

## Box 7 Considerations Regarding the Memory of Credit Bureaus

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One of the basic problems that credit markets face is the one that literature refers to as the problem of “asymmetric information” (Akerlof, 1970). This arises from the inherent difficulty of distinguishing debtors with good creditworthiness from those without creditworthiness. The latter represent a high risk of losses for credit institutions and their depositors. To deal with this problem, some credit institutions might establish hard lending standards for granting a loan (for example, high interest rates) that would discourage debtors with good creditworthiness. Thus, asymmetric information has negative effects on access to credit and financial inclusion and, to the extent that it discourages debtors who have the ability to pay, it also has negative effects on the stability of the financial system.

That is why public policy has sought to establish mechanisms that would mitigate the problem of asymmetric information in order to strengthen access to credit and promote financial stability. One of these mechanisms is the existence of credit bureaus (CB). As Jappelli and Pagano (2002) and Brown et al. (2008) have shown, CBs that provide accurate, reliable, and timely information have positive effects on the quantity and quality of credit in the financial system. This is especially pertinent to the case of debtors who do not have assets that could serve as collateral for a loan (e.g., debtors with low-wealth or low-income), in which case, their access to credit is crucially dependent on the information that exists about them.

Of course, a critical policy goal in this regard is the proper regulation of the CBs as well as activities associated with sources, users, and holders of information. An important element of regulation is the length of time negative reports are held under the understanding that it is important to

recognize that negative reports should be eliminated to the degree that they become less informative about the current creditworthiness of the owner of the information. At the same time, it is essential for the negative reports to stay in the CBs long enough so that they may be informative for the information users whenever a debtor’s creditworthiness needs to be assessed. Thus, efforts are made to ensure that the information that the CBs have is as accurate and reliable as possible and, as a result, the problem of asymmetric information is mitigated and greater access to credit, financial inclusion, and financial stability is ensured.

The literature has some empirical studies that evaluate the impact of reducing the time that negative reports remain on the books (something that is referred to in the literature as the CB memory). These studies conclude that reducing the memory has a negative impact on access to and quality of credit. In the case of Sweden, Bos and Nakamura (2011) found that the reduction of the memory carried out in 2003 (up to a maximum of three years) improved access to credit for borrowers with negative reports but increased the probability of default. This suggests that the reduction of memory destroyed negative reports that were still informative which, as a result, increased defaults and affected the stability of the financial system. In the case of Bolivia, Ioannidou and Ongena (2010) found that a short credit history (two months, in the Bolivian case) has an adverse effect on financial inclusion to the degree that it exacerbates the problem of asymmetric information for those banks that receive applications from potential debtors about whom they have no information. Musto (2004) found that in the case of the United States, the elimination of negative reports is “efficiency in reverse,” in the sense that, even though some debtors get more credit in the short term (since the elimination of negative reports artificially creates a better credit history), in the long term, this effect disappears and the only remaining consequence is a higher rate of defaulting on loans with the resulting negative effect on financial stability.

In the case of Colombia, Bos, Morales, and Roszbach (2017) found that the reduction in the CBs’ memory caused by the transitional regime of Act 1266/2008 had the effect of reducing the size of disbursements by banks and increasing their margins. This is consistent with the consequences of asymmetric information mentioned above. At the same time, one of the effects of the Act’s transitional regime was the increase in the periods of non-payment. With respect to the same transitional regime, Gonzalez and Osorio (2015) found that the reduction in the size of disbursements mainly affected debtors with an impeccable credit history. The above suggests that while the reduction in memory might benefit those debtors with negative reports, this would be achieved at the expense of borrowers with good behavior and clean credit histories. Public policy should strive to encourage and not jeopardize those debtors with this responsible and healthy behavior.

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These findings also have an important implication in terms of the culture of non-payment. In the public discussion, the tendency is to think that the reduction of the CBS' memory would have the effect of generating a culture of timely payments among debtors, who would have an incentive to pay their debts in view of the more limited time that the negative reports would remain on the books. However, what the literature suggests is that the effect of reductions of the memory is precisely the opposite, that is, it generates a culture of non-payment, to the extent that when the CBS' memory is reduced, those debtors who fail to pay their debts are rewarded while at the same time, those debtors who, in spite of all their difficulties, maintain a spotless credit history are harmed. The above would have a significant negative effect on financial stability: for example, as was mentioned earlier, according to Bos et al. (2017), when CBS' memory was reduced due to the Colombian transitional arrangements for Act 1266/2008, this had the unintended consequence of increasing default length. This reflected the increase in the culture of non-payment and certainly had a negative effect on financial stability.

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