Powering up the loans market

MIKE JOHNSTONE EXPLAINS HOW INCREASED STANDARDISATION AND EFFICIENCY IS THE GOAL IN THE INTERNATIONAL SYNDICATED LOAN MARKET.

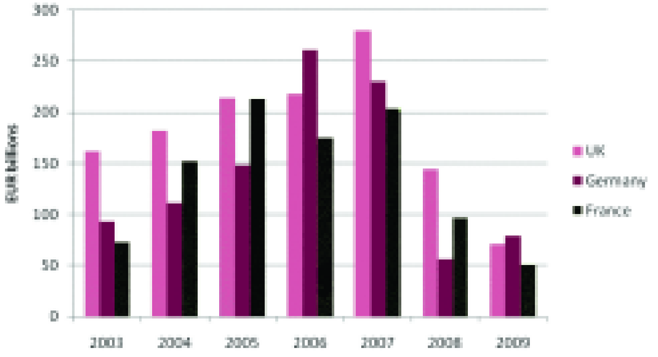
The international syndicated loan market is now systematically addressing many of the problems encountered in the loan agency, settlement and servicing operational aspects to the benefit of all market participants. In terms of maximising the use of automated settlement systems and methods of transferring information, the syndicated loan market has fallen woefully behind in comparison with other financial markets. But banks and vendors are now working hard to catch up and replace the current outdated practices, often mirroring the approaches adopted in other markets, to the benefit of both borrowers and lenders.

UNPRECEDENTED SURGE During the period 2003 to 2007, there was an unprecedented surge in loan volume issuance globally. Figure 1 shows sample data for the UK, France and Germany. Although there are slight timing differences, the trend for each country is very similar, as it is for all of Europe and other international markets. At the same time, other structural changes were taking place in the syndicated loan market, particularly in the non-investment grade sector. Those changes included ever larger syndicate groups, more complex transaction structures, many new global investors entering the market and increasing volumes in the secondary loan market.

However, during this period of booming loan issuance, there was little in the way of investment in the resources required to support the loan agency, settlement and servicing functions. Banks continued to rely almost entirely on manual processing and fax messages. Even more frustrating, for those banks that recognised the problems, there were no readily available system solutions.

In an effort to resolve this problem, in 2007, a group of leading banks, along with the Loan Market Association (LMA), started working with vendors seeking automated solutions. It was quickly recognised that global, industry-wide standards had to be established given the global nature of the syndicated loan market and many of the lenders, combined with the need for banks to find solutions which could be applied to all loan books (bank book and trading book for both investment grade and non-investment grade loans, and both primary and secondary markets). Consequently, the LMA and its US sister association, the Loan Syndications and Trading Association (LSTA), started working closely together with the banks in seeking solutions in line with the standards set. A Global Standards Group

Figure 1: Loan issuance by country



Source: Dealogic

(GSG) has now been established, comprising leading international banks, which will assume overall responsibility for providing governance over the industry standards. The GSG will work with the LMA/LSTA to agree and promote the key building blocks for the loan market to ensure that all the required standards are formally established. In this way, these fixed standards can be made available to all the international loan market participants, system vendors, regulators, etc, establishing authentic clarity.

TIGHT CONTROL The primary aim was to introduce systems that would enable administrative agent banks to exercise tight control over syndicates while retaining the ability to effectively manage their role. The agent bank's role in summary is:

- to administer all relevant loan documentation;
- to act as the principal contact between the borrower and lenders in the syndicate;
- to receive/record all communications from the borrower and communicate as appropriate with the syndicate;
- to maintain the official register of all lenders of record in a facility;
- to calculate all principal, interest and fee cash amounts and to collect all payments due from the borrower;
- to distribute all cash payments to lenders as appropriate;
- to notify lenders and borrowers of all facility utilisations;
- to notify lenders of all rate/maturity settings; and
- to manage requests for amendments and waivers.

The vital aspects of these operations are accuracy and completeness of all records, and effective communication, providing certainty to both borrower and lenders.

KEY OBJECTIVES Three key objectives were identified as the essential first steps in transforming the market, namely:

■ **Loan and participant ID numbers** In seeking to apply automated system solutions, the inescapable initial requirement is adoption of identifier numbers for (1) loan facilities/tranches/utilisations and (2) for the lenders/investors. The intention is that each loan facility/ tranche/ utilisation and lender/investor would be allocated a unique identifier number which would be quoted on all related communications.

