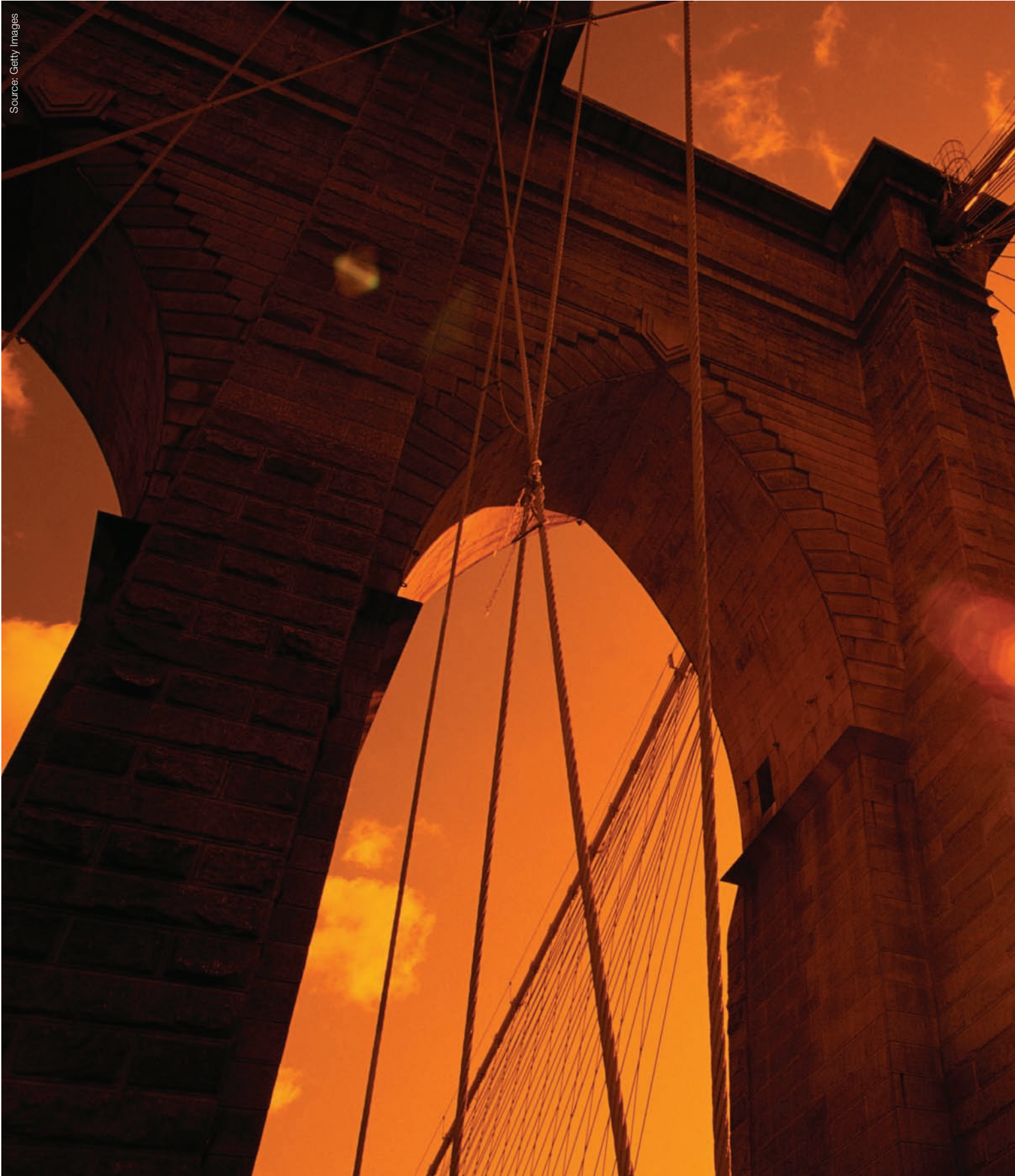


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Joe Widner, managing director, Markit talks candidly with leading experts in the loan industry on the issues and challenges involving loan trade processing. Representatives from Alcentra, CIFC, European Credit Management, Goldman Sachs, JPMorgan Chase, MJX Asset Management and Sankaty Advisors came together to discuss the importance of a trade settlement platform, universal instrument and counterparty identifiers, and a streamlined solution to third-party consents.

