Fostering Competition Among Lenders:

Proposed Light-touch Mandatory CCR Unlikely to Work

Report on:
Australia's National Consumer Credit Protection Amendment (Mandatory Comprehensive Credit Reporting)

Dr. Michael Turner
Patrick Walker

PERC
RESULTS AND SOLUTIONS

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Table of Contents

Abstract

This report exposes key deficiencies with the exposure draft legislation that would mandate comprehensive credit reporting as a means to facilitate competition within the highly concentrated retail and commercial lending markets in Australia. Simple, effective, and costless (to the government and taxpayers) measures are offered to enhance the affects of the proposed mandatory comprehensive credit reporting (CCR) on competition among lenders and credit bureaus. The Australian credit information sharing system, even after a mandate as advocated by the government, would neither be "full-file" nor "comprehensive" as these terms are conventionally understood. It is argued that the current exposure draft leaves the door wide open for deleterious outcomes including diminished competition among credit bureaus and among lenders resulting in reduced access to credit for consumers and very small businesses and higher credit prices. These unintended consequences could be mitigated by policymakers making clear that they expect lenders capable of comprehensive credit reporting to report as such and to all the major national Australian credit bureaus. By going beyond the current scope of the exposure draft and including provisions mandating the reporting of account balances, permitting non-financial institutions to fully report customer payment data (rent, wireless telecoms, broadband, cable and satellite TV, gas, water, electric) to licensed nationwide credit bureaus, and expanding permissible uses of credit file data to include using predictive data for extending firm offers of credit, the Turnbull Administration and Parliament would demonstrate a clear commitment to promoting competition among consumer lenders and ensuring sustained growth in lending to the private sector, increased financial inclusion, and dramatically improved safety and soundness owing to increased systemic transparency.

Executive Summary

Credit information systems (CIS) are a critical component of any nation's financial infrastructure. So important is the role of credit information in the efficient and effective operation of consumer and SME credit markets that it has gained considerable attention over the last decade from organizations such as the World Bank, Bank for International Settlements (BIS) and the Asia Pacific Economic Cooperation forum (APEC). In the case of APEC the implementation of a best practice CIS is regarded as such a high priority that in 2015 the member economies – including Australia - endorsed the Cebu Action Plan, which cites the World Bank's General Principles for Credit Reporting to guide legal and regulatory frameworks for the development of best practice credit information systems across the region.

The reason for this focus is apparent when one considers the benefits of an optimally designed and regulated CIS. Improved access to credit (particularly for the under-served) lowers costs for both consumers and lenders, and lower default rates and mitigates system risk in the lending sector. All of these benefits have all been proven to be the outcome of a CIS system designed to promote competition among lenders, particularly in markets where monopolies or oligopolies exist.

Yet despite being a signatory to the Cebu Action Plan Australia lags most of the developed world and much of the developing world in establishing a best practice CIS. Accordingly, Australia's credit reporting system fails to deliver the same economic benefits as experienced in other jurisdictions. The result is slower economic growth, higher interest rates and less access to credit. The impact of the latter point should not be underestimated. An estimated 1.86 million adult Australians are trapped in fringe lending markets paying exorbitant rates of interest on often poorly regulated credit products. For many in this group, being financially excluded is linked to the fact that Australia's credit reporting system fails to take account of their positive risk profile.

It should also be noted that the sub-optimal design of Australia's credit reporting system imposes excessive costs on the millions of small businesses that are unincorporated and rely upon consumer credit to fund their operations. These businesses are often denied access to basic banking services and pay punishing rates of interest for credit products that are unsuited to their needs all because Australia's credit reporting system fails to adequately report on their true risk profile.

The Australian Government has recognized that something must be done. Following the failure of earlier reforms to bring Australia's CIS into the 21st century, the Government has announced its intention to introduce Mandatory Credit Reporting compelling Australia's major lenders to share credit information with credit bureaus in the hope that this will create a more vibrant credit reporting market and expose Australia's banking oligopoly to true competition. Unfortunately, the exposure draft, as currently designed, is unlikely to achieve these objectives. Furthermore, it is highly likely that the unintended consequence will be to hand the four major lenders even greater power over Australia's credit information system resulting in less competition and worse outcomes for consumers.

"…the sub-optimal design of Australia's credit reporting system imposes excessive costs on the millions of small businesses…"

This need not be the case. Instead of a headlong rush to introduce these latest reforms after decades of relative inaction - often with the encouragement of vested interests - the Government should seize this opportunity to fundamentally rethink the structure and operation of Australia's credit reporting market. Using the 2015 APEC agreement as a guideline, the Government could create a CIS that improves credit risk and capacity assessment and fosters greater lending competition with significant benefits to consumers, small business and the Australian economy as a whole. It can't be overstated that the evidence from around the world clearly demonstrates that such a move would improve access to credit, lower default rates and boost economic growth.

Accordingly, this submission makes two core arguments:

1. That the Government should go beyond its current proposal and implement reforms consistent with the APEC Cebu Action Plan of 2015 that allow for credit bureaus to collect more comprehensive data (deeper and broader), compel credit providers of all shapes and sizes (bank and non-bank, large and small) to report that data, and expose Australia's credit market to high levels of competition.

2. That the draft legislation to introduce mandatory credit reporting should be amended to avoid a number of unintended consequences that are likely to reduce competition among lenders and further entrench Australia's existing banking oligopoly.

Such an approach would deliver an outcome consistent with the Government's stated intention of seeking to increase competition in Australia's banking sector while delivering clear benefits to consumers, small business and the broader economy.

Key Recommendations

To Improve Australian Credit Reporting System & Increase Bank Competition:

Mandate "deeper" credit reporting— current law preserves a massive blind spot in the Australian credit reporting system. Namely, lenders are unable to see a person's total level of indebtedness. This leads to over-indebtedness among some consumers, who must endlessly borrow from Peter to pay Paul. This is damaging to the entire lending system, and drives up the interest rates for everybody to pay for unnecessary bad debt. Mandating that lenders report account balances will remedy this problem.

Permit "broader" credit reporting— another historic blind spot in the Australian credit reporting system is non-financial payment data, also called alternative data. For many people—younger Australians with no prior credit experience, legal immigrants whose credit histories don't travel with them, elderly Australians who are widowed or divorced---accessing affordable mainstream credit is difficult. This large population are trapped in the "Credit Catch 22" whereby in order to qualify for credit, you must already have it. One proven and effective means of helping this group build a credit history—or repair and rebuild one after life happens—is by having non-financial payment data reported. This could include regular monthly payments such as a wireless phone bill, payments for cable or satellite TV, broadband, gas, water, electric, and rent. New Zealand, the United Kingdom, the United States, China, Brazil, and other countries permit and encourage this type of reporting for exactly this reason. It is time for Australia do the same.

Permit use of Predictive Data for Pre-qualifying Borrowers—the single most effective manner in which credit report data can be used to galvanize competition among lenders by enabling them to use credit report data to make firm offers of credit to consumers. In countries where this is permitted, it has had three primary impacts: (1) greatly increased access to affordable credit for individuals and small businesses; (2) dramatic reductions in the cost of credit paid for lower risk borrowers; and, (3) immediate competitive impacts including new products, investments in innovation, and improved customer service. Of course, individual consumers should have the right to opt-out of receiving firm offers of credit. Given the current market structure for consumer and commercial lending in Australia, this tool will work wonders for borrowers including small business owners. Dominant lenders may oppose it—and would likely cite privacy reasons (this is payment data, not privacy sensitive materials) to scare off politicians and regulators. Make no mistake, their opposition would purely stem from the fear of competition that would result should such a measure be approved. For those seeking a more competitive lending landscape, this is how to do it.

To Improve Australian Credit Reporting System & Protect Credit Bureau Competition:

Clarify that Mandate Is Permanent: One interpretation of the exposure draft legislation is that once pre-November 2, 2017 contracts expire, large banks are free to discontinue reporting to one or all private credit bureaus. They are also permitted to report to a new entrant—including hypothetically a credit bureau that is wholly owned by the big 4 lenders for their exclusive use only. By granting large lenders the right to pick and choose which, if any, credit bureau with which to share their data, they are granting large lenders massive leverage over credit bureau, including price-setting power. Contra the stated objective of the legislation, competition upstream and downstream will be greatly diminished should lawmakers fail to amend this provision. Lenders could elect to share with only one or two credit bureaus upstream, reducing competition greatly and enabling lenders to exercise undue influence over credit bureau policies. Downstream, competition could be diminished if the depth of data were limited, if the uses for which credit bureau data could be used were limited, or if access to a credit bureau's data were restricted in any manner. Given existing regulations, this is exactly the behavior to expect from the large lenders. Unless the rules binding lenders are changed, there is no reason to anticipate different outcomes.

Clarify that Mandate Applies to all Regulated Lenders—excluding Tier 2 and Tier 3 lenders from the mandate opens the door to the Balkanization of the credit reporting market. Evidence from around the worlds, gathered over decades, shows that "segmented" credit reporting systems consistently underperform relative to comprehensive and full-file systems, in many cases dramatically so. Should the current draft legislation become law, all lenders other than the big 4 are free to determine whether or not they wish to report to a credit bureau, whether to report to more than one, and the duration of their reporting agreement. This certainly favors the incumbent credit bureau, which has had far more time to establish business relations with the full spectrum of lenders. While we recognize that reliably reporting customer payment data to all licensed credit bureaus could be a tall order for some small lenders in Australia, this is certainly not the case for medium-sized lenders. Further, even the very small lenders will be able to report over time. The world is filled with examples of very small, cash-strapped micro-finance institutions consistently reporting payment data to a credit bureau (see Bolivia, Brazil, China, India, Mexico, and the US for just some examples). Finally, unless the other lenders fully report, competition will only be enhanced among the big 4, and not between the big 4 and all other lenders. This would not be ideal, as consumers would not enjoy the full benefits of competition nationally, and locally their lenders may be totally unaffected.

