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The pricing effect of certification on syndicated loans ☆

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Abstract

To verify if a delegated monitor can certify its ability to perform its assigned tasks, we test whether syndicated loans in which a larger share of the facility is retained by the arranger have lower interest rates. For a large sample of syndicated loans in over 80 countries we find that this certification effect exists and is greater for facilities characterized by greater due diligence and monitoring efforts. Further, for listed companies the announcement effect of the new loan on the stock price is an increasing function of the portions of the loan retained by the arranger.

JEL classification: G82; G14; G21

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1. Introduction

The last decade has witnessed rapid growth of the syndicated loan market. The volume of facilities granted worldwide increased more than seven-fold between 1993 and 2005, topping $2.3 trillion in 2005 (BIS, 2006). According to Sufi (2007), syndicated loans account for half of new lending to US corporations and generate more underwriting fees than either the equity or the bond market.

In a syndicated credit facility at least two lenders jointly offer a loan to a borrower. The tasks of organizing the syndication, monitoring and due diligence are not shared by all subscribers but are delegated to one or more arranger banks. A distinctive feature of the syndication process is the position of the arranger with

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respect to the borrower. When the borrower is seeking bidders for a facility, its interests conflict with those of the potential arranger. The former is on the buy side of the market, looking for the lowest possible price for the facility that it needs; the latter is on the sell side, looking to maximize its total revenues. But once the mandate has been awarded, the borrower and the arranger become partners in seeking a satisfactory result from the placement: the failure of the deal would not only leave the borrower without funds, but would also jeopardize the standing of the arranger.

Credit syndicates are therefore plagued by agency problems, because they add to the typical information asymmetry between borrowers and lenders that between the arranger and the other subscribers of the loan. Theoretical analysis on delegated monitoring (Leland and Pyle, 1977; Diamond, 1984; Holmstrom and Tirole, 1997) suggests that arrangers can mitigate these problems by contributing a larger share of their own assets to the overall funding, thereby certifying the accuracy of their screening and their commitment to proper monitoring and due diligence—in a word, putting their money where their mouth is. If this certification effect has value, then the interest rate on the facility should go down as the fraction retained by the arranger goes up, as Gorton and Pennacchi (1995) found for loan sales. This paper uses a sample of 2,951 syndicated credit facilities to borrowers in 59 countries between 1990 and 2001, to study the relationship between the structure of the credit syndicate and the interest rate.

This paper contributes to the literature on the effects of information asymmetries in lending contracts, showing that the delegated monitor of a credit syndicate, the arranger, can mitigate the cost impact of the agency problems by supplying a larger share of the facility. As the theoretical literature predicts, the effect of certification is greater when the agency problems are more severe, as when the borrower is more opaque or the loan requires stricter monitoring and due diligence. The paper also contributes to the literature on the uniqueness of bank loans (James, 1987), showing that the information generated by arrangers retaining a larger share of the loan goes beyond the lending syndicate to influence the magnitude of the announcement effect of new bank loans on borrowers' stock prices.

Although a number of papers have studied the effect of information asymmetries on the structure of loan syndicates, not much attention has been paid to the consequences of the syndicate's composition for the interest rate. A similar issue is addressed by Angbazo et al. (1998), who show that the spread on highly leveraged syndicated transaction loans is smaller when the arranger retains the largest share of any provider of funds. Ivashina (2005) addresses some potential issues of endogeneity in the reduced-form estimation of the effect of syndicate composition on interest rates, getting results consistent with the previous version of the present work (Casolaro et al., 2003).

The rest of the paper is organized as follows. Section 2 describes the institutional characteristics of the syndicated credit market and briefly reviews the recent empirical literature. Section 3 describes the data used in the empirical analysis; Section 4 presents the model and the main results and Sections 5 and 6 run robustness checks. Section 7 concludes.

2. The market for syndicated credit: institutional characteristics and some evidence to date

A syndicated credit facility is a loan originated by one or more arrangers that are responsible for screening and monitoring. The facility is split into brackets, possibly of different size, and offered to subscribers, who thus take the credit risk on their shares (Rhodes et al., 2000).

Syndicated loans are a hybrid form of private and public debt (see the seminal contribution of Dennis and Mullineaux, 2000). Like standard bank loans, they are much more flexible than public debt placements and are often tailored to the borrower's needs. Like bond issues, they can raise very substantial volumes of funds, and are placed among a potentially large number of institutions at harmonized conditions for all. Credit syndicates also have some features in common with loan sales, but crucially, unlike the latter, they establish a direct relationship between borrower and each subscriber from the outset.

There is overwhelming evidence of the fundamental role played by information asymmetries in shaping credit syndicates. Syndication is more likely when borrowers are more transparent, more closely linked to the arranger and less risky (Dennis and Mullineaux, 2000). The arranger's share is smaller when borrowers are less risky (Simons, 1993; Dennis and Mullineaux, 1994, 2000; Lee and Mullineaux, 2004; Jones et al., 2005) and when public information on them is available (Dennis and Mullineaux, 2000). The share retained is also