

ENHANCING THE LOAN ADMINISTRATION FUNCTION:

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The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 100 members that manage \$350bn of private credit assets.

The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council.

ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business.

The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.



The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than \$2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 100 members that manage \$350 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA)—the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

For further information, please visit AIMA's website, www.aima.org.



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BNP Paribas Securities Services, a wholly owned subsidiary of the BNP Paribas Group, is a leading global custodian and securities services provider. It had assets under custody of EUR 9.4 trillion as at 31.12.2017. Backed by the strength of the BNP Paribas Group, we provide multi-asset post-trade and asset servicing solutions for buy and sell-side market participants, corporates and issuers. With local expertise in 36 countries and a global reach covering 90+ markets, our network is one of the most extensive in the industry, enabling clients to maximise their investment opportunities worldwide.

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Foreword

Whether buying structured credit, investing in loan funds or setting up direct lending funds, today, private credit constitutes an important stream within the ocean of global finance.

However, this key segment of the investment management industry, also presents a range of challenges. Private credit remains a relatively illiquid physical loan investment. Fund managers require specialised systems and operational knowledge that support different credit strategies and instruments.

In this young and growing industry, the operational infrastructure is still maturing. This is particularly the case for private credit managers' loan administration capabilities.

BNP Paribas, an established partner to some of the world's leading private credit funds, and the Alternative Credit Council, the global representative of the private credit industry, invited clients and members to share their views on the challenges they face when administering loans.

We also explored the operational infrastructure required to support this function.

We are delighted to share the results of the survey with you, and we hope that the findings will inform you as you strive to implement the optimal operational model for your private credit fund.



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Introduction

The private credit industry has always been entrepreneurial: its initial growth was fuelled by managers seizing the opportunity to provide credit to underserved markets. In the ensuing years private credit has grown at a substantial rate, providing financing to the real economy and helping create jobs. The fundraising levels of both newer and more established private credit managers suggest that this growth will continue; research by the Alternative Credit Council (ACC)¹ shows that the private credit industry will reach \$1 trillion in assets under management by 2020.² This rapid growth can make it easy to forget that private credit is still a relatively young industry, the operational infrastructure of which is still maturing.

Nowhere is this truer than in the case of private credit managers' loan administration capabilities: the middle and back office aspects of a loan investment and the management of the attached operational risk. This component of a manager's operational infrastructure can be a source of significant competitive advantage. A proper loan administration function allows private credit managers to easily and effectively monitor and manage their loans—a significant challenge in an industry that uses paper-based documentation and revolves around non-standard loans.

A robust loan administration function provides a solid foundation for private credit managers' future growth, and allows them to balance that growth with the need to provide clients with bespoke lending solutions.

To learn more about loan administration, and how private credit managers can get the most out of their loan administration functions, BNP Paribas Securities Services and the ACC have conducted the research presented in this paper. Its findings come from two distinct sources. First, the ACC and BNP Paribas encouraged their members and clients, respectively, to participate in an online survey, the results of which form the foundation of this paper. Second, the ACC engaged in a series of structured interviews with survey respondents to better understand the primary issues private credit managers face when conducting loan administration.

PART 1

Part 1 of this paper will explore the challenges faced by private credit managers when it comes to loan administration.

PART 2

Part 2 will investigate how private credit managers employ their loan administration service providers.

PART 3

Part 3 will then examine the benefits private credit managers say they gain from using those service providers, and how they believe their loan administration service providers could improve their offerings.

¹ The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 100 members that collectively manage \$350bn of private credit assets.

² For more information, please see Financing the Economy 2017, <https://www.aima.org/uploads/assets/uploaded/b30be521-1092-479a-8d70f9d2db9d4ee7.pdf>

Survey demographics

The findings of this paper are based on the answers of private credit managers who have a combined total of over \$120 billion in capital committed to private credit—the equivalent of approximately 20% of the total universe of private credit capital.

Overall, the respondents represent a range of private credit market structures, with the two most common being senior secured lending, in which 75% of respondents are currently active, and direct lending, in which 65% are active (see Figure 3).

Senior secured lending typically takes the form of a secured debt financing obligation issued by a bank or other financial institution to a borrower. As a senior loan it would be considered in precedence to all other claims against the borrower and so would be the first to be repaid in the event of borrower bankruptcy.

Figure 1. Where does your firm have its HQ/primary asset management centre?

