

# SHOULD AUSTRALIAN SYNDICATED LOAN CONTRACTS *be standardised?*

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*Syndicated loans have become one of the most important sources of debt funding to Australian business, especially in light of an underdeveloped domestic bond market. This paper provides an overview of the Australian syndicated loan market and highlights the lack of a secondary loan trading market. It examines how standardisation of syndicated loan contracts would aid the development of a liquid trading place, and create opportunities for new institutional participants, especially non-banks, to enter the syndicated loan market.*

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In 2005 the Reserve Bank of Australia published a bulletin article which outlined the features and importance of the Australian syndicated loan market. It noted that syndicated loans accounted for about one-quarter of Australian non-financial debt raisings and that the number of syndicated loans doubled between 2002 and 2005. The syndicated loan is therefore a very important component of the debt market in Australia.

Since 2005, the Australian syndicated loan market has undergone significant change, following a rapid expansion in 2007 and a contraction after 2008. This article delves into a relatively unexplored aspect of Australian syndicated loans: its lack of a secondary market where loans can be resold and traded as a liquid asset. We argue the importance of a secondary market for syndicated loans and make a case for standardisation of loan documentation as a first step towards creating such a market.

A syndicated loan can be formally defined as one in which two or more lenders jointly provide credit to a borrower, with all lenders sharing a single loan agreement contract (Dennis and Mullineaux 2000). The lead bank (or lead arranger) is responsible for the initial loan screening, in which it gathers information on the borrower and evaluates the borrower's creditworthiness. Once the borrower's credit quality is determined, the lead bank proposes a set of financing terms to the borrower, including fees, interest rates, loan size, maturity, covenants, collateral and underwriting method. If the borrower accepts these terms, the lead bank then presents an information memorandum to potential syndicate participants. The syndicate is formally established when a sufficient number of lenders agree to provide the contracted amount of credit.<sup>1</sup>

Syndicated loans are a hybrid of private loan contracts and public debt issues (Boot 2000). They retain the attributes associated with relationship banking through repeated interactions between the lead bank and borrower. On the other hand, they may look like arm's-length public debt issues due to the presence of multiple lenders and hence the associated free-riding problem from monitoring by lenders. This problem, however, can be mitigated in a syndicated loan because: 1) a lead bank which 'underwrites' a syndicated loan is typically required to hold a significant portion of the credit provided; and 2) most lenders who participate in a loan syndication often have a long-term 'buy-and-hold' investment focus, rather than an immediate redistribution approach as with bond underwriting (Armstrong 2003).

Syndication can benefit both lenders and borrowers in various ways. A lead bank originates large syndications to compete with corporate bond issuance, to earn underwriting fees, to limit its risk exposure by sharing the loan with other institutional lenders, and to facilitate compliance with regulatory capital constraints. Through originating a syndicated loan, lead banks can also utilise their expertise in screening, structuring and servicing large loans. Other participating banks, especially those without loan origination capability, may join loan syndications to diversify their own loan portfolios, as well as to establish new customer relationships.

From the borrower's viewpoint, syndication helps to raise a larger amount of funds than any individual bank might be comfortable advancing, and potentially reduces loan interest rates via risk diversification.<sup>2</sup> Syndicated loans also help broaden a borrower's choice of financing, and facilitate a more competitive credit market.

## Features of the Australian syndicated loan market

### Market overview

The Australian corporate loan market is concentrated, being heavily dominated by the largest four domestic banks (the ‘big four’) acting as lead arrangers:

ANZ, National Australia Bank, Commonwealth and Westpac. Between 2009 and 2012, these banks led around 50 per cent of new syndicated loan deals to Australian borrowers. The remaining market is mainly served by foreign banks, with a limited role being played by regional domestic banks.

Table 1 presents a league table of the Australian syndicated loan market compiled from yearly Dealscan data over the 2005–2008 and 2009–2012 periods. Before the global financial crisis (GFC), the big four Australian banks originated about 40 per cent (by value) of new syndicated loans, but this increased to close to 50 per cent in the 2009–2012 period.

