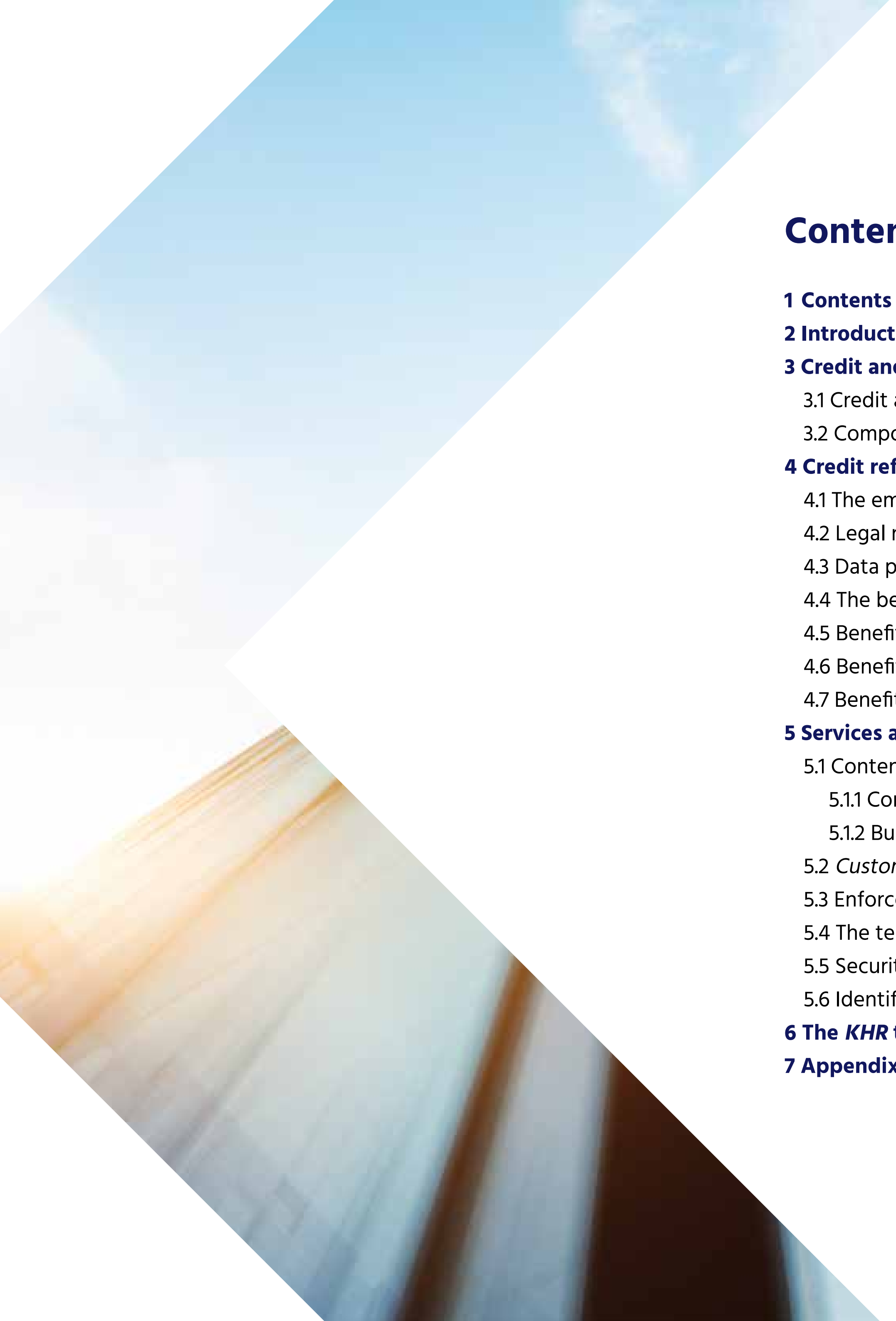
Credit referencing in Hungary

BISZ



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2 Introduction

Dear Reader,

Intended to explain credit referencing and the Central Credit Information System *(KHR)*, this publication will be useful to anyone who is about to borrow in one way or another, is currently a party to a *credit agreement*, or had borrowed previously. The reader will be introduced to the key features of credit referencing, and is offered practical advice on how to live with credit referencing as a bank *customer* so as to enjoy its benefits without ever encountering any problems from its contents and operation.

Throughout the text of the publication, a number of terms need to be used which tend to be specific to direct users (i.e. banks). Such terms are explained in the definitions appended to the publication, and appear in *italics* in the main body of the text.

The study contained in this publication discusses the key principles and services of credit referencing, describes the benefits to individual participants in the system, and explains the conditions concerning its legal, operational and security aspects. It can be read straight through, but may also be used as a reference manual, each chapter being informative in itself.

The Central Credit Information System *(KHR)* is an inevitable part of all our lives, affecting our present, and indeed, our future. The service provided by it is generally called credit bureau throughout the world, and is widely known as credit referencing in Hungary. In Hungary, such a service is provided by only one company, BISZ Zrt.

In the *KHR*, data are controlled for the borrowings of both individuals and businesses. In Hungary, nearly all individuals of working age, and a major part of businesses in operation currently have or have previously had credit. Consequently, we are confident that the *KHR* is one of the largest registers in this country, and also one of the most important.

In countries with developed economies, including Hungary, access to credit under appropriate terms is absolutely essential for both citizens and businesses. Credit has become a part of our daily lives, and so has credit referencing developed into a routine element, as well as a kind of objective control of our desires, goals, means, and decisions.

3 Credit and credit reference

3.1 Credit as a contemporary social phenomenon

Before a description of credit referencing, here is a brief overview of what credit is – primarily covering, of course, the credit facilities and loans granted to *customers* by banks.

Being a special type of merchant, a bank purchases money from those who have this 'commodity', i.e. collects deposits and pays interest in exchange for those deposits. Then, at a higher price, it sells the commodity purchased to those who need it, i.e. grants credit to such parties, and collects interest in exchange. Obviously, **the rates of the interest charged on credit are higher than those of the interest paid on deposits – the differential being the main source of income for the merchant, that is, the bank.** Any discussion of the purchase and sale of money must, clearly, also factor in time – the bank will naturally not make an immediate margin payment (principal reimbursed and interest) on the commodity purchased, and will ask for a margin (debt repayment and interest on the credit) on the commodity sold, i.e. the money lent, only after a certain amount of time.

All participants in the process run their own risks and have their own expected returns. Depositors know their money is safe, and they deservedly expect a pro-rated margin, i.e. interest, which is warranted by the bank. Borrowers have the benefit of the ability, by means of the funds borrowed, to achieve their goals sooner than they could without such funds, or to achieve them at all. Finally, the bank is sustained and managed by means of the interest spread, which constitutes its profit.

The bank plays a prominent technical and intermediary role in the credit process. But what good is all that, indeed? Well, many participants in the economy have excess funds they can do without for the time being (savings, money which they have no intention to use or spend immediately), while other participants in the market need funds to attain their goals, mostly economic ones. The bank is the intermediary that undertakes to channel the excess to wherever the funds are needed. Credit can, therefore, be seen as the oil that enables the engine of the economy to run smoothly, or as the transmission system whereby the power (profits, accumulated capital) generated on one side of the machine is used to drive other parts.

When should one borrow? The key point is that **they should be better off by borrowing than by not borrowing.** With businesses, this is a clear point: they must secure an economic advantage that provides ample coverage for the interest on their credit. For example, a business may carry out an investment for which its funds are insufficient, yet the return on the investment offers the perspective of a higher income even with payments of interest on the credit than what the business could expect without the investment.

It is less frequent for individuals to secure a direct financial advantage through borrowing. In their case, the point is rather the ability to accelerate the acquisition of something they need. Below is a list of key examples:

- it is very difficult to acquire a property or a home without credit › real estate credit or credit union membership is needed. The acquisition of the right home may also provide a source of income as opposed to renting. While the rent is net loss for a tenant, a borrower will increase their own assets through often equivalent debt repayments.

- increasingly expensive education › when an individual considers it appropriate to invest in themselves, they may derive considerable benefits e.g. from a student loan, which allows them attain a high qualification, and therefore, hopefully, a higher income.

- desirable commodities have become more numerous and more varied › many people want to own these objects immediately and may need credit for that purpose.

- an adequate level of creditworthiness may help overcome difficult situations which require major unexpected expenditures to be covered.

As can be seen from the above list, individuals may also have sound reasons to borrow.

Let us now look at the risks to each participant in the banking business. In a well-functioning economy, a depositor has little at stake; the bank's capitalisation, reliability, immense financial means and financial knowledge provide, in general, secure coverage, with additional security from specific insurance undertakings, i.e. deposit and investor protection funds. **The borrower's risk consists in having to face the consequences of enforcement and loss of creditworthiness in the event of failure to repay the debt,** which also provides an incentive to spend the borrowed funds toward the appropriate purposes, and ensure appropriate repayment of the debt. They have free reign to manage their own real risks, which involves responsible borrowing and an adequate management of their financial position.

The highest risk is faced by the bank: when even a not very large proportion of borrowers fail to repay their debt, the bank is bound to incur losses given that enforcement requires time and money, and is not always effective, which involves the risk of being unable to honour depositors' claims. It should always be borne in mind that **it is not its own money that the bank lends to its *customers*, but the money borrowed from its depositors** – consequently, the real risk it runs is not of losing its own money (though that would be a bad enough problem), but of losing the money of those who have trusted it. And that has severe consequences for both the bank and society.

