Developments in the international syndicated loan market in the 1980s

This article[1] surveys developments in the international syndicated loan market[2] during the 1980s. Although the market experienced high volumes of business at the beginning of the decade, there was a significant decline after the onset of the LDC debt crisis in 1982, which continued during the mid-1980s. From the end of 1986, activity revived and business has continued to strengthen. The article considers the advantages that syndicated loans possess over various capital market instruments, exploring two particular sources of demand for new credit facilities—merger and acquisition related activity and the arrangement of multiple-option facilities (MOFs).

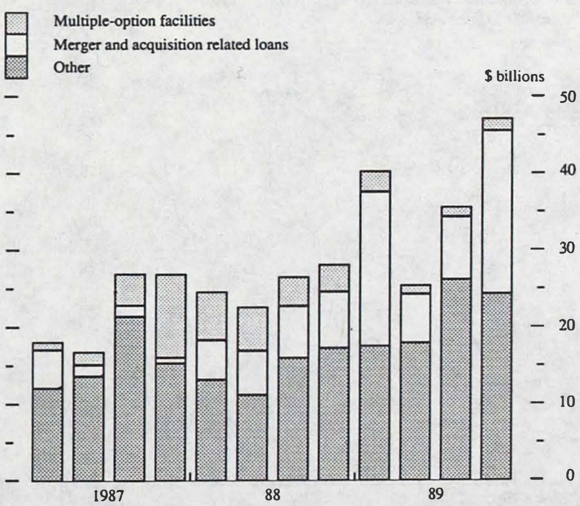
General overview

At the beginning of the 1980s, the market for international syndicated loans was already well established and business was buoyant. New credit facilities worth almost $83 billion were announced in 1980, and a further $101 billion were announced in the following year. Many major international banks were heavily involved in extending loans to borrowers from the less developed countries (LDCs) and newly industrialising economies (NIEs) in the period 1976–82. Some of the assumptions which underlay the banks' policy of portfolio diversification through more overseas lending were, however, increasingly being questioned, particularly in relation to loans extended to state entities in the LDCs. With the intensification of the debt crisis resulting from the decision by Mexico to suspend interest payments to its creditors in August 1982, the euroloan market entered a phase of sharp contraction. Activity reached a nadir in 1985, when the value of new international syndicated loans amounted to only $19 billion.[3] In contrast, in the capital markets, gross eurobond issues increased from $74 billion in 1982 to $163 billion in 1985. Thus the decline in the use of the syndicated loan as a vehicle for international financial flows was very clearly associated with the process of securitisation which was then having a major impact on financial markets. This phenomenon was related to an increased investor preference for tradable claims and the desire of some borrowers—notably major industrial companies—to exploit the fact that their creditworthiness relative to the banking sector had improved markedly, so giving them an incentive to issue securities directly to end investors.

Since the last quarter of 1986, however, the market for syndicated loans, both international and domestic, has once more experienced high levels of activity, although the composition of borrowers has changed significantly from that at the beginning of the decade. This resurgence has been attributable to three salient factors:

- the desire of corporate institutions in the developed countries to restructure their existing lines of credit into more flexible financing arrangements, such as multiple-option facilities (see below);
- the growth in debt-financed takeovers and management buyouts, reflecting, in part, the reduction in the cost of debt finance resulting from the decline in inflation from the early 1980s; and
- more generally, the competitive funding opportunities that this sector offers to second-tier corporate borrowers which do not possess a sufficiently high credit rating to obtain access to the eurobond market and utilise interest rate swaps at favourable rates.

Chart 1
Announcements of international syndicated credits



Source: Bank of England ICMS Database.

