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# Credit risk management and asymmetric credit information in smaller pacific Island Countries and Territories

**Michael Yemoh [1*], Vicky Yemoh [2]**

[1] Department of Accounting & Economics, Faculty of Business & Entrepreneurship, National University of Samoa, Apia, Samoa

* Corresponding Author: **Michael Yemoh**

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**Abstract**

Economic development, industrialization and the basic life cycle of businesses within every economy require effective financing and responsible credit. With a few exceptions, many of the smaller pacific island countries and territories are classified as low income economies that rely on external help. Some are still working on implementing appropriate regulatory framework, and financial risk management systems. There are however, various lending institutions in these economies that face material credit, operational, market, and liquidity risks in the absence of public or privately owned credit bureaus or registries. This report provides a review of the credit risk management practicies in the smaller island countries and territories amidst the asymmetric credit information challenges.

**Keywords:** asymmetric, bureau, credit, lending, pacific, registry, risk

## Introduction

Most start-up and operating businesses invest into their businesses from their pool of retained earnings, from their owners or from borrowing at a reasonable cost. However, it is not always that prospective borrowers can secure the funding they need, as lenders pre-determine if the borrowers can service the repayments before making the decision to provide credit. In most cases, the quality of income and credit history, provide good indicators of repayment of the outstanding debt. This crucial information may be widely available and accessible in economies that do have credit information systems, bureaus and registries. In some economies, such facilities are not available or in the process of being developed whether they are privately owned or publicly owned. As such, their benefits are not realised and their absence increases the level of risk that lenders face when lending. They have to engage in various risk assessments including qualitative risk assessmennts, quantitative risk assessment, Generic risk assessment, site-specific risk assessment or dynamic risk assessment.

The smaller pacific island economies face a major hurdle of providing lending in an environment that has limited customer credit information. The value provided by the credit information is reflected in the cost of borrowing. Knowing the credit profile of the borrowing makes enables the lenders to easily navigate towards the borrowers with the better repayment profile and away from those with a history of not servicing their credit. Those with better credit profile then end up with a lower cost of borrowing whilst those with a bad credit profile are charged extra or avoided in the lending activities due to the risk they present. Whilst the Bank of Cook Islands banking system is more advanced in the use of digital innovation the CRM at the Development Bank of Samoa is mainly manual(ICR Facility 2022) [55]. The Tonga Development Bank has also made progress in digitizing loan processing which provides linkages to performance appraisals and application of IFRS9.

The level of financial hardship and poverty that may exist in the economies also allows for unsecured lending. The material risks in unsecured lending leads to the cost of borrowing which is normally captured in the interest rate. A United Nations online survey of 286 Samoans taken between 11 June and 5 July 2020 reported that: Sixty-eight percent of the respondents have lost income and almost half of households have at least one unemployed member and 71 percent of people are having trouble repaying debts (United Nations 2020) [7]. Needs, wants, and desires must still be met in these times and as such there is an increase in the amounts and propensity to borrow as a result. Close to half of respondents have suffered a reduction in earnings, 23 percent said their employer has had to close a business, and 15 percent have had their job terminated. Only 19.6 percent of respondents said that those in their household who lost income have been able to find a new source of revenue. COVID-19 has hit the pockets and wallets of Samoans, reduced revenue, increased debt and for some households, and affected food security for some. On one hand, it is possible to assume that the consumption will be compensated by the international remittances into Samoa, however there has not been an equal documented compensatory increase in remittances to suggest that this is the case.

In 1999, the Basel Committee published its consultation paper that encouraged the focus on issues relating to consistency and robustness of financial institutions' internal credit risk management processes. Credit risk, also variously referred to as default risk, performance risk or counterparty risk is the potential that a contracted borrower will fail to meet their agreed obligations. Credit risk exists when there is an exposure to a party that may possibly fail to repay, when there is default probability and the possibility to retrieve what is loaned if a default takes place (Brown and Moles 2014) [4]. The economies that are able to implement the internal credit risk framework, will have Regulators to ensure that banks maintain appropriate capital for counterparty risks whilst the lending institutions need to determine both the level of risk and creditworthiness through its internal rating process. Much of the research done in this areas has been focused mainly in more economically developed economies and has been on the quality of regulations of the lending institutions, financial market development, institutional system stability, lending quality, the functions of the banks, the negative relationship between liquidity, capital, and credit risk (Anh, Xuan and Thanh, 2022) [1], debt composition and domestic credit cycles (Avdjiev, Binder and Sousa, 2021) [2]. Various factors including the limited development of the financial markets, and the economic weight that these economies carry with respect to the rest of the world account for this and thus very little research has been done in the pacific region. This research reviews the credit risk management practices amidst the asymmetrical credit information existing in the smaller pacific economies and encourages the facilitation of credit registries and bureaus in the region.

