The Syndicated Loan Market: Developments in the North American Context

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The syndicated loan market, a hybrid of commercial banking and investment banking, is one of the largest and most flexible sources of financing. Syndicated loans have been used for decades by governments. Over the past 20 years or so, they have also become an important source of funding for large firms, and, increasingly, even for mid-sized firms.[1] While this market has evolved continually over the years, there have been some striking developments since the early 1990s—particularly in the United States—as improvements in transparency and liquidity have resulted in a more efficient loan market with many of the features found in securities markets.

The major Canadian banks have become very active in the global syndicated loan market, particularly the U.S. market, and have assumed significant credit exposures. Canada's syndicated loan market is not at the same level of development as its U.S. counterpart in terms of features or range of participants. Nevertheless, it is being influenced by the evolution of the U.S. market, and it is expected to continue to develop.

Key Features

A loan syndication can be broadly defined as two or more lending institutions (often a dozen or more) that jointly agree to provide a credit facility to a borrower (Dennis and Mullineaux 2000).[2] While syndicates have many variations, the basic structure involves a lead manager (the agent bank) who will represent and operate on behalf of the lending group (the participating banks).

Virtually any type of corporate and commercial loan or credit facility can be syndicated. These include term loans, revolving credit facilities (offering the borrower the right, but not the obligation, to draw down a loan), and standby facilities (these are credit lines that are expected to be used only in extraordinary circumstances, such as market disruptions). Other more specialized facilities, such as construction loans, export-financing loans, and bridge financing facilities, can also be syndicated.

Syndicated credit facilities tend to be of medium-term maturity (1 to 5 years), although facilities have been arranged for periods as short as three months and as long as 20 years. Typically, the interest rate of a syndicated facility floats, in contrast to the fixed-rate instruments often found in debt markets, with the rate being reset every one, two, three, or six months. Large loan-syndication financings usually consist of multiple loan tranches, with the tranches having different features and terms targeted to different investors.

Syndicated loans have some elements in common with certain other instruments for transferring credit risk that have emerged over the last decade and that permit financial market participants to more precisely tailor their exposure to credit risk. These include rapidly expanding types of instruments, such as asset securitizations and credit derivatives.[3]

The Lending Environment: Transactions Versus Relationships

For years in North America (generally prior to the late 1980s), corporate lending mainly involved a series of bilateral arrangements

1. This article summarizes a recently published Bank of Canada Working Paper (Armstrong 2003).
2. In the U.S. syndicated loan market, it is not uncommon to have 50 or 60 institutions in a syndicate. In the Canadian market, syndicates tend to be much smaller—typically with 7 to 10 participants.
3. See the report by John Kiff in this issue (p. 33) for a discussion of credit-risk-transfer instruments.

between the borrower and one or more individual banks (Chart 1-A). These arrangements were supplemented by occasional "loan club" syndications, a technique whereby very large loans were shared among a number of banks. This early version of the syndicated loan market was essentially a private market with no transparency or liquidity (Asarnow and McAdams 1998).

In contrast, the contemporary syndicated loan market in its most developed state—currently in the United States and increasingly in other nations—uses a highly competitive primary distribution process similar to that used for the initial sale of bonds and stocks.[4] This is supported by an active secondary market, where loans are traded, to facilitate adjustments after the primary syndication phase. Thus, the corporate loan market now offers many of the features of securities markets.

Under these arrangements, lending is conducted on a transaction-by-transaction basis involving syndicates of lenders (Chart 1-B). Some have argued that in this environment, lending is based less on a relationship between borrower and lender and is much more "transaction-oriented." This implies that lending is driven more by the terms of the particular financing and by market conditions at the time of syndication than by a borrower-lender relationship. This may be true to a degree, particularly when investment banks are leading the syndicate. Nevertheless, commercial banks stress that their willingness to provide any corporate lending (in syndicated or bilateral form) depends heavily on the profitability of the overall relationship with the client. Syndicated loans involve elements of both approaches in the sense that the lead bank screens and monitors the borrower in a traditional relationship fashion, and then sells or underwrites some or all of the loan in a capital market-like setting (Dennis and Mullineaux 2000).

Chart 1 The Old Bilateral Lending World vs. the Current Multilateral Lending World

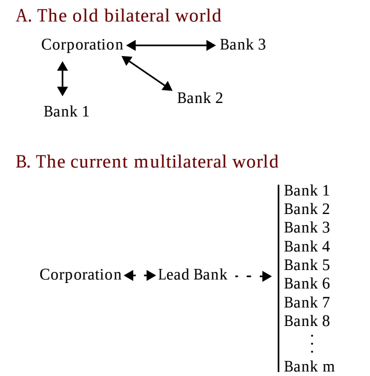


Table 1

Measures of U.S. Syndicated Loan Market Using the Shared National Credit (SNC) Program

	1998	1999	2000	2001	2002
Value of facilities (US$ billions)	1,759	1,829	1,950	2,050	1,900
Number of facilities	10,389	8,974	9,848	10,146	9,328
Number of borrowers	6,710	5,587	5,844	5,870	5,542

Source: Federal Reserve Board

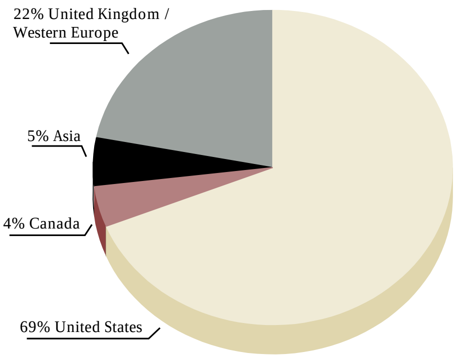
Evolution of the Market

The U.S. syndication market, which currently totals almost $2 trillion in drawn and undrawn commitments (Table 1), offers the most

4. Lead banks often compete for the "mandate" to manage a syndicated financing proposed by a borrower. Alternatively, a lead bank may take the initiative and present a financing proposal to a potential borrower.

