Competition law and syndicated loans: identifying the regulatory risks

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Introduction

The origination of deals and any related syndication process has a perfectly legitimate and pro-competitive purpose. It serves the provision of liquidity to borrowers where no individual institution would be willing or able to carry the risk alone. The ability of banks to carry out both loan origination and loan syndication in a competition law-compliant way is essential for the effective functioning of the market. Without syndications the market could not provide the required liquidity.

However, the process of underwriting and syndication is not without competition issues, and in May 2014 the Loan Market Association (LMA) published a notice on the application of competition law to syndicated loans (the LMA Notice).[2] The LMA Notice emphasised the recent changes to the UK competition law regime, and the need for banks involved in loan arrangements to recognise the need for caution when competing with each other on a prospective multi-bank deal. In particular the LMA Notice emphasises the need for caution in the following areas:

- general market soundings;
- conduct during the bidding phase;
- exchanging competitively sensitive information;
- interaction regarding 'flexing' of terms;
- conduct regarding refinancing/distressed arrangements.

However, the LMA Notice provides little guidance on how banks should conduct themselves in these areas to avoid committing an infringement of competition law. Furthermore, an overly cautious application of competition compliance rules could have an unintended negative impact on liquidity. This article attempts to shed some light on where the risks to competition law are most prevalent in the loan process and how these potential infringements should be assessed from a competition law perspective.

Background to the loan origination and syndication process

There are generally two different types of loan transaction: (i) fully underwritten deals and (ii) best endeavours transactions. In a fully underwritten deal, banks will take the transaction risk onto their balance sheets at a certain 'hold level' for each bank, thereby effectively guaranteeing the amount to the borrower (with the possibility of a later syndication). In a best endeavours scenario the banks will seek to do a back-to-back syndication in order to 'lay off' the risk in the market, ie transfer the credit risk generally by selling the loan on to other investors. There may also be a provision in the best endeavours loan agreement that

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2 Available to download from www.lma.eu.com.

allows the banks to 'flex' the pricing if the related syndication is not going well. This allows for changes in the spread or margin of a syndicated loan when demand varies from what was originally anticipated.[3]

There are important distinctions between loan origination and loan syndication. Origination refers to the process before a banking group is formed, and generally involves the issuing by the borrower of a request for proposal (RFP) and lenders replying to that RFP. The lenders will compete for the mandate under the terms of the RFP. Discussions with other banks during the origination process (and without the consent of the borrower) carry the highest competition risk, as at this stage the group has not been formed and each bank is competing individually for a role in the origination. Syndication refers to the process of laying off the risk in the market, and generally takes place after the responses to the RFP have been submitted and a banking group has been formed. Syndication discussions with other banks can be permitted provided they are specifically about the laying off of risk in the market, and they take place after the banks have been mandated and within the scope of that mandate. Both stages are discussed further below.

Origination: RFP and market soundings

It is important to recognise how competitive tension can be created by borrowers in a market where co-operation between banks is not just pro-competitive but quite possibly essential. A borrower will typically commence the process by sending out an RFP to a number of banks. The RFP will be sent individually to each bank, and may be coupled with the requirement to sign a non-disclosure agreement (NDA). The NDA will usually require the relevant bank not to discuss any aspect of the RFP (and sometimes even its existence) with anyone, including other banks.

At this stage, the syndication desks of the relevant banks may already engage in generic 'market soundings' with other banks or anchor investors to gauge the appetite for a successful syndication. However, at the point where the RFP is sent out to banks, no banking group has been formed by the borrower and such market soundings could become a conduit for pricing information that may influence the banks' individual responses to the RFP. It is therefore important to check that the NDA allows for such market soundings and to seek a specific written waiver from the borrower if that is not the case. A borrower may typically authorise some market soundings around the syndication (but not the origination) in circumstances where there is a need to ascertain the level of demand for the syndication. In those circumstances it can be in the interest of the borrower to elicit a larger number of quotes by permitting some market soundings at an early stage. Any market soundings around a potential syndication should be recorded as being specifically about the laying off of risk in the market and this should also be reflected in any documents that are submitted to the credit committee. As a general rule, it is never appropriate to engage in discussions with other banks unless those discussions have been expressly sanctioned by the borrower and/or they are specifically permitted by the NDA. Market soundings may also take place in a fully underwritten deal, but these would be focused on informing the bank's decision on hold-levels and the chances of a subsequent syndication. Such discussions are more difficult because hold-levels may themselves be a competitive factor between the banks in the origination. Borrower consent is absolutely essential for any such discussions.

In most syndicated loan transactions the borrower will appoint one or more managing lead arrangers (MLA) who will be paid through an arranger fee. The MLA is responsible for

3 'Upward flex' is an increase in the spread relative to LIBOR, or other market interest rate, and is made when the loan margin is too low to clear the market. 'Reverse flex' is the opposite, and involves a decrease in the spread which occurs when the loan is oversubscribed and the market clearing spread is lower than the original spread.

arranging the loan (or a tranche of the loan) and for the success of the syndication. The MLA may also become the bookrunner in the syndication, ie it will keep track of the amount that each bank is willing to take. Where a bank is asked to act as MLA at a stage before the consortium is formed, it is important that the remit of that mandate is clearly set out by the borrower. Although the role of MLA involves potential coordination of a consortium, it does not absolve the MLA of potential competition law liability where the basic mandate given by the borrower is exceeded.