Below is an excerpt of the roundtable discussion.

Bridging loan communities

Widner: Some of the difficulty in settling loan transactions can be attributed to how different they are from other asset classes. What makes the loan market so unique? Why have loans not gone more towards a security-type model?

Viens: If we go back to where the loan market began, it was a contract between two parties. That evolved to a market with syndication, which then led to secondary trading, and gave us the market we know today. There has been an evolution from a contract between two parties to where the trading environment is today but there has not been much evolution in the processes to settle transactions themselves.

Taheny: The main challenge at the moment is to speed up settlement through standardising documentation and thereby facilitating more automation. In Europe, there are issues due to multiple jurisdictions with differing security requirements that makes it hard to document on a “one size fits all” basis

Vaccaro: You also have other issues. Unlike bonds, with loans you have private side and public side investors, with different levels of disclosure. This is not something you have with public securities. There is also a much higher degree of control over the borrower compared with bonds. With bonds, you have covenant packages that are relatively

Attendees quoted in this article:



Pierre Batrouni, managing director and head of operations at MJX Asset Management

MJX Asset Management is a leading manager of high-yield debt with particular expertise in senior secured loans. Pierre had 23 years of managing loan operations before joining MJX, working for Citigroup, Merrill Lynch and WestLB.



Mark E. DeNatale, global head of loan trading at Goldman Sachs

Mark joined the company in 1994 as an analyst in the fixed income, currency and commodities division. He was an analyst in capital markets for three years and then moved to trading in 1997. He was named head trader in 2004 and managing director in 2005. Mark currently serves as a board member for The BC Fund. He earned a BS in Finance from Boston College in 1994.



Karoline Kane, executive director and global co-head of loan operations at JPMorgan Chase

Karoline is responsible for global loan origination and syndication middle office and global loan trading closings, supporting North America, Europe, Latin America, Asia and JPMorgan's MasterSwap Loan business in New York and London. Karoline's responsibilities include creating more efficient and liquid loan settlements, reducing settlement times, and promoting standardisation in the market. Her primary focus over the past two years has been electronic settlement in North America and Europe. Karoline joined JPMorgan Chase Bank and the syndicated loan business in 1997. She received a BA from Boston University and a JD from The New York Law School.



Stuart Medlen, executive director at Alcentra

Stuart joined Alcentra in 2004. He jointly heads up the global transaction management team. Previously, Stuart spent 4 years working in structured finance for JP Morgan.



Colin Taheny, business manager of leveraged loans at European Credit Management Limited

Colin joined the company in 2004 to establish and head a dedicated back and middle office for the leveraged loans business. Colin has more than 14 years' experience in the loans market, covering agency, loan closing and third party asset servicing, having previously worked in various roles with Bankers Trust and Deutsche Bank AG.

Steve Vaccaro, co-chief investment officer at CIBC

Steve has more than 32 years' experience in corporate lending and credit approval. He spent 25 years at JPM, where his roles included managing director and co-head of the media group, credit supervisory officer, credit audit and team leader in the land transportation and global automotive corporate lending groups.



Andrew Viens, vice-president of operations at Sankaty Advisors

Andy joined Sankaty Advisors in 2005. He is responsible globally for all trade settlement, data management, reconciliation and valuation functions. Previously, Andy was the director of treasury operations at Investors Bank & Trust, where he was responsible for all operations activities related to securities lending, foreign exchange, cash management and MBS portfolio functions. He received a BA in Economics from Assumption College.



Joe Widner, managing director at Markit

Joe is responsible for the Markit loan processing business. This business is tasked with increasing innovation and efficiency in the loan market and includes Markit WSOData, ClearPar, Markit Entity Identifiers and loan messaging. Joe has approximately 10 years' experience in the loans asset class and was formerly the chief operating officer at WSO.

standardised across most issues that are incurrence-based. Loan covenants are more tailored for each borrower and are maintenance-based. Additionally, borrowers (loans) are much more focused on who they are getting their money from as they realise that they are likely to renegotiate the terms of that loan at some point during its life (i.e., refinancing, financial covenant amendments). Revolving credit facilities also introduce an element of complexity that term loans and bonds do not have. With term loans and bonds, you lend the money and it is outstanding until it is paid down by either amortisation or final maturity. With revolvers, the relationship is ongoing. The money is borrowed, paid down and re-borrowed multiple times throughout the life of the facility. It is just a different relationship between the lender and borrower. Further, there is also the issue that loans are often secured by the assets and stock of the borrower.

