SYNDICATED LENDING[1]

Introduction

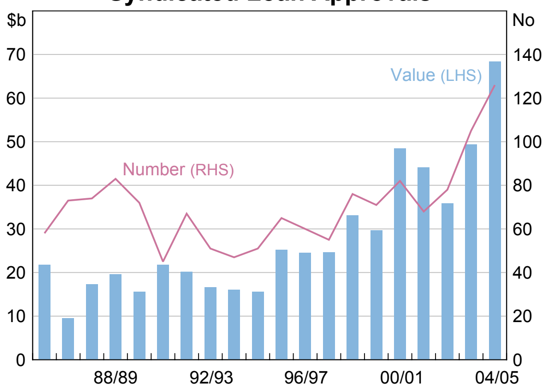
The borrowing requirements of businesses are sometimes beyond the funding and credit risk capacity of single lenders. As a result, some loans are arranged as syndicates with the funds jointly provided by two or more lenders. Though there is a single loan agreement, each participant to a syndicated loan maintains a separate claim on, and bears the credit risk for, the portion of the loan that it has provided. These loans therefore enable lenders to achieve greater diversification in their loan portfolios and maintain client relationships that can be beneficial in other ways.

Syndicated loans are a significant source of external funds for non-financial businesses in Australia, accounting on average for one-quarter of their intermediated debt raisings over the past three years. Moreover, their importance has been increasing recently as the value of annual signings has nearly doubled over the past few years. This article examines the size, characteristics and recent trends in the syndicated loan market in Australia.

Size and Characteristics of the Market

The syndicated loan market in Australia has expanded rapidly over the past few years. According to one source, 126 new syndicated loans were approved in 2004/05, totalling $68 billion (Graph 1 and Table 1). This was a sharp rise from the previous year, when just under $50 billion was approved, and was nearly double the value of syndicated loan approvals in 2002/03. Over the same period, the value of total bank loan approvals to businesses rose by 8 per cent, to $203 billion in 2004/05. As such, in the space of two years, syndicated loans have risen from around one-fifth to one-third of bank loan approvals. The value of syndicated loan approvals has also been more than double the amount non-financial businesses raised from bond issuance over this period, although this overstates the importance of loans in businesses' outstanding debt as many approvals are not fully drawn.

Graph 1
Syndicated Loan Approvals



Source: Thomson Financial

1 *This article was written by Institutional Markets Section, Domestic Markets Department.*

Table 1: Syndicated Loans to Australian Businesses

	2002/03	2003/04	2004/05
Value of syndicated loan approvals (A$b)	35.8	49.4	68.4
– Per cent of total bank loan approvals[(a)]	19	25	34
Number of deals	78	105	126
Average size (A$m)	460	470	540
Average maturity (years)	3.7	3.4	3.8
‘Jumbo’ deals (>A$1 billion each)			
– Value (A$b)	11.7	16.4	34.3
– Number	7	9	18

(a) Total bank loan approvals are by Australian-domiciled banks only
Sources: APRA; RBA; Thomson Financial

The pick-up in syndicated loan approvals has contributed to the upward trend in the growth of business credit over the past few years. Over the year to June, business credit grew by over 12 per cent, compared with average annual growth of 7 per cent in the previous two financial years. Non-intermediated debt also increased at a faster pace in 2004/05 than in the previous year, indicating that the rise in syndicated lending activity was part of a broader pick-up in non-financial businesses’ debt raising.

Although they are a form of intermediated debt, syndicated loans have some similar characteristics to corporate bonds, particularly to those issued in the US private placement market. As with bonds, average deal sizes tend to be quite high, at around A$500 million, reflecting the size of the companies that tap the market. A secondary market exists for lenders to trade their loan shares, much like bonds, but as yet such trading has been fairly limited in Australia; most banks have preferred to take a ‘buy and hold’ approach.[2] While syndicated loans have generally had shorter maturities than corporate bonds, at 3–5 years versus 8–10 years for bonds, the average maturity has lengthened a little recently as an increased proportion of deals have been in the 5–7 years range.

