PRI Principles for Responsible Investment

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PRI ACADEMIC NETWORK

RI QUARTERLY

ESG ISSUES IN BANK LOAN PRICING AND DECISION MAKING

IN THIS ISSUE

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The PRI Academic Network's goal is to bring academic research into practice and vice-versa. We bring academics and practitioners together, showcasing the best academic research to the investment industry, and ensuring that academia is responding to the research needs of investors and producing research that can help create a sustainable financial system.

Contact: academic@unpri.org

The RI Quarterly is produced by the PRI Academic Network and aims to be the go-to publication for investment professionals and anyone needing the latest research on responsible investment, but without the time to read through the original papers. Every issue will focus on a number of academic papers around a theme selected by the PRI's Academic Fellow, extracting the essentials of the argument and giving key findings in a clear and concise manner.

Editor: Rachel Whittaker, CFA.
Rachel is a sustainable investment specialist with experience in investment research, analysis and communications. Most recently she held positions in Mercer's Responsible Investment team in London, and at Vontobel Asset Management in Zürich.

INTRODUCTION

BACK

Welcome to the first issue of the PRI Academic Network's RI Quarterly.

This new publication aims to bring you regular highlights of academic research relevant to responsible investment and the impact of environmental, social and corporate governance issues on investment strategies. Each issue will focus on a high level theme and present summaries of a selection of published academic research chosen by the PRI's Academic Fellow, Dr Andreas Hoepner, in a format easily accessible to both RI specialists and non-specialists and relevant to all participants in the financial markets. This issue focuses on the impact of social and governance factors on corporate bank loans, a growing area of interest, but one that has received much less attention than the impact of ESG on equity risk and returns.

Banks occupy a privileged position in the finance world, gaining access to financial information about their borrowers that public debt or equity holders do not have, and with the ability to impose terms and conditions as they see fit. Consequently their decisions on which companies are creditworthy and the factors that influence their decisions has great significance for other stakeholders, not only in terms of the direct impact on the company finances, but also the potential implications for subsequent company performance.

The five academic reviews included herein summarise the influence of a variety of intangible factors on the cost of bank debt for companies: board structure, shareholder rights, corporate social responsibility, cultural differences and management's personal connections. The research covers different time horizons and both global and US-focused data sets, but all find evidence that intangible factors have an impact on pricing when companies arrange bank loans. They all also tackle the problem of how to evaluate subjective and disparate qualitative data, an often cited difficulty in incorporating ESG issues into investment decisions. This publication can therefore offer insights into how these factors could be incorporated into an investment strategy in addition to demonstrating their relevance for company returns.

The papers referenced here are not the only research on ESG issues in bank loan pricing, but represent five robustly researched and diverse perspectives on the theme. If you find the topic and the research interesting, we hope that you will share it with your colleagues and peers.

As you may know, in November I am moving on after ten years at the PRI. Helene Winch, the PRI's new Director of Policy and Research, will be taking over the management of the Academic Network. Please join me in welcoming her to this role, and please do not hesitate to send her your opinions and feedback as well as suggestions for themes and research papers for future issues of the RI Quarterly.

Dr James Gifford
Executive Director, *PRI*

BOARD QUALITY AND THE COST OF DEBT CAPITAL – THE CASE OF BANK LOANS

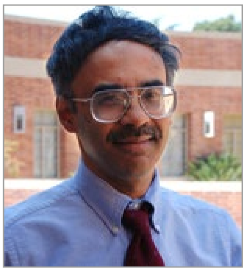
BACK

While corporate governance factors are often thought of as important issues for shareholders, in particular the characteristics and quality of the board of directors, less attention is given to their relevance for creditors. This paper explores the issue by focusing on the impact of board quality on a company's cost of debt. The authors hypothesise that a high quality board can reduce the cost of bank loans. Their analysis focuses on loans given to large US public companies between 2003-2005, and shows that during this period companies with larger, more experienced, and more diverse boards were able to achieve lower bank loan costs with fewer restrictive conditions (covenants) imposed. A further unanticipated finding is that companies with a lower proportion of institutional equity ownership appear able to borrow more cheaply than those with higher institutional ownership.