**TABLE 1: League table for Australian new syndicated loans, 2005–2008 and 2009–2012 (based on lead arranger role)**

Pre-GFC period: 2005–2008			
Rank	Lender	Amount (AUD billion)	Deal Count
1	Australia & New Zealand Banking Group Ltd	155.12	204
2	Westpac Banking Corp	145.67	195
3	Commonwealth Bank of Australia	133.94	166
4	National Australia Bank Ltd	133.07	154
5	Royal Bank of Scotland Plc	99.68	81
6	BNP Paribas SA	75.58	53
7–20		542.72	337
Post-GFC period: 2009–2012			
Rank	Lender	Amount (AUD billion)	Deal Count
1	Australia & New Zealand Banking Group Ltd	187.11	312
2	Commonwealth Bank of Australia	167.76	253
3	National Australia Bank Ltd	157.90	250
4	Westpac Banking Corp	143.23	267
5	Sumitomo Mitsui Financial Group Inc	72.77	63
6	Mitsubishi UFJ Financial Group Inc	64.78	65
7–20		443.18	427

Source: Compiled from Dealscan.

The European banks have reduced their involvement in this market in the post-GFC era, being replaced by Asian banks such as Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group and Mizuho. The big four are undoubtedly facing strong pressure from

overseas competitors. This reflects the importance of international money-centre banks, as well as Asia-Pacific banks, in the Australian syndicated loan market. Their presence aids the non-AUD funding of Australian borrowers with heavy foreign business exposure.<sup>3</sup>

### The absence of a secondary loan market in Australia

There are a number of possible reasons for the absence of a secondary market for Australian syndicated loans.

The first is the complexity and idiosyncratic features of syndicated loan contracts. Many Australian banks are members of the Asia-Pacific Loan Market Association (APLMA).<sup>4</sup> APLMA was founded in 1998 to promote liquidity in the secondary loan market of the Asia-Pacific region. One of its main objectives focuses on the standardisation of loan documentation with many templates available to member banks. But, because these standards are not compulsorily imposed by any regulatory body, many Australian syndicated deals do not follow the standard practice (Allens 2008). The syndicated loan contract itself is a very detailed one, further complicated by potential conflicts of interest among syndicate members. Without standardisation, it is extremely costly for non-bank institutions, which often lack syndication expertise, to make a fully informed investment decision, hindering their participation in the primary and secondary Australian syndicated loan market. While it may be implausible to standardise a syndicated loan contract down to every detail, syndicated loans typically consist of multiple tranches, suggesting one possible solution. That is to standardise some tranches to make them more appealing to non-bank investors and more tradeable in a secondary market. These tranches, referred to as Term Loan B to H in the US market, often have a bullet payment and less restrictive covenant structures (KPMG 2013).

The second factor impeding development of a secondary market may be the attractiveness of syndicated loans as an asset class to participating lenders. There is a strong incentive for banks (both domestic and international) to retain loans on their balance sheet (i.e. buy and hold).<sup>5</sup> Some banks may use syndicated loan holdings to gain investment banking business with the borrowers. This should not, however, undermine the importance of a secondary market, which could offer risk management benefits in the long run, for instance, when the bank faces a liquidity crunch or a shift in shareholders’ risk appetite.

A third possible reason is the lack of interest from potential investors such as superannuation funds and mutual funds. This could stem from their limited expertise in assessing credit risk and details of the

syndicated loan contract, as well as the inability to subsequently sell loans into a liquid market. In the United States, non-bank institutions and investment banks compete with commercial banks and play a significant role in this market. The US primary syndicated loan market share held by non-banks was recorded at 80 per cent in 2004 (Yago and McCarthy 2004). It is this source of non-bank financing that can create liquidity for the secondary syndicated loan market. This is the classic ‘chicken and egg’ problem where liquidity and market participation are endogenous.

#### Why should a secondary loan market add value?

For many years, the Australian authorities have been trying to promote the development of the domestic corporate bond market without much success. In fact, Black et al. (2012) reported a declining trend in bond issuance by non-financial corporations.

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*Syndicated loans could potentially resolve concerns about the absence of a domestic fixed income asset class for investors. This suggests that policy makers should perhaps focus on measures aimed at developing a liquid secondary market. The ability to trade loans, either in whole or in part, facilitates better risk management, which should encourage more investors to participate in the primary loan market.*

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This section summarises the main findings of past literature on the value added by an active secondary market for syndicated loans. It examines the key issues, using examples from the US syndicated loan market, and also addresses the differences between the Australian syndicated loan market and its domestic bond market. It highlights several reasons why the Australian syndicated loan market warrants a more developed secondary trading place.