Widner: What makes the loan asset class more challenging to own and transfer?

Medlen: There is a lot of paper that gets passed back and forth across multiple institutions. It is very backward and it slows things up. There is also a lack of a delivery versus payment system.

Vaccaro: I would agree with all that. There are a lot of issues. It is a very inefficient market even for "liquid" loans. It requires multiple levels of approvals in many cases; it is not just an agreement between yourself and the party with whom you are trading. You have upstream settlements, you often have to get agent and borrower consent; so you have three or four parties involved every time you trade and they each have to sign off. Further, these parties are not always economically incentivised to settle the trade quickly.

Kane: There are several reasons but I think one very important thing that creates settlement delays is that there is not a definitive settlement date. We

do not have a definitive settlement date for many reasons, one of which is the requirement for borrower consent and the consent of third parties such as administrative agents and LC issuers, which is an attribute of the private nature of the loan product. I think we can design a mechanism that can compel settlement, but we have to also explore how to satisfy third-party consents more effectively. There are possible solutions available. For instance, some loan agreements now require borrowers to respond to loan assignments within a certain number of days.

Viens: Layer on top of that a lack of common identifiers on both the instruments and participants; then combine that with the lack of a regulatory framework and operational inefficiencies – the problem with settlement times just gets compounded.

Batrouni: A lot of people are really very concerned about how it may change the market for loans; some of the proposed changes are making it more and more like a security. We have no alternative but to go in that direction to make sure that we are putting accurate procedures in the handling and transferring of loans. A lot of information has fallen through the cracks over the years due to the manual handling – which is now delaying the process on closing the trades, particularly with reps, warrants and step-ups. We have to decide which direction we are going. Whether it is through DTCC or another system, frankly something has to get done in order to reduce the operational life of a trade, reduce the delays in the settlements of trades, minimise the payments of delayed compensation and reduce the amount of capital that needs to be kept on hand for trades that have delayed settlement. We are all “paying the fee” right now. We need to start seriously thinking about these issues.

Widner: Do you think that reform will increase liquidity or attract investors to the asset class? Do you think that

“If we look at the past 12-18 months, many purchasers of loans in the secondary market were impacted because they could not liquidate their loan positions fast enough.”

investors are staying away from the market because of these inefficiencies?

Kane: Absolutely. If we look at the past 12-18 months, many purchasers of loans in the secondary market were impacted because they could not liquidate their loan positions fast enough. I am referring both to the implications on managing cash as well as trade execution. The lack of liquidity has concerned many in the secondary loan market because they needed cash quickly and could not get it. It was really a two-prong effect. Prices were dropping rapidly so many loan market participants were concerned about getting their trades executed. Once executed, they did not have certainty on when the trade would settle, therefore they were not certain on when they would receive the cash. Some of these participants have started to return recently on a cautious basis. However, volumes have yet to fully return. For loan market participants there is also an operational burden that includes being a loan expert, understanding the loan trade settlement procedures and having the resources to support many of the manual aspects of loan settlement.

Vacarro: From the buy-side perspective, over the past year if a fund has had elements that contribute to a lack of

overall pricing transparency, which has caused investors to sometimes view these funds as less attractive as they have been concerned about being able to calculate the value of their investment. Anything that improves transparency and price efficiency is good for the asset class.

Widner: We have seen recent regulatory interest in both the US and Europe around loans, what do you think will come of their involvement?

Batrouni: Settlement dynamics is going to be a 2010 event. The Fed is focused on it as they recognise it as a systemic issue. This will force the market to address these issues and present an orderly platform for settlement. Distressed trades are still outstanding in some cases for over 90 days.

