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The effects of reputation and relationships on lead banks' certification roles

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ABSTRACT

We investigate the certification roles of lead bank retention in US syndicated loans with respect to interest rates, then explore how lead banks' reputation and previous relationships with the borrower alter such certification effects. Our findings support the certification hypothesis. Loan spreads are found to decrease with a higher retention ratio, after controlling for the endogeneity of loan price and retention. The magnitude of certification effect is reduced when the lead bank is a more reputable lender and when there are prior bank–borrower relationships. Lead bank reputation and prior lending relationships can therefore substitute for the need to certify.

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1. Introduction

This study emanates from the syndicated lending literature where a lead bank can credibly certify loan quality by increasing its own financial stake. To curb the information asymmetry problems within a lending syndicate, the lead bank may signal favourable ex ante loan quality by retaining a larger loan proportion. Prior studies support this certification effect of lead bank retention as the interest rates required by syndicate participants are found to decrease with the amount of loan retained (Angbazo et al., 1998; Focarelli et al., 2008; Ivashina, 2009). This negative relationship between loan price and retention share is, however, not unequivocal, as risk diversification theories suggest that lead banks

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often require higher loan spreads as compensation for bearing more risk associated with higher retention. In other words, there are factors simultaneously influencing the loan's required spreads and lead banks' retention share. Furthermore, there is little evidence of how potential certification effects can be altered by two of the most important variables in syndicated lending, namely, lead bank reputation and prior bank–borrower relationships.

We first enrich the current literature by exploring potential certification effects among US syndicated loans while control for the classic endogeneity between loan price and lead banks' retention percentage. To date, Ivashina (2009) is the only work using instrumental variables to address such endogeneity problems. Our paper utilises a different set of instruments to investigate how a lead bank's reputation and prior relationships with the borrower may alter its certification effects. In particular, we hypothesise that more reputable lead banks may have less need to certify via higher loan retention. In other words, syndicate members may already lower the interest rates on loans originated by more reputable lead banks, and so a higher retention rate from these lead banks will have less effect on loan spreads. Similarly, the presence of past lending to a borrower may help signal that lead banks are positive about this current loan, thereby negating information conflicts and reducing the strength of potential certification effects. Our study examines how certification effects change in magnitude when lead banks are more reputable institutions or when they maintain previous lending relationships with the borrower.

While traditional sole-lender loan contracts only involve information asymmetries between the borrower and the lender (i.e. bilateral financing), loan syndications are further complicated by potential conflicts of interest among the syndicate lenders themselves. An information asymmetry problem may arise between the lead bank and other syndicate participants should the pre-loan screening give the lead bank an informational advantage. Furthermore, the lead bank's incentives in conducting ex post duties on other lenders' behalf are not easily observable. Such information conflict can be seen as either an adverse selection or a moral hazard problem (Simons, 1993; Dennis and Mullineaux, 2000; Jones et al., 2005). The adverse selection problem occurs because the ex ante quality of a loan being syndicated by a lead arranger is not known to other lenders. The literature has documented that the lead bank may choose to retain a larger loan proportion to certify better ex ante loan quality; this can be a credible signal as the lead bank exposes its own wealth to risk (Ivashina, 2009). Meanwhile, moral hazard argues that both the lead bank and syndicate members are equally informed about the ex ante loan quality; agency costs, nevertheless, arise because the lead bank's incentives for further due diligence and monitoring are not easily observable to other lenders. According to Sufi (2007), moral hazard is of a more serious concern in syndicated lending given that a positive relationship is observed between borrower opacity and lead bank retention. Both adverse selection and moral hazard theories imply that higher lead bank retention can mitigate asymmetric information problems, thereby reducing loan interest rates.

In contrast to the asymmetric information argument, risk diversification motives suggest that lead banks with higher loan retention seek compensation for bearing more default risk. Our study revisits this equivocal relationship between lead bank retention and loan spreads, while taking into account the roles of lead banks' reputation and their prior relationship with the borrowing firm.

The contributions of our paper are twofold. First, we provide further evidence on the certification role of lead banks in syndicated loans while controlling for the endogeneity of loan price and retention rate. Second, we consider lead banks' certification roles in conjunction with most important drivers of the credit syndication market, namely, lender reputation and prior lending relationships. Our findings support the certification hypothesis where higher lead bank retention results in lower loan spreads. We also find evidence that lead bank reputation substitutes for the need to certify by retaining a larger loan proportion. In particular, the negative loan spread–retention relationship is found to exist only among loans led by less reputable banks. Our findings also show that past loan relationships with the borrower help signal lead banks' incentives hence mitigate information asymmetries between the lead bank and other lenders, resulting in weaker certification effects. Certification effects via lead bank retention are particularly strong among small borrowers without past loan relationships as these are most prone to information problems.

The remainder of the paper is structured as follows. Section 2 summarises the major determinants of loan interest rates as established in past literature, while Section 3 further discusses the importance

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