STEPHENSON HARWOOD

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EU focus on Loan Syndication in Credit Markets

On 5 April 2019, the European Commission ("**Commission**") published the long-awaited report, entitled "EU loan syndication and its impact on competition in credit markets" prepared for it by Europe Economics, in conjunction with Euclid Law ("**Report**"). The Report follows a two-year consultation into the EU syndicated loan market considering the competition concerns at each stage of a syndicated loan from pre-mandate to secondary market trading. The Report focuses on three main market segments, namely, Leveraged Buy Outs ("**LBOs**"), Project Finance ("**PF**"), and Infrastructure Finance ("**Infra**") in a sample of six EU countries, which include France, Germany, the Netherlands, UK, Spain and Poland.

While the Report does not contain the recommendations or conclusions of the Commission itself, it should inform the Commission's policy and enforcement in this area. It also suggests a number of safeguards that banks should observe to protect competition in the loan syndication process.

Background

Syndicated loans are generally regarded positively as they allow institutional investors and banks to collectively provide funding for projects which would otherwise be deemed as too risky to be financed by a single institution. However, the cooperative nature of syndicated loans can give rise to greater potential for competition law risks to arise.

In its 2017 Management Plan[1], the Commission noted that the loan syndication market was showing signs of *"close cooperation between market participants in opaque or in transparent settings…which are particularly vulnerable to anticompetitive conduct*". Therefore, it announced its intentions to conduct an investigation into the market for loan syndication, subsequently publishing a notice inviting tenders to conduct an analysis of the EU loan syndication market.

Main findings of the report

Overall, the Report finds that markets are generally functioning well for borrowers and that compliance procedures are on the whole robust. The Report did not find that any of the market segments looked at were highly concentrated, although it did note that there could be some degree of concentration in the PF/Infra segment in smaller jurisdictions or where knowledge was more limited (compared to the LBO segment).

Generally, borrowers and sponsors were considered to possess sufficient sophistication either to assess and negotiate the price and terms of the loan in-house or to appoint advisers to assist them. The Report did however recognise some differentiation between Western Europe, where there were more market players, and Eastern Europe, where there were fewer. Indeed, a number of the concerns raised in the Report related primarily to Poland, which was the one non-Western European country covered by the Report.

However, the Report primarily found that there were a number of market features which could facilitate coordination, namely:

- Use of market soundings by Mandated Lead Arrangers ("**MLAs**"): this could give rise to the exchange of commercially sensitive information particularly where these soundings are deal-specific rather than generic, involving MLAs or entities connected to MLAs. However, the main safeguard here is if the deal-specific soundings have borrower consent as it demonstrates a lack of anticompetitive intent.
- Provision of ancillary services where this is restricted to the syndicate (or a subset of it): this involves an

[1] European Commission Management Plan 2017. See also, our previous update on the European Commission's Management Plan titled "Antitrust spotlight on syndicated loans – 2017"

obligation or strong expectation that ancillary services would be purchased from the MLAs.

- Potential scope for tacit reciprocity in the market: where book-runners deal directly with participating lenders on multiple occasions over time giving rise to an expectation of reciprocity. However, it is noted that there are several safeguards in place to prevent this (e.g. borrower/sponsors-driven whitelists, direct feedback loops between investors and sponsors, regular feedback from book-runners, and approval by borrowers/sponsors of final syndicate member allocations).
- Limited bargaining power of borrowers when they are facing default: this could occur as discussions on refinancing (as well as ancillary services) would involve lenders of the original syndicate, increasing the risk of collusion (e.g. a willingness (or lack thereof) of the market to provide new finance imposing a restriction on borrowers' bargaining power).

The Report proceeded to identify the following competition issues that could potentially exist within the market:

- Horizontal information sharing;
- Cooperation leading to overt collusion between lenders;
- Market power being conferred to a syndicate in certain circumstances; and
- Misaligned incentives between lenders within a syndicate, and between lenders and borrowers more generally.

Key Risks

The Report also more specifically identified a number of key risks at various stages of the syndication process, including:

- **Market soundings and bidding for appointment to lead banking group**

  In the LBO segment, market soundings are used by MLAs with investors. This creates the risk of information on specific lenders being communicated back to origination desks. This may be further exacerbated where some institutions have no significant functional separation between syndication and origination desks. However, while there is a risk that soundings may be abused to facilitate collusive action, the Report found that this risk was relatively low.