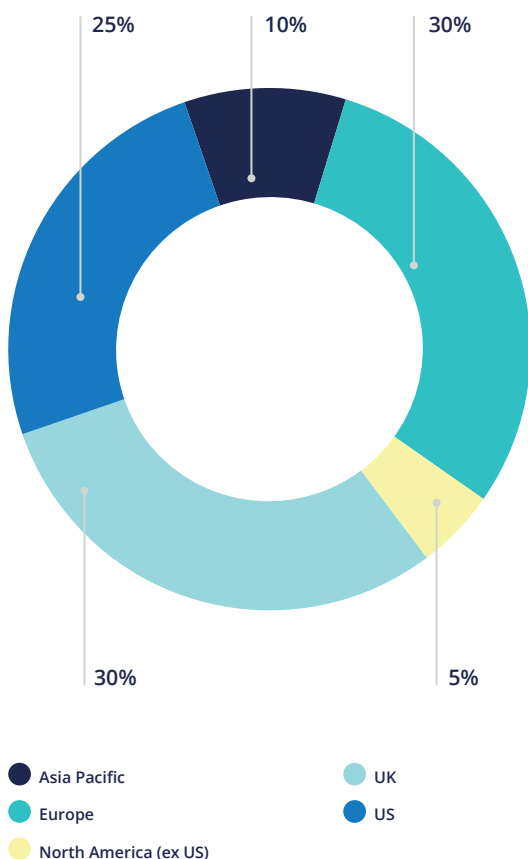


Figure 2. What is the estimated committed capital allocated to private credit across all vehicles/accounts you manage?

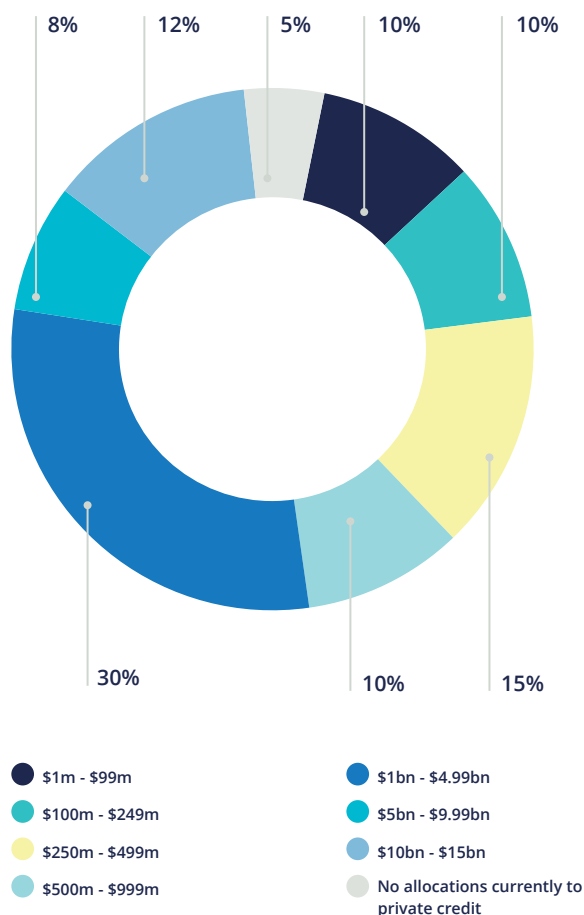


Figure 3. Describe your current participation in the following private credit markets

