



Local versus foreign banks: A home market advantage in loan syndications



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ARTICLE INFO

Article history:

Received 1 May 2014

Received in revised form 15 August 2014

Accepted 1 November 2014

Available online 7 November 2014

JEL classification:

G21

G32

Keywords:

Loan syndication

Home market advantage

Foreign banks

Asymmetric information

ABSTRACT

This paper investigates the contract terms of local versus foreign bank lead loan syndications to test two opposing theories: the home market advantage gained by closer geographical proximity and soft information from existing banking relationships, versus the hold-up problem where banks exploit their information advantage at the borrower's expense. The home market advantage was supported with domestic banks informationally superior to their foreign counterparts. Loans arranged by the former carry lower interest rates, have longer maturities, and are less likely to require collateral. These results are robust after controlling for the non-randomness of the lender–borrower matching process.

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1. Introduction

This paper investigates local versus foreign bank lead loan syndications to test the impact of two opposing theories: the home market advantage gained by closer geographical proximity and soft information from existing banking relationships, versus the 'hold-up' problem where banks use their soft information advantage and offer their clients more expensive, less attractive facilities.

Asymmetric information between the borrower and lender is the source of adverse selection and moral hazard in modern banking (Diamond, 1984). The classical theories suggest that reduced asymmetric information will benefit borrowers. For example, lower asymmetric information can reduce lenders' exposure to credit risk, as well as reduce monitoring costs, which in turn leads to more favourable loan terms. Bharath et al. (2011) show that borrowers with an existing bank relationship pay 10 to 17 basis points less on their loans, and have fewer collateral requirements. They attribute these effects to reduced asymmetric information due to the soft information obtained from the borrower's existing relationship. Berger and Udell (1995) also report that previous banking relationships strongly reduce interest

charges as well as collateral requirements. Petersen and Rajan (1994) and Cole (1998) both find existing relationships increase the availability of credit to borrowers.¹

Geographical distance may also reduce asymmetric information. Sufi (2007) and Knyazeva and Knyazeva (2012) argue that distance can be used as proxy for the bank's ability to acquire soft information, and so banks geographically closer to the borrower tend to offer lower loan spreads and less restrictive non-price terms. The closer the distance, the more likely banks are able to gather private information about the borrower. Distance can also lower the costs of monitoring and verifying soft information (Berger, Miller, Petersen, Rajan & Stein, 2005; Bushman & Wittenberg-Moerman, 2012; Dass & Massa, 2011; Petersen & Rajan, 2002; Sufi, 2007). Overall, these studies suggest that existing lending relationships and closer geographical

¹ In line with the prior literature, we focus on lead banks' information advantage as opposed to non-lead banks. This is because the screening and monitoring responsibilities are typically delegated to lead banks which have the expertise to do so and are incentivized through fees earned on those services. For example, Dahiya et al. (2003) and Bharath et al. (2011) examined the role of relationship banking in loan syndications, where their relationship variable was constructed with a focus on lead banks. Bharath et al. (2011) further highlighted the role of lead banks by arguing that non-lead banks view a previous relationship between the lead bank and borrower as a credible signal of lead bank commitment and therefore reduced moral hazard. Ahn and Choi (2009) reported that bank monitoring increases with lead bank reputation, but is insignificantly related to number of lenders, which may indicate a less active role of non-lead banks.

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distance between the borrower and lender translate into more favourable loan terms.

The opposing view is that such lenders with an informational advantage may exploit their power by charging a higher loan price, often known as the hold-up problem. With relationship lending, the lender may exercise rent extraction over the borrower's private information and so charge an above-cost interest rate (Greenbaum et al., 1989; Rajan, 1992; Sharpe, 1990). Schenone (2010) reports that for pre-IPO firms, interest rates decrease when the lending relationship commences, but then increase as the relationship deepens. This is because it allows lenders to 'lock in' their client borrowers. Borrowers located closer to their lending bank may similarly be 'informationally captured' via higher interest rates. This is particularly true for those smaller and more opaque borrowers with informational asymmetries (Agarwal & Hauswald, 2010; Degryse & Ongena, 2005; Degryse & Van Cayseele, 2000; Hauswald & Marquez, 2006).

Given the above discussion, the literature remains undecided as to whether existing banking relations and closer proximity (as proxies for soft information gathering) allow lenders to reward their clients better rates and conditions, or instead use their position to charge more. We contribute to this debate by addressing the following research question: Does the information advantage of domestic banks over foreign banks affect their terms in syndicated loans?