AUTHORS

Paige Fields

Donald R. Fraser



Avanidhar Subrahmanyam

ANALYSIS

The data sample covered bank loans taken out by around 1500 US companies, excluding financial companies and regulated utilities due to the advantage they enjoy in negotiating loan terms. The primary point of comparison is the interest rate charged, including all associated fees (the 'all-in' spread, obtained from a standard industry source, Deal Scan). As a result of the extent of data required, the sample set was tilted towards larger companies with relatively stronger financial profiles than the average company.

Additionally, the authors consider the extent of covenants attached to the loan, a factor that they believe previous research has neglected. Restrictive financial ratio covenants could impede management's ability to make operational decisions and therefore are an important non-financial cost to consider. Since covenants can be tailored to a specific borrower they are infinitely variable. The authors therefore focused on three general categories: if collateral was required, if there were more than two financial ratio restrictions, and if sweeps were required (where the proceeds of any equity, debt, or asset sales are required to be put towards paying off the loan).

The assessment of board quality incorporates a wide range of governance characteristics, including:

- Board size, i.e. the number of directors.
- Director independence.
- Compensation.
- Share ownership.
- Experience (the proportion of directors with more than fifteen years of service).
- Time commitment (the proportion of directors that serve on four or more other boards).
- Diversity (proportion of female directors).
- Advisory capability (the presence of at least one external director who is also employed by another firm in the same industry, or, more external senior directors than average).

Data is sourced from The Corporate Library and the IRRC (Investor Responsibility Research Center) Institute. To avoid problems with ascertaining causality, such as certain types of board directors attracted to companies with better loan rates, the quality measures lag one period relative to the loan, i.e. board quality measures are for the years 2002-2004.

RESULTS

Overall the key finding was that boards scoring highly on the board quality measures tend to achieve lower loan costs, and in addition are less likely to have restrictive financial ratio covenants imposed. The degree of influences varies between the different factors– board size, independence, experience, and diversity have the biggest influence, with larger boards, more external directors, more experience and more diversity leading

to lower loan costs – while there was no evidence for a correlation between loan costs and director commitment, compensation, or insider ownership.

Other notable findings include:

- A greater advisory presence on the board is correlated with lower loan costs regardless of the degree of board independence overall.
- The relationship between larger board size and lower loan costs holds regardless of firm size and financial characteristics. In the authors' view, this may perhaps be due to lenders perceiving large boards as having more combined expertise.
- Collateral requirements are minimised by greater diversity and more experience on the board, but board quality does not seem to influence the existence of sweep covenants.

These results are robust for company-specific characteristics such as size, leverage and profitability (in general larger, less leveraged companies with less volatile stock prices and higher returns on assets achieve lower loan costs), as well as various control factors including ownership structure, CEO pay, geographical remoteness of a company, and whether the company has taken a loan in the previous two years.

The authors also find that high CEO pay and a higher proportion of institutional equity ownership appears to increase the cost of borrowing. The reason for this is not clear, but the authors propose two contrasting explanations that would both lead to this outcome: firstly, that institutional owners may be considered more likely to influence management to put shareholder interests before debt holders, or, alternatively, that institutional owners may be thought too passive to help with monitoring and discipline.

CONCLUSIONS

Taking both loan cost and covenants into account, high quality boards appear to lead to decreased cost of debt. Fields et al posit this may be due to banks viewing high quality boards as providing additional monitoring, particularly when there is an advisory presence. They highlight that the findings support recent legislation and industry guidelines supporting the recruitment of outside directors to company boards in the US and further afield.

However, firms with higher levels of institutional ownership and greater shareholder protection are at a disadvantage. The authors speculate that this is due to a greater likelihood of takeover which may weaken a company's ability to repay its debt. This theory would be consistent with other studies that show fewer takeover defences leads to higher borrowing costs.

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Fields, L.P., Fraser, D.R. and Subrahmanyam, A. (2012)
Board quality and the cost of debt capital: the case of bank loans
Journal of Banking & Finance, Volume 36:5, p1536–1547

DO SHAREHOLDER RIGHTS AFFECT THE COST OF BANK LOANS?

