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Religion and bank loan terms ☆

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ABSTRACT

We examine whether religion affects the terms of bank loans. We hypothesize that lenders value the traits of religious adherents, such as risk aversion, ethical behavior and honesty, and thus offer favorable loan terms to religious borrowers. Consistent with this hypothesis, we find that corporate borrowers located in counties with a high level of religiosity are charged lower interest rates, have larger loan amounts and fewer loan covenants. These results suggest that the corporate culture of borrowers influences the availability and cost of bank loans.

1. Introduction

Departing from the traditional view that firms' decisions are made after careful economic calculations, a growing literature in social finance shows that corporate behavior is also shaped by the social norms surrounding the firms, such as prevailing religious beliefs around firms' headquarters. For example, firms headquartered in more religious counties tend to take less risk and maintain higher profitability (Hilary and Hui, 2009), have more transparent financial reporting and less accruals manipulations (Dyreng et al., 2012; McGuire et al., 2012), and are less likely to engage in unethical behavior, such as backdating stock options and granting excessive compensation to managers (Grullon et al., 2010). Arguing that managers and employees are likely to be bounded by local religious norms, these studies suggest that firms located in more religious areas tend to exhibit more conservative and ethical behavior.

Our study aims to extend this stream of research by investigating whether the market understands and values corporate behavior that is driven by religions. In particular, we study if one important group of stakeholders, namely bank lenders, appreciates and rewards the conservative and ethical behavior of firms located in more religious areas. This study is important for two reasons. First, rational economic agents would expect good corporate behavior to be rewarded by the market, which provides incentives for them to behave ethically.[2] Finding evidence that the markets reward good corporate behavior related to religious social norms would provide economic support to prior studies in social finance and religions. Second, bank loans have become the predominant source of external financing for U.S. companies. In 2007, for example, large U.S. corporations raised a record $2,282 billion new capital from the syndicated loan market, compared with $168 billion from the equity market.[3] Levine and Zervos (1998) find that bank loans are strongly and positively related to economic growth across countries. It is thus important to understand how banks make lending decisions and whether non-financial information, such as religious social norms, affects the terms of loan contracts.

We argue that banks are more likely to give better prices and lower loan spreads to corporate borrowers located in more religious areas for two reasons. First, firms in more religious areas exhibit observable characteristics that are associated with lower

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[2] Although fulfilling religious social norms by itself would bring positive utility for religious adherents, economic rewards would provide consistent incentives for individuals to behave ethically. In other words, if economic incentives conflict with social norms, it is unclear whether one can still uphold moral standards to refrain from unethical behavior.

[3] The loan data is from Dealscan and is aggregated by Ivashina and Scharfstein (2010). The data on equity issuance is from Federal Reserve System.

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risk. As documented in Hilary and Hui (2009), more religious firms tend to be more risk averse, have lower leverage, take less risky projects and report higher profitability. These characteristics suggest that more religious firms are less likely to default, thus warranting a lower loan spread.[4] Furthermore, more religious firms have more transparent financial reporting and therefore present less information risk for banks (Dyreng et al., 2012; McGuire et al., 2012). Finally, to the extent that religious social norms constraint agency problems (Grullon et al., 2010), including the conflicts between shareholders and creditors, banks may face a lower risk of being expropriated and disadvantaged by insiders and shareholders when dealing with more religious firms.

Second, religiosity may serve as a signal of unobservable characteristics that banks can use as soft information to adjust their pricing of loans. For example, religious social norms usually require adherents to be honest (Weaver and Agle, 2002). Dealing with honest borrowers will allow banks to reduce the cost associated with validating information and monitoring firms' performance. As another example, religiosity fosters trust (Guiso et al., 2003), and trust is critical in lending. In the words of J. P. Morgan, "A man I do not trust could not get money from me on all the bonds in Christendom." Duarte et al. (2012) find that people who just appear more trustworthy are more likely to obtain loans. Therefore, if religiosity signals that a borrower is trustable, banks may give more favorable considerations to a religious borrower.

To test the effect of religion on bank loan pricing, we collect data for a sample of 8355 loans taken out by 1500 U.S. companies located in 302 counties (45 states). Following Hilary and Hui (2009), we measure the religiosity of a firm by the ratio of religious adherents to the population of the county where the firm is headquartered. This ratio captures the strength of religious social norms in communities surrounding the firm's headquarters and provides a plausible measure of employees' religiosity for two reasons. First, employees working at the headquarters are likely to come from local communities and thus firms located in religious regions are likely to have a larger proportion of religious employees. Second, according to social norm theory, individuals tend to conform to the dominant values and the behavior of people around them (Cialdini and Trost, 1998). As a result, people in religious areas, including those who may not subscribe to a religious belief, are likely to behave in a way consistent with the norms of the religious adherents with whom they interact inside or outside work.

