Bad news – technological progress could be severely hindered in creditworthiness assessments (and beyond)

Explainer

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Credit reference agencies, like the German SCHUFA, produce credit scores and reports of natural persons that are, for instance, used by banks as an input to help decide whether or not to grant loans. The role of credit reference agencies is key for healthy lending and borrowing practices as they contribute to a bank's assessment of whether a person's willingness and ability to pay can be trusted. Traditional statistical techniques, but also Artificial Intelligence and other technological advances are being used by these companies to produce such scores.

Nevertheless, technological progress in creditworthiness assessments (and beyond) could be severely hindered following a recent preliminary ruling by the European Court of Justice (ECJ) on 7 December 2023. Indeed, the ECJ has in practice introduced a ban on automated credit scoring in the EU when it is deemed decisive – unless (i) the natural persons whose creditworthiness will be assessed give their express consent or (ii) an exception can be applied under the GDPR's Article 22(2)(b or (iii) the credit score is necessary for entering into, or the performance of, a contract between the data subject and the data controller. This ruling could have very relevant ramifications for automated processes in the EU, not only shaking up SCHUFA and other credit reference agencies' business model, but also spanning across a range of businesses that use algorithms as a basis for making decisions, such as healthcare, insurance and employment.

In a context where the prevention of over-indebtedness and the protection of financial stability are public goods to safeguard, impeding the use of new technologies for creditworthiness assessments that feed into lenders' decision is not good news. And if such a decision will have broader and – to some extent – unknown consequences for other businesses, it really is bad news.

The role of credit information agencies

The *Schutzgemeinschaft für allgemeine Kreditsicherung* (the General Credit Protection Association), better known as SCHUFA, is a German company set up in 1927 when an employee of the *Berliner Elektrizitätswerke* (Berlin Electricity Company) came up with the idea of assessing households' creditworthiness based on the regularity of electricity bill payments. More creditworthy households were thus offered the chance to buy white goods and other electrical appliances, such as refrigerators, in installments, allowing for the number of households benefitting from modern appliances to increase.

SCHUFA currently works closely with their contracting parties, namely businesses, offering them a platform to store the payment records of third parties, specifically consumers, and then to exchange these records within the network. Based on payment records and using mathematical and statistical procedures, SCHUFA assigns scores to individual consumers, basically predicting how likely it is that they would be able to afford repayments. This information is then provided to their contracting parties, mainly credit institutions, at their request. Benefitting from technological advances, SCHUFA uses automated processes to make these calculations, assigning a consumer to a specific group with other consumers who share similar features and who behave in a certain manner, assuming that such behaviour remains similar and thus allowing for probabilities to be calculated.

There are other companies like SCHUFA in the EU (e.g. Experian in Italy, Spain, the Netherlands and Denmark, Tiresias in Greece and Biroul de Credit in Romania). But it's SCHUFA that has become well-known in EU legal circles lately following the ECJ's 7 December 2023 judgment. Yet the decision could have large ramifications for the whole credit information industry and thus responsible lending and borrowing as a whole.

The SCHUFA case

The case started when a natural person, known as 'OQ', was denied credit by a bank after having been the subject of a credit score transmitted by SCHUFA to this bank. Based on Article 15 of the General Data Protection Regulation (GDPR), which allows an individual to access any personal data concerning them held by third parties, OQ subsequently requested that SCHUFA send them the personal data that it held on them and then to erase some allegedly incorrect data. SCHUFA subsequently replied by informing OQ of their score and the methodology used to calculate it.

Unsatisfied with this response, OQ then decided to refer the case to the *Hessischer Beauftragter für Datenschutz und Informationsfreiheit* (the Data Protection and Freedom of Information Commissioner for the Federal State of Hesse, Germany; 'the HBDI'), asking for full access to their information and the ability to erase what they saw as incorrect data, which the HBDI rejected. This was because it concluded that it could not be established that SCHUFA had not complied with Article 31 of the *Bundesdatenschutzgesetz* (Federal Law on data protection-BDSG), which deals with the 'protection of trade and commerce in the context of scoring and credit reports'.

Therefore, on the basis of Article 78 GDPR, OQ then lodged an appeal with the *Verwaltungsgericht Wiesbaden* (Administrative Court, Wiesbaden, Germany), which in turn decided to stay the proceedings and refer the case to the ECJ for a preliminary ruling, as explained below.

