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LOANS: Scratching and Clawing to Progress

A revamped approach to the sometimes-dysfunctional sociology and technology that govern the syndicated loans and collateralized loan obligation markets is now in thrall. Learning from previous Herculean efforts, incremental steps are now realizing significant benefits for the space, which, sources on both the buy and sell side say, is just what the doctor ordered as new, less experienced investors ponder entry to the market. By Tim Bourgaize Murray

Burgeoning with record issuance, secondary trading and securitization, the syndicated loans space remains nevertheless beset by long-established operational and trade workflow problems, stretching from settlement to reconciliation and custody, made worse by an unusual amount of institutional inertia and quibbling. And, unlike other complex markets where lawmakers insisted upon wholesale reengineering following the 2008 credit crisis, the regulators' touch here remains fairly light. In a rarity, it really is up to the market to fix itself.

An American football analogy illustrates the market's push: A few early industry efforts tried to air the ball out and gain large chunks of yardage all at once in the quest for straight-through processing (STP). Facing challenges from investment managers or agent banks (or both), however, none of those has quite connected yet. And so it's been back to the playbook.

But a change in strategy—"scratching and clawing now for every yard," according to one source—has shown encouraging results since the beginning of 2015, potentially signaling progress for a space that is thirsting for it.

Bottlenecks

So, how did the industry get here? A technology refresh has been heralded for years, decades even. But when asked, syndicated loans veterans note one technology initiative—perhaps unfairly—as a recent example of the industry's possibilities and limitations.

Markit Clear, an automated trade settlement hub and data repository, was designed in 2011 with the intent to solve many of these problems at once. It was designed to replace ClearPar, the legacy platform also owned by Markit, and ultimately achieve genuine, front-to-back STP. The project had big dreams … and still does.

But things didn't quite go as planned. Asset managers, for example, say agent banks, protecting their foothold, dominated the hub's initial build-out and left little room for buy-side input on key issues like delays, disputes and exceptions management. Further complicating matters, they also complain that the sell side has dragged its feet when it comes to adoption, which fast becomes a problem for a market where nothing is processed bilaterally, and administrative relationships can number half-a-dozen or more for a typical manager.

Pierre Batrouni, CFO and head of operations at $8 billion MJX Asset Management, cites the example of a recent test of the platform's cash-on-transfer (CoT) feature, which would allow par loans to settle at T+3. "We were very optimistic. When we went live, JPMorgan as agent was ready immediately. However, the other agent bank needed more time and when the second agent was eventually ready, they would only put a few deals on at a time. Therefore, settlement time was still lengthy," Batrouni says. "A provider will think they can work hard and create a platform that people can use, but it's always discussed with only one side of the market and not the other. It was a perfect example with the first demonstrations of Markit Clear."

Christopher Errico, head of operations at $14 billion CIFC Asset Management, also points a finger at the industry's largest players, suggesting that their inertia is down to a mix of priorities, regulations and budgets: "Fixing these bottlenecks requires having full transparency around where a trade is, which step we're at in the workflow, and that transparency is needed whether buy side, sell side or agent," he says.

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The challenge, he explains, is contending with priorities at large banks, especially with the pressure they're getting from a regulatory standpoint. Implementing a new solution like Markit Clear and where the budget is (or isn't) to do that, versus contending spend for regulatory requirements, poses the problem. That's why things are moving slowly.

"The current T+19.6 is nothing to be excited about, but that being said, we've shaved probably about a day off that average from last year," Errico adds. "It's a start, but getting the agents on board will definitely open up the gates."

New Tack

As the industry looks to do this, the ultimate goal, sources tell *Waters*, is to create the space for legitimate buy side–sell side engagement, by lightening the burden one piece after another. In some ways, it's a change of tack.

As Philip Raciti, managing director at $13.2 billion CVC Credit Partners, puts it, more needs to be tried to get the easy stuff—and excuses—solved. "We see the friction that occurs in settlement as so simple to address," he says. "By lining the process up, cutting out time and the extra phone calls that need returning, it will just get better. The industry is on the right path, and we'll adopt it because I don't see much alternative."

