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Foreign banks in syndicated loan markets ☆

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ABSTRACT

Foreign banks play a prominent role in syndicated loan markets. In this paper we examine foreign banks' motives in participating in cross-border deals in 25 European countries. We find that usual explanations of foreign banking activities can only account partly for the high rate of foreign involvement in syndicated loan markets. The usual argument is that foreign banks are at a disadvantage because they lack soft information and thus they tend to lend to more transparent firms compared to their domestic counterparts. We find that this relationship only holds in relatively small financial systems. We illustrate different motivations for the large amount of cross border lending in large developed markets. In these markets foreign banks tend to lend to especially risky borrowers and projects.

1. Introduction

Foreign bank activity has increased dramatically in recent years as barriers to foreign bank entry and activity have largely broken down. In many countries foreign banks are responsible for a large fraction of bank lending (Clarke et al., 2003).[1] Foreign banks are particularly active in the syndicated loan markets. In our sample of 24 European countries, a foreign bank acts as the lead arranger in about one third of all deals and participates as lead arranger together with domestic banks in another 40% of all deals. Moreover, foreign bank underwriting of syndicated loans is found throughout the European markets, in small countries as well as the largest countries with the most sophisticated domestic financial systems. Our objective is to examine why cross border activity is so high in syndicated loan markets. Our motivation is that the standard explanations in the literature on foreign bank activity are not always consistent with the levels and patterns of foreign bank participation in syndicated loan markets.

The syndicated loan market provides a good laboratory to examine foreign banking activity because it is large and has many cross border features. In this market firms can go to either domestic or foreign banks (or a consortium of both) that will syndicate a loan to buyers in any market. We will use detailed data on syndicated loans, including interest rates, from Dealscan. We match the loan data with information about the borrowing firms from Amadeus. Thus, our data set includes detailed information on lenders and borrowers throughout Europe for the period 1995–2007.[2] Furthermore, by focusing on Europe, we have a sample of many countries with both large and small financial markets.

Although syndicated loans are often viewed as a hybrid with characteristics of bank loans and public debt, they are closer to bank debt because of the role played by the lead arrangers (Dennis and Mullineaux, 2000; Sufi, 2007). The lead arranger drafts the loan terms, monitors compliance and typically holds the largest share of the loan. Of course, the fact that the loan is syndicated and that only a part of it is likely to remain on the balance sheet of the arranger creates pricing incentives that might be different than in other debt markets (Harjoto et al., 2006). However, our

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[1] According to the Bank for International Settlements, international financial claims of bank offices are now 38 times larger than 30 years ago (as of September 2008); see BIS locational banking statistics 2009.

[2] Our sample ends just before the start of the financial crisis. Lending in syndicated loan markets in 2008–09 was less than half of the 2007 level and de Haas and van Horen (2010) show that there were significant changes in the behavior of lenders.

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interest is not the comparison of syndicated loans to other sources of financing but in the activities of foreign arrangers in the syndicated loan market and differences in their market role across large and small financial systems.

The literature on foreign banks emphasizes the disadvantages faced by foreign banks. Foreign banks have less local, market or firm specific information (so called soft information) than their domestic counterparts and must also overcome cultural and bureaucratic barriers in the host country (see Khanna and Palepu, 1999; Buch, 2003; Petersen and Rajan, 2002; Mian, 2006). Given the costs imposed by these barriers, the literature provides some specific reasons why foreign bank entry takes place. First, foreign banks tend to follow their customers abroad when they undertake FDI or enter the foreign markets (Buch and Golder, 2001). When the foreign bank serves existing customers from their home country, informational and cultural barriers are basically not present. Second, foreign banks might have a technological advantages (e.g. in form of a better monitoring technology) over domestic banks and thus operate more efficiently.[3] Foreign bank entry occurs because the technological advantages out weigh the informational disadvantages.

The first motive for foreign banking activity (follow-your-customer) is unlikely to account for the large share of foreign banking activity that we observe in the syndicated loan data. The second motive (the technology advantage over domestic banks) might be present in small or less developed financial systems. Small financial markets suffer from diseconomies of scale (Bossone et al., 2001, Andritzky, 2007) and may be unable to provide the range of services found in major financial centers. Further, many of the smaller European countries in our sample were either transition countries with less developed banking systems or countries that were slow to liberalize their banking markets. The disadvantages from market size provide a motive for foreign bank entry. In large developed financial markets, it is however unlikely that foreign banks have a technological advantage over their domestic counterparts. So it remains unclear what motives or opportunities drive foreign banking activity in large developed financial markets. That this remains a puzzle is understandable because virtually all of the literature on foreign banking focuses on their activities in emerging markets or transition economies (see below) rather than cross border activity in large and small developed economies.