The internationally recognised ISIN/CUSIP[1] numbering system is widely used for other financial instruments, such as equities and bonds, and this system has now been agreed as the global standard for loan ID numbering. CUSIP numbers have been applied to loan facilities in the US for some years and ISIN numbers are starting to be applied by banks in Europe.

With regard to lenders/investors, numerous numbering formats exist but our focus has been on the list of Market Entity Identifiers being compiled by Markit. These MEI numbers are aimed at providing global coverage of entities engaged in the international syndicated loan market and have been recommended as the global standard[2].

■ **Position reconciliation** One of the major problems faced by banks is identifying and addressing differences between the agent bank's formal records and those of lenders about the amount of each lender's holding in the facility, and the relevant interest rate/maturity date. Accordingly, system vendors were asked to develop secure platforms which would enable the facility agent bank to post positions against which each lender could reconcile its records. These reconciliation platforms are now available, allowing agent banks and syndicate members to post their facility positions daily, so any differences between the respective records can be quickly identified. Each participant is permitted only to view its individual position whereas the agent bank is able to view all positions for which it is agent bank. This enables all participants not only to reconcile their position records frequently but also to check that the relevant accrual interest rates and maturity dates are correct. Differences can be identified quickly, allowing for more efficient settlement and substantially reducing the time spent on post-settlement investigations and corrections, thus addressing a significant element of operational risk for banks.

The Deposit Trust & Clearing Corporation (DTCC) and Euroclear, which both have extensive experience in providing settlement services to the financial sector, have developed such systems and Figure 2 schematically illustrates the typical system structure. A number of banks in Europe have now formally put reconciliation platforms in place and are already seeing material benefits.
More and more banks are researching these types of platforms and there is general anticipation that their use will steadily become increasingly widespread.

Figure 2: Typical structure of settlement services

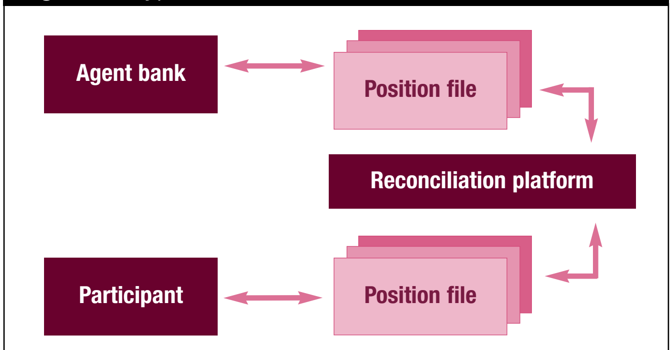
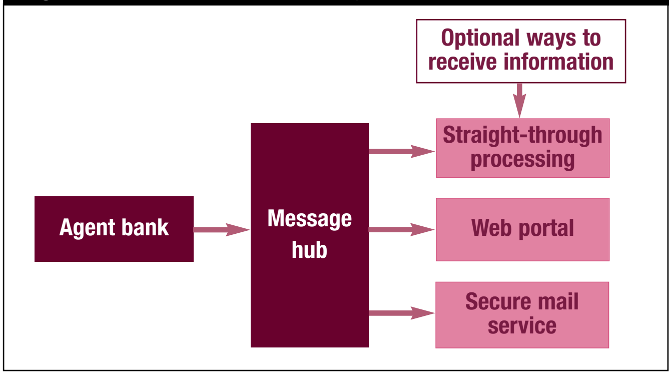
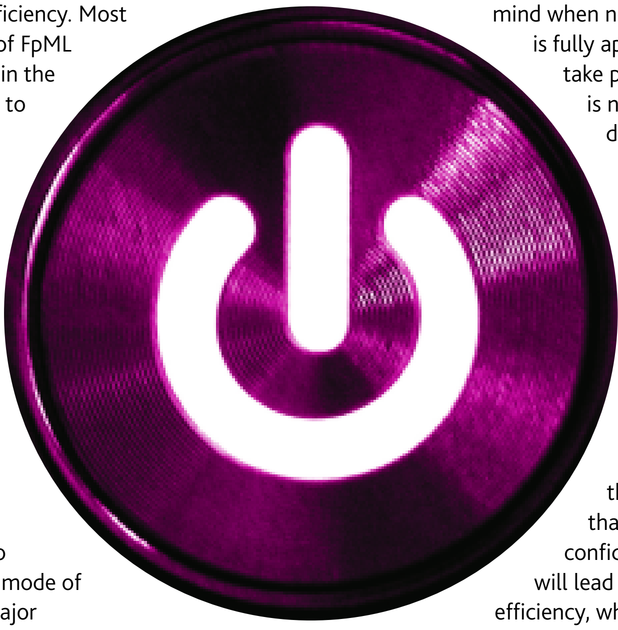


