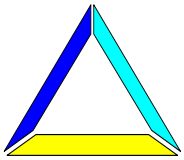
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**S28**

# Proposals for the Development of Credit Reporting in Ukraine

## Executive summary

The exchange of information through systems of credit reporting is highly beneficial for financial stability, but unfortunately is not developed enough in Ukraine where only public database of bad debtors exists. We consider the further development of credit reporting as a prior task of economic policy, since it can reduce credit risks of commercial banks, decrease cost of borrowing and facilitate investment activity in real economy. Besides that, it will enhance supervision abilities of NBU.

We propose three complementary sets of measures for the development of credit reporting in Ukraine. First, we suggest to improve the existing public database of bad borrowers in Ukraine by establishing compulsory participation of commercial banks and enhancing privacy protection. Second, we propose to develop a new public register of large credits, collecting positive information. Such register would monitor large exposures and timely inform commercial banks and supervisor authority about credit risks. Third, we propose to facilitate the creation of private credit bureaus by introduction of correspondent legislation.

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1. The economic role of credit reporting
2. International experience of credit reporting
3. Credit reporting in Ukraine
4. Policy recommendations
   - 4.1. Improvement of existing public database of bad borrowers
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## 1. The economic role of credit reporting

Commercial banks operate with two major items: money and information. Success of banks activities depends on the ability to collect and process information about their clients during granting credits as well as while monitoring borrowers performance. Unfortunately, banks often do not have full access to information about their clients, hence banks face problems in their lending activities: without complete data banks cannot adequately access soundness of their clients or evaluate how risky proposed projects are. As a result, banks would try to compensate for expected losses by raising interest rates and may also ration the credits[1].

Alas, such situation with incomplete information is prevalent in Ukraine. Almost half of Ukrainian enterprises are loss-makers and it is quite difficult to separate sound enterprises from unhealthy one. Besides that, financial machinations with obtaining loans and not paying them back are still widespread. From the other side, Ukrainian banking system is quite young and commercial banks do not have enough experience in conducting lending activities. As a result, banking sector experienced fast accumulation of bad debts back in 1990-s. Lately share of bad debts reduced, but is still quite high: prolonged, overdue and suspicious loans accounted for more than 12% of all credit portfolio in Ukrainian banks.

Solution to this problem is to exchange information between banks. Each individual bank typically has only fragmented picture about borrower, but if banks will use opportunity to share information between them, the overall picture will become much clearer and each bank will be able to access credit risk with higher accuracy.

In practise banks do share information via informal contacts between local bank managers, but such system is far from being as efficient as formal systems of sharing information on credits. Some of these systems are voluntary and privately owned (conventionally called credit bureaus), other systems are compulsory and public (called public credit registers).

Formal systems collect information about borrowers, specifically concerning their soundness and credit history, file it and then distribute it to the commercial banks. In doing so, systems of credit reporting help to solve problems of incomplete information and diminish credit risk as well as costs of lending. This leads to the decrease of the interest rates and expansion of the crediting. Besides that, such systems enhance discipline of the borrowers: when banks share default information about borrowers, they disseminate a signal of his bad quality that would lead to higher interest rates for such borrower or even refusal to provide a credit. Knowing that they can face such penalty, borrowers would try harder to fulfil terms of the credit agreement.

## 2. International experience of credit reporting

Cultural distinctions, specific laws and capital market differences lead to the development of quite diverse formal systems of information sharing across countries. Major differences concern 1) ownership and participation: private credit bureaus with voluntary participation and/or public compulsory credit registers; 2) threshold level for reporting: information on personal or small business loans or large loans or both; 3) type of information: positive or negative information or both.

***Public credit registers*** are databases, created by public authorities and managed by central banks. Public credit registers compulsory require information from lenders and grant the last right to obtain return flow of information. For instance, seven Western European countries have public credit registers (see Table 1). Generally, public credit registers are common in continental Europe and Latin America, absent in Anglo-Saxon countries. Most have been created in the last two decades, except for Germany (1934), Finland (1961), and Italy (1964).

