Expanding Financial Inclusion through Better Credit Reporting

A credit reporting system is an integral part of a well-functioning credit market. It reduces information asymmetries and helps increase access to credit. It also improves borrower discipline, lowers interest rates, and supports bank supervision and credit-risk monitoring. This SmartLesson looks at how economies may strengthen financial inclusion and access through upgraded credit bureaus and credit registries. It includes some of the latest developments and successful experiences, based on our first-hand exchanges with credit reporting professionals.

BACKGROUND

Today, 2.5 billion adults—many of whom are women and low-income individuals—still lack access to formal financial services. Microfinance institutions help bridge the gap in access to credit from traditional lenders by providing small loans—usually with collateral substitutes such as group guarantees—that can gradually increase in amount, based on good repayment patterns.

Over the past 20 years, the microfinance industry has grown to reach an estimated 200 million clients. At the same time, the rapid growth of microcredit, together with more loans offered to the low-income population by traditional lenders, may pose risks to the financial systems if microfinance clients over borrow or lack incentives to repay. A 2011 survey found that credit risk is the top concern for microfinance professionals in 86 countries.

LESSONS LEARNED

Lesson 1: Reporting microfinance data strengthens the microfinance sector.

Reporting microfinance data benefits 1) borrowers, by establishing repayment histories that help them obtain loans; 2) microloan lenders, by assessing repayment capacities; and 3) regulators, by monitoring credit markets and trends. The following are some examples:

- In India, the growing microfinance market is concentrated in just a few states, leading to multiple lending and overindebtedness within the same borrower base. Since 2012, IFC has helped Crif High Mark, India’s fastest growing credit bureau, expand its services to microfinance lenders, ensuring informed lending and promoting financial inclusion.

- In Bolivia, in the three years following the establishment of a microfinance credit reporting system, microcredit lending more than doubled (outpacing a 23 percent rise in traditional bank lending),


and the percentage of nonperforming loans decreased.3

• Similarly in Bosnia and Herzegovina, the inclusion of microfinance institutions in the credit reporting system contributed to a higher level of financial discipline and a significantly lower level of nonperforming loans.4

Microfinance credit reporting is gaining ground worldwide, as measured by Doing Business. (See Box 1.) Specifically, 60 percent of economies in Eastern Europe and Central Asia have an operational credit bureau or credit registry that reports microcredit information; 35 percent in the Middle East and North Africa; 34 percent in Latin America and the Caribbean; 32 percent in East Asia and the Pacific; 25 percent in Sub-Saharan Africa; and 25 percent in South Asia.

Lesson 2: It is necessary to educate consumers on “Finance 101.”

Financial literacy depends in part on understanding credit profiles. A 2012 household survey reported that the weighted average portfolio annual percentage rates (APRs) were 9 percentage points lower for consumer-credit users that lack basic credit literacy.5 Also, a 2013 study of financial education and debt behavior found that math education and financial literacy increased young people’s average Equifax credit score.6 Financial education is especially relevant for low-income populations, as a study showed that low-income households could particularly benefit from targeted financial education to enhance consumer knowledge as well as experience with credit reporting.7

Today, as measured by Doing Business, only 52 of 189 economies have an operational credit bureau or credit registry that posts a sample credit report on its website for the public’s information. These credit reporting service providers also commonly provide explanations of the following:

• Profile summary—35 economies educate consumers on terms such as credit commitment, installment balance, revolving balance, and past-due amount.

• Total lines of unsecured credit—35 economies educate consumers on loans by type of credit and information, such as credit limit, co-signer of a loan, and payment pattern.

• Recent inquiries—31 economies offer this information.

Of 189 economies, 70 have an operating credit reporting service provider that offers bureau or registry credit scores as a value-added service to lenders. Among those 70 economies, only 23 provide an ex-

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6 Meta Brown, John Grigsby, Wilbert van der Kaauw, Jaya Wen, and Basit Zafar, “Financial education and the debt behavior of the young,” Federal Reserve Board of New York Staff Report No. 634 (September 2013, revised September 2015).

plation of credit scores, such as what the scores mean and the characteristics and components used to compute the scores. Educating consumers about credit scoring is important. A 2008 study found that about one-third of consumers overestimate their credit ratings, and these same consumers are also less knowledgeable about general financial matters and less likely to invest, budget, or save.8

Around the world, borrower awareness and demand for credit education may soon rise, if it has not already done so. In a recent household survey in the United Kingdom, consumers with poor financial literacy were aware of their shortcomings and self-reported their lack of confidence in making borrowing decisions.9 A survey in Tanzania shows that over 80 percent of respondents were interested in learning more about interest rates, savings, loans, insurance, and a range of other topics.10 Today, 53 percent of OECD11 high-income economies have an operating credit bureau or credit registry that posts some educational material on credit reporting basics on its website (see Figure 1), followed by Europe and Central Asia (48 percent) and Latin America and the Caribbean (31 percent). (See Figure 2.) Good-practice examples include Ireland and the United States, where the credit bureaus upload an annotated sample credit report with informative boxes that explain details of each section of the report.

11 Organisation for Economic Co-operation and Development.
Lesson 3: Customized products make it easier to lend to small and medium enterprises (SMEs).

SMEs require access to credit for two main purposes: to finance their production cycle and to cover their capital expenditures when they wish to expand. However, information asymmetries in the market lead to barriers such as higher transaction costs and higher risk premiums. Studies estimate that the total unmet need for credit by formal SMEs today is in the range of $1.3 trillion to $1.6 trillion—or $700 billion to $850 billion if SMEs in high-income OECD economies are excluded. Furthermore, an estimated 55 percent to 68 percent of formal SMEs in emerging markets are either unserved or underserved.

Today, 34 of 189 economies have an operational credit bureau or credit registry that identifies SMEs as a distinct category of borrowers, based on annual turnover, total assets, paid-up capital, or other applicable legal definition. (See Figure 3.) Among the products

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that credit bureaus and credit registries tailor for SMEs, the most popular ones are customized SME credit reports and credit scores. SME credit scoring, provided by 17 economies worldwide, has the potential to boost access to finance to businesses that would otherwise stay out of the market, for example:

- A study from the United States shows that small business credit scoring is associated with a net increase in lending to relatively risky “marginal borrowers” that otherwise would not receive credit but pay relatively high prices when they are funded.14

- In Germany, Schufa reports the credit histories of 4.3 million businesses, including SMEs, and uses a credit rating index to capture information on the company’s managers and proprietors as well as its financial performance and obligations.

- In Kenya, Metropol Credit Reference Bureau established a membership program for SMEs, and those that share reliable information are rewarded with greater ease of access to credit when needed.

- Other popular services include linking personal credit files of proprietors, owners, or directors with credit obtained by the SME (19 economies) and debt-collection or tracing services (13 economies).

CONCLUSION

The overall trend is toward expanding the scope and quality of credit reporting services. Incorporating microcredit data in formal credit reporting systems and consumer education can facilitate financial inclusion, particularly for low-income populations. Customized credit reporting products for SME borrowers can enhance the prospects for entrepreneurs to obtain a loan to support their production cycle and their expansion plans. As development financial specialists seek ways to expand financial inclusion and access to credit, we hope these lessons present new inspiration for project design going forward.