

LAD CASE STUDY

Establishing the Individual Credit Registry System in China

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The Leadership Academy for Development (LAD) trains government officials and business leaders from developing countries to help the private sector be a constructive force for economic growth and development. It teaches carefully selected participants how to be effective reform leaders, promoting sound public policies in complex and contentious settings. LAD is a project of the Center on Democracy, Development and the Rule of Law, part of Stanford University's Freeman Spogli Institute for International Studies, and is conducted in partnership with the Johns Hopkins School of Advanced International Studies. LAD gratefully acknowledges support from the Omidyar Network.

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Introduction

In January 2006, Mr. Dai, director-general of China's new Credit Information System Bureau (CISB), was busy preparing for a briefing with senior officials of the People's Bank of China (PBC). His task was daunting: to outline the critically important issues that still had to be resolved in establishing a Credit Registry System (CRS) and clarify what the priorities should be as the bureau moved forward. Mr. Dai would need to carefully explain the advantages and disadvantages of building a public or private CRS, and justify his preference for a public system. Other key questions that needed to be addressed during the briefing included whether a national CRS could keep up with the enormous demand for credit reports and how the government would launch a national communications strategy to help the public become familiar with the new CRS. These and many other questions were on Mr. Dai's mind as he met with his team to prepare for the briefing.

Until the 1980s, credit was a foreign concept to China's *laobaixing*, or ordinary people. With the establishment of the communist People's Republic of China (PRC) under Mao Zedong in 1949, money was a passive tool, and state-owned commercial banks severely restricted lending to individuals. A Chinese citizen relied on cash or a savings book holding their earnings in a bank for daily financial transactions.

As part of China's transition from a planned economy to a market-oriented economy that began in 1978, the country changed from a strictly "cash territory" to "an emerging promise land of credit" in the relatively brief time span of ten years. In the 1980s the Bank of China began issuing credit cards, which was a major innovation by Chinese standards and the beginning of a major revolution in providing credit to consumers. Establishing an individual CRS—the main information source for lenders seeking creditworthiness information on borrowers—would be the cornerstone of this transition. "It was a dramatic departure from the past," noted Ms. Wang, a central bank official who played an integral role in developing the CRS. "We needed to create a credit registry system that had all the basic and borrowing information of individual consumers and the infrastructure required to build and maintain such a system." Complicating matters was the reality that China lacked the necessary regulatory framework, including consumer protection laws, bankruptcy laws and creditor

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rights. The country also did not have a consumer education program that typically accompanies a well-functioning CRS. China faced an uphill battle to build a modern financial system essentially from scratch.

Background: The Credit Information System Bureau

A CRS is a repository of information that enables a lender, such as a bank, to assess the creditworthiness of a prospective borrower. Without a CRS, lenders are at a disadvantage when they price and extend loans because they must rely on the accuracy of information provided by borrowers. This so-called “information asymmetry” occurs because the prospective borrower has more information about his or her true financial capacity to repay a loan than the bank does, and the borrower controls what information to provide the lender. As a result, the risk to the lender of making a decision based on inaccurate or incomplete information about the borrowers willingness and ability to repay the loan creates powerful disincentives to extend credit to unfamiliar borrowers. Many countries have mitigated this risk by creating credit registries or information reporting systems that provide banks with better information about prospective borrowers. (See exhibit 1 for a glossary of acronyms and terms.)

Basic functions of a CRS:

- Collect, validate, and merge data
- Generate and distribute reports
- Provide data security and back-up

The World Bank and other development finance institutions (DFIs) stress the positive effects of credit information reporting for the overall economy because it serves as a catalyst for increasing access to finance. By using a CRS, lending institutions share and have access to information about borrowers’ financial condition, which leads to significant gains in operating efficiency, a reduction in loan losses, and better risk management systems. Financial institutions are thus more willing to serve borrowers.ⁱ A significant concern with a credit reporting system, however, is privacy. Financial services providers may take advantage of this information by creating and marketing products that may be harmful to consumers. (A CRS addresses the credit needs of individuals, which is distinct from an enterprise credit registry system that contains information on companies.)

