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Credit ratings and information asymmetry on the Chinese syndicated loan market☆

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ABSTRACT

We study whether local credit ratings alleviate information asymmetry inherent in the fast growing Chinese market by examining the syndicate structure of loans issued by Chinese borrowers in 2003–2011. Despite the common criticism regarding the quality of Chinese credit ratings, our results suggest that they serve an important role in reducing information asymmetry in the market between corporate insiders and outside borrowers.

1. Introduction

Problems of informational asymmetry are fundamental in assessing the viability of various financing arrangements (Holmström, 1979; Holmström & Tirole, 1997). In China, the issues relating to information asymmetry are likely to be accentuated due to the country's institutional weaknesses. Despite the rapid growth of the local financial markets, the Chinese financial system continues to suffer from underdeveloped legal investor protection, lack of transparency, and poorly developed corporate governance mechanisms.[1] Market-based metrics, such as exceptionally high stock price synchronicity, have been attributed to poor investor protection that discourages informed trading (Gul, Kim, & Kiu, 2010, Morck, Yeung, & Yu, 2000). In this paper, we examine informational asymmetry in China by observing the structure of loan syndicates in the local market. We utilize a comprehensive sample of Chinese syndicated loan deals to examine the role of credit ratings, local stock listings, and cross border listings in reducing information asymmetry.

Syndicated loans are financial arrangements where multiple lenders jointly offer funds to a single borrowing firm on identical terms negotiated by a lead arranger. The lead arranger is later also responsible for monitoring the borrower. Given the nature of the arrangement, it is reasonable to assume that the required due diligence effort and complexity of the borrower's operations affect

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[1] The studies by Allen et al. (2005, 2009) provide a thorough analysis of the legal framework, institutions, finance and growth in China a highlighting the main problems that continue to trouble the financial system.

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the optimal outcome of the transaction. The syndicated loan market is a good laboratory for investigating the informational content of various borrower specific characteristics as it allows us to observe the decisions made by professional market participants, namely lenders in the syndicated loan market. Also, our main variable of interest, namely the syndicate structure, is less affected by market noise and imperfections than measures such as stock returns.[2] Previous studies that examine syndicated loan deals on more developed markets indicate that the effects of informational asymmetry are evident when inspecting the structure of the deals (Bosch & Steffen, 2011; Sufi, 2007).

Our work is motivated by the theoretical reasoning by Holmström and Tirole (1997). Their model relies on the assumption that firms with incomplete public information require monitoring by an "informed" lender in order to satisfy the participation constraint of "uninformed" lenders. A moral hazard problem emerges as the "informed" lenders' due diligence effort and monitoring is unobservable. Consequently, the "informed" lenders are required to participate in borrowing, in order to align interests with the "uninformed" lenders and thus assuring that they exert effort. Lead arrangers of loans to firms that require more monitoring or due diligence are required to retain a larger share of the loan to attract participant lenders. China offers an ideal setting for testing such hypotheses. The underdeveloped legal framework, paired with a lacking system of information assimilation, should widen the gap between informed and uninformed lenders, while the fast growth and the vast resources of the economy offer strong incentives for financial institutions to participate in the financing of Chinese firms.

We follow the reasoning by Sufi (2007) and Bosch and Steffen (2011) who argue that a larger number of participating banks indicates a lower level of information asymmetry in the loan deal as more banks are willing to participate (and less investment by the informed lead underwriter is required) in deals with less information asymmetry. Our primary measure of syndicate structure is the number of lenders in the syndicate. We find that syndicated loans to firms with credit ratings have a larger number of participants, indicating that ratings alleviate problems pertaining to information asymmetry. Our model specifications control for various borrower specific characteristics, such as public and cross-border listings, that previously have been linked to information asymmetry. However, having a credit rating emerges as the single strongest alleviating factor. We also examine foreign participation in loan syndicates separately. Our examination reveals that foreign banks' participation in Chinese loan syndicates follows a slightly different pattern compared to that of their domestic counterparts. However, the impact of our main variable is strikingly consistent. Firms with credit ratings, and those with non-state ownership, tend to attract a larger number of both foreign and domestic participants.

When we consider the relative share of foreign lending in Chinese syndicates, we find that it is not related to the credit rating or state ownership of the borrower, implying that the foreigners are not more sensitive to these borrower characteristics. This finding is in contrast with Bosch and Steffen (2011), who report that ratings are particularly important for foreign banks active in the U.K. syndicated loan market. Overall, our results are consistent with prior studies from Western markets (e.g. Lee & Mullineaux, 2004; Sufi, 2007), as they indicate that syndicate size varies in line with expectations with variables capturing borrower risk and familiarity, such as loan maturity or existence of previous loan issues.[3]

Our finding that Chinese rating agencies provide important information to the market is interesting, as the local rating agencies have been widely accused of disregarding issuers' default risk by putting too much effort on winning business by assigning excessively high ratings to most issuers (Asiamoney, 2006; Lee, 2006). A recent study by Poon, Chan, and Firth (2013) emphasizes quality differences among Chinese credit rating agencies. They indicate an important role for one of the Chinese rating agencies, the Shanghai Far East Credit Rating co., in reducing information asymmetry in Chinese SEOs. In contrast, we find that even ratings from agencies that have been deemed less reliable affect loan syndicate structures in a significant manner.

We contribute to the literature on information asymmetry and its effects in the Chinese market. Gul et al. (2010) find that stock price synchronicity is lower for Chinese firms issuing foreign-investor shares to the more developed Hong Kong market than for firms issuing foreign-investor shares to the less developed mainland exchanges. They argue that the results show that more firm-specific information is priced in the stocks that are cross-listed. Their result, thus, suggests that differences exist in the availability of firm-specific information across firms listed on the exchanges — or perhaps, in the enforcement of disclosure policies across exchanges. We, therefore, re-examine the effect of their variables using similar firm-specific controls on the syndicated loan market.

The paper is structured as follows. Section 2 describes the relevant institutional context. Section 3 discusses the research background. Section 4 describes the data and the empirical methodology. Section 5 presents the results. The robustness of the results is discussed in Section 6. Section 7 concludes.

2. Chinese banks as suppliers of corporate financing

The Chinese banking sector clearly dominates the local stock market as a source of corporate financing. As noted by Allen, Qian, and Qian (2005, 2009), the poor legal protection of minority and outside owners causes external financial markets to remain weak. Privately-held Chinese companies have grown significantly faster than listed companies, and their contribution to the growth of the economy exceeds that of publicly-traded firms, despite the limited access to bank financing that privately-held firms face. In a survey study, Cull and Xu (2005) document that only 28% of the private firms in their sample have access to bank loans. They also

[2] The informativeness of Chinese stock prices is discussed in Morck et al. (2000) and Gul et al. (2010) who examine the co-movement of stocks highlighting the problems that hinder firm-specific information from being capitalized into prices in an accurate and efficient manner. The effects of liquidity and ownership restrictions are also relevant when discussing Chinese stock prices (Wang & Jiang, 2004).

[3] To our knowledge, Pessarossi et al. (2012) and Pessarossi and Weill (2012) are the only previous papers to study the Chinese syndicated loans market. Both papers consider the impact of ownership structure on loan syndicates.