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CREDIT BUREAUS AND POSSIBILITIES OF THEIR APPLICATION IN THE AZERBAIJANI ECONOMY

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Abstract

The main goal of the study is to research the role of the credit reporting system in minimizing credit risks in the sector by acting as an information agent in the economy and to analyze critical factors for introduction of private credit bureaus in the Azerbaijani economy. To that end, the article researches the involvement of the credit reporting system in preventing information asymmetry, as well as in broadening access of economic agents to available financial resources irrespective the property type, and informs on its core, function and principles. Moreover, the article investigates capabilities of credit bureaus to accumulate information from alternate and wider information sources and which analytic services may be provided on the data collected to generate borrower's detailed risk profile in contrast to public credit registries, and exemplifies related cases from international practice. Consequently, the study displays the role private credit bureaus may play in boosting our country's credit rating and attracting foreign investments, and analyzes critical legislative and economic climate indicators.

Key words: *credit reporting system, credit bureau, credit registry*

JEL classification: *D82, G21, G28*

Introduction.

Rapid growth of information and communication technologies is irreplaceable in modern economic environment along with being felt in all fields of daily life. Information, which is considered to be the most valuable asset under today's reality, yields benefits both for the agent that owns it and the society as a whole if used properly for functions aiming concrete targets. Effective credit data sharing in the banking sector may trigger drops in interest rates in the credit market in the long run along with allowing to minimize credit risks. With this in view, it is crucial to shape and develop a credit reporting system (CRS) designed to enable data sharing.

Credit reporting system: core, principles, benefits.

The most proper way to generate accurate forecasts about future is to analyze past activities in depth. This is the simplest approach to measure the capability of the information owned by CRSs to impact the economy.

CRSs are one of the key elements of any country's financial infrastructure. They are critical in providing economic agents with financial services and elevating financial inclusiveness along with triggering the formation of sound competitive environment in the lending market and allocation of available financial resources across economic sectors. These systems supply lenders with crucial information in the course of credit decision-making meanwhile contributing to high quality of the lending portfolio and drops in transaction expenses.

Key system users

Let us focus on the following figure to identify key users of the credit reporting system:

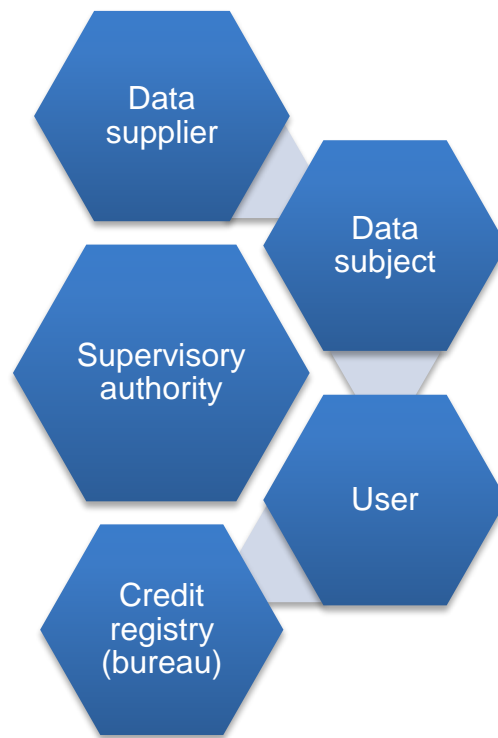


Figure 1. Participants of the credit reporting system

Here:

- *data suppliers*: organizations that provide the system with credit information. Banks and nonbank credit institutions are considered to be traditional data suppliers. Nontraditional suppliers include utilities and trade agents.
- *data subjects*: individuals or legal entities, who are the subject of personal data.
- *users*: individuals or legal entities, who request information from credit bureaus or registries by observing determined requirements.
- *credit registry (bureau)*: data sharing organization.
- *supervisory authority*: the body that exercises administrative – legal supervision over the credit data sharing system for the functionality of credit reporting.

