SUMMARY NOTE S/DC/0579/16 FINANCIAL DERIVATIVES

The Board of the CNMC has fined four financial entities for coordinating to fix supra-competitive prices in the contracting of financial derivatives used to hedge the interest rate risk in syndicated credits for project finance.

Through Resolution of 13 February 2018, the CNMC has sanctioned CAIXABANK, SA (CAIXABANK), BANCO SANTANDER, SA (SANTANDER), BANCO SABADELL, SA (SABADELL) and BANCO BILBAO VIZCAYA ARGENTARIA, SA (BBVA) for a total sum of 91 million Euros[1], for a single and continuous infringement of the provisions of Article 1 of Law 15/2007, of July 3, of Defence of Competition (LDC) and Article 101 of the Treaty on the Functioning of the European Union (TFEU), consisting of a concerted action aimed at setting the price, above market prices, of the derivatives used as hedges for the interest rate risk associated with syndicated credits in project finance between 2006 and 2016.

The Competition Directorate (DC) initiated a confidential investigation on 19 June 2015 as a result of the information provided by the company INVERSIONES EMPRESARIALES VAPAT, SLU (VAPAT), which in July of that same year, filed a complaint against CAIXABANK, SANTANDER, SABADELL and BBVA for arranging the prices of the derivative contracts used as a hedge on the interest rate risk of the syndicated credits signed by VAPAT with the four sanctioned financial entities.

Through the information provided by the accused parties, as well as the Spanish Central Bank (known by its Spanish abbreviation, BdE) and the Official Credit Institute (known by its Spanish abbreviation, ICO), the DC initiated sanction proceedings on 5 April 2016.

After the notification of the Specification of Facts (known by its Spanish abbreviation, PCH), the financial entities proposed the Conventional Termination of the Procedure, presenting commitments. The DC agreed not to initiate proceedings aimed at conventional termination and continued with the procedure.

Given the complex nature of the facts analysed and sanctioned, the operation of the syndicated financing operations of project finance is explained first and then the signing of financial derivative contracts takes place (which is the true problem analyzed in the file).

Project finance refers to financing mechanisms that are usually used in large-scale projects. In the face of corporate financing, where creditors have access to all of the debtor's resources, the guarantee of project financing is limited, in general, to the project's capacity to generate the necessary resources to meet the payment of the debt.

Due to the high amount of the projects and the level of risk, it is common in practice to create **syndicated credits,** that is, loans in which a group of financial entities (bank syndicate) participate, coordinated by a bank (agent bank), which will

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[1] 23.9 million euros to SANTANDER, 15.5 million euros to SABADELL, 19.8 million euros to BBVA and 31.8 million euros to CAIXABANK.

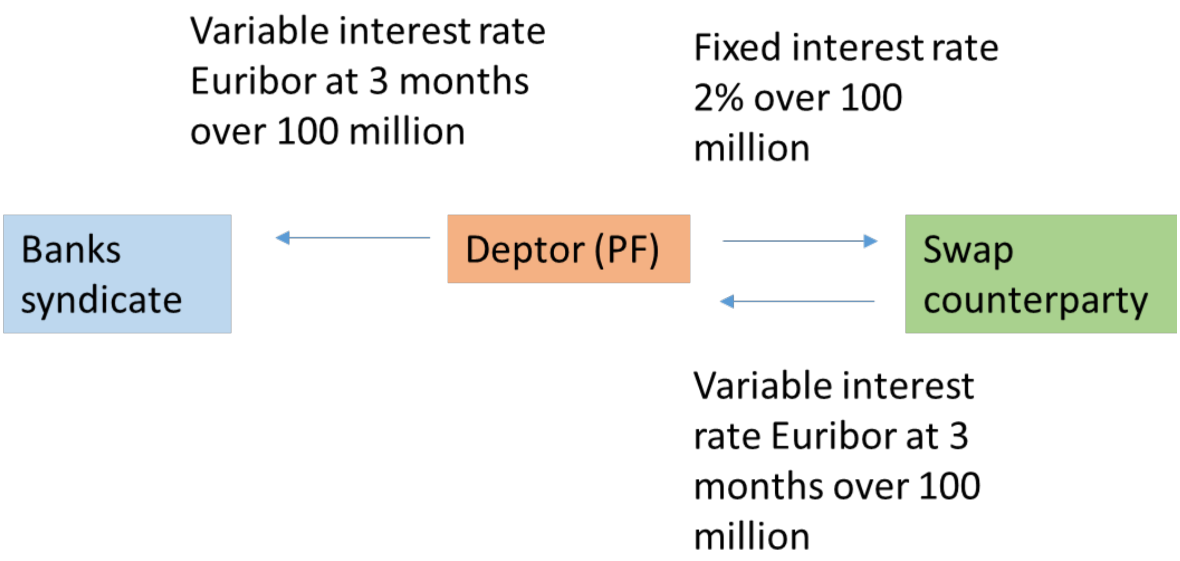
generally carry the weight of the negotiation and subsequently administer the loan on behalf of the syndicate. The syndicates are a temporary mechanism of association between entities, which make loanable funds available to a borrower with common terms and conditions and, consequently, with common documentation (financing contract or Term Sheet).

