THE EUROPEAN COMMISSION REPORT ON LOAN SYNDICATION AND ITS IMPACT ON COMPETITION

The European Commission has published a Report that it commissioned to study EU loan syndication and its impact on competition in credit markets. 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.

The Report indicates areas of antitrust risk and suggests certain critical safeguards that banks should observe to ensure that competition is maintained in the loan syndication process.

Background and methodology

On 5 April 2019, the European Commission published a Report that it had commissioned almost two years previously into the effectiveness of the loan syndication markets and whether any aspects might give rise to potential competition concerns. The Report does not contain the recommendations or conclusions of the Commission itself, but it should guide the Commission's policy and enforcement in this area.

Prepared by Europe Economics, the Report is based on extensive interviews with borrowers, sponsors and others in the industry (rating agencies and debt advisers). It covers three segments – LBOs, project finance (**PF**) and infrastructure finance (**IF**) – across six EU countries, UK, Germany, France, Spain, Netherlands and Poland.

The Report finds that, overall, markets are not concentrated, but there may be some pockets of higher concentration within the PF/IF segment, where knowledge (and hence ability to price credit risk) is more limited, or within smaller jurisdictions, for loans not denominated in a major currency. It finds some evidence of "home bias" (top ranked lenders tend to be from that country) and some inefficiencies resulting from regulatory requirements and settlement procedures. However, the main focus of the Report is on features of the syndicated lending markets that could facilitate collusion and the safeguards that can be put in place to prevent these features resulting in anti-competitive outcomes.

Key issues

- The Report focuses on whether features of the industry and processes within loan syndication are conducive to competition law concerns, rather than establishing instances of violation.
- The Report identifies a number of market features that could potentially facilitate collusion, including the conduct of market soundings, the provision of ancillary services, tacit reciprocity in general syndication and the possibility for coordination in secondary trading and refinancing opportunities.
- There are a number of critical safeguards that can mitigate the risk of an infringement, including information barriers, staff training, giving borrowers suitable options and limiting the cross-sale of certain ancillary services.

MARKET FEATURES THAT COULD FACILITATE COLLUSION

The Report identified the following market features that could facilitate collusion:

- <u>Information exchange through generic and specific market soundings</u>. This gives rise to a risk that the exchange of commercially sensitive information will lead to a collusive outcome, particularly where soundings cross the line between the generic and the specific and involve other mandated lead arrangers (**MLAs**), or entities connected to an MLA. The risk may be exacerbated where banks do not have significant functional separation between syndication and origination desks. Borrower/sponsor consent is a key factor in the context of deal-specific soundings and, although not determinative, provides prima facie evidence of a lack of anticompetitive intent. Conversely, information exchanged between lenders where the borrower has sought to prevent this through the use of non-disclosure agreements is problematic.

  The risk of anticompetitive information exchange reduces post-mandate, where market practice tends to be for loan terms to be agreed bilaterally between the borrower and individual lenders and joint discussions between lenders should be limited to agreeing loan documentation and syndication strategy. In club deals, where the borrower does bring lenders together to discuss terms at an early stage, lenders should be careful to avoid engaging in discussions outside of the borrower's mandate.

- <u>Coordination on the secondary market</u>. Competition law risks may arise if underwriting banks coordinate (subsequent to any coordinated sell-down agreed as part of the original loan negotiations with the borrower/sponsor) in relation to when to sell, what proportion to sell, or at what price to sell the debt in the secondary market. The Report suggests that such co-ordination is unlikely to be justified even if the borrower consents to it, and could be anticompetitive 'by object', such that a competition authority would not have to prove that it gave rise to anticompetitive effects. However, the Report finds no evidence of coordinated activity to manipulate prices in the secondary market and notes that competition law risks in the secondary markets are less plausible given the implied sophistication of the buyers. The Report also finds that terms seeking to limit secondary trading (often imposed by borrowers/sponsors) may limit the efficiency of the secondary market, which may have a knock-on effect on the primary market, at least in the PF/IF segment where secondary pricing data often informs primary price setting.

- <u>Provision of ancillary services</u>. This risks competition for related services being restricted where their provision is limited to the syndicate, or a sub-set of it. 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. In some cases, the MLAs make the provision of ancillary services a condition of the loan, which the Report raises as an area of potential concern (this issue was noted in a recent investigation by the Spanish competition authority). In the PF/IF segment, even where the terms of ancillary services are negotiated as part of the overall loan terms, the Report suggests that this may be problematic, as the lenders will know who they are competing with for these services. Similarly, restrictions on (for example) who can place hedging services will be problematic in markets where there is a limited number of lenders able to provide such services. Provisions giving a right of first refusal relating to ancillary services that are not directly related to the loan (e.g. further financing or investment services) have been banned in certain jurisdictions (e.g. the UK) and raise potential issues elsewhere. The Report also raises the possibility that conflict of interest issues may arise where a borrower seeks debt advice from an affiliate of a lender, but notes that this can be addressed through the well-established use of information barriers between advisory and lending functions.

- Tacit reciprocity in general syndication. Where bookrunners deal directly with participating lenders in multiple interactions over time, the Report suggests that this could give rise to an expectation of reciprocity, particularly in the absence of borrower involvement, such as the use of white lists, direct feedback or approval of final syndicate allocations.
- Refinancing. A potential issue arises where a borrower is in financial difficulties or facing default and a refinancing opportunity may emerge. The Report found that functionally separate restructuring teams would typically take over in case of default risk, meaning that any discussions on the refinancing terms are undertaken by different teams from loan origination (so reducing the risk of coordination) and also that in most cases, lenders from outside the original syndicate were involved in discussions, again suggesting limited coordination. However, the Report also identified a large minority of cases where negotiations for the refinancing (as well as ancillary services) involved only the original syndicate members, so increasing the competition law risk. This might be the case, for example, where the timing of the refinancing was urgent.

CRITICAL SAFEGUARDS

There are a number of critical safeguards identified in the Report which may serve to mitigate the antitrust risks in the loan syndication process:

- Banks' duty of care to clients. MLAs should ensure that alternative options are put to the borrower, including inviting in new lenders (subject to borrower consent), restructuring the loan, or involving the borrower in bilateral negotiations before aligning loan pricing or terms upwards. Banks should obtain clear prior and informed consent to their proposals and the scope of any discussion/mandate. MLAs should also train staff in the identification and management of conflicts of interest, especially where the MLA has an affiliated advisory arm.
- Information exchange should be managed. In particular, there should be enforceable protocols governing the circumstances in which any deal-relevant information obtained by a bank's syndication function may be transferred to the same bank's origination function. Ordinarily, information should be consolidated and anonymised. Where the syndication and origination functions are not separate, the Report suggests that different individuals perform these functions and, in any event, banks should make it clear what each role entails, i.e. that the role of the syndication desk is not to facilitate the origination desk in winning a bid for a given loan. Borrowers also have a role by structuring the bidding process so as to keep lenders separate for as long as possible and in communicating very clearly what, and with whom, a potential lender can discuss.
- Promotion of unbundling. Although not unlawful in many jurisdictions, syndicates should limit the cross-sale of ancillary services, particularly when not directly linked to the loan.

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