CONSUMER LENDING:
implications of new comprehensive credit reporting

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In March 2014, legislation will come into effect allowing credit providers such as banks and other lenders to share positive information about consumers through a credit bureau. The Australian transition from negative reporting to comprehensive reporting is largely an unprecedented and unique approach which will create challenges for government, regulators and the industry. An earlier version of this paper was presented to the 2013 Australian Centre for Financial Studies' Melbourne Money and Finance Conference.

There have been many studies presented about the benefits of comprehensive credit reporting relative to the negative-only credit reporting environment that has been operating in Australia since the *Privacy Act* was introduced in 1988.[1] Creating growth in lending, making lending fairer and helping lenders mitigate against risk are among the benefits advocated by these studies.

With the new comprehensive credit reporting due to be implemented in March 2014,[2] some realities are beginning to emerge. The consequences of the US sub-prime crisis, the differences for Australia relative to other countries with positive reporting and the structure of the Australian financial market create challenges for government and industry as we transition to the new credit reporting environment.

In March 2014, legislation will be effected to allow credit providers such as banks and other lenders to share positive information about consumers through a credit bureau. However, the industry has substantial work to complete prior to implementation including completion of the Credit Reporting Code, Credit Reporting (Industry) Code and Data Exchange Standards.

Components of comprehensive credit reporting

In simple terms, the industry refers to comprehensive credit reporting as introducing five new data elements:

> date account opened
> credit limit of the account
> type of credit
> date account closed
> repayment history.

Repayment history refers to the customer's monthly payment performance over the previous 24 months. Sharing of repayment history is permitted for credit licensees only (as defined by the *NCCP (2009) Act* and subject to responsible lending obligations). Telecommunications and utilities cannot share repayment history.

The new characteristics provide powerful additional information for lenders to better assess the creditworthiness of borrowers. Some of the insights that have been identified in studies show:

> Payment history is a very strong risk measurement characteristic and provides evidence of willingness to meet loan commitments.
> Total customer exposure (derived from the sum of credit limits) provides a reliable indication of exposure relative to customer disclosed.
> The type of credit providers are an indication of the customer's risk appetite and product mix.
> Analysis of the age of accounts has shown that long-term account relationships are lower risk.
> The number of lenders used by a borrower is a strong indication of high risk.

Participation options

While all credit providers will need to ensure compliance with the new legislation from March 2014, credit providers will have a choice in their level of participation in credit reporting. Essentially there are three participation options: negative only; partial; and full.

The rules of reciprocity mean that lenders can only use and access data at the level at which they supply data. The level at which a credit provider decides to participate will depend on their analysis of costs, risks and benefits. However, organisations that do not participate in comprehensive credit reporting are at risk of adverse selection.[3] More importantly, the degree of adverse selection depends on the industry participation level.

Some lenders may be reluctant to participate fully in comprehensive credit reporting as sharing information will dilute their relative competitive advantage.[4] For example, Commonwealth Bank holds around 23 per cent of customer lending accounts in the banking sector (see Figure 1). If they were to contribute full comprehensive data they would be providing more benefit in improved risk discriminatory power to other lenders relative to what they would get themselves.

Industry perspectives

Industry has been lobbying for positive reporting for at least a decade through the industry body ARCA (Australasian Retail Credit Association), drawing on research which supports the introduction of positive reporting in Australia. For example, frequent citations can be found to a research paper by Barron and Staten comparing the impacts of a positive reporting system (the US model) with negative reporting (the Australian model). This research found that implementation of positive reporting in an economy which used negative reporting would significantly reduce default rates while at the same time increasing consumer access to credit.[5] Further, a report prepared for MasterCard[6] which modelled the economic impacts of implementing comprehensive reporting in Australia concluded the following benefits would be delivered:

> improved competition in credit markets resulting in lower interest rates for borrowers

> more accurate pricing of risk premiums to individual borrowers

> broader access to credit across the income distribution

> a large credit market characterised by greater competition

> greater innovation in financial services

> increased productivity in the Australian economy valued at a net present value of $5.3 billion over 10 years.