Key Principles of a Modern Credit Reporting System

Over the past 15 years, the structure of a nation's credit information sharing system has come to be understood as critical financial infrastructure. Informed by theory and empirical evidence, a consensus has emerged among multilateral organizations and regional development banks concerning principles for credit reporting—a best practices of sorts.[1] Having the right type of credit bureau that collects the right type of data was seen as so important for growth in lending to the private sector—small businesses and individuals—that in 2015 the 21 member economies of the Asia Pacific Economic Cooperation (APEC) endorsed the Cebu Action Plan that includes a roadmap for the growth and development of regional financial services—the first point of which focuses upon using the World Bank's General Principles for Credit Reporting to guide legal and regulatory frameworks for national credit information sharing systems.[2] Below are several of the principles relevant to Australia:

World Bank's Credit Data General Principle 1: *credit reporting systems should have relevant, accurate, timely and sufficient data - including positive - collected on a systematic basis from all reliable, appropriate and available sources, and should retain this information for a sufficient amount of time.*[3]

This is trivially true—more predictive data in a credit bureau repository enables lenders to make better credit risk decisions. The result is an improved loan portfolio performance for lenders, greatly expanded access to credit for small businesses and individuals, and improved systemic safety and soundness with greater transparency (less over-indebtedness, fairer credit access, more competitively priced credit). Credit reporting systems lacking a minimum depth of data (Australia's today and even after the proposed mandate) and breadth of data sources (Australia's today and even after the proposed mandate) will underperform relative to their potential—in some cases by a wide margin.

[1] *General Principles for Credit Reporting*. The World Bank (WB), the Bank for International Settlements (BIS), and the International Bank for Reconstruction and Development (IBRD). Washington, DC. September 2011. Downloadable at: http://documents.worldbank.org/curated/en/662161468147557554/pdf/70193-2014-CR-General-Principles-Web-Ready.pdf

[2] In 2015, the finance ministers from the 21 member economies of the Asia Pacific Economic Cooperation (APEC) endorsed the Cebu Action Plan, Point 1A. of which specifically endorses the World Bank's General Principles for Credit Reporting as the guideline for credit information sharing within the APEC region. This was approved by Australia's Treasury. See: *Annex A - Finance Ministers' Process (FMP) Roadmap/Cebu Action Plan.* Pillar 1: Promoting Financial Integration. Point 1A. "Promote an enabling financing environment for MSMEs including trade, supply chain, and alternative financing means. Draw the support of ABAC, the SME Finance Forum, the World Bank Group and the OECD and other international organizations by establishing a Financial Infrastructure Development Network as a specialized subgroup within the APFF. The Network will facilitate workshops, dialogues and studies in consultation with the relevant APEC Working Groups, to support interested APEC economies to: Establish legal frameworks for Credit Information Systems (CIS) based on the World Bank's General Principles of Credit Reporting." Downloadable at https://www.apec.org/Meeting-Papers/Sectoral-Ministerial-Meetings/Finance/2015_finance/annexa

[3] *General Principles for Credit Reporting.* Pg. 25.

World Bank's Guideline A on Sufficient Data: *Credit reporting service providers should be able to collect and process all the relevant information needed to fulfill their lawful purposes. Relevant information comprises both negative and positive data, as well as any other information deemed appropriate by the credit reporting system, consistent with the considerations described in the other General Principles*.[4]

This was the original impetus for reforming the Privacy Act in 2013. Namely, that Australia was then, and continues to be hobbled by a "negative-only" credit reporting system wherein lenders only report late payment data to credit bureaus. This creates a black list of borrowers and is a tool for financial exclusion. It was recognized then that the national credit reporting system needed to increase the depth of information to included positive data. The reporting of non-financial payment data, though permitted in New Zealand in 2012, was prohibited. That is, credit data in Australia with the reforms of 2013 was to become somewhat deeper, but no broader.

World Bank's Guideline B on Sufficient Data: *Credit reporting service providers should set up clear rules on minimum data inputs and optional data inputs. Data elements to be collected should include, at a minimum: identification information, information on the credit including original amount, date of origination, maturity, outstanding amount, type of loan, default information, arrears data and transfer of the credit when applicable. Ideally this would also include credit risk mitigation instruments such as guarantees, collateral and an estimate of their value*.[5]

There is a well-established link between the depth of data reported to private credit bureaus and the ability of lenders to extend credit to the private sector (businesses of all sizes, and individuals). With full participation from all lenders reporting full-file data to licensed private credit bureaus—including outstanding balance—lending to the private sector (especially small businesses) would increase as much as 45% per annum sustainably while prices would decrease for borrowers at every risk tier.[6]

World Bank's Guidelines on collection of data on a systematic basis from all relevant and available sources: Credit reporting service providers should be able to gather information from all relevant data providers, within the limits established by the law. Credit reporting service providers should be able to access other data sources of relevance, within the limits established by the law.[7]

In the US, one of the most information rich environments on earth, more than 1 in 10 persons are "Credit Invisibles." This group is unable to access affordable sources of mainstream credit because they either have no credit report, or insufficient history to generate a credit score.[8] Trapped by the "Credit Catch 22"—that in order to qualify for credit you must already have it—this group relies upon high cost fringe financial institutions (pay day lenders, pawn shops,

[4] *Op. Cit.* Pg. 27.
[5] *Op. Cit.* Pg. 28.

[6] Djankov, Simeon, Caralee McLiesh, and Andrei Shleifer. 2007. "Private Credit in 129 Countries." *Journal of Financial Economics* 12 (2): 77-99. Downloadable at: https://scholar.harvard.edu/shleifer/publications/private-credit-129-countries
[7] *Annex A - Finance Ministers' Process (FMP) Roadmap/Cebu Action Plan.* Pg. 28.
[8] "Data Point: Credit Invisibles." Consumer Financial Protection Bureau, Office of Research. May 2015. Downloadable at: https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf

title lenders, check cashing, and rent-to-own) to have their real credit needs met. Most members of this group pay rent monthly, as well as making a host of other credit like payments for their cell phone(s), broadband, cable or satellite TV, gas, water, electric, and insurance. If this data were fully reported to licensed private credit bureaus, then lenders would be able to see these borrowers according to their true credit profiles—and many (an estimated 40%) would be granted access to some variant of prime credit.[9]

The mandatory comprehensive credit reporting system outlined in the government's February 8, 2018 exposure draft legislation falls short of the international standards endorsed by the Turnbull Administration in November 2015. Importantly, the discrepancies between the international principles endorsed by the leaders of the 21 member economies of APEC and the proposed legislation in Australia are all measures that would have the effect of promoting competition among lenders and among credit bureaus.

Comparing Best Practices with Proposed Mandatory CCR in Australia

Guideline	**World Bank Principles**	**Australian Exposure Draft CCR Mandate**
Comprehensive reporting (multi-sectoral including telecoms, utilities, rent)	✔	✖
Full-file (including both "negative" or late payment data, and "positive" or timely payment data	✔	✓/✗
Includes outstanding balance in credit file	✔	✖
CIS supports development of fair and competitive credit market	✔	✓/✗

As the table above shows, while the 2013 reforms to the Privacy Act and the exposure draft legislation represent progress over the decades old "negative-only" regime in Australia, primarily by including some positive data, important positive data is excluded as is proven non-financial payment data. Aligning credit reporting in Australia with APEC best practices would yield the best results for borrowers, small business owners, and the entire economy. It would also anchor Australia into the dynamic regional financial services sector making Australian banks more competitive regionally as well as domestically.

[9] Estimate offered by GE during release of the PERC/Brookings Institution joint-study *Give Credit Where Credit Is Due*. Washington, DC. December 2006. To access report, see: https://www.brookings.edu/research/give-credit-where-credit-is-due-increasing-access-to-affordable-mainstream-credit-using-alternative-data/

The next section examines the path dependency in efforts to reform credit reporting in Australia, with a particular focus on why past and current efforts remain disconnected from regionally endorsed best practices.

Mandatory Comprehensive Credit Reporting as a Tool to Facilitate Competition Among Consumer Lenders

On February 8, 2018 the Australian Treasury issued exposure draft legislation including a provision to mandate comprehensive credit reporting (CCR).[10] In tandem, explanatory materials were also released.[11] This was the culmination of a process begun 6 years earlier with major reforms to the Privacy Act of 1988, Part IIIA of which governs credit information sharing within Australia.[12] Part IIIA was substantially amended by Privacy Regulation 2013, and supported by the Privacy (Credit Reporting) Code 2014 (V. 1.2).[13]

The impetus for the earlier reforms to credit reporting were to increase financial inclusion, enable fairer and more responsible lending, and improve systemic safety and soundness through the inclusion of additional information in consumer credit reports and in analytic tools derived from credit bureau data (e.g. credit risk scores). The theory was that lenders, equipped with better and more complete data about a borrower's credit risk and credit worthiness, would be better able to differentiate high risk from low risk borrowers, could assess more borrowers in general, and would be able to compete with one another in a manner that would benefit borrowers and the Australian economy.[14] In turn, regulators, able to access more granular data, would better be able to perform regulatory, oversight, and supervisory functions.