If the role of credit is clear, it also does not need to be explained that **misplaced credit**, which is lost because it is not used for the appropriate purpose, **causes multiple damage.** It inflicts damage on the creditor, which will be forced to allocate provisions and will be required, provided that it is a bank, to pay its sellers even if some of its buyers fail to pay for the commodity. It inflicts damage on the buyer, as the bank will not readily tolerate the buyer's failure to pay for the commodity, and has a variety of sanctions at its disposal. It also inflicts damage on depositors, because if too many debtors fail to repay, this will ultimately drive higher interest rates on credit (i.e. *customers* with a good credit performance will pay for the losses caused by non-performing *customers*), which involves a higher risk of the bank's failure, i.e. losing its deposits.

There are several ways of reducing risks to the bank, perhaps the most important being the **collection of the most detailed and accurate information possible** on the borrower and their capacity and willingness to repay their debt. This mass of information is derived from the past andthe present, and can be used for predictions on the probability of future debt repayment. This is where credit bureaus play an essential role, and is therefore the focus of the following sections.

With large businesses, banks use their best endeavours to develop the deepest possible understanding of their *customers'* business processes and financial standing, for which they have access to abundant and often certified information. In most cases, credit granted to larger businesses serves a well-defined and specific purpose such as the purchase of inventories or the implementation of some technological or business investment. Knowing the *customer* and considering the probability of the achievement and estimated profitability of the purpose, **it is relatively simple for the bank to assess the risk in the credit granted**; and as the amount of money concerned tends to be high, **an easy return can be made on the major assessment effort invested** from the substantial amount of interest which the bank hopes to collect on the high amount.

The situation is completely different in the case of small businesses and particularly with borrowing individuals. The collection of adequate information on such borrowers essentially requires the same amount of work as with large businesses, but the bank can only hope to collect a low amount of interest on the low credit amount. Consequently, the bank is required to make use of cheap and efficient processes to collect information. Credit bureaus, and credit referencing, respond precisely to that requirement.

3.2 Components of credit referencing and credit bureau services

The primary aim of credit referencing and credit bureau services is to assist lending banks and other financial service providers with their lending decisions, while protecting borrowers against over-indebtedness.

A common feature of credit reference providers and credit bureaus is that they collect data on individuals and businesses that have borrowed, and use such data to provide information to parties that are planning to lend (for details on the conditions concerning the data content, and the technical and legal aspects of the process, see Sections 4.1 and 4.2). **The data collected are used to generate credit reports**, which profile prospective borrowers in general, and their credit histories in particular.

The most prominent difference between credit referencing and credit bureau services is that **credit referencing returns the credit data and facts collected** in an arranged form. In general, **credit bureau services** rely on a broader range of data than credit data, and **process such data in a variety of ways.** Often they also perform specific credit assessments, and, relying on the vast amount of data in their records, they even propose new credit plans to lenders.

Based on the nature of the data collected, a distinction can be made between two main groups:

1) credit referencing exclusively based on the collection and processing of credit data. Such services group, process and provide the credit data received from lenders (banks).

2) Information services that also rely on other data in addition to credit data. With such services,

   a) in addition to credit data, credit reports on businesses also include publicly accessible balance sheet and court data, data on circular debt, etc. from various registers, as well as data on shareholders and management;
   b) in addition to credit data, credit reports on natural persons also present other data on non- bank debt, rent, utility bills, etc. and possibly also data indicating the borrower's occupation, income and financial standing.

The **legal basis** of controlling data is a **key issue.** When a credit reference provider wants to collect *credit agreement* data from banks, this is amounts to an intention to control confidential banking information, but the rest of the data also constitute confidential business information or are personal data, all of which require some form of authorisation to be controlled. Such authorisation may be granted

> by the data subject – service providers based on such authorisation are called voluntary records. They include e.g. SCHUFA of Germany, CRIF of Italy, and all service providers of the UK and US type. The question of who will consent to the control of such sensitive data is justified indeed. The answer is that virtually everyone in the countries concerned, since they perceive the benefits of disclosing their data much rather the drawbacks. Despite that, there is no guarantee that voluntary systems will contain full records. Lenders will more readily grant a second or third credit to *customers* with positive credit histories, which also provides incentives for *customers* to give their consent in every case, enabling such histories to be built.

> law. In this case, legal regulations provide for the lawfulness of data collection, and makedata reporting mandatory. Such registers are maintained e.g. in France, Spain, Romania, and, combined with *customer* statements, in Hungary. In a system defined by law, the law itself guarantees the completeness of the data. This advantage is accompanied by the drawback that legal regulations also impose strict restrictions on the range of data that may be controlled, denying both banks and customers the benefits that could be derived from the control of external non-bank data. Banks will be denied access to more complete information, and *customers* will be denied the opportunity of having relevant external data (tax clearance, paid electricity bills, etc.) collected by a third party on their behalf in a fast a convenient manner.

The rest of this publication will limit its focus on bank data, which is what the KHR in Hungary is authorised to collect. The data collected can be classified into two groups:

1) Negative credit data – data on debt repayment problems, liquidity constraints, bankruptcy proceedings, and *fraud* attempts. The data specify the type, amount and date of credit on which *late payments* have occurred, and the amount of loss incurred. Negative data also include data on any attempted credit *fraud* and credit *card fraud*. Examples of credit referencing limited to negative credit data include the Interbank Debtor and Credit Information System ('BAR') previously used in Hungary, and similar registers used in France and Finland.

2) Positive credit data – data on performing and previously repaid debt. The *KHR*'s consumer and business credit reports are examples of credit referencing that incorporates both positive and negative data. Registers that incorporate both positive and negative data are commonly referred to simply as registers with positive or full records. Except for those used in France and Finland, all registers belong to this type.

In determining the creditworthiness of small businesses and individuals, the role of understanding their credit histories is much more important than with large businesses. That is, when a bank has developed an understanding of credit history, it runs a much smaller risk by financing a *customer* unfamiliar to it, and crucially, this information is available from the credit bureau virtually free of charge and in a matter of seconds.

In Hungary, **the *KHR* contains full records of the credit histories of both consumers and businesses,** including positive and negative credit data. The system also contains full records of the current level of indebtedness, i.e. it covers all credit and other liabilities held at any specific point in time by any bank or other financial institution). In the consumer system, however, full access to the data is also subject to the *customer's* statements (see 5.1.1).

Indebtedness ratios are derived by combining the data on currently outstanding debt with income data for individuals, and financial statements data for businesses. In Hungary, these indicators are calculated by banks in connection with specific credit applications. In other countries, indebtedness calculations are also done by credit bureaus or other undertakings dealing with credit and company information.

A key requirement for credit bureaus **is to keep data reliable and up to date.** *KHR* data are securely collected and stored online, in real time. The key to reliability and accuracy is banks' data reporting, the framework of which is regulated by law, and institutions perform this activity with the required care and precision.

4 Credit referencing in Hungary

4.1 The emergence and operating principles of credit referencing

Credit referencing services worldwide generally emerge in the aftermath of crises, which is what also happened in Hungary, although in several stages. The introduction of the two-tier banking system in 1987 gave rise to competition among banks, but the prohibition on sharing credit information was maintained. Competing banks had no means of finding out about *customers'* credits and their performance from any lawful, controlled and authentic source. Simultaneously, the disintegration of the socialist legal system and the emergence of a new type of thinking placed businesses and entrepreneurs themselves in the focus of public thinking. At that time, neither the banking system, nor businesses were prepared for the placement and absorption of a large volume of credit, and neither did credit bureau services support the exact measurement of risks, creditworthiness, level of indebtedness, repayment willingness and other critical factors. The *default* of loans on a massive scale virtually became the norm, which posed the threat of successive bank failures. To avoid that happening, a major bank consolidation in Hungary was needed in 1993, using state resources.

In the year following consolidation, a minor but absolutely necessary legislative change enabled the establishment of BISZ Rt., the first privately held company to provide credit referencing services in Hungary, owned by banks. BISZ stands for Bankközi Informatika Szolgáltató (Hungarian for 'Interbank Information Services'), which pointed to the development of a wide variety of interbank services over the long term. After its establishment in 1994, the ***first service offered by BISZ was available from June 1995*** to the financial institutions sector at that time. This service was called BAR after the Hungarian abbreviation of Interbank Debtor and Credit Information System.

The BAR was a system with positive (or full) records, which controlled the most important data of all *credit agreements* between a **financial institution** on the one hand, and a **business** with a VAT ID (including **sole traders**) on the other.

Under an agreement with BISZ, banks registered all new *credit agreements* in the BAR, and the register was updated with any changes in key contract data within five business days following such changes. When an agreement was closed, the BAR was also notified about the closure, and set the status of the relevant data to 'closed'. Under those rules, the BAR register was rather accurate and up to date, and contained all bank credits of all data subjects (in the first version of the BAR, only businesses). When a bank was preparing to enter into a *credit agreement* with a business *customer*, it queried the BAR for the *customer's* data, which allowed it to review the number, type, volume and performance of each of the *customer's* credits, to verify the *customer's* statements, and to develop an accurate understanding of the *customer's* credit standing. It is to be noted that to this day, the *KHR's* operations continue to follow precisely those key principles.

The first version of the BAR did not include consumer credit data. The first version of credit reports did not forward data on terminated business *credit agreements*, and did not contain any credit history or *customer* history data.

It marked the birth of the first credit referencing service in Hungary, which soon became highly popular among its users. The improvement in the placement of business credit and the reduction in the number of non-performing loans became apparent, which resulted in lower credit prices and good debtors' easier access to credit on the one hand, and less bureaucratic lending and, indeed, banks' increased profitability on the other.