The analytical framework at the pre-consortium stage can therefore be considered as follows:

(i) What is expressly permitted by the RFP and any associated NDA?

(ii) Are market soundings required for the syndication and what borrower consents will be required for market soundings?

(iii) In a fully underwritten bid, each bank should take its own commercial decisions where there is no related syndication.

(iv) In those circumstances market sounding calls without express borrower consent are inappropriate and an independent internal process should determine pricing and any proposed hold-levels.

(v) Any market sounding calls from other banks should be refused in such circumstances, and a proper paper trail of that refusal should be created. Any approaches should be notified to the borrower without delay – with a request to prevent further contact from rival banks.

(vi) At no point should calls be made to 'verify' the pricing information of other banks, even if that information comes from the borrower. It is the borrower's prerogative to lie to its banks about the pricing levels of others.

(vii) A bank's internal credit committee may apply pressure to know which other banks are considering the deal and who has received the RFP. Providing anecdotal or historic information is fine but no steps should be taken to verify that information directly with the banks concerned.

Demonstrating that the borrower has consented to discussions taking place between banks is key. The consent of the MLA is not sufficient and can never substitute for the borrower, and the borrower may expressly ask banks not to speak to each other under the terms of the NDA. This is important to respect: it is not the role of banks to form a group and agree on terms at this stage of the process.

Formation of the banking group

Once the individual banks have provided their initial responses to the RFP, it is the borrower who decides which banks to put together into a group (or perhaps even two groups competing against each other). The borrower may have a clear idea of the 'relationship banks' that it would like to have on the deal, or it may proceed entirely on the basis of price. The borrower may seek advice from a particular bank (or MLA) but this should not go beyond the mandate given by the borrower.

A borrower's final decision as to which banks to include in the group will therefore be based on (i) margins, (ii) fees, (iii) hold-levels (if applicable), (iv) reputation and track record, (v) bank reputation and (vi) the number of banks that the borrower wants to be in the consortium. The selected banks will usually be put into a consortium, with the borrower tacitly accepting the highest common denominator as the consortium price. This is because the consortium will have to offer a single unified price based on a single unified term-sheet. If the borrower becomes uncomfortable with that process, it remains his/her prerogative to split up the group and start again with individual negotiations.

At no stage in the process should banks have any pre-discussions around the nature or size of the consortium, nor should they seek to form alliances or to boycott a particular deal. Equally, banks should not promise each other tranches in the syndication process in exchange for dropping out of the origination. The same is true for 'consolation prizes' for those banks that are not chosen for the banking group. Such actions could give the impression of a pre-agreed plan to allow the losers a second bite at the cherry, which could be anti-competitive.

Negotiation: after the formation of the banking group

Once the consortium is formed, the competition analysis changes significantly. This is because the borrower has now given a mandate to (i) a group of banks, (ii) to devise a single term-sheet, (iii) at a given price and (iv) for a certain size of loan. This analysis is similar for fully underwritten and best endeavours transactions.

At this stage it is usual and permissible for the chosen banks to meet to discuss and agree the term-sheet, but always within the scope of the borrower mandate. It is not unusual for the term-sheet to be substantially negotiated, and in such circumstances it can move against the interest of the borrower at this stage. However, that is a natural feature of the borrower being obliged to agree everything with the 'highest common denominator' within the consortium. The only alternative is to lose banks from the consortium, which could then have an impact on potential hold-levels and the size of the loan.

Where a borrower is unhappy about this dynamic, it can always split up the consortium and re-commence individual negotiations with the banks. At that stage any discussions between banks should cease immediately. The alternative option is for the borrower to run two competing consortia against each other. However, it is rare to do so at the stage of negotiating the term-sheet, particularly as the borrower has the right to break up the consortium and re-commence individual negotiations at any time. It is also common to 'lose' banks that are unable to get credit approvals at a low enough pricing level.

The final result of the negotiations is a loan at a given pricing level for a given amount. The variable is whether the banks will hold the loan on their balance sheets, or whether there is a back-to-back syndication. The type of investors interested in a back-to-back syndication will depend on the particular market in which the deal takes place. It may either be other banks (including those who were originally sent the RFP, but were unsuccessful on the origination and were not selected for the consortium) or other anchor investors such as pension funds. The price of a loan is composed of (i) the margin and (ii) the fees. The level of pricing will be determined by the nature of the deal, the identity of the borrower and their credit rating, the amount, the required hold-levels (in a fully underwritten deal) and the number of banks in the consortium. As a general rule, the higher the amount, the higher the hold-levels, the higher the number of banks and the higher the pricing. Where the hold-levels are ultimately scaled back by the borrower because there is sufficient liquidity for the required amount, the pricing is generally unaffected. It is therefore in the interest of each bank to get credit committee approval at a level that is above the expected hold level in order to secure the best pricing. At no point should there be any discussion between banks about hold approvals or potential scaling back by the borrower.

