"Do Loan Officers’ Incentives Lead to Lax Lending Standards?"

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Abstract

We study a controlled corporate experiment in which loan officers’ compensation structure was altered from fixed salary to volume-based pay. The incentives increased aggressiveness of origination: higher origination rates (+31%), loan sizes (+15%), and default rate (+28%). Under the incentive system, loan officers have greater influence on loan approval decisions; however, their recommendations do not convey more information. Poor loan performance is caused by lax approval and aggressive loan terms, and more likely for end-of-month originations, male loan officers, and tenured loan officers. About 10% of loans under the incentive system are likely to have negative net present value.