Interest rates matter to both borrowers and lenders. To lenders, the interest rate dictates how much income they will receive from credit taken out by borrowers. To borrowers, the interest rate represents the cost of credit. The marketplace determines interest rates such that credit is allocated to the worthiest borrowers, and credit is sourced from most willing lenders. In the language of economists, market forces ensure the efficient allocation [sourcing] of credit among numerous lenders and borrowers.

For this simple yet efficient allocation of credit to happen, a crucial assumption is that lenders have access to all relevant information from potential borrowers. In reality, certain limitations keep lenders from extracting all the information they need. For instance, existing boundaries/rules/norms/laws are designed to protect the privacy of those who apply for loans. These limitations prevent lenders from accurately separating the risky borrowers from the more reliable ones. Both risky and non-risky borrowers populate the borrowing side of the market. Borrowers with higher credit risk will try to withhold information that enables lenders to identify them as such. Conversely, borrowers with lower credit risk will provide more information, to allow lenders to separate them from those representing high risks. The situation characterised here is referred to as one of information asymmetry. In Economics, information asymmetry is a major source of inefficiency in the provision of credit.

When creditors are in fact capable of separating high-risk from low-risk borrowers, say, with the guidance of credit rating agencies, they do charge higher interest rates to the former. (This applies to governments as well as to private firms, for some nation-states are less able, willing or likely to pay their debts than others.) Higher interest rates serve as a premium for the additional risks taken by lenders. Conversely, creditors offer lower interest rates, or cheaper loans, to low-risk borrowers. Obviously, however, high-risk borrowers don’t want to pay a higher interest rates than those being paid by low risk borrowers. To avoid the penalties attendant to poor credit ratings, they will try not to provide too much damaging information about themselves.

When lenders cannot calibrate interest rates to reflect the precise degree of risk, they charge an interest rate that is averaged between the lower interest rates for low risk borrowers and the higher interest rates for high-risk borrowers. Price averaging effectively means higher interest rates for low risk borrowers and lower interest rates for the higher risk borrowers. But this response further aggravates the inefficiencies generated by information asymmetries in the credit market.

The heightened inefficiency becomes apparent when low risk borrowers being charged higher interest rates either reduce the volume of credits they will borrow or are completely discouraged from
borrowing. In other words, the type of borrowers that a rational creditor would wish to multiply in the market are the very ones whose demand for credit will actually decrease. On the other hand, high-risk borrowers welcome the averaging of interest rates, which are lower than the rates they’d actually pay if lenders knew their true risk profiles. The risky borrowers will borrow more aggressively, and there will be more of them. Therefore, the type of borrowers that rational lenders wish to avoid will actually increase.

This scenario helps explain the alarming rise in the non-performing loans in the accounts of some major banks in the Philippines. Banks know that there are both high risk and low risk borrowers in the credit markets. Even if the banks closely scrutinise each loan applicant and approach credit investigation objectively, information asymmetry has eventually led to a proliferation of high-risk borrowers compared to low-risk ones. Inevitably, some high-risk borrowers are unable to pay. As a result, as banks close their accounting books and classified some loans as non-performing (six months of non-servicing of existing loans), the proportional share of non-performing loans to total loans of banks become larger.

Information asymmetry does not constitute the only or entire explanation of the increasing credit allocation to high-risk borrowers. There are other reasons why the share of non-performing loans to the total loan portfolios of several banks has risen alarmingly. These include a lack of objective implementation of existing banking regulations, a need for new rules and improved accounting practices, the high cost of financial intermediation in the Philippines or even outright corruption. But our explanation serves as a different perception platform for academics, businessmen, policy formulators and the banks themselves.

Mr. Marvin Castell and Mr. Joel Tanchuco, are assistant professors of the Economics Department, College of Business and Economics, De La Salle University

Keywords: pricing, information, credit

These article are contributed by the CBE Faculty in the column of Business Focus of Manila Bulletin published April 4, 2003.