DANGERS OF MAKING LOANS

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Adverse selection and moral hazard

Assume you have extra cash of 1000 EUR that you do not want to spend on fun. One alternative is to make a loan to your friends who can make a better use of your money than you. There are two friends of yours that are candidates to receive a loan from you. Fero wants to buy a car as he has a job delivering pizza from the best pizzeria in town which requires deliveries by own vehicle. The second candidate is Dano who has no job and does not care about getting one. He intends to spend your money on betting on football games. Whom would you like to lend your hard-earned money? Fero is a better choice. Dano is too risky. It is very likely that Dano will not pay you back. Dano is with very high probability going to lose your 1000 EUR and his reputation as well. However, if you do not know Dano and Fero very well the selection of your client would be difficult. It will be based on a chance like rolling a die. Moreover, more likely Dano will bother you a lot to obtain your money. For him it is an excellent opportunity to either get rich in gambling or loose just his reputation, which is probably low anyway. The chances are therefore high that high risk borrowers like Dano obtain the loan because they are very eager to get it. **One should be very careful whom to lend money.**

Even if you decide to make a loan to a person with better project, you are still not safe. Fero might decide after receiving your 1000 EUR that delivering pizza is time-consuming and there are easier ways to make money than working. Fero might be lured into betting on football games and you cannot do anything about it because you have already lent him your money. Therefore, it is very likely that you will lose 1000 EUR and your friend.

To succeed in your lending business, you might hire a lawyer who can help you in drafting a binding contract with the borrower on the use of your money. However, legal services are expensive and in many instances the contracts are not enforceable because you cannot get your money back from a person who has nothing. No money, no property and no job.

Should you therefore not lend money to your friends? Probably not if you care about keeping friends and having the loan repaid. What should you do? To make loans there are specialized institutions which are called banks that can deal with the dangers of lending money better than an individual person.

What do banks do?

Banks (financial intermediaries in general) borrow money from individuals (households, firms, government) that have extra cash and lend them to individuals (again households, firms or government) that need money for investment. They charge higher interest rate to their borrowers than they pay to their lenders.

Do banks suffer from the same problems as individual money lenders (these problems are called moral hazard and adverse selection)? Yes, they do, but they can cope with it better than individual person. How come?

First of all, banks are much bigger and have significantly more money than you or me. Therefore, they can hire lawyers and still make money on the loan. Lawyers can help them to write a good contract and to obtain money back from individuals that do not repay their loans. You could also hire an excellent lawyer but it is not profitable for the amount of money that you wish to lend. The lawyer would probably cost more than 1000 EUR you have to lend.

Secondly, banks have know-how and long-term experience with lending money. They have specialized experts who can better evaluate investment projects than you or me.

Thirdly, banks make many loans, not just one or two. For that reason, if they lose on one loan, they can still make profit and do not go bankrupt because other loans pay back. Individuals have no such opportunity. You can normally lend money to a few persons only and if one of those persons does not pay you back you are in a big financial trouble. To avoid unnecessary risk in your life, you should probably invest your money through banks.

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What are the new methods of money lending?

In recent years, the Internet has allowed new forms of lending and borrowing money.

Crowdfunding

Crowdfunding is a method of raising capital through the collective efforts of friends, family, customers and individual investors. This is most often done online via social media and crowdfunding platforms. For example, if a band wants to release a new CD, they can get the money through crowdfunding. If you contribute to it, you can get an advantage in the form of the CD itself for free, you can have a share in the profit from the release of the CD, or you can contribute in the form of a gift. Then it is not a loan.

Peer-to-peer lending

Peer-to-peer (P2P) lending allows individuals to obtain loans directly from other individuals, which eliminates the financial institution (bank) as an intermediary. Websites that facilitate P2P lending have significantly increased its acceptance as an alternative method of financing. P2P lending websites connect borrowers directly with investors. Each website sets interest rates and conditions and allows the transaction. Most sites have a wide range of interest rates based on the applicant's creditworthiness.

DEFINITIONS:

Adverse selection

It is a situation when the riskiest borrowers vehemently apply for a loan.

Moral Hazard

It is a situation when borrowers use their borrowed money for different and often riskier purpose than what was agreed.

Economy of scale

It is a situation when costs of a loan go down with the number of loans or value of loans.

Risk diversification

Banks diversify risk if they lend money to different customers which face different types of risks.