[1] In economic theory this phenomenon is known as adverse selection problem.

Due to the compulsory nature of public credit registers, they have quite strict regulations concerning confidentiality for participating institutions and privacy protection for individual borrowers. Banks are assured that information that they provide will be disseminated only in aggregate form and only to other commercial banks. Credit institutions can get information purely for the purpose of granting loans, i.e. either concerning existing borrower of the bank or on the ground of documents, signed by potential borrower. Individual borrowers are informed if there is a file on them in the database, have the right for access to this information and have the right to require changes it if it is not correct.

**Table 1. Systems of information exchange in selected countries.**

| Country | **Public system**, starting date[1] | Threshold for reporting (USD) | Information provided (Positive/ Negative) | **Private system**, starting date | Information provided (Positive/ Negative) |
|---|---|---|---|---|---|
| Austria | 1986 | 430 700 | P | | P/N |
| Belgium | 1985 | 27 000 | N | 1987 | N |
| Denmark | | | | 1971 | N |
| Finland | 1961 | 0 | N | 1961 | N |
| France | 1984 | 120 000 | N | | |
| Germany | 1934 | 1 500 000 | P | 1927 | P/N |
| Greece | | | | | |
| Ireland | | | | 1963 | P/N |
| Italy | 1964 | 0[2] | P/N | 1990 | P/N |
| Netherlands | | | | 1965 | P/N |
| Portugal | 1977 | 5 | N | 1996 | P/N |
| Spain | 1983 | 6 000 | P/N | 1994 | N |
| U.K. | | | | 1960 | P/N |
| Canada | | | | 1919 | P/N |
| Japan | | | | 1965 | P/N |
| USA | | | | 1890 | P/N |
| Argentina | 1991 | 50 | P/N | 1950 | P/N |
| Chile | 1975 | 0 | P/N | 1990 | P/N |
| Hong Kong | In the process | n.a. | n.a. | 1982 | N |
| Israel | 1975 | 160 000 | P/N | | |
| Singapore | | | | 1978 | N |
| Taiwan | | | | 1975 | P/N |

1) All compulsory except Finland
2) For bad loans

In a number of countries, lenders (banks, credit companies, retailers) share information on their borrowers through ***private credit bureaus***. Such credit bureaus act as information brokers based on the principle of reciprocity: banks voluntary provide information on borrowers and have the right to buy information from the credit bureau. Credit bureaus can be organized by lenders, associations of banking institutions, or third party and generally operate for-profit. Countries, with most massive amount of information, exchanged through credit bureaus are USA, Canada, the UK, Japan, Germany and Switzerland. Credit bureaus in those countries operate for a quite long period of time. In some Latin America and Asian countries credit bureaus just started to operate on a small scale.

Besides compulsory nature of participation by lenders, public credit registers differ from credit bureaus by the type of information they collect. Public credit registers concentrate on loans above certain threshold level, which is usually high enough to include mostly corporate loans. Credit bureaus also gather data on corporate loans, but do not restrict only to this information. Credit bureaus collect data on small personal loans and credit cards, include information from department and retail stores, etc. In many cases data to credit bureaus is provided not only by banks, but also by borrowers themselves, as they try to disseminate positive information about their companies.

Another distinctive feature of information exchange systems is whether they collect positive or negative information. The most basic form of data that lenders share is negative, consisting of defaults and arrears. In more sophisticated arrangements information exchange systems collect also positive information on credit history, financial situation, other detailed data.

## 3. Credit reporting in Ukraine

The only form of credit reporting in Ukraine is the public database of bad debtors by NBU (collects only negative information).

There is no public database that exchanges *positive* information. Although back in 1994 NBU attempted to create "Database of borrowers" that would collect positive and negative information, the database was not created[2]. The idea was to oblige commercial banks to provide information on credits over USD 20 000; data had to be processed through the automatic system of NBU and than made available for commercial banks. Currently NBU collects information on credits of commercial banks, especially large one's, but commercial banks cannot access it.