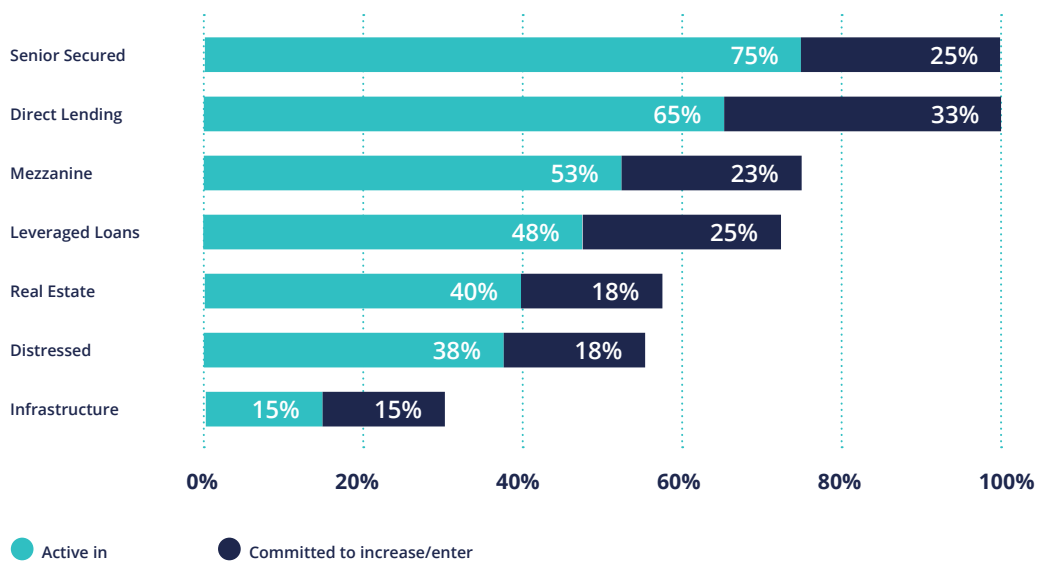
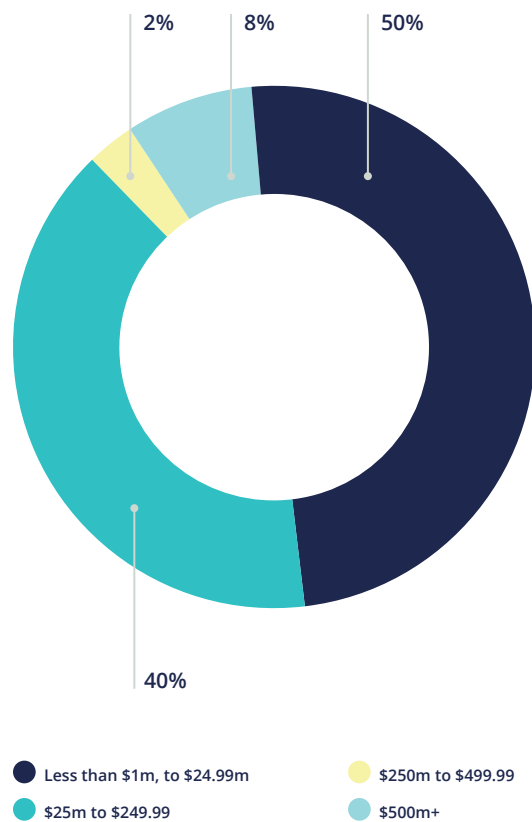


Figure 4. What is the target loan size for your firm?



PART 1:

Common challenges in loan administration

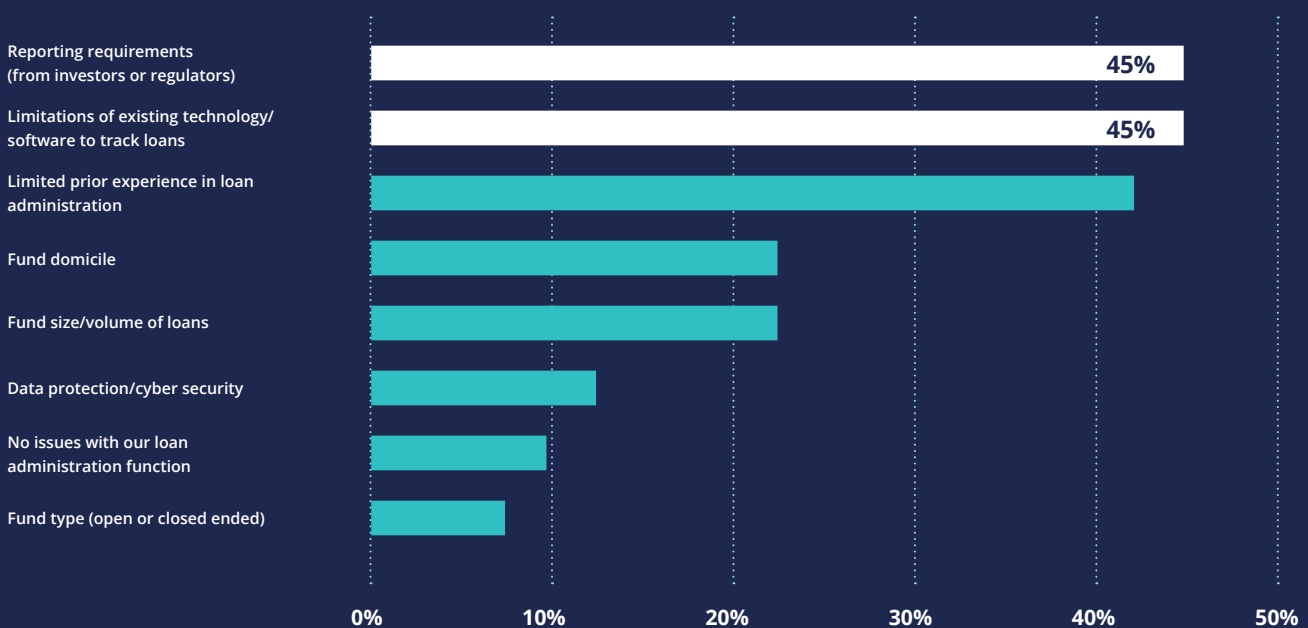
As shown in Figure 5 below, when asked about the challenges they face in loan administration just 10% of the private credit managers who responded to our survey said that they faced 'no issues.' In other words, nine out of ten private credit managers face challenges when administering their loans. After years of growth, private credit managers are having to upgrade their operational infrastructure in order to manage the greater levels of business they are attracting.³