In the years following its launch, as a result of several legislative changes, membership in the BAR was extended to include banks, specialised credit institutions, savings cooperatives, credit unions, leasing companies, broker firms, investment companies, financial enterprises and finally pawnbrokers. Simultaneous extensions were made to the database controlling business credits, *late payments* and their settlement, and closed agreements. While the business branch of the BAR was gradually approaching completeness, a consumer credit register, as a business branch, remained non-existent.

The boost in lending to businesses was followed by a recovery in consumer lending. When Hungary's accession to the European Union became a realistic prospect, consumer lending entered a steady course of growth. As in a number of subsequent entrants to the European Union (e.g. Spain, Portugal, Greece), the period immediately preceding accession was marked by a sharp increase in the volume of outstanding household credit.

However, in those years data protection was already a prominent factor, whereby the collection and recording of such sensitive data on natural persons was perceived to carry risks which considerably outweighed the potential benefits.

It was under such circumstances that the **BAR's consumer branch, with negative records, was launched in 1999**, which was defined by law **as a *credit default* register of natural persons** rather than a *credit agreement* register. The register recorded individuals who satisfied the dual criteria also set out by law. The dual criteria required borrowers to sustain a repayment *default* **exceeding the applicable amount of the minimum wage for more than 90 consecutive days** – this is called *credit default* in BAR terminology. This brought the BAR into notoriety as a kind of consumer blacklist, lending a negative overtone to being 'BAR-listed'. In 2006, the register was extended further to include additional negative consumer events by recording *card fraud* and *credit fraud*. Simultaneously, it was renamed as Central Credit Information System *(KHR)*.

2011 marks perhaps the greatest achievement in the development of Hungarian credit referencing, when following a number of failed attempts, the **consumer system with positive records** was created. By that time, the volume of non-performing consumer loans had grown to vast proportions. Additionally, one condition of the IMF loan was the launch of a credit register that contained positive records. (Since then, the entire IMF loan has been repaid.) With that move, Hungary joined the numerous countries using developed credit bureau services, leaving the small community of countries where only negative records were in use. The service was described in a separate and new act, Act CXXII of 2011 on the Central Credit Information System (KHR Act).

The consumer register with positive records **includes positive credit data and all *credit defaults* according to the dual criteria in respect of every consumer loan**; however, positive consumer credit data **require the *customer's* consent in order to be retrieved.** The customer's specific statement to authorise retention of the agreement concerned is required for the KHR to retain agreement data for five years following closure of the credit agreement, and for such data to be included in the customer's credit reports. By contrast, as provided for in the KHR Act, inclusion of negative data in the credit report is mandatory, irrespectively of the customer's consent.

Under the KHR Act, *KHR* queries are a mandatory step in both business and consumer credit assessments. In the course of a credit assessment, the bank is also required under the Act to inform the *customer* about the information contained in their credit report, and the conclusions drawn from that information.

If, by analogy of the business system, consumer credit referencing had been launched as a register with positive records right from the start, it could have reduced the extent of overlending to Hungarian consumers. In that case, the major exchange rate fluctuations following the 2008 credit crisis would not have had such a tragic impact on Hungarian families. As shown by a number of examples from the West, **high-quality credit referencing is capable** even of compensating for certain legislative deficiencies, and **of rationally regulating the functioning of the credit market.**

As a further addition to the contents of consumer credit referencing, **in 2015** credit reports were extended to include **information on *customers'* personal bankruptcy.** Bankruptcy proceedings have long been known to be available to businesses as an opportunity to rescue a business in severe distress by means of arrangements with creditors. Such an opportunity is equally important for natural persons. With the *debt consolidation process* for individuals, families forced into unsustainable situations through no fault of their own are offered an exit option, which is reasonable despite being a challenge to complete. Although a description of bankruptcy proceedings is beyond the scope of this document, it is to be noted that information on individuals' *debt consolidation processes* has been included in the *KHR* pursuant to legal provisions, and the *KHR* will forward that information to any financial institution that has an open *credit agreement* with the *customer concerned.*

4.2 Legal regulation of the *KHR*

As mentioned previously, the *KHR* currently in operation was created pursuant to Act CXXII of 2011 on the Central Credit Information System (KHR Act). The previous BAR, the *KHR*'s 'predecessor' was routinely regulated in the Act on Credit Institutions and Financial Enterprises, and it is a definitely significant fact that the ***KHR* is regulated in its own right by a separate act.** This indicates the legislator's recognition of the system as a particularly important legal instrument, which by all means warrants a separate legal act to provide for the rules and circumstances of its functioning.

In addition to the structure of the *KHR*, the KHR Act also provides for its **manager**, a **financial enterprise that requires a licence for its establishment and operations**, and is **subject to very strict supervision** similar to that of banks. Not only does supervision include licensing and the continuous monitoring of operations; it also empowers the National Bank of Hungary, which is responsible for supervision, to impose sanctions and, as measure of last resort, to withdraw the manager's licence.

Importantly, the records are not property of the company that manages the *KHR*. Data controlling is regulated in the KHR Act, and BISZ, as the financial enterprise that manages the *KHR*, is a 'mere' operator of the system. It does not own and **has no disposal of the data.** Data themselves cannot be owned, and may only be disposed of by the data subject, within the confines of the KHR Act in this case.

As **the data contained in the *KHR* constitute confidential banking information and to a large extent are personal data**, confidentiality and integrity are of utmost importance in the course of data controlling. Monitoring this falls within the competency of the National Bank of Hungary on the one hand and the data protection authority on the other, while data subjects' right of inspection also provides for continuous monitoring.

Bank lending, particularly in the segments of consumer, personal and retail credit, has accelerated, and credit assessment times have become shorter. For that reason, accurate data reporting, continuous availability and response times of less than a minute have become absolutely essential for the *KHR.*

Compliance with legal and business requirements has collectively resulted in the fully detailed regulation of *KHR*'s data controlling processes, as well as in the continuous, contained and controlled management of the data contained in the *KHR*, and of data flows.

4.3 Data protection and the *KHR*

The *KHR*, and every credit reporting system in general, is comprised of data. The records in the system hold data on millions of data subjects. Such data subjects may represent many types of bank *customer*: companies, apartment blocks, and in the vast majority of cases, natural persons. And **natural persons are entitled to the protection of their personal data.**

In recent years, data protection has been given increasing attention. Today, everyone is aware of their right to dispose of their own personal data, i.e. to decide who may access those data. Everyone knows that a bank, an insurer, or a telecom carrier cannot find out about every detail of an individual, and that the individual has the right to decline certain data requests. But what indeed is data protection?

Though it is somewhat different in every context, its essence remains the same. The rules applicable are consistent across the Member States of the European Union owing to an EU regulation. It essentially provides for informational self-determination, i.e. the right for each individual to dispose of their own personal data, deciding which particular items of data to disclose to what parties, and under what terms. Naturally, it does not always work like that, since the public interest is often given priority over personal interests. We are not free to decide whether to disclose our data to the police, or the tax authority for that matter. On the other hand, the legislator also frequently interferes with civil law relations, adopting legal provisions to enable private sector entities to restrict a natural person's right of disposal. A public utility provider or telecom carrier is thus entitled to request data subjects to provide personal identification details, and to control such details even after the *customer* relations have been terminated.

However, all forms of **data controlling required by law** are subject to the common guiding principle that a legal requirement for data controlling **amounts to a restriction on a fundamental right of the data subject, and as such may only be applied** in exceptional cases, **for a specific purpose, and to the minimum extent necessary to attain that purpose.** Therefore, in every case it is necessary to establish the public interest that is served by the data controlling required by law, and the mandatory elements of such data controlling must also be specified.

Data controlling required by law is complemented by **data controlling based on the data subject's voluntary consent.** For this to be lawful, the data subject must be fully informed about the data controlling, and be allowed to make a voluntary decision, free of any constraint and, at most, influenced only by their own best interests, on their consent to the data controlling. Naturally, the data subject may subsequently change their mind and withdraw their consent.

A requirement common to both legal bases is that the data subject's rights must be granted. **Each data subject has the right to be notified of their data being controlled, have any errors in their data corrected, and unless precluded by law, request their data to be deleted.** With few exceptions, the data subject may **check the data controller, and seek remedy against unlawful data controlling.**

Underlying credit reporting systems and credit bureaus are clear aims of data controlling: to **ensure the security of lending, to control data subjects' indebtedness, and to prevent over-indebtedness.** Thus, the aims of data controlling are obvious, as is the fact that those aims are justified by important public interest. This raises the question of what depth and nature of data controlling is warranted by this public interest.

In the system with full records, data protection issues were more prominent. The previous view that the use of positive records were not supported by powerful enough arguments, and that there were no aims or public interests that would warrant any restrictions on data subjects' rights, was swept away by the economic crisis and the collapse of foreign exchange based lending.

Suddenly, hundreds of thousands of loans were *defaulted*, leaving borrowers in distress on a massive scale due to their inability to make repayments on their debt. It was obvious that the recovery and subsequent protection of the market required the setup of records which supported lenders by filtering out risky transactions on the one hand, while protecting debtors by preventing over-indebtedness on the other. These records are kept in the *KHR*.

Obviously, the arguments for data protection are still kept in mind. What happened was that in 2011 the legislator (i.e. Parliament) resolved that, contrary to the previously held view, there indeed was an argument and public interest that warranted restrictions on data subjects' rights. Of course, only to a certain extent: **the *KHR* may only register the data specified by** the KHR Act, **and only in the manner specified in that act.** The KHR Act also specifies the parties that may be granted access to the data, the terms of such access, and the period of retaining the data. The regulations ensure that data subjects are informed on a regular basis, and are thus enabled to seek remedy against any unlawful data controlling, for which specific rights are also granted.