The CRS's cycle is as follows:

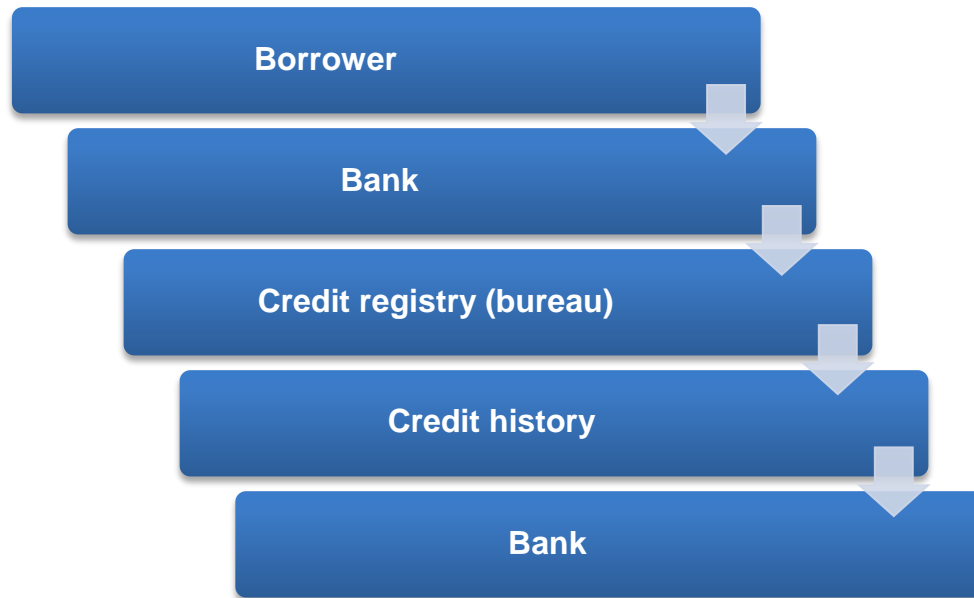


Figure 2. Credit reporting cycle

As is seen from the figure, a borrower applies to a bank to get a credit resource. The bank receives data from a credit registry (or credit bureau) to verify borrower's creditability in credit decision-making. And the registry in its turn return's borrower's credit file to the bank.

Principles of credit reporting

To provide public benefit in credit reporting, it is critical to have international standards and requirements in place. Given this fact, the World Bank determined 5 main principles, which create global application opportunities on the CRS, protect rights of data subjects and encompass all of its chains. The principles and their core are as follows:

- I. **Data:** CRSs should have accurate, timely and sufficient data and retain this information for a sufficient amount of time.
- II. **Security:** CRSs should have rigorous security standards and be efficient.
- III. **Governance:** accountability, transparency and effectiveness should be provided in managing CRSs.
- IV. **Legal and regulatory framework:** the overall legal and regulatory framework should be clear, nondiscriminatory, and consist of provisions

supportive of both data subject and consumer rights. Moreover, legal and regulatory framework should include judicial, or extrajudicial dispute resolution mechanisms.

- V. ***Cross-border data transfers:*** should be ensured, if appropriate requirements are met.

Which factors necessitate credit reporting?

Nowadays credit institutions are forced to face many challenges to be profitable in the lending market. One of the similar problems is asymmetric information. CRSs are considered to be a countermeasure to the problem of asymmetric information, i.e. these systems minimize the risks likely to emerge due to incomplete or erroneous information on borrower's creditability when he applies to a bank for a loan and completes the information chain. The CRS acts as an information agent in the sector meanwhile preventing moral hazard. Moral hazard is the risk that the party with more information (borrower) jeopardizes the lesser informed party (creditor) providing incomplete or distorted information, as a result of which the creditor may incur financial losses. The CRS supports creditor's sound decision-taking sharing credit data, eventually leading to lesser losses by the creditor.