Our paper provides new insights about the underlying forces that drive foreign bank activities. We find that foreign banks are extremely active in syndicated loan markets in both large and small countries, but there are significant differences in their activities in these two different types of markets. In small financial markets, we find that syndicated loans with foreign bank lead arrangers go to larger firms with more tangible assets that are more often publicly listed than the loans with domestic bank lead arrangers. It appears that the foreign banks can exploit their technological advantage in these markets and lend to large borrowers that are able to provide 'hard' information to their creditors. In large financial systems foreign banks lend to significantly more leveraged borrowers than domestic banks. Thus, different motives have to explain foreign banking activity in large financial systems. We believe that the motivation of foreign banks in large financial systems is actually opposite from the motives in small or less developed financial systems. In large financial markets, foreign banks tend to take on especially risky projects and diversify these risks by international syndication. That is, after controlling for loan and borrower characteristics, we find that foreign bank lead arrangers charge higher spreads in large as compared to small financial systems.

We maintain that the risk appetite of foreign lenders in large markets is a more important determinant of their activity than the costs of overcoming the barriers faced by foreign lenders. Costs in overcoming these barriers are likely to be higher in small financial markets and this should be reflected in the spreads foreign banks charge to compensate for these extra costs. There are other differences between small and large financial markets which would tend to lead to higher spreads in smaller markets. First, larger more developed financial systems are more competitive. They tend to have less concentrated banking systems and more active non-bank financial institutions competing as lenders (Bossone et al., 2001). Furthermore, equity and bond markets are concentrated around large financial centers and play a negligible role in small financial systems. Second, the prevalence of large banks leads to scale economies in financial services that should be reflected in smaller spreads in large countries. Third, standardized accounting information, ratings agencies and active public securities markets all serve to make information about firms more transparent in large markets (Bossone et al., 2001). Thus our finding that foreign banks charge a relatively higher spread in large financial systems is evidence for our risk taking argument.

Although loan syndication is an international phenomenon with broadly similar characteristics in many countries, there is little prior cross-national research. Carey and Nini (2007) examine the home bias in syndicated lending and are puzzled by unexplained pricing discrepancies between the US and European markets. Nini (2004) shows that syndicated loans in emerging markets with both foreign and domestic lead arrangers have lower spreads than other similar loans which he attributes to the local knowledge of the domestic arranger. Most recently, Giannetti and Yafeh (2010) show that loan spreads increase with the 'cultural distance' between the lead arranger and the borrower. There does not appear to be any prior research that looks at the specific role of foreign banks in syndicated loan markets in both large and small markets.

Most of the literature on foreign banking discusses their expansion into smaller or emerging markets (e.g. Giannetti and Ongena, 2008). Foreign bank lending to informationally opaque borrowers is restricted by the geographic and cultural distance between a foreign bank's headquarters and the local market (Mian, 2006). Berger and Udell (2002) and Petersen (2004) argue that since foreign banks are less able to collect 'soft' information about local firms, they are likely to refrain from lending to small firms, for which such information is more relevant. Thus, foreign banks are expected to lend more to large firms thereby neglecting small and medium enterprises (see also Sengupta, 2007). Claessens and van Horen (2008) argue that banks enter a foreign market when they can increase profitability within an acceptable risk profile. In a similar manner, Mian (2003) concludes that private domestic banks in emerging markets appear to be more 'aggressive' in their lending than foreign banks. Thus, the literature indicates that foreign and domestic banks behave differently. While we find support for these implications from the literature on emerging markets and small financial markets, foreign banks tend to behave differently in large financial markets. We show that foreign banks lend to significantly more leveraged firms and charge a higher spread (after controlling for borrower and loan characteristics) in large as compared to small financial systems.

In the next section, we describe the dataset constructed from Dealscan and Amadeus and briefly summarize earlier work on syndicated loans. In the following section, we develop our empirical strategy and present our empirical estimates. The last section presents our conclusions.

[3] Empirically, Bonin et al. (2005) and Claessens et al. (2001) find that foreign banks tend to operate more efficiently than domestic banks in transition and developing financial markets.