

Syndicate Structures and Loan Contract Terms: Evidence from US Syndicated Loans

Summary

A growing firm emerges over its "life cycle" from borrowing from a single lender to using multiple lenders and afterwards often taps the public bond market (Diamond, 1991). A syndicated loan¹, a hybrid between the two afore mentioned extremes (Dennis and Mullineaux, 2000), can therefore be seen as an essential step in the development of a firm. Furthermore, syndicated loans are also globally one of the largest and most flexible sources of capital and are used by all kinds of firms whether they are blue-chip or small, publicly listed or privately held. The volume of new syndicated loans rose from USD 137 million in 1987 to over USD 1 trillion in 2007 and moreover, the volume of syndicated loans already exceeds the volume of public debt market issuance, according to Drucker and Puri (2007).

Therefore it is worthwhile to focus on the syndicated loan market which we do and more specifically, we examine the impact of relationship lending for both lenders and borrowers. Previous research has already addressed various natures of relationship lending, however, the outcome if it is beneficial both to lenders and to borrowers is ambiguous. Theories of financial intermediation emphasize the role of both information gathering and information processing first through screening (Diamond, 1991) and then through monitoring (Rajan and Winton, 1995). Relationship lending as given by Berger (1999) involves by its definition per se repeated interaction between a lender and a borrower, resulting in the lender's attainment of proprietary information about the borrower. If the information is reusable, this should reduce the past lender's cost of monitoring future loans of the borrower, but it also should help to understand the needs of the borrower better. This would consequently put such a lender in a favorable position to win future syndicated loan mandates from its relationship borrower. This view is supported by existing theories that predict that the establishment of an intact lender-borrower relationship can generate significant benefits for the lender (Boot, 2000). However, empirical support for this argument is limited for the syndicated loan market beside a recent publication of Bharath, Dahiya, Saunders, and Srinivasan (2007).

With our sample, covering a time period from 1987 to 2007 and consisting of more than 69,000 loans to nearly 20,000 different firms of every variety (publicly listed, privately held, rated and unrated), we examine whether the existence of a lending relationship translates into a higher probability of winning future syndicated lending business for the relationship lender. The results strongly support this assumption by giving us a probability increase of more than 55%. *Ceteris paribus*, a lender with a prior lending relationship has a 58.9% probability of obtaining future syndicated loan mandates from its borrower while a lender having no past relationship to a borrower has only a 3% probability for this. In accordance with theory, we find that borrowers suffering from greater information asymmetries, such as small or non-rated firms, are more likely to use their relationship lender for future syndicated loans. Holding all else constant, the absence of a credit rating, for example, increases the probability that a relationship lender will be chosen by 5.5%. At any rate, we can conclude that a definitive benefit for a relationship lender is the increased probability of winning future syndicated loan mandates and thereby earning future fees.

In contrast to the benefits for the lender, the impact of relationship lending for the borrower is already vastly examined both empirically and theoretically, however with an ambiguous outcome. On the one hand, relationship banking is seen as beneficial for the borrower. Here relationship lending

¹A syndicated loan is defined as a loan "that is provided by a group of lenders and is structured, arranged, and administered by one or several commercial or investment banks known as [lead] arrangers," according to Standard and Poor's (2007, p. 7).

leads to better loan contract terms, such as lower interest rates and reduced collateral requirements (Berger and Udell, 1995), as well as an increased availability of credit (Petersen and Rajan, 1994). On the other hand, relationship lending may result in higher interest rates for the borrower. Rajan (1992) and Sharpe (1990) point out that a relationship lender can use its monopoly power to extract additional rents on future loans to a relationship borrower, especially for borrowers unable to credibly reveal its credit quality to the public.

We try to shed light on the effect of relationship lending for borrowers by using a sample, in contrast to the majority of earlier studies, consisting of publicly listed firms. Despite the circumstance that publicly listed borrowers have several financing alternatives available, our sample offers nevertheless a large range of firm sizes as measured by assets or sales. These different borrower and syndicate characteristics allow us to extensively study the impact of relationship lending on price as well as non-price contract terms.

Our central result across different relationship intensity measures is that obtaining a future syndicated loan from a relationship lender reduces the all-in-spread-drawn (AISD) from 10 to 13 basis points compared to a loan from a non-relationship lender. The pricing benefit of relationship lending is also visible for informationally opaque borrowers. Surprisingly, we find that really large firms, whether measured by asset size, sales or workforce, do not benefit from relationship lending since we always find a positive interaction between relationship lending and one of the three aforementioned measures. These results suggest that there exists a "benefit boundary" between relationship and transactional lending. A reason for this could be that large firms offer interesting fee-generating potential for all banks and therefore the competition on this borrower is intensive, resulting among others in aggressive syndicated loan pricing. The argument of Petersen and Rajan (1995) that increased competition is likely to erode the benefits of relationship lending, seems to be true but only for the largest firms.

Furthermore, we examine the effect of relationship lending on potential syndicate moral hazard concerns. Syndicate moral hazard concerns of participants in a loan syndicate stem from the reasoning that the lead arranger may shirk from its monitoring duties since the lead arranger has the whole endeavor but gains less than 100% from it (Holmstrom and Tirole, 1997). However, our results demonstrate that a lender's past relationship to a borrower is seen by other participating lenders as a significant commitment to dutifully monitor the borrower and thereby attenuates syndicate moral hazard concerns of participants, since the presence of relationship lending in high moral hazard syndicates is associated with lower spreads. Representatively, following Sufi (2007) and Lee and Mullineaux (2004), a more concentrated syndicate is a sign of more pronounced syndicate moral hazard concerns which is accompanied with a rise in the all-in-spread-drawn of 11 basis points in our sample. However, a loan arranged by a relationship lender reduces the AISD by 6 basis points in such a syndicate.

Remarkable is also the finding of relationship lending and a lead arranger's reputation. A syndicated loan arranged by a bank with a lower reputation increases the all-in-spread-drawn by 18 basis points, however a past relation between such a lender and a borrower does more than offset this increase (-25 bps). It nearly seems so that an existing relationship has a positive effect on the all-in-spread-drawn whether the lead arranger has a high or low reputation. Regarding non-price contract terms, we find evidence that relationship lending reduces the likelihood of both collateral requirements and the attachment of covenants. This is consistent with theory of non-price contract terms in syndicated loans. For example, Holmstrom and Tirole (1997) argue that a lending relationship is a credible commitment to monitor and makes the requirement to post collateral less likely. Similar reasoning could be specified for the existence of covenants.

All in all, the results seem to suggest that relationship lenders pass on some of the benefits to their borrowers of which borrowers seem to be aware.

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