#### Past research findings

Secondary market syndicated loan sales can take the form of participation or assignment. In participation, the seller remains the official holder of the loan (i.e. lender of record) while the buyer is entitled to receive loan payments from the originator. In assignment, the buyer becomes an official syndicate member (Wittenberg-Moerman 2008). Loan trading allows syndicate lenders flexibility to buy and sell loans to diversify their loan portfolios (Simons 1993; Demsetz 1999). Through loan assignments, syndicate lenders can also better comply with capital adequacy requirements (Pennacchi 1988).

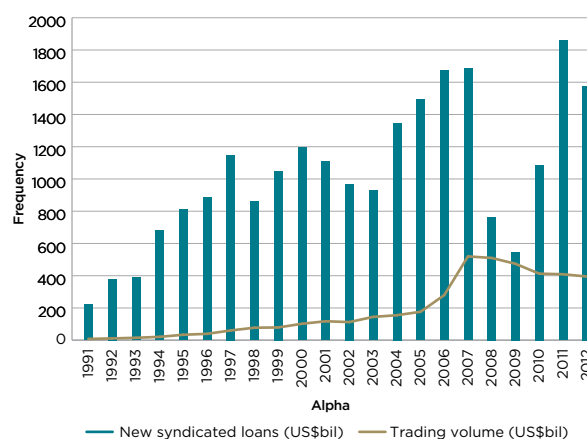
There may also be benefits for borrowers. Borrower's stock prices react positively on the first trading day of its loans, help ease the borrowing firm's financial constraints, and increase future credit availability (Gande and Saunders 2012). By providing better risk transfer across market participants and increasing market liquidity, loan sales may reduce the borrower's cost of capital (Gupta et al. 2008; Parlour and Winton 2012).

A common concern regarding loan sales is the moral hazard arising from situations where existing lenders retain good loans and only sell ‘lemons’ in the secondary market, thereby providing incentives for lead banks to reduce their monitoring of loans. These problems, however, can be efficiently mitigated by requiring lead banks to hold a sufficiently large proportion of these loans, thereby maintaining their ‘relationship bank’ incentives (Gorton and Pennacchi 1995). In addition, the ability to syndicate future loans relies heavily on lead bank reputation and repeated transactions between institutions, which then prompts the lead bank to act diligently (Dennis and Mullineaux 2000; Lee and Mullineaux 2004; Sufi 2007).

#### Lessons from the US market

Apart from being dominated by a few lead banks, Australian loan syndications also differ from their US counterparts due to the absence of an active secondary loan trading market. Dealscan reports that in 2010, US secondary loan trading comprised around 40 per cent of US loan market outstandings. In the equivalent time period, trading of Australian syndicated loans was only 8 per cent of the total market size.

**FIGURE 1: US annual new syndicated loan issuance and market trading volume (in US\$ billions), 1991–2012.**



Source: Compiled from Dealscan.

Figure 1 shows the syndicated loan trading volume in the US secondary market relative to annual new syndicated loan issuance between 1991 and 2012. Until 2007 the primary and secondary markets grew in line with each other, with both markets peaking in 2007 when the trading volume in the secondary market accounted for over 30 per cent of new loans originated. Since the GFC, secondary loan trading has slowed, while new loan issuances recovered significantly between 2008 and 2011.

There are three main reasons for the development of a very deep and liquid loan trading market in the United States. First is the availability of loan ratings from major credit ratings agencies, such as Moody's, Standard & Poor's, and FitchRatings. Second is the publication of Gold Sheets,<sup>6</sup> which provide detailed information on market trends, price indexes, and related news. Third is the formation of the Loan Standardisation and Trading Association in 1995 aimed at promoting standard loan documentation and establishing recognised market practice, among other goals. These factors have created an environment in which non-bank investors can understand and have confidence in assessing the level of risk in the syndicated loan market.

We view the participation of non-bank institutions as an extremely important factor in facilitating the development of a secondary market. This can only be achieved if non-bank investors are provided with detailed information on this market. With the ratings agencies well established in Australia, and Gold Sheets now easily constructed by data vendors, standardisation of syndicated loan contracts appears to be the final piece of the puzzle missing before the development of a secondary market can occur here.

