

Do Cultural Differences Between Contracting Parties Matter? Evidence from Syndicated Bank Loans

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We investigate whether cultural differences between professional decision makers affect financial contracts in a large data set of international syndicated bank loans. We find that more culturally distant lead banks offer borrowers smaller loans at a higher interest rate and are more likely to require third-party guarantees. These effects do not disappear following repeated interaction between borrower and lender and are economically sizable: A one-standard-deviation increase in cultural distance, approximately the distance between Canada and the United States or between Japan and South Korea, is associated with a 6.5 basis point higher loan spread; the loan spread increases by about 23 basis points if the bank-firm match involves culturally more distant parties, for example, from Japan and the United States. We also find that cultural differences not only affect the relation between borrower and lender, but also hamper risk sharing between participant banks and culturally distant lead banks.

Key words: financial contracts; risk sharing; behavioral bias; culture

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1. Introduction

Psychologists and management scholars document that national culture affects codes and norms used during negotiations and that, consequently, in simulated negotiations between parties with different national cultures, joint gains are lower than in negotiations between parties that share the same culture (Brett and Okumura 1998, Adair et al. 2001). Evidence on whether the outcomes of real life negotiations are indeed affected by cultural differences is sparse. The frequent failures of mergers involving organizations with different national cultures would suggest that they do (e.g., Weber et al. 1996). An effect of cultural differences between contracting parties on contract terms would also suggest that common codes and norms (or the lack thereof) play an important role in actual negotiation outcomes.

This paper examines whether financial contracts written by parties with different national cultures are affected by the extent of cultural differences. National cultures may matter for several reasons. First, communication is more effective when the source and the receiver share codes and norms, which is more likely to happen if individuals share the same culture (Rogers and Bhowmik 1970). Second, national culture is related to the organizational structure of companies

and affects, for instance, how centralized they are (Bloom et al. 2009). Similar organizations may communicate and cooperate more easily.

In a large sample of international syndicated bank loans, we show that the bigger are the cultural differences between the countries of the syndicate's lead bank and of the borrower, the less favorable are the loan terms for the borrower. *Ceteris paribus*, more culturally distant borrowers are offered loans at a higher interest rate, are more likely to need a guarantor, and receive smaller loans. These effects are economically sizable as a one-standard-deviation increase in cultural distance, approximately the distance between Canada and the United States or between Japan and South Korea, is associated with a 6.5 basis point increase in the loan spread; the loan spread increases by about 23 basis points (or 15% of the sample median) if the bank-firm match involves culturally more distant parties, for example, from Japan and the United States. Importantly, the effects of cultural differences do not disappear if culturally distant banks lend repeatedly to a particular borrower or if the lender has a subsidiary in the country of the borrower.

Because negotiations between lead banks and participant banks parallel negotiations between lead

banks and borrowers, we also explore the extent to which cultural differences affect the interaction between the banks participating in the syndicate. A one-standard-deviation increase in the cultural distance between a participant bank and the lead bank increases the difference between the lead bank's portion of the loan and the share of the loan held by the participant bank by 5%, suggesting that cultural differences reduce risk sharing within the syndicate. Repeated interaction between banks lowers the impact of cultural differences; however, the negative effect of cultural distance on within-syndicate risk sharing disappears only after more than 30 joint deals. This is a rare occurrence as 75% of all banks in the sample are involved in 10 joint deals or less.

We thoroughly investigate whether differences in financial contracts may arise from the fact that culturally distant banks attract less creditworthy borrowers using selection models, borrower and lender fixed effects, fixed effects for the borrower's and the bank's nationalities, and comparisons across different subsamples, time periods, and regression specifications. All tests consistently indicate that the more conservative terms offered by culturally distant banks are not driven by the poor quality of the borrowers. Moreover, we explore borrowers' ex post performance and find no evidence that, after the loan is granted, the performance of firms borrowing from culturally distant banks is worse than that of other borrowers.

An interpretation of our findings is that cultural differences make negotiations more cumbersome and thus increase contracting costs. The effect may be nonpecuniary if interaction with culturally distant borrowers increases the lenders' disutility from writing the contract.¹ The effect may also be pecuniary as more time and resources may be needed in writing contracts between culturally distant parties. What matters is that contracting costs appear to be related to the culture of the parties involved in the negotiations, suggesting that behavioral patterns arising from the use of different codes and norms should be incorporated in contract theory.

Another interpretation of our results is that cultural dissimilarities increase the cost of information gathering (or make information gathering less efficient). Having less precise information, culturally distant banks consider borrowers riskier than culturally

closer banks do, and therefore offer loans with more restrictive contract terms. The persistence of the effect of cultural differences despite repeated interaction and across institutional environments and borrowers with different levels of opaqueness makes it unlikely that our results are due solely to asymmetric information. In addition, we find no evidence that the variance of contract terms offered by culturally distant banks is lower than that of loans offered by domestic banks; this, together with considerable empirical evidence showing that the clients of culturally distant banks are similar to the clients of other banks, suggests that culturally distant banks are as discerning as their culturally close peers.

The paper is related to several strands of the literature. The link between culture and economic behavior has fascinated social scientists ever since Max Weber. Whereas most of the papers in the literature explore the effects of culture on economic outcomes (see Guiso et al. 2006 for a review), we do not investigate the effects of culture per se, but focus on cultural differences. In this respect, our paper is closer to the literature on cultural differences and the flows of foreign direct investment and international mergers (Kogut and Singh 1988, Ahern et al. 2010, Licht et al. 2011). A related strand of literature initiated by Guiso et al. (2009) explores the effects of trust and shows that trade and investment flows are larger between countries that exhibit higher mutual trust. Especially related to us is Bottazzi et al. (2007), who provide evidence that venture capitalists are less likely to fund entrepreneurs in countries whose citizens they trust less and, if they do, the contracts they use are different from the contracts used in countries they trust more. Unlike the literature on mutual trust, we ask whether cultural similarity eases economic interaction. The depth of the syndicated loan market allows us not only to study a much larger set of countries, but also to explore whether the effects of cultural differences disappear following repeated interaction.

Our paper is also related to the literature on the home equity bias. Many studies have shown that lack of familiarity limits investment (Coval and Moskowitz 1999, Huberman 2001). Familiarity is enhanced by cultural similarity (Grinblatt and Keloharju 2001). Our paper contributes to this literature by introducing a new proxy for familiarity and by showing that it enhances financial flows in the form of corporate debt, not only equity. Furthermore, we document that familiarity affects not only quantities, but also the structure of financial contracts.

Finally, our work is related to papers analyzing the structure of syndicated loan contracts. Esty and Megginson (2003), Qian and Strahan (2007), and Bae and Goyal (2009) explore how creditor protection and law enforcement in the borrower's country shape

¹ Nonpecuniary costs are equivalent to taste-based discrimination (Becker 1971). In a similar vein, individuals may focus on (irrationally) pessimistic scenarios when they deal with culturally dissimilar counterparties. In this respect, our findings are related to a few recent papers showing that ethnic minorities, female borrowers, and less attractive individuals pay higher interest rates for reasons unrelated to their risk (Alesina et al. 2008, Ravina 2008). However, an irrational focus on certain scenarios is unlikely for international banks.

financial contracts. We contribute to this literature by showing that cultural distance also matters.

2. Background and Data Sources

2.1. The Syndicated Loan Market and Cultural Differences

We study whether cultural distance affects financial contracts in the syndicated loan market. A syndicated loan is jointly extended by a group of banks, including one (or a few) lead banks and many participant banks. Prior to signing the loan contract, lead banks assess the quality of the borrowers and negotiate terms and conditions. Once the key terms are in place, participant banks are invited to buy a stake of the loan. As a consequence, the issuance of a syndicated loan is preceded by lengthy negotiations between borrowers and lead banks first, and between lead banks and participant banks afterward. Our focus is on the borrower–lender (lead bank) relation; in §5, we briefly analyze the risk sharing between lead banks and participant banks.

The syndicated loan market is an appropriate context to explore the effects of cultural differences on financial contracts for several reasons. First, as Duffie et al. (2005 and 2007) highlight, obtaining a syndicated bank loan presents search and bargaining frictions. Because of the length of the negotiations involved, borrowers cannot approach multiple potential lenders contemporaneously and cannot compare multiple offers. Because of an increasing cost of funds or capacity constraints, banks are not always available to extend loans. Borrowers, having opportunity costs of waiting, are therefore not necessarily matched to the most suitable counterparties.

Second, negotiations are important to establish contract terms. As psychologists and management scholars point out (Brett and Okumura 1998, Adair et al. 2001), sharing similar norms and codes facilitates communication and the exploration of alternatives (for instance, a borrower may need long maturity, but may be willing to concede on the loan amount).