It is noteworthy that the current context into which the mandatory comprehensive credit reporting legislation has been shoe-horned is completely different. Today, rather than being about improving an unfair, monopolistic, and anachronistic national credit information sharing (CIS) system (because voluntary reforms have not worked, CIS in Australia remains, to this very day unfair, concentrated, and anachronistic), efforts now are aimed at promoting competition among a handful of very large lenders that dominate the consumer and commercial lending

[10] National Consumer Credit Protection Amendment (Mandatory Comprehensive Credit Reporting) Bill 2018. No. , 2018. Downloadable at https://treasury.gov.au/consultation/c2018-t256276/

[11] *Op. Cit.*

[12] The Privacy Act of 1988. Act 119 of 1988. Downloadable at https://www.oaic.gov.au/privacy-law/privacy-act/ ;

[13] Privacy Regulation 2013. SLI 2013 No. 262. Downloadable at https://www.legislation.gov.au/Series/F2013L02126 ; Privacy (Credit Reporting) Code 2014 (Version 1.2). CR code v1.2. Downloadable at https://www.oaic.gov.au/privacy-law/privacy-registers/privacy-codes/privacy-credit-reporting-code-2014-version-1-2 .

[14] Turner, Michael. Patrick Walker, Robin Varghese. *Credit Impacts of More Comprehensive Credit Reporting in Australia and New Zealand*. Durham, NC. PERC Press. August 2012. PERC, working with the Australian Retail Credit Association (ARCA) and Dun and Bradstreet Australasia, were able to secure a Parliamentary exemption in order to access massive quantities of customer data from the largest banks in Australia. This data was used in simulations designed by PERC to assess the likely impacts from the proposed credit reporting reforms upon borrowers, lenders, the financial services sector, and the economy in Australia (and New Zealand). The study can be downloaded at http://www.perc.net/wp-content/uploads/2013/09/PERC-Report-Final.pdf

markets. In other words, instead of occupying center stage as it did during the 2013 reforms, credit information sharing reform is a small part of a much broader effort to reform the functioning and structure of the Australian financial services market.

This seemingly trivial observation is an important point as it has consequences. It is the position of this paper that because the government's efforts are focused largely on changing the structure of consumer and commercial lending markets, insufficient attention has been paid to: (1) the impacts of the proposed mandatory CCR on the structure of the credit reporting market; and, (2) how further reforms to the national CIS system could in fact be the single most effective tool for achieving the primary policy objective of facilitating increased competition among lenders in business and retail credit markets.

"…credit information sharing reform is a small part of a much broader effort to reform the functioning and structure of the Australian financial services market."

As will be detailed below, not only has this relationship between the structure of the CIS market upstream and the structure of credit markets downstream seemingly been misunderstood (and possibly ignored altogether), but the actual reforms contained in the exposure draft legislation of February 8, 2018 are so fraught with engineered problems that they could result in more harm to consumer and commercial credit markets than good—an ironically could actually impede competition both upstream among credit bureaus and ultimately downstream among lenders as a consequence.

The key here is understanding firm behavior given a specific regulatory framework. Lenders dragged their feet under the voluntary system, and watered down efforts to make the system more robust not because they were led by immoral or unethical executives. Rather, firms behave in their self-interest given a regulatory framework. They are always seeking profit maximization. Indeed, PayPal co-founder Peter Thiel once quipped, "Monopoly is the condition of every successful business."[15] To change firm behavior, lawmakers in Australia must seek to change the environment—the rules by which firms must accord themselves.

[15] Thiel, Peter. "Competition is for Losers." *The Wall Street Journal*. September 12, 2014. Downloadable at https://www.wsj.com/articles/peter-thiel-competition-is-for-losers-1410535536

Part A: Establishing an Optimal Credit Reporting System in Australia

Brief Overview of 2013 Reforms to Privacy Act of 1988

In considering the 2013 reforms of the Privacy Act of 1988, predictably, those efforts failed. While large lenders publicly paid lip service to the virtues of credit reporting reform, they had earlier opposed such reforms fearing competition from more data savvy multinational lenders such as Barclay's, HSBC, Standard & Chartered, GE and Citibank among others. It is well known that even after the 2013 reforms, executives and lobbyists from large Australian banks pleaded with legislators to move slowly and incrementally, if at all.

Large lenders clearly understood that expanding data elements reported to credit bureaus, expanding the breadth of data furnishers reporting to credit bureaus, and expanding the credit purposes for which credit data could be used would result in greater competition among all lenders. It may be for this reason that so-called comprehensive credit reporting in Australia by design falls well short of international best practices and standards in other advanced countries such as the US and the UK.[16] It is also no accident that the spirit of voluntarism among lenders in the nation's voluntary credit information sharing system has been mostly low to non-existent. Simply put, lenders do not have an incentive to increase competition and potentially reduce their margins, and, as such, have acted to restrain deeper and broader credit reporting. By all measures, they continue to do so and will unless the rules are changed.

Promoting Inclusive, Responsible, and Competitive Lending

A credit reporting regime shift from a primarily negative-only system to a *more* full-file system (increased data depth) and comprehensive system (increased data breadth) will enable lenders to make better credit decisions and result in more inclusive and responsible lending. PERC's 2012 report "Credit Impacts of More Comprehensive Credit Reporting in Australia and New Zealand," used Australian credit data and compared credit decisions based on credit scores using primarily negative data to ones that used more comprehensive data.[17] For instance, the same report found safe lending was able to rise over 25% with the use of fuller, more comprehensive data.[18]

A visual representation of this is the following ROC curve that compares the accuracy of using no data or worthless

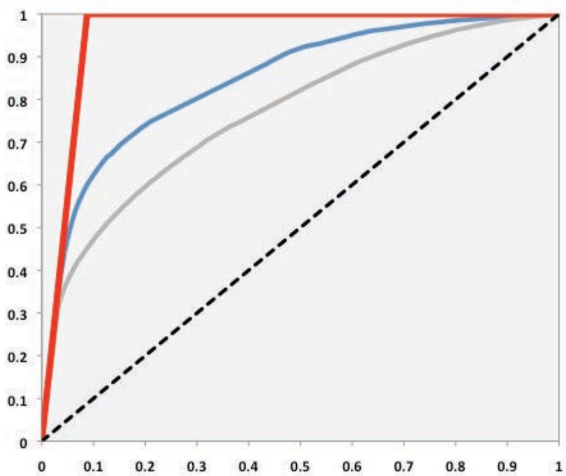
[16] Sections 2.3 and 3.2 discuss the types of data elements to be included in comprehensive and full-file credit reporting systems. The International Consumer Credit Reporting Committee of the World Bank Group endorses the practices detailed in the General Principles that includes full-file (more data elements than under the Australian system) and comprehensive (more sectors reporting than allowed under the Australian system). *General Principles for Credit Reporting*. Washington, DC. World Bank Group. September 2011. Downloadable at http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/Credit_Reporting_text.pdf

[17] Turner, Michael, et al. *Credit Impacts of More Comprehensive Credit Reporting in Australia and New Zealand*. PERC. August 2012. Available at: http://www.perc.net/wp-content/uploads/2013/09/PERC-Report-Final.pdf

[18] *Op. Cit.*

information (dashed black line) to using primarily negative data (grey line) to using fair file data (blue line) to the perfect case in which all good loans and defaulted loans could be determined with information at the time of application (red line). This chart is not theoretical, but was drawn using actual Australian data for the 2012 PERC report.

ROC Curve, % of Defaults



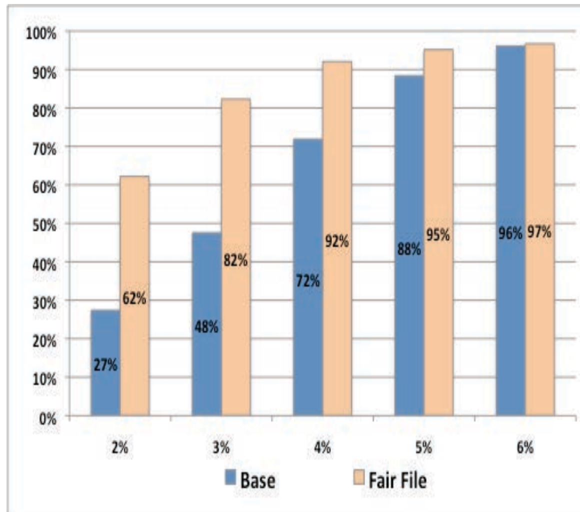
Share of Applicants Ordered by Score

What is clear is that while negative-only data is useful, adding payment histories and other positive data in the fair file system adds meaningfully to the predictive power of credit scoring models and, ultimately, the accuracy of credit underwriting.

It is important to note that if additional key data elements (such as balance) were added to the fair file data, a line between the blue (fair file) and the red (perfection) would be produced. Such data would dramatically reduce the probability of default while opening access to affordable credit for many more small business owners and individuals.

Another way to see the impact of switching to fair file data is to see for a given default rate, how many borrower could be accepted with a credit score using the status quo data versus one using fair file data. This is shown in the following figure.

Acceptance Rates for Different Target Default Rates (Known Goods and Bads)



As can be seen, for portfolios with a 3% or 4% default rate, many more borrowers could be accepted with the richer, fair file data.