That path, says John Olesky, director and head of product management in Markit's loans business, is a pragmatic one. The idea is that benefits can be reaped by going outside-in first—gaining four of five yards at a time and getting a rhythm going—and then tackling the toughest aspects when you're on a roll. In this case, that means engaging a new set of participants in the loans ecosystem.

"We asked where people are spending their time with mundane activities," Olesky explains. "Through lots of conversations with customers, we determined that there was an area overlooked by the market: specifically, the preparation of documents for trustees and custodians. And these are institutions that were not traditionally involved with our loan settlement platforms early on."

The custodian's piece of the loans workflow occurs after trades settle, although it is still a "last mile" communications problem for which a solution could help, according to Olesky. "Our view is that streamlining the document exchange with custodians and trustees gives loan ops teams more time to

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settle more trades more quickly. The opportunity cost of not networking in the custodians is potentially longer T+,” he says.

Markit conservatively estimates the platform, built on IBM’s MQ messaging middleware, will save around 45,000 annual man-hours, assuming 680,000 trade allocations and full penetration for the free service. But a recent buy-side survey indicated that the number could be significantly higher.

“The intent of the system is to give providers—custodians and trustees—the option to reduce or eliminate callbacks, because documents are delivered via a secure system and in theory should not require re-validating,” Olesky continues. “Different buy-side requirements for review and signatories create complexity and our solution had to accommodate a variety of needs. It took several months of practical experience to understand the various approaches and to add to the flexibility of our solution.”

Direct Impact

Done right, this has a direct impact for market participants: Whatever time is saved means that personnel can do higher-value activities. The move started with a handful of buy-side firms after launch in February 2015, but uptake has doubled month-over-month, and Markit expects to be able to more closely measure the benefits to trustees as well.

US Bank’s Gregory Farley, senior vice president and US CDO head of operations in global corporate trust services, says it’s indicative of the “incremental approach” required for loans to push forward. Each small improvement, he says, usually implies technology costs for every participant that wants to adopt them, and in many areas it means both parties in a transaction need to adopt the technology at the same time, moving in sync. It’s about keeping things simple and not letting perfection be the enemy of the good.

“Markit Clear seemed like a good concept but it never really got off the ground. I think the reason the custodian file delivery works where some other innovations have struggled is that it is an improvement to an existing process that all parties are already doing—settling trades in ClearPar,” Farley says.

“Sometimes the smallest things can make the biggest difference,” Batrouni adds. “Prior to this automation, our folks would be sitting at the scanner for an hour or so just to send a complete package to the trustee. We’re in 2015 now, and this is taking automation further in the right direction. Markit’s done this with BNY and US Bank and is in talks with a third major trustee, which are the major players. So that’s been a good impact for us.”

Next Up

If file delivery seems foundational, even rudimentary, in a 21st century context, that’s because it is. The real benefit comes with the next step, direct systems integration, whereby trustees are able to provide faster information via their client access portals—US Bank’s Pivot and BNY Mellon’s Connect, to name two—back to clients, and speed up the process of reconciliation.

“Unsurprisingly, investment managers want more timely information,” says Magnus Wilson-Webb, global strategy manager for the financial institutions within BNY Mellon’s Corporate Trust department. “A CLO would report once a month back in the day to see where they stand; now they want to see a version of that every day and we’re driving toward that. Giving managers access to the data every day allows issues to be identified immediately, thus smoothing the month-end process. As clients do more and more with the data, they can just suck it into their internal systems and punch those numbers to get meaningful analysis. That’s obviously not unique to the loan class, but it’s harder to accommodate with loans.”