Negotiations may also be made less effective by the fact that, in different cultures, organizations are represented by individuals with different skills and roles. For instance, in Anglo-Saxon individualistic cultures, companies tend to select the most energetic members for the negotiations; Chinese or Japanese teams are often led by a senior person, who has a high status in the organization and may lose face when dealing with the younger representatives of the counterparty. Also, negotiators from individualistic and egalitarian cultures have the power to accept and reject offers, whereas in more hierarchical cultures the members of the organization with actual decision power are not present at the meetings. Cultural values also affect

corporate policies such as gender equality, diversity, and (attitudes toward) environmental policies. Similar ethnic and gender stereotypes or expectations on environmental standards affect how comfortable negotiators are with the counterparties. All these factors can make cross-cultural negotiations lengthy and ineffective and increase contracting costs. After the bank obtains a fair remuneration on its investment, these contracting costs are manifest in less favorable loan terms for the borrower.²

It is also possible that cultural dissimilarities increase the cost of information gathering and that, as a consequence, an identical borrower may be considered riskier by a culturally distant bank. This mechanism would also suggest that cultural similarity facilitates negotiation by enhancing information sharing. Whereas information asymmetry is known to play a role in the syndicated loan market (Dennis and Mullineaux 2000), the results we present below lend stronger support to a story based on contracting costs.

2.2. Syndicated Loan Data

Data on syndicated loans are from Dealogic's Loanware Database, which provides information on borrowers, lenders, and loan price and nonprice terms at origination. This database is widely used for studying the international syndicated loan market (Esty and Megginson 2003, Carey and Nini 2007).

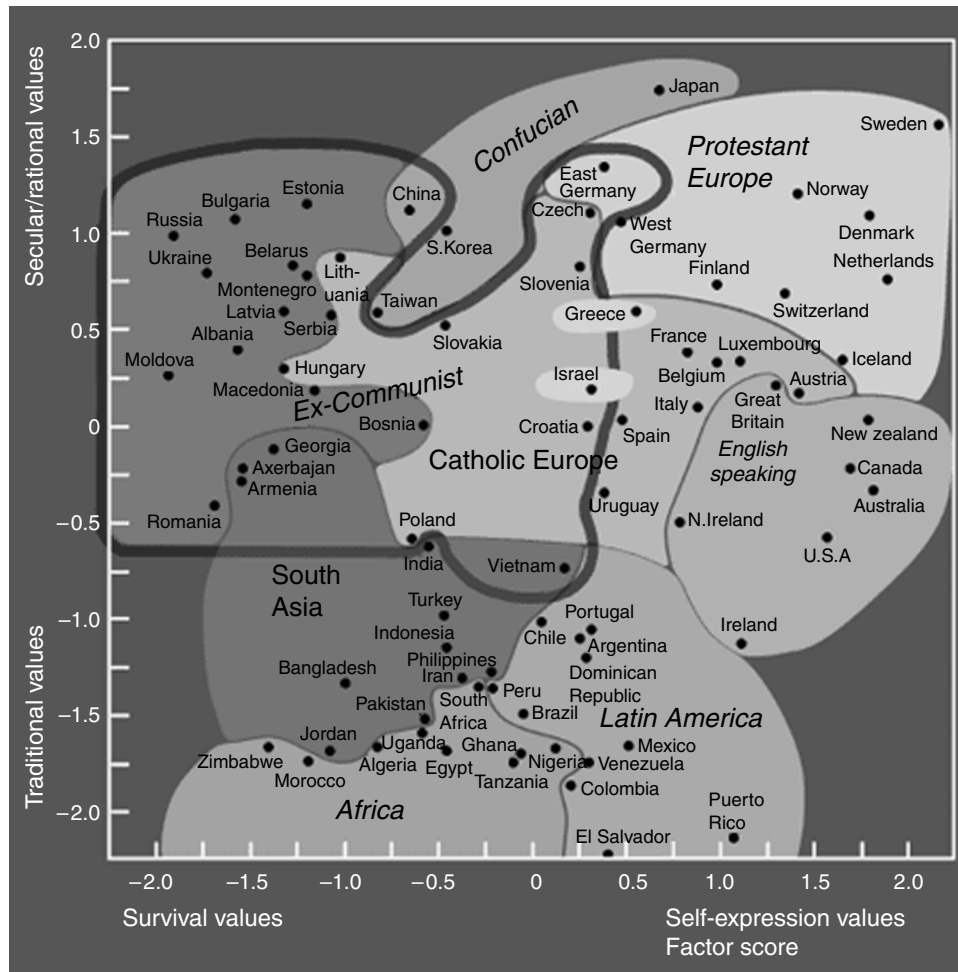
Whereas Loanware contains information on syndicated loans to local and central governments, we focus on corporate borrowers. We extract information on contracts from 1980 to 2005. Less than 15% of the contracts are signed in the first 10 years, reflecting the fact that the syndicated loan market was still underdeveloped during the 1980s. It is also possible that Loanware coverage is less complete at the beginning of the period or for some countries. Therefore, in the empirical analysis we make sure that our results do not hinge upon the inclusion of the 1980s or of countries with fewer than 100 loans.

2.3. Measuring Cultural Distance

The definition of culture usually includes some notion of shared values, beliefs, codes, and norms. The World Values Survey (WVS) is an attempt by social scientists to measure cultural values around the world. The WVS initially covered only 22 countries and was conducted at ten-year intervals; currently, the survey covers about 80 countries and is updated every five years. The survey consists of a detailed questionnaire on

² Contracting costs may be pecuniary or nonpecuniary. The line of demarcation between the two is tenuous. For instance, Becker (1971) recognizes that taste-based discrimination may arise not from the prejudice of the employer (the firm), but from the tastes of coworkers who demand to be compensated by higher wages for working with minorities.

Figure 1 Cultural Map of the World



Source. World Values Survey, <http://www.worldvaluessurvey.org>; Inglehart and Welzel (2005, p. 63).

concrete aspects of life (about 250 questions) administered in face-to-face interviews; the average number of respondents is 1,400 per country.

Inglehart (1997) and Inglehart and Baker (2000) show that diverse orientations tend to cluster together in coherent patterns. Consequently, they use factor analysis to summarize the salient features of different cultures along two dimensions (values): (1) the extent to which a society emphasizes traditional as opposed to secular values; (2) the extent to which a society emphasizes values related to survival as opposed to self-expression. In societies with traditional values, individuals emphasize religion, family ties, and deference to authority. Survival values are considered to be predominant in societies with low interpersonal trust, which tend to be intolerant of ethnic and cultural minorities, do not support gender equality or environmental protection, and often favor authoritarian governments. Besides affecting corporate policies on gender, diversity, environment etc., cultural values are related also to the degree of centralization of

organizations, the identities of the individuals conducting the negotiations, and whether they actually have the power to make decisions.

Cultural distance between any pair of countries can be measured as the Euclidean distance between the traditional versus secular/rational and the survival versus self-expression orientations. The cross-country cultural differences that emerge are summarized in a cultural map of the world, reproduced in Figure 1 on the basis of a recent edition of the survey. Although the time-series variation in cultural distance is limited, whenever possible, we measure culture in the years that immediately precede the signing date of the loan.

We attribute to each borrower the culture of its own country and to the lead bank the culture of the country where its headquarters are located for two reasons. First, the individuals writing the contracts or the executives with high decision power are likely to be nationals of the bank's and the borrower's country. Second, the culture of the headquarters' country

affects organizational culture and the degree of centralization of the subsidiaries (Bloom et al. 2009).

Because religion has an important role in shaping cultural values, we also use a dummy variable that takes the value one if the countries of the borrower and of the lead bank share the same religion as a proxy for cultural similarity. In Giannetti and Yafeh (2010), we also show that our results are robust to the use of alternative measures of cultural distance, constructed by Hofstede (2001) and Schwartz (2006). In particular, Hofstede's "power-distance" score captures the centralization of decision power and allows us to measure cultural differences related to organizational structure. Finally, in Giannetti and Yafeh (2010), we also examine to what extent cultural distance captures trust between nations. We run a horse race between our measure of cultural distance and the proxy for trust proposed by Guiso et al. (2009) and find that, although our proxy for cultural distance is positive and statistically significant, trust is not, indicating that cultural differences matter beyond trust.³

3. Main Variables and Descriptive Statistics

Our sample includes about 86,000 loans to over 40,000 borrowers in more than 70 countries from 1980 to 2005. There are more than 6,500 lead banks from nearly 60 countries and over 8,000 participant banks. The list of the largest borrower and lead bank nationalities and the cultural distance between them is presented in panel A of Table 1.

Panel B of Table 1 describes ex ante loan characteristics. In most of the analysis, we focus on the loan spread, which is measured as the basis point spread over the LIBOR (London Interbank Offered Rate), inclusive of all fees. Our results, however, are robust if we use a measure of the cost of the loans that excludes fixed fees. Nonprice terms also affect the lender's ability to obtain a fair return on the loan; these include the loan amount, its maturity, and whether the loan is secured or guaranteed by a third party. Finally, we also observe the borrower's credit rating (if any) at the time the loan is granted and any subsequent changes in rating before the maturity of the loan, including whether the loan is downgraded to default.

