FROM STONE ADMINISTRATION TO LOAN ADMINISTRATION. PRIVATE DEBT IS IN DEMAND.

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The concept of debt predates money, having been used as an efficient tool of trade by early civilisations. In Medieval times, England's Exchequer recorded debt on "tally sticks" (the incineration of which caused the original Palace of Westminster to burn down in 1834). Up until the 1940s one South Pacific island community used a system of immovable large stones called "Fei" to record and settle debt. As the stones were too heavy to move, the system relied on a spoken history of ownership and the recording of investments and lending was carved into the stone.
Administration of private investments is a little more complex for today's institutional investor and particularly for private debt, a group of asset classes that is growing in Europe, but the simplicity which lies at the heart of it partly explains why it is a growing asset class.
Typical examples of private debt are leveraged loans, infrastructure debt, direct lending, and mid-market lending. These can be then structured into debt funds, which are not publicly traded and do not have a centrally cleared agent.
In this article we look at the loan administration infrastructure needed for private debt.

PRIVATE DEBT IN DEMAND

According to Preqin, as of early 2017, global private debt AuM stood just shy of $600bn, a four-fold increase over the past decade, with public and private pension funds accounting for more than half (56%) of debt-fund allocations. What has driven the growth?
The crisis of 2008 and the subsequent raft of legislation, including Basel III, drove banks to reduce their balance sheets and increase the capital they hold. This in turn reduced the availability of traditional bank originated credit. As the global economy recovered from the downturn, demand for credit, particularly from smaller to mid-market sized firms grew rapidly. The resulting vacuum has created an opportunity for non-traditional lenders to enter the market.
For pension funds, private debt has numerous advantages.

- It is secured debt and mostly senior in the capital structure, thereby offering more protection than similarly-rated fixed income instruments.
- Private debt assets tend to pay a premium over similarly-rated public bonds to compensate for their lack of secondary trading. Given their typically long-term liability profile, pension funds are able to take advantage of this illiquidity premium.
- Its low correlation with other asset classes makes it a strong contender for a diversification strategy.

Another important consideration for investors is the potential upside from interest rate rises. Because their rates are readjusted to reflect current market metrics (typically on a quarterly basis), debt funds are generally less sensitive to interest rate moves than standard fixed-income vehicles. Thus, while stronger economic activity can often weigh on longer-duration bonds as interest rates move up and coupon prices fall, such conditions bode well for debt fund investors, whose income payments rise due to the funds' floating-rate structure.
The lion's share of the private debt market is in the US. The European market is arguably in its infancy but growing in demand. In Europe, debt was traditionally accessed using a CLO (Collateralised Loan Obligation), but now we are seeing private debt in the form of more widely secured syndicated loans and directly originated loans.

THE INFRASTRUCTURE TO SUPPORT PRIVATE DEBT

Pension funds can access the private debt market in two ways: direct investing (where the pension fund will act as direct lender) and via debt funds (where the pension fund will invest into a fund run by an asset manager). The former requires loan administration and the latter both loan and fund administration.
If a pension fund invests directly, it will source the investment, assess credit risk, undertake due diligence (possibly with the support of a consultant) and negotiate the debt. This level of in-house expertise is generally found in the largest and more sophisticated self-managed pension funds.
Ongoing credit monitoring and loan administration is required for the lifetime of a loan. This can be done in-house up to a certain point. This depends on the middle and back office functions within the pension fund and whether these are able to undertake a variety of specialist tasks. With several direct investments the pension fund's portfolio of loans can soon become too time consuming and complex to administer.
Debt funds are offered via an asset manager. This is where we see a broader value chain. The asset manager will not only originate the debt but will source fund financing, determine the domicile of the private debt fund, and will undertake ongoing operations. The loans held within the fund will each need to be administered individually according to their unique characteristics.
The loan administration requirements will vary according to the type of loans invested: direct lending, i.e. bilateral loans, does not demand the same degree of settlement activity as a portfolio of broadly syndicated loans which can be traded. Large corporate syndicated loans, which are generally quite standardised, will not present the same challenges during their lifetime as bespoke bilateral agreements.
The complexity and variety of the underlying assets means that fund administration to support private debt requires specialisation (understanding different debt strategies and instruments) and the ability to provide accurate and timely accounting and reporting services – such as financial accounting and bookkeeping, trade capture, cash settlements, investor reporting, carried interest and performance fee calculation, equalisation calculation and regulatory reporting.

SELECTING YOUR OUTSOURCED LOAN ADMINISTRATOR

Loan administration is a specialist area and if outsourcing there are few loan specialists in Europe who have a track record in private debt and the dedicated systems required. When choosing a loan administrator you should be sure of a provider's pedigree in this area – one which has a dedicated team and an existing book of business. In some ways, it is comparable to choosing an asset manager – specialised knowledge is required to help unlock this potentially fruitful asset class.
At BNP Paribas, we provide asset owners with middle and back office solutions to manage loan collateral either as direct investments or as part of dedicated loan funds. We also have flexible reporting solutions tailored to loan type and investor profiles. For asset managers we offer a fully integrated service model, including loan administration, investment accounting and fund administration.
It's certainly a marked improvement on stones.