Therefore, the *KHR* restricts data subjects' rights on the one hand, while giving them rights and opportunities on the other.

Restrictions:

- credit data are registered in the system irrespectively of the data subject's will;
- the data will be controlled in the *KHR* for the duration of the *credit agreement*, and for additional years in the event of *default*;
- the KHR Act also restricts access by the banks that use the data, granting access only for the preparation of credit agreements, subject to the requirement of presenting and explaining the data to customers.

Rights and opportunities:

- comprehensive information, and the explanation of the data in and the interpretation of credit reports provide *customers* with a detailed description of the process, scope and content of data controlling;
- data subjects may, at any time, inspect the data held on record about them, which will provide information on what is on record and who submitted each data item;
- in the event of unlawful data controlling, data subjects may raise a complaint with the financial institution that submitted the data, or BISZ;
- where the complaint fails to produce the desired result, data subjects may file credit data action on grounds of the data controlling;
- on the other hand, data subjects are granted the opportunity to gain insight into data controlling, and exercise their rights, and measures are also in place to ensure that data are only used in compliance with the set structure.

The KHR thus provides a certain balance by safeguarding the public interest in the security of lending, while also allowing data subjects to exercise their rights.

4.4 The benefits of the *KHR* for individuals and families

The key benefit of the *KHR* for individuals and families is that it **helps them avoid insolvency, and prevents the occurrence of personal bankruptcy.**

Admittedly, a large majority of individuals do not have a wide range of financial knowledge, and are often unaware of the nature of their credit, and the burdens and consequences that borrowing entails.

When taking out credit, the borrower undertakes a future commitment (repayment of the credit), and also a risk. Risk cannot be excluded completely; this would only be possible by not borrowing. The point is to make a responsible decision and undertake reasonable risk when borrowing.

In banks' experience, borrowers generally face repayment problems in the following cases:

- Overborrowing, when the borrower takes out more credit than what they can repay.
- Negative changes in the life circumstances of the individual or the family (serious illness, divorce, etc.).
- Deterioration of the debtor's economic situation, or the overall decline of the economy and the labour market (unexpected loss of job, a major economic downturn, a drastic increase in unemployment, wage cuts, negative changes in exchange rates).

In reality, the above reasons are often interrelated and occur simultaneously. For example, when a debtor overborrows in an effort to take out the maximum amount of credit available in their situation at the time, they will become much more vulnerable in the event of an unexpected event (illness, loss of job) occurring.

In a severe case of repayment problems, the individual and their family may be caught in a debt trap, which will lead to great financial stress, and could lead to bankruptcy. Although a personal bankruptcy procedure allows their home to be saved, the debtor will lose control of their finances, and will be supervised by an assigned administrator for 5 to 7 years. In a worse case, not even personal bankruptcy will provide a solution, and the debtor in distress could lose all of their assets without achieving a meaningful reduction in their debt.

One of the main purposes of the *KHR* is to protect against over-indebtedness, the occurrence of private bankruptcy, and financial failure.

However, **for the *KHR* to discharge this protective function, the individual is required to make a statement on granting access to data on all of their currently outstanding and performing loans** (negative credit information is automatically included in the *KHR*, whereas access to positive data always requires the data subject's consent). Banks need information about all currently outstanding credit to calculate the exact level of indebtedness, which is required to determine the amount of credit that can still safely be repaid.

In addition to protecting the individual and the family against over-indebtedness, the *KHR* also offers **other key benefits.**

A positive credit history is an asset. Banks assign a **better rating** to *customers* that are known to have repaid or be repaying their loans without any delays or *default*. Lenders may grant such *customers* more favourable interest rates, instalments, collateral requirements and other terms.

A positive credit history may also counterbalance potential repayment problems and negative credit data. Banks may take into account timely repayments as a mitigating circumstance in the case of *customers* with closed credit problems.

Importantly, **an individual may, at any time, request a free report on the data held on record about them in the *KHR***, which enables the individual to verify deletion of a previous problem or negative entry. The request for a report may be made at any bank branch, where clerks can provide assistance with both the request and the interpretation of the information in the proprietary credit report. Where an individual has previously had credit problems, requesting a report is particularly recommended to prevent the failure or delay of the credit application due to any negative data, which may also have remained on record by mistake.

Borrowers should remain mindful of the fact that although **the *KHR* is an essential tool to prevent over-indebtedness**, borrowing is always a matter of the **individual's decision.** They should consider whether indeed they need the product or service to be purchased using borrowed funds, and whether or not the burden of repayment would be excessive. Other than their momentary situation, they should also consider whether they have sufficient reserves to maintain regular repayments in the event of an unforeseen problem (illness, unexpected expenses) occurring. Whenever borrowers have trouble understanding certain terms of the credit, they should seek professional advice. Borrowers must always exercise due care, and make responsible decisions.

4.5 Benefits of the *KHR* for businesses

For businesses, the *KHR* offers the primary benefit of **minimising the number of debt repayment problems and the associated company bankruptcies.**

Businesses comprise a highly complex and diverse group, in which further subdivision by size appears reasonable. On that basis, a distinction is made between micro, small and medium-sized enterprises (SMEs), and large businesses.

As large businesses have powerful finance teams and knowledge at their disposal, are highly conscious about cash flow management, generally prepare their borrowing carefully, and are fully aware of the level of their indebtedness, they tend to benefit from the *KHR* in indirect ways (see later).

Micro-enterprises do not necessarily have in-depth knowledge of finance, and tend to have less experience, and limited means, in the field of managing debt and credit. In terms of lending and finances, micro-enterprises are more like individuals (natural persons), as their existence and activities are completely intertwined with the life of the individual or family running them.

Although SMEs already have a wider range of finance knowledge and tools, generally the scale of their finance teams and expertise is not on a par with that of large businesses.

The *KHR* provides transparent access for banks and financial providers to data on businesses' outstanding debt and liabilities, which is highly instrumental in the prevention of over-indebtedness. This is of particular significance for the micro and SME segments, where companies have limited financial experience, and repayment problems tend to be more frequent.

In addition to the prevention of bankruptcy, **the *KHR* may also assist micro-enterprises and SMEs in obtaining credit and more favourable terms.** A positive credit history is also an asset in these segments, i.e. previous performing debt provides evidence to banks on the responsible borrowing of the business, as well as on its capacity and willingness to repay its debt.

Previous repayment problems (which frequently occur for reasons not attributable to the business concerned) may be counterbalanced by a history of timely repayments. Thus, positive credit histories held on record in the *KHR* will contribute to a more favourable assessment of credit applications, and may also result in more favourable interest rates, and collateral and other terms.

By providing central access to credit histories, **the *KHR* is also instrumental in bank switches and refinancing** (as not only a company's own bank will be aware of its good repayment history), i.e. it **promotes competition among financial institutions.**

As the use of the *KHR* reduces the frequency of financial problems and bankruptcies in the business sector, the system makes **an indirect contribution to increased transaction security among businesses.** The buyers and suppliers of a business are also continuously monitored by banks through the credit they allocate and the related *KHR* queries, which means that there is also a third party to safeguard the financial stability of counterparties.

Experience from Hungary indicates that businesses generally use a variety of company information services when they need information about their counterparties. Although it is a lesser known option, businesses may use the *KHR* in conjunction with such information, e.g. by requesting new or relatively unfamiliar buyers to present their proprietary *KHR* credit reports in support of claims for preferential payment terms. A detailed understanding of a counterparty's credit history may be an important addition to company information available from other sources.

4.6 Benefits of the *KHR* for financial institutions

Financial institutions, like other businesses operating on a market basis in general, set profitability that is sustainable in the long term as one of their key goals. As the profitability of lending is strongly influenced by losses, an essential prerequisite for the achievement of the goal is the containment of loses, i.e. ensuring that **losses are minimised.**

Lending inevitably carries risks, which obviously cannot be excluded completely; however, financial institutions seek to ensure that risks are assessed as accurately, and managed as efficiently, as possible.

Risk does not only arise from the uncertainty of the future, but also from the fact that not all relevant information is available in the present either. This is the problem of so-called information asymmetry: in comparison with a lender, a borrower will always have a much clearer understanding of their own real financial standing and actual willingness and capacity to repay their debt. It is thus essential for financial institutions to have information of the greatest possible accuracy and relevance about their existing or prospective debtors.

The *KHR* is one of the most important sources of information for banks: an understanding of **credit histories and of debt currently owed to financial institutions** is a major contribution to the mitigation of loan losses.

Up to date information immediately available from the *KHR* makes the lending decision process faster and more efficient. The *KHR* supports several aspects of banking operations related to lending:

Credit histories are a part of *customer* rating, facilitating the distinction between good and bad debtors. In the event of a serious issue, negative *KHR* information is an automatic disqualifier. As a key element of lending decisions, credit outstanding is taken into account for the **calculation of indebtedness ratios and maximum loan amounts.**

An understanding and analysis of credit histories and of the type and amount of each credit outstanding could be an important element in ***customer* pre-screening**, or in the compilation of target lists and the generation of credit proposals.

Overall, the *KHR* is indispensable for secure and prudential lending. At the same time, there are additional opportunities inherent in the massive amount of data stored in the *KHR*, as more in-depth analysis and research on the data could be a source of competitive advantage for financial institutions.

4.7 Benefits of the *KHR* for the state

The legal background of the *KHR* is provided by the legislator and the state itself. This is not a coincidence given that the state is not only responsible to establish the framework for a transparent and secure financial institutions sector, but also has significant direct and indirect interests in the existence of such a framework.