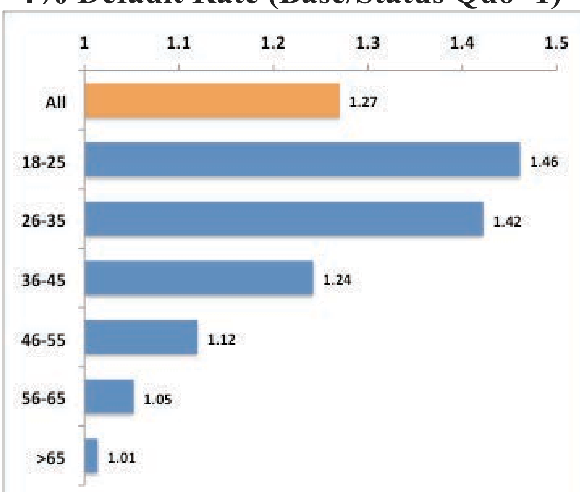
The biggest beneficiaries of the improved ability to underwrite credit with fair file data were the youngest adults (18-25 year olds) who had the least credit history. So, while safe credit approvals could rise 27% overall with a switch from status quo to a fair file regime, it would increase over 40% form the younger borrowers.

Importantly, if Australia were to mandate the sharing of deeper data (e.g. permitting account balance) and broader data (proven payment data such as wireless telecoms, broadband, cable and satellite TV, and energy utility payments), the acceptance rates for small businesses and consumers would be higher still at every risk tier.

Should lenders target a 2% default rate, an industry norm, acceptance rates under full-file should go close to 7 in 10.[19]

"… safe lending was able to rise over 25% with the use of fuller, more comprehensive data."

Change in Acceptance Rates with Addition of Fair File Data by Age at 4% Default Rate (Base/Status Quo=1)



[19] PERC has considerable experience using credit file data to estimate impacts from data inclusions and exclusions. Regarding exclusions, early PERC work on proposed changes to the US Fair Credit Reporting Act showed reductions in access to credit ranging from 20% to over 50%. While these were different data elements—given the known predictive power of account balance we believe an increase in credit access of 10% is a conservative and defensible estimate. See Turner, Michael A. The Fair Credit Reporting Act: Access, Efficiency, and Opportunity. Washington, DC. Published by The National Chamber Foundation. June 2003. Downloadable at: http://www.perc.net/wp-content/uploads/2013/09/fcra_report.pdf

In addition, the richer data could allow lenders the ability to better identify risk and reduce portfolio default rates. The shift to fuller file data also means the credit records could be more forgiving of consumers who had past delinquencies and defaults. For instance, in a negative-only environment, having a past default could act to cut off access to credit until that derogatory aged off the credit reports. But with positive payment data added to reports, consumers could rehabilitate their credit reputations after such derogatories by making on-time payments to show that they had righted their finances.

An example of this, again using actual Australian data from the 2012 PERC study, is shown in the following table.

	With Prior Derogatories	
Target Default Rate	Base (Neg-Only)	Fair-File
2%	0%	0.5%
3%	0%	1%
4%	0%	6%
5%	0%	16%
6%	0.3%	28%

Using a credit score based on full file data, many borrowers with past severe derogatories could be extended intro credit offers with moderate interest rates, while this would not be possible with a credit score based on negative only data. A credit underwriting process that utilized a negative only credit score would act to curtail attempts at credit redemption.

For these benefits of full-file data to emerge, it is necessary for data furnishers (lenders and non-financial institutions) to actually report the more comprehensive data. Hence the need for reforms to the proposed mandate and the need for policymakers and regulators to make it clear that they expect all large lenders capable of full-file credit reporting to do so, and continue to do so, and report to all major national credit bureaus (even though this is not explicitly required in the current draft of the proposed mandate).

Going beyond the current scope of the current draft of the proposed 2018 Mandatory Comprehensive Credit Reporting Bill, Australian policymakers should move forward on three additional reforms that could noticeable improve credit inclusion, responsible lending, and banking competition.

The first area is in what data is reported by lenders. The current proposed "comprehensive" regime does not include account balances. This is an extremely odd circumstance. Given that monthly payment data and credit limits are reported, there is neither a logical privacy nor a technological issue with also reporting balances. Not including this element in the "fair file" scheme may simply have resulted from initial push back by lenders.

With balances, how indebted a consumer is can be determined. This can prevent consumers from becoming over-indebted.

Whatever the case, not having balances reported hobbles credit reporting. Knowing balances relative to credit limits helps in risk assessment. For instance, a person with a $100,000 line of credit conveys limited information. A person with a balance of $0 would have a different risk profile than one with a $100,000 balance.

"With balances, how indebted a consumer is can be determined. This can prevent consumers from becoming over-indebted."

Knowing the monthly payment alone is not helpful since a person might be paying $500 a month on their credit card because they are paying the minimum on a large balance or because they pay off their card every month and never accumulate a balance. Knowing the credit utilization rate is key. A person with $80,000 of total credit available across several credit cards and utilizes little of that would appear to be a different risk than someone who has recently and suddenly maxed out all of their cards.

Second, policymakers should push to have payments for telecom and energy utilities reported to credit bureaus. This so-called proven payment data (PPD) enables consumers with little to no credit history to easily demonstrate their bill payment history. This has been shown to disproportionately benefit younger consumers (with little credit history) and lower income consumers.[20] The reporting

[20] Turner, Michael, et al. A New Pathway to Financial Inclusion. PERC. June 2012. Available at: http://www.perc.net/publications/new-pathway-financial-inclusion/

of this data also allows consumers to build a positive credit and bill payment history without going into debt. This helps break the credit Catch-22, that ones need to have a history of credit to get credit. This data also improves credit underwriting more generally (improving risk assessment and making lending more responsible).[21] Further, in PERC's 2012 report using Australian data, we found that the reporting of fair file Australian telecommunication payment data could increase safe lending by 20%, without increasing delinquencies.[22] This would be a powerful force for financial inclusion. Collecting balances could also help feed FinTech applications or financial advisors that work to help consumers manage their budget and debts.

Third, data collected by CRBs should be able to be used for extending credit offers by lenders. This is an obvious way to make the lending sector more competitive. For instance, lender A could be given a list of consumers with good credit standings that have credit cards. Lender A could then send offers for a credit card with a low interest rate to these consumers. Such transparency could jumpstart competition. Lenders would have to be on their toes and not assume that their current customers are so sticky that they need not offer them the best rates and prices. For obvious reasons, large lenders would oppose this and come up with many reasons why this would not be a good thing. For consumers who would view receiving credit offers a hassle, they could be given the option of opting out.

"… in PERC's 2012 report using Australian data, we found that the reporting of fair file Australian telecommunication payment data could increase safe lending by 20%, without increasing delinquencies."

That is, beyond getting major lender off the dime and actually reporting fuller file data to the Australian CRBs, which is a great first step, policymakers should be forward looking in ways to further promote inclusive, responsible, and competitive lending. Key ways to do this would be to work to expand the data that lenders report, expand the types of furnishers that reports, and expand the uses for the collected data. The next three sub-sections examines each of these policy ideas more fully, explaining why they are important to the Australian financial services sector and the entire economy.

[21] Turner, Michael and Patrick Walker. Predicting Financial Account Delinquencies with Utility and Telecom Payment Data. PERC. May 2015. Available at: http://www.perc.net/wp-content/uploads/2015/05/Alt-Data-and-Traditional-Accounts.pdf

[22] Turner, Michael, et al. Credit Impacts of More Comprehensive Credit Reporting in Australia and New Zealand. PERC. August 2012. Available at: http://www.perc.net/wp-content/uploads/2013/09/PERC-Report-Final.pdf

Increase Breadth of Data Reported to Credit Bureaus

First, to call the current system in Australia "comprehensive credit reporting" is a misnomer. Outside of Australia, the term CCR refers to the breadth of data sources within a national credit information sharing system. For example, a system that includes data from regulated financial institutions, non-bank financial institutions, micro-finance institutions, energy utility companies (gas, water, electric), media companies (mobile and landline telecoms, cable TV, broadband), insurance payment data, rental payment data, and other data is considered comprehensive. One that includes just data from regulated financial institutions—which is the case in Australia—is "segmented." [23] In segmented systems, lenders must assemble data from multiple sources, for instance specialty credit bureaus, if it is available at all.

What is referred to as CCR within Australia is commonly called "full-file reporting" in much of the rest of the world. Full-file reporting describes the depth of data elements that are reported to a private consumer credit bureau. On a high level, a full-file system includes both positive payment information (*e.gs.* credit inquiries, data account opened/closed, credit limit, current balance, payment amount and date, type of credit, utilization rate, balance ratios) and negative payment data (*e.gs.* delinquencies, defaults, credit judgments, liens, evictions, and bankruptcy information). Historically, and presently, Australia is a negative-only system, with fragmented data and not comprehensive data.

While over 30 countries[24] accounting for more than one-third of humanity have credit information sharing systems permitting non-financial entities to report payment data to private credit bureaus, and while the Privacy Commission in New Zealand permitted this when they reformed the Credit Reporting Privacy Code in 2012, Australia elected not to permit this data to be fully reported to private credit bureaus.[25] This was a grave mistake, and has undoubtedly contributed to the existence of a non-trivial population of Credit Invisibles within Australia. Credit Invisibles are those persons who either have no credit report at a private credit bureau, or have insufficient information to generate a credit score.