Vacarro: Regulatory concerns aside for a moment, from an economic point of view, this is an OTC market with very little liquidity even in the most liquid of loans. Anyone that managed a portfolio of loans that lived through the past 12-month period of hedge fund redemptions and market value fund unwinds would ask “What is the fair market value for a loan?” When all the trading volume is one-sided, you cannot say that fair

“Through the whole period 2007 and 2008, bid-asks were fairly tight considering the severity of the crisis and the extreme volatility.”

value is the market price. Just think back to the first quarter of this year. I just do not think the instrument is mature enough.

Denatale: Can you say why you do not think it is mature enough?

Vacarro: Mature is perhaps the wrong word. I just do not think it is liquid enough.

Denatale: I would take the other side. I think this is a very robust market. I was really impressed during 2007-2008 of how liquid the market was, all things considered. Now it is fair to say that people probably did not like the price levels but there was always a clearing level for a trade. If you go back to 1998, you were lucky to get a handful of names to trade through the whole Asian crisis and even if you did get a name to trade, you were probably looking at a five to 10-point bid-ask. Through the whole period 2007 and 2008, bid-asks were fairly tight considering the severity of the crisis and the extreme volatility. You saw not only at Goldman but also JPMorgan, Barclays, Bank of America, and likely others, very healthy flow with somewhere between \$1bn to \$3bn of trading in actual loan flows getting done each week. All of that said, we cannot scale the business and I do not think you

can scale the market without an established settlement platform. Sometime soon there is going to be a lot of scrutiny of the major underwriters to really highlight why there has not been more progress on these issues. If we all want to be in this business in the next five to 10 years, we are not going to be able to do it without an established settlement platform.

Vacarro: I agree totally that we need a more efficient settlement process. We all want faster settlement times. I would just say this: our book of business is a little different. Bid-ask spreads in the first quarter were quite wide. When you get down to medium and small loans, there is no liquidity. You get away from the bigger “on the run” names and liquidity dries up quite rapidly. 30 per cent of our book is middle market: 20 per cent of that has no price mark at all. So, if you bought it, you own it. Loans in the middle size-wise (small broadly syndicated and large middle market loans) trade by appointment and it may take up to a week to get a bona fide quote.

Widner: Do you see more of a movement to middle market lending in current market conditions?

Vacarro: As an asset manager that has about 30 per cent of our positions in

middle market loans, I would say that before the securitisation market shut down, the attraction to middle market loans for fund investors was due to the perception that they were better relative value versus broadly syndicated loans. Right now, because of their lack of liquidity, many fund investors are shying away from anything that lacks price transparency. As middle market loans have less price transparency than larger “flow” names, their perception has been negatively impacted. I would add that bank “club loans” to middle market companies seem to have a consistent level of deal flow with banks being the primary participants.

Widner: What are your general thoughts on delayed compensation? Is it standard to enforce it? Should there be more penalties? Can a fault-based model drive additional change that perhaps a platform cannot?

Batrouni: While the LSTA standardised penalties for delayed compensation, they made it too easy for some institutions to just say: “We cannot close and we will just pay the delayed compensation.” It is not as big an issue for the sellside as the buy-side. Every bit of interest, positions and ratings affects our books when we book the trades into our systems. With the agent banks and

sellside having more flexibility around the delayed compensation, there definitely has to be more controls and penalties in place or at least an understanding that you cannot just put a trade on for 30, 60, 90 days and just say: "OK. When it settles that is what the delayed compensation will be." If we are not going to lean more towards effectively regulating when loan trades should settle, then we should penalise more significantly those institutions that continue to not have the position on their books and pass on the delayed compensation.

Kane: The current framework is non-fault based. It allows the buyer and seller to make a decision whether or not to settle the trade or pay/receive delayed compensation. For example, if a buyer's cost of funds is lower than the delayed compensation, there is not a strong incentive there to settle under certain circumstances, but delayed compensation is absolutely enforced on 100 per cent of our trades. We have to consider two things: 1) do we move to a fault-based model; or 2) do we neutralise the spread between buyer and seller so that neither party has an incentive to delay the settlement of the trade.