Mandatory use of the *KHR* **makes lending more secure, while it also helps borrowers to avoid over-indebtedness**, whereby it plays a key role in the prevention of personal and business bankruptcies and insolvencies.

The mitigation of personal bankruptcies and business insolvencies, and the reduction of loan losses **contribute to the emergence of a stable economy and financial sector**, which in turn will provide the state with reliable and steady sources of tax revenue.

The failure of attempts to prevent over-indebtedness and default on a massive scale will lead to a crisis that gives rise to complex problems and enormous expenses for the state, as follows:

- Loss of tax revenues. Severe loan losses often lead to an economic downturn, which is accompanied by rising unemployment, and reduced consumption and output. In a situation like that, not only will the state see its regular tax revenues reduced in the financial sector, a decline will be experienced in virtually all tax types, whether associated with households, businesses or consumption.

- Costs of preventing bank runs and of stabilising the financial sector. Bank bailouts, i.e. lending to or capitalising financial institutions in distress, impose a major burden on the central budget. In the course of bank consolidation, the state will, permanently or temporarily, assume the losses of the institutions in distress.

- Expenditures to mitigate the effects of an economic downturn. Economic stimulus attempting to counterbalance a crisis involves major expenses. Government purchases, preferential loans, and state aid granted to industries in distress are financed from state reserves. In the absence of reserves, the state will levy special taxes or incur additional debt to raise the funds required for such measures.

- Compensation and assistance for particularly affected social groups. Such measures include unemployment benefits to people who have been made redundant, or, for example, coverage of the costs of various bailout schemes for foreign-exchange debtors (unfortunately, even such forms of assistance are often insufficient to counterbalance the losses incurred).

Other than the avoidance of the negative consequences explained above, the *KHR* also has positive implications. Using the *KHR* **facilitates the move to a balanced and sustainable debt path.** The long-term stability of the consumer, business and financial sectors serves the economic growth of the country, which, in addition to driving higher state revenues, contributes to an improvement in the satisfaction and living standards of individual citizens, and society as a whole.

Importantly, contrary to popular belief, data controlling, data checks, statements, queries and data evaluation in the *KHR* are not a 'nationwide zero-sum game' in which banks are always winners and everyone else is a loser – these operations bring clear benefits, and only benefits, at all levels of society.

Statistical analyses of the data controlled in the *KHR*, as part of which analysts are concerned with the changes and trends observed in the data of a large number of entities rather than with the data of specific entities, may result in **a better understanding, and possibly more efficient control, of macroeconomic processes.**

5 Services and operations of the *KHR*

5.1 Contents of credit reports and possible conclusions

5.1.1 Consumer credit reports

For natural persons, consumer credit reports contain all of the information that is used by banks to check *customers*' credit status in the course of credit assessments. A credit report consists of two parts: summary data presented on the cover page, followed by detailed data.

As a first step, here is an overview of detailed data. In this part, the *KHR* lists the **data of the *customer's credits*, any *credit defaults*, the data of any *card fraud* or credit fraud incidents, and data on the *debt consolidation process***, if any. It is to be noted that the ***credit report will not include any indication for the requesting bank as to which item was registered in the KHR by which bank.***

Below is an explanation of positive data, the credit data.

In the detailed part, the *KHR* provides a list of the *customer*'s open *credit agreements*, and in reverse chronological order, *credit agreements* that have previously been carried out and closed.

- Concerning each **open agreement**, the data disclosed will include the type of the agreement, the date and expiry date (term) of the agreement, and the initial amount and currency of the agreement; additional data include the typical amount (and currency) of instalments, the method and frequency of repayments, and for open agreements, the amount of principal debt outstanding. The report thus provides an overview of the contents and performance of the agreement.
  For good debtors who have made regular and timely repayments, no negative data will be included, i.e. the *KHR* will indicate that the credit taken is being repaid as agreed.

- **Closed *credit agreements***, which concern credit previously taken and have hopefully been carried out, are listed in the detailed part after open agreements. This section also includes the agreement data listed above, plus data on closing, which specify the closing date of the agreement, and principal debt outstanding on closure (agreements duly carried out will have been closed around expiry with zero principal debt outstanding). Under the KHR Act, data on closed *credit agreements* may be controlled in the *KHR* for up to five years.
  Closed *credit agreements* that have been carried out are particularly important for the purpose of credit assessment because they demonstrate, over a history of several years, that the *customer* acted responsibly in the course of borrowing and repayment, and is thus a reliable and good debtor.

Positive data are also classified into two types according to the nature of the *credit agreement.*

- One basic type of credit involves the disbursement of a specific smaller or larger amount, subject to a **definite repayment plan.** This type includes most mortgage, retail, personal, etc. loans. For this type, data providers specify a meaningful instalment amount and repay ment frequency, which the assessing bank can use to estimate the *customer*'s debt service (repayment) obligations, and the expected schedule of their fulfilment.

- The other type includes **credit facilities**, typical examples being overdraft facilities and credit card agreements. With these facilities, in the vast majority of cases banks specify a very low or zero instalment amount, which, set against the type of the agreement as well as the method and frequency of repayment, will clearly indicate that the facility does not have a definite repayment schedule. In such cases, possibly in cooperation with the *customer*, the bank will estimate the cash flow of the facility; for example, the limit of a credit card will be assumed to cover the *customer*'s living expenses, and accordingly, the bank will consider the *customer* to receive and spend only a part of their pay in cash – with a sufficient level of income, this will not affect their creditworthiness.

If the combined amount of repayment obligations is sufficiently low to accommodate additional credit, the bank will probably grant the credit requested. If, however, set against the income specified, the amount of debt service, derived as a sum of known repayment obligations and the amount of the obligation arising from the new credit being requested, would apparently exceed the debtor's capacity, the bank will warn the *customer*, allowing them to reconsider the additional borrowing with the bank's assistance. If the *customer* can demonstrate their ability to repay both existing and new credit, they will obviously be granted the latter; however, if the probability of becoming insolvent is real, both parties are better off withdrawing from the new *credit agreement.*

Next is an overview of negative data.

- If, in violation of a *credit agreement*, the *customer* fails to pay or makes insufficient repayments over a prolonged period, the reporting bank will, pursuant to the provisions of the KHR Act, add a negative event (a so-called *credit default*) to the data of the *credit agreement* concerned. ***Credit default* occurs when the *customer's* delinquent debt exceeds the mount of the minimum wage for at least 90 consecutive days** – which means a substantial *late payment* assuming average credit. *Credit default* will indeed considerably deteriorate creditworthiness. A disqualifier? It used to be an obvious disqualifier. Today, however, evaluating the data in combination with positive data and jointly with the *customer*, for the purpose of credit assessment an institution may well ignore a previously settled *credit default* ("yes, I fell into arrears two years back because I lost my job and someone in the family was also ill, but everything is back on track now; you see, I've repaid all my debt, and I haven't had any trouble ever since...").

- Under the *KHR* Act, ***credit default*** **data may be controlled in the *KHR* for either one year or five years.** The *credit default* will be removed from the *KHR* after one year in cases where settlement was made in cooperation with the consumer (by means of repayment, transfer of collateral, contracted rescheduling); however, it will remain visible for five years in cases where the lender was forced to write off the debt as a loss. Note that pursuant to the KHR Act, the *credit default* will be removed after ten years even if the bank has not closed it, i.e. failed to indicate that the *default* no longer occurs.

- **Incidents of *card fraud* and *credit fraud*** are more severe cases, and **involve a lender reporting a data subject's abuse of a card or their wilful and *fraud*ulent attempt to mislead the lender when submitting a credit application** (submission of forged documents, falsification of income or other data to inflict a loss on the lender). Under the KHR Act, a financial institution will submit such data on an individual if it can provide evidence of the *fraud*. It is indeed difficult to offer excuses for such an incident (e.g. the use of forged documents in the course of a credit application). Once it has occurred, the perpetrator had better wait until the *fraud* data are removed from the *KHR* before they submit a new credit application, and be wiser next time.
  Under the KHR Act, data on *card fraud* and *credit fraud* **remain on file** with the *KHR* **for five years after being reported.**

- What about the instrument of personal bankruptcy and related data? These concern lending and borrowing only to the extent that an individual in bankruptcy can only take out credit subject to very strict conditions, and the lender must definitely be aware of the circumstances. At the same time, in bankruptcy proceedings, adequately secured credit that is offered at a favourable rate and is taken to settle outstanding debt may greatly facilitate the successful completion of the process, which means that bankruptcy proceedings cannot be regarded as disqualifiers.

The very end of the detailed part specifies the natural identification data (birth name, mother's name, date of birth, place of birth) and descriptive data (current name, residence and mailing address, identification numbers, nationality) that are linked to each data item by the reporting financial institution, and hence the *KHR*. The *customer* should also review these data very carefully. The probability that someone else's data will be mixed with the *customer*'s own data based on natural identification data is extremely low, but not zero. Therefore, whenever the *customer* finds personal data which are not their own (or someone else may be supposed to have entered into the agreement concerned in the *customer*'s name using a personal document that is proven to have been lost by the *customer*), they should immediately contact the reporting institution and seek to clarify the situation.

The first part of the credit report is the summary, which is explained second for better clarity, **simply provides a summary of the data retrieved from the *KHR***: it indicates the number of each item (*credit agreements, credit defaults,* incidents of *card fraud* and *credit fraud*), including the number of those outstanding and those already closed. Additionally, it indicates the combined amount of principal debt outstanding, and the monthly amount of repayment obligations. The summary part of the credit report can be reviewed in a minute, allowing the most urgent and most important conclusions to be drawn immediately (any *credit default, credit fraud* or *card fraud* outstanding; amount of debt service obligation, etc.).