When things go badly: flex, default and refinancing

Certain syndications contain provisions that allow the banks to 'flex' the pricing if a syndication is going badly. It is not unusual to have a threshold at which flex can be invoked and that threshold would be negotiated collectively. However, each participating bank will then be responsible for its own syndication and there should generally not be any discussions between the banks about whether or not to flex the pricing of the loan – other than through

the contractual mechanism contained in the loan agreement. Any discussions between a bank and the borrower about flexing the pricing in order the help the syndication should be conducted on a bilateral basis and within the terms of the loan agreement. If a discussion between banks about flex is required, that discussion should be instigated by the borrower (or with express written consent) and not by individual banks.

Refinancing of a loan after an event of default can raise some difficult questions from a competition law perspective. As a general rule, banks should not have any speculative discussions about the potential 'post-default' world, in circumstances where the event of default has not yet occurred. If an event of default is imminent, banks should simply agree the process to be followed if such an event occurs. It is only after the event of default has actually occurred that the banks will need to communicate in order to decide whether to refinance the loan.

It should be noted that in the event of a default the banks under the original facility may have a different interest from other bilateral lenders. Any joint discussions between those under the facility and bilateral lenders should be avoided, as bilateral lenders will be required to take their own independent decisions.

Following an event of default, it is possible that the original banks that provided the facility also have a degree of market power, as the market would not offer the refinancing. In those circumstances it is particularly important that the actions of the banks are objectively justifiable (ie strictly necessary in the circumstances). Due to the potential market power of the existing banks, it is also important to avoid any 'bundling in' of other services as a condition of the refinancing. The decision on whether or not to refinance should be taken independently, regardless of whether or not the borrower is willing to take other services. If, ultimately, a decision is taken not to grant the refinancing, the paper trails should evidence that this decision was taken independently by the bank to avoid any suggestion of a collective boycott.

Where a bank is only willing to refinance at a certain (higher) price level, it should in the first instance communicate that to the borrower. If the borrower then instructs the bank to speak to other banks, the price level can be discussed with them. It is natural for the price level on a refinancing to be significantly higher than on the original loan. Again, any discussions between banks should be within the consent of the borrower.

Syndication under the regulatory microscope

The syndicated loan market is yet to be investigated by the regulatory authorities in the UK. However, the Office of Fair Trading (OFT) considered the syndications market more generally in its 2011 report, *Equity underwriting and associated services*.[4] Following the financial crisis and recession, the OFT noted a significant increase in the number of banks involved in underwriting syndicates. The OFT concluded that this may have been a result of the 'historically high levels of equity capital being raised, and the sheer scale of the transactions during the financial crisis and recession, which meant that investment banks sought to share the risk to an even greater extent than before'.[5]

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4 Available at http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/market-studies/OFT1303.pdf.

5 Ibid, para 5.15.

The Financial Conduct Authority (FCA) references the OFT's findings in its wholesale sector competition review 2014–2015[6] and weighs up the pros and cons of the increase in syndicated activity. On the plus side, an increase in the number of banks involved in a syndicated transaction may enable the issuer (or borrower) to reach a range of potential investors (or banks). The FCA also suggests that competition can be increased by inviting more co-managers for the lead underwriting position (or MLA role). However, concerns are raised that larger syndicates could result in 'inefficient bookbuilding and allocation process, lower net fees for banks which may not motivate some banks to work in the clients' interests and some banks adding no value to the process'.[7] The FCA concludes that the effect that syndication has on competition depends on how the syndication process takes place, and acknowledges that the way in which syndication works for loans differs from equity and debt issuance. The FCA therefore considers that syndication 'may' be an area which would benefit from further investigation.

Conclusion

The level of competition law risk associated with origination and syndicated loans will depend on the stage of the transaction. As a general rule, the completion law risk decreases through the stages of a transaction as the competition around the origination will take place at the beginning of the transaction. Before the banking group is formed by the borrower, each bank competes individually and should avoid any communications relating to the origination. After the group is formed, there is a limited instruction from the borrower to work towards a term-sheet. Banks are allowed to communicate and work together within the scope of that instruction. After the mandate is signed there is less competition risk but there may still be competitive issues, for example how to deal with a potential event of default or how and whether to exercise flex. A guiding principle at all times should be ensuring that the borrower has consented to any discussions taking place.

Assessing the application of competition law to syndicated loans is both complex and challenging. However, the FCA has a mandate to do so and, given the FCA's current market study focused on competition in investment and corporate banking, it is only a matter of time before the syndicated loan market comes under the spotlight.

6 FCA Feedback statement on the main themes arising from the responses to the call for inputs for the wholesale sector competition review; available at https://www.fca.org.uk/static/documents/feedback-statements/fs15–02.pdf.

7 Ibid, paras 2.26–2.28.