has value in determining the probability of a consumer´s repayment behaviour[6].

Relevant data must be accurate, meaning that the data is correct, truthful, complete and up to date (as defined by the World Bank[7]). In order to better meet this requirement, any information on which the credit assessment is based should ideally be appropriately verified by reference to documentation, ‘independent’ of the consumer.

In addition, data used in creditworthiness assessments should include all data that is necessary to appropriately assess the borrower’s probability to repay the debt in each specific case.

Data which take part in creditworthiness assessments may derive from one or multiple data sources. Lenders have the flexibility to gather that data from among the existing different data sources, including the consumer him/herself.

That flexibility cannot, however, mean that lenders can disregard data sources that essentially contribute to the fulfilment of the ultimate policy objectives of any creditworthiness assessment[8].

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Principle 3. To effectively support creditworthiness assessments, credit reporting systems should contain optimal depth and breadth of data, including positive data.

In the majority of the EU Member States, credit reporting systems collect and process positive and negative credit data and data from a variety of sources and sectors. However, it is a fact that data collected and processed by CRAs differs across the EU, based on national legislations or approaches. Notably, not all credit reporting systems collect information on a borrower’s good payment behaviour (= positive credit information), and not all systems allow for non-credit data providers to contribute data to CRAs (e.g. utilities).

Sub-optimal data coverage in terms of depth and breadth of data reduces the accuracy of products such as credit scoring, increases the cost of credit, and contributes to both unduly restrictive lending and unaffordable lending. Conversely, credit reporting systems with optimal volumes of information a) help to ensure better compliance with the 'responsible lending' principle; b) enable favourable terms on credit granting for borrowers with good payment history and; c) could contribute to the expansion of access to credit to the underserved and unbanked.

It is, therefore, important to optimize the depth and breadth of credit reporting systems where existing national legislations or approaches have not allowed that evolution.

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Principle 4. Credit reporting systems should contain adequate information

Adequacy means that credit reporting systems only collect and process data that are limited to what is necessary for the purposes for which they are processed, i.e. help lenders to sell products that are affordable and suitable for borrowers.

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[6] In some EU Member States, it is compulsory for the lender to consider the existence of any payment defaults and credit history of the consumer in creditworthiness assessments, as these data are regarded as possessing a higher, predictive power about the possible default of a borrower. This so-called traditional credit data should however be differentiated from other sources of (non-traditional) data that could be, for example, complimentary to traditional data and whose actual relevance and necessity should be subject to careful evaluation.

[7] General Principles for Credit Reporting, September 2011 – General Principle 1 (pp. 25 – 29).

[8] In some EU Member States, lenders have the obligation to check the existence of certain information about the consumer e.g. any payment defaults and credit history of the consumer. See ‘Mapping of national approaches in relation to creditworthiness assessment under Directive 2008/48/EC on credit agreements for consumers’ (October 2018).

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In addition, adequacy means that data is only retained for the time necessary to achieve this purpose[9]. While excessive retention periods can render data obsolete (losing its predictive value), too short retention periods may also reduce the ability of lenders to perform effective creditworthiness assessments given the lack of a sufficient numbers of years of relevant data (an issue that exist in some EU countries).

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Principle 5. All lenders across the EU should have access to CRAs in other EU countries on a non-discriminatory basis.

In the case of cross-border data access for creditworthiness assessment e.g. for cross-border credit, and in order to avoid any discrimination, each Member State shall ensure access for lenders from any other Member State to the local credit databases, including to CRAs, under the same conditions as local firms i.e. with no additional barriers or privileges and respecting the principle of reciprocity.

[9] General Principles for Credit Reporting, September 2011 – paragraph 62.

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