The two most common challenges cited by private credit managers are reporting requirements (be they to regulators or to investors) and the limitations of existing loan-tracking technology and software. Both these challenges were cited by 45% of private credit managers.

These findings were supported by our conversations with private credit managers. Several of them stressed the importance of rapid reporting to investors: investors expect to be given timely information on a manager's loans.

One private credit manager with whom we spoke explained that this is particularly the case for institutional investors—an important class of investors for the industry as it grows.

Figure 5. Which of the following present an operational challenge to your loan administration function?



Respondents were given the choice to select multiple answers.

3 See Financing the Economy 2017, <https://www.aima.org/uploads/assets/uploaded/b30be521-1092-479a-8d70f9d2db9d4ee7.pdf>

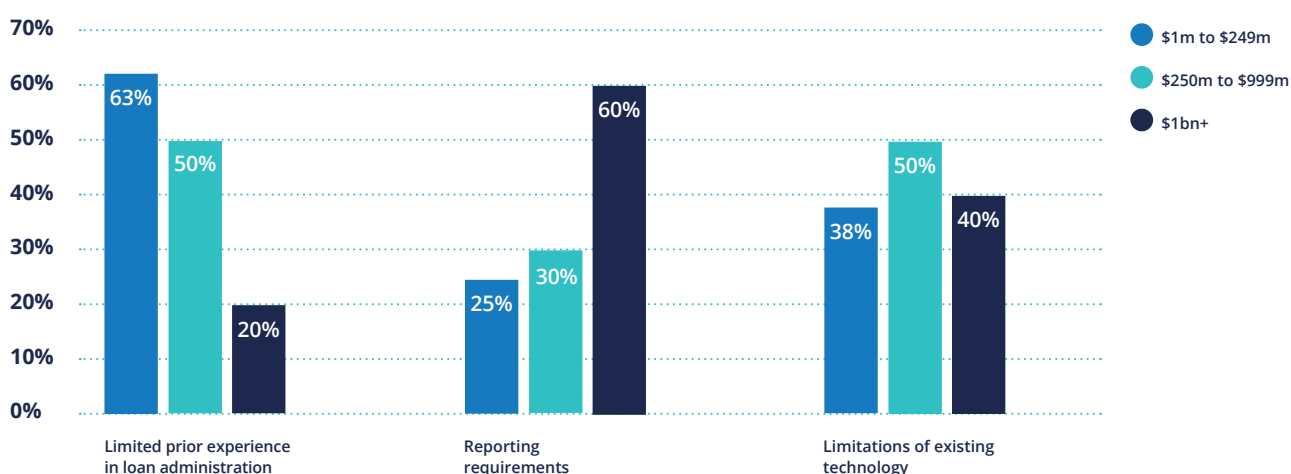
However, given the ‘paper-based’ nature of many private credit loans, reporting cannot yet be fully automated, as loan-tracking software still requires human intervention. As such, managers often face the challenge of reporting to investors as rapidly as possible whilst ensuring there are no human errors when doing so.

As the number of loans being administered by a manager increases, they may find that processes and systems cannot be scaled to support the increasing volumes of business. Legacy systems may not be able to contend with the new demands being placed on them, and thus may not be able offer the clear and comprehensive reporting that a growing manager needs for internal decision making, regulatory reporting, and investor reporting. Some managers with whom we spoke found themselves in just this position, and had to invest considerable resources into acquiring or developing new administration systems.