Figure 3: How the hubs will operate



■ **E-messaging** Reliable and timely communication is essential for the agent bank to perform its duties effectively and there is widespread recognition that the use of fax messages as the principal mode for transmitting information is wholly outdated and should be replaced by electronic messaging, similar to the types successfully used in relation to other financial products, thus significantly improving certainty and efficiency. Most banks are already familiar with the use of FpML (Financial Products Markup Language)[3] in the financial derivatives markets. The aim is to extend the use of FpML to the loan market as the global standard language for electronic exchange of information between agent bank and syndicate members. The LMA has worked closely with the LSTA to define the content for a fixed set of standard agent bank messages, such as drawdown notice, rate change notice, etc. The FpML standard formats for these message types have now been developed and made available, allowing banks to actively research their use.



Clearly, this initiative will take time to develop fully and become the universal mode of transmitting messages, and there are major challenges to be overcome, such as extracting the relevant data for transmission from in-house systems and consuming the data received. Nevertheless, it is very clear, and widely accepted by the market, that the use of e-messaging will be a major stride forward, bringing material benefits for agent banks and lenders generally.

Both DTCC's and Euroclear's reconciliation systems are also being developed as secure message hubs and Figure 3 sets out how these hubs will operate. Senders will transmit e-messages to the hub and the intended recipient will receive the messages in line with their own predetermined instructions. Initially, it is envisaged that recipients will want to store/process their incoming messages via a web portal but the natural evolution of e-messaging is the tantalising proposition of STP (straight-through processing), although this is likely to be some way off.

While faxes will continue to be the most often used mode of transmission in the short term, there is widespread acceptance that e-messaging will take over in time, eliminating the costs of fax management and introducing instant messaging with improved reliability and accuracy. The expected outcome is that the days of agent banks sending a million faxes each year, with all the resulting uncertainty and consequential telephone queries, will come to an end.

KEY REQUIREMENT The operations/settlement aspects of the syndicated loan product throw up many challenges which are now being tackled in a systematic way with the application of the globally agreed standards and approaches outlined above. In doing so, the market is primarily seeking to address the key requirements of agent banks to assist them in managing the administration of loan portfolios as well as reducing associated operational risk factors. It is essential that the solutions are applicable across the entire range of loan portfolio types, in both primary and secondary markets. Steady progress is being made in this respect.

One key factor going forward will be the essential requirement that loan documentation consistently empowers agent banks to maximise their use of available system/communication platforms, and both borrowers and lenders are urged to bear this in mind when negotiating the documentation. While it is fully appreciated that commercial issues will take precedence in these negotiations, there is no reason why the required language dealing with these issues, currently provided in the LMA primary documents, should not become standard in the agreements.

The imperative need for certainty, timeliness and accuracy, without impacting negatively on liquidity, is a fundamental one , and there will undoubtedly be changes to the way the operational aspects of the syndicated loans business is managed. It should be recognised that there will be steady evolution rather than sudden change, but LMA has every confidence that these changes, over time, will lead to markedly increased market efficiency, which will materially benefit both borrowers and lenders.

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This article necessarily explains the current situation at a high level. Anyone wishing to discuss the issues in more depth should contact Mike Johnstone on +44 (0) 20 7006 2267 or at
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Footnotes

1 See **www.anna-web.com** for information on ISIN/CUSIP numbering

2 For more on MEIs, go to **bit.ly/9RmGjU**

3 See **www.fpml.org** for additional information