Loanware also provides information on the identity of the lead banks and their nationalities, as well as on the composition of the syndicate. For over 75% of

the loans in our sample, there is only one lead bank. We thus consider the lead bank as *the* lending bank (as is customary in the literature) and use the lead bank's nationality to define cultural distance from the borrower and all the other lead bank's nationality-based variables. In the few cases in which there are several lead banks, to be as conservative as possible, we define all the variables with respect to the lead bank that is culturally closest to the borrower.⁴

Panel C of Table 1 presents the various measures of distance between borrower and lender. Beside the measure of cultural distance from the WVS, we also use physical distance and the absolute value of the difference between the index of creditor rights in the borrower's and the lead bank's countries. Moreover, in most of regressions, we include four dummy variables (not tabulated) capturing, respectively, countries with a common border, with a common legal tradition, with the same language, and with common colonial ties. These features have been shown to favor international trade (Rose 2004). Admittedly, language and common history capture aspects of culture. Nevertheless, we include these variables as controls because the aspects we want to capture are not necessarily related to the spoken language or to colonial history.⁵

Panel D of Table 1 summarizes the salient features of the syndicate composition. Our goal here is to explore the extent to which risk sharing within the syndicate depends on the cultural distance between the lead bank and each of the participants. In a situation of perfect risk sharing, all (similar) banks in the syndicate would equally fund the loan. However, if negotiations between culturally distant banks are less effective, the extent of risk sharing may be lower. We define actual risk sharing in the syndicate as the loan amount provided by a given participant bank standardized by the loan that each bank in the syndicate would provide under perfect risk sharing, minus the loan amount provided by the lead bank, also standardized by the loan that each bank would extend under perfect risk sharing. This variable does not depend on the total size of the loan and on the number of syndicate participants and therefore allows us to measure a participant bank's willingness to share risk with a particular lead bank. As in the case of lead bank–borrower relations, we define distance variables

⁴ Our results are unchanged if we restrict the sample to syndicated loans with one lead bank only.

⁵ For instance, management scholars suggest that negotiators from France or Belgium should expect greater problems in cooperating with negotiators from Denmark, New Zealand, or the United Kingdom than with negotiators from, say, Korea or El Salvador because the culture of the latter stresses authority to a similar large extent (Mead and Andrews 2009).

³ We also explore whether the effect of cultural distance is asymmetric. First, we consider whether cultural distance matters more if the borrower is in a weaker creditor protection country than the lender. Second, we consider whether borrowers from countries that tend to stress more traditional and survival values obtain worse loan terms. In all these unreported tests, we find that the effect of cultural distance is symmetric.

Table 1 Variable Definitions and Sample Statistics

Lenders	Borrowers																Total lenders					
	AU	BRZ	CA	CHN	FR	GR	HK	INDIA	INDO	IT	JPN	MX	NL	NOR	SING	KOR		SP	SWE	TUR	UK	US
Australia (AU)	635		10 (0.2)						15 (2.6)											18 (0.7)	101 (0.6)	875
Brazil (BRZ)		158 (0.2)	0																	97 (0.4)	1,470 (0.4)	176
Canada (CA)		11 (2.0)	1,574										15 (1.0)									3,306
China (CHN)				189			293 (0)								13 (1.5)	21 (0.21)						540
France (FR)	13 (1.3)	20 (1.8)	27 (0.9)	39 (2.1)	610		41 (1.7)	29 (1.7)	76 (2.2)	39 (0.5)	30 (1.4)	17 (1.7)	16 (0.8)			76 (1.2)	48 (0.9)		54 (1.8)	98 (0.5)	671 (1.4)	2,097
Germany (GR)	31 (1.7)	16 (2.6)	24 (1.6)	70 (1.8)	19 (0.8)	777	72 (1.7)	24 (2.2)	50 (2.5)	37 (1.0)	45 (0.8)	13 (2.6)	14 (1.2)	108 (0.3)	22 (2.0)	112 (1.3)	37 (1.2)	21 (0.9)	36 (2.4)	143 (1.2)	1,177 (2.1)	3,388
Hong Kong (HK)				44 (0)			86															140
India (INDIA)							213															242
Indonesia (INDO)								208														220
Italy (IT)				23 (1.9)			15 (1.6)	13 (1.8)	1,288							11 (1.2)	41 (0.4)		54 (1.5)	16 (0.5)	63 (1.0)	1,744
Japan (JPN)	107 (2.4)	25 (3.2)	20 (2.2)	167 (1.6)	29 (1.4)	38 (0.9)	268 (1.5)	53 (2.5)	155 (3.1)	97 (1.6)	256		14 (1.9)	16 (1.0)	41 (2.4)	413 (1.0)	55 (1.8)	28 (1.6)	23 (2.8)	116 (1.9)	1,001 (2.8)	3,150
Mexico (MX)											80											85
Netherlands (NL)	10 (1.0)	15 (2.9)	19 (1.0)	12 (2.7)			34 (2.7)	42 (3.1)				14 (2.7)	505 (0.6)	18 (0.6)	10 (2.6)	17 (2.5)	11 (0.8)			34 (0.9)	986 (1.4)	1,884
Norway (NOR)														267							49 (2.0)	342
Singapore (SING)															222							552
South Korea (KOR)				61 (0.5)			73 (0.2)	69 (2.2)								789					45 (2.7)	1,098
Spain (SP)		34 (1.4)								18 (0.4)		66 (1.1)					1,160		25 (1.0)	19 (0.8)	22 (1.3)	1,617
Sweden (SWE)																		402				538
Turkey (TUR)																						142
United Kingdom (UK)	50 (0.6)	21 (2.0)	55 (0.4)	33 (2.5)	28 (0.5)	28 (1.1)	185 (2.2)	29 (2.0)	62 (2.2)	25 (0.6)	13 (1.8)	20 (1.6)	30 (0.9)		39 (1.8)	81 (2.1)	63 (0.9)		13 (1.9)	4,093	848 (0.9)	5,913
United States (US)	102 (0.6)	115 (1.7)	229 (0.4)	17 (3.1)	26 (1.3)	26 (1.9)	56 (2.8)	47 (2.2)	119 (2.1)	32 (1.2)	38 (2.6)	265 (1.3)	35 (1.4)		27 (1.9)	52 (2.6)	60 (1.3)		90 (1.7)	238 (0.9)	52,650	54,909
Total borrowers	1,029	503	2,048	719	755	906	1,198	516	974	1,615	421	525	679	457	427	1,626	1,540	504	621	5,085	59,810	

Panel A. Number of loans to major borrowing countries

Table 1 (Continued)

Variable	Definition/source	Units	Mean	Std. dev.	25%	Median	75%	Obs.
Panel B. Contract characteristics								
<i>Spread</i>	Loan cost including all fees/Loanware	Basis points p/a above LIBOR	189	219	62.5	150	250	86,354
<i>Amount</i>	Loanware	Million USD	190.5	517.2	20	60	175	116,803
<i>Maturity</i>	Loanware	Years	4.3	3.2	2	4	5.5	101,202
<i>Secured</i>	Dummy that takes the value 1 if the loan is secured/Loanware	0/1	0.29	0.45	0	0	1	117,194
<i>Guaranteed</i>	Dummy that takes the value 1 if the loan is guaranteed/Loanware	0/1	0.07	0.26	0	0	0	117,194
<i>Tranched</i>	Dummy that takes the value 1 if the loan is offered in several separate tranches/Loanware	0/1	0.46	0.49	0	0	1	86,354
<i>Number of banks</i>	Number of banks in the syndicate		7.6	9.1	2	4	10	86,354
<i>Foreign bank</i>	Dummy that takes the value 1 if the firm borrows from a foreign bank/Loanware	0/1	0.22	0.41	0	0	0	86,354
<i>Borrower interaction</i>	Total number of loans (including current) of the lead bank to the borrower/Loanware		1.5	1.1	1	1	2	86,354
<i>Rating</i>	Borrower credit rating at the time the contract is signed on a scale from 1 (AAA) to 21 (C or lower); refers to the lower of Moody's and S&P's ratings, if both are available	1 to 21	10.9	4.4	7	11	15	25,202
<i>Default</i>	Proportion of borrowers classified by Moody's or S&P's as in default	Percentage	0.5	0.7	0	0	0	86,354
Panel C. Measures of distance between borrower and lead bank								
<i>Cultural distance</i>	Euclidean distance between the cultures of the borrower's and the lead bank's countries/WVS	See text for details	0.30	0.68	0	0	0	86,354
<i>Distance</i>	Physical distance between the capital of the country of the lead bank's headquarters and the capital of the borrower's country/Infoplease.com	1,000 km	1.21	3.27	0	0	0	86,354
<i>Creditor rights distance</i>	Absolute value of the difference between creditor rights in the lead bank's country and in the borrower's country/Djankov et al. (2007)	0 to 4	0.27	0.70	0	0	0	86,354
Panel D. Syndicate composition and characteristics								
<i>Risk sharing</i>	$(\text{Loan held by participant } i)/(\text{loan amount}/\text{number of banks}) - (\text{loan held by the lead bank})/(\text{loan amount}/\text{number of banks})/\text{Loanware}$		-2.3	17.92	-1.82	-0.98	-0.5	225,704
<i>Interaction syndicate</i>	Number of previous deals of a participant bank with a lead bank, including current/Loanware		7.99	11.34	1	2	9	225,704
<i>Banks' cultural distance</i>	Cultural distance between the participant bank's and lead bank's countries/WVS	See text for details	0.68	0.88	0	0.22	1.17	225,704
<i>Banks' distance</i>	Physical distance between the capital of the country of the lead bank's headquarters and the capital of the country of the participant bank's headquarters/Infoplease.com	1,000 km	2.79	4.18	0	0.3	5.86	225,601
<i>Creditor rights distance syndicate</i>	Absolute value of the difference between creditor rights in the participant bank's country and in the lead bank's country/Djankov et al. (2007)	0 to 4	0.64	0.93	0	0	1	225,704