Unlike a typical CRS, which is solely focused on the collection and distribution of financial data about an individual/household, the Chinese credit system has the additional objectives of promoting social stability. PBC Deputy Governor Su Ning explained that in traditional Chinese culture “social credit” refers to the reputation of a person in society. It’s based on mutual trust between individuals.ⁱⁱ Building a CRS, the deputy governor explained, is “an objective demand of the socialist market economy system, a basic requirement of building a socialist harmonious society . . . and the foundation and guarantee of financial development.”ⁱⁱⁱ Thus, even as China was undergoing a gradual transition from rigid central planning to a market economy with greater reliance on the private sector, Chinese leaders still intended to retain a political system based on fundamental socialist values.

Background: A brief history of Chinese financial sector reform (1947-78)

From 1948 to 1978, the PBC was China's only public bank, and also served as the central bank. The PBC controlled the issuance of the Chinese currency and was the sole supervisor of financial institutions.^{iv} Under Deng Xiaoping, gradual steps were taken to change the banking system. In 1982, the state-owned Industrial and Commercial Bank of China (ICBC) was spun off from the PBC and operated with commercial banking functions. Later, the government created the Bank of China, China Construction Bank, and the Agricultural Bank of China. These state-owned banks, commonly referred to as the "big four," continue to dominate the financial sector. One news report in 2011 estimated that they accounted for 35-40% of total loans and a larger share of deposits.^v But, because of Deng's initiatives, state owned enterprises (SOEs) were allowed to gradually diversify their financing sources and become less dependent on the "big four."

"Crossing a river by feeling the stones" (1992-2002)

Chinese leaders have typically favored a gradual, pragmatic approach to economic policymaking. The government tests new programs on a small scale before launching a nationwide mandate, following the famous Chinese saying "crossing a river by feeling the stones."

In the 1990s, Chinese leaders announced a broad set of banking reforms. The "big four" were transformed from specialized state banks to wholly state-owned commercial banks, and they were required to begin adapting professional practices that are commonplace in well developed financial institutions, such as asset-liability ratio management, internal risk control, standardized accounting and a non-performing loan classification system. The government also allowed the mortgage-lending market to expand to meet the needs of an increasingly prosperous middle-class seeking to own homes. To further support a growing consumer demand for loans, the PBC, in cooperation with local governments, created experimental credit registry systems in Shenzhen and Shanghai.

A precursor to the first credit registry, a loan certificate program (*daikuanzheng*), was launched in 1992 in Shenzhen, a major manufacturing center near Hong Kong in southern China. The Shenzhen municipal government cooperated closely with PBC local branches, but this pilot program was rudimentary. Bank officials manually filled out a notebook with a borrower's basic information and credit history and shared the information with banks when requested.

Five years later, in 1997, the Chinese Party Central Committee (CPCC) and State Council (the most senior administrative branch in the PRC government) affirmed that promoting higher levels of consumer credit stimulated domestic demand, promoted economic growth, and contributed to the overall goal of poverty alleviation. By 1999, the power to issue consumer credit was transferred from the PBC to commercial banks, and at the same time mortgage lending began to take off, stimulating a rapid expansion of the commercial

residential housing market.ⁱ As a result of these measures, consumer demand for loans from commercial banks increased dramatically, but there were long waits for loan applications to be processed.

In 1999, the PBC approved the first CRS, the Shanghai Credit Information Services Co. Ltd. (SCIS), on a trial basis. As a special economic zone and leading industrialized city on China's eastern coast, Shanghai was ideal for launching this kind of experimental program. The new CRS company was controlled by a steering committee comprised of the Shanghai PBC branch, representatives from 15 local banks, and the Shanghai Information Center under the Ministry of Information Industry. The 15 local commercial banks were required to participate in the database.^{vi} Within 8 months, the database had collected about 2 million consumer records.^{vii}

The pent-up demand by banks for consumer credit information was extremely high—the number of inquiries in Shanghai soared from 300 in 2000 to 100,000 in 2004.^{viii} Based on this exponential growth, PBC and Shanghai authorities quickly realized that a local credit information database was inadequate for an increasingly mobile population. As individuals moved in and out of the city seeking better job opportunities, many disappeared without a trace. As a result, bank records were incomplete or non-existent for recent arrivals. Learning from the problems encountered during this early experience, the PBC prepared to roll out a nationwide system.

The Credit Information Services Bureau (2002-2003)

The State Council has an authoritative voice in every major policy decision, including those concerning the country's economic and financial development. In 2002, the Council, chaired by Premier Wen Jiabao, instructed the PBC to form a task force to develop a national credit reporting system. With the lending boom, Chinese commercial banks were under enormous pressure to verify customer identification to prevent credit fraud and ensure the legality of credit transactions. A CRS, the Council believed, would systematically compile essential consumer data from different government agencies and disseminate it to commercial banks. The State Council hoped that a CRS would encourage businesses and individuals to develop credit awareness, respect rules and contracts, and raise the level of social integrity.

