CREDIT SCREENING AND THE LIMITS OF TRANSPARENCY AND COMMUNICATION IN ROMANIAN BANKING SYSTEM

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In this paper, we examine the influence of contract costs on the pricing of bank loans. We find that the loan spread depends on a bank's screening and monitoring incentives through transparency and communication, which varies across differentially regulated classes of banks. This leads to significant price disparities in the loan market. Better information about borrower's type encourages tighter lending standards and competition in laxity can arise with multiple banks. Both better information ex ante and stronger legal protection ex post are shown to facilitate the entry of low-cost outside competitors into credit markets. When banks can strategically adjust the test characteristics by investing resources in the screening technology, we show that credit markets are not easily contestable.

Key words: screening, borrower's type, transparency, communication.

Credit screening and borrower's type

Mainstream theories on banking commonly attribute the existence of intermediaries to their efficiency in the credit-screening and monitoring of borrowers (e.g., Diamond, 1984; Campbell and Kracaw, 1980; Boyd and Prescott, 1986). For policymakers and regulators, the effect of credit standards on loan availability and economic output is material – in such manner that the Fed administers periodic surveys that measure the change in credit standards by studying the qualitative answers of loan officers. For instance, a study of a Senior Loan Officer Survey on Bank Lending (Lown, 2006) suggests that a tightening of credit standards explains a significant portion of the subsequent decline in business lending and wholesale inventory investment. In a theoretical framework, Ruckes (2004) develops the hypothesis that banks choose stricter standards of screening when the quality of the borrower pool is toward the middle of the quality spectrum than when the quality is either too low or too high.

The intuition is simple: when the marginal benefits of screening out bad projects exceed the marginal costs of credit verification, the bank will adopt high lending standards (i.e., evaluate applicants more carefully and lend more often to good types). This result holds when the probability that screening the borrower will reveal a good type is sufficiently – but not too – high. In contrast, bank's incentives to screen are the lowest if the probability of discovering a high type is close to zero (e.g., severe recessions, or small regional banks) or one (e.g., economic booms, or large money-center banks).

Traditional theories of financial intermediation assert that information asymmetries are central to bank lending. Prospective borrowers typically know more about their ability to repay loans than lenders do. Accordingly, banks screen borrowers to select high-quality clients and reduce risk of default among low-quality ones. A more recent literature on relationship lending takes the view that repeated interactions can reduce such information asymmetries between bank and borrower (Boot, 2000). According to this view, banks gain knowledge about payoff-relevant borrower attributes during the course of a lending relationship. Consequently, relationships emerge as a prime source of an incumbent bank's comparative advantage over potential outside lenders. This undermines competition in credit markets; the incumbent's superior information about its own clients weakens a competitor's ability to offer credit at lower interest rates.

Banks could require the borrower to secure loans with collateral. Both theoretical and empirical findings have shown that collateral requirements fall over the duration of the bank-borrower relationship (Boot and Thakor, 1994; Petersen and Rajan, 1994; Berger and Udell, 1995; Harhoff and Körting, 1998). This contrast between secured lending for new borrowers and unsecured lending for established ones is suggestive of the information content in collateral requirements (Sharpe, 1990; Boot and Thakor, 1994).

Theoretical studies that demonstrate collateral use as a screening device also assume that collateral is costly (Bester, 1985; Besanko and Thakor, 1987a, b; Boot, Thakor, and Udell, 1991). Banks incur a dissipative cost in taking possession of and liquidating collateral. Consequently, the lender valuation of collateral is typically lower than that of the borrower (Barro, 1976). Given that collateral is costly for a bank; better information on borrower credit-risk (gained in the course of a bank-borrower relationship) reduces a bank's incentive to secure loans with collateral.

This is consistent with the findings that collateral requirements fall over the duration of the bank-borrower relationship. It also implies that, in markets with poorer borrower quality overall, collateral assumes greater importance for entrants than for incumbents. Stronger legal protection reduces the deadweight losses of seizing and liquidating collateral, and this enables an entrant to bid more aggressively by screening the incumbent's clients. In contrast, weak legal protection discriminates against the uninformed entrant because it reduces the efficacy of collateral use. The model formalizes how variations in law and its enforcement are central to the efficiency and growth of financial markets in general (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1997, 2000), and the banking sector in particular (Levine, 1998, 1999).