In the long run the CRS contributes to drops in interest rates in the market. However, in the short run banks increase the price of the product they realize due to high credit risk when they lack necessary information to differentiate acceptable borrowers from risky ones. At that, a borrower may decide to borrow lesser amount or even refuse to take a loan, which eventually may result in shrinkage of the bank's lending portfolio and decrease in profits. To minimize related risks banks attach greater importance to securitization, which may be both movable and immovable property. However, if to take note of the current situation in developing markets one can see that small and middle-size enterprises (SMEs), that are key for the responsiveness of the lending market, experience securitization problems. Moreover, in case of failures to repay loans, procedures for realization of

securitization is both time consuming and cost intensive. Accordingly, it takes high income OECD countries a year and a half (538 days) on average to sell securitization, which costs 21% of total credit debt. The following table illustrates the time and funds spent to sell credit securitization across zones:

Region	Period (days)	Cost (% of claimed amount)
OECD	538.3	21.1
East Asia and Pacific	553.8	48.8
Europe and Central Asia	480.7	26.2
Latin America and the Caribbean	736.9	30.8
Middle East and North Africa	653.3	24.7
East Asia	1,076.90	30.5
Sub-Saharan Africa	653.1	44.9

Table 1. Comparison of the time and funds spent to sell securitization.

These indicators stand at 277 days and 18.5% respectively for Azerbaijan.

To avoid the challenges of the type the CRS comes up with a new type of securitization – *credit history*. Borrower’s favorable debt burden on past periods and positive repayment discipline both ease access to credit resources and make them relatively low priced.

Private CRS: credit bureaus.

In essence, CRSs are databases where technological innovations and innovative solutions are applied, and where execution of operations are covered with exact legal frames. They are available in 2 forms:

- *private credit bureau (PCB);*
- *public credit registry (PCR).*

PCBs considerably differ from PCRs in terms of the form and content of the data they collect, and the scale of services they offer. In light of this, we should mention PCBs data suppliers in the first instance. Unlike PCRs, PCBs collect data not only from credit institutions, but also from utilities, telecommunication companies, and trade outlets. Depth of data sources is useful both from the standpoint of PCB’s realizing its commercial goals and access of persons on whom

information is collected to credit resources. Hence, PCBs make profit helping users accelerate credit decisions, and organize business processes and rendering other similar services through processing information they obtain from various sources on borrowers. And a data subject manages to create a sentiment on himself at a credit institution, offering credit resources, demonstrating payment manner on utilities, communication and other directions even though he lacks credit history over the past periods and gets easy access to financial resources. The following table illustrates alternate data sources of PCBs based upon the findings of the study over the previous reported year by the Association of Consumer Credit Information Suppliers (ACCIS) that has 44 member organizations and that shares credit information on 28 European countries.

Data supplier	# of countries
Lease companies	17
Credit unions	11
Debt collectors	11
Retailers selling on hire purchase	14
Judicial organs	10
Telecommunication companies	6
TV service providers (cable, satellite etc.)	6
Internet providers	6
Utilities	5
Real estate agents	3
Tax authorities	3
Law enforcement authorities	2

Table 2. Alternate data suppliers of PCBs in Europe

Legal regulation

Supervisory authorities use a number of legal frames to regulate PCBs. A Law on Credit Bureaus is considered to be a critically fundamental legal act for the performance of bureaus, which includes the definition of a credit bureau, formation and principles of use of credit files, and the form and methods of public control over its performance.

Generally, one of the World Bank's five credit reporting principles relates to legal and regulatory environment. Those requirements include:

- Clarity and predictability – legislation should be clear and specific. Participants should be capable to analyze any results and risks likely to occur due to other actions or inactions. Also a set of documents, reflecting the regulatory framework, should be published.
- Non-discrimination – to allow participants to become a chain of credit information sharing system, the environment should be established in a fair manner. At the same time, requirements on data quality and security should be clear, and consumer rights should be ensured.
- Proportionality – all system users should be treated from the same perspective.

PCBs also should protect fundamental rights of the subjects, on whom they collect information. Many countries have laws that classify individual data and establish rules for their usage. The World Bank's related requirements on consumer rights are as follows:

- Consumer may veto his information being shared;
- Consumer may be informed on collection, processing and distribution of information about him;
- Consumer may access the data held about him;
- Consumer may challenge accuracy of information about him.

PCBs are usually founded by credit institutions as legal entities. Organizations included to bureaus share data on the basis of voluntary principles. However, the legislative framework, regulating PCBs, may include provisions on mandatory data sending to bureaus. For instance, in many countries of Latin America, which is considered to have highly developed credit reporting, (e.g. Columbia, Mexico) credit institutions are obliged to send data to at least one credit bureau under the existing legislation. We believe that such provisions translate into the development of credit bureaus.