BACK

AUTHORS

Sudheer Chava

Dmitry Livdan

Amiyatosh K. Purnanandam

This study explores the effect of a firm's corporate governance structure on the cost of its bank loans. The ability to raise capital is vital for any business and factors that influence the cost of capital could have significant economic impact. The authors hypothesise that banks charge higher loan costs to corporate borrowers with more shareholders rights because such companies tend to have lower takeover defences, and are perceived to be more likely to be acquired with a subsequent increase in risk to the lender. The study focuses on loans taken out by US companies (excluding financial companies) during the period 1990-2004, and finds that companies with more shareholder rights are charged higher interest rates, while those with lower shareholder rights are able to achieve lower loan costs.

ANALYSIS

The bank loan data is sourced from a standard industry database, Dealscan, and the primary measure of loan cost is the interest rate charged plus additional fees (the 'all-in' spread) with most loans being syndicated. Information on shareholder rights and takeover vulnerability is sourced from the Investor Responsibility Research Centre (IRRC), specifically its 'Corporate Defences Index', which ranks the strength of shareholders rights across companies based on the number of defensive provisions in its corporate charter, for example, methods to delay hostile takeover bids, protection of company directors, shareholder voting rights, and state laws.

RESULTS

The statistical analysis of loan costs and the takeover vulnerability measure suggests a correlation between increased takeover vulnerability in the variation in interest rates offered to different borrowers, independent of other company characteristics known to influence loan spreads such as company size, leverage and profitability. The difference between the rates charged to the most and least vulnerable companies is of the magnitude of 25% of the loan spread. Furthermore, if a company adds three extra defensive provisions to its corporate charter (one standard deviation from the mean number of provisions), this decreases the loan cost by about 10%, or 12 basis points.

The authors examine a number of factors that interact with takeover vulnerability to affect the loan cost – notably company leverage, syndicate size, and the presence of loan covenants. They find that companies with low leverage are more likely to experience an increase in leverage in the event of a takeover, and correspondingly that companies with more shareholder rights and low leverage are charged the highest loan spreads.

The impact of syndicate size and covenants is more complex. Usually small syndicates are associated with low credit risk as banks typically syndicate higher risk loans across a larger number of participants to diversify their risk exposure. However, within small syndicates the companies with greater takeover vulnerability are charged higher spreads. Similarly, fewer covenants is typically associated with borrowers with lower credit risk. However, the authors find that borrowers with high takeover vulnerability are charged higher loan spreads when they have no collateral or fewer covenants, most likely because a lack of covenants leaves the lender unprotected in the event of a merger.

Chava et al discuss in detail whether the observed relationship between the IRRC takeover vulnerability index and loan spreads is causal, or driven by some other external factor. They believe that banks are indeed pricing the risk of a takeover occurring for several reasons:

- The average age of companies in the samples is 30 years, and since anti-takeover provisions are typically adopted at the time of IPO and rarely changed it is unlikely that a separate factor is influencing both takeover vulnerability and a loan cost determined 30 years later.

- Firms with an increase in takeover risk from one year to the next pay significantly more on their loans than firms with a decrease or no change.
- During periods of high takeover activity the effect of takeover vulnerability on loan costs is seen to be much higher.
- In states where the legal framework is favourable to corporate takeovers (notably Delaware), companies incorporated here were found to be paying more for their loans despite the companies appearing to have a lower credit risk on average than the national sample.

CONCLUSIONS

The authors conclude that after controlling for loan and company specific characteristics, companies with higher takeover risks, as indicated by shareholder-friendly policies, are charged a higher rate for their loans because they believe there is more chance of a takeover that increases the repayment risk. Takeover vulnerability is most significant for companies with better credit profile, low-leverage, and taking out loans with no collateral or covenants or with smaller syndicates.

The reasons for banks' concern about corporate takeovers are not apparent, and from the results in this study the higher costs charged to more vulnerable companies do not appear to be entirely justified. Although takeovers are likely to come with a period of uncertainty and a possible impact on cash flow and leverage, this study finds no evidence to suggest that firms that appear to be takeover candidates are more likely to default in future (in fact they appear to default less frequently than companies that are less vulnerable to takeovers). Nor is there any evidence to suggest that banks are concerned about companies favouring shareholders with higher dividends, since the takeover/loan spread relationship is as strong in states where shareholder payouts are controlled as in states where they are not. The authors believe that their results have important implications for designing optimal corporate governance structures, since companies relying on the equity market as a corporate governance mechanism are likely to be penalised by higher cost of bank debt, but further research would be needed to investigate the reasons behind this phenomenon.

