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Bank loan terms and conditions: Is there a macro effect?

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ABSTRACT

We examine whether macroeconomic factors contain significant information for bank loan contracting terms and conditions (T&Cs), over and above that of standard firm-specific or country-level institutional factors. Our estimation is based on a seemingly unrelated mixed-processes methodology that accommodates two salient data properties: (i) the fact that loan contract terms are determined jointly as a single lending contract, and (ii) the fact that the elements of loan T&Cs are generated by different distributional formats. Our findings indicate that cross-country variation accounts for a significant portion of observed variation in loan T&Cs. In addition, macroeconomic fundamentals significantly explain the "package" of loan T&Cs offered to corporate borrowers, with this effect being distinct from any influence that T&Cs receive from firm-specific factors, and also from country-specific institutional factors.

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1. Introduction

Bank loan contract terms and conditions (T&Cs) reflect lenders' expectations about the future cash flows of the borrower, and thereby its ability to honor future loan payments, as well as any asymmetry of information between lenders and borrowers (Graham et al., 2008). Bank loan T&Cs consisting of price (the interest rate spread) and non-price (loan amount, collateral, maturity, covenants) elements are simultaneously set by lenders as a single multidimensional loan contract (Graham et al., 2008; Melnik and Plaut, 1986; Strahan, 1999; Watanabe, 2005).

The extant empirical literature has shown that several observed firm-specific characteristics may explain the cross-sectional and time variation in loan T&Cs (Boubakri and Ghouma, 2010; Chava et al., 2009; Strahan, 1999). Furthermore, the literature has shown that good governance mechanisms at the firm or country level work towards insuring lenders' repayment in case a firm defaults (Graham et al., 2008). This literature has also considered that lender protection, through relevant legislation or enforcement mechanisms, may be connected to GDP per capita (Bae and Goyal, 2009; La Porta et al., 1998). However, this research examines the association between country-specific legal protection and enforcement characteristics and loan contract terms, by controlling for macroeconomic influences, among robustness controls.

In this study, we argue that cross-country differences in lender protection and legal enforcement mechanisms do not fully incorporate country-specific macroeconomic differences. Past research in a single-country setting has pointed towards

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macroeconomic factors having a significant influence on bank loan contracting: for example, the magnitude of credit spreads depends on the phase of the economic cycle (Colin-Dufresne et al., 2001; Graham et al., 2008), or banks adjusting the ease with which they approve loan applications depending on macroeconomic conditions (Puri et al., 2011). At the same time, the borrower's probability of default, a crucial determinant of bank loan terms according to traditional banking theory (Francis et al., 2012a), is found to be affected by macroeconomic factors (e.g., Bhimani et al., 2013).

Moreover, to the extent that macroeconomic conditions influence the financial health of the banking sector, there might exist an impact on the tightness of loan contracting terms. Bank financial health has been found to significantly affect loan contracting terms, with financially weaker banks charging higher interest rates (Watanabe, 2005) and more liquidity-constrained banks being more prone to reject loan applications (Puri et al., 2011), with a negative effect on the supply and the cost of lending (Drakos, 2013), which, on a secondary level, can be transmitted into the real economy (Schnabl, 2012). Overall, country-specific macroeconomic conditions are expected to (i) influence the performance of firms via business cycle variations, with subsequent repercussions on the tightness of loan terms provided to financially weaker (vs. stronger) firms; and (ii) affect the financial health of the banking sector, with a corresponding effect on the tightness of loan terms offered by these institutions.