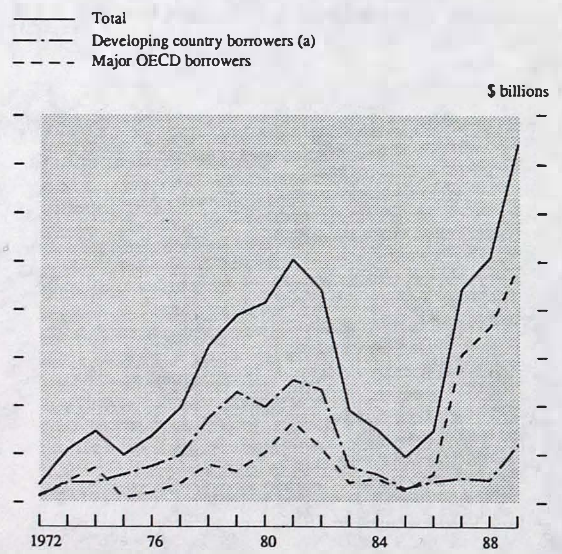
(1) Written by T J Allen in the Bank's International Division.
(2) The Bank of England's International Capital Markets Database records all announcements of syndicated credits other than those which represent banks' domestic currency lending to home country residents. It therefore includes both 'eurocurrency' credits, where banks resident in one particular centre arrange loans denominated in foreign currencies (from the banks' point of view) for either residents or overseas borrowers, and domestic currency loans (again from the banks' point of view) for non-residents.
(3) Domestic syndications, however, fell less precipitously over the period 1982 to 1985.

The relative importance of multiple-option facilities and merger-related loans is illustrated in Chart 1. The syndicated loan market, together with its fixed-income competitors, has also benefited from the extended period of growth that the major OECD economies experienced after the economic slowdown of the early 1980s. In particular, investment expenditure has been strong over the past three years, increasing the demand for funds. During 1989, there also appears to have been a recovery in the value of commitments raised on behalf of developing countries. This increase was partly associated with project finance opportunities and lending related to commodity earnings, rather than reflecting new money packages to borrowers from heavily indebted countries requiring funds for general or unspecified purposes.

Conditions in the syndicated loan market, 1980–89

Until 1985, borrowers from the LDCs and the NIEs generally accounted for a more substantial share of the international syndicated loan market than did borrowers from the major OECD countries (see Chart 2 and Table A). The recovery in volumes which has taken place since the end of 1986, however, almost entirely reflects greater activity by borrowers from the major industrial economies. In recent years there has also been a change in the importance of industrial borrowers generally relative to sovereign borrowers, although the former have always represented the single most important group of borrowers since 1980. Borrowing by central governments and other government departments accounted for approximately 20% of all credits in the early 1980s. After 1982, this proportion declined significantly and is now around 5% of the overall market: governments of LDCs have, in many cases, been excluded from the market altogether, and those of the industrial countries have increasingly turned their attention to bond financing and the euronote sector, where they have been able to obtain finer rates and pursue more precise debt management policies. For example, the Kingdoms of Belgium, Spain and Sweden developed large commercial paper or medium-term note programmes either in the US domestic market or in the euromarket. In contrast, credit facilities arranged on behalf of industrial borrowers have represented over 45% of all syndicated loans in every year since 1982, reaching 88% of all announcements in 1988 and 81% in 1989. US dollar denominated credits have always formed the most significant component of the total market; in every year since 1980 dollar facilities accounted for more than 60% of all international syndicated loans.

Chart 2
Announcements of international syndicated loans,1972-89



Source: Bank of England ICMS Database.

(a) Includes less developed countries, newly industrialising economies and oil producing countries.

Table A
International syndicated credits: borrowers, by region
$ billions

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989(a)
Major OECD countries	20.5	33.2	22.6	8.2	9.9	5.1	11.6	61.4	72.8	98.7
Minor OECD countries	19.4	15.7	18.4	13.6	6.2	4.4	6.5	14.9	18.3	23.9
Eastern Europe	2.8	1.1	0.5	0.5	2.2	3.6	2.3	1.9	1.2	2.2
International institutions	0.6	0.4	—	1.2	0.1	—	0.4	0.4	0.1	0.1
Less developed countries	15.0	22.5	19.7	5.1	4.0	1.5	3.7	6.5	6.2	15.0
Newly industrialising economies	11.1	14.7	11.8	3.5	3.5	3.0	1.1	1.1	1.5	3.7
Oil producing countries	13.0	12.9	13.8	5.5	3.8	1.2	3.3	2.0	1.6	5.3
Other	0.4	0.4	1.4	0.4	0.4	0.2	0.7	0.5	0.1	0.1
Total	**82.8**	**100.9**	**88.2**	**38.0**	**30.1**	**19.0**	**29.6**	**88.7**	**101.8**	**149.0**

Source: Bank of England ICMS database.