Chava, S., Livdan, D. and Purnanandam, A. (2008)
Do shareholder rights affect the cost of bank loans?
EFA 2004 Maastricht Meetings Paper No. 5061.
Available at SSRN: http://ssrn.com/abstract=495853 or
http://dx.doi.org/10.2139/ssrn.495853

THE IMPACT OF CORPORATE SOCIAL RESPONSIBILITY ON THE COST OF BANK LOANS

BACK

Corporate social responsibility (CSR) has become a major issue for company management, with much debate over whether it adds or destroys value. Many researchers have examined the value-adding potential of CSR from a share price performance perspective, but less so from a debt perspective, and where debt has been considered it is typically from a bond holder perspective. This study considers whether CSR practices impact the cost of bank debt. Since banks typically gain access to company information that is not normally available to outsiders, they may be in a better position to evaluate the value of a firm's CSR programme than other outside parties such as bond credit rating agencies.

The research focuses on loans to US companies over the period 1991-2006, and finds that companies exposed to more CSR-related risks (typically meaning concerns related to environmental, social, or corporate governance issues) pay more for their loans than companies with few or no CSR risks. However, companies with CSR strengths, i.e. proactive CSR programmes, are treated differently if they are in a strong financial position (i.e. high quality borrowers), than if they are weaker. Low quality borrowers appear to be penalised for investing in discretionary CSR programmes, while high quality borrowers are not. The authors suggest that this demonstrates lenders discriminating between genuine attempts to align firm goals with societal needs, and CSR programmes that are merely for show and destroy value.

AUTHORS

Allen Goss

Gordon S. Roberts

ANALYSIS

The authors hypothesise that firms with more CSR risks will face higher costs of borrowing since the risks represent a potential impact on future cash flow that may prevent the borrower from repaying the debt, and that this would be exacerbated in the absence of collateral.

In common with other studies looking at the impact of intangible factors on the cost of bank loans, the primary measure used by the authors is the all-in spread, i.e. the interest rate including additional fees. The data comes from a standard industry source, Dealscan.

To evaluate CSR practices, the authors use KLD Research and Analytics data, an established provider of CSR research and CSR-based company rankings, to source information on a range of different factors that typically form part of a CSR programme. These include a range of environmental, social and governance issues such as community relations, corporate governance, employee diversity, employee relations, environmental impact, human rights, and any product-specific issues. Both strengths and risks in these areas are identified for all companies, in addition to any exposure to six sectors that are perceived by investors to have substantial inherent CSR concerns: alcohol, gambling, firearms, military, tobacco and nuclear power.

RESULTS

The results suggest a significant correlation between CSR risks and loan costs, with loan costs increasing as CSR risks increase. Within the sample, companies with above average CSR risks paid nearly 10 basis points more for their loans than companies with below average CSR risks did. However, companies with CSR strengths did not benefit from a corresponding reduction in loan costs. Companies with high risks and high strengths pay approximately the same premium as companies with high risks and low strengths. Over the whole sample, the impact of CSR strengths is not significant. Furthermore, if collateral is provided for the loan then the impact of CSR risks on the interest rate is reduced. The authors also found that the impact on loan cost varies between individual CSR factors. For example, of the six sectors with CSR

concerns, only tobacco companies appear to pay higher loan spreads than average.

The results are robust, controlling for company and loan characteristics such as size (larger firms are generally viewed as less risky by banks), loan security, company balance sheet strength and profitability, loan maturity, type, purpose, and whether it is a single lender or a syndicated loan. Different time periods, regional differences between companies, and improved monitoring by banks over time are also shown to not diminish the relationship. However, regardless of CSR strengths, the authors found that companies with lower risks tend to take larger loans, corroborating other research that suggests firms with better CSR performance have easier access to financing, and that longer maturities appear to be correlated with lower loan costs.

CONCLUSIONS

Goss and Roberts' theory to explain their findings is that banks view CSR programmes as a risk management exercise, i.e. companies that act irresponsibly may be subject to future cash costs to correct the impact of their current activities. Such companies may therefore be less able to repay their debt in the future, with the risk of future costs increasing as the length of the loan term increases. Since the evidence suggests that longer maturities are actually leading to lower loan costs, the authors believe that higher risk companies may be effectively frozen out of the long term debt market.

