The Effects of Information Asymmetry in the Performance of the Banking Industry: A Case Study of Banks in Mombasa County.

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ABSTRACT

Over the last few years, the Banking sector in Kenya has continued to grow in assets, deposits, and products offering. The growth has been mainly underpinned by; an industry wide branch network expansion strategy both in Kenya and in the East African community region and automation of a large number of services and a move towards emphasis on the complex customer needs rather than traditional óff-the-shelf' banking products.

As the banking sector continues to embrace innovations, the intensity and variety of risks that the players are exposed also continue to increase in tandem. To ensure that the growth in the banking sector does not jeopardise its stability, risk management is crucial.

The paper analyses and evaluates the effects of information asymmetry in the banking sector on the cost of borrowing and lenders determination of creditworthiness of borrowers. It also recommends protective mechanisms to be employed to reduce the effect of information asymmetry in the banking sector. The paper analyses the legal system on enforcement of financial contracts to identify the loops and recommend additions to the legal system that will reduce the effects of information asymmetry.

A conceptual framework model was used to show the relationships existing between the independent variables and the dependent variables used in the study. Primary data was extracted from the questionnaires and secondary data was collected from annual reports, Central Bank of Kenya publications, newspapers, journals and other publications. Data was collected, organized and transformed with the goal of highlighting useful information from which conclusions were drawn and recommendations were made.

Keywords

- Information asymmetry
- Borrower's creditworthiness
- Cost of borrowing
- Legal system
- Protective mechanisms
- Character of the borrower

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1.0. Introduction

As the banking sector continues to embrace innovations, the intensity and variety of risks that the players are exposed also continue to increase in tandem. To ensure that the growth in the banking sector does not jeopardise its stability, risk management is crucial. The current survey carried out by the central bank show that credit risk is still essentially as significant as it was in the earlier survey which may be attributed by banks large portfolio made up of loans and advances to customers.

One of the primary functions of banks is to gather information about borrowers and screen creditworthy borrowers from non-credit worthy ones. Much of this information is obtained in the process of lending and in the subsequent monitoring role that is often seen as defining characteristic of bank financing. Information asymmetries in credit markets constitute the backbone of the financial ineffectiveness and financial crisis. From various surveys carried out by the Central Bank of Kenya, credit risk still continues to exist as banks continue to expand.

This paper seeks to analyse and evaluate the effects of information asymmetry by responding to the following questions;

I. How does borrower's creditworthiness affect the banking industry?
II. How does the cost of borrowing affect the banking industry?
III. How does the legal system on enforcement of financial contracts affect the banking industry?
IV. How do the protective mechanisms employed affect the banking industry?

Understanding the impact of information asymmetry in the banking sector underscores the need for banking sector regulators to fully adopt Risk based supervision and incorporate the international risk management best practices envisioned in the 25 Basel Core Principles for Effective Banking Supervision.

1.1. Literature Review

The primary reason why people give their money to financial intermediaries instead of lending or investing the money directly is because of the risk that is present from the information asymmetry between the provider of funds and the receiver of those funds. A seller knows more about the sale item than the buyer. So the buyer would be taking a risk buying the item. The buyer asks, why is the seller selling? Likewise, a borrower knows more about his financial condition and his future prospects than the lender.

Problems relating to the imperfect information were discussed by the eighteenth and nineteenth-century economists. According to Stiglitz "…information is imperfect, obtaining information is costly, there are information asymmetries, and the extent of information asymmetries is affected by actions of firms and individuals".

Information abuse of agents working within lending organisations on a systemic scale will upset the whole banking system, creating inefficiencies on an economy – wide scale. If persistent, and unmanaged, it could possibly lead to banks failing abruptly, in a short period of time that would create further disturbance to the system.

1.2. Research Methodology

To establish the impact of information asymmetry in the banking sector, the study adopts a descriptive research design. Descriptive research was used to obtain information concerning the current status of the phenomena to describe "what exists" with respect to variables or conditions in a situation.

1.3. Results and Discussion

1.3.1. Effects of borrower's creditworthiness in the banking industry

The respondents indicated that Bank statements, Credit Information Sharing and borrowers past credit history are among the mechanisms that banks use to evaluate borrowers creditworthiness.

High loan default in new markets due to lack of information. Therefore, it is clear that if the banks are able to determine the borrower's creditworthiness, then this will lead to deserving borrowers getting the loan, hence reduce the high rate of loan defaults. But if it doesn't, then there will be a high rate of loan defaults. High rate of loan defaults will adversely affect the performance of the banking sector.

1.3.2. Effects of cost of borrowing in the banking industry

The reason why information asymmetry affects the cost of borrowing is that it increases the risk element leading the lender to charge an average price on loans. The cost of borrowing is inversely proportional to the performance of banks.

1.3.3. Effects of the legal system on enforcement of financial contracts in the banking industry

It was evident in the study that an efficient and water tight legal system is more efficient in enforcement of financial contracts.

1.3.4. Effects of protective mechanisms employed in the banking industry

From the responses, it is clear that some of the protective mechanisms used in the banking industry are: use of collateral security, use of insurance and use of CIS data to vet loan applicants. These mechanisms increase the probability of giving loans to qualified clients who won't default in payment. Therefore, this increases the performance of banks. Credit Information Sharing was rated as the most appropriate mechanisms to be employed to cap information asymmetry. Credit Information Sharing may be the most appropriate but does not completely eliminate information asymmetry factor in new markets.

1.4. Character of the borrower

The actions of the borrower that affect the performance of banks highlighted by the respondents were; use of flawed bank statements, Lack of funds due to market failures e.g. inflation, dynamic credit history and qualified people without bank accounts. Bank statements may not necessarily depict the financial status of the borrower.

1.5. Conclusions

More information has to be extracted from the clients before loans are issued out to them. This will reduce the chances of loan defaults; hence increase the performance of banks.

Conflicts of banking and monetary policies should be managed at the extent to which market forces are left to determine economic growth. An efficient legal system should be put in place to reduce problems caused by information asymmetry in the banking sector.

Due to significantly reduced transaction costs, policymakers and academics agree that economies with smaller interest rate margins have a better developed banking industry and faster economic growth rates than economies while economies with a higher interest rate margin struggle with banking sector reforms and economic growth.

1.6. Recommendations

Credible exogenous information proxies are hard to find and there are relatively few natural experiments that result in significant shifts in the information environments. Asymmetric information can lead to distorted investment strategies within the banking industry. It is evidence that credit evaluations can have significant effect on banks. This suggests that financial sector scrutiny may lead to more productive and successful investment.

The ethical aspect of financial contracts must be addressed. A borrower is an individual who does take the opportunity to fool the lender by hiding risks or profits. The economic and finance theory revolves around individuals whose sole objectives is to maximize profit, and thus have no morals. The undeniable existence of asymmetric information behaviour in the real world leads us sadly to admit that such representation is not just a theoretical simplification.

The government of Kenya should ensure that there is a water tight and efficient legal system on enforcement of financial contracts to avoid poor performance in the banking industry.

1.7. Suggestions for further research

This research mainly focused on few banks and hence the findings cannot be replicated in the entire banking industry. Further research should be done on other financial institutions like Microfinance Institutions and private forex bureaus.

This study is by no means complete. A more exhaustive study could look to also capture the impact of information asymmetry on economic growth and other sectors.

A comparative study of different developing economies will also be beneficial as the result would improve our understanding of how different developing economies respond to effects of information asymmetry in their banking sector.

Finally, it is possible to further improve on the statistical properties of this study by making use of time series data over a longer time period.

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