Notes. Panel A presents the top 20 borrowers and lenders' nationalities in the sample. The nationality of the lead lender is listed in the rows and borrower nationality is listed in the columns. The total figures in the rows (columns) include all loans from lenders (to borrowers) in each country, not only the ones involving the top 20 borrowing nations. Cultural distance, from the World Values Survey, appears in parentheses. The figures are time varying and are calculated for the years in which contracts are signed; therefore, the average cultural distance between, for example, lenders from France and borrowers from Germany, need not be exactly equal to the cultural distance between lenders in Germany and borrowers in France. The other countries included in the sample, but not reported in panel A either as lenders or as borrowers are Algeria, Argentina, Austria, Bangladesh, Belarus, Belgium, Bulgaria, Chile, Colombia, Croatia, Czech Republic, Denmark, Egypt, El Salvador, Finland, Ghana, Greece, Hungary, Iran, Ireland, Israel, Jordan, Latvia, Lithuania, Morocco, New Zealand, Nigeria, Pakistan, Peru, Philippines, Poland, Portugal, Puerto Rico, Romania, Russia, Saudi Arabia, Slovakia, Slovenia, South Africa, Switzerland, Tanzania, Ukraine, Uruguay, Venezuela, Vietnam, and Zimbabwe. The statistics in all panels of Table 1 are calculated using only observations included in subsequent tables. For variables used in the analysis of loan spreads, we use only observations included in column (5) of Table 3, which we use as a benchmark in most of the subsequent tests. For other variables, we use only observations included in the regression where the variable is used.

using the countries where the headquarters of the participants and of the lead bank are located. As above, if there are multiple lead banks, we select the lead bank that is culturally closest to a given participant.

Besides the loan ratings, the following untabulated loan characteristics allow us to control for borrower heterogeneity: 56 industry dummies; 21 dummies capturing the loan purpose (e.g., whether the loan is needed to finance an acquisition, to buy a specific asset, or as working capital); and 11 borrower type dummies capturing whether the borrower is publicly or privately owned and whether it is a bank, another type of financial institution, a utility company, or a company in another industry. All these borrower characteristics and, in particular, the credit rating, capture differences in the risk of firm assets and capital structure (Kisgen 2006). We also include 46 dummies capturing the loan instrument type (e.g., whether the loan is a credit line, a term loan, a bridge facility etc.) and 69 currency dummies.⁶

In addition, we match by name Loanware firms with Worldscope to obtain financial statements for a subsample of large listed borrowers. For this subsample, whose size is comparable to the sample of Qian and Strahan (2007), we have information on sales, percentage of foreign sales, the market to book ratio, profitability (net income over assets), and the proportion of tangible assets (property, plants and equipment) over total assets. Finally, we collect time-varying country controls, including a proxy for the supply of credit in the borrower's country (credit to gross domestic product (GDP)) as well as creditor rights and GDP per capita in the countries of both the borrower and the lead bank.

A major question is whether domestic banks, culturally close banks, and culturally distant (foreign) banks attract different types of borrowers. In Table 2, we define culturally close banks as those whose cultural distance is below the mean of the subsample of foreign banks and show how contract terms and borrower characteristics vary across lending banks. Loans extended by culturally distant banks have, on average, lower spreads than loans extended by domestic banks, but are more expensive than the ones extended by culturally close (foreign) banks. Because we include no controls, this evidence is not necessarily inconsistent with our conjecture. Even though on average foreign banks are able to extend cheaper loans than domestic banks, they may provide more restrictive loan terms to culturally distant borrowers than to the average of their other clients. Culturally distant banks appear to be more likely to extend smaller loans and to require guarantees or collateral.

⁶ Even though some of these are endogenously chosen contract features, their inclusion may help capture the risk of the loan. The omission of subsets of the dummies does not affect our estimates.

Differences in borrower characteristics across different subsamples are economically quite small. For instance, the average rating of loans issued by domestic banks is slightly lower than the average rating of loans issued by culturally distant and especially culturally close foreign banks. To the extent that any unobserved heterogeneity is correlated with the initial rating of the loans, having domestic banks, for which cultural distance is zero, as the bulk of the sample makes it more difficult to find a negative effect of cultural distance on contract terms. Similar conclusions on the direction of any unobserved heterogeneity can be drawn from the ex post performance of the loans issued by different groups of banks. Focusing on rated borrowers and on loans whose rating changes, the proportion of upgraded loans is larger for loans issued by culturally distant banks than for loans issued by domestic banks. Also, culturally distant banks do not appear to lend to firms with more volatile performance as the rating of a smaller fraction of their borrowers is changed after the granting of the loan.

Finally, firms borrowing from foreign banks have similar size and profitability. Most importantly, in comparison with firms borrowing from domestic lenders, firms borrowing from culturally distant banks have lower leverage ratios and more tangible assets, suggesting that they are more creditworthy. Overall, Table 2 provides no indication that culturally distant banks systematically attract worse borrowers and makes it unlikely that unobserved heterogeneity drives our results.

4. The Effects of Borrower–Lender Cultural Differences on Loan Contracts

4.1. Empirical Approach

We estimate reduced form equations. Besides cultural distance and the controls described in §3, in all equations, we include dummies for the borrower's and lead bank's nationalities, which may systematically affect contract terms. For instance, the expected repayment may be systematically lower for borrowers in countries with weak creditor protection (Qian and Strahan 2007). Similarly, the cost of extending a loan may be systematically higher for banks from countries with higher funding costs. We also include year dummies to control for differences in credit market conditions over time.⁷

⁷ In unreported specifications, we include interaction terms of borrower nationality and year dummies thus controlling for any possible changes in the borrower's economic environment. The effect of cultural distance is similar to the one we report.

Table 2 Characteristics of Firms Borrowing from Domestic, Culturally Close, and Culturally Distant Banks

	Domestic banks	Low cultural distance bank	High cultural distance banks
Observations	68,084	8,841	9,429
Outcomes			
Spread	193* (150) [226]	169* (108) [195]	180 (131) [190]
Loan amount	217* (73) [570]	159* (60) [400]	125 (50) [387]
Loan maturity	4.2* (4.0) [2.9]	4.8* (5.0) [3.5]	4.6 (4.0) [3.5]
Secured (%)	31*	26*	35
Guaranteed (%)	5*	12*	18
Ratings and rating changes			
Average rating (on a scale from 1 (AAA) to 21 (C))	11.1* (11) [4.4]	9.7* (9) [4.4]	10.4 (10) [4.6]
Unrated (%)	70.4*	71.3*	75.8
Proportion of upgraded firms out of all firms for which the rating changed after the granting of the loan	48.2*	50.4%	51.5%
Proportion of firms whose rating changed after the granting of the loan (%) relative to firms with unchanged rating	29.6*	27.9*	25.2
Proportion of unrated firms that obtained a rating after the granting of the loan (%)	10.7	11.2	10.6
Default (%)	0.4	0.7	0.5
Firm attributes			
Observations	10,371	1,353	1,171
Sales (million U.S. dollars)	3,175,593 (645,878) [10,500,000]	3,871,536 (1,186,925) [12,600,000]	3,029,002 (1,511,165) [4,393,677]
Leverage	0.34* (0.30) [0.38]	0.34* (0.31) [0.26]	0.32 (0.30) [0.21]
Net income over assets	0.08 (0.11) [0.42]	0.09 (0.10) [0.29]	0.08 (0.11) [0.32]
Property, plant, and equipment (PP&E) over assets	0.37* (0.31) [0.27]	0.38* (0.36) [0.31]	0.42 (0.44) [0.30]

Notes. This table presents sample means, medians (in parentheses), and standard deviations (in square brackets). Low cultural distance is defined as positive cultural distance below the sample mean that is about 1.4 for the subsample of foreign banks and high cultural distance is defined as cultural distance exceeding 1.4. We present statistics for contract terms, initial ratings, and rating changes (upgrades or downgrades after the loan was granted) and firm characteristics.

*Denotes differences in means statistically significant at the 5% level relative to the means reported in column (3).

Our extensive set of controls should capture borrower heterogeneity. Thus, any effect of cultural distance on loan terms should be interpreted as arising from culturally distant banks' policies toward (similar) borrowers. However, it is important to stress that the ordinary least squares estimates of the effect of cultural distance on loan terms rest on the assumption that bank and borrower characteristics unrelated to cultural distance drive the matching of borrowers and lenders. As discussed in §2.1., this identifying

assumption is consistent with the organization of the syndicated loan market, in which borrowers face search and bargaining frictions. To the extent that the nonrandom selection of borrowers could affect our estimates, the direction of the bias may be against finding any negative effect of cultural distance on contract terms as, for instance, in Table 2 we find that the clients of culturally distant banks are more likely to be upgraded after the loan is granted.