Their theory would also imply that proactive CSR investments should lower risk and lead to lower loan costs, but only up to the point where the cost of the investment equals the reduction in loan cost. Hence companies that have major CSR risks are penalised for spending on CSR programmes that will not offset the higher cost of debt resulting from these risks.

Although the relationship between CSR risks and bank loan costs is statistically significant, the economic impact is relatively modest, suggesting that CSR is a secondary determinant of loan spreads rather than a major consideration. However, banks are also able to impose restrictive covenants and there is some evidence that banks also respond to CSR risks with less attractive contract terms. The authors highlight the impact of loan covenants as a potential area for future work.

Finally, the variation in impact of different CSR factors suggests that all parties with an interest in evaluating the impact of a company's CSR performance should consider individual factors, not only aggregate scores that attempt to create a single CSR performance reference point with which to compare companies.

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Goss, A. and Roberts, G.S. (2011)
The impact of corporate social responsibility on the cost of bank loans
Journal of Banking & Finance, Vol 35:7, p1794–1810

DO CULTURAL DIFFERENCES BETWEEN CONTRACTING PARTIES MATTER? EVIDENCE FROM SYNDICATED BANK LOANS

BACK

AUTHORS

Mariassunta Giannetti

Yishay Yafeh

Behavioural factors are frequently the subject of management and investment psychology studies, and the difficulties encountered in mergers between organisations with different national cultures suggest that common cultural norms can play an important role in business transactions. This paper by Giannetti and Yafeh examines whether cultural similarities or differences between banks and their corporate customers have an impact on the decision about whether to extend a loan, and, if so, the size, interest rate, and conditions associated with the loan.

From analysis of the syndicated loan market between 1980-2005, the authors find that banks from all over the world are more likely to offer smaller loans, at higher interest rates, and require more guarantees, the more 'culturally distant' the borrowing company is from the lending bank, i.e. the terms of a loan between counter parties in the US and Japan will be more onerous to the borrower than the loan terms between counter parties in the US and Canada, or between Japan and South Korea. Moreover, this difference persists in susbsequent transactions suggesting that it is not related to an initial lack of familiarity between lender and borrower but for some other reason. The authors' theory is that higher contracting costs between culturally dissimilar parties leads to this pricing difference.

ANALYSIS

The research considers loan contracts in more than 70 countries and focuses on two key relationships where cultural differences could come into play – the interaction between the lead bank in the syndicate and the borrowing company, and the interaction between the lead bank and other participant banks in the same syndicate. The primary loan characteristic used for comparison is the interest rate charged inclusive of all fees (the 'all-in' spread, taken from a standard industry source, Dealogic).

Measuring cultural distance is much much more subjective and therefore difficult. Giannetti and Yafeh use a social science study, the World Values Survey (see chart on p. 10), which evaluates the position of countries along two major dimensions of cultural variation – the relative importance of religion (traditional versus secular), and the relative development of its society along a scale from prioritising economic and physical survival to a greater focus on self-expression and quality of life. Plotting countries along these two dimensions results in a map grouping culturally similar countries, and allowing mathematical measurement of the distance between any two points to be used as a proxy for cultural distance. This is supplemented with other factors such as the physical distance between countries; whether there is a common border, a similar legal framework, the same language or historic colonial ties, and any differences between the rights of creditors in each country.

RESULTS

The findings point to the cultural distance between borrower and lender having a consistent positive and significant correlation with the loan spread. For example, a one standard deviation increase in cultural difference, which is approximately the same as between the US and Canada, adds 6.5 basis points to the overall cost of a loan. Between the lenders within the syndicate, the greater the cultural distance between the lead bank and a participant bank, the lower the share of the risk that the participant bank takes.