The comments of the private credit managers we interviewed are borne out by looking at the challenges faced by private credit managers of differing sizes, as measured by capital being committed to private credit (see Figure 6). Mid-sized managers—those with between \$250 million and \$999 million committed to private capital—are most likely to cite not only limited prior experience, but also limitations of their existing technology (whether this is proprietary or something they bought off-the-shelf) used to support their in-house operational infrastructure as their most common challenges. These managers are the most likely to be in the position of having too much business to rely on old systems, but not enough to justify purchasing new ones. Further, many such managers hail from banking backgrounds, where they would have had large, dedicated middle and back offices to support their work—something most private credit managers do not have.

The largest private credit managers—those with over \$1 billion in capital committed to private credit—are most likely to be challenged by loan servicing reporting requirements. 60% of such managers cite this as a challenge. The lending activities of such private credit managers are likely to cover a broad range of business sectors, geographic regions and strategies. As a manager takes on a greater variety of loan deals, it will have to report to an increasing number of parties—more investors, and, depending on the jurisdictions in which it invests, more regulators—in more languages. These managers are also the most likely to invest institutional investors’ capital. Such investors generally expect more rapid reporting; private credit managers will need to find ways to efficiently manage that process if they are to support the growth of their portfolio.

Figure 6. Which of the following present an operational challenge to your loan administration function? (Based on level of capital committed to private credit)



Respondents were given the choice to select multiple answers.

PART 2:

Capacity for success

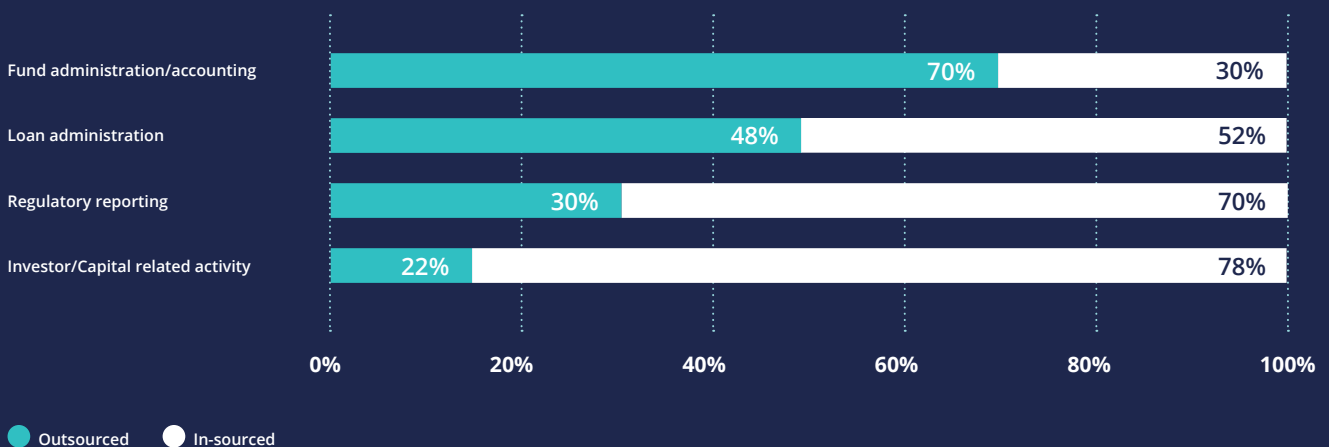
Given the increasing complexity of private credit loan administration, it should come as no surprise that almost half of the private credit managers we surveyed already use third-party service providers to support their loan administration (see Figure 7).

The only operational function more commonly handled by third parties on behalf of private credit managers is fund administration and accounting (contracted out by 70% of private credit managers).



of respondents contract out fund administration and accounting

Figure 7. What is your current approach to the following reporting requirements for your fund(s)?



The decision to use third-party loan administration is relatively similar for all sizes of private credit managers, as shown in Figure 8. This is an indication not only of how potentially onerous maintaining loan administration in-house can be, given the attendant challenges described above, but also of how service providers are able to offer solutions that meet the needs of managers at different stages of development. For many managers just starting out, it is often cheaper and more efficient to leave loan administration to a service provider with relevant experience and the scale necessary to invest in the best administrative systems.