In an environment of pervasive automated underwriting, such persons are almost always rejected by lenders when seeking

[23] *General Principles for Credit Reporting*. Washington, DC. World Bank Group. September 2011. See the discussion beginning at paragraph 54 on Pg. 15. Here, definitions are offered for "comprehensive" and "segmented" credit reporting, as well as "full-file" and "negative-only." Even today, and likely until positive data reporting is mandated, Australia is best characterized as a fragmented negative-only credit reporting system. That is, data in credit repositories is overwhelmingly, if not exclusively, from regulated financial institutions—and contains late payment data and other derogatory information. Downloadable at http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/Credit_Reporting_text.pdf

[24] As identified by the World Bank in the Doing Business database, Getting Credit index. Within this index is the index "Depth of credit information" that measures, among other things, whether a nation's credit information sharing system includes fully-reported non-financial payment data. See http://www.doingbusiness.org/data/exploretopics/getting-credit?dataPointCode=DB_gc_creditInformation

[25] For a brief description of the changes to national credit reporting law implemented by the New Zealand Privacy Commission in 2012, see https://www.privacy.org.nz/the-privacy-act-and-codes/codes-of-practice/credit-reporting-privacy-code/credit-reporting-what-changed-in-201/

credit. Most often, such persons are younger (Millennials) or elderly (late-stage divorcees, widows/widowers), lower income, immigrants, and members of minority communities (Aboriginal Australians).

Credit Invisibles remain trapped by the Credit Catch 22—that in order to qualify for credit you must already have credit. It's like applying for your first job, and being told by human resources that they love your resume, but are seeking someone with more experience. For Credit Invisibles, the single best means of escaping the Credit Catch 22, and building or rebuilding a good credit history, is through the inclusion of fully reported proven payment data (PPD) such as non-financial payment data (energy utility, rent, telecoms) in a consumer credit report. Decades of research and practice from countries around the world establish this fact.[26]

"An estimated 1.8 million Australian Credit Invisibles remain trapped by the Credit Catch 22—that in order to qualify for credit you must already have credit."

[26] Turner, Michael A. Alyssa Stewart Lee, Robin Varghese, Patrick Walker. *Give Credit Where Credit Is Due: Increasing Access to Affordable Mainstream Credit Using Alternative Data*. Washington, DC. The Brookings Institution and PERC. December 2006. Downloaded at http://www.perc.net/wp-content/uploads/2013/09/alt_data.pdf

Increase the Depth of Data Sources Reporting to Credit Bureaus

Importantly, because the 2012/2013 reforms to the Privacy Act stopped well short of full-file reporting, it was referred to as "fair-file" reporting by the Australian Retail Credit Association (ARCA) and other proponents of reform. While ARCA and large ADIs publicly cited privacy concerns to explain their incremental approach, the reality is that the data elements excluded from the earlier reform efforts (and current reform efforts) are absolutely essential to promote competition among consumer lenders, and to ensure systemic safety and soundness. Specifically, absent information about account balance, lenders have no means of determining a borrower's level of indebtedness or, more dangerously, of over-indebtedness. As such, the dilemma of "borrowing from Peter to pay Paul" has not been solved. This dilemma was well known in Australia as far back as 2008, and the recognition of this dangerous blind spot in credit risk assessment was part of the national discourse for the following 4 years.[27]

The reason this blind spot was left unaddressed has more to do with competition among lenders than anything else. After whether or not a bill is paid on time, variables using balance are extremely predictive of credit risk and credit worthiness. One such variable derived from account balance is called

[27] Turner, Michael. Katrina Dusek, Robin Varghese, and Patrick Walker. *Roadmap to Reform: Lessons from around the world to guide consumer credit reporting reform in Australia.* Melbourne, AU. Prepared for the Asia Pacific Credit Coalition by Dun and Bradstreet Australia. See specifically Section 3.2 "Expecting the Unexpected." October 2008. Downloadable at http://www.perc.net/wp-content/uploads/2013/09/Roadmap_fullreport.pdf

utilization rate. This is simply the ratio of total account balance to total credit limit. Someone with a high utilization rate represents a relatively higher risk, especially if the utilization rate remains high over time with little new credit and payment activity. Without this information, lenders are unable to identify genuinely lower risk borrowers and undertake risk-based pricing. Consequently, large lenders experience greatly reduced competitive pressures and are able to extract higher rents from existing and new borrowers. And, of course, customers/borrowers, who maintain balances and pay their bills on-time represent cash cows for lenders. Lenders would not want competitors to be able to easily identity these individuals and offer them better terms.

Permit Use of Credit Data Enabled Marketing

Not only is the Australian credit information sharing system relatively below international best practices concerning the depth and breadth of data elements reported to credit bureaus, but it is far more restrictive concerning the range of permissible purposes for which credit bureau data can be used. In many advanced countries, credit file data can be used for employment screening, tenant screening, insurance underwriting, and for a credit data enabled marketing whereby lenders obtain lists of people with specific credit characteristics in able to extend them firm offers of credit. Credit data enabled marketing is the single most effective means of using credit bureau data to promote competition among lenders.

While it is understandable that this was left off of the table during the public policy debate leading up to reforming the Privacy Act in 2012/2013, it is more than puzzling that this powerful tool for promoting competition among lenders has been completely ignored in a piece of legislation with the chief policy objective being to promote competition among consumer and commercial lenders. This oversight is not something that slipped through the cracks. Large banks will vociferously oppose this use of credit file data, and will bandy about the usual privacy arguments even though their very own data mining and database marketing practices unequivocally demonstrate that personal privacy is a compliance issue and something to be managed as opposed to a core value.[28]

Credit data enabled marketing can transform stagnant, concentrated credit markets into vibrant, hyper-competitive markets in a relatively short period of time. Consider the credit card market in the US. In the 1980s, cards were issued by brick and mortar bank branches and were the domain of the well-heeled. Few cards were issued to women, members of minority communities, or low-to-moderate income people. American Express even touted “membership has its privileges.” The era of county club credit in the US was shattered by firms like AT&T, Discover, and Capitol One. Firms that had no physical bank branches, but instead could use credit file data for prescreening to extend firm offers of credit.

[28] “Mining EFTPOS data for one of the ‘big 4.’ Monash University. Downloaded at https://www.monash.edu/research/infrastructure/delivering-impact/research-outcomes/massive/big-data-mining-market-segmentation-of-anz-bank-eftpos-data

"Credit data enabled marketing can transform stagnant, concentrated credit markets into vibrant, hyper-competitive markets in a relatively short period of time."

Almost overnight, credit data enabled marketing made access to finance far more inclusive and affordable. In a survey of card issuers in the US conducted by PERC, it was found that credit data enabled marketing accounted for 68% of new accounts acquired, while the next closest channel—direct mail no prescreening—accounted for just 17% of new accounts acquired. [29] Credit data enabled marketing was found to have reduced new account acquisition between $4 and $14 per account ($5 US to $19 US in 2017 dollars), saving cardholders between $239 US million to $1.36 US billion a year in reduced credit costs ($325 US million to $1.85 US billion in 2017 dollars).[30] PERC estimated that consumers saved an average of $30 US billion per year between 1998 and 2002 on card interest payments owing largely to the competitive effects of prescreening ($40.8 US billion in 2017 dollars).[31]

Expanding Mandatory CCR and Amending the Privacy Act

When considering proposed changes to Australia's anachronistic and punitive "negative-only" credit reporting system in 2007, the Bank and Financial Services Ombudsman Limited drew the following conclusion:

"In our view, the need for appropriate information to appear on a credit information file must be balanced against the rights of individuals to conduct their financial affairs privately. While we are of the view that the additional financial information on a credit information file (limited to the names of current credit providers) would enhance good lending practices, in our view, the appearance of any further information such as account descriptions and current balances would be an unnecessary and excessive imposition on the right to privacy." [32]

Upon closer examination, the factual basis for this conclusion was tenuous at best, and relied upon baseless assertions and unsubstantiated speculation from unqualified and biased sources at worst. To be clear, the prevailing view of previous governments when considering credit reporting reform punishes consumers and distorts the entire Australian financial services system. All policy decisions involve an understanding

[29] Turner, Michael A. Robin Varghese, Dan Balis, Anne Schnare, Larry Buc. *The Fair Credit Reporting Act: Access, Efficiency, & Opportunity—The Economic Importance of Fair Credit Reauthorization.* Washington, DC. Published by the National Chamber Foundation. June 2003. For a discussion of the impacts of pre-screening, see Section VII, on pages 54-62. Downloadable at http://www.perc.net/wp-content/uploads/2013/09/fcra_report.pdf

[30] *Op. Cit.* Pg. 58.

[31] *Op. Cit.* Pg. 5. See also endnote 51.

[32] Australian Law Reform Commission. "Review of Privacy Credit Reporting Provisions: Issues Paper 32." Submission by the Banking and Financial Services Ombudsman Limited. March 2007.

of tradeoffs. For instance, raising gas tax to reduce toxic carbon emissions may make it harder for lower income people to make ends meet. However, lawmakers may increase funding for affordable mass transportation to help mitigate the regressive nature of a gas tax.

From a practical perspective, being able to report credit limits, monthly payments, and type of credit, but not balances makes little sense. For installment loans (mortgages, auto loans, other bank installment loans) the balance is easily determined. But it would not be possible to determine balances on revolving loans (credit cards, lines of credit). So, not reporting balances does not really hide many balances but at the same time does not allow for a consumer's total balances or utilization rate to be known by lenders.