Our study predominantly[1] focuses on a particular case of bank lending; that is, syndicated loans, which are loans provided to a single borrower by multiple financial institutions, which form a "syndicate" for that purpose, and allow credit risk sharing among syndicate members without the disclosure and marketing burden that bond issuers face. Syndicated loans have been considered to provide a form of debt financing falling between bank financing and bond financing (Maskara and Mullineaux, 2011). It is hard to underestimate syndicated loans' significance in international financing, since they account for about a third of all international financing, including bond, commercial paper, and equity issuance (Gadanecz, 2004), and their worldwide volume exceeds that of public debt market issuance (Drucker and Puri, 2007). Although syndicated loans are a hybrid, having commonalities with bank loans and public debt, they are closer to the former due to the role of the lead arranger, who drafts the loan T&Cs, monitors the borrower, and usually holds the largest share of the loan (Dennis and Mullineaux, 2000; Sufi, 2007). Hence, despite the fact that syndicated loans may possess several distinctive features from standard bank loans, when it comes to the determination of their contract T&Cs, they largely adhere to the same principles applied in standard bank loans. In this context, there exists extensive research that examines the determinants of loan T&Cs by making use of large samples of syndicated loans (e.g., Bae and Goyal, 2009; Hasan et al., 2012; Maskara and Mullineaux, 2011; Qian and Strahan, 2007, among many others).

Having these as a springboard, we examine the impact of cross-country differences in macroeconomic fundamentals on bank loan T&Cs, over and above the impact of firm-specific or institutional-related influences, motivated by the anticipated impacts of these factors on (i) the generation of future cash flows for borrowing firms; (ii) their probability of default; and (iii) the effect that business cycles have on banks' loan decision-making process. The question that this study aims to answer is whether bank loan T&Cs are influenced, after controlling for the firm's own financial performance, by the macroeconomic factors of the country in which the firm is based. In other words, how loan contracting terms are expected to differ for otherwise similar firms according to a number of corporate characteristics, but located in countries with different macroeconomic conditions. In particular, we examine the influence of macroeconomic heterogeneity for a sample of 61 countries with loan data on LPC's Dealscan database and accounting information from Worldscope for the period 1990–2011.

Although past research clearly recognizes the multidimensional nature of loan contracts (Graham et al., 2008; Melnik and Plaut, 1986; Strahan, 1999; Watanabe, 2005, among others), it usually treats econometrically the elements of the loan T&Cs as separate facets of a loan deal (e.g., Bae and Goyal, 2009; Graham et al., 2008; Qian and Strahan, 2007). We tackle this problem head on by assuming that loan contract terms are jointly determined and treat the relevant T&Cs equations as seemingly unrelated. A further econometric difficulty is the fact that observed T&Cs elements are generated by diverse distributions. For instance, while loan interest rate spreads can be modeled in a standard ordinary least squares (OLS) context since they are continuous, the same does not hold, for instance, for collateral requirements that typically are recorded in databases as binary and therefore call for a probit or logit estimation. In the present study, we employ a system mixed-processes methodology (Roodman, 2009), which not only allows for the joint determination of T&Cs, but also is flexible enough to take into account the different generating distributions of T&Cs elements. To the best of our knowledge, our study is the first to apply this type of methodology in order to empirically evaluate this theoretical concept, given that past research has made use of either separate assessment of loan terms (e.g., Bae and Goyal, 2009; Graham et al., 2008; Qian and Strahan, 2007) or two-stage least squares methodologies to address endogeneity concerns in the determination of loan contract terms (Drakos, 2013; Ferreira and Matos, 2012).

Our findings indicate that in a simple country fixed-effects setup, cross-country variation is a significant determinant of loan T&Cs, being able to explain up to about 15.5% of the overall behavior of loan T&Cs. When estimating our model with the inclusion of variables accounting for firm- and loan-specific factors (in addition to year and industry controls), the combined explanatory power of our model increases to values ranging between 30% and 60%. Most importantly, even after including factors capturing the country-specific institutional profile (reflecting creditor protection and efficiency of legal and contract enforcement), we find the borrower's country macroeconomic performance (GDP growth, external deficit, government debt,

[1] Specifically, about 81% (or 57,007 out of 69,920) of the total number of bank loan facilities used by the study mention "syndication" as their distribution method, according to Dealscan (sample description provided in Section 3).

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