That scenario is similar for US Bank, where new loan notice search functionality serves as one example, according to Farley. “We knew that it would take a lot of development for clients to be able to make copies of the bank loan notices for their deals in a useable format,” he explains. “So we allow clients to search through the notices we have processed for their deals by portfolio, facility, type of activity, and date. More broadly, we know that many of our buy-side clients will engage third-party servicers to maintain their loan portfolios on their behalf at this point, so we want to make sure our data is a true independent source to reconcile against.”

Increasing data velocity and full transparency earlier is the means to that ultimate end, according to Olesky. “The buy side came first and 2016 is when we can crack that next piece.”

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Fresh Momentum

Even if the industry is still far from the Promised Land, fixing issues on the edges has changed the tenor of the narrative for the better and has built fresh momentum. The question going forward is whether negotiation around the more political points of contention can benefit, or indeed if the current T+19.6 settlement time can be halved over time, perhaps to T+8 or T+10 or—as Batrouni suggests for loans at par—even be brought in line with corporates at T+3.

To get there, the comprehensive approach will need to continue. Sources say more standardization around loan identifiers is necessary, and the Bloomberg-backed Financial Instrument Global Identifier (FIGI), while still in its early days, has gotten good traction from US Bank, Deutsche Bank and front-end specialist Virtus Partners, among others. Efforts around FpML-based messaging adoption have also continued apace, though initiatives need more take-up. Blockchain startups are heavily focused on the space and sources highlight greater technology consolidation as proof of impetus, too.

But know-your-client is an increasingly annoying wrinkle, and Markit Clear, or something resembling it, will still need broader adoption—ultimately, that issue isn’t going away. Olesky points to recent work Markit has done to streamline the front-end interface between the ClearPar and Markit Clear engines as significant progress.

“The platform had a high barrier to entry; we knew going in that it would be a journey of several years,” Olesky says. “It also can produce a high level of achievement, once that barrier is breached, and we now have a feeling that we’re close.”

But by itself, a technology solution isn’t going to improve settlement times “by half overnight,” according to Errico. “The sheer volume is overwhelming now with increased secondary trading and new entrants to the market. Settlement is something where there’s a lot of personal interaction to move from trade date to settlement date. There’s no silver bullet for it.”

Benchmarks, Penalties

Indeed, for his part, Batrouni notes a couple of specific areas—one technical, the other financial—that could further force the issue. The first is published benchmarking of settlement performance.

“When you’re getting toward quarter end or warehousing a loan, a firm of our size can see up to 200 trade settlements a day, depending on how many funds we have running,” he says. “So to start with, reporting within ClearPar needs to be updated to allow a CLO manager to compare how they rank among other CLO managers; the same goes for hedge funds. The reports would be more useful to the manager when having this kind of information.”

As for settling at T+3 for par, whether primary or secondary, what the market is really trying to do is control short-selling, Batrouni continues, noting punitive measures for delays as another possibility up for discussion.

“There’s always pushback against penalties, so the Loan Syndications and Trading Association (LSTA) needs to better understand the CLO product and the reasons for delayed settlement first,” he says. “There are a lot of moving targets, and it has to be thought through very well in order for this to work.”

With much of the peripheral work to speed up communications now completed or well under way, the theory is that extra time and bandwidth made available can make that happen. A space is being carved out to get the trickiest work done and investors—both new and seasoned—can’t wait. W

SALIENT POINTS

- As efforts have slowed at wholesale settlement automation for syndicated loans, the industry has taken a new tack by addressing peripheral concerns that can free up headcount, operating budgets and space for negotiating the tougher issues.
- One of these initiatives involves eliminating manual file delivery via a new portal built by Markit that has focused on investment managers in the space and their trustees.
- The next step is direct systems integration for firms using ClearPar, allowing more fluid reconciliation, and further streamlining of the ClearPar and Markit Clear front-end interfaces.
- These efforts, it is hoped, will help push forward other technical developments—messaging standards and entity identifiers as well Markit Clear itself—and provide a solid basis for developing needed conventions like settlement performance benchmarking and penalties for delays.