In the case of credit reporting reform (past and current), lawmakers must place on the proverbial scale the costs and benefits of proposed reforms against the status quo. The benefits—increased access to affordable credit for individuals and MSMEs, fairer lending practices, reduced default rates given any acceptance rate, increased transparency within the financial services sector, an increased ability for regulators to undertake micro- and macro-prudential oversight, to regulate and supervise the sector, sustained growth in lending to the private sector, and sustained economic growth—must be weighed against the costs—costs to banks and other data furnishers for upgrading their IT systems, compliance costs, and allegedly privacy costs.

Fortunately, the cost/benefit analysis involves asking questions that can be answered with empirical evidence. There exists decades of work in both theoretical and empirical economics on the impacts of increased credit information sharing on financial services and the macro-economy. Theoretical literature demonstrates how increased credit information sharing reduces information asymmetries between lenders and borrowers (reveals to lenders hidden information about a borrowers willingness and ability to repay a debt obligation), and creates reputational collateral to be used in credit risk assessment (a borrower who is delinquent in repaying a debt obligation or who defaults will have their credit reputation damaged, making access to credit in the future more difficult and more costly). In this manner, credit information sharing reduces the probability of adverse selection (lenders less likely to misidentify high risk as low risk and vis-a-versa) and moral hazard (borrowers will be less likely to take on debt and then fail to repay).

Apart from direct costs from upgrading IT systems and retooling software platforms, quantifying other costs has proven to be difficult. Opponents of CCR overly-rely upon assertions and murky and unquantifiable potential outcomes. Further, weak assertions about "privacy" costs are buttressed by addition unsubstantiated assertions that have absolutely nothing to do with data privacy—such as data accuracy and data security, both of which are entirely separate domains.

For instance, misspelling my name, associating my name with an incorrect address or date of birth are all data accuracy issues. Whether a party should have access to my personal identifying information (PII) and for what purposes are data privacy issues. One can agree that access to a person's PII for a specific purposes is legitimate and does not violate a person's individual privacy rights (especially with their prior affirmative consent) but still be deeply concerned about the integrity or accuracy of the data maintained by a data aggregator. This is certainly the case in consumer credit reporting, where access is granted to very sensitive personal financial information to credit bureaus but bureaus are bound by regulatory provisions to ensure the maximum possible accuracy of the data.[33]

Measuring the Costs and Benefits of Broader and Deeper Credit Reporting

Granting access to truly comprehensive (multi-sectoral) and full-file (robust credit and payment data including negative and positive information) has thus far been hindered by heavy skepticism about the benefits enhanced credit information sharing coupled with a great willingness to accept a range of baseless and non-quantifiable assertions from unqualified sources about potential risks and harms.

Here, it is worth analyzing specific claims put forward about the costs/risks associated with comprehensive credit reporting. The main arguments are summarized and analyzed below.

Actual data privacy: In their assessment of this topic, the Australia Law Review Commission (ALRC) cites the Victorian Government submission that stated CCR would have a "…potential impact on privacy…particularly in relation to financial matters."[34] Totally devoid of any factual basis, Australian telecoms giant Telstra was cited by the ALRC report as having submitted "…it is by no means clear that more comprehensive credit reporting would provide additional benefit outweighing the additional exposure to an individual's privacy." Finally, Veda Advantage (now Equifax) was also cited in the ALRC report. According to the report:

"Veda Advantage characterised the privacy risks as involving: first, the risk to the individuals arising from a more significant quantity of data about them being held and shared among credit providers; and secondly, the potential harms arising from the misuse of the data, for both credit and non-credit related purposes."

These claims, and to a degree the claimants, share common characteristics. First, the claims are speculative. They assert potential privacy harms without establishing specific privacy risks or quantifying the probability of harm or magnitude of potential harm. In other words, how much harm is associated with unauthorized access and use of expanded credit file data? Is it really account balance information that would greatly

[33] In the US, the Fair Credit Reporting Act requires nationwide consumer reporting agencies to undertake all reasonable measures to ensure the maximum possible accuracy of credit file data. See 15 U.S. Code § 1681e. Downloadable at https://www.law.cornell.edu/uscode/text/15/1681e

[34] Consumer Affairs Victoria, *The Report of the Consumer Credit Review* (2006), 273. Cited in the ALRC's report titled *For Your Information: Australian Privacy Law and Practice.* (ALRC Report 108). Sections 52 through 58 concern aspects of credit information sharing. Section 55 focuses upon alleged problems with comprehensive credit reporting. This section can be accessed using the following link: https://www.alrc.gov.au/publications/55.%20More%20Comprehensive%20Credit%20Reporting/problems-more-comprehensive-credit-reporting#_ftn120 The full report is downloadable at https://www.alrc.gov.au/publications/report-108

empower an identity thief over and above what is already available in a credit file should the thief access a person's credit file? Second, the actual risks asserted are already prohibited. Credit data in Australia is limited to being used for credit risk assessment, period. Credit file data cannot be used for third-party marketing and other non-credit purposes. Third, Telstra and Veda Advantage aren't exactly disinterested parties. Both were/are near monopoly firms in their respective industries, and each would confront dramatically more competition should truly comprehensive and full-file reporting and credit data enabled marketing come to be in Australia. Fourth, it is unclear from their submission to the ALRC exactly what qualifies the Victorian government or Telstra to assess the benefits from CCR, or even whether they have even made any attempt to do this at all (no quantitative studies cited in either submission as the basis for these claims).

"This government must not be distracted by the privacy red herring. No privacy rights would be violated by the reforms proposed by PERC in this paper. Failing to act, however, will harm millions."

Ultimately, the actual privacy concerns submitted to the ALRC are either wafer thin (asserted and not backed by any credible research), or come from dubious and conflicted sources (firms seeking to preserve a privileged market position by deploying a privacy red herring to suppress competition). This government must not be distracted by the privacy red herring. No privacy rights would be violated by the reforms proposed by PERC in this paper. Failing to act, however, will harm millions.

Other potential costs from expanding the contents of consumer credit files, and expanding the range of permissible purposes include decreased data accuracy, increased access to credit file data by a larger number of firms for a broader range of purposes, and data security. Each is addressed in turn below.

Data accuracy is a legitimate concern, regardless of how many data furnishers are reporting to credit bureaus, and how many data fields they are reporting. Of course, credit bureaus work closely with each individual data furnisher to qualify them for reporting to a bureau before any of a furnisher's data is loaded in a live credit file. Furnishers unable to consistently report in a satisfactory and timely manner are unable to have their data included. Credit bureaus monitor credit reports with sophisticated tools to ensure data accuracy over time, and meet with any furnishers who have a pattern of issues and work to resolve them. Further, consumers routinely review their credit files and are able to freely dispute inaccurate items. Despite popular perception, based largely on experience from decades ago when data was loaded from a variety of media (paper, magnetic tape) and in a variety of formats, credit file data is now overwhelmingly transmitted digitally in a single format—which has resulted in credit file data being highly accurate.[35]

Integrating data from telecommunications and energy utility firms, companies that relay on sophisticated bill payment software platforms for their revenue stream, is not an exceedingly difficult or costly process. Further, analysis of credit file data accuracy in other countries has not found non-credit data to be less accurate than other tradeline information. There is simply no evidence to suggest that increasing the quantity of predictive data—either by having regulated lenders include additional data fields such as account balance or by having non-credit data fully reported—presents any additional risk to consumers from inaccurate data. Further, this additional data has proven instrumental in driving financial inclusion as it helps Credit Invisibles overcome the "Credit Catch 22," as it is the primary source of non-credit data that can help thin-file/no-file persons build a credit history without having to take on unneeded debt.[36]

Expanded access/loss of control (greater number of organizations for additional permissible purposes) was a further concern cited in the 2008 ALRC report on CCR. National Legal Aid argued that: "The risk is too great that comprehensive information about individuals' finances will be used for a range of purposes that go beyond simply assessing the creditworthiness of an applicant for credit."[37] This "strawman" is a puzzling concern as restricting access to and the uses of credit file data is something easily accomplished. Indeed, the current regime only permits credit file data to be used for credit risk assessment and other credit purposes (identity verification, anti-money laundering, fraud protection). While no one is proposing open access to credit file data, expanding the range of permissible purposes could yield tremendous benefits to Australian consumers and the entire economy.

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[35] To date, there are two well-regarded and rigorous assessments of the quality of consumer credit file databases. Both studies were done in the United States, and both directly involved consumers (data subjects), all nationwide consumer credit bureaus (data custodians), and lenders (data furnishers). One study was conducted by PERC, and the other by the U.S. Federal Trade Commission (FTC). Despite slight differences in methodology, most key results from both studies were statistically identical. In fact the FTC detailed its assessment of the earlier PERC analysis in their report to Congress giving it credit as a exemplary study. PERC subsequently compared the results from both studies and explained any significant differences. For the PERC study, see Turner, Michael A., Robin Varghese and Patrick Walker. U.S. Consumer Credit Reports: Measuring Accuracy and Dispute Impacts. Durham, NC. PERC Press. May 2011. Downloadable at http://www.perc.net/wp-content/uploads/2013/09/DQreport.pdf ; For the PERC comparison of their data quality study with the FTC's, see Turner, Michael A. Robin Varghese and Patrick Walker. Comparing FTC and PERC Reports on Measuring the Accuracy of U.S. Consumer Credit Reports. Durham, NC. PERC Press. April 2013. Downloadable at http://www.perc.net/wp-content/uploads/2017/10/FTC_PERC-Layout2.pdf ; For the FTC report to Congress on the accuracy of consumer credit reports, see:

[36] Turner, Michael A. Alyssa Stewart Lee, Robin Varghese, Patrick Walker, Joseph Duncan. Give Credit Where Credit is Due: Increasing Access to Affordable Mainstream Credit Using Alternative Data. Washington DC. The Brookings Institution and PERC. December, 2006. Downloadable at http://www.perc.net/wp-content/uploads/2013/09/alt_data.pdf ; Turner, Michael A. Patrick Walker and Katrina Dusek. New to Credit Through Alternative Data. Durham, NC. PERC Press. March 2009. Downloadable at http://www.perc.net/wp-content/uploads/2013/09/New_to_Credit_from_Alternative_Data_0.pdf

[37] National Legal Aid, *Submission PR 521,* 21 December 2007. Cited in ALRC Report 108.