Nevertheless, we explicitly examine whether unobserved heterogeneity biases our estimates using two alternative methodologies. First, we include borrower-fixed effects and explore whether cultural distance affects the terms at which the same borrower obtains loans from different banks. Second, we consider a two-stage selection model. This involves modeling the probability that a firm obtains the loan from a given lead bank and including the inverse Mills ratio obtained from the estimated probability in the second-stage equation. In the first stage, we hypothesize that a given borrower could obtain a loan from any of the domestic and foreign lead banks that ever extended a syndicated loan to borrowers in the same country up to the year in which the contract is signed. We estimate the probability of observing a match between a particular lead bank and a particular borrower as a function of borrower, country, and lead bank characteristics.⁸

To capture the variation in the probability of a bank-firm match that is independent of borrower characteristics and directly test for the existence of a matching mechanism driven by search and bargaining frictions, we posit that the probability of a bank-firm match depends on the distribution and the numbers of banks active in a country. In particular, we include the bank's rank in the country (obtained by counting the number of deals the bank completed up to the year in which the contract is signed) and the number of physically and culturally close banks (banks with physical or cultural distance below the mean). Similarly to Sorensen (2007) and Bottazzi et al. (2008), our identifying assumption is that the characteristics of the other investors in the market should not be directly related to the cost of funding, after controlling for the aggregate supply of credit.

4.2. Loan Spread

Table 3 shows that the effect of cultural distance on the loan spread is consistently positive and significant. Because we include lead bank nationality dummies, a positive effect of cultural distance on the cost of the loan does not necessarily imply that the borrower receives funding at a higher absolute cost from a culturally distant bank than from a domestic one. For example, French banks on average extend loans at a lower interest rate than domestic banks to culturally distant U.S. borrowers and, at the same time, offer worse contract terms to U.S. borrowers than to culturally closer Belgian borrowers. The effect of

cultural distance is also economically significant. In column (5), the benchmark specification with a comprehensive set of controls, a one-standard-deviation increase in cultural distance, approximately the difference between Canada and the United States, increases the spread by approximately 6.5 basis points, or about 4% of the sample median spread of 150 basis points.

We explore whether borrower unobserved heterogeneity leads us to overestimate the effect of cultural distance by including different sets of controls for borrower heterogeneity. To the extent that unobserved heterogeneity in borrower characteristics is correlated with the observed controls, the coefficient estimates should vary a lot across columns. In fact, the coefficient estimates are very similar, when we include no controls for borrower rating (column (1)), when we control for rating by including 4 or 14 rating groups (columns (2) and (3), respectively). In column (4), we add controls for a number of loan characteristics. The latter are admittedly jointly determined with the interest rate; yet they help in further controlling for borrower heterogeneity, for loan size, and for the possible effects of risk sharing within the syndicate.⁹ The coefficient of cultural distance remains unaffected.

In column (5), we include other controls for distance. In line with our maintained hypothesis, the spread is slightly lower if we include the same religion dummy, an alternative proxy for cultural similarity. Sharing the same language or colonial history seems largely irrelevant. Other aspects of remoteness such as the physical distance between the capital cities of the borrower's and the lead bank's countries do not have a significant effect. This is probably because many lead banks have subsidiaries in the country of the borrower or in nearby countries, which may mitigate the effect of geographical, but not of cultural distance; we revisit this issue in §4.5. Interestingly, differences in creditor rights between the countries of the borrower and of the lender increase loan spreads. However, the effect has only weak statistical significance.

In column (6), we include only loans extended by foreign lead banks; our estimates are qualitatively unchanged, showing that the results are not driven by the difference between domestic and foreign banks. The results are also unchanged if we include lender fixed effects (column (7)). In addition, the effect of cultural distance remains unchanged when lead banks from the United States or the United Kingdom are excluded (results not reported) suggesting that the effect is not driven by the behavior, or market power, of the largest and most reputable banks, which tend to

⁸ In these tests, to keep the size of the data set manageable, we rank lead banks according to the loans issued up to the contract year in each country and keep in the sample at most the top 500 active lead banks; any loans extended by lead banks that are not among the top 500 are excluded. Different cutoffs (50, 100, 200, and 300) yield similar results.

⁹ The nationalities of banks participating in the syndicate without leading it are not expected to affect the loan terms, which are determined by the lead bank before other participants join the syndicate.

Table 3 The Determinants of Loan Spreads

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	No rating controls	4 rating groups controls	14 rating groups controls	Contract terms controls	Other distances	Foreign banks only	Lender fixed effects	No U.S. borrowers	Firm level controls	Rated borrowers
<i>Cultural distance</i>	12.86*** (3.172)	13.09*** (3.190)	13.11*** (3.187)	11.15*** (2.533)	8.692** (4.130)	11.20*** (4.169)	11.57*** (4.196)	17.44*** (4.473)	12.99* (7.612)	23.81*** (4.679)
<i>Distance</i>					−0.0339 (0.682)	−0.974 (0.754)	0.263 (0.717)	−0.0193 (0.773)		
<i>Common border</i>					−10.04 (6.949)	−23.04*** (7.893)	−3.184 (8.371)	−7.303 (7.414)		
<i>Same legal origin</i>					7.607 (4.912)	8.573* (4.887)	5.716 (6.049)	6.440 (4.686)		
<i>Same religion</i>					−7.806* (4.391)	−10.81** (4.823)	−9.325* (5.284)	−9.781* (5.246)		
<i>Same language</i>					−5.431 (6.857)	−0.00283 (7.163)	−1.895 (7.349)	−7.230 (6.709)		
<i>Common colonial ties</i>					3.699 (6.173)	−12.30 (17.12)	2.633 (7.425)	12.72 (8.000)		
<i>Creditor rights—borrower</i>					−10.56 (7.590)	−10.87 (8.848)	−12.42 (8.090)	−5.233 (7.777)		
<i>Creditor rights—lead bank</i>					16.77*** (6.163)	8.987 (6.379)	12.87* (7.404)	8.041 (7.340)		
<i>Creditor rights distance</i>					2.293 (2.792)	3.182 (2.851)	4.905* (2.723)	4.512 (3.325)		
<i>Creditor rights are better in lender country dummy</i>					−8.358 (9.867)	−8.594 (9.278)	−18.44** (9.012)	−9.608 (10.86)		
<i>Credit to GDP—borrower</i>	0.0498 (0.0873)	0.0535 (0.0886)	0.0407 (0.0884)	0.0424 (0.0685)	0.0610 (0.0668)	0.320*** (0.116)	0.0283 (0.0741)	0.106 (0.0768)	0.0646 (0.141)	−0.132 (0.112)
<i>Per capita GDP—lead bank</i>	−4.52*** (1.742)	−4.48*** (1.710)	−4.359*** (1.643)	−4.006*** (1.360)	−4.99*** (1.414)	−4.67*** (1.790)	−3.199** (1.396)	−3.70*** (1.347)	−13.41** (5.237)	−7.49*** (2.367)
<i>Per capita GDP—borrower</i>	1.747 (1.789)	1.070 (1.713)	1.165 (1.660)	0.449 (1.303)	1.203 (1.360)	−0.915 (1.473)	−0.808 (1.265)	−1.423 (1.388)	−1.787 (5.227)	6.404** (2.909)
<i>Tranched</i>	25.61*** (2.644)	25.06*** (2.638)	23.16*** (2.249)	22.50*** (4.581)	25.27*** (4.997)	16.50*** (3.613)	25.00*** (1.631)	12.08*** (2.525)	11.68*** (4.025)	25.17*** (1.658)
<i>Number of loan purposes</i>	−4.05*** (1.104)	−3.55*** (1.103)	−3.13*** (1.097)	−2.830 (2.522)	−3.484 (2.159)	−4.071 (4.154)	−3.331 (2.072)	−2.259 (2.793)	−10.85** (5.465)	−5.73*** (1.452)
<i>Rating group 2 (B-letter ratings)</i>		43.26*** (14.10)			44.02*** (12.15)	7.752 (8.073)	49.28*** (3.283)	1.410 (6.157)		56.68*** (7.227)
<i>Rating group 3 (C-letter ratings)</i>		137.0*** (18.50)			137.8*** (26.90)	56.21*** (18.94)	136.2*** (6.129)	91.47*** (21.52)		146.4*** (9.068)
<i>Rating group 4 (unrated)</i>		51.55*** (15.34)			52.30*** (12.34)	13.71* (7.591)	59.12*** (3.017)	8.823* (5.050)		
<i>Number of banks</i>				−0.66*** (0.166)						
<i>Amount</i>				−0.01*** (0.00260)						
<i>Maturity</i>				2.303*** (0.631)						
<i>Secured or guaranteed</i>				−4.518 (3.895)						
<i>Sales/100</i>									−0.0008*** (0.0000001)	
<i>Financial leverage</i>									2.792*** (0.383)	
<i>% foreign sales</i>									−0.0208 (0.0303)	
<i>Net income over assets</i>									−0.526 (0.388)	
<i>Property, plant, and equipment/assets</i>									−7.058 (5.423)	
Observations	86,701	86,701	86,701	77,771	86,354	18,607	86,772	26,544	6,108	24,530
R ²	0.100	0.106	0.111	0.118	0.106	0.183	0.186	0.309	0.170	0.170