## The limitation of credit information sharing and associated lending risks

Risks associated to credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation risk are the largest risks lending institutions face are. As such, lenders are always on the lookout for low-risk borrowers. These will generally be clients with good credit records. Where such records are kept and is accessible, it will demonstrate the borrowers diligence in repaying previous debts. On the other hand, high risk borrowers will have a low credit score that is also linked to their history with credit. Such borrowers pose a great deal of risk to the lending institutions. In the World Bank Group's 2020 report on doing business in Samoa, they report that there is zero credit registry coverage of adults, zero credit bureau coverage with zero depth of credit information index available (World Bank Group 2020). Lenders therefore do not have any credit rating or scoring reports of the prospective borrowers to have an insight into their history. This increases the risks that lenders face as there is asymmetric information differences between the information that the lenders do not know and what the borrowers know. Some lenders may then take some extra steps to mitigate the associated credit risk that may include the use of risk-based pricing, requesting for loan covenants, and diversifying their portfolio.

Firms and businesses have access to two primary sources of borrowing which includes loans from private sources and public securities issued in the market. The academic literature offers a number of theories on the interaction between public debt and private markets and empirical evidence on cross-sectional and time-series variation in the quantities of loans and bonds issued (Becker and Ivashina 2014) and the cost differences between borrowing from banks to borrowing from the capital market(Schwerts 2019). The central finding of Schwert M 2019's paper is that lending institutions charge a substantial premium relative to the price of credit risk implied. Much is now known of the fact that lending institutions have to charge a premium on their lending though the exact rate chargeable reflects various factors. The lending institutions in economies that provide credit information of borrowers are applying an interest rate that reflects the credit profile to the borrowers, this suggests that in economies like the small pacific island countries and territories. Similarly, the credit profiles of the borrowers are not as readily accessible in the absence of economies that do not yet have credit information systems as in other economies and as such the premium chargeable to borrowers reflects this.

In the more advanced economies, private or governmental institutions provide credit information of adults. Firstly, in a country where such information is provided, the very first step will be fixing the borrower's credit score. In such economies, the credit rating has the most significant impact on the borrowing costs. In that those with good credit rating are deemed less risky of defaulting or turning into bad debts for the lenders and therefore their premium charged to those are much lower than those with poor or low credit score. Countries like Samoa that does not have such credit rating system or information for adult debtors, have to refer to the information that the lending institutions have and hold on their clients as the basis for making such decision which is limited in its scope and quality. In order for debtors to improve their credit score, they would have to pay off any bad debts, and paying off debts as soon as possible. Whether they are payday loans, credit cards, or car loans. From a credit risk standpoint, the key difference between loans and bonds is that loans are senior in bankruptcy. Default is the only state in which creditors are not paid in full, so expected payoffs in default are a crucial determinant of the cost of credit (Schwert M 2019).

In many of the smaller pacific island economies, there are no private or public credit information brokers to bridge the asymmetric information gap that exists between the lenders and their prospective borrowers. The absence of a credit registry, credit information of adults, and credit bureau in the country means Samoan adults do not have credit information for which the lending institution can base their decision to lend on (World Bank Group 2020). Lending institutions, therefore, have to rely on what information they have of the prospective borrower to make an informed decision on their creditworthiness or an insight into their chances of default. What this leads to is that prospective borrower who do not have any history with the lending institution will be considered a lot risky to the lending institutions and as such, they will most likely have to pay a higher premium for the chance to borrow. Those with little history with the lending institution will still be required to pay a premium for the lack of credit information but not as much as those without. This suggests that within the current lending environment, some firms are having to borrow at a premium given that they are not able to use their history of credit history to convince the prospecting lender that they are creditworthy. This can be eliminated by the institution of a credit registry which all of the lending institutions can refer to in the event of reviewing a prospective debtors application. One way that lenders protect themselves is by writing into the loan terms that the borrower can extend this term for an additional six months to a year for a fee to the borrower. Lenders may also offer to waive the exit fee when a borrower chooses to refinance the loan with the existing lender.

## Conclusion

Covid-19 has caused a major need for consumption with reduced income and in most cases the international remittances have not sufficiently adjusted to compensate for the needs, wants, desires, the cultural, family and village obligations that most village dwellers have to encounter on a daily basis. Most people living within the smaller pacific island countries and territories have therefore resorted to borrowing to augment the gap left. Firms and businesses have traditionally relied on debt to finance their start up or operations from various sources. Borrowing especially from lending institutions comes at a cost regardless of the purpose or intention. The credit risk to the borrowing normally includes the components of exposure, the default probability and the recovery rate. This depends on the credit history of the prospective borrower which also affects the amount of premium that the lenders require before lending. In many of the smaller pacific island countries and territories, there is no adult credit information available which means the total cost of borrowing will effectively be higher than usual. Lending institutions will have to charge a premium to do what technically the credit bureau would have done. Inversely, the need to borrow means that those who are borrowing will be driven deeper into debts, and the need for a credit registry or bureau seems to be the logical requirement for the economies. The decision to lend to a prospective borrower normally includes the evaluation of their repayment history and the existing level of debt which will be compared to their income and debt service coverage. Credit bureau reforms are known to have a significant and robust effect on firm financing through the increase access to finance, it lowers the cost of borrowing, encourages a longer borrowing duration, and the share of working capital financed by banks increases(World Bank 2014). The effects of credit bureau reforms are more pronounced the greater the coverage of the credit bureau and the scope and accessibility of the credit information-sharing scheme.

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