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Strength in numbers?

Loan syndication and potential competition issues

by **Jacques Derenne, Ciara Barbu-O'Connor, Benoit d'Udekem** and **Rachel Bechek**

The syndicated loan market has recently triggered attention from competition authorities worldwide. In April 2017, the Directorate General for Competition (DG COMP) of the European Commission (Commission) commissioned a study on the syndicated loan market in the EU with a focus on evaluating to what extent syndication and close cooperation among syndicate participants might lead to certain anti-competitive behaviours.[1] In its 2017 Management Plan, DG COMP described the motivations for the study: "*This area exhibits close cooperation between market participants in opaque or in-transparent settings, such as over-the-counter (OTC) activities, which are particularly vulnerable to anti-competitive conduct. Work will focus on obtaining relevant information on market structure, dynamics between market participants and potential competition issues*".[2] In anticipation of the results of the study, this article seeks to highlight some competition law risks of particular interest and concern, along with providing an overview of this sector and of selected economic considerations.

Defining loan syndication

To go back to basics, loan syndication is a process that enables a borrower to obtain funds (often of considerable size) from a group of two or more lenders. Syndicated loans are a significant source of financing for multinationals, and a common source of funding for large-scale endeavours and projects. Syndication may occur when the borrower has no or limited access to the bond market or is seeking to acquire a sum too large or too risky for a single lender to provide independently. These lenders are banks or other types of financial investors (eg insurance companies, fund managers, hedge funds) who are able, when they act in concert, to lend very significant amounts and/or take on significant risks more generally. Syndicated loans lie on the continuum between bank (relationship) loans and bonds (transaction loans) and are therefore often considered a "hybrid of private and public debt".[3]

In practice, loan syndication is most often used in corporate financing. Companies seek loans to finance mergers and acquisitions, buyouts, and other capital expenditure projects, or when they temporarily or permanently do not have access to bond markets. For example, at the end of 2015, Volkswagen AG was granted a €20bn bridge (that is, temporary) loan by a syndicate of thirteen international banks "to help shoulder the costs of its emissions scandal".[4] Eight of the banks each lent €1.825bn, while five lent €1.08bn each. The rationale for taking out a syndicated loan, instead of borrowing from the market by issuing a bond, was that Volkswagen "hoped its bonds would have returned to more normal levels by [the] next spring, allowing it to issue debt and repay the bridging loan".[5] In the same year, a syndicate granted AB InBev a loan of US$75bn to finance AB InBev's acquisition of South African brewer SABMiller. At the time, this loan was the largest ever commercial loan in history.[6] The financing was agreed with AB InBev's existing relationship banks, as well as with 16 additional financial institutions.[7] Reflecting AB InBev's sophistication (as well as, probably, its bargaining power), the loan was syndicated by AB InBev itself rather than by one of the financial intermediaries involved.[8]

According to Refinitiv,[9] global syndicated lending activities in 2018 exceeded US$5tn, up 8% from 2017. The US captured 58% of the global market, with proceeds of US$2.9tn. By contrast, the European syndicated lending market reached US$915 billion in value in 2018. Within Europe, the UK, France and Germany are the largest markets in terms of borrowed amounts, with combined proceeds of approximately US$470bn in 2018. For lenders, syndicated lending appears to be attractive. Bookrunners, that is, the agents and co-agents, earned close to US$20BN in total fees over the course of 2018.[10]

Syndication process

Syndication processes often follow a similar pattern. First, the borrower initiates the process by soliciting bids from potential syndicate agents,[11] typically through a request for proposal (RFP) process in which each bidding lender is invited to detail its pricing and syndication strategy.[12]

After reviewing the bids submitted, the borrower awards the mandate for the syndicated loan to a syndicate agent bank, or "lead".

Second, once chosen, the syndicate agent prepares an information memorandum that it distributes to potential syndicate members to market the loan. This memorandum generally includes an overview of the transaction, proposed loan terms and conditions, an industry overview, a financial model, and proposed lender compensation details.[13] Based, in part, on this memorandum, invited parties choose whether or not to pursue a role in the project.

