Incentivizing Calculated Risk Taking

- The paper asks an extremely important question.
- “What kind of a compensation scheme can best incentivize loan officers of banks to effectively screen prospective borrowers?”
- The importance of this question cannot be over stated.
- Banks are the only institutions that provide screening services.
- If they do this job well they can reduce the number of project failures and thus reduce the private and social costs of such failures.

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- It can be argued that banks are well placed to conduct this screening of projects because they may have considerable experience with similar projects under taken in a wide variety of businesses and may have more intimate knowledge of both business prospects in particular localities or products and general economic trends.
- There exists evidence that shows that bank financed businesses have higher survival rates than firms financed by family investors [Ried G.C. (1991) "Staying in Business" IJIO vol.9 pp 545-556].

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- A comparable study for India is as yet unavailable but I believe such a conclusion is very likely to be supported by Indian data.
- With a perfectly completive banking sector and complete contacts banks would be in a position to directly sell these services for a fee.
- Unfortunately in no county can screening services of banks be enforced by contract and the results of screening (if at all it is under taken by banks) always remains as private information with the bank, till the time the bank actually sanctions the loan.

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- The paper could spend a little more time in convincing the reader about the criticality of the screening services of banks.
- The incentives of banks to screen can be said to be influenced by at least two sets of factors.
- The legal and institutional environment within which a bank functions as represented by nature of security interest legislations in particular and the bankruptcy code in general.

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- It is well known in the literature that use of collateral debt contracts reduces the screening efforts of banks in general. [Manove M., Padilla A.J. and Pagano M. (2001) “Collateral versus Project Screening: A Model of Lazy Banks” The Rand Journal of Economics, Vol.32, no.4 pp 726-744.]
- In other words project screening and collateral are substitutes.

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- There is a large amount of empirical evidence from advanced countries that suggests that [Fleisig H., Mehnaz S. Pena N.(2006) Reforming Collateral Law to expand access to Finance, The World Bank, Washington D.C.
- loans secured by collateral have more favourable terms than unsecured loans, for any given borrower or size of loan;
- borrowers able to offer collateral can obtain a larger loan relative to borrower's income, with a longer repayment period and a lower interest rate.

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- Another interesting set of empirical results is provided by [Berger A.N. and Udell G.F. (1990) “Collateral Loan Quality and Bank Risk” Journal of Monetary Economics Vol.25 pp 21-42]
- riskier than average firms tend to borrow on a secured basis;
- the average secured loan tends to be riskier than the average unsecured loan (meaning that recourse to collateral does not fully offset the greater riskiness of secured borrowers);
- banks that make a higher fraction of secured loans tend to have riskier portfolios

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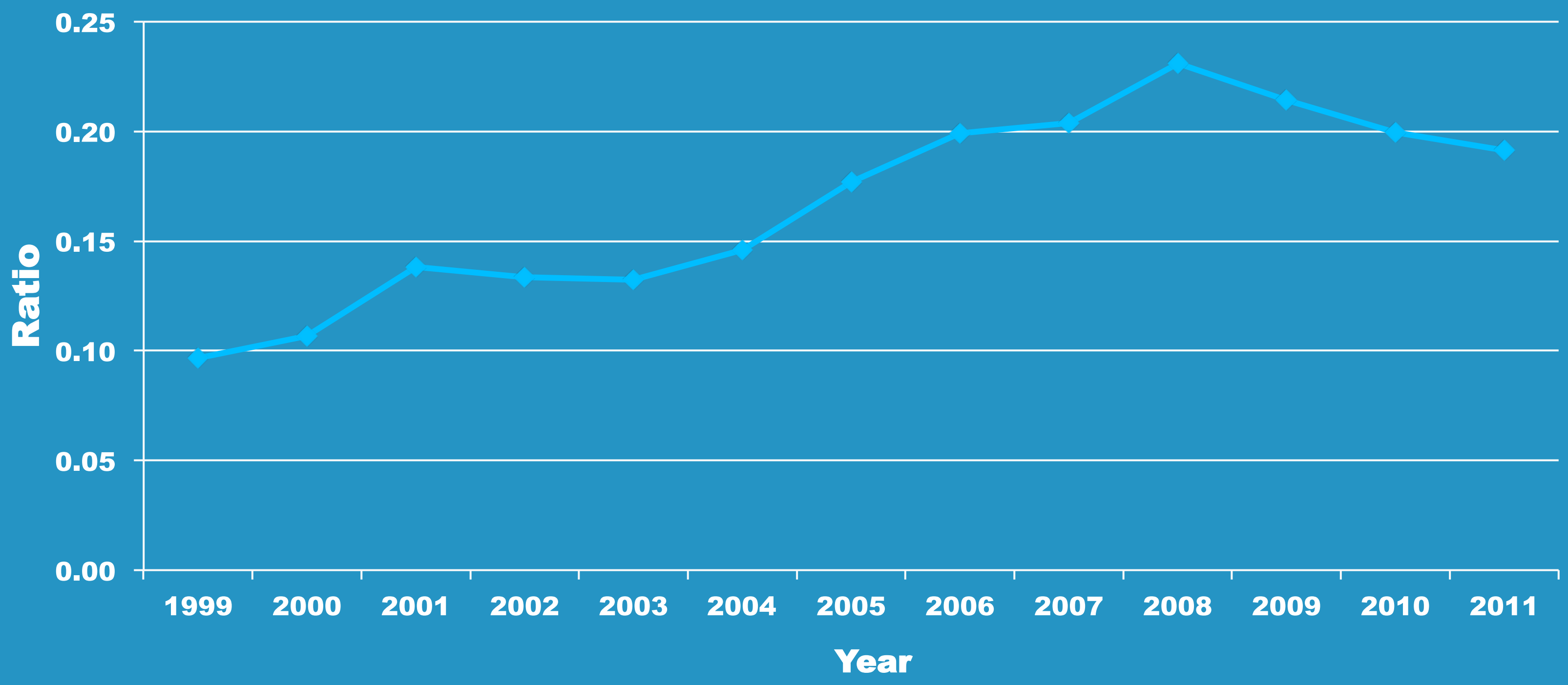
- What is the relevance of this legal environment in India?
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) 2002 has provided a legal basis on which banks can very easily take charge of collateral in case of default.
- This is expected to reduce the incentive for banks to screen projects.
- Empirically it is not yet clear if this is true in the Indian context.

