CPI's Europe Column Presents:

Antitrust Limits to Cooperation in Syndicated Loans: Derivatives Rate Manipulation in Spain

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Introduction: The CNMC’s Fining Decision

On 13 February 2018, the Spanish Competition Authority (Comisión Nacional de los Mercados y la Competencia "CNMC") issued a decision in *Case S/DC/0579/16, Financial derivatives* fining four financial institutions (Santander, Sabadell, BBVA and CaixaBank) a total of 91 million Euros for an infringement of Article 1 of the Spanish Competition Act (Law 15/2007 of 3 July 2007) as well as of Article 101 of the Treaty on the Functioning of the European Union (“TFEU”) by manipulating the price of certain interest-rate financial derivatives.

The fined banks have appealed the CNMC's decision in court.

The Affected Market

According to the Decision, the market affected by the infringement is project finance, which includes a variety of mechanisms used to finance large projects. The special feature of project finance is that a company is set up to manage the project requiring funds and to reimburse the loan with the income generated by such project. In such cases, due to the high volume of financing required, it is common practice to resort to long-term syndicated loans, i.e. loans involving several financial institutions, offering common terms and conditions.

The interest rate on these loans is usually variable. Therefore, to protect themselves against fluctuations in the reference rate that could lead to defaulting, it is common for lenders to request that the borrower hedge the risk of a change in the interest rate exceeding a certain *cap*, usually through a financial derivative.

The borrower could directly sign up for a *cap* in exchange for a premium. However, more commonly, the borrower offers a *floor* as a counterparty to reduce the premium, so that the derivative is set as a *collar* (i.e. both a cap and a floor for the interest rate) or an interest rate swap (which resembles a *collar* in which *cap* and *floor* are the same, effectively turning a variable interest rate into a fixed rate).

The hedging instruments are agreed in bilateral agreements between the customer and each of the suppliers, such agreements being separate from the loan agreement.

At this point, it is important to note that, while the *cap* is initially set in the loan agreement (at the maximum rate "supported" by the project), determining the *floor* or the fixed rate of the swap is left for the hedging agreement at the end of the transaction.

Thus, throughout the Decision, the CNMC distinguishes between two sub-markets within project finance:

a) the credit market, in which different loan syndicates compete for funding; and

b) the market for hedging instruments, in which various banks (that may or may not be part of the loan syndicate) should compete individually for providing the hedge.

The Infringement: Manipulating the Price of Derivatives

The various practices developed by banks in the area of syndicated loans and hedging instruments, all of which are included in the Decision together with the explanations provided by the banks and the CNMC's assessment thereof, are set out below.

First, the syndicate banks decided jointly to require that the borrower of the syndicated loan obtains interest-rate risk hedging from the syndicate members. In other words, borrowers were not allowed to contract the derivatives with a third party.

Secondly, each bank's individual share in the hedging was decided by mutual agreement among the members of the syndicate.

Thirdly, the banks expressed the need for everyone to offer the same price for hedging, i.e. the same *floor* of the *collar* or fixed swap rate, which had to be determined simultaneously just after signing the loan transaction by means of a conference call between the customer, already at the public notary's office for signing, and the representatives of each bank's treasury desk. According to the banks, the identical price responded to the need to keep a balance in the banks' guarantees, while the high volatility of the hedging markets required conditions to be set at the very last moment. This meant that the borrower could not know beforehand the rate of the *floor* or swap to be hired and, as a result, their room for manoeuvre was significantly reduced.

As regards the need to offer the same price, banks used to assure the borrower that it was the best possible price, i.e. the market price. However - and this is possibly the key element in the CNMC's assessment - the investigation and the evidence gathered (notably, mandatory recordings of the conversations among treasury desks prior to closing) made it possible to establish that the common price finally offered to the customer was a manipulated price. In other words, a price clearly above what could be considered the "market price" for the hedging contracted given market conditions at the time.

Although the *floor* or the fixed rate of the swap was theoretically set by means of a conference call at the time of closing the hedging, the truth is that beforehand banks exchanged information – without the borrower being present – on the offers that they would subsequently make, agreeing behind the borrower's back on a price that exceeded market levels.

As said before, according to the Decision it is agreeing a derivative price above market levels and behind the borrower's back that is decisive for the finding of an infringement and, therefore, for the fine that is finally imposed on banks.

Brief Comments

We would highlight the ambiguity of the conclusions reached in the Decision, which seem to limit the scope of the infringement to fixing interest rates above market prices.

Thus, the CNMC avoids a clear stance on the lawfulness of the other aspects of the banks' conduct described above.

While it seems clear that deliberate joint pricing above market levels is unlawful, the question remains what assessment would apply had the institutions not misled borrowers by setting the price behind their backs, but had actually fixed it at the conference call just before closing, in which borrowers participated.

In this regard, the CNMC points out that '*it is not so much fixing a single set interest rate for the floor or a single set interest rate for the swap that is questionable, but whether the banks fixed said interest rate at market conditions*' (page 69). In fact, the CNMC seems to censor not the coordination itself but the fact that prices are not set at market conditions (page 79).

In our opinion, CNMC's lukewarm position on this may be criticised, if only because it is not clear enough on a key aspect of the mechanics of this type of financial practices which –as the very banks fined say and the Bank of Spain's own report included in the file corroborates– are common practice for any bank in Spain and abroad.

Is it really lawful – from a competition law perspective – to set the same common rate for all banks? The sanctioned banks argue that, to ensure that all banks participate alike, that common rate must be the highest of those offered by the banks – because otherwise the bank offering the highest rate would not want to join in – and would certainly never be the lowest of those quoted. Can that common rate be a "market price"?