CHOOSING TO USE A SERVICE PROVIDER

When it comes to why they chose to use a service provider for their loan administration, private credit managers are clear. As shown in Figure 9 (see next page), the three most common reasons for doing so are:

- (i) access to expertise from the service provider (cited by 78% of private credit managers),
- (ii) the impact on the manager's capacity to support new business (75%), and
- (iii) the ability to effectively manage the loan administration function (73%).

Private credit managers pride themselves on their ability to deliver bespoke credit arrangements and tailor-made loans to meet the specific needs of a borrower. While this has proven a compelling proposition for borrowers it also requires a more sophisticated back office solution. In the words of one manager we contacted, the loans issued by private credit managers "aren't vanilla." This explains why they prioritise the need for expertise when deciding whether to use an external loan administration service provider. Arguably, private credit managers cannot rely on off-the-shelf third-party solutions.

Figure 8. What is your current approach to the following reporting requirements for your fund(s)? (Based on level of capital committed to private credit)

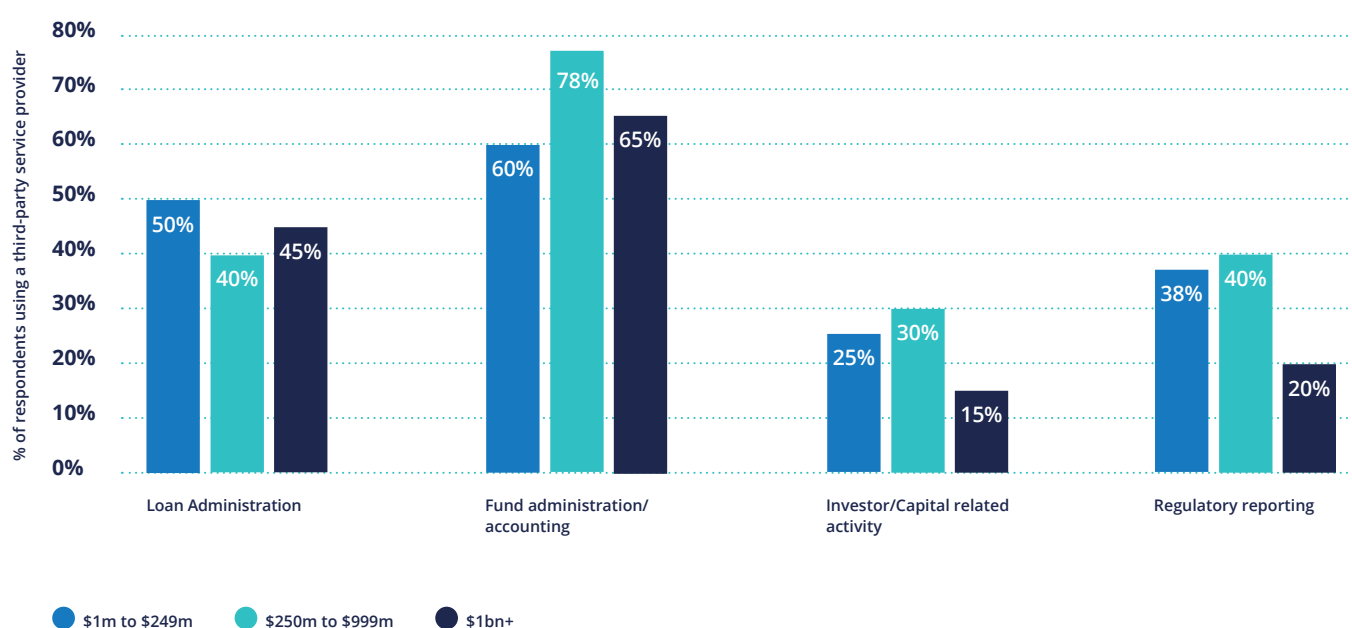
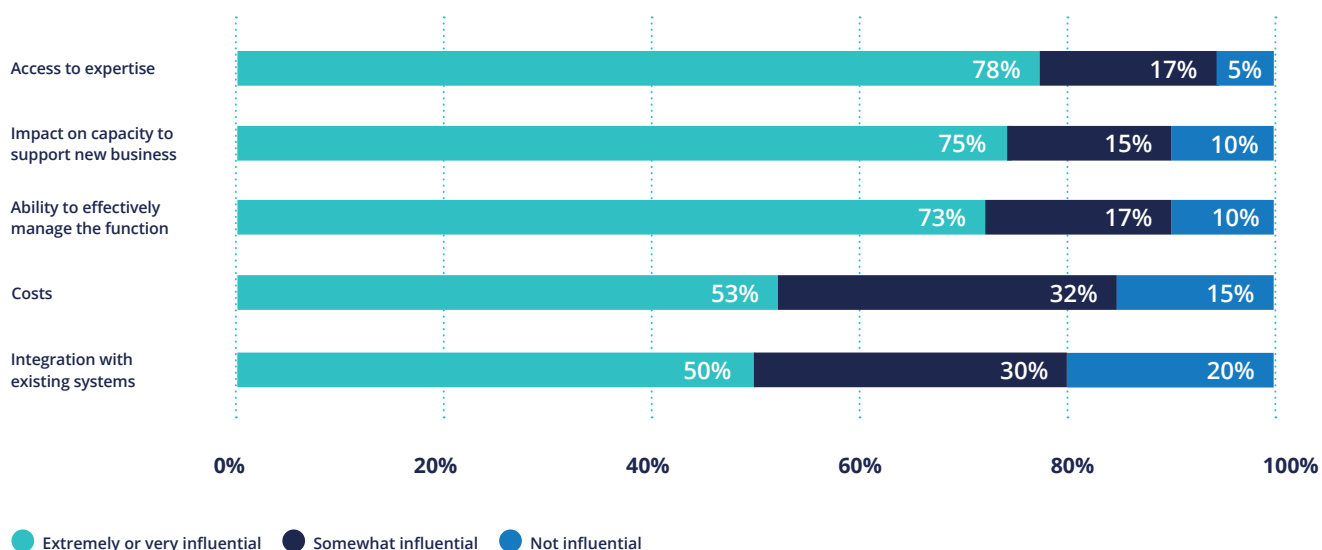