I think where we should end up is somewhere between the two. We need to get the settlement cycles tighter and we need an efficient settlement platform with some transparency as to who is holding up settlement. Then we can move to fault-based compensation. For the time period where there are delays because of third-party consent, we need to neutralise the benefit to either the buyer or seller. Delayed compensation today is not and will not be a mechanism to compel settlement. People can still make the decision whether or not to take the economic hit. So even if we reform the delayed compensation framework, it will still fall short of compelling settlement.

Batrouni: More use of the settlement platforms has definitely helped but it has not created any type of regulated atmosphere. All it is really doing is just

settling the trade and not really providing any confirmation of inventory or affecting penalties for not settling on time beyond LSTA guidelines. So, without a doubt, the industry needs to start focusing on that. By forcing the DTCC-type projects, it is really going to help us all in the future. We need a lot of help from the agent banks to provide a lot of the information. Someone recently did an analysis that shows that only about 30 per cent of the loan trades are currently on DTCC, so I am not even sure if it is really useful at this point; but somehow, some way we have to start.

Widner: How valuable is the position reconciliation?

Kane: It is critical. We have agent banks that process loan activity and lender systems that do the same thing. The data is manually keyed. We do not enter the same data. For example, agents and lenders round differently. Positions are sometimes off by the penny, sometimes significantly more. This is a material process on which we need certainty. From a lender perspective, when you settle you have to take a step back to ensure you reconcile with the agent.

From the agent perspective, interest and principal payments are sent out at quarter-end to lenders where they are coming back and indicating that the payments are incorrect due to incorrect positions. The reconciliation tool lets us reconcile daily, instead of quarterly, and doing that is vital to begin solving the problem and getting our systems talking to one another. Standard identifiers are also critical in making sure the systems can talk to one another.

Batrouni: We want to start taking advantage of DTCC. We have uploaded our positions and started using it. Participation by buy-side is still at an early stage but I think our participation has helped identify and resolve issues early. You also need to see more involvement by trustees in DTCC as you can really accelerate the process. The biggest hurdle so far on the buy-side is related to identifiers. The solution is available but it has not been communicated clearly to the buy-side how they can get the identifiers they currently use today to match against CUSIPs. On the DTCC project, no one on the buy-side is being represented on that board, which is causing things to be delayed simply because the

"We need to get the settlement cycles tighter and we need an efficient settlement platform with some transparency as to who is holding up settlement."

communications happen much more slowly. If the buy-side reflects a position that the agent bank has not uploaded, there is no easy way to communicate that.

Widner: What about the 'growing pains' in the European market as it works to overcome the increased confidentiality requirements?

Taheny: Unfortunately, this is why we stepped away from the DTCC and Euroclear projects. Until the confidentiality issues are resolved, data cannot be posted in a way that is meaningful to us. I am not sure where we are with this at the moment. I am not even certain if they are even publishing on DTCC and Euroclear in Europe?

Batrouni: I can say that some positions are being uploaded by European banks but they are not identifying the asset clearly to you. The CUSIP number has to be clarified.

Medlen: The European loan market tends to follow the US by five or six months. We took a look and noticed

that most agents were not putting up positions and we were not prepared to do a partial reconciliation.

Widner: There has been many efforts during the past year in Europe to make the data more available, how much longer do you think it will take?

Medlen: Agents and the LMA have been working on this. It will take more time, maybe six to eight months. That is going to prolong the reconciliation. It should not though. More communication is needed. For example, if Markit WSO let people cross-reference internal CUSIPs to market CUSIPs that would be tremendously helpful.

Widner: What about the documentation requirements?

Taheny: On the documentation side, there are numerous amendments to credit agreements and revisions to transfer documentation. What would be incredibly useful is if the agent banks provided a workspace that stored the latest form transfer certificates, accession deeds and summary terms detailing

transferability, any additional requirements needed to perfect security, dates on which agents process transfers, if the agent pays on a lender of record basis, transfer fees etc. A one-stop shop for all the transfer documentation and guidance notes could really speed up the approval process at agent banks.

Denatale: The experience of the past three years tells us that the loan market needs to take some steps to become a truly scalable market. We need an established settlement platform. We need to re-establish viability of LCDS contracts to a bullet form so that clients are comfortable with the valuation and its use. We need a more standardised document that the market is comfortable using.