A recent report by Policy and Economic Research Council (PERC)[7] suggested that introduction of comprehensive credit reporting will create growth in lending to the private sector, make lending fairer and help lenders mitigate against risk.

Implementation issues and consequences

While some lenders may be reluctant to contribute data due to competitive advantage, there is a number of lenders in the process of implementing large-scale technology programs which may impact the timing of their contribution to comprehensive reporting. Taking into account the rational response to competitive threats and technology impediments of some lenders, it is likely that a fully comprehensive credit environment will not be in place until late 2015.

As we now approach implementation, some realities are emerging:

> The US sub-prime crisis demonstrated that over-reliance on credit reporting (e.g. FICO credit scores) for credit decisions is flawed.

> Regulators now insist on lenders assessing a borrower's ability to repay (e.g. NCCP), limiting the impact of credit reporting.

> Australia's proposed credit reporting is different from overseas (e.g. does not include balance).

> The competitive advantage of bigger lenders is threatened.

> Australia is different from other countries studied (i.e. mature environments in the US and UK; emerging markets in Asia, South America and Eastern Europe):

  – ready availability of credit and high consumer indebtedness

  – competitive financial markets

  – consumer and privacy advocates are more influential

  – higher socioeconomic population (fewer underserviced segments).

The over-indebted segment is particularly vulnerable to adverse consequences of comprehensive credit reporting. In today's negative-only credit reporting regime, consumers generally have ready access to credit and are able to exploit information asymmetry to manage their over-indebtedness. Over-indebted consumers are able to use multiple lenders, multiple accounts (credit cards, personal loans, store finance etc.) and if they are a home-owner, they are able to leverage home equity from rising house prices.

As Australia transitions to comprehensive credit reporting, a borrower's lender will become aware of credit provided to the borrower by other lenders. The lender is unlikely to offer any further increase in credit and is more likely to decrease/restrict credit to the borrower. As other lenders become aware of previously undisclosed debts, the borrower's access to credit diminishes. The problem is exacerbated if house prices fall, which will also restrict the borrower from drawing on home equity.

If the borrower is unable to reduce their debt repayments or alter their lifestyle expenses, they are likely to be left with three options:

> Find a lender which does not rely on credit reporting to make the lending decision. These types of lenders are typically defined as sub-prime

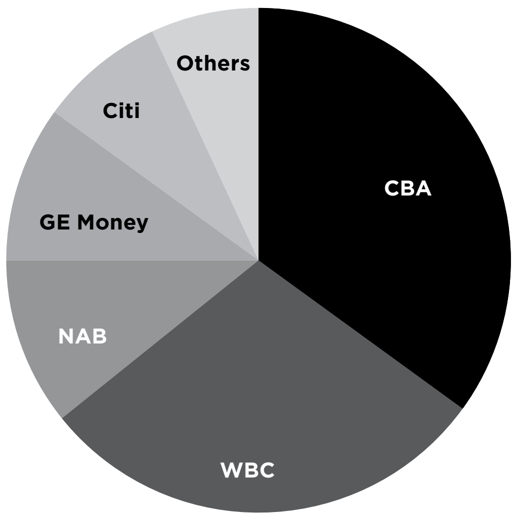
lenders that are prepared to lend to borrowers with credit impairment history at an interest rate that is commensurate with the risk of the borrower.

> Continue with mainstream lenders but seek financial hardship arrangements from their lenders. The sustainability of this option depends upon the willingness of mainstream lenders to provide suitable debt restructure alternatives for over-indebted borrowers and work with the borrower's other creditors.

> Realise that their financial position is unsustainable and declare bankruptcy.

Studies by Veda, Australia's largest credit bureau[8] have suggested that 5–10 per cent of borrowers could be in an over-indebted situation. The adverse impact of credit reporting on the economy is dependent upon the timing of transition to comprehensive credit reporting, the size of this segment as well as government and lender responses.

FIGURE 1: Loan market shares



Sources: APRA Monthly Banking Statistics, RBA Lending Aggregates, Author estimates.

