

Electronic loan

TRADE SETTLEMENT

arrives in Europe

by Joseph F. Salerno, Richard Levy, Ariel Elkayam and Mathew K. Lewis, ACBS ClearPar

After years of slow, steady progress, electronic settlement of loan trades has nearly rendered paper-based settlement obsolete in the US. By dramatically increasing operational productivity, electronic trade settlement has enabled US lenders to keep middle office staff levels comparatively stable through a period of staggering growth in secondary trading volumes.

Moreover, early adopters of e-settlement technology point out that prior concerns about security and reliability proved unfounded. More than 200,000 trades have now settled electronically without a single break attributable to the switch away from paper.

With loan trading in the LMA market beginning to soar, European lenders face the choice to adopt electronic settlement or to continue business as usual and increase settlement staff substantially. While e-settlement offers the promise of improved operational efficiency and risk mitigation, many are concerned that the particulars of European trading practice make this change impossible. American institutional buyers, on the other hand, are demanding that European lenders offer the same service levels they have come to expect at home.

A small number of LMA trades have already settled electronically. In the US, a similar trickle in 2001 became a mighty river. A handful of forward-thinking bankers led the way, long before a broad consensus was established. Will similar leaders emerge in Europe?

THE RISE OF E-SETTLEMENT IN THE US

At the height of the Internet frenzy, the US syndicated loan market was abuzz with paradigm-shifting ideas to capitalise on the new web technology. Most of these grand ventures ultimately failed to deliver on their lofty ambitions. Out of the din of that era, however, a few narrowly focused companies endured to thrive in the ascendant syndicated loan market of recent years. Among these survivors are firms that settle loan trades electronically, ClearPar and Trade-Settlement Inc. ('TSI').

Unlike the more ambitious fintech dot-coms, e-settlement providers sought to bring about only incremental improvements to the unwieldy lifecycle of a syndicated credit. Aided by a handful of implacable bank customers, they carved out a tiny industry niche. Chipping away for years, these firms expanded that niche so that it now envelopes the substantial majority of US par loan trading.

E-settlement might have failed were it not for a handful of bankers who understood the importance of an efficient clearing mechanism to the growth of the loan market. These banks ran pilot trades and worked with vendors to hone the systems. Yet, most lenders were slow to warm to e-settlement, settling only a few hundred trades electronically in any month through the end of 2002.

Hesitant lenders expressed concerns about investor acceptance, system reliability, data privacy and security. These fears impeded adoption in the US and, for a handful of American institutions, prevent online participation to this day.

In March of 2003, Credit Suisse powerfully expressed its view that the obstacles to e-settlement could be surmounted when it took the exceptional step to forego assignment fees for trades settled electronically. This provided a strong incentive for more lenders to experiment with e-settlement. The

rate of increase of the number of trades settled electronically rose sharply that very month. Since that time, the rapid growth of e-settlement in the US has continued unabated.

ClearPar projects that it will settle more than 80,000 trades in 2006 (see Exhibit 1), representing more than 180,000 discrete assignments and in excess of US\$270bn of single-sided notional volume (combining work in both primary and secondary markets). In the first three quarters of 2006, ClearPar settled more than US\$100bn of secondary trades, which is more than two-thirds of the total estimated to be traded in the US par market by Reuters in its LPC Traders Survey. TSI does not disclose absolute numbers, but recently published that the percentage growth in US dollars settled on its platform has increased an impressive 747% from 2004 to 2005.

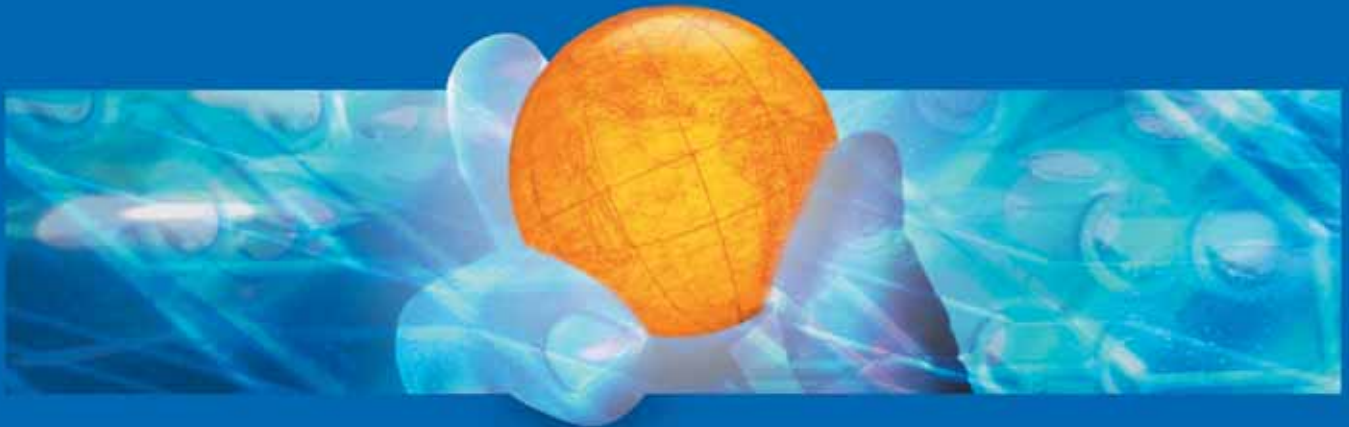
Thus, the fraction of par trades settled on paper in the US is rapidly becoming insignificant.