In summary, past and current arguments against broadening and deepening credit file data in Australia fail to meet even the lightest burden of proof test. Arguments are asserted and not proven or even supported in any scientifically meaningful manner. By stark contrast, the benefits of opening the Privacy Act to reconcile the Australian credit reporting system with international best practices are well established, supported by mainstream economic theory and by decades of empirical economic research from countries around the world, as well as by practice in many markets across the globe.

It is important to point out, that by failing to reform the Privacy Act to enable credit reporting in Australia to adhere to international best practices, policymakers are harming Australian borrowers—especially the estimated 1.8 million Credit Invisibles—lenders, and regulators who will struggle to perform lending and oversight functions with more limited data assets.

Part B: Issues with Exposure Draft Legislation on Mandatory CCR

Contracting Provision Likely to Distort Credit Reporting Market

Large ADIs Behavior After Pre-November 2, 2017 Contracts Expire

The dilemma faced by regulators and policymakers with regard to credit information sharing is clear. They *want* lenders (particularly larger lenders) to share information with credit bureaus to improve competition in lending, efficiency, credit access for individuals and SMEs, and safety and soundness. In markets like Australia, where positive information sharing is permitted but not actually reported by lenders, regulators and policymakers have gone beyond permitting and encouraging information sharing and have moved to some form of mandate.

In market economies, there is also an understandable tendency for policymakers to act cautiously and limit mandates to only what is viewed as the minimum necessary measures to achieve the desired outcomes. However, it is important to recognize that limited mandates, like more expansive ones, can have unintended consequences and market distorting impacts too. It is also important to recognize that the same business incentives for large lenders to *not* voluntarily report positive data—and that have acted to keep this data out of the national credit reporting system for the past 6 years—will continue to exist after the proposed legislation is passed. As such, one would expect the lenders to act in the same ways, and take advantage of any loopholes or details of the laws including the mandate.

The proposed National Consumer Credit Protection Amendment Bill 2018 requires large ADIs to report "comprehensive" data to the CRBs with which the large ADIs had a contract in force on or prior to 2 November 2017. Our concern is that the bill does not require reporting to all CRBs or to a CRB for which a contract in force on or prior to 2 November 2017 has expired. That is, our reading is that the exposure draft legislation:

- *Permits large ADIs to stop comprehensive credit reporting (CCR).* For contracts entered into after 2 November 2017, it does not appear to be the case that CCR is mandated. As such, despite the mandate, large ADIs could begin reporting negative data to a new CRB and then decide to stop reporting comprehensive data to the CRBs with which they previously contracted;
- *Grants large ADIs enormous leverage over CRBs.* It is also possible that large ADIs could simply use the threat of not reporting to an individual credit bureau to exert control over prices and services offered by one or more credit bureaus.
- *Enables large banks ability to dampen competition.* Since CRBs can act to increase lending competition, self-interested lenders could act out of a fear of competition and try to reign in CRBs. That is large lenders could use the details of the 2018 bill and reshape credit reporting in a way that suites their own private, particular interests, such as maximizing profits and minimizing competition.

Any of these three outcomes would be detrimental to consumers, small businesses, and the Australian economy. If large ADIs do actually switch CRBs, playing one CRB off another, with some lenders reporting to some credit bureau(s) and others reporting to a different bureau(s), the result would be a segmented credit reporting system, also detrimental to Australian credit information sharing and, as a result, consumers.

> **"Such credit data segmentation was found to be stifling consumer and small business credit markets and was difficult to correct once becoming established."**

Such segmentation is seen in a number of markets in which data furnishers choose to report to a credit bureau that benefits their narrow interests and then have influence over how the credit bureau operates. Examples of this outcome include Japan and Mexico. In Japan, where large traditional banks report to one credit bureau and credit card and finance companies to another. In Mexico, large traditional lenders report to one credit bureau and retailers and other lenders to another.

This sort of segmentation distorts the credit information sharing markets since credit reports and the score built from them only represents one segment of a person's actual total credit profile. Such credit data segmentation was found to be stifling consumer and small business credit markets and was difficult to correct once becoming established.[38] In Japan, an estimated 25% of all consumer lending is done in the black market. Further, Japanese lenders have long struggled to set margins on loans to small businesses, contributing to Japan's "lost generation" of stagnant growth because they lacked a domestic engine to propel economic growth. In Mexico, the four largest banks (all foreign-owned) are the most profitable subsidiaries for the owner institutions on earth. Consequently, despite being a middle income economy, Mexico consistently maintains one of the highest rates of financial exclusion in all of Latin America. Segmented credit reporting systems can either constrain economic growth (how much stronger would Japan's economy be with a full file, comprehensive system?) or can be devastating to a national economy (how much suffering have middle and lower income Mexicans endured to line the wallets of executives at the 4 largest Mexican banks).

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[38] Turner, Michael A. Robin Varghese, Patrick Walker. On the Impact of Credit Payment Reporting on the Financial Sector and Overall Economic Performance in Japan. PERC. March, 2007. Downloadable at http://www.perc.net/wp-content/uploads/2013/09/Japan.pdf

Tier 2 and 3 Lenders Not Required to Report to All Licensed Credit Bureaus

Another aspect of the National Consumer Credit Protection Amendment (Mandatory Comprehensive Credit Reporting) Bill 2018, is that the mandate as currently envisioned only covers large ADIs. That is, the four largest lenders in Australia. The logic behind this could be that it is the largest of the banks that have the least incentive to report comprehensive data, but if they do report then the smaller lenders would also have an incentive to report and access the data from the larger banks. Our concern is that the next largest banks, beyond the big four, should also be comprehensive credit reporting, but may choose not to report positive data. If many of the tier 2 and tier 3 lenders choose not to report positive data, or elect to share their customer payment data with a single credit bureau instead of all licensed credit bureaus, this could produce a Balkanization by lender size and limit the types of data available to various lenders.

Unless Tier 2 and (eventually) Tier 3 lenders are required to fully report to all licensed credit bureaus, one of two outcomes are highly likely, neither of which is optimal for Australian borrowers (individuals and small businesses) or the economy:

1. The credit bureau market is increasingly segmented. Either the majority of Tier 2 and Tier 3 lenders will furnish to a single bureau (most likely the incumbent), creating a dominant single credit bureau, or they will report scatter shot across the three licensed bureaus (or new entrants), making it difficult for lenders to get a comprehensive view of a single borrower without buying reports from all licensed credit bureaus.
2. The competitive effects of mandatory data sharing will be less than it could be owing to non-participation from some Tier 2 and Tier 3 lenders. Absent this data being reported to all bureaus, competition will be more limited, primarily to among the big 4 and not between all lenders. Depending on a local or regional retail lending market structure—a locality may be dramatically underserved by large lenders and/or small lenders—the local lenders may not feel any competitive effects from data sharing, especially as less of it is shared from smaller lenders.

While some may see these concerns as extreme or unjustified, it is worth noting again that Comprehensive Credit Reporting is currently permitted and encouraged but is *not* being carried out voluntarily by most lenders of any size. This is the reason for the mandate.

"Absent this data being reported to all bureaus, competition will be more limited, primarily to among the big 4 and not between all lenders."

The current version of the draft exposure legislation takes a very light touch with regard to mandating CCR. In this way, we assume the regulators and policymakers are using this bill to get lenders off the dime, assuming the once lenders begin reporting that they will report to all major national credit bureaus and continue to report. However, given the revealed actions by lenders in the current voluntary regime, we would suggest that policymakers and regulators make their intentions clear. That is, either mandate that large and medium-sized lenders (beyond just the big 4) begin reporting more comprehensive data, do so to all major national credit bureaus, continue to report in perpetuity, and refrain from using their market power to curb CRBs and their services that may increase lending competition. This could be done in the language of the proposed bill or by making clear that this is what policymakers and regulators expect and will act swiftly if this is not seen.

It is instructive to note that the US voluntary comprehensive reporting system arose when the lending industry was diffuse and not nearly as concentrated as it is now. Some believe that this is the reason that voluntary comprehensive reporting took off in the US. Large lenders know that regulators would now prohibit them from discontinuing credit reporting and/or exercising control over credit reporting to suit their own self-interest. There are sufficient quantities of attempts by creditors in the US to do both; attempts that were met with swift opposition from regulators. For regulated lenders in the US, while there is not a *de jure* mandate there is a *de facto* mandate. Given the role of credit bureaus in promoting lending competition, policymakers and regulators in markets with large banks and a concentrated lending sector should make it clear that there is a *de facto* reporting mandate even if there is not a *de jure* mandate.