Article 22 GDPR aims to protect consumers against the risks linked to decisions based purely on automation. To achieve this, Article 22(1) of the GDPR requires three cumulative conditions to be met for such protection to be activated, namely: (i) there must be a 'decision'; (ii) the decision must be 'based solely on automated processing, including profiling'; and (iii) the automated decision must produce 'legal effects on the interested party or similarly significantly affect him or her'. However, such protection may be lifted in three cases, as listed in Article 22(2) (a), (b) and (c) of the GDPR:

a. when it is necessary for entering into a contract between the data subject and the data controller;
b. when it is authorised by EU or Member State law to which the controller is subject;
c. or when it is based on the data subject's explicit consent.

Besides this, Article 6 of the GDPR deals with the lawfulness of data processing, indicating it will only be lawful to the extent that:

a. the data subject gives consent to the data processing or
b. the data processing is necessary for:
   I. the performance of a contract;
   II. compliance with a legal obligation, as stated in EU or Member State law;
   III. the protection of the vital interests of natural persons;
   IV. the performance of a task carried out in the public interest, as stated in EU or Member State law;
   V. for the purposes of the legitimate interests pursued by the controller or by a third party.

The key matters referred to the ECJ by the Administrative Court of Wiesbaden are the following:

1. Does the automated establishment of repayment probabilities, when the third party draws strongly on these data to make a contractual decision, fall under Article 22(1) GDPR? Or, to put it another way, are SCHUFA scores to be considered automated decisions that produce legal effects or that significantly impact an interested party? The Administrative Court of Wiesbaden raised its doubts over the argument that Article 22(1) GDPR should not be applied to SCHUFA, given the influence that the scores produced by SCHUFA have over the lender's final decision.
2. If the answer to the previous question were to be negative, the Administrative Court indicates a lacuna (essentially a gap or absence) in legal protection would result, since SCHUFA would not be required to grant access to the additional information to which the data subject is entitled to under Article 15(1)(h) GDPR. And given the fact that the bank would not have access to the full set of information produced by SCHUFA, the data subject would simply not be granted access to the information they are entitled to under the GDPR. This line of reasoning drove the Administrative Court of Wiesbaden to assume that the scope of Article 22 GDPR should be interpreted in a broad manner, which includes SCHUFA's specific activities.

From its side, SCHUFA challenged the request's admissibility for a preliminary ruling on two grounds:

1. The Administrative Court of Wiesbaden should not examine the HBDI's decision but only verify whether the HBDI correctly processed OQ's complaints.
2. The questions referred to by the Administrative Court of Wiesbaden are not decisive for resolving the dispute with OQ, which basically concerns the disclosure of information and its erasure.

SCHUFA also opposes the matters on substance.

The ECJ's preliminary ruling

The ECJ examined whether the three cumulative conditions under Article 22(1) GDPR were fulfilled in this case:

1. Regarding the existence of a 'decision', the ECJ acknowledges that the concept of 'decision' is not defined by the GDPR. Still, it interpreted this concept in a broad sense, finding support for such an interpretation under Recital 71 GDPR, and coming to the conclusion that a 'decision' could encompass a number of acts that may affect a data subject, including the result of calculating a person's creditworthiness in the form a probability value.
2. As for the decision being 'based solely on automated processing, including profiling', the ECJ finds support in the Opinion of the Advocate General and concludes that activities such as those performed by SCHUFA definitely fall into the category of 'profiling'.

3. The ECJ finally considered that probability values such as those used by SCHUFA, that have a strong impact on the final decision as to whether a loan application is to be accepted or rejected, would indeed fulfill the condition of producing 'legal effects on the interested party or similarly affecting him or her'.

Therefore, the ECJ concluded that SCHUFA's activities fall under Article 22(1) GDPR and, more generally, it considers that the automated establishment by a credit information agency of a probability value based on personal data relating to a person and concerning their likely ability to meet payment commitments in the future constitutes 'automated individual decision-making' within the meaning of Article 22(1) GDPR.

The ECJ then moved to the question over whether the protection granted by Article 22(1) GDPR may be lifted in light of German law as per Article 22(2)(b) GDPR, and more specifically, on the basis of Article 31 BDSG.

While the ECJ indicates that it is for the Administrative Court of Wiesbaden to indicate whether said provision of national law constitutes a legal basis for Article 22(2)(b), it also makes it clear that the national court should verify that conditions set out in Articles 5, 6 and 22(4) GDPR are also fulfilled. In practice, this means that the Administrative Court of Wiesbaden will have to ascertain that the principles relating to the processing of personal data as embedded in Article 5 GDPR[1] are met and that the conditions for data processing to be considered lawful as covered under Article 6 GDPR (see above) are fulfilled.