Chart 2 **Global Syndicated Loan Market**

Issuance by region of borrower 1995–99



Source: T. Rhodes, *Syndicated Lending Practice and Documentation* (London: Euromoney Books, 2000), exhibit 1.8

advanced features of contemporary corporate syndicated lending. Growth in this market was rapid through most of the 1990s, although it has recently slowed. Globally, the U.S. market constitutes by far the largest in terms of gross issuance (Chart 2).

The origins of many of the features of the contemporary syndicated loan market in the United States go back to the period of corporate restructuring, strategic buyouts, and leveraged acquisitions that started in the 1980s, a period when lenders were looking for more efficient ways to manage their rapidly expanding credit exposures. In the 1990s, this market continued to evolve, and today the global syndicated loan market is much more transparent and efficient than earlier versions, as evidenced by a rapidly evolving set of standardized institutional arrangements and a broader range of participants.

The significant developments in the past 10 to 15 years that have contributed to the evolution of the U.S. syndicated loan market include the following:

- The emergence of a group of large syndication banks that operate more like investment banks than commercial banks, focusing on earning fees from managing syndications rather than from earning interest-spread income by holding loans to maturity.
- The rapid growth in the non-investment-grade portion of the market, which offers higher fees to underwriters and higher yields to investors than the investment-grade market. This part of the market also involves higher potential risks.
- The emergence of loans as a new asset class, with a unique set of investment properties, which has attracted the participation of non-bank institutional investors. This development has been facilitated by the introduction of credit ratings on loans by the major ratings agencies—a step taken in 1996. It was also helped by the development of commonly accepted indexes for price and rate of return that expedite comparisons with other asset classes.
- The growth of an active and relatively liquid secondary market for loans, supported by standardized trading arrangements.

Ongoing Risk Issues

Major new developments in financial instruments and markets can pose risk issues that can adversely affect individual financial institutions. With respect to the contemporary syndicated loan market, two concerns that have been raised are briefly discussed.

Asymmetric Information

The role of lead bank has evolved over the years from one of primarily representing a group of banks that share a large loan to one of acting as intermediary between the competing interests of its client—the borrower—and the participating banks. If the lead bank has more information than the other syndicate members, then, potentially, it could engage in opportunistic behaviour, such as retaining a relatively large share of high-quality loans and a lower share of low-quality loans than would be retained if there were no information asymmetries. But the empirical work completed to date finds little evidence of such abuse by the lead bank.[5]

Risks in the "Firm-Commitment" Underwriting Process

It is not uncommon for the lead bank to commit to underwriting the whole amount of the financing and then selling loan shares to other syndicate participants. This "firm-commitment" approach contrasts with the alternative "best-efforts" approach, where the lead bank agrees to take only a specified minimum portion of the planned financing, with the remaining amount syndicated or marketed to a group of banks and other institutions.

A firm commitment is often crucial for the borrower, who needs to know that the funding is in place to support an imminent merger, acquisition, buyout, or other strategic corporate transaction. The lead bank then assumes the risk that other banks may not join as lenders. Contractual arrangements have, however, evolved to mitigate some of the risks associated with firm commitment. For example, it appears that most syndicated loan agreements now have material adverse change (MAC) clauses, which specify predetermined grounds for legitimate retraction of the commitment by the lender. A more recent contractual development is referred to as "market flex" pricing, which is meant to help the lead bank manage normal market risk.[6] Under the terms of market flex, the lead bank has scope to vary the borrowing spread over the base rate of the loan (e.g., LIBOR or the prime rate) by a certain number of basis points, depending on how market conditions have changed from the start of the syndication to the closing of the loan.[7]

Conclusion

The rapid evolution of the syndicated loan market over the past decade or so has contributed to greater efficiency and transparency in corporate loan markets. The new corporate loan market is one facet of a surge in the use of various instruments to transfer credit risk that includes credit derivatives and securitizations. This development also points to an important change in the business of banking, as loans become more like tradable securities.

As financial instruments and markets undergo important changes, they can pose risks that need to be monitored. In the case of syndicated loans, some recent developments may pose risks, but they also have the potential for a broader dispersion of credit risk, which should be positive in terms of financial stability.

5. Simons (1993) finds that the proportion of the syndication retained by the lead bank actually increases as credit quality declines. A more recent study by Jones, Lang, and Nigro (2000) analyzes a large panel of loan data from 1995 to 1999. They find that agent banks tend to retain a larger proportion of the lower-quality loans, refuting the notion of opportunistic behaviour.

6. Market flex arrangements seem to have become common in the aftermath of the market disruptions in late 1998 related to the Russian default and LTCM events.

7. Market flex can also work to the benefit of the borrower if market conditions improve over this period.

References

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