(a) Provisional.

Table B
International syndicated credits: breakdown by type of borrower
$ billions

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989(a)
Industrial borrowers	48.5	65.1	53.3	22.0	17.1	8.5	15.2	67.8	89.4	120.6
Banks and financial institutions	16.9	18.9	16.9	5.0	9.0	8.2	9.0	15.0	8.9	21.1
Central banks	—	—	1.1	1.9	0.3	0.5	1.5	1.0	1.1	1.2
Central government	14.2	14.4	16.0	8.8	3.6	1.6	3.7	4.0	1.5	4.5
Other government	3.2	2.5	0.9	0.3	0.1	0.2	0.2	0.9	0.9	1.6
Total	**82.8**	**100.9**	**88.2**	**38.0**	**30.1**	**19.0**	**29.6**	**88.7**	**101.8**	**149.0**

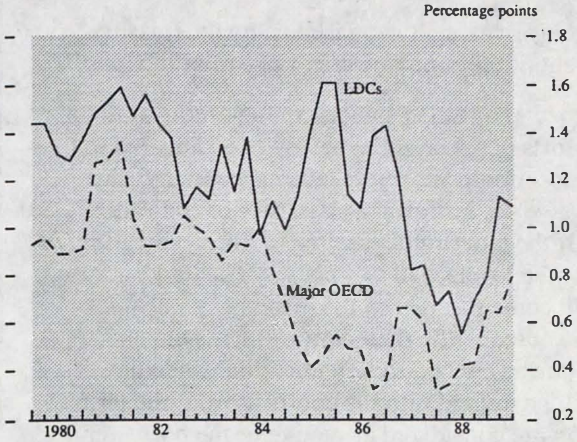
Source: Bank of England ICMS database.

(a) Provisional.

Margins[1] on international syndicated loans for major OECD borrowers underwent a general but not continuous decline from 1982 to the first half of 1988 (see Chart 3). The fall in average margins which took place after 1983 can be attributed to two main factors. First, with the onset of the debt crisis many prime corporate borrowers turned to the various securities markets to service their financing requirements. In particular, the growth of the eurocommercial paper and floating-rate note markets provided borrowers with alternative sources of short-term and floating-rate funding. The banks were therefore obliged to compete more aggressively for international

(1) International syndicated loans are generally priced with reference to the Libor benchmark, although other bases such as the Paris interbank offered rate (Pibor), the US prime rate or various CD rates are also used. As well as being influenced by market competition, the margin that is charged above this will essentially be a function of country and credit risk.

Chart 3
Spreads[a] on major OECD and less developed country loans



Source: Bank of England ICMS Database.

(a) Three-quarterly moving average.

and wholesale business as well as turning their attention to off-balance-sheet financing. Second, the major international banks became involved in arranging standby credit facilities designed to support the commercial paper activities of industrial companies or provide short-term cash advances for working capital purposes. As such loan facilities are not intended to be fully drawn upon in normal circumstances, the margins attached to them are comparatively low and the facility fee represents a more important element in the overall pricing. For almost all of the period from 1982 to 1988, the average margin on loans for borrowers from the major OECD countries was below that incurred by borrowers from the LDCs.