Compared with corporate bonds, however, syndicated loans can offer more flexibility in the way they are structured. Revolving lines of credit that can be drawn down and repaid at will are common, and even fixed-term loans can offer some prepayment flexibility, albeit at a cost, that is generally not available with corporate bonds. Loans are quicker to arrange, having less onerous disclosure and marketing requirements. There is also generally no requirement for a borrower to obtain a credit rating, unlike public bond issues, contributing to the fact that syndicated loans are used by a wider cross-section of borrowers.

Participants in Syndicated Loans

There are two groups of lenders in a typical syndicated loan deal. The more senior group consists of a small number of banks chosen by the borrower – usually from among its existing relationship banks – to put the deal together. These banks, usually known as arrangers or lead

2 *This is despite a number of developments in the past few years aimed at increasing secondary market activity, such as the standardisation of loan documentation through the Asia Pacific Loan Market Association.*

managers, are responsible for structuring the loan facility, including negotiating the pricing and terms and conditions. Most of the banks in this lead group would be involved in funding the loan and, in larger deals, also responsible for underwriting and marketing the loan to other banks. This second group of junior participants simply provides funds for the loan. In addition to helping arrange the deal, one of the lead banks will usually act as an agent, administering the loan after its execution and managing the ongoing relationship between the syndicate members and the borrower.

While the number of banks involved depends on the size and complexity of the deal, in a typical-sized deal in Australia of around A$500 million there would usually be between two and five banks involved in arranging and funding the deal. On some very large deals there can be as many as 30 or so banks involved.

In recent years, strong competition between banks has led to loan participation becoming more concentrated. Over the past two years, for example, over one-third of deals were arranged as so-called 'club' deals in which the syndicate usually consists of only a handful of banks and the borrower may take on the job of arranging the loan itself. Moreover, and notwithstanding the increased share of syndicated loans, some banks recently have been willing to fund loans themselves which are of such a size that in the past they would have been syndicated.

In terms of the main participants, the four major banks play a dominant role in the syndicated loan market in Australia. In nearly all of the deals completed in 2004/05, at least one of the major banks was involved in arranging the loans, and together they committed around half of the funding for these deals.[3] However, foreign banks, particularly Asian, are said to have been increasingly active in the Australian market in recent years, with syndicated loans providing a convenient means for them to gain exposure to Australian credits without the need for a large domestic presence. According to BIS data, foreign banks, including their domestic subsidiaries, participated in deals that together accounted for around three-quarters of the value of total signings in 2004, though it is difficult to measure the exact size of their contributions. Their increased presence reflects a number of factors, including Australia's perceived political, legal and economic stability. It has also been suggested that returns have generally been higher in Australia than in other markets.

Pricing of Syndicated Loans

Syndicated loans are generally priced as an interest rate spread above a floating reference rate such as the bank bill swap rate, or LIBOR in the case of non-Australian dollar denominated loans. The spread will mainly depend on the credit risk of the borrower and the size and term of the loan but may also vary with general demand and supply conditions in the market. For example, a strong increase in the supply of loans by banks is said to have contributed to a narrowing in spreads in recent years. The spread may be fixed for the term of the loan, or it may be linked to certain corporate events, such as changes in the borrower's gearing or profitability.

In addition to earning the spread on the portion of the loan that is drawn, syndicate members also receive various fees depending on their role in the transaction as arranger, underwriter, agent

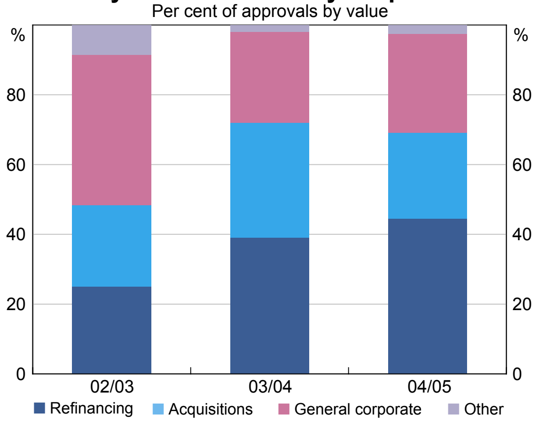
3 *By comparison, the four major banks are responsible for around 70 per cent of all bank loan approvals to businesses, suggesting these banks play an even more dominant role in bilateral lending, particularly to smaller businesses.*

