Researcher examines inconsistent lending practices

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Research published in the *European Economic Review* finds that lenders' profits improve at an increasing rate with more intense screening of prospective borrowers; however, somewhat paradoxically, lenders experiencing a greater return on investment are less prone to closely screen an applicant's project.

When the economy tanked in 2008, lenders tightened borrowing practices, increased credit standards and began to closely scrutinize all funding requests, even from those with solid credentials.

In the wake of the credit crunch, borrowers were subject to increased loan inspection, however lending policies fluctuated. That's according to research titled "Extreme Pricing Policies" published in Issue 8 of the 2012 *European Economic Review*.

According to Pal, the purpose of their research was to examine "why lenders implement variable levels of credit screening," he says.

Pal states that an underlying factor for increased lending inspection can be tied to screening standards. The group found that lenders who experience a greater return on investment were less prone to closely screen an applicant's project. Their research also revealed that a lender's profits improved at an increasing rate with more intense screening, thereby reducing associated risks.

"So, the increasing marginal returns can lead a lender to implement either a very high or a very low level of screening accuracy," Pal says. "However, in deciding screening accuracy, the lender faces a trade-off, as better screening requires additional resources."

Pal also noted that small changes in industry parameters could produce large changes in a lender's screening intensity.

"In other words, the lender 'rationally' overreacts," Bose says. "As a consequence, an initial mild downturn in economic activities motivates lenders to substantially increase their lending standard and limit credits, causing further downturn in economic activities."

More information: econpapers.repec.org/article/e … _3ap_3a1607-1620.htm

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