More recently, however, average margins have increased for both borrowers from the major OECD countries and those from LDCs, although they remain below the levels seen at the beginning of the decade. The new capital adequacy rules introduced under the auspices of the Bank for International Settlements represent one factor that should cause banks to negotiate higher margins. The increase in spreads may also be attributed to a change in the composition of loan facilities which have been arranged in recent quarters. For example, high margin business in the form of loans to finance acquisitions has become a greater component of the total market. The strength of potential competition among banks in the syndicated loan market, however, acts as a countervailing force, limiting the extent to which spreads may rise.

Market attributes

The demand for international syndicated credit facilities, which predominantly reflects private sector funding requirements, results from the fact that the syndicated loan market, or more generally the banking sector, is able to perform certain essential functions more satisfactorily than securities-based capital markets. The main advantages of a syndicated loan facility are:

- a credit facility provides the borrower with a stable source of funds—of particular value in the event that other capital markets are subject to some form of disruption;
- the syndicated loan sector generally allows borrowers to raise larger sums than they would be able to obtain through either the eurobond or the equity markets in the short term;
- the ability to arrange deals quickly and discreetly, which may be of value with certain transactions such as takeovers;
- the capacity to provide commitments to lend which can be cancelled relatively easily; it would be difficult to cancel borrowing in the securities markets without reducing investor confidence.

To some extent these advantages are relative rather than absolute. For example, the US domestic commercial paper market and the ECP market can offer a wide range of borrowers access to short-term funds, albeit on an uncommitted basis, and the medium-term note market can be regarded as a form of contingent bond financing. As dealers in these markets will only place notes on a 'best efforts' basis, such programmes do not offer the certainty of committed bank lines. For prime industrial corporate borrowers and well-regarded sovereign borrowers, this does not present a major problem as they will be able to place their paper and bonds at more competitive rates than they could obtain funding in the bank market under normal circumstances. But for a wide spectrum of companies, particularly in Western Europe where the domestic CP markets are less well developed than in the United States and an established 'below investment grade' bond market has not as yet emerged, the stability and certainty of banking relationships continue to be attractive.

Multiple-option facilities[1]

A multiple-option facility (MOF) is the general name for a number of credit and money-market fund-raising mechanisms which are documented in a single agreement and are administered by a single agent on behalf of a syndicate of banks. The MOF is typically based upon a committed revolving credit and incorporates other arrangements which allow the borrower to obtain finance on an uncommitted basis, such as tender panels for multicurrency cash advances and bankers' acceptances or facilities allowing for the issue of commercial paper or some other form of note. Such facilities therefore represent a more convenient packaging of existing banking services rather than a fundamental innovation; instead of managing a series of bilateral banking relationships, the corporate treasurer can arrange a significant part of his company's funding through one agent. Under normal circumstances borrowers will obtain funding through a tender panel mechanism or by issuing

(1) A more detailed discussion of this instrument is included in the May 1988 *Bulletin*, page 212.

The syndication process

The syndicated loan market is able to provide a broad spectrum of borrowers with funding for a wide range of projects. Loans can vary in size from small club deals, where three or four relationship banks can participate in transactions for as little as £10 million, to very large acquisition or project-related credits worth in excess of a billion pounds. For example, Eurotunnel obtained two syndicated loans in the third quarter of 1987 with a combined value of £5 billion, where the syndicate comprised approximately 160 banks. More recently, RJR Acquisition Corp obtained a package of loan facilities worth $13.6 billion in order to provide a consortium headed by Kohlberg Kravis Roberts with the necessary finance to complete the leveraged buyout of R J R Nabisco.

The syndication process commences when either a borrower approaches a bank and invites it to become a syndicate arranger or when the bank itself approaches a corporate borrower which it believes to be seeking funds. The arranger, or in some cases the arrangers, once mandated will then set about co-ordinating a consortium of banks who are prepared to lend money given an initial set of terms. The borrower's relationship banks will usually form the basis of the syndicate and further invitations may be extended according to the size, complexity and the pricing of the loan as well as the desire of the borrower to increase the range of its banking relationships.