What conclusions can be drawn by the requesting bank from all this?

- An empty credit report can mean two things: either the *customer* is not suitable for the bank's assessment because they tend not to or refuse to take credit, or the *customer* currently does not have, and over the past five years, has not had, any *credit agreements.*

- If the credit report lists some performing open agreements and some closed agreements which have been duly carried out, the *customer* is indeed a good prospect. Closed agreements show the *customer*'s willingness to borrow, their responsibility in borrowing, and repayments without *default* – in this respect, for assessment purposes closed credit weighs more on the positive side than outstanding credit.

- The presence of one or several open *credit defaults* in the credit report is by all means a strongly negative signal. In such a case, powerful arguments are needed to convince the bank that it can safely grant credit to the *customer*. One such argument is debt consolidation: "If I'm granted this favourably rated credit, which I can repay from my income, and can also secure by providing collateral, I'll immediately settle these *credit defaults*…".

- If the credit report lists one or two closed and settled *credit defaults*, this can be explained, depending on the case. If the *customer* is able to make it clear for the bank that the problem indicated was temporary and no longer occurs, the bank may choose not to give the problem a negative assessment.

- As mentioned above, data on *card fraud* and *credit fraud* are very difficult to explain, as they are evidence of the *customer*'s action in bad faith. If the credit report includes such data, it would be wiser for the *customer* to wait until the data are removed from the *KHR*.

What is the bank supposed to do with the credit report when a *customer* applies for credit?

- It is required to request a credit report – the National Bank of Hungary will check whether lenders have consulted the *KHR* in the course of lending (i.e. whether the credit report is attached to the credit file).

- It is required to explain the contents of the report to the *customer,* and the conclusions drawn.

Consumer credit reports subject to a *customer* statement

Following the above explanation of the contents of the 'full' credit report, it will be easy to understand the two statements requested by the financial institution for the purposes of lending.

The *customer* may make a general statement covering all of their credit data, which is called *statement of consent to disclosure*. If this statement is

- positive: all data controlled in the *KHR* will appear in the credit report, including all open *credit agreements* as well as any negative data;

- negative: the credit report will include only the negative data controlled in the *KHR*, and an indication that a negative *statement of consent to disclosure* has been given.

It is to be noted again that **negative data –** any *credit defaults* that remain outstanding, or no longer occur but remain controlled, incidents of *card fraud* and *credit fraud*, and *debt consolidation processes* – **will always be included in the reports, irrespectively of the *customer*'s statement.**

When the *customer* has made a negative *statement of consent to disclosure*, the requesting bank will be notified of the negative statement itself, but will have no means of knowing whether or not the negative statement conceals any information, and whether the *customer* has a *credit agreement* the disclosure of which they are withholding, or they have no such agreement. From this point, the contents of the credit report become uncertain as to whether it contains full or only partial information on the *customer*'s credit status.

It is to be noted that the *statement of consent to disclosure* can be made either when entering into a *credit agreement* or when applying for credit, and **always the most recent statement will be valid.**

The other important statement is the *statement of consent to retention*. This statement must be made separately for each *credit agreement*, and can be adjusted subsequently at the *customer*'s option. If the statement is

- positive: the *credit agreement* concerned will remain controlled in the *KHR* for five years after its closure, and will be included in credit reports according to its status on closure;

- negative: the *credit agreement* concerned will be removed irretrievably from the *KHR* on the date of its closure and will no longer be included in credit reports unless it is associated with a credit default, in which case the agreement will remain on file with the KHR as long as the credit default itself. This means that a credit agreement which has not been carried out will continue to appear in credit reports for one year, and potentially for five years, after its closure.

Proprietary credit reports for consumers

Proprietary credit reports are different from credit reports issued to banks in three respects, two of which are material and one is less so.

- The first material difference is that **proprietary credit reports indicate for every item of data the institution that submitted that item to the *KHR*** (this information is not provided by the *KHR* to banks);
- The second is that such reports also carry information as to who queried the *customer*'s data, and when;
- The less material difference is that such reports have no summary page.

The report is therefore an efficient means to protect consumers' interests. When a *customer* finds erroneous or inaccurate data in the report, they will know which financial institution to contact to have the data corrected or deleted, and they will also know who has queried their credit data. The *customer* can request the report any number of times, free of charge.

Tactics and advice for adopting a view on the *KHR*

At first glance, the *KHR* clearly appears as a public enemy to every borrower. 'BAR-listed *customer*' is a derogatory term, which is understood by everyone as a life-long prohibition against the consumer's additional borrowing.

The situation, especially since the consumer credit register has contained both negative and positive records, is completely different. As the credit report includes all of a *customer*'s *credit agreements*, the **requesting entity will get the big picture.** The odd previous *credit default*, especially if it has been settled using the *customer*'s own resources, may in practice be disregarded in the light of positive credit data – negative data in themselves would 'blacklist' a *customer*, but in combination with positive data, the *customer* would already be in 'light grey' territory. Moreover, negative data remain on file only for a limited period, which means that a problem will naturally put the *customer* at a disadvantage, but **only temporarily.**

What should a *customer* do when a *KHR* statement is requested at the time of borrowing?

- *Statement of consent to disclosure.* Having read the foregoing, it will become obvious that **concealing positive data** that could complement the always visible negative data **is not a smart decision**, while it also implies that the *customer* is not truly cooperating. It follows that 'Yes' is the reasonable answer.
- *Statement of consent to retention.* The benefit and drawback of a positive statement:
  - Benefit. If, as the *customer* should hope, the loan is repaid without any *default*, this will be a positive factor in credit assessment for five years.
  - 'Drawback.' If the *customer* falls into arrears with repayment and a negative event (a *credit default*) is added to the agreement data, under the KHR Act the negative event will be included in credit reports on a mandatory basis for at least one year, and potentially five years. That is, a negative statement will not be sufficient to 'conceal' a *default*; consequently, **the customer will not be put at a disadvantage by saying 'Yes'.**

Customers who continuously perform well on a number of credits and also have a positive credit history are the most promising and most sought-after *customers* for every bank. A negative statement will put such *customers* on a par with *customers* who are unknown, and therefore of high risk, to the bank.

By making negative statements, for the purposes of a credit assessment a *customer* can only conceal from a bank their positive credit history and current good debtor status, i.e. only positive information that would otherwise give them an advantage.

In summary, what the *customer*'s discretion granted by law amounts to in reality is that if they make an uninformed and emotionally driven decision, they can only put themselves at a disadvantage in the course of credit assessment. Making a negative statement is not unlike concealing admirable traits and highlighting undesirable ones in a courtship.

5.1.2 Business credit report

The credit report on businesses is similar to the one on consumers, with the following differences:

- in the event of a breach, *credit agreement* data are associated with data on *late payment* rather than *credit default*; a ***late payment* is registered in the *KHR* after 30 days** instead of 90 days, **and has no statutory minimum** – in practice a threshold of 1 HUF applies;

- so-called ***queued* items** are recorded as negatives events. Items are *queued* against a business when it **fails to settle a justified claim on its bank account** (demands for payment, bank account levies) **for a prolonged period (30 days) in a significant amount (1 million HUF).** In practice, *queued* items indicate a temporary liquidity problem or insolvency of the business, or even its bad faith regarding claims payment, and are thus a strong negative signal.

- data on abuse related to *bank card acceptance* are registered; although in many cases the abuse will have been committed by an employee rather than the business itself, the responsibility of the latter cannot be disputed, and such a negative entry will also reflect badly on the business.

For businesses, credit reports are outweighed by verifiable cash flows, balance sheets and credit-related business plans. However, in banking practice lending to micro-enterprises and small businesses follows similar procedures to those applied in consumer lending, and in such cases the credit reports of the business, of its owner and of its managing director collectively may already be of decisive importance.

Proprietary credit reports for businesses

Businesses also have the right to inspect the data held on record about them. In this case, proprietary credit reports are different from those available to banks in the same way as with consumers: **for each item of data, the KHR will identify the reporting bank, and the report will also list the banks that have queried the data subject.**

Businesses should also consider requesting a *proprietary credit report for businesses* before a borrowing decision, interpret the contents of the report, arrange for the correction of any errors, and use it to prepare for negotiations with the bank.

5.2 Customer information, credit data action

As mentioned above, the *KHR* involves mandatory data controlling, regarding which data subjects' discretion is restricted: they cannot decide whether to be registered in the *KHR* or not, and neither can they, in certain cases, decide whether their data may be retrieved by financial institutions. Data controlling is thus mandatory, and involves an obvious restriction on the data subject's rights. However, this does not mean that the data subject has no rights and cannot exercise them.

A key element of the right for the protection of personal data is the right for information. Already before data controlling, the data subject must be given information about all facts related to the controlling of their data, so that they can make an informed decision. This right must also be granted to the data subject in respect of the *KHR*.

Information is mandatory before borrowing. The lender is required to provide detailed information to the data subject about the fact that the *KHR* will be queried in connection with their credit application, including the presentation and explanation of the information contained in the credit report. The data subject must be informed about the fact that if they take out credit, their data will be registered in the *KHR*, and that information must also explain the *KHR*'s operations and the detailed of data controlling. The information includes the sample brochure released by the National Bank of Hungary. In this way, the data subject can gain a detailed understanding of data controlling, and will indeed be required to make a statement to that effect, and can make an informed decision on the basis of that understanding.

30 days before the envisaged registration of a *credit default*, the lender is required to provide written information that unless the debtor's delinquent debt is settled, the ***credit default* will be registered in the *KHR*.** The lender is also required to provide written information after registration of the *credit default*. Consequently, no *credit default* can be registered in the *KHR* without the data subject's knowledge.