Other key findings include:

- Foreign and culturally distant banks appear more likely to offer cheaper loans than domestic banks, but are more expensive than foreign but culturally close banks.
- Foreign and culturally distant banks give smaller loans and are more likely to want guarantees.
- A subsidiary of the lender local to the borrower reduces but does not eradicate the effect of

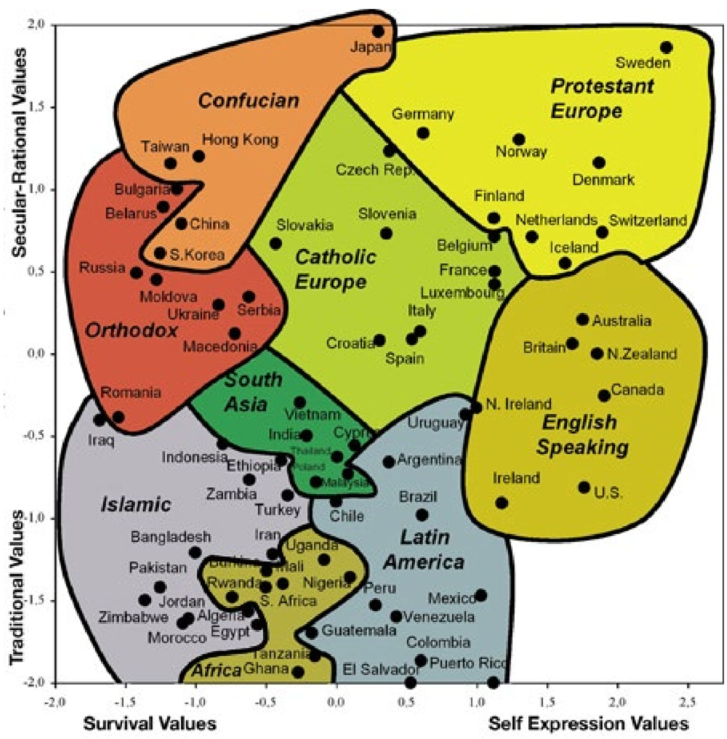
cultural distance (the interest rate significantly decreases but the loans are likely to be smaller with greater security required).

- Repeated loans mitigate the effect of cultural differences but only disappear when a borrower has received more than four loans from a particular lead bank and this is extremely rare in reality.
- Risk sharing between culturally different banks within the syndicate increases with repeated joint deals, but only disappears after more than thirty interactions and again this is very rare.

The results are robust when controlling for differences in loan amounts, maturity and collateral; as well as differences in trade relationships between countries, currencies, industry, and the borrower's ownership structure. The results also hold when lead banks from the US and the UK are excluded from the sample, suggesting that the phenomenon is not limited to the largest and most well-known international banks or to the Anglo-Saxon financial sphere. Most importantly, the relationship holds when the authors control for external factors influencing borrower-lender matching, such as credit rating, i.e. it is not the case that the worst borrowers match with culturally distant banks and therefore pay higher interest rates on their loans. In fact, the financial profile of companies borrowing from distant lenders actually appears to be stronger than those borrowing from domestic or culturally close lenders.

THE WORLD VALUE SURVEY CULTURAL MAP

2005-2008



Source: Ronald Inglehart and Christian Welzel, "Changing Mass Priorities: The Link Between Modernization and Democracy." Perspectives on Politics June 2010 (vol 8, No. 2) page 554.

CONCLUSIONS

Giannetti and Yafeh discuss various theories to explain the relationship between cultural differences and loan cost including whether monitoring costs are greater when lending to a culturally distant borrower. However, the persistence of the impact of cultural differences despite repeated interactions with the same lender makes the monitoring cost theory less likely. They conclude that an increase in contracting costs is the most likely explanation. Writing contracts between two culturally different parties is likely to consume more time and resources than between two parties that share common cultural norms, language, legal framework, communication style or organisational structure. Professional decision makers may therefore be inclined to offer better terms to culturally similar counter parties.

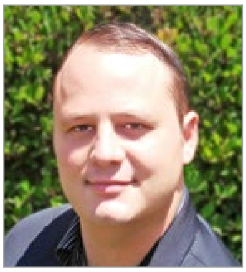
Giannetti, M. and Yafeh, Y. (2012)
Do cultural differences between contracting parties matter? Evidence from syndicated bank loans.
Management Science, Vol 58:2, p365-383

FRIENDS WITH MONEY

BACK

This study investigates whether personal connections between the senior management of lending banks and the senior management of borrowing companies, such as having previously studied or worked at the same organisation, has an impact on the outcome of a company's application for a loan in terms of both interest rate charged and restrictive covenants imposed. The authors find evidence that personal connections lead to significantly lower interest rates being charged, and that companies with personal connections to their lenders appear to outperform companies that have no personal connection in terms of both improved credit ratings and share price performance. Other studies have explored the impact of personal relationships on business and investment decisions, and some evidence suggests that they may compromise a lending bank's objectivity and ability to make a good decision. However, the evidence presented contradicts that point, and although the reasons are not clear, the findings are interesting in the context of whether personal connections help to facilitate more efficient capital markets.