Eventually, the arranger or lead-manager may find itself at the apex of a whole hierarchy of institutions, who may accept positions as co-lead managers, managers, co-managers or just participant banks, depending on the amount of money that they are prepared to lend or commit and the input that they have in the syndication process. The larger the credit, the more complex the structure. The lead-management role itself is occasionally undertaken by the treasury department of the company seeking to raise the loan.

The arranger may either undertake the syndication on a 'best efforts basis' or, if the borrower is prepared to pay an appropriate fee, put together an underwriting group to give the borrower a guarantee of committed finance. If the latter route is adopted, the syndication process will take place in two phases. The underwriting group will come together in the primary syndication and then subsequently their commitments may be reduced during a secondary syndication, when new banks will be invited into the consortium. If the terms of the loan are considered attractive or the borrower is well-regarded by the market, the loan may well be oversubscribed. In this case the arranger may either invite the borrower to increase the size of the total credit or the banks may find that the amounts they have committed are scaled down *pro rata*. The completion of a transaction is often evidenced by the publication of a notice, generally referred to as a 'tombstone', in the financial press.

As well as earning a margin over Libor (or any other benchmark) when the loan is drawn, banks in the syndicate will receive various fees. The arranger and other banks in the lead management team, who may be responsible for various aspects of documentation, will generally receive some form of front-end management fee. Other participants will usually expect to receive a participation fee for agreeing to join the facility; the actual size of the fee will vary with the size of the commitment. Once the credit is established, members of the syndicate will often receive an annual facility or commitment fee, again proportional to their commitments. Loan documents may sometimes incorporate a penalty clause, whereby the borrower agrees to pay a fee or give some consideration to the lenders in the event that it pre-pays its debts prior to the specified term.

short-term promissory notes, and will achieve finer rates than they would have to pay if they were to make drawings upon the committed credit component of their MOF. For many major companies the MOF has represented a rationalisation of existing banking services, rather than a net increase in bank intermediation. Moreover, available evidence suggests that drawings made under these facilities are generally modest when compared with the total value of funds that could potentially be obtained under the uncommitted portions.

During 1987 and the first half of 1988 there was a trend among many major industrial companies to consolidate their existing bilateral credit lines into more flexible arrangements such as MOFs, while refinancing debt at favourable rates at the same time. This tendency was particularly evident in the United Kingdom and France, where borrowers took advantage of the greater flexibility provided by MOFs. The development of other banking products such as the revolving underwriting facility and the note issuance facility had already established the concept of competitive bidding mechanisms such as tender panels and the MOF sought to combine this feature with a standard credit. Banks decided to bid aggressively for mandates to arrange such transactions and strongly marketed the product, particularly as such arrangements gave them the opportunity to establish new business relationships after a period in which volumes in the syndicated loan market had been low. The fees and margins attached to these arrangements have generally been regarded as being fine—a number of well-regarded UK companies have been able to obtain MOFs where the annual facility fee was less than 10 basis points and the spread no more than 12.5 basis points over Libor.

As many major companies, both in the United Kingdom and elsewhere, have now acquired MOFs, the demand for such arrangements will increasingly come from second-tier corporate borrowers, for whom various eurocurrency options are less relevant. The implementation of the Basle capital convergence agreement by the United Kingdom and other countries should make banks more reluctant to participate in MOFs at the aggressively-priced margins which were common in the early part of 1988. Some banks may, however, choose to participate in this lower return business in order to establish or retain long-term relationships with customers. Moreover, the more cautious attitude which some bankers have adopted towards high yield mezzanine debt and leveraged transactions could result in a desire to reweight portfolios more towards lower-geared companies wishing to have access to funds for general corporate purposes.

Merger and acquisition related lending

The stock market crash of October 1987 led to speculation that new merger and acquisition activity would decline significantly, reflecting the perceived difficulties of raising new equity finance. The continued buoyancy of company profits within the major industrial economies during 1988, together with the depressed state of many companies' stock market valuations, however, provided a considerable stimulus to new acquisitions. In many cases the syndicated loan has been the vehicle through which such takeovers have been financed. As mentioned above, the banking sector, through consortium loans, allows borrowers to raise larger sums than they are able to obtain through either the eurobond or the equity market over the short term, and to do so quickly. Moreover, borrowers may subsequently refinance such debt by utilising other markets.