Third, once the syndicate members have been confirmed, the syndicate agent must determine how to allocate loan shares across lenders and decide what role each of the syndicate members will perform. For example, the syndicate agent may choose to appoint a number of *co-agents* to assist with administrative responsibilities such as computing interest payments, collecting loan repayments, drafting loan documents, and managing the collateral.[14] Co-agents are usually compensated for performing these duties with a greater share of proceeds from fees. Accordingly, syndicate agents tend to offer more senior roles to relationship banks.[15] Often, co-agents also monitor the syndicate agent to ensure that it acts in the best interests of the syndicate.[16]

Fourth, once the syndicate agent has allocated loan shares and appointed co-agents, the syndication closes, lenders sign the agreement, and funds are transferred to the borrower.[17] During the course of the loan, the syndicate agent's role in the syndicate is largely administrative. For example, the syndicate agent is responsible for handling disbursements and repayments, duties for which it is payed a fee by the borrower.[18]

Possible pro- and anti-competitive aspects of syndication

Article 101(1) of the Treaty on the Functioning of the European Union (TFEU) prohibits any agreement and concerted practice which has as their object or effect on competition between member states. This need not be limited to formal contracts or written agreements. According to the Court of Justice of the European Union's case law, "*the concept of an agreement within the meaning of Article 85(1) EC, as interpreted by the case law, centres around the existence of a concurrence of wills between at least two parties, the form in which it is manifested being unimportant so long as it constitutes the faithful expression of the parties intention*".[19]

By promoting risk-sharing, loan syndication may permit lenders to jointly offer loans that they would not be willing or able to offer independently. Thus, loan syndication has clear pro-competitive advantages in that it expands the availability of credit, and may be essential when other debt mechanisms like bonds or straight bank loans would be costly or infeasible alternatives. In other words, syndicated loans fill a gap in the market and have few substitutes, if any.

Nonetheless, syndication also introduces potential competition concerns. By requiring coordination among participating lenders, syndication may inadvertently permit exchanges of competitively-sensitive information. These exchanges, and generally the coordination opportunities granted by syndication, may give rise to collusive practices. For example, combined with unlawful information exchange, the mechanics of syndication may introduce risks of bid-rigging. Collusive behaviours could also permit lenders to set above-market prices for loans and ancillary products, or take advantage of a borrower's reduced bargaining power vis-à-vis the syndicate when restructuring or refinancing a loan.

Economic aspects

Given these potential competition concerns, insights from the academic literature on the pricing of syndicated loans can be particularly valuable. Notably, two recent economic studies provide evidence of a link between market concentration in syndication markets and prices.

Hatfield, et al (2018),[20] first, suggests that when there are sufficiently many potential syndicate members, that is, when the market is fragmented, the scope for collusion may be *higher*. In these markets, collusion can be sustained by a punishment mechanism in which a bidding lender that deviates by undercutting the collusive price is punished during the syndication formation process.

If the deviator offers a low price, it is bound to be selected as the syndicate agent and must market the loan to potential syndicate members. However, other participants may choose to punish the deviator by refusing to join the syndicate. If the loan is too costly or too risky for the deviator to offer on its own, this punishment will prevent the project from moving forwards. Alternatively, the other participants may agree to join the deviator's syndicate only if it increases the fees it pays to these participants, an increase in costs that may make the transaction uneconomical for the deviator. In either case, this punishment mechanism should sustain collusive outcomes by discouraging market participants from undercutting the collusive price.

The authors conclude that it is only at intermediate levels of market concentration that prices will be competitive. This conclusion has important implications. Namely, this finding suggests that in markets with syndication, collusive outcomes might not be effectively disrupted by efforts to break up firms and facilitate entry.[21]

Chen and Ritter (2000)[22] and, more recently, Cai, et al (2018),[23] echo some of these conclusions in two distinct syndication markets. The former study showed that, in the late 1990s, the spread of Initial Public Offering (equity) syndications in the US clustered around 7%. After assessing this phenomenon, its authors concluded that "*the evidence is consistent with underwriters realizing that if one investment banker tries to win business by cutting spreads, the underwriting industry is likely to move to an equilibrium with low spreads*", in line with Hatfield et al

(2018)'s reasoning. The second study finds that lending syndicates tend to attract lenders with similar expertise. The similar skills and competencies of the lenders have a two-part (and opposing) effect on loan pricing: while these similarities may result in lower screening and monitoring costs that may be passed on to borrowers in the form of lower prices, they may also make it easier for lenders to collude. Consistent with the theoretical arguments presented in Hatfield et al (2018), the authors find evidence of higher prices when the market is more fragmented, and of lower prices at intermediate levels of market concentration.

The economic research just summarised suggests that syndicated markets can be prone to collusive practices. Such practices are not mere abstractions: They can lead to supra-competitive prices.