Notes. The dependent variable is the spread. All regressions include 21 primary loan purpose dummies, 46 loan instrument dummies, 69 currency dummies, 11 borrower type dummies, 56 borrower business (industry) dummies, year dummies, borrower nationality dummies, lead bank nationality dummies and a constant term. Regression 3 includes 14 rating group dummies whose coefficients are not reported. Parameters are estimated by ordinary least squares. Standard errors are presented in parentheses and are corrected for heteroskedasticity and clustered at the borrower nationality times lead bank nationality level.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

be headquartered in the United States and the United Kingdom. The robustness of the results to the exclusion of U.S. and UK lenders, as well as to the exclusion of U.S. borrowers (column (8)) suggests that the effect of cultural distance is not restricted to the interaction between “Anglo-Saxon” economic agents and the rest of the world. The estimated effect of cultural distance on the spread remains unchanged even after controlling for firm size (sales), financial leverage, percentage of foreign sales, profitability, and the proportion of tangible assets (property, plants, and equipment) in column (9). Thus, any remaining unobserved heterogeneity biasing our results should be uncorrelated with any of these factors, which is unlikely.

We also run the regressions for groups of borrowers with the same ratings, for rated borrowers (for which information problems are presumably less severe) and for loans issued in different continents. The estimates (reported only for the subsample of rated borrowers in column (10)) show that the effect of cultural distance is once again unchanged. Finally, we consider whether the effect of cultural distance changes over time. The results are qualitatively unchanged if we drop the loans issued during the 1980s; however, during the 1980s, the effect of cultural distance is larger than the one we report in Table 3.

Some insights can be gained from the coefficients of the control variables. It is comforting that loan spreads are higher for borrowers with ratings below A; unrated borrowers obtain credit at lower interest rates than borrowers with C or lower ratings. Furthermore, stronger creditor rights in the borrower’s country tend to decrease the loan cost, even though—unsurprisingly given that we include borrower nationality fixed effects—the coefficient is not statistically significant in most specifications.

We further address the issue of unobserved heterogeneity by using borrower fixed effects. Column (1) of Table 4 shows that, not only does the effect of cultural distance on the loan spread continue to be positive and significant, but the magnitude of the coefficient is similar to the one in Table 3. We also estimate a two-stage Heckman selection model. The first-stage estimates in column (2) of Table 4 confirm that our instruments are statistically significant: The probability that a loan is obtained from a given bank is decreasing in the number of physically and culturally close banks. In addition, cultural distance does not affect the probability of a bank-borrower match, in line with empirical evidence showing that agents understate the effect of cultural differences on economic outcomes (Weber and Camerer 2003). In the second stage, the coefficient of the inverse Mills ratio is not statistically significant, further indicating that selection problems are not driving our results. Most

strikingly, the effect of cultural distance is now almost twice as large as in Table 3.¹⁰

4.3. Nonprice Contract Terms

An effect of cultural differences on contracting costs should be reflected also in more restrictive nonprice loan terms. Estimates in Table 5 show that culturally distant banks provide smaller loans (column (1)) and are more likely to request loan guarantees from a third party (column (4)). These effects are also economically significant: A lender whose cultural distance from the borrower is about one (roughly the cultural distance between Germany and the United Kingdom) is likely to receive a loan that is nearly four million dollars (6.7% of the sample median) smaller than a similar domestic borrower; the probability that a third party guarantee for the loan would be required is higher by about two percentage points, a large number given that only about 7% of the loans in the sample are guaranteed. Cultural distance also has a positive impact on the probability that the loan is secured, although the effect is not statistically significant at conventional levels. We find no effect of cultural distance on loan maturity.

4.4. Ex Post Performance

If culturally distant banks had a rational concern about attracting clients with poor credit prospects, then the loans to these borrowers should exhibit poor performance relative to the average loan. To evaluate the ex post performance of borrowers, we first consider the probability of default. As in previous literature (Altman and Suggit 2000, Emery and Cantor 2005), we identify defaulting borrowers as borrowers that are rated when the loan is extended and are then downgraded to a default rating. As mentioned above, we first verify that cultural distance increases the cost of the loans also in this subsample. Then, we test whether the probability of default after the loan is granted is higher for borrowers receiving loans from culturally distant banks. Column (1) of Table 6 shows that cultural distance is unrelated to the default probability.

Because default rates in the syndicated loan market are quite low, they may not fully capture the exposure of the lender to credit risk. We therefore explore changes in the credit rating of borrowers after the loan is granted. A borrower’s upgrade (downgrade)

¹⁰ The standard errors we report in Table 4 are not corrected for clustering. This is because, with our large set of controls in the fixed effect and the Heckman models, Stata is unable to compute clustered standard errors. This inconvenience disappears if we exclude some controls, such as the instrument type dummies; the estimates of our variable of interest remain highly statistically significant with clustering at the borrower nationality times lead bank nationality level.

Table 4 Addressing Selection Problems

	(1)	(2)	(3)	
	Borrower fixed effects		Heckman selection model	
	Spread	Bank-firm match	Spread	
<i>Cultural distance</i>	11.07** (5.129)	−0.0178 (0.012)	17.59** (7.03)	
<i>Distance</i>	−0.247 (0.855)	0.000702 (0.0026)	3.275** (1.43)	
<i>Same religion</i>	−6.475 (6.272)	0.0164 (0.018)	−35.91*** (9.47)	
<i>Bank rank</i>		−0.102*** (0.015)		
<i>Number close banks</i>		−0.790*** (0.032)		
<i>Border × Number of close banks</i>		−0.0791*** (0.0061)		
<i>Number of culturally distant banks</i>		0.109*** (0.0073)		
<i>Border × Number of culturally distant banks</i>		−0.0859*** (0.0067)		
<i>Mills ratio</i>			−17.786 (14.298)	
Observations	86,354	350,411	15,963	
Wald chi-squared			7,726.77	
R^2	0.502			

Notes. Column (1) presents estimates obtained by controlling for borrower fixed effects. Columns (2) and (3) report the estimates of a Heckman selection model. In column (2) (first stage), we consider how a borrower is matched to all top 500 potential lead banks in the country; the unit of analysis is the potential borrower-lead bank match and the dependent variable is a dummy that takes the value one if a borrower receives a loan from a given lead bank that has been operational in its country in the past, and equals zero if the borrower does not receive a loan from that lead bank. In column (3), we consider all loans issued by the top 500 lead banks in country. In addition to variables defined in Table 1, the selection equation in column (2) includes the rank of the lead bank in a country according to the number of deals concluded up to the year of the loan, the number of close foreign banks (foreign banks from countries with a capital city less than 2,000 km from the capital city of the country of the borrower), and the number of culturally distant foreign banks (foreign banks with cultural distance above the median cultural distance from the country of the borrower). In addition to the reported coefficients, we include all the control variables used in column (5) of Table 3 as well as 21 primary loan purpose dummies, 46 loan instrument type dummies, 69 currency dummies, year dummies, dummies, lead bank nationality dummies, and a constant term. Standard errors are presented in parentheses.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

indicates that its credit quality has improved (deteriorated) after the extension of the loan and prior to its maturity.¹¹ In column (2), we present estimates of an ordered probit model in which we consider obtaining a rating as an upgrade and losing a rating as a downgrade. Strikingly, after controlling for loan and borrower country characteristics, culturally distant borrowers are more likely to be upgraded, not downgraded. This confirms that the loan terms offered by culturally distant banks are not justified by the borrowers' poor credit prospects.

The estimates in column (2) include unrated firms and cases where such firms obtain a rating (lose a

rating) are treated as upgrades (downgrades). In column (3), we restrict the sample to firms with actual rating changes. The estimates again suggest no systematic effect of cultural distance. This result holds also when a rating change refers not only to letter grade changes but also to changes in notches within the same letter grade.¹²

¹² We also estimate separate probit models for upgrades and downgrades. For upgrades (downgrades) we define the dependent variable to be equal to one if the borrower is upgraded (downgraded) by at least a notch and equal to zero if the borrower's rating is unchanged or if the borrower is downgraded (upgraded). Including the same controls as in the ordered probit models in Table 6, we find that a marginal increase in cultural distance increases the probability of an upgrade by 16% (the effect is statistically significant at 5%). By contrast, an increase in cultural distance has no statistically significant effect on the probability of a downgrade.

¹¹ An upgrade cannot be interpreted as incorporating positive information generated by the granting of the loan because this information is already incorporated in the borrower's rating when the loan is granted.