AUTHORS



Joseph Engelberg

Pengjie Gao

Christopher Alan Parsons

ANALYSIS

The authors address two main questions: firstly, whether there is a causal relationship between personally connected borrower and lenders and the lending deals that are made between them (i.e. do they give their 'friends' better deals), and secondly, whether these personal connections lead lending banks to make good or bad lending decisions.

Loan information was drawn from a standard market data source (Dealscan) and uses three key variables: deal size, interest rate charged including fees ('all-in' spread), and the number of covenants. The sample included syndicated loans made to over 5000 US public companies between 2000 and 2007, by around 2000 commercial banks. The study considers whether the borrowing company has connections to any of the lenders in the syndicate, not only the lead, on the basis that previous studies have shown many banks often syndicate as a group for many deals and the lead position is rotated between them.

Data on senior management was sourced from the data agency BoardEx. Personal connections between 65,000 individuals who had been either board members or executives at borrowing or lending institutions were evaluated using university connections (if they graduated from the same educational institution in the same year or one year removed) and past professional connections (if they worked for the same corporation or were members of the same board at the same time, at least five years previously and only if the connection did not involve the current borrowing or lending company). The time lag is an important control to ensure that the personal connections are distant enough from the loan that the authors can be confident the connections between lenders and borrowers have not come about as a result of the lending relationship, i.e. reverse causality is highly unlikely. For similar reasons connections through participation in social networks, as opposed to professional networks, are excluded, because accurate data on the timing and extent of participation is not widely available.

RESULTS

The statistical analysis finds that the presence of at least one pre-existing personal relationship significantly reduces borrowing costs, and the impact increases with more relationships within the syndicate. The absolute impact is smaller for firms with better credit ratings as might be expected given that their loans costs are smaller, but the downward

impact on borrowing costs increases as credit quality declines. At least one connection results in a better deal by about the same magnitude as a shift in credit rating, and on average 1.5 additional connections leads to 24 basis points reduction in loan spread, though the incremental value of each connection reduces with an increase in number of connections.

Personally connected syndicates also seem to lend more than average, are less likely to impose covenants, and where present the covenants are fewer. Loan covenants are considered only in terms of the number, not type (which can be highly variable) and the authors find that doubling the number of personal connections reduces the likelihood of covenants being attached to the loan.

These results are robust when controlling for specific firm, industry, loan and macroeconomic characteristics. The authors also consider in detail other possible explanations and sources of external influencing factors, such as geographical proximity (which could logically affect the number of personal connections), the presence of previous lender relationships, and the size and activity of the lenders, and find that the effect of personal connections is still strong.

To evaluate whether the personal connections are leading banks to make good or bad decisions, Engelberg et al use the development of credit ratings as a proxy for loan performance (since specific loan performance data is not usually publicly available). Subsequent to loans being made, the credit ratings of companies that have personal connections with their lending syndicate appear to improve. This relationship holds for all rating categories, although the magnitude varies, and the effect increases cumulatively up to 3 years after the loan. Subsequent stock returns also support the lending decisions, with connected firms outperforming unconnected firms over 1, 2, and 3 years after receiving a loan. Doubling the number of personal connections is associated with an increase in risk-adjusted stock returns of almost 5%.

CONCLUSIONS

The authors conclude that personal connections between borrower and lender are leading to preferential terms for the borrower and an improved outcome for the lending bank and that this is especially influential for firms with poor or even no credit rating. The precise reasons for the outcome are difficult to discern since it is possible to formulate multiple theories, but the authors speculate that it could be due to better information flow or monitoring that is permitted by the common professional networks. They cite the example of microcredit organisations such as the Grameen Bank seems to support this theory, where the community network plays an important role in loan screening and monitoring.

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Engelberg, J., Gao, P. and Parsons, C.A. (2012)
Friends with money.
Available at SSRN: http://ssrn.com/abstract=1572386 or
http://dx.doi.org/10.2139/ssrn.1572386

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More information: www.unglobalcompact.org

United Nations Global Compact