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Lead arranger reputation and the structure of loan syndicates

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ABSTRACT

This study explores the effects of information asymmetry and arranger reputations on syndicated loan structures. The moral hazard problem arising from information asymmetries between borrower and syndicate can be overcome only by the most reputable arrangers. Both moral hazard and adverse selection problems appear when arrangers have an information advantage over other syndicate participants. However, the adverse selection problem arises only when low-reputation arrangers lend to opaque borrowers.

1. Introduction

Bank loans have become a substantial and important source of external finance for firms. Since the late 1990s, US borrowers annually raised more than $ 1 trillion in form of bank loans.[1] While lending contracted by more than 40% during the 2007/08 financial crisis (Ivashina and Scharfstein, 2010), the US loan market has since recovered with loan volumes exceeding the $1 trillion mark again by 2010 and reaching $ 1.8 trillion in 2011. In the US, bank lending now accounts for more than 50% of newly raised corporate funds, exceeding public debt and equity issuance (Drucker and Puri, 2006; Sufi, 2007). Given this strong reliance of US firms on bank loans as an external financing source, it is important to understand whether and how the relationship between borrower and bank shapes the loan contract.

This paper studies the effects of information asymmetry in the US syndicated loan market. Due to the specialization of banks in the syndicate, information asymmetry manifests itself not only between bank and borrower – as it does in bilateral bank lending – but also among different members of the lending syndicate. This differentiation in the banks' role adds complexity. When deciding whether to join the syndicate and how much to lend, participating banks consider not only the borrower but also the lead arranger, his reputation and his prior relationship with the borrower. In principle, there are two types of lenders in a loan syndicate: First, lead arrangers who structure and arrange the loan and who monitor the borrower after loan signing and, second, participants who passively fund the loan. Information asymmetry problems arise

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[1] These figures are based on data reported by the Loan Pricing Corporation (LPC) in their DealScan database. This database covers large bank loans, almost all of which are syndicated. The data for 2010 and 2011 are based on all non-cancelled loans to US borrowers reported in DealScan.

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between syndicates and borrowers as well as within syndicates. If arrangers have limited information about borrowers, then the arrangers must overcome their resulting moral hazard problem, e.g., shirking from monitoring because lead arrangers' efforts are unobservable. Lending shares and arranger reputation can serve as devices promoting commitment, whereas prior interactions with borrowers and borrower reputation directly reduce monitoring costs and thus the moral hazard problem. In sum, moral hazard considerations are driven by the fact that *all* lenders have limited information about borrowers. In contrast, the signaling argument postulates that arrangers know more about borrowers than participants do. Participants anticipate adverse selection problems (e.g., arrangers attempting to syndicate more loans of poor quality), but arrangers can signal loan quality through their lending shares.

We build on the empirical syndicate structure literature, particularly the work of Sufi (2007), with the primary objective of gaining additional insights into the role of arranger reputation in loan syndication. Whereas Sufi (2007) investigates only loans arranged by the 100 most reputable lead arrangers, we consider the total population of arrangers who are active in the syndicated loan market. By analyzing all arrangers, including those with poor or unestablished reputations, we are able to test whether the benefits of reputation documented i.e., by Sufi (2007) are universal or restricted only to the most reputable arrangers. Our findings indicate the latter: only the most reputable arrangers are able to use their reputation as credible commitment devices, thereby reducing the moral hazard problem. In contrast, arrangers of average or moderate reputation are not able to overcome the moral hazard problem. Furthermore, we provide new evidence. Whereas Sufi (2007) and also Bosch and Steffen (2011) find that moral hazard rather than adverse selection determines the lending shares of the 100 most reputable arrangers, we are the first to document an adverse selection problem that is driven by low-reputation arrangers but that the most reputable arrangers can mitigate.

2. Information asymmetry in syndicated lending

In a typical bilateral lending relationship between borrower and lender, asymmetric information manifests itself in the form of adverse selection and moral hazard. An adverse selection problem arises when one of the parties possesses private information *before* the loan contract has been signed. Here, the lender is not fully aware of the affairs of the borrower and selects a 'bad' borrower because of a lack of information. A moral hazard problem arises due to the existence of asymmetric information *after* the signing of the loan contract. The borrower begins shirking after the signature of a binding loan contract because it is not in the lender's control to determine borrower behavior. Banks can obtain private information by ex-ante screening or ex-post monitoring of the borrower. Additionally, repeated interactions between the borrower and the lender help to generate private information and, hence, decrease information asymmetry. A prolonged relationship is beneficial from the perspective of both parties. Borrowers gain due to the reduction in borrowing costs, the increase in the availability of credit and the easier access to future loan contracts. Similarly, banks benefit from the reduction in the counterparty risk and smooth future cash inflows (Diamond, 1991; Berger and Udell, 1994; Boot and Thakor, 1994; Petersen and Rajan, 1994; Ongena and Smith, 2001).

Contrary to the bilateral lending characterized by the bank-borrower relationship, there are three important relationships in syndicated lending: between borrowers and lead arrangers, between borrowers and participants and between lead arrangers and participants. To better grasp the information asymmetry in the syndication setting, we consider the three principal phases of a syndication transaction. The first is the pre-mandate phase, during which the details of the proposed transaction are discussed and finalized between the arrangers and the borrower. Because borrowers have an information advantage over lead arrangers, there is a potential adverse selection problem. This is more severe when the borrower is opaque, e.g., when very little public information is available about the borrower. Lead arrangers can reduce adverse selection through screening. A prior lending relationship between lead arrangers and borrowers can also reduce the severity of the adverse selection problem. The second phase is the post-mandate phase, during which the syndication itself takes place and facility agreements are negotiated. At this point, an information memorandum is drawn up, and information is ready for dispatch to potential participants. Until this time, participants have no information about the loan, and they depend on the arranger for due diligence. The information superiority of lead arrangers over participants can lead to an adverse selection problem. Because participants are ignorant about the dynamics of the loan and the affairs of the borrowers, the lead arrangers can shift bad loans toward participants. This problem is potentially more severe when lead arrangers fund only a small part of the loan and less severe for reputable arrangers. The third and final phase in the syndication process is the post-signing phase, which lasts for the life of the facility itself. After the disbursement of the loan to the borrower, lead arrangers generally assume the monitoring and administering responsibilities and bear all costs associated with the monitoring and administering. During this third phase, the information advantage of the borrower over all lenders leads to a moral hazard problem (Rhodes and Dawson, 2004; Yener et al., 2006; Miller and Chew, 2008). This moral hazard problem is more severe when the borrower is opaque or when the lead arranger has no prior relationship with the borrower. There is, furthermore, a moral hazard problem between the lead arranger and the participant if the arranger does not fulfill the monitoring task as promised. As arrangers have limited information about borrowers, they must overcome their resulting moral hazard problem, e.g. shirking from monitoring because lead arrangers' efforts are unobservable (Holmstrom and Tirole, 1997; Sufi, 2007; Bharath et al., 2011). This moral hazard problem is potentially more severe when lead arrangers fund only a small part of the loan and less severe for reputable arrangers. Because lead arrangers are repeat players in the syndication loan market, shirking would lead to a loss of reputation and future quasi rents (Pichler and Wilhelm, 2001).