Widner: I know that the LMA is now consolidating its documentation even further with all but three fields defined as a standard confirmation. If you can get it boiled down to a very discrete set of fields, you can go to a more automated system with automated confirmations, but typically I hear from the naysayers when I bring this up.

Denatale: It is really important to step back and appreciate that the market has spent the last three years surviving. I think it is very important to move forward, be constructive and figure out how we can have a really robust product and attract more investors to the asset class. This is why we are seeing people, and the momentum growing, join in the solution that Markit and some others are looking to provide. We need to get to a straight-through-processing (STP) solution.

Viens: Surviving the last three years is a fair point. That is what makes this whole conversation more relevant now. Coming out of this survival mode, people are really focused on risk management and transparency: settlement risk, systemic risk, counterparty risk and operational risk. These issues have always existed but people at every level

“The experience of the past three years tells us that the loan market needs to take some steps to become a truly scalable market.”

are now focused on it like never before. Quite candidly, this is what makes me really optimistic that we may start to see solutions actually get implemented. Confirming online and a true delivery versus payment settlement model are huge steps forward in this regard.

Widner: Delivery versus payment (DVP) – the transfer of assets and simultaneous movement of the cash is something we are working with DTCC on. Do you think it will work? Are there alternatives that should be considered?

Batrouni: DVP for us would be something we would welcome very much. Manually reviewing bank statements from trustees and uploading them into an accounting solution like Markit WSO, it really does take a lot of resources and headcount to do properly. Even though more technology is becoming available, there is still some manual effort involved. If it is all in DTCC, it would make it much easier to reconcile and ensure timely receipt of funds.

Widner: How about a collateral versus DVP model? Would anyone from the buy-side be willing to put up a certain amount of cash to help ensure a trade clearing?

Batrouni: What we would like to see is our end-of-day cash, once it is reconciled, to be in the DTCC cash account which would be linked to our trustee's account. This way, there would be no reason to do collateral. The trustee could simply wire the cash for us if needed. But, for the most part, we would have no problem putting up our capital in the DTCC account.

Denatale: We would be comfortable moving toward that. We basically do this in derivatives. It would be helpful in managing counterparty exposures.

Vacarro: Most CLO indentures would preclude putting up cash collateral. For the majority of the existing loan market, this would probably be unworkable.

“What we would like to see is our end-of-day cash, once it is reconciled, to be in the DTCC cash account which would be linked to our trustee's account.”

Widner: Fair point. It also does not get past some of the bankruptcy issues with prefunding. What we are doing here at Markit with ClearPar is we are trying to look at every step in the settlement process to address the major issues: know-your-client, borrower consent, allocations and trade matching, etc. But the issue around upstream positions and intended/unintended shorting remains difficult to solve. How do you take that delay out of the equation?

Batrouni: I do not think you can until the settlement times are reduced. There is too much backed up. It is simply too easy for someone to short you and wait a few months to pick up a deal in the market.

Widner: We are running out of time, any final comments?

Medlen: It is as good a time as any to try and iron out some of these inefficiencies. Primary market is showing some signs of life. We need to be prepared.

Taheny: I believe that the standardisation of loan documentation, automation of the loan settlement process and a movement towards full STP should be the key goals

for 2010. We are very much appreciative of the efforts by LMA, DTCC and ClearPar in trying to achieve this goal.

Vacarro: STP will be a big cost saver. Loan investor transparency is great for everybody. For us, the other huge hidden cost of long settlement times is related to managing funds that are calculated on a settled basis on determination dates. It makes it difficult to determine what your actual portfolio will be prior to a determination date. It represents a potential cost to investors if a fund's ability to make a distribution to equity investors is dependent on whether a loan settles. Getting clarity and certainty around settlement times would be a huge improvement.

Kane: We need to avoid developing these settlement systems in a vacuum. We need to ensure that the agent bank and lender settlement systems are talking to one another, as well as, accelerate FpML messaging to facilitate system to system communication. Just doing that will reduce settlement times significantly. Finally, moving away from paper is also a game changer. This is where I think Markit and others can add a tremendous amount of value. ■