Credit bureaus in international practice and their services

PCBs render various services to CRS users. However, the key target of these services is to minimize credit risks and provide financial discipline promoting responsible borrowing.

PCBs primarily offer underwriting based services, the heart of which is scoring. Scoring is a mathematical-statistic model, reflecting the relationship of borrower's behavior to the credit risk level. PCBs also offer alternate services. According to the 2010 ACCIS study, member organizations offer the following services:

Service	# of PCBs	%
Credit reporting (credit history)	30	100%
Scoring (PCB score)	23	82%
Consultations	19	70%
Scorecard development services	17	65%
Software support	14	56%
Prevention of frauds	14	54%
Identification	12	50%
Marketing services	10	37%
Verification of current accounts	7	30%
Debt collector	2	30%

Table 3. Services offered by European PCBs

Moreover, PCBs also develop area specific products. For instance, TARDES by the Turkish Kredi Kayıt Bürosu (KKB). KKB developed and introduced the Farmers Registration System (*Çiftçi Kayıt Sistemi*), which is very active and socially beneficial in agricultural lending. These systems both allow to fight the problem of underwriting in crediting of the agri-sector, and motivate credit institutions to invest there.

How we can introduce credit bureaus in Azerbaijan.

PCBs are critical for financial inclusiveness and overall financial stability. At the same time, they highly contribute to investments to the economy. In this vein, the Getting credit index, of the Doing Business report assesses the level of any country's CRS. The index includes to following sub-parameters:

- i. Strength of legal rights;
- ii. Depth of credit information;
- iii. Credit registry coverage;
- iv. Credit bureau coverage.

The Doing Business report provides measures on 11 parameters across 188 economies. The below table illustrates rankings of our country over recent 5 years:

Year	Ranking	Strength of legal rights (0-12)	Depth of credit information (0-8)	Coverage <i>(over 18 year of age, in %)</i>	
				Credit registry	Credit bureau
2012	48	5 ¹	5	15.6	0
2013	53	5	5	17.7	0
2014	55	2	5	23	0
2015	105	2	6	28.7	0
2016	109	2	6	33.6	0

Table 4. Azerbaijan's overall Doing Business and Getting credit rankings

As is seen from the table, although the coverage of the credit registry has become wider and the range of collected credit data has elevated, the ranking is prone to decline on the related category. Even though one of the reasons is that no credit bureaus are functioning in the country, the key factor here is that changes were made to the evaluation methodology. Thus, evaluation parameters were changed with parallel increase in their number in the Strength of legal rights sub-index (it analyzes normative acts and legal procedures to get credit); since our country meets only two of those indicators, they resulted in decline. Let us review relevant indicators across Europe and Central Asia and high income OECD countries for the sake of comparative analysis:

Indicator	Azerbaijan	Europe & Central Asia	OECD
Strength of legal rights	2	6.2	6
Depth of credit information	6	6.3	6.5

¹ Evaluation methodology was changed in 2014, the number of parameters was shifted to 12 from 10.

Indicator	Azerbaijan	Europe & Central Asia	OECD
Credit registry coverage	33.6	23.8	11.9
Credit bureau coverage	0	37.4	66.7

Table 5. *Azerbaijan's comparison with other regions on the credit reporting index*

As previously noted, a law on credit bureaus is critical in performance of PCBs. The draft Law on Credit Bureaus has been under way jointly with experts of the International Finance Corporation for a long time. The relevant draft law has already been discussed at the parliament. Undoubtedly, specialized companies will take interest in the sector upon adoption of the Law on Credit Bureaus. A number of advanced credit bureaus currently operating in South Caucasus and Central Asia, familiar with the region's economic climate and business environment, may find the Azerbaijani market very attractive, since the Azerbaijani economy accounts for 68% of the overall economy of South Caucasus. The share of Azerbaijan in overall credit investments to the economy of the region is 55%. Moreover, the Asian Development Bank predicts year over year 2.8% rise of GDP in the region, Azerbaijan is a part of, while the inflation rate will drop to 5.9% from current 10.8% in 2017, favorable for effective and efficient performance of businesses.

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