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Bank reputation in the private debt market

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A B S T R A C T

We examine the impact of lead arrangers' reputation on the design of loan contracts such as spread and fees charged. Controlling for the non-randomness of the lender–borrower match (self-selection bias), we find that the reputation of top tier arrangers leads to higher spreads, and that top tier arrangers retain larger fractions of their loans in their syndicates. These larger spreads are especially pronounced for borrowers without credit rating that have the most to gain from the certification assumed by virtue of a loan contract with a top tier arranger. This certification channel differs from the one found in public markets, where certification leads to a reduced spread offered to the best clients. These differences between public and private markets can be explained by differences in the way they operate and are structured. Interestingly, the effect is strongest for transactions done after the changes in the banking regulations (including the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994) that led to significant consolidations in the banking industry, including among the largest commercial banks.

1. Introduction

Loan syndication is a major segment of the wholesale business of commercial banks in the United States (US).[2] With more than two trillion dollars in commitment volume outstanding, the syndicated loan market is an increasingly important source of financing for corporations. Typically, a loan syndicate is formed by a mandated arranger, who is appointed by the borrower to bring together a group of institutional investors and banks that are prepared to lend money on specific terms to the borrower.

The reputation of the lead bank can be seen as a certification of the quality of the loan being syndicated.[3] The role of underwriter reputation is known to have large price consequences for bond issuers, especially for those underwriting below-investment grade bonds (see, for example, Fang, 2005).[4] Top tier underwriters offer better terms to their best clients in order to certify to the market a quality assurance on the issues they underwrite (Cook et al., 2003). Most recently, An and Chan (2008) show that underwriter reputation affects IPO underpricing and price revisions. Underwriters seeking to avoid a loss of reputation will attempt to gain commercially sensitive information about their clients to help them identify and market high quality issues. In this way, investors can infer the quality of an issue when specific underwriters put their reputation at stake. Less experienced

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[1] Tel.: +31 13 46 62 306.
[2] A recent survey is provided in Drucker and Puri (2006).
[3] This approach is consistent with papers on underwriter reputation associated with less severe underpricing in initial public offerings (Carter and Manaster, 1990; Megginson and Weiss, 1991; Gomes, 2000).
[4] Gatti et al. (2007) provide evidence of similar effects in project finance.

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underwriters, on the other hand, avoid this signaling strategy if they are less capable or find it too costly to obtain information about the true quality of their borrowers.

However, it is unclear whether the above phenomenon is also at play in the private debt market, and whether it is done through the same channel as in the public market. There are several reasons why the reputation of an underwriter may have a different effect on bank loan structure than on public bonds. While bond underwriters only act as intermediaries, loan arrangers typically retain a substantial fraction of the loan being issued. This strongly affects the potential costs associated with certification of borrowers. Moreover, the bank industry has undergone significant restructuring and consolidation (Brook et al., 2000) that most likely have impacted outcomes.

A further important feature is that the most reputable loan arrangers may have the capability to sherry-pick the best borrowers, notably because their certification effect may provide benefits to these selected borrowers even beyond the loan market (Cook et al., 2003). This selection effect has been evidenced in other financial markets, such as the bond underwriter market (Puri, 1996; Fang, 2005) and the IPO market (An and Chan, 2008). More broadly speaking, dealing with endogeneity in corporate finance issues remains important, as evidenced by the recent contribution of Wintoki et al. (2010) on controlling for the dynamic nature of corporate finance relationships.

In this paper, we investigate how investment bank reputation influences the structure of bank loan contracts and thereby the terms at which corporations are able to access debt finance. Do reputable commercial banks that have better access to good borrowers signal quality through the same channel as bond underwriters? If yes, how does this affect the spread and fees charged? Does reputation affect deal characteristics of private debt through other channels than simply pricing? Further, how does reputation influence the structure and composition of loan syndicates?

An important departure in this paper is the development of a unified model of bank reputation that takes into account both the lending and syndicate markets. This is important because it provides the reader with a more complete understanding of the costs and benefits of bank reputation. To understand this point, consider the consequences of arrangers choosing not to resell any of their loans. It would be clear that there would be no need to certify to others the quality of the loans and thus we would witness few differences in loan structure between top tier arrangers and other banks with respect to certification, everything else being equal. However, arrangers that sell entire issues would very well benefit from certifying the quality of the borrowers if they could. Papers on bond markets have not taken this approach. With the bond market, it is reasonable to focus simply on a single market, the underwriting market, as here it is only intermediaries that resell most of the issued securities. In contrast, lead arrangers in the private debt market continue to hold a significant proportion of loans well after the issuers' offering.[5] Consequently, this provides commercial banks with an alternative tool to signal quality by retaining large fractions of the deal. Finally, offering better terms to the best borrowers would be at some cost to lenders if lenders retain higher fractions of their deals. This cost is not incurred by bond underwriters as they only play the role of intermediary. This analysis provides a novel perspective on existing empirical findings on the extent to which bank reputation matters in private debt markets. The syndicated loan market offers a good setting for testing this.

The analysis in this paper provides a number of key empirical results. It shows, consistent with the differences between the bond and commercial loan markets, that while reputation significantly affects the design of loan contracts, the channel is different from what has been observed in bond markets. While most reputable lenders do indeed offer better terms, this is consistent with the idea that they also arrange loans for the best borrowers. Moreover, it strongly supports the notion that the top tier loan arrangers are able to select the best deals. This suggests that reputable arrangers self-select their borrowers, which may affect the analysis on pricing due to self-selection bias. However, when controlling for the non-randomness of borrower–lender match, we find that reputable arrangers charge *higher* spreads compared to a situation where reputation does not matter. The effect is strongest for borrowers without any investment grade or credit rating, who most likely suffer from information asymmetry. This is consistent with the view that top tier banks exploit the informational advantage that gives them more market power to charge higher spreads, compared to what borrowers would get in the absence of arranger reputation. The premium charged is highest for those who gain most from certification by a top tier lead arranger. Interestingly, the effect is strongest for transactions done after the 1994 banking deregulation that led to significant consolidations in the banking industry (the Riegle-Neal Interstate Banking and Branching Efficiency Act),[6] including among the largest commercial banks. This suggests that the resulting mergers have increased the market power of the top tier arrangers, who may have charged higher spreads subsequent to market consolidation. While reputation significantly affects spreads, we find, however, no evidence that it affects the inclusion of restrictive covenants in loan agreements. The latter is best explained by publicly available credit rating, such as Standard & Poor's (S&P), of the borrower, with no evidence of trading of price or protective covenants. These results are robust for a number of alternative specifications. While Fang (2005) obtained different results for the bond market, both sets of results are consistent with important differences observed between the two markets, in particular with respect to market concentration at the top.

This raises the question of whether top tier banks ask for lower arranger fees, given their spread structure. We find weak evidence that top tier arrangers indeed charge lower arranger fees, even when controlling for the self-selection of borrowers. However, they do so only for borrowers with credit rating. In line with our results on loan design, this again suggests that

[5] In recent years, lenders have sold some of these participations through securitization of loans. This however does not mean they do not bear the risk anymore, since (besides retaining some of the loan) they typically attach credit enhancement guarantees or put options to the securitized loans. Moreover, the fact that these loans cannot be sold that quickly means that lenders bear substantial risk between the time of loan issuance and resale of the loan.

[6] See, for example, Kroszner and Strahan (1999), Brook et al. (2000), Levine (2004), and Huang (2008), for related discussion on the deregulation of the US banking industry.