

TYPES OF CREDIT AND THE IMPORTANCE OF SYNDICATE CREDIT

Kurganova Barno Islamovna

Master of Banking and Finance Academy of the Republic of
Uzbekistan



Abstract *We assess the relative importance of ratings versus stock exchange listings in reducing information asymmetry using a dataset of syndicated loans to public and private firms in the UK. We find that the certification effect of ratings is largest for private firms and that syndicates are smallest if firms are privately held or unrated. Moreover, we find that the marginal effect of being stock exchange listed is insignificant once these firms are rated. Exploiting the heterogeneity among lenders, we find that especially foreign bank and non-bank investors do not provide capital if firms are unrated. Our paper highlights the information produced by rating agencies as an important mechanism by which ratings improve access to capital. Our results also emphasize the importance of syndicate moral hazard on the supply of uninformed capital: bank–borrower relationships significantly increase the loan share syndicated to investors particularly if firms are not listed and unrated.*

Key words: *Credit, types of credit, syndicated loan, syndicate credit, loan market, foreign bank, stock exchange.*

Introduction

Credit can be classified into various types based on how it is extended, its terms, and the parties involved. Some of the main types of credit include:

1. **Revolving Credit:** This type of credit allows borrowers to access a pre-approved credit limit and borrow funds repeatedly as long as they repay what they owe.
2. **Installment Credit:** This involves borrowing a fixed amount of money, which is paid back in installments over time, usually with interest. Mortgages and car loans are examples of installment credit.

3. **Trade Credit:** This type of credit is extended by suppliers to businesses, allowing them to purchase goods or services on credit and pay later.
4. **Secured Credit:** This credit is backed by collateral, such as a house or a car. If the borrower defaults, the lender can seize the collateral to recover the loan.
5. **Unsecured Credit:** This type of credit is not backed by collateral, and lenders assess the borrower's creditworthiness before approving the loan. Credit cards are an example of unsecured credit.

Importance of Syndicated Lending

Syndicated lending refers to a loan provided by a group of lenders, known as a syndicate, which collectively finances a single borrower. It is commonly used for large-scale projects or loans that require significant capital.

The importance of syndicated lending includes:

1. **Risk Diversification:** By sharing the loan amount among multiple lenders, the risk is spread, reducing the exposure of any single institution to the borrower's default.
2. **Access to Large Funds:** Syndicated lending allows companies to raise larger amounts of capital than a single lender might be willing to provide.
3. **Cost Efficiency:** Since the risk is distributed, interest rates may be lower compared to individual loans, making it a more cost-effective solution for borrowers.
4. **Improved Credit Terms:** With multiple lenders involved, borrowers may have access to more favorable loan terms and conditions.
5. **Strengthened Relationships:** Syndicated lending fosters cooperation among financial institutions, creating stronger ties within the financial sector.

In conclusion, understanding the different types of credit and the significance of syndicated lending helps businesses effectively manage their financing needs while minimizing risks.

Analysis and Evaluations

The syndicated loan market is an important source of global corporate finance, exceeding the total annual issuance volume of equity and bond markets. A significant portion of these loans have been allocated to private and unrated firms.¹ Information asymmetry therefore plays a key role in the development of this market. Information frictions caused by borrower adverse selection or moral hazard can be mitigated if lending is performed by a single lender (Diamond, 1984, Ramakrishnan and Thakor, 1984, Fama, 1985) which can be even further improved if this lender has prior relationships with this borrower (Boot, 2000). However, in a syndicated loan setting, where the loan is shared among multiple lenders, there is an additional element of moral hazard between the lead arranger and other syndicate members (Holmstrom and Tirole, 1997) which is referred to as “syndicate moral hazard” in the literature. The lead arranger has an incentive to shirk on his monitoring effort because he only keeps a fraction of the loan in its own books. Syndicate moral hazard is important because it has substantial supply side effects, i.e. investors who are not familiar with the borrower (the “uninformed investors”) are not willing to provide capital (Sufi, 2007). Mitigating information problems is therefore at the heart of much economic literature.

In this paper, we assess the relative importance of ratings versus stock exchange listing at reducing information asymmetry. We address this issue by explicitly investigating whether syndicates are larger (and therefore the supply of available debt financing) if firms are rated rather than stock exchange listed. As there is no financial data on private US firms readily available, we use a dataset of syndicated loans taken out by public and private firms in the UK over the period from 1996 to 2007. We exploit a specific institutional feature in the UK related to the corporate structure of firms: firms can either be private limited liability companies (“private”) or public limited liability companies (“public”) which in turn can either be “listed” or “not listed”. Both private and public firms can be “rated” or

“unrated”. We exploit this heterogeneity to assess the marginal impact of being rated rather than listed on syndicate composition and the supply of uninformed capital.

Existing research highlights the importance of credit ratings. Kisgen (2006) provides evidence that ratings affect capital structure decisions if firms are near a credit rating upgrade or downgrade. Faulkender and Petersen (2006) find that credit ratings are associated with better access to public debt markets and higher leverage. Sufi (2009) examines the effects of the introduction of bank loan ratings and finds that bank loan ratings increase the access of borrowers to debt financing, lead to higher leverage, higher asset growth and more investment in working capital. Our paper contributes to this literature analyzing the relative importance of credit ratings and stock exchange listings at expanding the supply of debt financing.

We find that loans to opaque firms have much smaller syndicates than do transparent firms. For example, we find that the number of lenders would be expected to decrease by a factor of 0.84 (0.80) if loans are allocated to private (unrated) firms relative to transparent firms. Further, unrated listed firms have significantly smaller syndicates than do listed and rated firms. The marginal effect of being rated is larger for not-listed than for listed firms.