The main cost to the borrower of a syndicated credit is the **interest** that must be paid on the part of the loan arranged. The interest rate is usually variable and is formed with a reference interest rate plus a differential or **spread** that is the most important remuneration factor for the lender.

Projects financed through project finance are usually considered high risk, so it is common for syndicate banks to request the client to contract a financial instrument to hedge risk, mainly **derivative contracts.**[2]. These instruments are used to cover possible deviations in interest rates that could adversely affect the ability to repay the loan and therefore the viability of the project. In the file, two types of derivatives have been analysed: **interest rate swaps and collars**.

Interest rate **swaps**[3] consist of the exchange of a fixed interest rate for a variable one. As in syndicated project financing operations they are usually carried out at variable interest rates (i.e. 6-month Euribor + margin), the debtor can contract a swap of interest rates so that the counterparty pays a variable interest rate (with which to handle the payment of the debt) in exchange for paying a fixed rate.

Outline of an interest rate swap type



[2] A derivative is a financial product whose value is based on the price of another financial asset, called the underlying product.

[3] Interest rate swap or IRS.

The result for the debtor is the elimination of the risk of interest rates because having two symmetrical operations (payment and collection of a debt with the same nominal and the same variable interest rate) the risk is eliminated and only a net payment would remain which is the fixed interest rate.

In the operations related to the investigation, the role of the counterpart of the swap was held by the same entities that participated in the bank syndicate for project finance.[4]

Collars are complex derivative instruments that incorporate two types of interest rate options, called cap and floor. Through a collar, customers of syndicated loans (debtors) buy cap options, which allow them to protect themselves from possible interest rate hikes, while at the same time selling a floor option, for which they are obligated to the bank to cover the difference if the interest rate falls below the fixed rate (or floor) and therefore allows banks to protect themselves from possible decreases in the interest rate of the credit. Both operations are established on the same nominal credit. In practice, a band of maximum (cap) and minimum (floor) interest rates is created between which the debtor's payments and the creditor's revenue will be moved. This instrument covers the risk of both parties (debtor and creditor). On the one hand the debtor is insured (in exchange for the purchase price of the cap) that they will not pay interest above the rate fixed in the option and for another waiver, in exchange for the sale price of the floor option, to pay less if variable rates fall below the agreed minimum rate, in the form of a floor clause. This serves the bank (buyer of this option) to ensure a minimum return on credit (clause floor).

Hedging contracts are usually bilateral. Although the coverage is offered by several entities, each must subscribe to a different framework contract with the client.

Within this framework, and in light of the facts, the CNMC Board separately analyses two conducts: i) the coordination to set the economic conditions of the derivatives for interest rate risk coverage of the syndicated loan destined to project finance and ii) the link between the granting of the syndicate credit and the contracting of the derivative with the same banking entities that participate in the syndicated credit.

Regarding the first conduct, the Board of the CNMC considers it accredited that the fined entities coordinated to set a price above the one agreed in the contract with the client in both risk coverage instruments.

It is important to note that these complex derivative contracts were set at "zero cost" or "no cost" or "market value". The terms zero cost or no cost refer to the fact that, at the time of contracting, none of the parties must make any disbursement, given that the price of the purchase and sale of options are the same. The relation to "market value" refers to the fact that the price of the options purchased and sold (in the case of the collar) is made at market prices and that therefore there is no type of margin charged by the financial institution.

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[4] The suppliers of the derivative can be financial entities already participating in the financing or a third party external to it (or a mixture). If they already participate in the loan, their participation in the provision of the coverage will usually be proportional to their participation in the credit. Each financial institution must evaluate its risk and, whether or not it is eligible for the formalization of a derivative of coverage if it needs it.

The mechanism to determine the value of options included in the collar and the swap is complex and will vary depending on the time of contracting. This makes it possible to wait until the signing of the contract to establish all the conditions.

