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The flight home effect: Evidence from the syndicated loan market during financial crises ☆

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ABSTRACT

This paper shows that the collapse of the global market for syndicated loans during financial crises can in part be explained by a flight home effect whereby lenders rebalance their loan portfolios in favor of domestic borrowers. The home bias of lenders' loan origination increases by approximately 20% if the bank's home country experiences a banking crisis. This flight home effect is distinct from flight to quality because borrowers of different quality are equally affected. The results indicate that the home bias in capital allocation tends to increase when adverse economic shocks reduce the wealth of international investors.

1. Introduction

During financial crises, international markets often collapse. For instance, during the Japanese banking crisis of the 1990s, Japanese banks and firms retracted from international financial and goods markets (Peek and Rosengren, 1997, 2000; Klein et al., 2002; Amiti and Weinstein, 2009). The financial crisis that started in the summer of 2007 in the United States was no different. It was accompanied by a collapse of global trade (Levchenko et al., 2010), a reduction in gross capital flows (Broner et al., 2010), a reversal of capital flows from advanced economies to emerging markets (Tong and Wei, 2011; Milesi-Ferretti and Tille, 2011), and a decline in international bank lending (Cetorelli and Goldberg, 2011).

Existing research has shown that banks transmit negative shocks to their capital both domestically (Kashyap and Stein, 2000) and internationally (Peek and Rosengren, 2000; Cetorelli and Goldberg, 2011, forthcoming; Popov and Udell, 2010; Schnabl, forthcoming) and some contraction in international bank lending following the financial crisis was therefore to be expected. In this context, the reduction in international credit during financial crises can be viewed as a reflection of the reduction in the overall supply of credit owing to capital constraints. Importantly, the international transmission of shocks may occur simply because banks

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choose not to alter their portfolio mix of loans to domestic and foreign borrowers and borrow from (lend less to) foreign subsidiaries to counterbalance the effect of capital shortages in their domestic market. The transmission of shocks and resulting decrease in international lending would then be a consequence of integration in international credit markets and the existence of internal capital markets within globally active banks.

The dramatic collapse of international lending markets during 2008, however, raises the question whether lenders retract disproportionally from international markets to the advantage of domestic markets at times of crises, when uncertainty and risks increase and capital constraints become binding for many lenders. In other words, following negative shocks, banks may alter their loan mix in a way that reduces credit market integration.

In this paper, we study whether lenders, when hit by shocks that negatively affect bank wealth in their home market, have a tendency to rebalance their portfolio away from international markets to their domestic market. We explore this *flight home* effect in the context of the syndicated loan market, a highly internationalized financial market, in which it is common for large banks to offer loans to a variety of borrowers in a broad set of countries. After carefully controlling for the effect of contemporaneous demand shocks in borrower (''host'') countries, we explore whether lenders not only transmit shocks to host markets, as highlighted in previous literature, but also whether they further amplify these effects by reducing loans to foreign borrowers (''foreign loans'') more than loans to borrowers in the bank's home country (''domestic loans''). To establish whether this is the case, we not only compare to what extent a bank's foreign loans are affected by negative shocks in the bank's home country relative to loans extended by domestic banks in the host country, as in most of the existing literature on the international transmission of shocks to bank lending, but also analyze how the relative importance of domestic and foreign loans of a given bank varies following negative shocks.

Our results are consistent with the existence of a *flight home* effect. The proportion of loans granted to domestic borrowers increases by approximately 20% if the country of origin of the bank experiences a banking crisis, or more generally, if the stock prices of banks in the home country show a large decline. Lenders with less stable funding sources, being more vulnerable to negative liquidity shocks (Demirgüç-Kunt and Huizinga, 2010; Ivashina and Scharfstein, 2010a), exhibit a stronger flight home effect. Overall, the results indicate that the home bias in the international allocation of syndicated loans increases in the presence of adverse economic shocks affecting the net wealth of international lenders. Put differently, the extent of integration of the syndicated loan market is positively related to the financial conditions of the participating banks.

The flight home effect coexists with but is distinct from the *flight to quality* effect highlighted in previous literature. Bernanke et al. (1996) and Lang and Nakamura (1995) argue that during recessions the share of credit flowing to borrowers with more severe asymmetric information and agency problems decreases. The flight home effect does not appear to be driven by international banks' desire to rebalance their portfolios towards higher quality borrowers when faced with negative shocks. Banks rebalance their portfolio away from foreign borrowers, irrespective of whether or not these borrowers are affected by a banking crisis in their home country. Furthermore, when their home country experiences a banking crisis, lenders grant fewer loans to foreign borrowers in advanced economies and emerging markets alike. Similarly, the flight home of international lenders does not appear to be limited to borrowers with lower credit ratings or to countries with weak creditor protection, or to depend on the institutional environment in the home country of the lender.

We provide empirical evidence suggesting that the degree of proximity to the domestic market affects the perceived risk and expected returns of banks experiencing negative shocks for the following reasons. First, the cost of negotiating and monitoring syndicated loans may be higher for foreign loans. Therefore, when reducing exposure in response to negative shocks, banks may revert to more profitable domestic markets. Second, banks that extend more domestic loans, especially to government and government-owned firms, may be more likely bailed out in case of distress. Thus, banks may increase the proportion of domestic loans they extend in an attempt to increase the bailout probability. Finally, in response to negative shocks, banks face increased uncertainty regarding their ability to meet their capital requirements and, as a result, their effective risk aversion increases. If banks are also less able to evaluate foreign borrowers and view them as riskier, they may as a consequence of negative shocks choose to extend fewer foreign loans, as models of home bias based on ambiguity aversion would imply (Epstein, 2001).

Our work complements and expands along several dimensions existing studies of the syndicated loan market during the 2007–08 crisis. Ivashina and Scharfstein (2010a, b) and Santos (2011) explore the effect of the 2008 crisis on the syndicated loan market in the U.S. to show that this market experienced a sharp decline in loan supply and an increase in loan spreads.[1] In contrast to these other papers, we study not only the US syndicated loan market, but also foreign syndicated loan markets. Moreover, unlike these other papers, we incorporate both global and domestic shocks to bank capital into our multi-country analysis.

The distinction between shocks affecting the banks' country of origin (and ultimately banks' net wealth) and shocks affecting the banks' host countries (and therefore borrowers' net wealth) is similar to Morgan, Rime, and Strahan (2004) who explore how banking system integration affects the evolution of business cycles, without considering the effects on bank loans. Their conclusion that banking system integration mitigates the effect of

[1] Other studies of the syndicated loan market include Giannetti and Yafeh (forthcoming) who indicate that familiarity biases are relevant in the international syndicated loan market, and De Haas and Van Horen (2011) who find that lending to relationship borrowers was less affected during the 2008 financial crisis.