or participant. Those involved in arranging the deal are paid a fee, often called a *praecipium*, for their role in putting the deal together. Any banks underwriting the transaction will earn a fee for guaranteeing the availability of funds, and the agent bank will earn an annual fee for administering the loan after origination. In some cases, junior participants may earn a participation fee for joining the syndicate, with the size of the fee usually dependent on the size of their commitment. Also, for that part of a facility that remains undrawn, the participants will typically receive an annual commitment or facility fee to compensate them for the cost of tying up regulatory capital. Even when the facility is drawn, some deals also incorporate a utilisation fee, in which case the interest rate spread may be somewhat lower than otherwise.

Because of the variety of fees involved and the relatively limited amount of public information on them and interest rate spreads, it can be difficult to calculate the total cost of syndicated loans. Nonetheless, the available evidence suggests that the interest rate spreads on syndicated loans have narrowed considerably over the past few years, with some recent five-year deals carrying spreads of around 60 basis points for BBB or similar-rated borrowers, compared with a typical spread of 70–80 basis points three years ago. Upfront fees would typically be equivalent to an additional 40–60 basis points, depending on the size of the transaction. The decrease in loan spreads suggests that the recent increase in syndicated loan activity is more supply than demand driven, which is consistent with trends evident in other financing markets, such as corporate bonds, whereby a strong supply of funds has led to a narrowing in spreads.

In addition to interest rate spreads and fees, there are various non-pricing conditions, known as covenants, that are also attached to syndicated loans. These are undertakings given by the borrower in a loan agreement that are designed to limit the lenders' risks. Typical covenants include limits on the amount of additional financing the borrower can obtain and restrictions on the use of any funds it might realise from asset sales. Together with the lower pricing, competition among lenders in recent years appears to have also resulted in some relaxation of covenants packages.

Graph 2
Syndicated Loans by Purpose
Per cent of approvals by value



Sources: RBA; Thomson Financial

Recent Drivers of Activity in the Australian Market

A number of trends, most notably the more competitive funding conditions, have contributed to the strength in the syndicated loan market in Australia in recent years. Some borrowers have taken advantage of these funding conditions to refinance their loans on cheaper and/or easier terms. Just under one-half of syndicated loans by value were used for refinancing in 2004/05, up from one-quarter in 2002/03 (Graph 2). As well as accessing cheaper financing, some borrowers have taken the opportunity to lock-in their funding arrangements at longer terms, contributing to the above-noted increase in average maturities.

Mergers and acquisitions have been another recent driver of activity in the syndicated loan market. Because of the potential size and speed with which they can be arranged, syndicated loans are often used as bridge finance for acquisitions before more permanent arrangements, often bonds, are put in place. Acquisitions-related deals accounted for a little over one-quarter of signings in the past two years, including three of the five largest deals in the first half of 2005 (Graph 2).

Associated with refinancing and acquisitions activity, the past year has seen a larger-than-usual number of so-called 'jumbo' deals, defined here as loans in excess of A$1 billion. There were 18 such deals in 2004/05, the largest being a little over A$5 billion. In total these deals accounted for half the value of total signings (Table 1).

Conclusions

Syndicated loans have become an increasingly important source of finance for Australian non-financial businesses over the past few years. While the pick-up in lending activity is indicative of the strength of the Australian economy, and of the corporate sector in particular, it is as much a sign of banks' strong supply of funds, as evidenced by the reduction in loan spreads. This downward re-pricing of loans has raised some concerns that banks may not be taking full account of the risks inherent in these loans. There have been suggestions, for example, that some banks may be using syndicated loans as loss-leaders to gain investment banking business. The decrease in loan spreads is consistent with the aggressive pricing of risk that has been observed in other markets, such as corporate bonds, both within Australia and globally.