Next steps

Once the ECJ has made its preliminary ruling public, it is for the Administrative Court in Wiesbaden to present its final ruling. In light of the above, the main open element is whether Article 31 BDSG constitutes a national legal basis for the application of the exception under Article 22(2)(b) GDPR.

The ECJ's preliminary ruling already gives some hints as to the direction of the final ruling, as it indicates that '*there are serious doubts as to the compatibility of that provision [Article 31 BDSG] with Article 22 GDPR because the German legislature regulates only the 'use' of a probability value such as that at issue in the main proceedings, and not the establishment in itself of that value*'.

Possible consequences

While fully acknowledging and respecting the content of the ECJ ruling, it does not refer to the initial complaint made by OQ and provides a very broad interpretation of the GDPR's scope, which risks having very relevant ramifications for automated processes in the EU. Indeed, the ECJ's preliminary ruling implies a practical ban over automated credit scoring in the EU when it is deemed decisive, unless (i) the natural persons whose creditworthiness will be assessed give their express consent, or (ii) an exception can be applied under Article 22(2)(b) GDPR or (iii) the credit score is necessary for entering into, or the performance of, a contract between the data subject and the data controller. But this ruling risks having a substantial impact on businesses, going well beyond just creditworthiness assessments.

First, the ECJ has not ruled on the initial point brought forward by OQ, namely full access to their data that is held and processed by SCHUFA and their right to erase what they believe to be inaccurate data. Article 15(1)(h) GDPR grants a data subject the right to access information regarding the 'existence of

[1] Lawfulness, fairness and transparency, purpose limitation, data minimisation, accuracy, storage limitation, integrity and confidentiality, and accountability.

automated decision-making, including profiling, meaningful information about the logic involved, as well as the significance and the envisaged consequences of such processing for the data subject.' While keeping some elements private for trade secrecy issues, there is no evidence that SCHUFA did not comply with these disclosure obligations when transmitting information to OQ. This is also in line with the HBDI's decision.

Second, moving to the content of the ECJ's preliminary ruling, it is of utmost relevance not to lose sight of the fact that the institution that made the decision not to grant credit was the bank and not SCHUFA itself. Whether the bank only used the information transmitted by SCHUFA to make its decision should not have a direct impact on SCHUFA's business and methodologies. In fact, safe lending practices should encourage lenders to run their own thorough risk analysis of potential borrowers, not relying exclusively on those provided by third parties, such as SCHUFA.

In any case, the fact that the bank's final decision to not grant a loan was aligned with SCHUFA's score does not necessarily indicate that the bank was engaging in unsafe lending practices, but that the high quality of SCHUFA's scores are also a possible (and likely) explanation. Whereas one of the GDPR's objectives is to safeguard individuals against opaque and potentially biased automated decisions, this should not be the basis for an expanded interpretation that risks hindering the use of technological advancements in credit decision-making processes.

As stated above, this ECJ decision will most likely lead to (negative) spillover effects for automated processes in the EU. Indeed, this decision not only risks shaking up SCHUFA and other credit reference agencies' business model, potentially forcing them to reassess and adjust their practices to ensure alignment with GDPR but its implications could well span across a range of businesses that use algorithms as a basis for making decisions, e.g. healthcare, insurance or employment, among others.

Furthermore, since the ECJ's interpretation is very broad and not only applies to the decision-maker, as in the SCHUFA case, many businesses throughout the value chain could also be affected by this interpretation. Data providers will have to disclose relevant information concerning the logic involved in algorithmic risk assessment when the automated decision-making plays a determining role – even if not exclusively so – in the data user's choices. In practice, this means that businesses using automated processes will have to seek legal advice and potentially reshuffle many of their processes. In light of the ECJ's very broad interpretation, legal certainty issues could arise, with opportunistic class-action exploiters possibly deciding to take these types of cases to court.

Thinking about SCHUFA's specific case, unless a legal basis to allow for the application of Article 22(2)(b) was deemed applicable, this ruling could severely hinder the use of technological progress for assessing natural persons' creditworthiness, which will ultimately lead to worse lending practices. In a context where the prevention of over-indebtedness and the protection of financial stability are public goods, impeding the use of new technologies for creditworthiness assessments that feed into lenders' decisions is by no means good news.

And if such a decision will have broader – and to some extent – unknown consequences over other businesses, it really is bad news.

European Credit Research Institute

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