In our opinion, this is dubious at the very least. Certainly, the justification given by banks – the alleged need for a balance among each bank's guarantees – does not seem to have been sufficiently verified, especially if one takes into account the very negative consequences for borrowers of such a measure, as competition between syndicated banks is eliminated.

Moreover, if the practices of banks are called into question, it could also be asked whether the other elements of agreement considered above –the need for the hedging contract to be signed with the same banks that grant the syndicated loan and in the same proportion as their share in the syndicate– are justified or not.

As regards this point, it should be remembered that the substantive test must be that of Article 101(3) TFEU, since the conduct described undoubtedly has features restricting competition that are prohibited by the first paragraph of such Article: not only did the banks eliminated competition by third parties in the derivatives market, but also competition between each other within a loan syndicate (intra-syndicate competition).

The prohibition in Article 101(1) TFEU may be declared inapplicable to such restrictions provided that it is shown that: (i) they have contributed to 'improving the distribution of products'; (ii) 'while allowing [borrowers] a fair share of the resulting benefit', and without (iii) 'imposing on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives.'

Hence, we consider that the CNMC does not address this issue enough, nor does it give a clear opinion about it. In fact, the Decision goes so far as to say that there are not enough elements to assess and make a conclusive judgment on the unlawful nature of the mere linkage, considered in isolation (pg. 82). This is at the very least shocking, given that elsewhere in the Decision the CNMC acknowledges that:

> Depending on the information contained in the file, the suppliers of the derivative may be financial institutions already participating in the financing or a third party external to the financing (or a combination of both). If they already participate in the loan, their participation in providing the hedge will normally be proportional to their participation in the loan (page 7346). Each financial institution must evaluate its risk and may or may not choose to formalise a hedging derivative if it deems it necessary.

Therefore, it is clear that it is *possible* that the suppliers of the derivative are third parties external to the financing, as it is also possible that participation in providing the hedge is not proportional to the banks' participation in the loan. In fact, this is what happens in all cases where the State-owned bank ICO participates in the syndicated loan, because ICO never participates in the hedging, which is stated in the Decision.

And if both are possible... then we think that the test contained in Article 101(3) TFEU is hardly met: the restrictive conduct does not contribute to a better distribution of the products; is not advantageous for the customer and, of course, is not indispensable.

Scope For Claiming Damages

The competition infringement analysed here is one of the first to which the new provisions of Spanish law that implemented Directive 2014/104/EU at the end of May 2017, both on substance and on procedure, will apply.

Companies affected by the practice for which the CNMC imposed fines may claim before civil courts full compensation of damages caused by manipulating the price of financial derivatives, which, at a first stage, would be limited to the extra costs borne by the borrower (as compared to the market price for the derivative chosen).

Thus, among other novelties introduced by the Directive, the affected companies will benefit from the new 5-year statute of limitation. In addition, this deadline will not start until the court proceedings filed against the CNMC Decision come to an end and such Decision becomes final.

Moreover, the implementing provisions offers potential claimants two important tools to file successful claims:

- On the one hand, they make it easier to prove the infringement of competition law by allowing plaintiffs to request that banks or any third party − including the competition authority – produce any relevant evidence in their possession.

  This allows customers to request, for example, recordings of the banks' treasury desks which, according to the CNMC Decision, show that the price of the derivatives was being illegally manipulated.

- On the other hand, they much simplify quantification and evidencing of damages by expressly empowering the courts to order the payment of merely estimated damages, if these are proven to exist but are practically impossible or excessively difficult to quantify precisely.

Along with that action, given the mechanics of price manipulation in this case, in which the collusive agreement and the resulting deception of the borrowers took place in each specific contract, the borrowers could even plead nullity of the hedging instrument under the general rules applicable to the contract – vitiated consent due to deception.

In this way, borrowers would be able to claim full reimbursement of all amounts paid for derivatives to financial institutions, not just the extra costs incurred, which is a clear advantage over an action for damages under Directive 2014/104/EU.

Conversely, in contractual nullity proceedings, the burden of proof regarding collusion between banks and its impact on the financial derivative chosen would be strictly on the plaintiff, who would not be able to invoke the new provisions implementing the aforementioned Directive. For example, the plaintiff could not request access to the recordings of the treasury desks of the fined banks.

Companies That May Have Been Affected

If we take into consideration the facts established by the CNMC in the Decision analysed here, the infringement would have affected borrowers that bought from the fined banks (Santander, Sabadell, BBVA and CaixaBank) derivatives as interest rate risk hedging instruments in syndicated loans for project financing between 2006 and 2016.

However, it is not unreasonable to assume that borrowers having bought derivatives to hedge interest rate risk on syndicated loans in any type of financing from the fined banks or from another financial institution or on any other date might also have been affected.

The rules on access to sources of evidence introduced in Spain following implementation of the Damages Directive, described above, are an extraordinarily useful tool for filing claims for damages as regards funding that the CNMC did not look at.

Final Remarks

As a final remark, it would be interesting to see how this case may affect the financial industry, not only in Spain but also in all other Member states, as it cannot be excluded that the practices described have also been implemented in other jurisdictions.

It should be noted that the European Commission has repeatedly declared that it is monitoring business practices of capital providers in wholesale financial markets and, more precisely, in connection with syndicated loans, as these are characterised by negotiations between lenders and borrowers over-the-counter and outside transparent trading platforms, with potentially relevant competition issues arising from it.

In fact, DG COMP launched a study in April 2017 (COMP/2017/008 – EU loan syndication and its impact on competition in credit markets). We will see very soon if the results of this study, which were expected by the end of 2018 or early 2019, indicate whether or not competition concerns regarding syndicated loans are sound and widespread. Bets are accepted.

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