The State Council set ambitious goals for the CRS, mandating that corporate and personal credit information databases be established quickly, and a credit information network be created that would cover the entire country. Premier Wen also expected reforms to include legislation to support supervision and regulation of a credit registry system, as well as a mechanism for enforcing laws.

The Council debated which government entity should be in charge of the CRS, with different stakeholders strongly advocating on behalf of their preferred institutional candidate,

ⁱ According to estimates, only 1.3% of households possessed a mortgage in 1998, compared with 12.6% by 2006.ⁱ

such as the Ministry of Commerce, Ministry of Public Security, and the State Development and Reform Commission.^{ix} Given the critical role of stewarding China's economic growth as well as overseeing the explosive credit growth and consumer spending in the country, the central bank believed that it was the ideal place to house the public CRS. The State Council resolved these internal differences by selecting the central bank to play the lead role in creating the CRS, but also instructed the PBC to collaborate with other agencies. [See exhibit 2.]

With this authority, the PBC set up the Credit Information System Bureau (CISB) and selected Mr. Dai as the director-general in November 2003. Prior to his appointment, Mr. Dai was a senior economist at the PCB, where he had been involved in economic policy making for more than 30 years. Mr. Dai started his career as a civil servant in a PBC branch office, and then began gradually to move to higher positions within the bank. Just before being appointed to his current position, Mr. Dai had been director of PBC's Monetary Policy Department, with a concurrent post as secretary-general of the Monetary Policy Commission. During his long career at the PCB, Mr. Dai had witnessed the dramatic economic changes taking place in his country, including the rapidly increasing consumer demands for access to credit.

The new CISB under Mr. Dai was "responsible for managing credit information system; setting development plans and administrative rules for credit information collection and relevant risk evaluation standards; and, promoting public understanding of financial risks and knowledge."^x

The early stages of the CISB (2004-2005)

Mr. Dai's mandate was daunting. His first task was to collect personal credit data from financial institutions and ministries, then enter the data into a national online database. Banks were required to provide the relevant information to the CISB through special-purpose online databases that had to be created. Other institutions were also required to share consumer information with the CISB, such as subscriber information and telephone bills, as well as information from the water and electric companies.

Information collected for each individual included identification card number, loan and repayment history, and non-banking data, such as criminal record and utility payment history. To obtain the required information, Mr. Dai and his CISB staff coordinated with their government counterparts to secure identification through the Ministry of Public Security Bureau. Other ministries and public bodies were also involved, such as the Telecommunications Department, the Social Security Department, and the State Administration of Quarantine Inspection. Data quality and completeness naturally varied from place to place. Major city centers, for example, possessed better information on consumers than smaller towns.

Beginning in 2004, the CISB tested operations of the credit database with 15 state-owned

and joint-stock commercial banks, as well as eight city commercial banks. Participating banks were required to pay a fee to connect to the central database. Mr. Dai and his staff monitored the progress during this pilot phase and were pleased with early results.

The public-or-private debate

At CISB, Mr. Dai was responsible for determining what kind of CRS was appropriate for China—public, private or public-private partnership. To make this critically important decision, the CISB team studied a variety of CRS models and best practices from around the world. But in the end, the decision must be based on what was most appropriate for China. As a colleague pointedly remarked, “We do not follow this country or that country. We must choose what is best here.”

In weighing the advantages and disadvantages of building a public or private CRS, Mr. Dai worked closely with the International Finance Corporation (IFC), an affiliate of the World Bank. The IFC had been actively involved in China since its first investment in 1985. In the early 2000s a Chinese delegation visited the IFC headquarters in Washington, D.C., and requested technical assistance to establish a CRS. This initial knowledge-sharing relationship turned into a stronger partnership in 2004 when the IFC and PBC cooperated on a feasibility study that led to the creation of the national CRS.

World Bank criteria to set up a successful CRS:

- Change perceptions of and build awareness in the community
- Ensure commercial viability
- Establish an appropriate legal and regulatory framework
- Identify appropriate technology and software
- Ensure adequate data availability
- Specify staffing needs

In countries with a public CRS the exchange of credit information between borrowers and lenders is usually mandatory, whereas with a private credit system the provision of credit data is voluntary. Complicating the public-private choice for Mr. Dai and his staff was the fact that Chinese consumer behavior was changing very quickly, and the objectives of the CRS had to be clarified before clear laws or regulations had been created. Mr. Dai had to adeptly navigate the debates going on throughout the government about the merits of a public versus a privately operated CRS. (See exhibit 3.)