*Private credit bureaus* are not present at the Ukrainian market either. Association of Ukrainian Banks and Kiev Banking Association at the end of 2002 announced that they consider establishing credit bureaus, but no real moves in this direction were made.

Lets look at the existing public database of bad debtors in Ukraine, collecting *negative* information. Database was created in June 2001 and its main features are following[3]:

- ✓ Participation of banks is voluntary;
- ✓ Information provided is only on bad debtors (overdue and suspicious);
- ✓ Information is provided concerning both, physical and juridical persons;
- ✓ Banks report on credits over UAH 10 000;
- ✓ No limit on data inquires from the banks;
- ✓ NBU covers all expenses[4];
- ✓ Banks transfer data through secured communication channel of NBU;
- ✓ Banks report and get following information:
  - Borrower (name, identification code, resident/non-resident, juridical/physical)
  - Information on credit (number of contract, data of issuance, currency)
  - Amount of debt and data when credit became bad.

At the very beginning of the database existence, banks were quite sceptic about it, but substantial progress was made during second half of 2002. As of the end of 2002 the database accounted for 116 commercial banks out of 157 banks operating in Ukraine. Members of the database represent 80% of total assets of the Ukrainian banking system. Banks reported about 2500 bad loans with a total volume of UAH 1 bn, or almost 50% of total bad credit in the banking system[5]. Since the beginning of database activity banks applied for information around one thousand times.

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[2] Letter of the NBU About creation of "Database of Borrowers" № 176, 31.07. 94

[3] Decree of the National Bank of Ukraine "About creation of common database of borrowers" № 245, 27.06.2001

[4] NBU plans to introduce fees for commercial banks later on.

[5] NBU gets data on bad debts in two ways: First, all commercial banks in Ukraine are obliged to report to NBU aggregated information concerning their bad loans, as of the end of 2002 total amount of overdue and suspicious credits in the banking system amounted to UAH 2.1 bn. Second, commercial banks-members of the database of bad debtors give information to the database on their bad credits. As of the end of 2002 loans reported to the database came to UAH 1 bn, or roughly 50% of total bad loans in the banking system.

There may be two reasons why the database contains only half of all outstanding bad loans: first, banks-members of the database do not report all information accurately and second, banks outside the database contain substantial share of bad debts. By the end of 2002 all seven biggest banks with capital over EUR 50 m joined the database. List of the banks-members of the database shows that mainly small banks did not join. The fact that 116 banks with 80% of total assets cover 50% of bad loans gives ground to suspect that the rest 40 banks with 20% of assets are indeed have most risky portfolio and hold large part of the remaining uncovered bad loans.

Bankers name following reasons for slow development of the database:

First of all, it is bad credits to banks' insiders. In case if commercial bank provided credits to its insiders and such loans were not served, bank has no incentives to open this information to other banks. Bankers name this problem as the most serious one. Big banks already realised benefits of the system and are eager to participate and provide information on their bad loans. At the same time so-called "pocket" banks, which were created for low-cost financing of banks' shareholders, are strictly against such database.

Besides that, in some cases banks do not wish to open information about bad loans to NBU, being afraid that the last would impose stricter regulation on bank. Banks may not want to report on some bad debtors, since they hope that such borrower would re-take loan in another bank and pay back to the first one. In case if information about this borrower is available to all banks, such practice will not work. Frequently opponents of the information sharing in Ukraine state that database of bad debtors contradicts the Law "On Banks and Banking Activity" in parts, concerning banking secrecy. Finally, bankers concerned that information will leak to the third party, such as tax authorities or financial intelligence.

# 4. Policy recommendations

We advocate for a mixed system of information exchange in credit markets, consisting of both, public credit registers and private credit bureaus. Public credit registers should first of all enhance financial stability and collect negative information on bad debts and positive information concerning large exposures of the banks. Private credit bureaus should be able to collect both positive and negative information, concerning not only large loans, but also loans to households, credit cards, etc.