The data subject may also request information subsequently at any time during data controlling, and can contact any financial institution for that purpose. The information specifies the data that are held in the *KHR* about the data subject, and the institutions which received those data. In compliance with the very strict requirements in the KHR Act, within a few days following the request the data subject will receive the requested information in writing in a closed envelope, or at its option, electronically. The information is free of charge. This provides the **data subject simple and free access to information on data controlling at any time.**

Obviously, the data subject's rights are not limited to information. **The data subject may raise a complaint about data controlling**, and may request their data to be corrected or deleted. Where, on grounds of the information received as explained in the foregoing, the data subject considers that their data are held in the *KHR* unlawfully, or have been unlawfully retrieved by a financial institution, or are inaccurate or erroneous, it will be sufficient for them to raise a complaint with BISZ Zrt. (the manager of the *KHR*), or with the institution that unlawfully reported the data. The data controller and the data reporter are required to examine and respond to the complaint on its merits, and take any necessary action.

If the data subject is not satisfied with the action taken, or has not received the information provided for in the KHR Act, **they may file court action within 30 days.** The case **will be heard promptly**, and will be greatly facilitated for the data subject by the fact that the burden of proof in respect of the lawfulness of data controlling will be placed on the defendant. The data subject will be granted the right of prenotation, which will exempt them from the payment of duties on commencement of the proceedings. Duties are normally paid by the unsuccessful party subject to the final ruling of the court.

Apparently, despite the *KHR* involving mandatory data controlling, the rights of the data subject are granted; indeed, **the provisions of the KHR Act greatly facilitate the data subject's enforcement of their rights.** Over the years since the *KHR* was created, also data controllers have demonstrated that they care about the protection of data subjects' data: a negligible number of credit data actions have been taken, and a vast majority of these have been awarded to the financial institutions (including the financial enterprise managing the *KHR*), as the lawfulness and accuracy of data controlling can rarely be disputed.

5.3 Enforcement of personal rights

The *KHR* does not endanger the personal rights of the data subject, the key to which is the self-contained and regulated character of the system. The natural persons and businesses on record have adequate means to remedy any injurious situation.

Obviously, data subjects have other legal instruments available to them in addition to complaints and credit data action. Where their personal data are deemed to have been controlled unlawfully, the data subject may file a report with the Hungarian National Authority for Data Protection and Freedom of Information (NAIH), which may conduct an inquiry on the data controller as part of administrative proceedings, and may also impose a fine.

The option of judicial enforcement is also available. In a credit data action, the data subject may only demand deletion and correction of their data controlling, and in general, termination of unlawful data controlling. By contrast, in a 'traditional' civil-law action, the data subject may also claim damages for losses attributable to the *KHR*. For example, when someone is denied credit due to erroneous data in the *KHR* and therefore loses their down payment in a property purchase and sale transaction, they may seek indemnification for the damage. For restitution to be awarded, material damage to the data subject is not a prerequisite. The fact of contravention and evidence of the injury will provide sufficient grounds for the court to award restitution.

There is also another **essential safeguard** to protect the data subject's rights, and that is the **reputational risk to financial institutions and BISZ Zrt., the manager of the *KHR*.** If a lender is proven to be acting unlawfully in the submission of data to or the retrieval of data from the *KHR*, it may easily make headlines on blogs and internet sites about consumer protection. And the impact of that on the institution concerned is even worse than a fine. BISZ Zrt. has a strong vested interest in controlling data lawfully because if evidence is found for unlawful data controlling and the *KHR*'s unlawful operations, it may even have its licence withdrawn as a result.

The foregoing demonstrates that **the *KHR* is a self-contained system subject to detailed regulation, which was designed with the protection of data subjects' rights in mind, and offers a number of options for the enforcement of those rights.**

5.4 The technical structure of the KHR

As an information technology system, the *KHR* runs in a state-of-the-art hardware and software environment. The core of its operation is a central server, which is accessed through broadband telecommunication interfaces by the financial institutions that subscribe to the *KHR*.

The *KHR*'s records are managed by an efficient database management system, and the software actually responsible for the management of the records has been developed using an object oriented development tool. The software provides

- adequate access by operating personnel, ensuring the operation and surveillance of the server and database management software;
- the opportunity for the *KHR*'s institutional subscribers to maintain their data; and
- the opportunity for the *KHR*'s institutional subscribers to retrieve data.

Telecommunications are provided by means of standard devices through a private network called GIROHÁLÓ. This network is accessed directly by each financial institution engaged in lending. Naturally, even financial institutions require specific tools to access the *KHR*.

During its operations, the *KHR* **runs automated content and formal checks on the data submitted,** verifying that they are accurate (e.g. that business VAT identifiers are check digit validated, and that natural identifiers are accurate), and are free of inconsistencies (e.g. that *credit default* occurs at a date subsequent to the date of the relevant agreement). Financial institutions receive detailed feedback on each error, which provides for fast error correction.

Data are accessed and retrieved using an entirely different methodology. Lending institutions consult the *KHR* when in the course of preparing *credit agreements* they are required to assess *customers*' creditworthiness against credit information. Therefore, rather than in banks' data centres, the need for queries arises in the branches responsible for credit assessment, which is also where the reports are used. In this way, requests are submitted to the *KHR* in small packages (usually one request per package), and the reports are also returned in small packages to the place of their use, usually within a very short time (3 to 30 seconds).

5.5 Security of the *KHR* and data protection

By nature, the *KHR*'s records are highly delicate, as they contain sensitive personal data (natural identifiers, home addresses, mailing addresses), as well as financial and confidential banking information. This makes the **CONFIDENTIALITY of the system** (a key concept in information security) **absolutely critical.** Another critical aspect is the **INTEGRITY** of the system, i.e. that the data are not lost either partially or in their entirety, are not compromised, and provide a true and fair view at all times. As a number of financial institutions now rely on *KHR* data checks for their lending, it is critical to ensure the continuous **AVAILABILITY** of the system – if the service were to be interrupted even for 15 minutes, it would cause downtimes and severe losses to many banks.

The fourth critical aspect, **DEMONSTRABILITY**, is not commonly regarded as a key pillar of information security; however, the *KHR*'s communications provider GIRO Zrt., and BISZ Zrt., which is responsible for the *KHR*'s operation and maintenance, consider to be bound by this key aspect as well, attaching critical importance to ensuring that the institutions submitting and accessing the data also carry out their duties authentically and responsibly.

The *KHR* provides a continuous service, serving credit information to hundreds of users on a 24/7 basis. The high-level protection of network connections is provided through users' dedicated terminal systems and the online encryption method applied. The network security arrangements of the centre ensure that access to the *KHR*'s central system is limited to authorised users who have dedicated tools. Online encryption prevents the information from being 'tapped into' while in transit. Network connections are shared with GIRO's data network, and thus their operability and integrity are safeguarded by GIRO's network operations and surveillance.

In order to maintain the quality of data controlling on a continuous basis, and to address security challenges, BISZ Zrt. operates ISO-certified quality control and data security systems, while its internal audit organisation exercises daily control over compliance, the prevention of any attempted abuse, and the disclosure of such attempts.

Over its more than 20 years in existence, no data losses or data leaks have been detected in the *KHR*, or its predecessor BAR. In that two-decade period, on the few occasions when non-standard data controlling issues were detected on the users' side, prompt notification was given to the parties concerned, who took the necessary actions immediately.

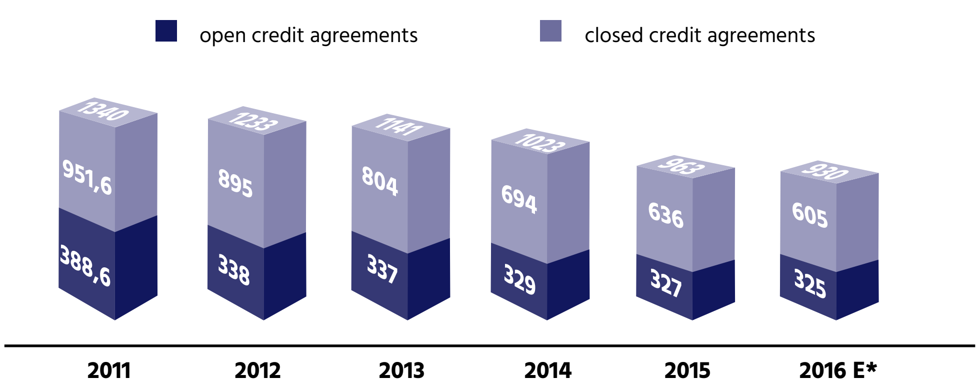
5.6 Identification of KHR items, size and traffic of registers

The *KHR* consists of two separated registers. The older register records ***credit* and *credit default*** data for **businesses**, while the more recent register records similar data for **consumers.** This separation is not attributable to the nature of credit; there are a number of examples worldwide for systems which incorporate both types of information, and use the loan amount or mortgage collateral as selection criteria. In Hungary, separation is primarily a result of legal regulations, and second, in accordance with those regulations, of the identification of registered items, and consequently, of the methods used for searches and access.

In the business register, identification is unambiguous, each business being identified by the first eight digits of its VAT ID (reference number), which enables accurate and fast searches. In the consumer system, legal restrictions prevent the KHR from using any of the unique personal identifiers that exist in Hungary (personal ID number, taxpayer ID, social security ID). As a result, the individuals on record are identified and searched by natural identifiers (birth name, place and date of birth, mother's name), which are more difficult to handle. Accurate identification and efficient searches are hindered by identical names, as well as by orthographical differences in the names recorded in various documents and by various financial institutions.