Conclusion

There is strong evidence that comprehensive credit reporting provides significant advantages over a negative-only credit reporting regime. However, the Australian transition from negative reporting to comprehensive reporting is largely an unprecedented and unique approach which will create challenges for government, regulators and the industry. Most studies into the implications of positive credit reporting have relied on translating overseas experience into an Australia environment. The timing and approach in Australia is different and therefore the impacts are largely untested. ■

Notes

1. For a recent example, see Joon-Ho Hahm and Sangche Lee 2011, 'Economic effects of positive credit information sharing: the case of Korea', *Applied Economics*, vol. 43, iss. 30.
2. The forthcoming introduction of comprehensive credit reporting has been enabled by *The Privacy Amendment (Enhancing Privacy Protection) Act 2012 (Reform Act)* which was passed by Federal Parliament on 29 November 2012.
3. Hahm and Lee (2011) demonstrate this in the case of Korea.
4. Cross-country evidence on how banking sector structure affects the development of credit bureaus can be found in Miriam Bruhn, Subika Farazi and Martin Kanz 2013, 'Bank competition, concentration, and credit reporting', *World Bank Policy Research Working Paper*, no. 6442, May. They note that 'large banks stand to lose more monopoly rents from sharing their extensive information with smaller players'.
5. The Barron and Staten research is discussed in *Australian Law Reform Commission Australian Privacy Law and Practice (ALRC Report 108)/55. More Comprehensive Credit Reporting — Empirical studies*, available at http://www.alrc.gov.au/publications/55.%20More%20Comprehensive%20Credit%20Reporting/empirical-studies#_ftn137
6. ACIL Tasman 2004, *Comprehensive credit reporting: Main report of an analysis of its economic benefits for Australia*, prepared for MasterCard International.
7. Michael A Turner, Robin Varghese and Patrick Walker 2010, *Financial Inclusion through Credit Reporting: Hurdles and Solutions, a PERC Policy Brief, April,* available at https://senate.aph.gov.au/submissions/comittees/viewdocument.aspx?id=2585e761-cbcf-4007-b16e-992e1787c13b
8. Comprehensive Credit Reporting Pilot Studies conducted by Veda in 2013.

APPENDIX 1: Credit Assessment in Retail Lending

Additional information from comprehensive credit reporting will improve the accuracy of credit assessment by lenders. In a negative-only credit reporting environment, a lender is restricted to information provided by the borrower in the application form, verification of the information through various sources and supplemental information from the credit bureau. In a comprehensive credit reporting environment, a lender will have additional verified information such as the total customer exposure, length of relationship with lenders, type of credit and monthly repayment history.

The additional information means that the lender will have more confidence in their assessment of the creditworthiness of the borrower. Typically, lenders define the level of confidence by comparing actual default rates for groups of borrowers against their predicted default rates. For consumer credit such as home loans, personal loans and credit cards, most large lenders use credit scorecards to predict the likelihood of a borrower defaulting on their loan.

Consumer credit scorecards are developed by assessing information known about the borrower at the point of application and determining the predictive nature of certain characteristics. For example, a borrower who has long-term full-time employment will have a lower likelihood of defaulting compared to an unemployed borrower. The characteristics are analysed and modelled to create application scorecards.

A good scorecard is defined as one which is able to discriminate between good borrowers (i.e. those that do not default on their loan obligations) and bad borrowers (i.e. those that do default). A perfect scorecard would identify all bad borrowers distinctly from good borrowers, however, in reality there will be a margin of error and it is the margin of error that determines a good scorecard.

The most common metric used by lenders to measure the discriminatory power of a scorecard is the Gini coefficient.

The Gini coefficient generally improves relative to the amount of good quality data available to the lender at the point of application. For example, a scorecard that relies on unverified information disclosed by a customer in an application form will perform worse (i.e. a lower Gini) than a scorecard that relies on verified data from reliable sources.

Industry studies have shown that inclusion of comprehensive credit reporting information can improve the Gini performance of a lender's scorecard by around 20 per cent compared to a scorecard that relies on negative-only credit reporting information.

The uplift in Gini performance is even greater for borrowers who do not have an existing relationship with the lender. The ability to assess the creditworthiness of new-to-lender borrowers is considerably higher because in a comprehensive credit reporting environment the lender can access previously unavailable information about the borrower's credit history with other credit providers.