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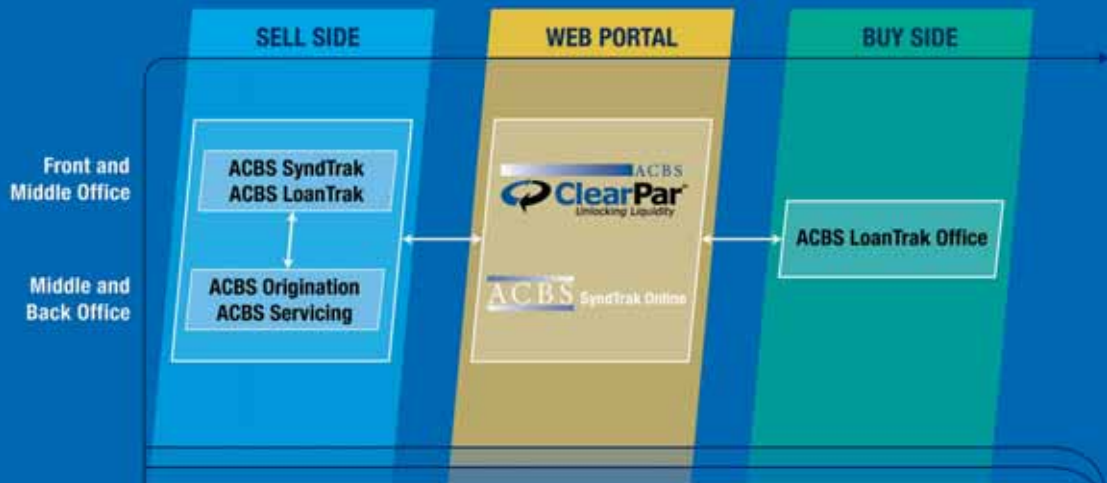


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US office: 140 E. 45th Street, 10th Floor New York, NY 10017, United States of America

Tel: +1 (212) 832 6784 • Fax: +1 (212) 832 6786 • Web: www.acbs.com • Email: info@clearpar.com

UK office: 82/86 Fenchurch Street, 2nd Floor, London EC3M 4BY, UK • Tel: +44 (20) 7423 5611 • Fax: +44 (20) 7488 0619



FIDELITY NATIONAL
INFORMATION SERVICES

Senior Vice President, Global Head of Business Development: Scott Kostyra
Tel: +1 (212) 832 6784 ext. 239 • Email: skostyra@acbs.com

Director, Business Development - EMEA & AP: Mathew Keshav Lewis
Tel: +44 (20) 7423 5611 • Email: mlewis@acbs.com

E-SETTLEMENT MECHANICS

E-settlement providers recognised that the mechanisms of the public securities markets could not easily be adapted to the private syndicated loan market. Instead, they sought only to accelerate existing clearing protocols by the application of Internet based technology. Thanks to work done at the LSTA in the late nineties, loan trade settlement documents and procedures had already been well standardised in the US. Thus, customers were asked to accept only a new conveyance, the Internet, for an existing settlement practice, rather than to adopt an entirely new clearing model.

E-settlement vendors are not, *per se*, firms that independently bring together buyers and sellers. Rather, they act as agents of sell-side banks, which are the paying customers of this service. On behalf of these banks, e-settlement firms securely capture, store and share the confidential information that constitutes a loan trade.

Security

Pre-requisite to any online financial transaction, e-settlement firms provide robustly secure web platforms. Routinely audited by third parties and many participating institutions, e-settlement systems utilise the electronic and physical safeguards necessary to confirm the integrity of each action on every settlement.