Additional permissible purposes for using credit file data

As was stated earlier in this report, we are not advocating for the expansion of permissible uses of credit file data for non-credit purposes (e.g. insurance underwriting, employment and tenant screening). Rather, we are advocating for the immediate expansion of permissible purposes to include credit data enabled marketing for extending firm offers of credit. This policy change, coupled with the expansion of data reported to nationwide credit bureaus to include account balance—both in the context of the mandatory CCR framework—and by permitting the reporting of non-financial proven payment data, would do more to promote competition among lenders than anything else available to the government. Best of all, these are pen-stroke policy changes that will cost Australian tax-payers nothing.

Having said that, there exists compelling empirical evidence to support the use of credit file data and credit risk scores for a range of other purposes.[39] While these

[39] For a study showing how credit scores are predictive of insurance risk, see: Golden, Linda L., Patrick L. Brockett, Jing Ai and Bruce Kellison. "Empirical Evidence on the Use of Credit Scoring for Predicting Insurance Losses with Psycho-social and Biochemical Explanations." North American Actuarial Journal. Volume 20, 1 September 2016, Issue 3. Pgs. 233-251. Downloadable at https://www.tandfonline.com/doi/full/10.1080/10920277.2016.1209118; See also, "Findings Report: Use of Credit Scores by Insurers." Credit Score Working Group of the Canadian Council of Insurance Regulators. Downloaded at https://www.ccir-ccrra.org/en/init/Credit_scor/Credit_Scoring_Findings_Report_EN.pdf ; For an excellent study on the value of using credit report data for employment screening, see: Alexander W. Bartik and Scott T. Nelson. "Credit Reports as Résumés: The Incidence of Pre-employment Credit Screening." March 17,

studies are first generation and will invariably spawn further future research, the gist of the analysis boils down to risk-taking behavior in one realm (reckless credit behavior, for example) translates to risk-taking behavior across other realms (driving, treatment of personal property, behavior at work). Studies show that low credit scores correlate with a much higher probability of filing insurance claims. According to the Golden study: "Credit scores were significant correlated to incurred losses, evidencing both statistical and practical significance." [40] Further, concerns that the use of credit-based insurance scores serve as proxy for income—leading to discrimination against lower-income persons—have dissipated given new evidence showing this fear to be unfounded.[41]

While using credit report data for employment screening and insurance underwriting has certainly been controversial in some markets around the world, the use of the same for tenant screening has been far less so. This is because renting an apartment is a form of credit. Further understanding someone's past credit repayment behavior, as well as their credit capacity reveals important information to landlords about the ability and probability of timely rental payments. PERC recommends that this application be considered as a near-term option for expanding the list of permissible purposes for using credit data.

Conclusion

Now is the time to upgrade the national credit reporting system in Australia. Currently, Australia is saddled with a legacy system from the 1980s designed for technology and lending practices from the 1970s. An earlier attempt to modernize by deepening the credit reported by lenders to licensed private credit bureaus failed miserably as banks likely wanted to avoid the competition that would result from increased data sharing—even a modest increase.

Given the loud public outcry for reforming the lending system that led to the creation of a Royal Commission to draft and promote legislation that would accomplish this, there are sufficient grounds to re-open the Privacy Act to ensure that the tool of credit reporting is fully used to promote competition among lenders. Instead of simply mandating half-measures promoted by banks in 2013 designed to minimize the competitive impacts of credit information sharing, the government would do well to consider the following:

Mandate must be for all lenders, to all licensed credit bureaus: the exposure draft legislation excludes all but the big 4 lenders (ANZ, Commonwealth, NAB, Westpac). Others are free to report to just onecredit bureau (this favors the incumbent credit bureau and leads to market segmentation) or none at all. Given recent history, there is little reason to

2016. Available online from the Department of Economics at the Massachusetts Institute of Technology (MIT). https://economics.mit.edu/files/14223 Among other findings was the fact that blacks seeking jobs in areas where the use of credit reports for employment screening was banned had a harder time finding work, and were fired at higher rates than in those areas permitting this practice.

[40] *Op. Cit.* Pg. 233.

[41] Steeg Morris, Darcy. Daniel Schwarcz, and Joshua C. Teitelbaum. "Do Credit-based Insurance Scores Proxy for Income in Predicting Auto Claim Risk?" Washington, DC. Georgetown University Law Center. June 15, 2016. Downloadable at https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=2530&context=facpub

believe that PRDE and other incentives will have the desired influence on lender behavior. Medium-sized lenders should be covered by the mandate, and small lenders that can demonstrate hardship or capacity issues can be exempted until able to report. Small lenders with modest means around the world have found ways to reliably report customer payment information to credit bureaus. There is no reason why this cannot be so in Australia too.

Mandate must be permanent: Even the big 4 lenders are free to pick and choose which credit bureau with which they will share data after their contracts expire. This gives each of the big 4 tremendous leverage over the credit bureaus (become price-setters, even term setters). This could result in an even more concentrated credit reporting market that is less innovative and less effective in supporting competition downstream among lenders. Such an outcome must be avoided at all costs, as it will lead to harmful outcomes for borrowers, including small businesses, the financial services sector, and the entire Australian economy.

Draft legislation preserves blind spot—does not prevent over-indebtedness: A critical flaw in Australia's system is that it does not mandate that lenders share account balance with licensed credit bureaus. Without this piece of information, a lender has no way of knowing how indebted a borrower actually is. Loans could then be extended to a person who is already over-indebted. This harms the borrower (increases debt burden), the lender (has mistakenly identified a high risk borrower as a low risk borrower), and the safety and soundness of the entire Australian financial services sector. This also acts to dampen competition among lenders as they cannot be certain of a prospective borrower's debt burden. This information is highly predictive of risk, and variables derived from account balance (such as utilization rate, and debt ratios) are nearly as predictive as whether or not a person has paid their credit obligations on time.

Proposed Mandatory CCR Won't Enable Financial Inclusion: Only those who already have credit are included in credit bureau databases. Those who have no prior credit history, or have insufficient data to generate a score—known as "Credit Invisibles"—will remain trapped by "Credit Catch 22"—that in order to qualify for credit you must already have credit. By excluding non-financial payment data—mobile telecoms, cable and satellite TV, broadband, gas, water, electric, rent—the best means of driving financial inclusion is denied.

Permitting Credit Offers using Predictive Data Drives Competition Among Lenders, Reduces Interest Rates: Before credit data enabled marketing, getting a credit card in most countries was a privilege reserved for the elite. The era of "country club credit" changed when card issuers without physical branches could market cards to qualified consumers. It is the single most effective means available to card issuers for finding new customers. PERC estimates that US cardholders save nearly $43 billion US each year in reduced interest rates largely as a result of prescreening.

About PERC

Founded in New York City in 2002, PERC is the only non-profit public policy research and development organization exclusively dedicated to the relationship between financial inclusion and access to/the use of information and information solutions. Our mission is to stamp out Credit Invisibility worldwide, and drive financial inclusion, through the responsible use of information and information solutions. PERC have undertaken projects in more than 25 countries on 6 continents. PERC have been retained as consultants to the US Department of Treasury, the US Department of Housing and Urban Development, The World Bank, The International Finance Corporation (IFC), the Inter-American Development Bank (IDB), and the Organization for Economic Cooperation and Development (OECD). PERC serve as "Sherpa" to the APEC Business Advisory Council (ABAC) on all matters relating to credit information sharing. PERC CEO and founder Dr. Turner was appointed and served on the inaugural Data Privacy and Integrity Advisory Committee of the US Department of Homeland Security (DHS), and has testified before Congress and in federal courts on numerous occasions. Dr. Turner was also a campaign advisor to Barack Obama. PERC have co-published reports on credit reporting with the OECD, the IFC, the Brookings Institution among others. To date, our research and outreach has helped change national policy in dozens of countries, and has resulted in helping more than 1 billion people build or rebuild a positive credit history. To learn more about PERC, see www.perc.net

PERC's History in the Australian Credit Reporting Policy Debate

PERC began working on credit reporting reform in Australia in 2005. Early on, PERC partnered with Dun and Bradstreet Australasia (now illion) to raise awareness of the social and economic benefits from credit reporting reform, and the costs of preserving the status quo. PERC engaged in extensive outreach with national lawmakers, regulators, members of the media, consumer and privacy advocacy groups, as well as industry groups. PERC also released a series of studies attempting to quantify the inefficiencies and injustices associated with Australia's punitive "negative-only" credit reporting system, and quantify the range of benefits associated with proposed reforms. PERC was granted a Parliamentary exemption to be able to access data from large lenders, as well as some Tier 2 and Tier 3 lenders in Australia for purposes of completing this analysis. PERC also advised one licensed private credit bureau on the development of production grade credit risk scorecards using full-file data and non-financial payment data.

About the Asia-Pacific Credit Coalition

Founded in 2007, the APCC have been promoting principles for consumer and commercial credit information sharing among the 21 members of the Asia Pacific Economic Cooperation (APEC). The APCC have been designated as "Sherpas" for the APEC Business Advisory Council (ABAC), and have worked with ABAC on credit reporting issues since 2007. More recently, the members of the APCC have provided guidance to ABAC for the Asia Pacific Financial Forum (APFF) and the Financial Infrastructure Development Initiative (FIDN) concerning credit information sharing policy. To date, working with ABAC and APEC, the APCC have served as a resource on credit information sharing policy to more than half of all APEC member economies (Australia, Canada, Chile, China, Indonesia, Mexico, New Zealand, the Philippines, Singapore, Thailand, the United States, Vietnam). For more about the APCC, visit www.apeccredit.org

PERC
6409 Fayetteville Road., Suite 120-240
Durham, NC 27713USA
www.perc.net

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