  In the PF/Infra segments, the Report found there was a higher risk of anticompetitive behaviour because interactions between lenders will usually cross over the general/specific sounding boundary in the bidding stage. This creates the possibility of information sharing, allowing coordination within the syndicate such that price and terms of the loan could move against the borrower. The Report observed that the risk could be heightened where the MLA is also acting as an adviser or other limitations are in place on the replacement of the bank as an MLA. However, the Report noted that there was no evidence that this was actually taking place.

  In response to the identified risks, the Report suggests that the boundary between generic and specific market soundings be carefully defined such that in its strongest form, borrower consent should be obtained in advance and be specific as to who can be contacted. Additionally, ensuring the sounding only contains information as specific as is needed for its purpose and the signing of NDAs can emphasise to parties the seriousness of any breach in terms of information-sharing.

- **Post mandate collusion by lenders discussing the loan terms**

  The Report found the risk of this low since the borrower/sponsor generally agrees terms bilaterally with each lender following the mandate where joint discussions between lenders should be limited to agreeing loan documentation and syndication strategy. However, there was some evidence that the syndication process may not always work in the borrower/sponsor's favour in terms of it agreeing the price to the highest common denominator rather than negotiating a common price. In particular, this risk was identified in the context of club loans in some PF/Infra deals, where lenders were brought together at an early stage to discuss terms. However, this may simply be a reflection of the relative attractiveness of the credit itself and is not it appears a common phenomenon.

  The Report also discussed the possibility of lenders engaging in discussions outside of the borrowers' mandate, especially in circumstances where the borrower is not sophisticated. There is a risk that lenders may observe each other's behaviours and strategies, enabling coordination on future loan

transactions, although the Report found no direct evidence to support this.

It was suggested that to combat this risk, the borrower/sponsor should exercise control by monitoring discussions taking place between lenders.

- **Allocation of ancillary services**
  In relation to this stage of the syndication process, the Report finds that in most cases the allocation of ancillary services is decided as part of the initial agreement or as a separate competitive process. However, even is such circumstances, especially in the PF/Infra segment where there was a tendency for ancillary services directly related to the loan to be allocated by the borrower/sponsor to lending banks at the initial stage of agreeing overall loan terms, this could be problematic as the lenders will know who they are competing with for these services. Consequently, this provides the banks with scope to discuss and collude on pricing.

  The Report also observed that some MLAs make the provision of ancillary services by them a condition of the loan, which could be an area of concern resulting in sub-optimal outcomes (which was recently noted in a Spanish competition investigation).

  Additionally, restrictions by lenders on who can provide hedging services can be problematic where there is a limited number of potential providers within the syndicate as this restricts choice. However, the Report found no evidence of this happening in practice.

  The Report also noted that outside the UK both "right of first refusal" and "right to match" clauses (which are banned for UK regulated firms) that are not directly related to the loan are still used, which could result in potential issues.

- **Use of debt advisers who are also lenders**
  The Report found that in the PF/Infra segment in particular, adviser banks are often also part of the syndicate. Additionally, some lenders bundle their adviser and lender services at the request of the borrower/sponsor. This creates a risk to competition as a bank could potentially influence the borrower/sponsor towards a structure which suited its lending arm.

  In response, the Report suggests that where the debt adviser is also one of the lenders, the advisory role should be functionally separate from the lending role. Further, strong Chinese walls should be implemented between the lending arm and the advisory arms.

- **Secondary market considerations**
  The Report found that competition law risks could arise if underwriting banks coordinate subsequent to any coordinated sell-down agreed as part of the original loan negotiations with the borrower/sponsor (i.e. in relation to when to sell, what amount to sell and at what price to sell debt in the secondary market). Such coordination would unlikely be justified even with the borrower's consent. However, the Report also finds that there was no evidence of coordinated activity to manipulate prices on the secondary market given the sophistication of the buyers. Nonetheless, it was also observed that in the PF/Infra segment there was widespread evidence of borrower/sponsor restrictions on secondary trading which could limit the development of the secondary market and have minor knock-on effects on the primary market (given that secondary pricing data often informed primary price setting).