Trade capture

E-settlements begin with the entry of a trade by the sell-side customer. This may be done either directly on a web page or via an automated upload process. Note that only one side of the trade is entered; trades are not entered by both buyer and seller and subsequently matched.

Trade document generation

Once loaded with the trade details, e-settlement software produces familiar trade documentation. For each trade, systems generate:

- Trade confirmations. Confirms are produced in accordance with regional market standard (i.e., LSTA or LMA).
- Transfer certificates/assignment agreements. These contracts for the transfer of rights and obligations of lenders are built according to the terms of the underlying credit agreement.
- Pricing letters/settlement memorandum. The cash transfers required per the terms of the trade are calculated and memorialised in these documents by the e-settlement system. The software automatically determines common fees such as delayed compensation, break funding costs and assignment fee splits.
- Complex trades. Advanced systems can minimise the number of assignments necessary by combining trades, creating multilateral agreement and full-or-partial netting agreements.

To ensure the production of accurate documents, e-settlement vendors must model new loans and new trade counterparties at the time of the initial trade. Thereafter, document production is automated.

Electronic signatures

To authenticate a signor and create an audit trail linking the individual to a particular document without risk of repudiation, e-settlement systems require an affirmative action on the web form, accompanied by the entry of an identifying PIN code. System log files can confirm the identity of the signor via the timestamp of system login and of the PIN code entry. The trade revision history log verifies the content of the associated document at the time of signing.

Advanced e-settlement systems facilitate document signing by providing configurable workflow tools for document review. Productivity enhancing workflow tools include, for example, allowance for review by one or several persons, signing of multiple documents simultaneously after review, re-routing of documents for workload management, etc. These features are especially

valuable for administrative agents, which manage optional workflows such as obtaining of consents from borrowers.

Document production and storage

Both e-settlement providers chose to obtain hand written signature samples, which are subsequently scanned and stored in the software system. This allows for production and storage of documents that appear identical to non-electronic versions, in commonplace Word or PDF formats.

Unsurprisingly, all lenders require maintenance of copies of all executed trading documents. These documents may be downloaded onto in-house networks or accessed from within the e-settlement system for an extended period of time.

Firms that prefer to maintain physical copies can, naturally, print out all documents. These hard copies are equivalent in all material respects to facsimile copies of manually executed documents.

Customer support

The two e-settlement vendors approach customer support differently. ClearPar maintains a large staff of closers in addition to its 24/7 help desk. ClearPar closers assist the parties as necessary with the trade. While this human assist to the electronic process most often involves nothing more than help in the coordination of the settlement date, ClearPar closers will go so far as to upload documents that are manually executed by those parties not yet willing to participate online at all. TSI provides help desk support for use of its system, but otherwise delegates all aspects of the settlement to the parties involved in the trade.

EUROPEAN MARKET CHALLENGES

Despite the ubiquity of electronic loan settlement in the US, only a handful of LMA trades have settled online.

European lenders have expressed concerns reminiscent of those voiced in the US years ago, over acceptance, safety and security. While the empirical success in the US may assuage these fears, many in Europe believe that certain unique characteristics of the LMA market could significantly delay adoption, or prevent it altogether.

E-settlement purveyors stress the productivity gains inherent in the commoditisation of the settlement process on the web. However, many European lenders see advantages to distinctive service, even in the commonplace work of trade settlement.

In contrast to the US, the confirm details of many European trades are significantly negotiated after trade date. Further, most sell-side institutions have adapted confirms that differ from the LMA standard. Even the European credits themselves are less uniform than those in the US. As a result, e-settlement vendors must balance competing needs for standardisation with the market's desire for customisation. Whether a successful compromise can be reached is yet to be seen. An executive at a large bank with trading desks in the US and Europe is not optimistic, "This is not the US market and credit docs are not as conformed. The point is that systems should be flexible. If you want to do business in the London market, you can't pick and choose your credits; it is an 'all or none' process."

Others cite Europe's preference for tighter operational controls and greater data privacy as an obstacle to e-settlement. In consideration of the FSA's know-your-customer regulations, many banks hesitate to alter long-established processes that force personal interaction with counterparties prior to settlement. Even the collection of documents with physical signatures gives comfort to some bankers for whom liquidity is not the predominant concern.

However, strong market forces for change are at work in Europe.

