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Impact of ethical behavior on syndicated loan rates

Moshe Kim [a], Jordi Surroca [b], Josep A. Tribó [b,*]

[a] Department of Economics, The University of Haifa, Israel
[b] Universidad Carlos III de Madrid, Department of Business Administration, Spain

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ABSTRACT

This paper shows that borrowers' ethical behavior leads lending banks to loosen financing conditions when setting loan rates. We advance the banking literature by stressing that the previous financing loosening is enhanced when there is similarity of lenders *and* borrowers along their ethical domain given that such similarity brings about familiarity and trust in non-opportunistic behavior between them, thereby contributing to lower information frictions. Unique data composed of 12,545 syndicated loan facilities from 19 countries for the period 2003–2007 indicate a 24.8% reduction in the mean spread associated with an increase of one standard deviation in the degree of borrowers' ethical behavior from its mean value. Such reduction is enhanced to 37.6% when lenders also behave in an ethical way. Results withstand a battery of robustness tests including the use of alternative databases that capture the effect of the 2008 financial crisis, financing alternatives such as equity financing as well as nonparametric estimations.

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1. Introduction

Many companies worldwide are integrating social, ethical and environmental principles in their business practices. According to the latest McKinsey survey on sustainability, 73% of the 3000 executives of companies all over the world included in the survey responded that the incorporation of these principles into the CEO's agenda is a priority. In another survey, 65% of CFOs and 77% of investment professionals who have formed an opinion about ethics agreed that ethics programs do create value for their shareholders. This perceived importance of ethics brings about the question of whether firms' engagement in ethical conduct is priced by shareholders, and more specifically by bank debtholders. The answer to this question is important for understanding how ethics influence the severity of information asymmetries between borrowers and lenders in the debt market and, thus, the cost of bank debt financing.

Despite the large number of research efforts attempting to elucidate the determinants of loan rates, evidence still remains fragmented and sometimes contradictory. Even after taking into account the differences in borrowers, lenders, industries, and macroeconomic conditions, loan rates still often exhibit substantial dispersion among firms. This feature suggests that the quantitative (hard) information that it is usually used by lenders as proxies for evaluating the viability of firms and their projects does not always alleviate asymmetric information problems between borrowers and lenders (Cerqueiro et al., 2011). For this reason, it is becoming increasingly common among financial institutions to assess a firm's qualitative (soft) attributes in order to fix credit conditions. Although managerial quality is frequently seen as one of the most important soft attributes for these banks (Grunert et al., 2005), in recent years many financial institutions voluntarily screen borrowers' social, ethical and environmental practices to fix lending conditions (Renneboog et al., 2008; Scholtens, 2006). In this line, research on the effects of these ethical practices on financing costs has lately been gaining momentum given the progress in the recognition of the utility of non-financial attributes for credit risk assessment and the growing attention that social, ethical and environmental practices are receiving from business audiences (Galema et al., 2008; Jo and Harjoto, 2011). To date, however, work in this area is far from conclusive, thereby needing additional research to understand how these practices relate to external financing (Jiao, 2010; Renneboog et al., 2008).

This paper seeks to advance our understanding of the relationship between social and ethical practices and the cost of bank financing in two ways. First, unlike previous research that has adopted overreaching measures of firms' social responsibilities, we focus on a particular subset of socially-driven initiatives: the adoption of business ethics practices. Second, we also include in our analyses the ethical behavior of the lenders to examine

* Corresponding author. Address: Department of Business Administration, Universidad Carlos III, Calle Madrid, 126, Getafe, Madrid 28903, Spain. Tel.: +34 91 624 9321; fax: +34 91 624 9607.
E-mail address: joatribo@emp.uc3m.es (J.A. Tribó).

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whether the ethical similarity of both lenders *and* borrowers influences loan rates. Business ethics involve decision-making processes, codes of conduct, and efforts to impregnate a firm's policies and major decisions with a broader set of values that foster honesty and integrity rather than opportunism (Treviño et al., 2006; Waddock, 2004; Weaver et al., 1999). Although some business ethics theorists have suggested that ethics programs may improve a firm's financial performance (e.g., Gatewood and Carroll, 1991; Jones, 1995; Quinn and Jones, 1995), existing empirical evidence far from supports that view. For example, Hillman and Keim (2001) documented that pursuing ethical goals that fall outside of the direct relationships with primary stakeholders reduces shareholder value. Thus, behaving ethically is costly, as the firm self-limits the possibility of benefiting from non-ethical activities (Noe and Rebello, 1994).

The previous discussion raises the question of why some firms adopt ethics programs. We posit that business ethics may be an important element in contracting bank loans. An ethical agent (the borrower in our case) is one that does not lie, cheat, or steal (Gibson et al., 2013). On the contrary, s/he is an agent that behaves honestly (Rode, 2010). Through their commitment to behave honestly and thus avoiding opportunism, ethical agents are signaling their trustworthiness (Bews and Rossouw, 2002; Fulmer and Gelfand, 2012; Jones, 1995; Kramer and Tyler, 1996). Thus, the outcome of fostering ethical behavior is an increase in trust from business partners (the lender in our case), who will not need to monitor borrowers so intensively in order to prevent their opportunistic behavior (De Bruin and Moore, 2005; Detert et al., 2007; Treviño et al., 2006). As a result, trust attenuates the agency problems derived from the existence of information asymmetries, thereby reducing the perceived credit riskiness of borrowers, and with this, lenders' monitoring necessities. The result is a reduction in the cost of bank debt financing (Boot and Thakor, 1994). Hence, we hypothesize that borrowers' ethical behavior can be a signal of their trustworthiness, which in turn will influence the lenders' perception of the borrowers' default risk, thereby reducing loan rates.