Next, we use the number of foreign banks and non-bank investors as dependent variables. We find that the smallest syndicates are associated with private and unrated firms; in other words, credit rating certification is critical to the supply of debt financing. We also find that public and rated (but not listed) firms have the same number of lenders as stock exchange listed and rated firms, i.e. the marginal effect of being stock exchange listed is insignificant. However, the number of lenders declines by a factor of 0.80–0.83 if firms are listed but not rated (holding everything else constant).

Overall, our results suggest that the information produced by rating agencies is an important mechanism by which ratings improve access to capital.

The model by Holmstrom and Tirole (1997) implies that syndicate moral hazard is an important determinant of the supply of uninformed capital. Informed lenders need to hold a financial stake in the borrower to certify his quality before uninformed lenders invest. The empirical literature has just started to examine syndicate moral hazard (Sufi, 2007, Bharath et al., forthcoming). We provide further evidence for syndicate moral hazard evaluating the effect of being opaque (for example, being unrated or private) on syndicate structure for relationship versus non-relationship borrowers. Relationships are important and generate private information to banks about the clients (Fama, 1985). A testable hypothesis is that, if borrowers are opaque, relationship lenders keep a smaller share of the loan. We use three proxies for prior bank–borrower relationships measuring the existence and strength of the relationship. We find that relationships significantly reduce the financial stake lead arrangers have to hold in the borrower if firms are unrated. Moreover, this effect is particularly strong if firms are not stock exchange listed and unrated. In other words, if borrowers are opaque, the information gained in bank–borrower relationships is important as it reduces the amount of informed capital needed in the economy. Our results are consistent with syndicate moral hazard being an important determinant of the supply of debt financing.

Table

Syndicated Credit Rates¹

Lender	Loan Share (%)	Interest Rate (%)	Loan Amount (USD)	Fee (%)
Lender 1	40%	5.0%	40,000,000	1.5%
Lender 2	30%	4.8%	30,000,000	1.3%
Lender 3	20%	5.2%	20,000,000	1.6%
Lender 4	10%	5.1%	10,000,000	1.4%

Explanation:

¹ Ehsan Nikbakht "The Economics of Syndicated Lending" – 2015 y. 225-232 pages

- **Lender:** The financial institution providing a portion of the syndicated loan.
- **Loan Share (%):** The percentage of the total loan that each lender is providing.
- **Interest Rate (%):** The interest rate that each lender is charging on the portion they are lending.
- **Loan Amount (USD):** The dollar amount of the loan provided by each lender based on their share.
- **Fee (%):** The fee charged by each lender for participating in the syndicate.

We perform several robustness tests using OLS, Poisson and negative binomial models. We further estimate the regressions in reduced form and include borrower fixed effect to control for endogeneity. Additionally, we use an instrumental variable approach to address the endogeneity concerns associated with being rated and several tests to address selection into being private or stock exchange listed. All of our previous results hold.

This article is related to three strands of existing research. First, it is related to the literature on how syndicated loans are structured (Panyagometh and Roberts, 2002, Lee and Mullineaux, 2004, Jones et al., 2005, Sufi, 2007, Champagne and Kryzanowski, 2007, Maskara, 2010), why loans are syndicated (Simons, 1993, Dennis and Mullineaux, 2000) and how syndicated loans are priced (Hao et al., 2006, Ivashina, 2009, Santos and Winton, 2008, Bharath et al., forthcoming, Hale and Santos, 2008, Norden and Wagner, 2008). It also relates to several international studies examining syndicate structures across countries (Esty and Megginson, 2003, Esty, 2004, Qian and Strahan, 2005). Second, this paper also contributes to the literature that argues that access to debt financing affects firm financing and investment policy (Faulkender and Petersen, 2006, Kisgen, 2006, Sufi, 2009). Third, it relates to the broader literature on the importance of credit rating agencies (see, for example, Bannier and Hirsch, 2010, Boubarki and Ghouma, 2010, Lu et al., forthcoming).

The paper is structured as follows. The next section describes the theoretical motivation and hypothesis of this paper. Section 3 presents the data and methodology. Section 4 presents the analysis and Section 5 discusses the results and shows several robustness checks. The last section concludes.

Conclusion

This paper analyzes different ways to overcome information asymmetry and their differential impact on the structure of loan syndicates using a dataset of syndicated loans extended to UK borrowers during the 1996–2017 period. We provide evidence that credit ratings are of first order importance in reducing information asymmetry over and above being listed on a stock exchange. *Ceteris paribus*, public rated firms attract a larger number of uninformed investors than firms that are stock exchange.

List of used literature

1. **"The Syndicated Loan Market: An Overview"** by Mark J. Flannery
This paper provides a thorough introduction to syndicated loans, including the structure of loan syndicates and the market's role in corporate financing. – 2000 y.
2. **"Corporate Finance: Theory and Practice"** by Aswath Damodaran
This textbook offers a comprehensive explanation of corporate finance, including a section on syndicated loans and how they are used in business financing. – 2000 y.
3. **"Syndicated Lending: A Guide to the Structuring and Documentation of Syndicated Loans"** by M. B. Jackson
A detailed guide covering the structuring, documentation, and best practices in syndicated lending, including legal and financial perspectives. – 2012 y.

4. **"The Economics of Syndicated Lending"** by Ehsan Nikbakht

This book explores the economic principles behind syndicated loans, focusing on how these loans function in modern financial markets. – 2015 y.

5. **"Syndicated Loans: A Guide to the International Loan Markets"** by John A.

Vint/ This book provides insights into how syndicated loans work, detailing the loan process, market trends, and the different players involved. – 2022 y.

6. **"Lending and Credit Risk Management"** by John O. G. Horne

This book covers various types of credit, with a focus on risk management practices in syndicated lending and the role of credit ratings in loan syndication. – 2022 y.