More than 50% of the 192 member countries of the United Nations are served by some form of credit reporting agency, of which 43 were private, 33 public, and 31 public-private partnerships.^{xi} The United States, for example, has a private credit reporting system comprised of four national credit companies that provide basic or customized credit reports. France, in contrast, has a public CRS, which is a single registry for all data received from reporting institutions. Most Latin American countries have also opted for public CRS.

The IFC recommended to Mr. Dai the creation of a private CRS, with one or multiple private institutions mandated to collect and disburse information obtained from various financial and non-financial institutions. According to the IFC, a private CRS tends to be more profitable. Private credit bureaus receive credit information for free from financial institutions, creditors, and other public sources. They then analyze the data and sell it back to lenders. The IFC also asserted that the benefits of private credit bureaus included the standardization of business practices and increased transparency. A public CRS, according to the IFC, would be less likely to meet the demands of an increasingly diverse and rapidly growing market. Furthermore, the IFC contended that a public CRS would not charge a fee for its services, thereby placing a financial burden on the government.

But, for a number of reasons, most PBC officials were not in favor of IFC's recommendation for a private system. They were concerned about allowing private firms access to sensitive personal information. Moreover, a private CRS is often predicated on a voluntary exchange of information, and the PCB team believed this would require significantly more time to develop than a public CRS. With a public CRS, on the other hand, the PBC would have clear authority to mandate financial institutions to share the information, which would save time and allow a more rapid roll-out of the new system. Although a private CRS based on market competition is often seen as increasing specialization, innovation and price competition, the PBC believed there were higher risks. It was noted for example, that when developing countries do not have strong regulations, such as data protection laws, for-profit credit bureaus often do not operate as efficiently as public credit bureaus. Moreover, there were concerns that private credit bureaus would go beyond the intended scope of the CRS and market the sale of additional commercial products. Although some reformers in the PBC were in favor of eventually allowing a private CRS that would benefit from market competition, this would only make sense later, once the system was well established.

Mr. Dai concluded that a public CRS model was a better fit with the Chinese reality: "The development of Chinese credit markets is relatively backward. The individual credit report must be very simple, as most Chinese are like me and do not have much credit or loan information. This is so different from the American system, and therefore it is more efficient for us to adopt a public centralized system." He also believed that the PBC was the only institution in China with enough power and credibility to push forward the collection of individual credit data. He explained, "If we adopted an American private model, different firms would have different channels to interact with banks. The collected information might become inconsistent and problems would occur."

Social concerns

Mr. Dai's decision also was influenced by a larger social dilemma. Unlike a standard CRS, China's national CRS must focus on dual objectives: economic development and social stability. The Chinese traditionally maintained a high savings rate (about 40% of GDP in the 1990's)^{xii} and a high proportion of these savings were allocated to health care, education and retirement. But Chinese consumer spending patterns were shifting as the country grew more

prosperous, and increasing number of Chinese had disposable income. Increasingly, the Chinese were keen to spend in the present, instead of saving for the future as their parents' generation had done in order to climb out of poverty.^{xiii} The Chinese government cautiously allowed the issuance of credit cards to increase, but did not want reckless lending, over-indebtedness or identity fraud, all of which could harm social stability. Mr. Dai believed that the public had a responsibility to become more credit-conscious before taking out large amounts in personal loans.

Legal framework for the CRS

A well-functioning CRS requires an effective regulatory framework, including credit reporting laws, data protection laws, consumer protection laws, and personal and corporate privacy laws. In China's case, the absence of a well-established legal and regulatory framework for the CRS increased uncertainty about how the average Chinese borrower would feel about the safety and confidentiality of his or her personal information before these laws were well defined, operative and enforced.

From the beginning Mr. Dai's staff alerted him to CRS' legal vulnerability. The team noted that some individuals complained that their credit reports were inaccurate; others felt the reports were an invasion of their privacy. The CISB realized that they needed to rapidly implement laws to give them the legitimate and transparent mandate to collect data from enterprises and government agencies.

Enforcement also was a significant problem. Typically countries have two types of enforcement: (1) A strong government supervisory authority with the power to license, register, and control credit bureaus and (2) industry self-regulation with the power to collect complaints and sometimes address systematic violations. But in China there was no enforcement mechanism formally in place. Going forward, this would be an additional challenge that had to be addressed.