The results show a strong negative association between loan spread and the level of religiosity in the county where a firm is headquartered. The result holds after we control for a number of firm characteristics and loan characteristics, as well as fixed effects for industry, year, loan purpose, and loan type. More importantly, the negative association between loan spread and religiosity remains significant after we control for observable risk measures, such as leverage, profitability and Altman's *Z*-score, suggesting that religiosity may serve as a signal of unobservable factors, such as honesty and trustworthiness. The effect of religion on loan spread is also economically significant. For example, if we divide the sample of loans into two groups based on the median level of religiosity, moving from low religiosity counties to high religiosity counties would lead to a reduction of about 8.9 basis points in loan spread. The relation between religiosity and bank loan spread survives after we address potential endogeneity issues. The relation is stronger for firms with only one geographic location, suggesting that religiosity of headquarters has a weaker impact on bank loan cost for geographically dispersed firms. The relation is also stronger for firms with weak corporate governance, measured by *G*-score constructed by Gompers et al. (2003), implying that religious social norms play a more important role for firms with inherent governance problems.

We also find evidence that religiosity is related to non-pricing loan terms. More specifically, we show that bank loans to corporate borrowers located in more religious areas have fewer covenant constraints, particularly those covenants that are based on financial information. More religious corporate borrowers get larger loans from banks, after controlling for firm and loan characteristics. Collectively, our evidence suggests that religiosity of corporate borrowers is an important determinant of both pricing and non-pricing terms of bank loans.

In a recent study, Giannetti and Yafeh (2012) examine whether culture differences between foreign lenders and local borrowers affect loan terms in the international syndicate loan market. Measuring culture differences at country level, they show that more culturally distant lead banks offer borrowers smaller loans at higher interest rates, suggesting that differences in national culture impact the process and outcomes of loan negotiations. To the extent that companies and banks located in the same county share the same religion and culture, our results are consistent with their findings that culture similarity facilitates loan negotiation. However, our study differs from Giannetti and Yafeh (2012) in two important ways. First, we examine religion, a relatively well-defined aspect of culture, while the measure of culture in Giannetti and Yafeh (2012) captures how much people value traditions and self-expression. Second, we focus on the U.S. market where financial development and competition among banks are relatively homogenous across counties. This helps avoid compounding effects of institutional factors that could be correlated with culture difference in cross-country studies.

Our study contributes to the literature in a number of ways. First, we show that qualitative characteristics, such as corporate culture and religion, could have a significant impact on the contracting outcomes of bank loans. This important finding complements prior literature that focuses on default risk and information asymmetry (see, for example, Sufi, 2007; Roberts and Sufi, 2009; Bharath et al., 2011). Together with Giannetti and Yafeh (2012), we provide large sample evidence on the effect of culture on the outcomes of bank loan negotiation.

Second, this study extends a growing literature on the role of religion in the economic development and financial markets. One stream of research examines the relation between religion and macroeconomic activities. Weber (1905) and Barro and McCleary (2003) relate religion to economic growth. Stulz and Williamson (2003) show that a country's principal religion predicts the cross-country variations in creditor rights. Guiso et al. (2003) find that, across countries, religious beliefs are associated with economic attitudes that are conducive to higher per capita income and growth. Guiso et al. (2009) document that sharing the same religious belief facilitates foreign direct investments between two countries. Our contribution to this stream of literature is to show that, at firm level, religion is associated with lower cost of external financing, which allows firms the financial flexibility to take up more growth opportunities. This evidence provides a potential explanation to how religion facilitates economic growth in a country.

Another stream of research shows that firms located in more religious counties in the U.S. have lower risk exposures (Hilary and Hui, 2009), less optimistically biased financial reporting (Dyreng et al., 2012; McGuire et al., 2012), and fewer unethical misconducts (Grullon et al., 2010). Our results indicate that these religion-induced behaviors may have favorable consequences in loan contracting with banks and other lenders. Therefore, we add to the growing literature on social finance that studies how social norms, moral attitudes, religions and ideologies affect financial behaviors (Hirshleifer, 2014).

[4] Baele et al. (2014) examines the default rate of Islamic loans using data from Pakistan over the period from 2006 to 2008. They find that Islamic loans are less likely to default than the conventional loans, particularly during Ramadan.