Int. Fin. Markets, Inst. and Money 22 (2012) 913–935

Contents lists available at SciVerse ScienceDirect

Journal of International Financial Markets, Institutions & Money

journal homepage: www.elsevier.com/locate/intfin

Asymmetric information among lending syndicate members and the value of repeat lending☆

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ARTICLE INFO

Article history:
Received 26 July 2011
Accepted 18 April 2012
Available online 9 May 2012

JEL classification:
F30
G21

Keywords:
Syndicated loans
Repeat lending
Asymmetric information among lenders
Arranger reputation
Opaque borrowers

ABSTRACT

We examine the effect of information asymmetries among syndicate members on loan prices. To this end we focus on the previous number of borrowing/lending relationships between individual borrowers and lenders and the duration of these interactions. Using this new, direct and explicit measure on a sample of 5867 syndicated loan transactions between 1993 and 2006, we find that when participant banks have information inferiority in the syndicate, they require higher loan spreads to compensate for this asymmetry. This is amplified when the borrowers are more opaque. We thus show how junior participant banks with repeat relationships with the same borrower graduate from uniformed to informed lenders (the spread goes down as asymmetry diminishes) and how they rely both on the arranger's reputation and their own repeat experience with the borrower.

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☆ The authors would like to thank to Werner De Bondt, Stefano Gatti, Benjamin Klaus, Juliusz Jabłecki, Alberto Pozzolo, as well as the seminar participants at the Bank for International Settlements, for valuable comments and suggestions.

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http://dx.doi.org/10.1016/j.intfin.2012.04.007

1. Introduction

The structure of syndicated lending[1] results in information asymmetries within the lending syndicate between banks of varying degrees of seniority.[2] Firstly, there are information asymmetries between the group of lenders and the borrower. Secondly, there are asymmetries among the arranger and participant banks. Arrangers are likely to have more proprietary information about borrowers than participants, either because they have experience in lending to the borrower/sector, or because they are the borrower's relationship bank. At the pricing phase, the participant banks depend on the arranger to evaluate the riskiness of the borrower. Arrangers, therefore, may be tempted to retain smaller shares of riskier loans, syndicating a larger proportion to less informed participants and collecting syndication fees upfront. It may be in the interest of arrangers to conceal the full information on borrowers from participants if the arranger has a relationship with the borrower and wants to pass on better syndication terms to the borrower. Arrangers may also engage in this type of behaviour to avoid loan concentration and related credit risks.

When loans are granted, participants rely on arrangers to monitor the performance of the borrower. Delegation of monitoring to the arranger leads to a second type of opportunistic behaviour as the arranger bears all the costs attached to the monitoring activity, but shares only part of the benefits from engaging in a relationship. This may also incentivise arrangers to 'push' lower quality credits to uniformed participants so as to help cover the greater monitoring expenses. Alternatively, it may encourage arrangers to hold a higher proportion of the syndication on their own books to mitigate participant credit risk concerns. However, it may be difficult for participants to gauge the riskiness of the portion of loan held by the arranger and this too can cause asymmetric information problems.

The interaction between arrangers and participants directly relates to the pricing of the loan. In lending syndicates the price of the loan is determined by negotiations between the arranger and the participant banks. It is plausible to expect that information asymmetries between arrangers and participants regarding the borrower will be reflected in loan spreads. There are two effects. Firstly, participant banks may require an extra risk premium at the initial pricing stage if they have less information than the arranger on the credit quality of the prospective borrower. Secondly, participant banks may demand an extra premium to hedge against any possibility of ex-post arranger opportunistic behaviour (of the sort described above) in monitoring activities. Previous studies have sought to use indirect proxy measures to capture the effects of such information asymmetries in the syndicated loan market. In this paper we propose a more direct measure. This offers new insights into how junior and senior banks rely on their own and each other's information sets in lending syndicates.

An established literature investigates the implications of information asymmetries among syndicate members on the structure of loan syndicates (Simons, 1993; Jones et al., 2005; Panyagometh and Roberts, 2002; Sufi, 2007). Specifically, these studies examine whether the arrangers behave opportunistically by selling more of the lower quality loans to participants and find that arranger opportunistic behaviour is non-existent. Arrangers are found to hold larger proportions[3] of low quality loans granted to borrowers that require more monitoring.

Other studies examine the effects of such information asymmetries on loan pricing (Ivashina, 2009; Focarelli et al., 2008; Bharath et al., 2011). The aforementioned papers utilise the *share of the loan held by the arranger* and *the size of the syndicate* as major proxies for measuring information asymmetries among lenders. They find that when arrangers retain higher proportions of the loans to signal their

[1] Syndicated lending, where two or more banks agree jointly to make a loan to a single borrower, has evolved into one of the world's largest financial markets. Prior to the recent financial and economic crisis, some \$3.4 trillion in new facilities was raised during 2007, amounting to one third of all funds raised internationally, including bond and equity issuance. In a typical syndicated loan, arranger (or senior) banks are situated at the core of the process. They help to put together the deal at a given set of terms and sell parts of the loan to participant (or junior) second tier bank while retaining the loan partially. In this format participant banks do not normally negotiate directly with the borrowing firm, but rather have an "arm's-length" relationship acting through the arranger (Simons, 1993; Sufi, 2007).

[2] See for example: Pichler and Wilhelm (2001), Lee and Mullineaux (2004), Jones et al. (2005), Sufi (2007), Bharath et al. (2011), Ivashina (2009) and Focarelli et al. (2008).

[3] A larger share of the loan retained by the arranger increases the latter's "skin in the game" and is often viewed as a mechanism to alleviate arranger opportunistic behaviour or moral hazard.

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