#### **Why syndicated loans and not the bond market?**

So far we have argued for the development of a secondary loan market in Australia. Market liquidity – the ability to buy and sell securities easily – facilitates efficient capital allocation and therefore enhances long-term economic growth (Levine 1991). Over the past few decades, the Australian Government and government financial agencies have made efforts to develop the domestic bond market. Black et al. (2012) conducted a comprehensive review of the Australian bond market and reported that the domestic source of public debt finance to Australian non-financial firms remains limited.

There are many reasons for the lack of progress in the development of the domestic bond market. This paper is not intended to discuss those reasons. However, we note that in 2011, total new syndicated loans to domestic non-financial corporate borrowers were over AUD80 billion, while total outstanding corporate bonds were valued at less than AUD50 billion, based on Dealscan and RBA statistics. Such

figures indicate that the syndicated loan market is better placed to supply credit than the bond market, even without any government assistance. Given a strong domestic demand for funds, the Australian syndicated loan market should warrant a more liquid loan trading place if sufficient progress is made with regard to loan document standardisation. A recent study by Altman et al. (2010) reported that due to the monitoring advantage maintained in syndicated loans, which is not present in public bonds, loan trading should be informationally more efficient than bond trading. They find that loan returns tend to lead bond returns prior to a borrower's loan default.

#### **Summary and policy recommendations**

This paper has discussed the Australian syndicated loan market, and outlined the merits of standardisation of syndicated loan contracts as a first step towards creating a liquid secondary loan market.

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*A market for trading loans can serve as an effective risk management tool. It provides opportunities for investors, both bank and non-bank, to diversify their portfolios, including opportunities to access currently unavailable forms of credit risk for higher expected yields. While credit risk is not always desirable, lead bank retention of a large proportion of the loan provides some mitigation against unfavourable outcomes.*

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Potential beneficiaries include smaller institutions with limited expertise in originating syndicated loans, such as regional banks, credit unions and building societies. Managed funds and finance companies, often under the pressure to yield higher promised returns for their clients, can also benefit from having an alternative investment. The volume of funds under management of these non-bank entities is rapidly growing. For instance, it has been estimated that superannuation funds will grow from AUD1.3 trillion to AUD3 trillion in the next decade, to reach AUD5 trillion in 2030 (Medcraft 2012). With an almost non-existent domestic corporate bond market, these non-bank financial firms are faced with a limited investment menu, where the dominant choice is equity investment.<sup>7</sup> An active secondary loan market should also benefit borrowers in the sense that lenders are willing to charge a lower loan spread given lower ex ante liquidity risk.

To facilitate broader investment options, the Australian Securities and Investments Commission has strongly emphasised the need for standardised documentation of securitised products to enhance

disclosure quality and transparency (Tanzer 2013). Because this has not yet occurred in relation to syndicated loans, this has partly delayed the participation of non-bank entities in this market. Efforts to develop a secondary bond market should therefore be complemented by efforts to encourage a secondary syndicated loan market, with a first step being policies designed to standardise syndicated loan contracts.

### Endnotes

- 1 Loan syndications can be underwritten under the best-efforts or firm-commitment approach. Under the best-efforts method the ultimate amount of credit provided may differ from the targeted amount, or the syndication may also fail. The firm-commitment method mandates that the lead bank provide the entire credit amount under any circumstance (Armstrong 2003). Public data is only available on completed syndications.
- 2 Angbazo et al. (1998) and Dennis et al. (2000) observed higher interest rates for sole-lender loans in comparison to syndicated ones and argued that this is evidence supporting the risk diversification effect.
- 3 Esho et al. (2007) investigated foreign currency syndicated loans in Australia and reported that borrowers with higher foreign exposures are more likely to obtain loans in foreign currencies. They attributed this to borrowers' operational hedging strategy.
- 4 See [www.aplma.com](http://www.aplma.com).
- 5 Some industry experts on Australian syndicated lending have suggested that banks often view these syndicated loans as part of their prime asset portfolio, with a good risk-return profile, so they tend to keep them on the book and only sell for liquidity reasons.
- 6 Published by the Loan Pricing Corporation.
- 7 Based on the Australian Prudential Regulation Authority statistics as at end-June 2013, Australian shares comprised 26 per cent, and international shares comprised 25 per cent, of aggregate equity investments of Australian superannuation funds.

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