We pose this question in the context of Australian loan syndications.² There are a number of key differences in the characteristics of the Australian market compared to its US counterpart. Unlike prior US studies, the Australian market structure offers many advantages in respect to its big four local banks³ dominating local syndications, a strong presence of foreign bank lead loan syndications, the domination of the big four on local banking, the lack of an active non-bank presence in loan syndications, and a poor secondary market for bank loans. First, the four major banks' dominance in local lead syndications is important in that these lead institutions are very similar in terms of size, complexity and risk exposure among themselves and their foreign bank competitors.⁴ This means our results are less likely to be driven by institutional specific characteristics. Second, the strong presence of foreign bank lead syndications also provides the opportunity in Australia to test them against local lead facilities. Third, the big four's 80% control of the local banking system means that almost all potential loan syndication customers in Australia will have had some level of relationship with a big four bank. Fourth, the lack of non-bank (hedge funds and investment banks) participation in Australian loan syndications also removes the need to control for their differences in business exposures as well as isolates any impact that these participants might otherwise cause. Finally, a poor secondary market for loan syndicate participations means that the lead and participating banks must effectively hold these loans to maturity. This ensures that any prior relationships are continued and strengthened and that more care would be taken before making such a commitment.

Given the prior literature, we argue that a home market advantage may exist for the domestic banks due to ongoing banking relationships and closer geographical proximity. While proximity may apply to domestic banks in other countries, the concentrated banking sector and lack of a secondary market for loan sales in Australia further bolster the idea that Australian banks, through their prior relationship banking, are better information producers than foreign banks in this market. Given Australia is a country rich in natural resources, the domestic banks may have also earned superior knowledge in lending to resources firms. We conjecture that the domestic banks possess an information

advantage over foreign banks due to their dominating involvement with local business borrowers, as well as their closer geographical proximity, and so will offer more favourable syndicated loan terms.

We examine these matters using endogeneity-corrected regressions on a sample of 305 Australian syndicated loan facilities originated between 1992 and 2010. Our research design addresses the non-randomness of the borrower–lender matching process. A certain type of borrowers (often smaller and more opaque) may have a higher tendency to source funds from the domestic banks rather than foreign lenders, due to the former's local knowledge and existing relationships. This non-random choice between a domestic and a foreign lead bank is controlled via the treatment effect and instrumental variable models.

Our results support the view that reduced information asymmetries represent a home market advantage and so allow domestic banks to charge their borrowers lower loan spreads. As for the non-price terms, loans led by domestic banks are associated with longer maturities and are less likely to be secured than those led by foreign banks. All in all, soft information is found to add value even in the current state of modern banking developments where informational barriers have been remarkably lessened.

This study makes several important contributions to the literature. First, we show that the origin of lead banks is an important factor in determining syndicated loan contract terms. While others such as Ross (2010) and McCahery and Schwiendbacher (2010) consider lead bank identity, this study is the first to explore the relevance of the lead bank's origin. Second, we contribute to the debate about the effect of soft information on borrower welfare, and find support for the classical banking theory. Our results indicate that soft information helps reduce asymmetric information thereby benefiting the borrower.⁵ Third, this study adds to the foreign banking literature which has emphasised their competitive disadvantages when entering into a new foreign market, such as unfamiliarity with the host country's business culture, social differences, regulatory environments, and information network.⁶ Though not testing these challenges directly, our results do suggest that foreign banks fare worse than domestic banks in lending to domestic borrowers. Fourth, we contribute to a much under-researched Australian syndicated loan market. While this market is responsible for about a quarter of Australian non-financial borrowers' debt raisings, to our best knowledge, this is the first in-depth study of the domestic syndicated loan market. The findings of this paper are not only applicable to the Australian market but can be generalised to many other non-US markets with high market concentration and strong reliance on relationship banking. The Canadian market, for example, is dominated by six major domestic banks with a similar market structure. Other markets with a similar degree of concentration and relationship banking focus include (but are not limited to) the United Kingdom, Ireland, Switzerland, New Zealand, South Africa, most of the Scandinavian countries, and some Asian countries such as Singapore, Thailand, and Sri Lanka (Beck et al., 2007).⁷

The remainder of the paper is organised as follows. Section 2 provides a background on the Australian syndicated loan market. A model is developed in Section 3 to control for the non-random choice of lead arrangers (i.e., domestic versus foreign). Section 4 presents a description of the data sources and variables. The descriptive statistics and multivariate regression estimates are presented and discussed in Section 5, while Section 6 concludes the study.

² Our question could be answered using bilateral loans, but unfortunately, we do not have access to such data. Dealscan does provide data for US bilateral loans but the same search criteria for Australia produce only syndicated loans.

³ Australia & New Zealand Banking Group Ltd., Commonwealth Bank of Australia, National Australia Bank Ltd., and Westpac Banking Corporation.

⁴ Domestic banks outside the top four (i.e., Australian regional banks) are negligible in this market, as are any non-banks.

⁵ Support has been found for the classical banking theory by Petersen and Rajan (1994), Berger and Udell (1995), Cole (1998), Petersen and Rajan (2002), Berger, Miller, et al. (2005), Berger, Espinosa-Vega, et al. (2005), Sufi (2007), Bharath et al. (2011), Dass and Massa (2011), and Bushman and Wittenberg-Moerman (2012).

⁶ See, for instance, Zaheer (1995), Zaheer and Mosakowski (1997), Miller and Parkhe (2002), and Portes and Rey (2005).

⁷ Beck et al. (2007) measured banking concentration as the fraction of assets held by the three largest banks in each country. All countries listed here have a concentration ratio between 0.54 and 0.86.

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