Table 5 Determinants of Other Contractual Features

	(1) Amount	(2) Maturity	(3) Secured	(4) Guaranteed
<i>Cultural distance</i>	−3.877** (1.551)	0.0482 (0.0794)	0.00517 (0.00728)	0.0202** (0.00875)
<i>Distance</i>	0.453* (0.245)	−0.0177 (0.0166)	−0.00130 (0.000953)	0.000205 (0.00122)
<i>Same religion</i>	3.159* (1.755)	−0.215** (0.108)	−0.0113 (0.00923)	−0.0122 (0.00809)
Observations	116,803	101,202	117,194	117,194
Adjusted R^2	0.312	0.380	0.250	0.200

Notes. The dependent variables are loan amount, loan maturity, and binary variables denoting secured or guaranteed loans. In column (1), where the loan amount appears as a dependent variable, the largest observations are winsorized at the 1% level. In addition to the reported coefficients, we include all the control variables used in column (5) of Table 3 as well as 21 primary loan purpose dummies, 46 loan instrument dummies, 69 currency dummies, 11 borrower type dummies, 56 borrower business dummies, year dummies, borrower nationality dummies, lead bank nationality dummies, and the constant term (coefficients not reported for brevity). Parameters are estimated by ordinary least squares. Standard errors are presented in parentheses and are corrected for heteroskedasticity and clustered at the borrower nationality times lead bank nationality level.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Finally, because ratings and their changes are noisy proxies for borrower performance, we turn to the subsample of loans with firm-level data from Worldscope, in which, as shown in Table 3, we find a positive effect of cultural distance on the loan spread.

Table 6 shows that, for these borrowers, cultural distance is unrelated to changes in the market to book ratio, leverage, sales, and profitability in the two years following the issuance of the loan (in unreported specifications, we show that this is the case also one year, three years, and four years after the issuance of the loan). Because changes in creditworthiness should be related to changes in firm value or accounting performance, this strongly suggests that clients of culturally distant banks are as creditworthy as the clients of other banks.

4.5. Local Subsidiaries and Repeated Interaction

We now explore how the effect of cultural distance varies with the lender's experience in the borrower's country or with repeated borrower-lender interactions. Banks with a subsidiary in the borrower's country should have more within-country experience because they tend to have extended a larger number of loans in that country and have at least some local employees. The effect of culture may nevertheless persist if the managers of the subsidiary in charge of approving the loans are from the headquarters' country or if the culture of the country of origin affects the subsidiary's organization.

Table 7 shows that having a local subsidiary in the country of the borrower mitigates, but does not eliminate the effect of cultural distance. The effects of cultural distance on the spread (column (1)) and the probability of having a loan guarantor are almost

Table 6 Ex Post Borrower Performance

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Default	Changes in rating			Changes in borrower characteristics			
	Rated companies only	Acquiring rating = Upgrade	Actual rating changes	Actual rating changes; finer ratings	Market to book	Leverage	ROA	Sales
<i>Cultural distance</i>	−0.000501 (0.00187)	0.0284* (0.0154)	0.00362 (0.0259)	−0.0241 (0.0243)	0.235 (0.394)	0.0254 (0.0734)	0.129 (0.231)	0.0192 (0.198)
Observations	9,943	41,336	9,943	9,943	1,970	2,093	1,989	2,090
R^2	0.19	0.30	0.26	0.06	0.034	0.040	0.026	0.095

Notes. The dependent variables are measures of borrower performance after the loan is granted. In column (1), the dependent variable is a dummy that takes value 1 if a borrower's rating is changed to default before the maturity of the loan and equal to zero if the borrower continues to have a no default rating; parameter estimates are obtained using a probit model. In column (2), the dependent variable takes the value 1 (−1) if the borrower was upgraded (downgraded) by Moody's or S&P after the loan issuance and before its maturity and the value zero if the rating remained unchanged; obtaining (losing) a rating is treated as an upgrade (downgrade). In column (3), the dependent variable takes the value 1 (−1) if the borrower was upgraded (downgraded) by Moody's or S&P after the loan issuance and before its maturity and the value zero if the rating remained unchanged; we exclude unrated borrowers. Whereas in columns (2) and (3), we consider as a change in rating only changes in letter grades, in column (4), we consider changes in notches; we exclude unrated borrowers. In columns (2)–(4), estimates are obtained using an ordered probit model. In columns (5)–(8), the dependent variable is the change in the measure of borrower performance indicated on top of the column during the two years after the loan is granted. Parameter estimates in these columns are obtained by ordinary least squares. In all equations, we include the following control variables whose coefficients are not reported: year dummies, borrower type dummies, the borrower's initial rating group, GDP in the country of the borrower, and the time since the loan was issued. Standard errors are presented in parentheses and are corrected for heteroskedasticity and clustered at the borrower nationality times lead bank nationality level.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 7 Local Subsidiaries

	(1) Spread	(2) Amount	(3) Maturity	(4) Secured	(5) Guaranteed
<i>Cultural distance</i>	10.09** (5.01)	-2.38 (1.637)	0.12 (0.08)	-0.0036 (0.0078)	0.023*** (0.009)
<i>Cultural distance</i> × <i>Local subsidiary</i>	-4.13* (2.13)	-4.64** (1.96)	-0.21*** (0.06)	0.027*** (0.009)	-0.009* (0.005)
<i>Distance</i>	0.005 (0.823)	0.50** (0.25)	-0.0155 (0.0162)	-0.0016 (0.00097)	0.0003 (0.0012)
<i>Same religion</i>	-7.37 (4.69)	3.71** (1.88)	-0.19* (0.11)	-0.015 (0.010)	-0.011 (0.008)
Observations	86,354	116,803	101,202	117,194	117,194
Adjusted R^2	0.11	0.31	0.380	0.250	0.200

Notes. The dependent variables are spread, amount, maturity, and binary variables denoting secured or guaranteed loans. In addition to the reported coefficients, we include all the control variables used in column (5) of Table 3 as well as 21 primary loan purpose dummies, 46 loan instrument type dummies, 69 currency dummies, 11 borrower type dummies, 56 borrower business dummies, year dummies, borrower nationality dummies, lead bank nationality dummies, and a constant term (coefficients not reported for brevity). In addition to the previously defined variables, Local subsidiary is a dummy variable that takes the value one if the lead bank has a local subsidiary in the country of the borrower and zero otherwise. Parameters are estimated by ordinary least squares. Standard errors are presented in parentheses and are corrected for heteroskedasticity and clustered at the borrower nationality times lead bank nationality level.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 8 The Dynamics of Cultural Biases

	(1) Spread	(2) Amount	(3) Maturity	(4) Secured	(5) Guaranteed
<i>Cultural distance</i>	11.45*** (4.233)	-2.723 (1.772)	-0.0127 (0.0919)	0.00978 (0.00814)	0.0175* (0.0104)
<i>Borrower interaction</i>	0.919 (0.855)	-1.503*** (0.154)	-0.0735*** (0.00728)	0.00432*** (0.000816)	-0.00232* (0.00121)
<i>Cultural distance</i> × <i>Borrower interaction</i>	-2.999*** (0.945)	-0.802* (0.473)	0.0425* (0.0244)	-0.000239 (0.00224)	0.00125 (0.00393)
<i>Distance</i>	-0.182 (0.601)	0.545** (0.272)	-0.0232 (0.0205)	-0.00198* (0.00112)	0.000290 (0.00141)
<i>Same religion</i>	0.182 (4.693)	2.046 (2.004)	-0.295** (0.127)	-0.0109 (0.0107)	-0.00809 (0.00877)
Observations	79,022	105,433	91,892	105,753	105,753
Adjusted R^2	0.102	0.321	0.375	0.227	0.183

Notes. The dependent variables are spread, amount, maturity, and binary variables denoting secured or guaranteed loans. We consider only syndicated loans made starting in 1990. In addition to the reported coefficients, we include all the control variables used in column (5) of Table 3 as well as 21 primary loan purpose dummies, 46 loan instrument dummies, 69 currency dummies, 11 borrower type dummies, 56 borrower business dummies, year dummies, borrower nationality dummies, lead bank nationality dummies, and a constant term (coefficients not reported for brevity). Parameters are estimated by ordinary least squares. Standard errors are presented in parentheses and are corrected for heteroskedasticity and clustered at the borrower nationality times lead bank nationality level.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

halved (column (5)). The negative effect of cultural distance on the size of the loan is, however, magnified. Furthermore, culturally distant banks with local subsidiaries grant loans with shorter maturity and are more likely to secure the loan. Because short maturity and collateral are useful if the lender monitors the borrower, this finding suggests that the lender's experience makes monitoring less costly. The reduction in the marginal cost of monitoring appears to dominate

any decrease in contracting costs, which should have led to less restrictive contract terms.¹³

In Table 8, we find some evidence that repeated interaction with a given borrower mitigates the effect of cultural distance. To avoid biases deriving from

¹³ We also examine the effect of lead bank experience in the borrower's country and find little evidence that the effect of cultural distance disappears after the lead bank has concluded many deals there (results not tabulated).

the fact that previous interactions are, by construction, very few at the beginning of the sample period, we only include loans signed on or after 1990. For the effect of cultural distance on the spread to disappear, the borrower has to receive nearly four syndicated loans from a given lead bank. However, in 95% of the loans in the sample, the borrower received at most two previous loans from a given lead bank (the median number of loans from a given bank is one).¹⁴ Thus, the effect of cultural differences is only partially mitigated by repeated borrower–lender interaction. Repeated interaction with a culturally distant lead bank appears to enable the borrower to receive loans with longer maturity; however, it does not increase the size of the loan and has no significant impact on the probabilities that collateral or third party guarantees are required. Given that its effect persists despite repeated interaction, cultural distance is unlikely to exclusively capture information gathering costs, which should be most relevant for first-time borrowers.