The concerns listed above explain the fact that the *KHR* is currently comprised of two separate systems, their only possible common elements being sole traders who have VAT IDs and have taken out business credit, and simultaneously have *credit agreements* as individuals.

Annual number of open and closed credit agreements in the KHR business subsystem (as of year-end in thousands)

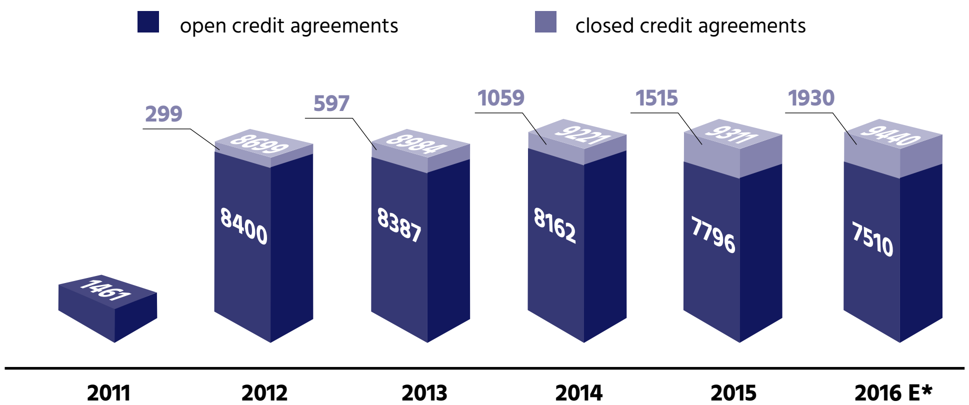


* Estimated

The business system currently controls about 1 million business agreements. In terms of the number of agreements, one-third are open and two-thirds are closed agreements in their limitation periods. The number of late payments outstanding has been around 50,000. The business agreements belong to approximately 145,000 businesses, the number of which has been fairly stable. This number of businesses is close to the relevant number of businesses in Hungary, given that a business operating in real market circumstances is also often a borrower. The business system supports business credit assessment decisions by issuing approximately half a million credit reports a year.

The consumer system holds data on nearly 7,5 million open and almost 2 million closed *credit agreements.* The 9.5 million agreements belong to just under 5 million individuals. This indicates that the active half of a population of approximately 10 million currently has credit or has had credit in the recent past, and also that an active individual has 2 credits on average. The consumer system supports risk management work across the industry by providing an annual 3.5 million credit reports.

Annual number of open and closed credit agreements in the KHR consumer subsystem (as of year-end in thousands)



The sharp increase in the number of credit agreements was due to the submission of positive credit agreements from March 2012.
Before 2012, only the number of defaulted credit agreements is shown.

6 The *KHR* today and opportunities for development

The *KHR* has evolved into its present form over the past 20 years following a number of changes in Hungary's legislative environment. In comparison with the content of similar services in other countries, however, there is considerable room for development for the *KHR*'s services.

Making a meaningful extension to the content of credit referencing and widening the group of users accessing the service require **amendments to the legal regulations that specify the system.** There is social demand for extensions to the contents of both the business and the consumer registers. There could be enormous benefits to the Hungarian business sector, banking sector and families from data sharing between various independent registers in the country and the *KHR*, which would allow the *KHR* to **provide more complex, value-added information in the context of** both business and consumer **credit referencing.**

Information sharing regulated by law leads to reduced bureaucracy, a shortened time requirement for the achievement of credit purposes, and ultimately for accelerated, more accurate and more efficient credit assessments. As the *KHR* is comprised of two separate systems, consideration should be given to **opportunities for the separate aggregation and analysis of the data** currently held in each system, as well as to **opportunities for connecting** the contents of **the two separate systems with other databases in Hungary.**

The aggregation of open and closed data currently held in the *KHR*, and mapping them to a scale of predefined values (scoring), or to put it in *KHR* terms, the generation of single business and single consumer credit reference values, would be of high significance.

Business credit assessment is currently supported by a number of public databases. These include a variety of publicly accessible balance sheet, court and *default* data, and the services of businesses offering company information services, all of which are currently used by banks. Carefully elaborated cooperation with legislative support would enable the *KHR* to access, based on the principle of reciprocity, the registers (containing primarily negative records) of other sectors. Such registers record, for example, information on *defaulted* utility and telecom claims, or information on circular debt, which are relevant to the SME sector and significantly influence creditworthiness.

In the case of the consumer system, the situation is more complex, as several legal regulations prevent data sharing among various registers. The first step would be to link available negative data on *defaults* to *KHR* data. Worldwide, data on *defaulted* claims related to utility services, telecom services, housing and car rental are commonly shared with registers of *defaults* in the financial sector. In developed market economies, it is absolutely common for an individual to be prevented from renting a car due to a credit *default*, or to have their credit card application rejected due to failure to pay rent.

A more serious legal issue is raised by the possibility of controlling data on incomes, assets and lifestyles, although creditworthiness can only be determined through the complex assessment of such data. It would be valuable for consumer credit reports to generate the updated payment-to-income ratios required under the relevant Decree of the National Bank of Hungary, which would efficiently and effectively promote banks' credit assessments and borrowers' interest. However, this is currently not possible for lack of income data.

7 Appendix – Key terms

Although it has not been our intention to provide full details on technicalities, a brief explanation of some key terms could be useful, if only to clarify the relationship between the words used in everyday conversation, the wording of the act regulating the operations of the KHR, and the expressions used by financial institutions.

KHR	Central Credit Information System
Reference data provider	A collective name for the financial institutions that subscribe to the KHR. They are required to report data in accordance with the KHR Act, and may access the contents of the data submitted to the KHR by other reference data providers.
Customer	Any natural person or business whose credit-type agreements with reference data providers are recorded in the KHR. The concept of customer covers both natural persons and businesses that participate in the economy. A key criterion of the customer concept is an entity's role in the credit agreement: debtors and co-debtors qualify as customers, whereas sureties, guarantors and pledgors do not qualify as customers for the purposes of the KHR.
Statement of consent to disclosure	A statement by an individual concerning disclosure of their positive data held in the KHR, i.e. the inclusion of such data in consumer credit reports. This statement applies to all of the customer's credit agreement, and can be adjusted at any time (even during submission of a credit application before a credit report is requested), so that always the most recent statement will prevail.
Statement of consent to retention	A statement by a customer, being a natural person, concerning a particular credit agreement, which specifies whether the KHR will be authorised to control the credit agreement in question for an additional five years after its closure, and include it in credit reports where a positive statement of consent to disclosure has been given. The statement must be made at the time of contracting, and may be adjusted at any time during the term of the agreement. Where a negative statement has been given, the agreement will be untraceably and irretrievably deleted (obviously, no subsequent positive statement is allowed), unless a negative event is associated with it. Where the customer has given a positive statement and withdraws that statement at any time during the retention period, the agreement concerned will irretrievably be deleted upon withdrawal of the statement, unless a negative event is associated with it.
Credit agreement	Any agreement between a financial institution and a consumer giving rise to debt which is owed by the customer to the financial institution. Such agreements include common loans (short and long-term loans, fixed-purpose and general-purpose loans), overdraft facilities, and credit card plans, but also financial leases, financial factoring, discounted bills and a host of other arrangements; excluding, however, current accounts without an overdraft facility (although such accounts may also have negative balances).
Credit default	A special KHR term relating to the consumer register, used for the negative designation non-performing debtors. It is subject to the dual criteria of i) delinquent debt exceeding the minimum wage ii) outstanding for more than 90 days.
Late payment	For businesses, a negative event associated with a credit agreement may already be indicated after 30 days, without an amount threshold. This reflects the expectation that businesses should make timely and cautious repayments (late payments due to oversight and prevention are not accepted), and the fact that the amount of business credit is generally higher, and so is the risk to lenders.
Queue	(Business insolvency) This term indicates an unpaid claim on a bank account of the business for more than 30 days, in a combined amount exceeding 1 million HUF, due to insufficient funds. In practice, this is equivalent to the failure of a bank account levy on the account, which indicates the prolonged inability of the business to fulfil its payment obligations.

Card fraud As understood for the purposes of the KHR, card fraud occurs when a natural person uses a cash equivalent to commit fraud, and this is established in a court order.

Credit fraud As understood for the purposes of the KHR, credit fraud occurs when a natural person uses a forged or falsified document or supplies false data in an attempt to gain access to credit, and the financial institution can provide documentary evidence or a court order to support its claim to that effect.

Debt consolidation process A process for the consolidation of the debts of bankrupt individuals, commonly known as personal bankruptcy procedure, which is conducted with the contribution of the institution established for this purpose. This institution submits data on the debt consolidation process to the KHR, and the KHR will include those data in credit reports.

Data control period The period during which the KHR is authorised to control the data held by it. The data control period is usually five years after the data item concerned has lost effect.

More specifically:

Business credit agreement	five years after termination of the agreement;
Business late payment	one year after settlement of the late payment;
Business queue	five years after settlement of the queued items;
Merchant fraud	five years after the occurrence (reporting) of the fraud;
Consumer credit agreement	five years in the case of a positive statement of consent to retention, otherwise the data will be deleted when the agreement is closed;
Consumer credit default	one year after closing where the default is settled positively (repayment by customer, enforcement of collateral, suretyship); five years after closing where the default could not be settled positively (the claim was written off), which will add to the controlling period of the relevant agreement even where a negative statement of consent to retention has been given; ten years where the default could not be settled;
Consumer card fraud	five years after reporting the fraud;
Consumer credit fraud	five years after reporting the fraud;
Consumer bankruptcy procedure	five years after completion of the procedure.

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