The effectiveness of business ethics as a signal also depends on the ability of the receiver to interpret it. Signaling models recognize the possibility that the signal sent by the sender may not truthfully reveal her/his characteristics. Signaling theory suggests that this problem can be eliminated when the sender and receiver of the signal are ideologically proximate to each other (Crawford and Sobel, 1982), for example, when they share the same cultural values (Giannetti and Yafeh, 2012). Under these circumstances, a receiver possesses enough information to trust the signal sent by a sender. Hence, when the ideological distance between sender and receiver is short, a receiver is more able to receive more precise signals about the sender's quality. We therefore argue that the similarity in convictions regarding ethical behaviors between borrowers and lenders facilitates the interpretation of signals, thereby contributing to generate trust and, thus, to the amelioration of frictions inherent among contracting parties in debt financing. The result is a reduction in loan rates.

The relation between borrowers' and lenders' ethical stance and the cost of bank debt financing is investigated in this paper using data from syndicated loans around the world. The syndicated loan market plays a pivotal role in firms' external financing. We match the data, obtained from the DealScan database with data on business ethics obtained from the Sustainalytics Platform database. These data are compiled by Sustainalytics Responsible Investment Services—one of the world's largest companies specializing in the analysis of social issues. The final data set covers 12,545 loan facilities corresponding to 513 firms in 19 different countries for the period 2003–2007. All tests performed consistently indicate that loan spreads decrease with borrowers' ethics and particularly so when lenders are also ethical organizations. Specifically, our results indicate that there is a reduction of 19.5 basis points in spreads (24.8% reduction from the mean loan spread of 78.6 basis points) when there is an increase of one standard deviation in borrowers' business ethics score from the mean value of the distribution. Moreover, we find that the aforementioned reduction deepens when both lenders and borrowers belong to a group of agents with high values of the business ethics score distribution. Specifically, the aforementioned reduction in spreads is further enhanced to 29.6 basis points in the event that the lender is an ethical institution as well (37.6% reduction in average spread). Thus, we suggest that proximity in ethical values between lenders and borrowers provides better bank debt financing conditions.

This paper is related to several strands of the literature. In recent decades, numerous studies have investigated the relationship between financial performance and corporate social responsibility (CSR), which is an overall measure that includes, among other dimensions, the firm's ethical behavior, and (see Margolis and Walsh, 2003; Orlitzky et al., 2003). Despite the large amount of attention CSR has received, the study of the effect of CSR on the cost of raising capital has only been addressed in recent years. These studies focus on overall measures of CSR (El Ghoul et al., 2011; Goss and Roberts, 2011; Nandy and Lodh, 2012; Oikonomou et al., 2012), or in particular dimensions of CSR such as environmental management (Schneider, 2011; Sharfman and Fernando, 2008) or corporate philanthropy (Ye and Zhang, 2011). As far as we are aware, ours is the first study that examines the impact of ethical behavior on the cost of raising capital considering two instruments: bank debt and equity. By empirically examining the importance of business ethics in banks' lending practices, our study is therefore adding to the incipient finance ethics literature (Boatright, 2008, 2010). Furthermore, our international sample allows us to overcome the exclusive focus on a single country (US or China) of previous studies. Most importantly, one limitation in all these studies is that they assume that corporate social initiatives, including ethical behavior, contribute to reducing the borrowers' perceived risk of default to the lender without considering lenders' ethical stance. This means that in order to examine the effects of ethical behavior on loan rates more closely, we should take into account lenders' perception of ethical initiatives. One key contribution of the present study is, therefore, the inclusion in the analysis of the ethical behavior of *both* partners during financial contracting. The inclusion of both sides to the financial contract allows examining the complementary effect on loan spreads of the ethical similarity between borrowers and lenders. In this way, our paper completes the existing literature on the economic effects of social capital or trust.[1]

This literature suggests that the mutual trust that results from the belief in the honesty and desirability of contracting partners, the existence of a shared language and values, and an effective flow of information among contracting agents, lead to positive economic outcomes. The effect of mutual trust between transacting agents on the efficiency of economic decisions has been studied in different contexts (for a review, see Guiso et al., 2006). Adding to previous studies, our database comprises firms of different countries and combines micro and macro data for each borrower–lender pair. Additionally, we employ standardized codifiable data reflecting actual behavior. These features allow us to address different sets of questions and perform a battery of robustness tests including the control for cultural distance, potential endogeneity, and sample selection biases as well as

[1] We adopt here the vision of Fukuyama (1995), who equated trust with social capital. As alternative approaches, Putnam (1993) sees trust as a source of social capital, and Coleman (1988), as a form of social capital.

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