We propose three complementary sets of measures for developing information exchange in Ukraine: first, improvement of the existing public database of bad borrowers, collecting negative information; second, development of new public register of large credits, collecting positive information; third, introduction of legislation for private credit bureaus, enabling them to operate at the information market and collect both, positive and negative information.

## 4.1. Improvement of existing public database of bad borrowers

As we could see, database of bad borrowers have been developing quite slowly. On our mind, the main issues that should be tackled are incomplete information in the database and insufficient security of information. Below we propose measures, aimed at compulsory reporting of bad debts and at the same time granting that information will be used only for proper purposes and no third party access will take place.

### Compulsory system

Currently, participation in the public database of bad debtors is voluntary for commercial banks. NBU was considering compulsory system, but ambiguity of legislation (Law "On Banks and Banking Activity") inclined to voluntary system.

Experience of Ukraine as well as other countries showed that voluntary information exchange systems are not efficient as a starting point of information exchange systems. Although such a system will be beneficial for the banking sector as a whole, at the current

stage of development individual banks do not have enough incentives to create the system. In certain cases malfunctions of individual banks may become even a barrier (as in cases with credits to insiders or hopes that bad creditor will go over to another bank). Hence, it is better to create system with compulsory participation of all banks and explicitly guarantee that no third party will have access. It is reasonable to support initiative of the NBU to make amendments to the Law "On Banks and Banking Activity" concerning banks secrecy and foresee ***compulsory participation for all banks***.

**Enhance privacy protection**

Access to the public database of bad borrowers is a key point that determines incentives of the banks to report to the system at full extend. There are two sides that should access information: naturally it is commercial banks and it is borrowers, if database contains information on them; central bank coordinates work of the system.

In Ukraine, fears that information in the database of bad debtors would be disseminated to the third party prevented from faster accumulation of data in the system. We think that database of bad debtors should serve its main goal of maintaining stability of the financial sector but not be a source of information for fiscal or anti-money laundering purposes. Thus, data in it should be securely protected from access of any third party, like tax administration, financial monitoring institutions, etc. We propose to amend the Decree of NBU "About creation of common database of borrowers" and ***explicitly guarantee no third party access to the information***.

Commercial banks should use database only for purposes of evaluating current or prospective borrower and should not be allowed to use data for assessing financial stance of other banks or other similar objectives. Thus, in many countries public credit register regulates that ***commercial banks can access information only on its old borrowers or new credit applicants if the last gave written permission***. Such a mechanism does not require large and costly additional efforts. In Germany, for instance, banks ask potential borrower to give written permission, but do not send it to the database. Instead, they store it, while Bundesbank has the right to checks these files.

Finally, if information on any borrower is contained in the database, the borrower should have the right to access this data. NBU's Decree "About creation of common database of bad borrowers" should have regulations, that foresee:

1) borrower should be ***notified*** that it is in the database;
2) borrower should ***have the right to access*** the information from NBU, not only from commercial bank;
3) borrower should ***have the right to require correction of improper information***.

The issue of data access is also important in terms of Ukraine's efforts to correspond to European legislation. In order to secure privacy protection, European Parliament issued the Directive 95/46 "On the protection of individuals with regard to the processing of personal data and on the free movement of such data". The Directive regulates data collection, processing, dissemination and storage activities and prevents from improper usage of information and violation of privacy protection. All EU member states are required to bring their legislation into accord with given directive.

**Keep record on bad debt for several years**

The number of years, information about bad borrower is stored in the database is another important factor. At one extreme, if information is saved infinitely, a borrower does not have a "second chance" to improve its performance. At the other extreme, if information is immediately erased as soon as borrower repays the debts, this would have very little disciplinary effect and would provide very little information to lenders. The coordinator of the public credit register has the task to find balance between these two extremes. Usually public credit registers store data for no more then 5-10 years. In some cases, for instance in Belgium, information about borrowers who redeem their debt disappears from

credit register more quickly than information about borrowers who still did not repay loans.