The value of international credits arranged to finance acquisitions or mergers increased from $8.8 billion in 1987 to $24.6 billion in 1988 and then expanded to $55.8 billion during 1989 (see Table C). UK companies together with their subsidiaries were the most important national group of borrowers in both 1987 and 1988. To a large extent, this reflected the arrangement of a small number of very large facilities for major UK companies. For example, three financings, arranged for Grand Metropolitan Finance ($6 billion), the Tate and Lyle Group ($1.3 billion) and BAT Industries ($3.2 billion), accounted for almost three quarters of the UK total in 1988. Many of the credits arranged in the period 1987–89 were intended to finance acquisitions of US companies. Consequently, merger-related syndicated loans have been overwhelmingly dollar-denominated—82% during 1989.

Merger-related business can provide banks with two major forms of income: fees from giving advice on the mechanics of mounting a takeover (or defence) and interest charges and other fees from participating in any financing package arranged on behalf of the acquirer. While there is some debate on the subject of exactly how generous are the returns on merger and acquisition business, the greater emphasis which many banks have placed on this type of activity since the beginning of 1988 indicates that it has been perceived as a welcome source of income. While a prime corporate borrower might pay 12.5 basis points or less over Libor on drawings obtained under the committed portion of a MOF, the average margin attached to merger-related eurocurrency loans during the first three quarters of 1989 was 112 basis points; such returns do, however, involve banks assuming a higher risk/return profile. The spread of perceived risk is illustrated by the range of margins from which that average is calculated, which stretches from 15 to 600 basis points. Recently, a number of well-regarded borrowers who were not highly geared nor likely to become so after making their acquisitions were able to obtain large merger-related syndicated credits in the London market at relatively fine rates. There is perhaps a tendency for pricing on merger-related loans for major companies with limited debt levels to move closer to the rates that such companies could obtain on facilities intended to finance working capital.

Table C
Merger and acquisition related international syndicated loans
US$ millions

Country of borrower	1987	1988	1989(a)
Australia	641	2,311	1,247
Canada	750	150	2,100
France	—	2,447	789
Japan	—	1,472	—
United Kingdom	5,794	14,141	10,059
United States	900	1,705	33,703
Other	710	2,367	7,946
Total	**8,795**	**24,593**	**55,844**
of which:			
Sterling	*457*	*515*	*8,335*
US dollar	*7,788*	*22,898*	*46,292*
Other	*550*	*1,180*	*1,217*

Source: Bank of England ICMS database.

(a) Provisional.

Mezzanine debt

Another development which has received considerable attention during the last two years has been the growing use of mezzanine or subordinated debt. This instrument has generally been associated with the current wave of corporate restructuring that is taking place in Western Europe and North America, particularly in connection with leveraged buyouts, where companies are acquired with borrowed funds which result in the acquirer assuming a relatively high gearing ratio. Mezzanine funding can take a number of different forms and refers to the issue of any form of subordinated debt claim. In the United States, mezzanine debt often takes the form of 'below investment grade' bonds, while in Europe it is generally some form of bank debt with equity warrants attached. Although mezzanine debt is usually associated

Announcements of international syndicated credits and international banking flows

Data on announcements of syndicated loans can yield useful information on a number of issues, such as the degree of competition within particular sectors of the banking market, the extent to which companies in certain countries are restructuring their financial commitments and the growth of new loan products (mezzanine finance, multiple-option facilities). It has also been suggested that announcements of new international syndicated credits could be used as a leading indicator of bank lending to non-banks. The arrangement of credit facilities, however, represents the establishment of commitments to lend and, therefore, it is not always possible to make direct inferences about the value of actual drawings; trends evident in the international syndicated loan market are not necessarily reflected in cross-border flows. A recent study at the Bank using univariate time series techniques came to the conclusion that there was only a weak statistical relationship between announcements of new international syndicated credits and international banking flows. The difficulty in relating the two data sets also arises from the fact that the Bank of England's data on international syndicated loans do not include facilities with a maturity of less than one year; moreover, data on international banking flows will also incorporate drawings upon bilateral lines of credit.

with financing acquisitions and buyouts, it could have other applications, such as certain forms of project finance, where the actual project involved is particularly cash-generative.