Thus, in the case of collars, the operation of contracting and fixing the caps and floors was carried out through the following process: the debtor of the syndicated credit went to the notary to sign while the representatives of the financial entities were in communication through teleconference from their respective entities to carry out the calculation of caps and floors. In general terms, the agent bank performed the calculations and offered values that needed to be accepted (or rejected) by the debtor of the syndicated credit and by the rest of the banking entities.[5]

The competition conflict analysed[6] occurs because the financial entities, before the conversation with the client, communicated with each other to agree on a floor above the market level. Thus, if the floor type that caused the derivative to be at market rates was 2.5%, they would agree to specify a higher rate. In this sense, it should be noted that the higher the cap rate or the higher the floor type, the lower the value for the syndicated debtor.

In the investigation carried out by the DC, phone calls and e-mails were obtained in which the financial entities, prior to contracting, communicated the levels obtained by each of them in the simulations and coordinated to set a higher floor than the one corresponding to the market value.

Along with the operations reported, the DC analysed a large number of different operations where this coordination is shown, as stated in the resolution of the Council of the CNMC.

The conclusion of the Board is that the four entities sanctioned coordinated to set economic conditions for the coverage of risk of adulterated interest rates, with implicit margins imposed in a multilateral and concerted manner, and superior to what was agreed with the client in the contract "under market conditions". The Board has ruled that this conduct is a restriction of competition by object.

The parties argued that coordination in setting conditions is necessary and intrinsic to the conclusion of a syndicated credit (and its coverage). The CNMC considers that, even if coordination is necessary to set the same price eliminating the minimum differences between the different entities by the different means of calculation, in this case, it is the prior agreement of the banks, completely unknown to the client, which is charged as an infringement, and not that of the final negotiation with the client through teleconference, since it is the first one that allows the investigated entities to eliminate uncertainty inseparable from an autonomous action under market conditions, to know offers from the rest of banks beforehand and to illicitly agree on a price that is more beneficial for them. The fixing of prices significantly higher than the agreed (market) excludes the possible defence of the need to ensure the viability of the syndicated loan. And, in the absence of unlawful coordination, each bank would set its floor or swap price based on its portfolio or position against

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[5] The operation is similar for contracting the interest rate swap.

[6] Throughout the investigation, it has been assessed whether coordination of the same cap and floor types by all financial institutions is necessary. However, in light of the parties' allegations of being a general practice in this type of operations, no further analysis has been made.

the risk, at a fixed price "under market conditions", which would provide the customer with the element of necessary contrast and would discipline entities to reach a common price that responded to the contractual commitment to determine the price of coverage "under market conditions".

In this way, the Board also invalidates the consideration made by the parties to take into consideration that the practices could be considered an ancillary restriction to the derivative contract or, in a subsidiary way, that the legal exemption of article 1.3 of the LDC or 101.3 of the TFEU could be applied. The fixing of prices higher than those agreed with the client does not allow "consumers or users to participate equally in their benefits". Nor has it been possible to demonstrate that it is essential that it should be the banks who lend the derivative.

On the other hand, and in relation to the second conduct analysed, the link between the syndicated loan and the derivative with the same financial entities has been an element developed extensively in the Resolution. The DC considered that the infraction of Article 1 (LDC) and 101 (TFEU) was constituted by two individualized but related behaviours. The first one is the already analysed price coordination. The second is the unjustified link between the granting of the syndicated credit and the contracting of the derivative to cover interest rates with the same banking entities that financed the project. The Council deviates from the opinion of the DC when considering that "it is not possible in this case to conclude on the unlawfulness of the fact, nor, consequently, is part of the theory of damage in this file, the fact that the charged banks force clients of the syndicated credit to contract the coverage against the risk of interest rates with the same banks." Although this linkage could have operated as a facilitator of price coordination.

Finally, and given the fact that although it is a restriction by object, which due to its special potential for distortion of competition does not require proof of anti-competitive effects, the CNMC considers that the charged conduct has had effects on the market, duly accredited during the instruction of the procedure, with a negative effect, through the prices set in a collusive manner on the quality of the derivatives, that is, on the value of the coverage for the client, which is negative instead of "at zero cost". According to the information contained in the file, during the period of the offense, the four entities accused participated simultaneously in 30%-40% of Project Finance operations financed with syndicated credits, although this average increased to almost (40%-50%) since the purchase of Banesto in 2013, and even more so when considering the operations in which at least two or three of the charged banking entities participated simultaneously.