According to the NBU decree on the database, information on bad debt is stored for no more than 10 years. In practise, information is erased as soon as banks report about repayment of loan. NBU reasoning for such a procedure are harsh economic conditions in Ukraine and malfunctions in relations between economic agents (borrower may be conscientious, but not its suppliers, etc.). Although there are no objections against the fact of difficult economic conditions in Ukraine, such system with immediate disappearance of information ruins principles of credit reporting and credit history. Commercial banks in Ukraine can find data only on current indebtedness and have no information about credit history of borrower, even if it had overdue credit even one month ago.

From our perspective it is worth to keep information for some time and thus, enhance discipline of borrowers as well as build up credit history. We propose to ***keep data for several years and store it the longer, the harder the "the crime"***: if credit was repaid, but with delay, it should be in database less than data on complete default. For instance, if borrower repays an arrear, the information can be removed in one year, if borrower repays default, it will be removed in two years, if bad debt is not repaid, data should be kept for five years or longer, depending on amount of credit.

**Threshold level**

At current stage banks should report about credits over UAH 10 000. Although this figure is rather small, comparing with many developed countries, it is acceptable for Ukraine for the time being.

We should keep in mind that threshold for reporting to the public credit register in fact divides market for information exchange between public and private systems: private credit bureaus in many cases specialise (but do not limit themselves) in collecting information below threshold line. ***With creation of private credit bureaus threshold level can be raised.*** In such way, NBU would more efficiently concentrate on large credits that actually determine financial stability, while private credit bureaus would collect information on smaller borrowers.

### 4.2. Development of new public credit register of large credits

Besides sharing information on bad debts, another important issue is exchange of positive data concerning large loans. The point here is that default of large exposures of commercial banks can be dangerous for stability of the whole banking system, thus special attention is needed here. Default can come either due to economic shocks or due to financial machinations of borrowers: borrowers can take credits in several banks in order to repay old debts at the expense of new ones or for fraud purposes, intentionally not planning to repay them. Sharing information can timely stop spreading of such swindle activities or diminish negative consequences of economic shocks.

Currently NBU requires banks to report on credits over 10% of banks' capital as well as monitors credit exposure of each bank on the monthly bases, but commercial banks do not have access to this information.

In order to establish a system of information exchange concerning large exposures, NBU can follow experience of Bundesbank's "Evidenzzentrale" and maintain credit register of large loans. In Germany Bundesbank collects information on large loans over EUR 1.5 m and notifies lenders of the overall indebtedness of their borrowers. Moreover, banks can request information from this database about large borrowers before granting the credit. The report must list all borrowers in Germany and abroad whose indebtedness to these lenders totalled EUR 1.5 m or more at any time in the preceding quarter. The reports have to indicate the amount of the exposure at the end of each quarter. This reporting requirement for large loans has been in existence since the mid-thirties. It was introduced at that time in connection with the Great Depression, since banks often did not have

sufficient information on the overall indebtedness of their major borrowers and frequently had difficulties when such enterprises collapsed.

Primarily, the information on large loans is collected by the branch offices and then reported to the database of Deutsche Bundesbank. If several lenders report on loans of EUR 1.5 m or higher to the same borrower, Bundesbank sends the lenders concerned a notification of the total indebtedness of that borrower and the total number of lenders involved. For data protection purposes no information provided on the identity of the other lenders.

Information on loans over EUR 1.5 m is not used solely for informing lenders, but also serves for supervision purposes, providing central bank with relevant data. By evaluating the data, supervision institutions can gain an up-to-date insight into the credit commitments of the major lenders and borrower. When major debtors become insolvent, the banking supervisory authorities can quickly obtain an overview of the exposure of individual institutions and the overall burden for the banking sector as a whole.

We think that the ***creation of public credit register of large loans*** in Ukraine could have a significant positive impact on soundness of the banking system, protect it from negative economic shocks and financial machinations as well as serve for supervision purposes of NBU. Such database could be created as a complementary to the existing database of bad borrowers. Of course, threshold for reporting should be chosen according to Ukrainian economic conditions.