The subordinated debt packages arranged for European buyouts have generally been domestic transactions with relatively little intermediation taking place outside the capital market of the country in which the acquired company is located. This situation could change in the future. The completion of the leveraged buyout of R J R Nabisco at the beginning of 1989 demonstrated that even the very largest companies can be subject to a takeover. Mezzanine financings may also be structured to include layers of debt which possess varying degrees of subordination; the interest rate or the value of the equity warrants attached to more junior claims will be correspondingly higher. The mezzanine market has grown quickly in a comparatively short time and the potential returns from this type of lending are attractive to many banks who have been used to standard corporate credits carrying narrow margins over Libor in recent years. Banks are not the only participants in this market. A number of special-purpose funds have been set up since the beginning of 1988 to provide subordinated finance for buyouts. The reduced creditor protection attached to these loans means that the margin over Libor may be 3% or more, somewhat higher than the margins which might be charged on the senior loan component of a LBO financing. At present, however, the current pattern of European short-term interest rates is having an adverse impact upon new lending opportunities. Nevertheless, if the market in leveraged buyouts were to develop further in Europe, as a result of prominent companies being subject to takeovers or management buyouts, the local markets in mezzanine debt might become insufficient to accommodate the demand for funds, resulting in greater cross-border activity.

Secondary market

Another major development since the early 1980s has been the increasing tendency for banks to trade credit participations in the secondary market. While there are few statistics on the total size of the secondary market, the LDC debt problem and more recently the growth in LBOs have encouraged banks to adjust the balance of their loan portfolios. The recent Basle agreement on capital adequacy has presented many banks with the choice of increasing capital or removing assets from their balance sheets; many appear to have chosen to adopt the latter option to some degree, using loan transfers or securitisation to effect the reduction. There are three main methods by which loan participations may be transferred: novation, assignment and subparticipation. Novation involves the replacement of one legal agreement with another, thus extinguishing the contractual relationship between the original creditor and the debtor; assignment and subparticipation are non-recourse funding arrangements which do not normally involve the borrower as they operate in parallel with, rather than instead of, the original loan. This heightened emphasis on marketability could result in the syndicated loan market assuming some of the characteristics of the FRN market. The existence of a well-developed market in participations in syndicated loans results in banks developing many of the same skills that are required to operate successfully in the bond market, namely the ability to market debt claims and to establish a major network of potential investors. This could be regarded as part of a more general process in the euromarkets, where in recent years innovation and securitisation have led to the gradual dissolving of the boundaries between money, credit and capital markets. The existence of an established market in loans or loan participations also raises some interesting issues for bank supervisors. After consultation with the markets, the Bank issued a Notice in February 1989 (BSD/1989/1) which sets out the Bank's supervisory policy on the treatment of loan transfers involving banks.

Conclusion

Over the last three years, the international syndicated loan market has clearly demonstrated its ability to mobilise substantial volumes of funds on behalf of a variety of different borrowers. The strength of investment spending over the past three years and the buoyant levels of merger and acquisition activity in recent years have generally provided international financial markets with a major stimulus on the demand side. In particular, acquisition-related lending has come to represent a major component of the overall market for international syndicated credits. More recently, there have been some indications that borrowers from the less developed countries are making greater use of the market in specific contexts. The market has also shown its ability to meet the increasingly complex needs of major corporate borrowers. While the demand for syndicated loans may fluctuate over time, this sector is likely to remain a significant and durable component of international financing.