Figure 9. To what extent did the following considerations influence your firm's decision whether to outsource your loan administration function?



Respondents were given the choice to select multiple answers.

The three most common reasons behind the use of service providers:



of respondents say
access to expertise
from the service provider



of respondents say the
impact on the manager's
capacity to support new
business



of respondents say the
ability to effectively manage
the loan administration
function



describe the ability to integrate the loan administration provider with existing systems as extremely or very important

This is also why managers would be well advised to use service providers with proven experience in handling non-standard loans. It is crucial that any service provider be comfortable with a wide range of assets across different geographic regions and loan types. A skilled service provider should be able to independently record all the relevant data points from the loan contracts that a manager sends to them, reducing the need for reconciliations and control on the part of the manager to the bare minimum. Such skill often comes from the corporate memory of a service provider, so private credit managers should look for service providers with low staff turnovers.

A good service provider will understand not only a manager's fund structures, but also the manager's own organisation. This will allow them to offer the best possible service, as well as minimise any operational risk in the handling of the manager's loan portfolio. Such understanding usually comes with time and continuity of service.

Interestingly, 50% of private credit managers describe the ability to integrate the loan administration provider with existing systems as extremely or very important to their decision to use a third-party service provider. To get the most out of loan administration service providers, data integrity should be preserved. In other words, a manager should try to ensure that a service provider handles loan data in such a way that it can be fed directly into the manager's other administrative systems—for instance, into their fund accounting and depositary systems.

Another solution in the hands of managers is to look for a service provider able to offer both loan and fund administration, as in this way many integration issues can be avoided.

Private credit managers that are starting out will need to decide between selecting a series of service providers, each specialising in a different part of administration, or a single service provider who could, in the future, offer them not only loan and fund administration but also other integrated services such as depositary, reporting, and financing administration—a 'one stop shop' that could serve all their reporting and administration needs.

PART 3:

How your loan administrator can work for you

The benefits gained by private credit managers from using third-party loan administration service providers are in line with what you would expect from a growing industry. As shown in Figure 10, the benefit most commonly cited by respondents to our survey is the ability to handle non-standard loans (private credit's hallmark), cited by 70% of all respondents. This is followed by 68%

of the total number of respondents identifying the capacity to service an increasing volume of assets, and 63% of the total citing the ability to independently manage middle and back office tasks for loan administration.

Despite the rapid growth of the private credit sector, private credit managers still view the ability to

handle non-standard loans, and not the ability to handle a large volume of assets, as the greatest benefit they gain from loan administration service providers. By drawing on service providers with expertise in the private credit market, managers may be able to square the circle of administering greater volumes of loans without standardising them.