### 4.3. Introduction of legislation for private credit bureaus

Public credit registers gather negative information or information on large exposures and do it for supervision purpose or for maintaining financial stability in the country. At the same time there is a large scope for activities concerning information on smaller loans and detailed positive information. Public credit registers do not deal with this data, but in many countries this niche is occupied by private credit bureaus. Such systems act as private organisations with voluntary participation, broad information. Credit bureaus do not require direct participation of the government, but bring substantial benefits in terms of sounder financial situation of the economy and efficient allocation of credits.

Thus, simultaneously with improvement of the public credit register, government and NBU should facilitate creation of private credit bureaus and assure competition on the information market. Of course credit bureaus will develop as soon as there would be sufficient demand for their services and there is no need for government to push development of such systems. What is really needed is the ***creation of law on credit bureaus*** that would sharply define "rules of the game" and amendment to the law on banks concerning bank secrecy.

Law on credit bureaus should define following:

- Procedure of creating the credit bureau (possibly condition to obtaining license from NBU), requirements to owners;
- Type of information that can be collected and reported by the credit bureau;
- Privacy protection;
- Responsibility for not accurate or false information for both, credit bureau and reporting entity;
- Supervision of the credit bureaus

It is interesting to notice that other transition countries also try to solve the same problems, for instance Russia. Although number of organisations have created National Credit Bureau in Russia, the law concerning gathering and disseminating of information does not allow this activity to develop. Currently Central Bank of Russia and Ministry of Economy of Russian Federation prepare amendments to the law on banks concerning banking secrecy as well as work on the law on credit bureaus.

In the process of creating favourable conditions for private credit bureaus, NBU can turn to the experience of other countries, especially Germany, which has one of the oldest credit bureaus, SCHUFA, operating since 1927.

## 5. Conclusions

Lending activity of commercial banks highly depends on availability of information about borrowers. Unfortunately, in many cases banks cannot acquire sufficient information about the soundness of their clients, as a result, credit risk increases, leading to higher interest rates and less crediting. Efficient solution to this problem is systems of information exchange through credit reporting. Systems of credit reporting are widely spread in many countries and can take a form of public credit registers or private credit bureaus.

Exchange of information through systems of credit reporting is not developed enough in Ukraine and only database of bad debtors exists. We consider development of credit reporting as a prior task of economic policy, since it can reduce credit risks of commercial banks, decrease cost of borrowing and facilitate investment activity in real economy.

We advocate for a mixed system of credit reporting, consisting of public credit registers collecting negative information on bad debts and positive information on large exposures, and private credit bureaus, collecting both types of information, but on smaller loans and with more details. In such way public credit registers would help to provide fundamental security of financial stability, while private credit bureaus would serve as complements, covering information on smaller loans and other detailed positive information. We see three complementary parts of development:

First of all, we propose to ***improve existing public database of bad borrowers***. We support idea of NBU to make amendment to the law on banks and foresee compulsory participation of all banks. We also suggest introducing explicit guarantee of no third party access. Commercial banks should get information only about its existing borrower or credit applicant if the last gave written permission. Borrower should be notified if it is in database as well as have right to get information about itself and require correction of improper data. Finally, information on bad debtors should not be erased as soon as debt is repaid; rather, data should be kept in the database for several years, the longer, the harder is "the crime" of non-repayment.

Second, we suggest to ***create new public database of large credits***, collecting positive information, as a complementary to the database of bad debtors. Large exposures of commercial banks can be potentially dangerous for stability of the whole banking system, while exchange of information through database of large loans can timely inform commercial banks and supervisor authority about credit risks.

Third, we propose to ***facilitate development of private credit bureaus***. Credit bureaus do not require direct participation of government, but bring substantial benefits in terms of exchange of information and efficient allocation of credits. We think that NBU and government should support development of private credit bureaus by introduction of legislation on private credit bureaus.

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