Consistently, the empirical tests a pattern that would not seem obvious had one not considered the variation in credit standards: Bank loan-portfolio performance can be first increasing and then decreasing in the richness of the bank's loan-origination opportunities. The intuition behind the inverse U-shaped relation is also close in spirit to the strand of literature (e.g., Diamond, 1991; Berlin and Loeys, 1988; Hoshi et al., 1993; Rajan, 1992) that analyzes when it is optimal for borrowers to choose bank loan (debt with bank monitoring) over public debt (arm's-length debt with no monitoring). A central result of these papers is that the firm's choice between debt with or without monitoring depends on the firm's credit rating (i.e., the probability that the firm is a high type).

Borrowers with too low a credit rating choose public debt - if they can obtain debt financing at all. Those borrowers with too high credit rating choose public debt over bank loans (except in Rajan's model where the high type is indifferent between the two sources of finance). The managers of highly rated firms do not need bank monitoring to commit to exerting a high level of effort (i.e., choosing the good project) because of their reputation capital at stake. At the same time, from the bank's point of view, the benefits of monitoring or of pre-issue screening high-quality firms does not justify the costs of doing so. For the intermediate-quality firms, however, the costs of monitoring or pre-screening are less than the benefits of committing the firm to undertake efficient projects, or the benefits of screening out the low types. In equilibrium, therefore, only firms with intermediate credit ratings rely on debt with monitoring.

Banks whose loan-origination opportunities exceed their funding capacities (e.g. money center banks with constrained capital) originate more loans than they can profitably keep on their books and sell the excess to other domestic and foreign banks, as well as to nonbank financial institutions such as money-market funds. Thus, the "comparative-advantage" hypothesis, which formally develops these arguments, predicts a positive correlation between loan sales and lending opportunities. The key feature of the analysis is to use loan sales activity at the bank level as a proxy for the bank's lending opportunities (with certain caveats to be discussed shortly). These criteria were also studied by Dragulanescu in 2008.

Güth and Kliemt (1994) have analyzed the evolution of trustworthiness for the simple game of trust. In this game, a seller can trust the buyer or refrain from cooperation. Whereas the latter decision ends the game, it continues after "trust" with the buyer's decision to pay or not. What is studied evolutionarily is whether or not a conscience evolves preventing the buyer from not paying. The result depends crucially on what the seller knows about the buyer's type: Only trustworthy buyers will survive if the seller can recognize the buyer's type. If, however, only the buyer knows his type, the opposite is true: Only opportunistic exploiters, who do not pay the price, remain (see Güth and Kliemt, 1994). Perfectly signaling types or no type signaling are just the extremes.

Limits of transparency and communication in Romania

From banking sector point of view transparency means to offer current customers and potential ones basic information about the products and services in use and to train them to ask for further information about the real benefits and the actual costs of banking services. The development in competition among banks and the desire to increase market share lead to an adequate environment for promoting services and products in a misleading way because it accentuates on the benefits, while basic details are overlooked. Such behavior can jeopardize the reputation of the whole Romanian banking industry which will ultimately lead to large discrepancies among banks and their clients.

Clients have to have proper information about the benefits and the costs associated to banking services. They want, also, better quality of services and a diversified supply in the banking sector. For any bank competition, reputation, quality should be words with great impact on their position on the market. Borrowers, often, need consultancy on the services they want in order to access the best solution for their problem. The employees of the banking system must assist and guarantee the best consultancy and the most precise information regarding their solutions.

Incomplete information or even wrong ones, large waiting periods at the office and, in some cases, rude behaviors are only few of the problems in the Romanian banking system. Bureaucracy and employees deficit affect in the worst manner possible the relationship bank-client, thus the average period for solving problems has risen.

The banking system is considered to be one of the most fragile mechanisms in an economy, because it is very sensitive at economic shocks. Romanian banking system was affected since 1990 by a number of bankruptcies of some private banks considered at that time to be efficient. But times chanced and banking system proved it self to be one of the areas in which constant development was made, thus influencing in a positive manner the national economy. The banking system reform started in 1991 through a two level system: separating the commercial character of the National Bank of Romania therefore appeared the Commercial Bank of Romania, and opening the market for foreign competition.