Leveraged deal volume has doubled since 2001, deal sizes are increasing dramatically and carve-outs for non-bank institutions have soared. The institutional market share of Europe's leveraged loan market is

closing in on 50%. In addition to a growing number of European funds purchasing loans, US institutions have leapt into euro-credits, snapping up the most aggressive European structures. All of this leads to more (and more and more) secondary liquidity.

These buyers have made clear that they are not sympathetic to operational delays. Chris Porter, European Loan Trading at Bank of Scotland feels his settlement operation puts him at a competitive advantage, “Investors have told us that they avoid traders who have slow or inaccurate closing teams. Why would you trade with a house that has difficulty closing a trade in the already-adequate T+10?” Chris is looking to extend this advantage by working with internal and external technology providers to “speed up settlement and automate as much as possible.”

The regulatory environment presents another stress for process change. No Basel II or Sarbanes-Oxley risk assessor could assign high marks to the cumbersome

procedures inherent in manual settlement.

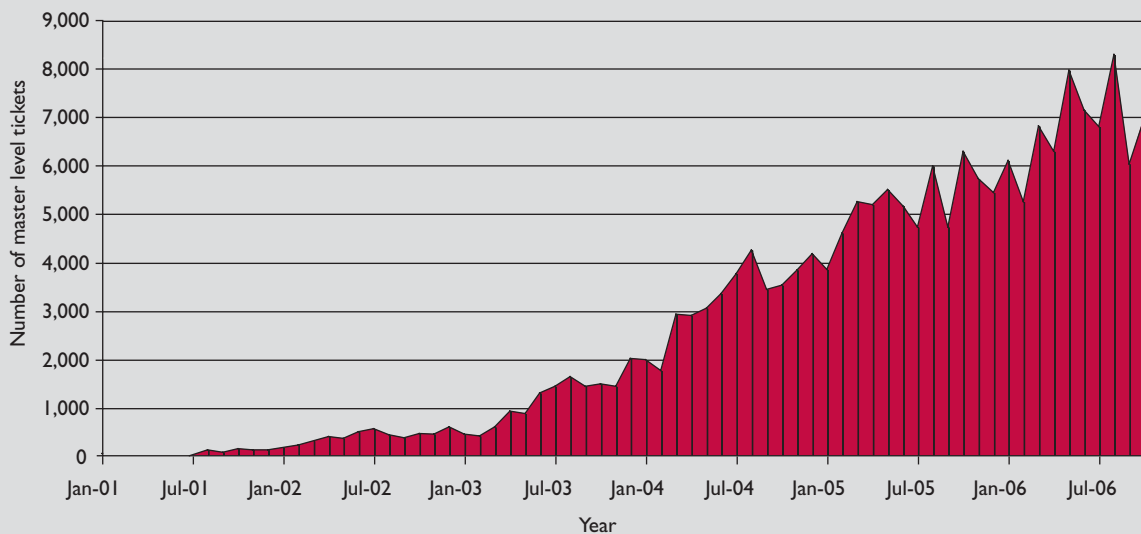
Perhaps the most important agent for change is the simple desire for banks to be as cost effective as possible in the face of dramatic growth in trade volumes. The operational metrics established in the US side of multinational banks put extreme pressure on European desks to improve productivity.

2007 AND BEYOND

The pace of technological innovation in the US loan market continues to accelerate. ACBS, the leading provider of syndicated loan software systems, acquired ClearPar at the end of 2004. To drive faster settlement and greater productivity, automation and liquidity across the loan market, ACBS has been integrating ClearPar to its front office sales and trading systems and to its back office servicing system. Meanwhile, TSI has joined with

ACBS ClearPar's closed trades 2001-2006

Exhibit 2



Source: ACBS ClearPar

other loan market vendors to offer similar connections through the use of open standards.

Fortified by the widespread adoption in the par market, e-settlement providers are branching out. Electronic clearing of distressed credits and loan derivatives are obvious next steps. The ideas of outsourcing certain administrative agent activities or of central hosting of asset-and-account data have evolved from visionary to credible, perhaps even to necessary.

It took more than five years for the US market to get to this point (see Exhibit 2). European market makers may have the opportunity to leverage this American investment by adopting existing e-settlement solutions. Regardless, investors are making clear that

Europe will not have the luxury of working out the details for that long.

**Joseph F. Salerno is Senior Vice President,
Richard Levy is President – ACBS,
Ariel Elkayam is General Manager –
Front Office Operations and
Mathew K. Lewis is Director –
Business Development at ACBS ClearPar.
For further information, please
telephone +1 (212) 832 6784 (New York) or
+44 (20) 7423 5611 (UK) or
e-mail: info@clearpar.com**