- **Refinancing in conditions of default**
  The collaborative manner in which restructuring discussions and negotiations are conducted enhances the risk of coordination. While the Report found no evidence of this occurring, it noted that any subversion of the correct process would be problematic. Additionally, the Report found that there is an opportunity for ancillary services to be tied to any refinancing on non-competitive terms. Such risks were exacerbated where negotiations are limited to existing members of the syndicate.

  In order to combat the risks of anticompetitive activities, the Report suggests that on top of competition training, restructuring teams be functionally separate from origination teams (i.e. discussions are undertaken by different teams to reduce the risk of coordination) with discussions between lenders occurring only at the borrower's instigation (i.e. with the borrower's consent).

  On the whole, the concerns highlighted in the Report appeared to be largely hypothetical and a number of the "*critical safeguards*" which the Report advocated to deal with these concerns (e.g. ensuring that banks' advisory roles are functionally separate from their lending roles and that Chinese walls are in place to prevent information leakage, providing competition law training for lenders' restructuring teams) already appear to be in place at a number of lenders.

Action points for financial institutions

While the Report offers a number of safeguards that may be adopted by financial institutions at each stage of the syndication process, the Report concludes by emphasising the most critical safeguards that should be adopted in order to ensure competitive outcomes in the syndication process. The safeguards deemed most important to be adopted are:

- Avoidance of unwarranted information exchange: Any market players capable of forming the lead banking group while remaining competitors in the origination should have protocols in place to allow which will not promote anticompetitive alignment of prices.
- Promotion of unbundled price competition: Syndicates should limit the cross-sale of ancillary services, particularly where services are not directly linked to the loan. The Report suggests that the offer of such services should be kept outside the syndication process.
- Training and policies: The Report emphasises the need for training and policies for relevant staff at MLAs, in particular regarding the duty to provide neutral advice to clients and to identify and manage conflicts.
- Promoting competition between lenders: The Report calls for borrowers to ensure a competitive bidding process by approaching more lenders, maintaining bilateral negotiations with each of them prior to mandate.
- Ensuring alternative options are introduced to the borrower: The Report calls for MLAs to ensure that alternative options are put to the borrower prior to aligning loan terms (including pricing) to a highest common denominator. Such alternatives may include inviting other lenders to participate or restructuring the loan.

Other developments in loan syndication

Several competition authorities have considered aspects of syndicated lending or syndicated activity in financial services in recent years:

- In February 2018, the Spanish competition authority fined four Spanish banks €91 million for manipulating interest-rate derivatives that were associated with syndicated loans for financing projects.
- In 2017, the FCA issued a number of 'on notice' letters to firms suspected to be involved in anti-competitive practices involving syndicated loans. This followed its review of the syndicated loans market in its market study on corporate and investment banking in 2016.
- In 2014, the Loan Market Association also published a notice on the application of competition law to syndicated loans[2], reminding members of the need to adopt and comply with compliance measures and the criminal consequences of non-compliance.

[2] Notice on the application of Competition law to syndicated loan arrangements 2014

the transfer of deal-relevant information obtained by the virtue of the syndication from other potential participants to the origination function in a manner

- In 2010, the Dutch Competition Authority conducted a market study into the syndicated loan market, concluding that borrowers' choices were being limited.

Conclusion

While the Report is not deemed official Commission guidance, the identified risk areas provide an indication of the areas in which the Commission may focus in the future. However, the good news for the moment is that no enforcement action is anticipated for now (and nor is a sector inquiry likely at this stage).

Given the flurry of activity that has taken place in the sphere of syndicated loans in the past few years in Europe, it is clear that regulators are concerned about the effective operation of the syndicated loan market. It is therefore important that banks and other institutions in this space closely monitor developments in this area and take the opportunity to review their compliance programmes in to ensure that they are up to date and compliant.

Contact us

If you would like any further information, or if a brief discussion on any of the issues arising in this briefing would be helpful, please do not hesitate to get in touch.

Marta Isabel Garcia
Partner, Competition
T: +44 20 7809 2141
E: marta.garcia@shlegal.com

Zoe Tan
Trainee, Competition
T: +44 20 7809 2352
E: zoe.tan@shlegal.com