

Bank Debt: Controlling Your Operational Complexity in a Rapidly Changing Market

In a word: complexity. Bank debt – as with all components across the global financial marketplace – has endured the most brutal economic conditions since the Great Depression. For alternative asset managers within the space, the result of those tumultuous market dynamics has been an escalating degree of complexity, brought on by the growing number of participants, greater frequency of credit-related adjustments to loan documents, more amendments to credit activity and evolving fund structures to better match the illiquid nature of assets. All of this in a multi-jurisdictional world.

The evidence of the marketplace's growing complexity is apparent in the trading data. While the overall trading volumes of bank debt shrunk in 2009, the distressed debt component — the complex settlements — increased 250% to \$140 billion in 2009 vs. 2008, according to the Loan Syndications and Trading Association.

On the settlement side, the complexity within the space and the larger trading volumes of the distressed paper are extending settlement times, which leads to increased counterparty risk and adds to the overall operational complexity. As reported by the LSTA, last year par trades settled within the LSTA guideline of T+7 fell to a two-year low of 22%. Likewise, the percentage of distressed trades settled within the LSTA guideline of T+20 dropped to a two-year low of 14%.

Contributing to the complexity, too, are the rising amounts of amendments to credit agreements. Because borrowers are finding it increasingly difficult to refinance loans, they are restructuring them and amending credit agreements, often to extend maturities, at previously unseen levels. These complications will only be exacerbated by increasing loan activity as issuance rebounds. In the first quarter of this year, Thompson Reuters reported that issuance reached \$159.13 billion, up 36% over the \$116.88 billion level in 1Q09.

A Flexible End-to-End Solution, Seamlessly Integrated

At Citi, we believe the solution to controlling the complexity within the bank debt marketplace is an operating model that's end-to-end, aligning data production with loan servicing. It requires flexible, continuous, integrated communications across the entire process — from loan settlement through loan administration and ultimately down into the accounting system. In this environment, any adjustment or amendment to a credit agreement is automatically updated throughout the system supplemented by the necessary expertise for a high touch process.

This comprehensive, tightly bundled operating model leads to a more controlled operating environment through:

Improved Settlement Processing. An experienced and proactive settlement team, backed with the technology and data sources to track credit activity, greatly improves participants' ability to manage principal and interest activity of unsettled loan transactions. Buyers will have improved visibility into underlying credit data for purchased yet unsettled loans to better manage upcoming settlement obligations.

Streamlining the process for improved efficiency. Automating processes for obtaining credit data from agent banks enhances straight through processing to record credit activity in the accounting system and reconcile inbound P&L in near real-time, while maintaining flexibility to handle complex loan activities.

Eliminating data redundancy. The ability to produce and share credit activity across functions – i.e., front office/settlements/administration/cash management/accounting — optimizes data flows rather than relying on a point-to-point architecture.

A consolidated ledger across assets, updated seamlessly. The capability to generate and edit accounting activity at the transaction level for any type of fund including complex funds; managed accounts, hybrid private equity structures, SPVs, without having to depend on topside or summary entries that are difficult to interpret over time, results in a single set of books and records for all asset classes, enhancing the ability to more effectively audit.

The Future

Although bank loans are similar in many respects to traditional fixed income securities, borrowers utilize the loan market for a reason: to preserve the flexibility of a true credit agreement that can be amended on a bilateral basis versus a bond that is restricted by its covenants. That feature of the asset class drives complexity and is here for the long-run. Without question, bank debt is evolving from an esoteric asset type to a much more mainstream offering. And much is being done within the industry to solve for the operational pains of loans, including efforts by the DTCC, Euroclear and others. In the meantime, bank debt owners need an integrated and specialized system and operation at their disposal to truly understand what they own, avoid settlement issues and put themselves in a position to make the optimal investment decisions.



Jeffrey Law, CFA
Vice President
Product Manager
for Complex Assets,
Hedge Fund Services



Timothy Downey
Senior Vice President
Head of Bank Debt
Operations, Hedge
Fund Services