Ratio of unsecured advances to total advances scheduled commercial banks in India



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- If it is true then given the low over all incentives for screening in general what particular banks can do the push loan officers to increase screening efforts would be of relatively less importance.
- It may be difficult for banks to induce their loan officers to screen effectively. This paper addresses only this problem completely disregarding the general legal environment.
- Their sample is restricted to the loans size range “Rs. 150,000 and Rs.500,000. These are priced in the range 15% to 30%.

Outstanding loans of Scheduled commercial banks according to size of credit limit (Rs. Lakhs) March 2009

Credit limit range	No of accounts	Credit limit	Amount outstanding
Rs. 25,000 and Less	35.6	1.4	1.5
Above Rs. 25,000 and upto Rs.2 Lakh	51.4	10.9	10.8
Above Rs. 2 Lakh and upto Rs.5 Lakh	8.7	7.8	8.3
Total	110056177	402987684	284771312

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- The data thus refers to the range that possibly accounts for the largest no of loans accounts.
- The interest range 15% to 30% accounted for 15.2% of all loan accounts as of March 2009.
- In the introduction the authors say
- "We focus on ***new applications*** for ***uncollateralized loans*** to small entrepreneurs with very limited credit histories-precisely the type of loans for which an assessment of credit risk depends most crucially on the judgment and expertise of the bank's employees."

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- I find it a little hard to understand why the authors have chosen to do this when the data in their possession could have unearthed some interesting empirical insights with regard to collateral, loan risk and screening.
- A first time loan applicant is asked whether he is willing to provide collateral. This is clear from loan application forms available on the web sites of banks.
- Why should a loan applicant willing to post collateral be excluded from the analysis? No clear reason is provided in the paper.

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- Is this done because once an applicant is willing to provide collateral there is no incentive for a bank to screen? As the Manove et al (2001) paper is not cited I doubt if the authors had this in mind.
- Is this done because the effort needed to screen loan applicants willing to post collateral is much lower?
- This again seems unlikely because the collateral given would have to be "screened" in addition to screening the project, to arrive at its market value. This is not very straight forward in the Indian context.

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- In fact small and new applicants would have a very large incentive to offer collateral because it may increase the probability of getting loan on more favorable terms.
- Whether this is true can be easily answered given the data that the authors possess.
- Moreover given the fact that a very large proportion of loan given by banks are in fact collateralized and there is good reason to believe that small loans are more collateralized than large loans. Doing away with applicants willing to provide collateral amounts to unnecessarily throwing away useful data.

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- Why focus only on new applicants? These are small entrepreneurs and an additional loan would be expected to substantially alter their businesses.
- In any case all these businesses would be expected to be very young, as firm growth over, say five years, would move the entrepreneurs out of the credit size class.
- Does having no credit history and having a few years of credit history make a very large difference?
- Concentrating only on new applicants again I suspect amounts to throwing away useful data.

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- Given that some amount of relevant data is disregarded the papers focus thus becomes extremely restricted.
- The experiment design is well thought out and the data generated in these experiments is very competently analyzed.
- The general conclusion that performance based incentives work doesn’t really come as a surprise.
- The finding that more experienced loan officers exert higher effort regardless of the incentive scheme makes me a little proud of the age group I belong to.

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- Though at the level of the bank it is difficult to imagine how banks could easily increase the number of experienced loan officers thereby automatically increasing screening effort.
- The results provided are extremely interesting but their over-all relevance in the Indian context I suspect is rather limited.
- I consider looking at the relationship between collateral and project screening, which can easily be done given the data at hand a more immediately relevant empirical exercise.