A possible concern is that the estimates in Table 8 are driven by unobserved risk profiles characterizing repeated borrowers from culturally distant banks. To evaluate the merit of this alternative explanation, in unreported specifications, we test whether the effect of cultural distance on the probability of loan default differs between first-time and repeated borrowers: Cultural distance continues to have an insignificant effect on the probability of default in both subsamples; this confirms once again that the effect of cultural distance does not depend on borrower unobserved heterogeneity.

4.6. Further Robustness

Although our results so far indicate that the effect of cultural distance is unlikely to be driven by borrower heterogeneity, concerns may remain that cultural distance is related to some characteristics of the country pair. For instance, low levels of international trade or investment may be correlated with cultural distance and lead to limited information flows between certain countries. However, our results hold even when we control for bilateral trade or investment flows or for industrial similarity of the lender–borrower country pair (see Giannetti and Yafeh 2010). The results also hold if we exploit only the limited time-series variation of cultural distance by including borrower nationality times lender nationality fixed effects.

¹⁴ Interestingly, in unreported regressions we find that the number of loans that a borrower receives from a given lead bank decreases with cultural distance. Our main results, however, are not driven by the fact that borrowers are less likely to engage culturally distant banks in repeated relations: The effect of cultural distance on the loan spread is larger if we consider only the first loan a borrower receives from any given bank.

Finally, we try to shed some further light on the mechanism through which cultural differences affect financial contracts. If culturally distant banks are less informed than other banks, under the hypothesis, strongly supported by the empirical evidence, that the clients of culturally distant banks are similar to the clients of other banks, the variance of the contract terms that culturally distant banks offer to borrowers in a given country should be lower than the variance of contract terms of culturally close banks. In unreported specifications, we find no evidence of that, suggesting that culturally distant banks are as informed as other banks.

5. Cultural Distance Between Banks and Risk Sharing within the Syndicate

If cultural differences affect interactions between economic agents, we should observe their effects also on the interaction between lead banks and participant banks. Keeping culture constant, negotiations may be faster for a smaller investment. If culture increases negotiation costs, participant banks may buy a smaller share of the loan to reduce the negotiation time. *Ceteris paribus*, a negative effect on the difference between the share of the loan bought by a participant bank and the share of the loan retained by the lead bank would suggest that cultural distance negatively affects negotiations and reduces risk sharing.

Because our unit of analysis is the extent of risk sharing between the lead bank and each participant bank, and given that each loan has, on average, several participant banks, we have multiple observations for each loan. For this reason, we cluster standard errors at the loan level.¹⁵ The results show that, indeed, participant banks hold smaller portions of loans syndicated by culturally remote lead banks. In column (1) of Table 9, a one-standard-deviation increase in cultural distance, approximately the difference between United States and Canada, decreases risk sharing between two banks by nearly 5% (relative to the sample mean). The effect is even more pronounced if we exclude observations for which the lead and participant banks share the same nationality (column (2)). In this case, a one-standard-deviation increase in the cultural distance decreases risk sharing by over 10%. These results are consistent with the notion that cultural differences increase contracting costs, but harder to explain with an omitted factor: There is no reason to believe that an omitted factor

¹⁵ The statistical significance of the results is similar if we cluster errors at the lead bank nationality times participant bank nationality level.

Table 9 Risk Sharing Within the Syndicate

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Whole sample	Foreign participants	Loan FE; whole sample	Excluding U.S. borrowers	Excluding U.S. lead banks	Foreign participants	Foreign participants	Foreign participants
<i>Banks' cultural distance</i>	−0.162*** (0.056)	−0.334*** (0.12)	−0.0367** (0.015)	−0.408*** (0.082)	−0.377*** (0.079)	−0.300* (0.17)	−0.493*** (0.14)	−0.387* (0.20)
<i>Banks' cultural distance</i> × <i>Interaction syndicate</i>							0.0138** (0.0068)	0.0129* (0.0069)
<i>Interaction syndicate</i>							−0.0222* (0.012)	−0.0237* (0.013)
<i>Banks' distance</i>						−0.122*** (0.026)		−0.132*** (0.029)
<i>Same religion syndicate</i>						0.456*** (0.17)		0.450** (0.19)
Observations	225,704	114,159	227,752	115,522	124,073	114,049	101,656	101,562
Adjusted R^2	0.03	0.03	0.89	0.07	0.07	0.03	0.03	0.03

Notes. The dependent variable is risk sharing. For each loan we have a number of observations equal to the number of participant banks. In columns (2) and (6)–(8), we include only observations for which the nationality of the lead bank is different from the nationality of the participant bank (foreign participants). Additionally, in the regressions in which we include the number of bank interactions (columns (7) and (8)), we consider only syndicated loans made since 1990. All regressions include controls for per-capita GDP in the lead and participant banks' countries, controls for the loan rating, for whether the loan is tranching, for the number of loan purposes as well as 21 primary loan purpose dummies, 46 loan instrument type dummies, 69 currency dummies, 11 borrower type dummies, 56 borrower business dummies, year dummies, borrower nationality dummies, lead bank nationality dummies, participant bank nationality dummies and a constant term. In addition, in columns (6) and (8) we control also for common border, legal origin, language, and colonial ties in the lead and the participant banks' countries, creditor rights in both countries, and the absolute value of their difference (coefficients not reported for brevity). Parameters are estimated by ordinary least squares. Standard errors are presented in parentheses and are corrected for heteroskedasticity and clustered at the loan level. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

should be similarly correlated with the cultural distance between borrowers and lenders and with the cultural distance between lead banks and participant banks.

Because we have multiple observations for each loan, we can perform a more stringent test for unobserved borrower heterogeneity. In column (3), we include loan fixed effects. The estimates show that, even for the same loan, culturally distant participants share less risk with the lead bank than culturally closer participants. The effect of cultural distance is robust across different samples. For instance, in column (4), we exclude loans to U.S. borrowers, and in column (5), we exclude loans for which the lead bank is from the United States. Similarly, the coefficient of cultural distance is qualitatively unchanged in column (6), when we include additional controls for distance and investor protection.

Some of the control variables offer further interesting insights. Risk sharing is higher if the participant bank is from a country with the same religion as that of the lead bank's country, but is significantly lower if banks are from physically remote countries: A one-thousand kilometer increase in distance decreases risk sharing by 12 percentage points.¹⁶

In columns (7) and (8), we explore whether the effect of cultural distance on risk sharing declines as a bank participates in more deals with a given lead bank. We focus on interactions within a country to capture the possibility that employees responsible for a given country may learn to interact with the representatives of the lead bank in that country. In this case too, in order to avoid biases resulting from the fact that previous interactions are, by construction, very few at the beginning of the sample period, we only include loans signed on or after 1990. We find that, indeed, the effect of cultural distance becomes smaller as the number of previously concluded deals with a given lead bank increases. Nevertheless, the pace at which the negative effect of cultural differences dies out is very slow, and over 30 deals are needed to fully offset the effect of cultural distance on risk sharing. The mean (median) number of deals that a participant concludes with a given lead bank is, however, only eight (two).

6. Conclusion

This paper shows that professional decision makers are inclined to offer better terms to culturally similar counterparties. Not only do cultural differences

¹⁶ In unreported specifications, we also control for the size of the lead bank and the participant bank in terms of the syndicated loans they held during the previous year. As expected, large lead banks

share risk less; however, the size of the participant bank does not seem to affect its portion of the loan. More importantly, the effect of cultural distance on risk sharing is unchanged.

between borrower and lender increase the loan spread and limit the loan size, cultural differences between the lead bank and participant banks reduce the extent of risk sharing within the syndicate. Although we cannot provide a definitive statistical proof that self-selection problems and unobserved heterogeneity are not driving our findings, we perform a battery of tests consistently showing no evidence that cultural distance is related to loan and borrower characteristics that negatively affect loan terms and risk sharing. We therefore propose that cultural differences make negotiations more cumbersome and increase contracting costs. Future work exploring the relevance of the effects we document to other contexts, perhaps through controlled experiments, will be able to cast more light on the effects of cultural differences on contractual outcomes.

Our findings also suggest new avenues for both theoretical and empirical research in behavioral economics. Although we document that cultural differences adversely affect contract terms, we are unable to describe the precise mechanisms through which differences in codes and norms affect contractual outcomes. Theories and hypotheses on potential mechanisms would be useful in guiding future empirical research with the goal of identifying the mechanisms at work.

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