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journal homepage: [www.elsevier.com/locate/jacceco](http://www.elsevier.com/locate/jacceco)Social networks in the global banking sector<sup>☆</sup>Joel F. Houston<sup>a,\*</sup>, Jongsub Lee<sup>b</sup>, Felix Suntheim<sup>c</sup><sup>a</sup>John B. Hall Chair Professor of Finance at the University of Florida, USA<sup>b</sup>UF Term Assistant Professor of Finance at the University of Florida, USA<sup>c</sup>Financial Conduct Authority, UK

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## ABSTRACT

We show that banks with shared social connections partner more often in the global syndicated loan market and that central banks in the network play dominant roles in various interbank transactions, indicating that social connections facilitate business connections. However, more centralized banks in the network also contribute significantly to the global systemic risk. Moreover, we find the soft information generated by social networks is particularly valuable when potential partners operate under different accounting and regulatory standards. Finally, we show that the recent banking crisis significantly limited the positive soft information effects of social networks in the global banking system.

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## 1. Introduction

In recent years, a number of interesting papers have highlighted the myriad ways in which personal connections influence financial transactions. For example, there is evidence that portfolio managers are more likely to invest in firms in which

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they share social connections (Cohen et al., 2008), and that connections between board members and CEOs influence the level and structure of executive compensation (Engelberg et al., 2013; Hwang and Kim, 2009). Another part of this literature has shown that connections between board members of borrowers and lenders affect the pricing and structure of bank loan agreements (Engelberg et al., 2012; Ferreira and Matos, 2012). At the same time, there is somewhat conflicting evidence regarding how the connections between merging firms influence the market's response to the merger's announcement (Cai and Sevilir, 2011; Fracassi and Tate, 2012).

The personal connections among firm managers and directors have also been shown to influence corporate decision-making. For example, Duchin and Sosyura (2013) show that division managers who have stronger social ties to the firm's CEO are more inclined to receive internal capital from headquarters. In another study, Fracassi (2012) demonstrates that firms with stronger personal ties between their board members tend to have more similar investment policies. Looking more directly at the possible value of social networks, Larcker et al. (2013) show that firms that play a more "central" role in the director social networks generate higher risk-adjusted stock returns and a higher growth in ROA. Similar evidence is found for venture capital firms that hold central positions in their syndication networks (Hochberg et al., 2007).

In a variety of contexts, we might expect that these connections would generate valuable soft information. Common backgrounds and experiences may make it easier for managers and directors to share information that is otherwise hard to communicate. In a broader sense, such enhanced flow of soft information could be construed to encompass things like cooperation and trust, which make it easier for participants to better respond to unforeseen contingencies.

In an attempt to better understand the importance and relative value of these network influences, we examine the social connections among the largest 99 global banks in the Boardex database ranked by their total assets in 2003 over the 2000–2010 time period.<sup>1</sup> For many reasons, the global banking industry over this time period provides an interesting laboratory to study these issues. The existing banking literature has emphasized the importance of information asymmetry among lenders and the vital role that soft information plays within their relationships (Beatty et al., 2016; Champagne and Kryzanowski, 2007; Ivashina, 2009; Morrison and Wilhelm, 2007, among others). Consequently, we might expect that social connections among banks' board members are important, particularly for large cross-border banking transactions, where these global banks face significant socio-economic, political, accounting and regulatory barriers (Bae et al., 2008; Giannetti and Laeven, 2012; Houston et al., 2012; Karolyi and Taboada, 2015; Yu and Wahid, 2014). Enhanced information sharing between connected banks thus may make it easier for them to engage in a wide variety of valuable inter-bank transactions. However, these connections may also cause banks to make similar bets that ultimately increase the systemic risk of the global banking system. These concerns are particularly relevant in the aftermath of the recent financial crisis.

With these concerns in mind, we address three specific issues. First, we provide what we think is the first detailed evidence regarding the degree of social connections within the global banking industry. More specifically, we look at two broad types of measures. One set of measures calculates, for each possible pair of global banks in our sample, the number of connections among the respective board members in a given year.<sup>2</sup> The other set of measures estimates the extent to which the bank is "central" to the overall social network of banking firms. Our results strongly indicate that network connections in banking are meaningful and have become increasingly important over time. We find that average pairwise connectedness between two global banks in our sample has increased by 47% over the 2000–2010 period, and that on average, government credit institutions, investment banks, and bank holding companies hold more central positions in the network relative to commercial banks and other savings institutions.

Second, we explore whether these extensive social connections within the global banking sector lead to more active business partnerships and/or similar investments among connected banks. Here we find that connected banks are more likely to partner together in loan syndicates, and that more central banks in the social network are more likely to lead or co-lead large syndicates. These results suggest that the central banks in the network promote and send signals of common investment ideas to the banks that are adjacent to them in the network, and stack up the common assets through the connected party transactions in loan syndicates. In this regard, we argue that these central banks play a crucial role in the financial system to the extent they serve as "intermediaries among intermediaries." We further confirm this notion of network central banks by documenting that they are net lenders in the interbank market. However, these net positive interbank asset positions held by network central banks could also raise concerns about a greater risk concentration among the small set of banks that are relatively well-connected to other banks within the network system.

In this regard, we ask our third question - whether the structure of social connections has had an influence on the systemic risk of the banking industry. We first find that socially-connected banks' pairs show significantly positive correlations in their equity returns, both their total and idiosyncratic components. We also find a strong link between the measures of centrality and the  $\Delta\text{CoVaR}$  measure of systemic risk (Adrian and Brunnermeier, 2011). Put together with our earlier findings, these results suggest that connected banks make similar bets and that systemic risk is concentrated among banks that play

<sup>1</sup> We interchangeably use banks and financial institutions throughout the text.

<sup>2</sup> Social connections are based on common educational and professional ties. For each pair of banks, we consider social connections between both their managers (employee board members) and their non-manager board members (non-employee board members). These non-manager board members not only perform a supervisory role but they also provide useful information or advice to banks' managers (Coles et al., 2012; Larcker et al., 2013, see also Masulis et al., 2012, for the advisory capability of foreign non-manager board members to develop a network of foreign contacts). The advisory function of these non-manager board members is important to promote informative managerial decision making, and thus, their connections would serve as an important information bridge among banks.

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