Since 1990 the banking system visibly changed and provides the public more stability and better regulation then the other economy sectors. There were some doubts over the manner in which some credits were accessed but in the end led to better crediting standards, lowering general credit risk and emerging specialized funds to guarantee credits, especially for small and medium sized companies and private agricultural sector. The integration of Romania in European Union at 1st of January 2007 had a great impact on the national banking system as it follows: first of all increasing competition among banks, and second of all increasing capital flows in the country, either trough structural European funds, either trough private capital.

The banks that are currently operating on Romanian banking system, regardless of the nature of their capital, must be very careful because the integration in EU means stronger competition which will ultimately lead to better performances, services, products and administration. Is the Romanian banking system ready of such competition? It's been only an year, so there aren't significant changes, but we can say that domestic commercial banks aren't there where they should be, in other words no. The Romanian banking system is confronting increasing levels of client's mobility, raised interest and low standards in services quality. In the end the client of a bank needs comfort in accessing services and some kind of insurance that his demands are and will be respected.

For a bank it also counts the manner in which it monitors risks and the way it communicates with its clients. Romanian banks have a risk adverse behavior as they try to protect themselves from any kind of "bad" borrower. They consume a lot of time and energy in finding every thing that there is to know about the borrower's type. Thus they often forget that among their objectives should be having clients, having profits and having a market share, then accomplishing all that a bank will have awareness on the market, will have devoted customers and can diversify its services. The costs trend to lower in the attempt to increase market share and to have devoted clients. Lowering credit interest and increasing the volume of overall credit doesn't mean that we have bigger competition on the market. Some analysts in the banking industry assume that the public lending will tighten. But, we can say that because competition is in its first stage, the services and product supply of most banks is similar. Thus, credit institutions have credits with the same characteristics like: the refund period (10 years, 20 years, and 30 years depending on the type of the loan), the interest (although it is different the overall cost is the same because of the Annual Actual Interest), the number of documents needed, the same promoting campaigns, and so on.

One of the reasons for which banks maintain high interests is the lack of banking culture among the public. In example, the websites of the banks offer information about the interest of a deposit and the gain at the end, without mentioning the commissions or the taxes. For instance for a term deposit or a savings account there should be a system through which the public can calculate on its own the interest, the commission, the ending period gain, the tax on interest and the way the Annual Actual Interest it's calculated. In the case of credits bank offer information about the necessary documents and a calculator for monthly payments, but most of the times the payment calculated includes only the interest of the credit, leaving for the imagination the commission percentage and the life insurance costs.

Another reason for which banks speculate the lack of banking culture is the rising trend of consumption credit, or for personal needs. People came to the bank for a loan without asking the actual costs, because most didn't have the economic background or knowledge. Banks gave the loan to the uninformed party, but until reaching the end period they couldn't afford paying the loan. Accordingly they went to other banks in order to take a refinance credit, thus paying off the credit at the first bank and becoming a customer of the latter. So we can observe a migrating tendency of the population from one bank to the other.

Now on the financial market in Romania we deal with too much information and banking products, most being deviated from other, but the public still has low banking culture. Most of the times there are incomplete standards and advertising campaigns that misinform the public. Transparency in banking system can be obtained through educating the public, lowering restrictions, understanding associated costs of the banking products and services and most importantly by communicating to the public. To be transparent means you have to be prepared to offer your clients the best advice, better information and more professionalism.

Conclusion

First of all this paper makes several contributions to the literature. First, it put together the early literature on information theories of credit to more recent studies under a single framework. Second of all, the paper emphasized the Romanian commercial banks policies that are characterized through lack of transparency, asymmetric communication, low quality standards and risk adverse behavior. This paper has shown that banks' main specific function is to engage in information production about borrowing firms or public opinion, this without offering themselves some basic information in order to eliminate errors.

A characteristic of Romanian banking industry is that its main objective is to attract more clients and to increase market share. Let's have a minute and think why few banks agree with the notion of transparency. Probably they assume that the client it's not interested in the quality of the services offered, in the sense that the public doesn't need rapidity, a special way in which to be approached or some kind of professionalism. Probably some Romanian banks don't realize that giving comfort to your clients may result in a longer relationship, a more willingly to pay more kind of client or even a better informed one.

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