Decisions moving forward

All of these challenges weighed on Mr. Dai and the CISB staff. By the end of 2005 they were under significant time pressure: consumer credit was expanding faster than they could keep up with using the new, evolving CRS. Government officials, from local authorities up to the highest level of the government, were expecting the team to quickly produce tangible results. Senior PBC officials were pressing the CISB team for a progress report on the pilot phase and a timeline for a public, nationwide rollout of the CRS.

Mr. Dai and his staff began to prepare a briefing for senior PBC staff that would describe what had been achieved to date, the critically important issues that still had to be resolved, and CISB priorities as they moved forward. The main issue, of course, was whether China should proceed with a public credit reporting system or a private system, as IFC recommended. Did the PBC have the financial resources and a staff of professionals with the

necessary skill set to roll out a national CRS and keep up with the enormous demand for credit reports? What should the government do to assist the population become familiar with the new CRS, perhaps using public awareness campaigns? And, finally, could the new CRS meet the needs of the stakeholders in the financial sector—commercial banks, private-sector companies that allowed point-of-lending, and new financial institutions?

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Annexes

Exhibit 1: Glossary of terms and acronyms.

CISB: Credit Information System Bureau.

CPCC: Chinese Party Central Committee.

CRS: Credit Registry System.

DFIs: development finance institutions.

ICBC: Industrial and Commercial Bank of China.

IFC: International Finance Corporation.

PBC: People's Bank of China.

Exhibit 2: The functions of PBC.

PBC's functions, per the amended Law of the People's Republic of China on the People's Bank of China, adopted by the 6th meeting of the Standing Committee of the 10th National People's Congress on December 27, 2003:

- Drafting and enforcing relevant laws, rules and regulations that are related to fulfilling its functions;
- Formulating and implementing monetary policy in accordance with law;
- Issuing the Renminbi and administering its circulation;
- Regulating financial markets, including the inter-bank lending market, the inter-bank bond market, foreign exchange market and gold market;
- Preventing and mitigating systemic financial risks to safeguard financial stability;
- Maintaining the Renminbi exchange rate at adaptive and equilibrium level; Holding and managing the state foreign exchange and gold reserves;
- Managing the State treasury as fiscal agent;
- Making payment and settlement rules in collaboration with relevant departments and ensuring normal operation of the payment and settlement systems;
- Providing guidance to anti-money laundering work in the financial sector and monitoring money-laundering related suspicious fund movement;
- Developing statistics system for the financial industry and responsible for the consolidation of financial statistics as well as the conduct of economic analysis and forecast
- Administering credit reporting industry in China and promoting the building up of credit information system;
- Participating in international financial activities at the capacity of the central bank;
- Engaging in financial business operations in line with relevant rules;
- Performing other functions prescribed by the State Council.

Exhibit 3: Comparison of Public vs. Private CRS

Topic	Public CRS	Private CRS
Function	Banking sector oversight Recent secondary purpose to provide credit data to supervised financial institutions	Provide lending institutions and other qualified users with timely, comprehensive, and accurate credit information
Coverage	Limited to banks and other supervised financial institutions	Broad market coverage for any user with permissible purpose
Sources of information	Banks and other supervised financial institutions	All credit grantors; public record; collateral, land title, and corporate registries; and other sources that have information related to borrowers' paying habits
Compulsory Participation	Yes	No
Flexibility	Unlikely	Yes, responsive to clients' needs
Products	Limited Typically paper-based	Many, including credit scoring, fraud detection, etc. Often electronic-based systems
Response to market	Reactive	Proactive, based on users' needs
Consumer rights and protections	Not usually unless data privacy laws are strong	Normally mandated by law
Fee for Service	Unlikely	Yes
Reporting Threshold	Possibly	No
Positive and Negative	Normally	In Most Circumstances

Source: Adapted from FS Share Primer, p. 7-8.

Endnotes

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- ^{xi} World Bank, *Doing Business 2009*.
- ^{xii} Wei, Shang-Jin. "The mystery of Chinese savings." *VOX*. 6 February 2010. <<http://www.voxeu.org/index.php?q=node/4568>>.
- ^{xiii} Based on household surveys, the poverty rate in China in 1981 was 64% of the population. This rate declined to 10% in 2004, indicating that about 500 million people have climbed out of poverty during this period.