Legal aspects

The banking sector is no stranger to cartel and price-fixing probes. To note only a few, in the *Austrian Banks – "Lombard Club"* case,[24] eight Austrian banks were found guilty of participating in a collusive cartel which included price fixing on interest rates on loans, household savings, fees for retail banking services and corporate banking. In another case, competition authorities found that international banks RBS, UBS, JP Morgan and Credit Suisse engaged in unlawful information exchange regarding Swiss interest rate derivatives.[25] More recently, a number of unnamed banks have been subject to a probe by the Commission for their involvement in a bond trading cartel. In late January, the Commission informed eight banks that it held the preliminary view that they had breached competition law by colluding to distort competition when acquiring and trading European government bonds.[26]

With respect to syndicated markets, competition authorities worldwide have taken great interest in the potential competition concerns discussed above. For example, competition authorities in three jurisdictions, Turkey, Spain, and Australia, recently investigated banking consortia for anti-competitive behaviour in the context of syndicated transactions.

Turkey

In November 2017, the Turkish Competition Board (TCB)[27] imposed a total fine of TL1.1bn (approximately US$204m) to a number of banks active in the Turkish loan syndication market. The TCB investigated whether thirteen international banks had violated Turkey's equivalent to Article 101 TFEU (Article 4 of the Turkish Competition Act). The investigation followed an immunity application made by one of the banks, Bank of Tokyo-Mitsubishi UFJ.

More specifically, the TCB suspected that the 13 banks, which supply loans to corporations, had been regularly exchanging sensitive and confidential information, including information on prices and loan conditions, with the aim of restricting competition. The TCB concluded that Bank of Tokyo-Mitsubishi UFJ had an agreement or concerted practice with two other banks which had the intention of restricting competition, and that consisted of anti-competitive exchanges of information regarding, for example, prices, loan amounts, and syndicate participation. However, Bank of Tokyo-Mitsubishi UFJ applied for immunity and enabled TCB's investigation, and therefore the bank was fully exempted from the imposed fine.

Spain

In February 2018, Spain's National Commission on Markets and Competition (hereafter CNMC)[28] imposed fines on four major Spanish banks totalling approximately US$102m (€91m) for colluding to set the prices of interest rate derivatives bundled with syndicated loans above market levels. The Spanish investigation was initiated after VAPAT, a company that builds and operates wind farms, brought allegations that four leading banks had colluded to set prices and that VAPAT had suffered harm because of their collusive practices.

Importantly, the CNMC did not contest the rationale for banks to coordinate to a certain extent in order to syndicate loans. Nor did the CNMC question the rationale for bundling interest rate derivatives with loans or for jointly setting prices for these interest rate derivatives. Instead, the CNMC reasoned that it may be justified to have the syndicate members also be the counterparties of the interest rate derivative contracts, or, in other words, that bundling was not anti-competitive.

The CNMC concluded only that the four banks had entered into an agreement to set the prices of the interest rate derivatives above market prices. Such high prices, according to the CNMC, reflected hidden margins and misled borrowers into believing that they were purchasing interest rate derivatives at market prices, thus at no extra cost.

Australia

In Australia, an underwriting syndicate has been accused of criminal cartel conduct. In June 2018, the Australian Competition and Consumer Commission brought charges against ANZ, Citigroup and Deutsche Bank and six of their senior executives in relation to the syndicated placement of ANZ shares in 2015.[29] The sale of US$2.5bn worth of ANZ shares to institutional shareholders was organised and underwritten by Citigroup, Deutsche Bank and JP Morgan in an effort to meet the demands of banking regulator APRA. The Australian subsidiaries of Citigroup and Deutsche Bank both face charges; JP Morgan was not charged. At the time of writing, the case is still ongoing.

Conclusion

As said, DG COMP has indicated in its 2017 Management Plan that it is now scrutinising loan syndication because it *"exhibits close cooperation between market participants in*

opaque or in transparent settings". Although it is plain that from an economic perspective, syndicated loans present an important source of funding for largescale loans, they could have potential implications on competition that cannot be ignored. Indeed, those implications could come about in a more implicit manner than in the case of more "classic" cartels since the risk is hidden in the act itself of forming a syndicate.

In our experience, companies – in this case banks – under such scrutiny from the European Commission under the guise of "studies" or "inquiries", better prepare their factual statements and a solid defence of their business practices because the European Commission swiftly follows with investigations and fines.

***Jacques Derenne** is a partner at Sheppard, Mullin, Richter & Hampton LLP in Brussels Brussels and a professor at Liège University & Brussels School of Competition. **Ciara Barbu-O'Connor**, is an associate at Sheppard, Mullin, Richter & Hampton LLP in Brussels. **Benoit d'Udekem** is vice president (Brussels and Paris), and **Rachel Bechek** is an associate (London), at Analysis Group.*

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Editorial queries: Please contact Kate Clifton on tel: +44 (0)20 3377 3976, or email kate.clifton@informa.com

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