Figure 10. Which of the following aspects of loan administration services do you find most valuable for your firm? (three most common answers given by respondents)



of respondents say ability to manage non-traditional loans



of respondents say capacity to service increasing volume of assets



of respondents say ability to independently manage middle and back office tasks for loan operations

The pattern of private credit managers prioritising the ability to deliver bespoke loans is reinforced by the answer private credit managers give to the question as to what service providers could most improve about their loan administration offerings. As shown in Figure 11, almost 60% of private credit managers say that the ability to handle non-traditional loans is the aspect of service that could most be improved by service providers.

This is significantly greater than the number of respondents who said the same of the ability to handle a greater volume of loans, and an indication of the priority private credit managers give to offering bespoke solutions, despite their need to contend with the challenges brought on by growth.

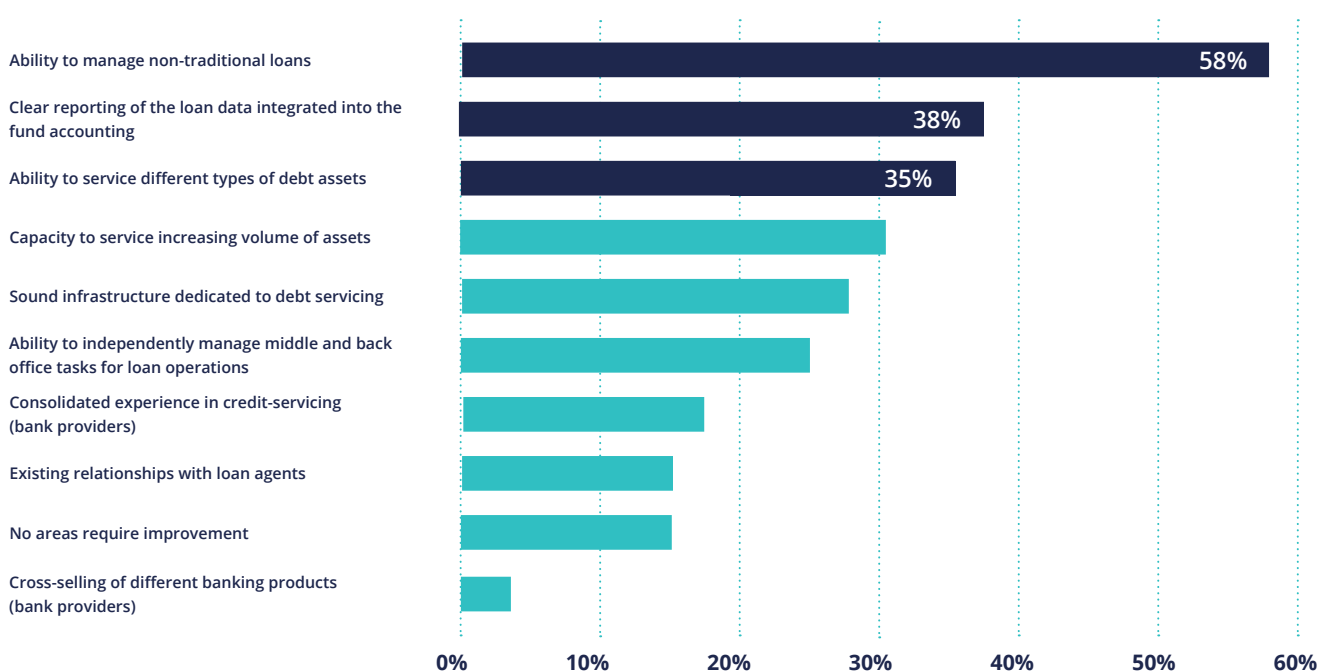
Interestingly, only 15% of respondents felt that there were no areas for improvement on the part of service providers.

Figure 12 (see next page) shows these results broken down by capital committed to private credit. Mid-sized managers were more positive overall in terms of the value they find from working with loan administration service providers. Smaller managers are most likely to cite the ability to handle non-traditional loans as the benefit they gain from loan administration service providers, in keeping with the boutique nature of many such managers.

The larger private credit managers, meanwhile, are most likely to cite the capacity to handle an increasing volume of assets (cited by 65% of such managers), closely followed by the ability to handle non-traditional loans (60%) and the ability to independently manage back office functions (also 60%).

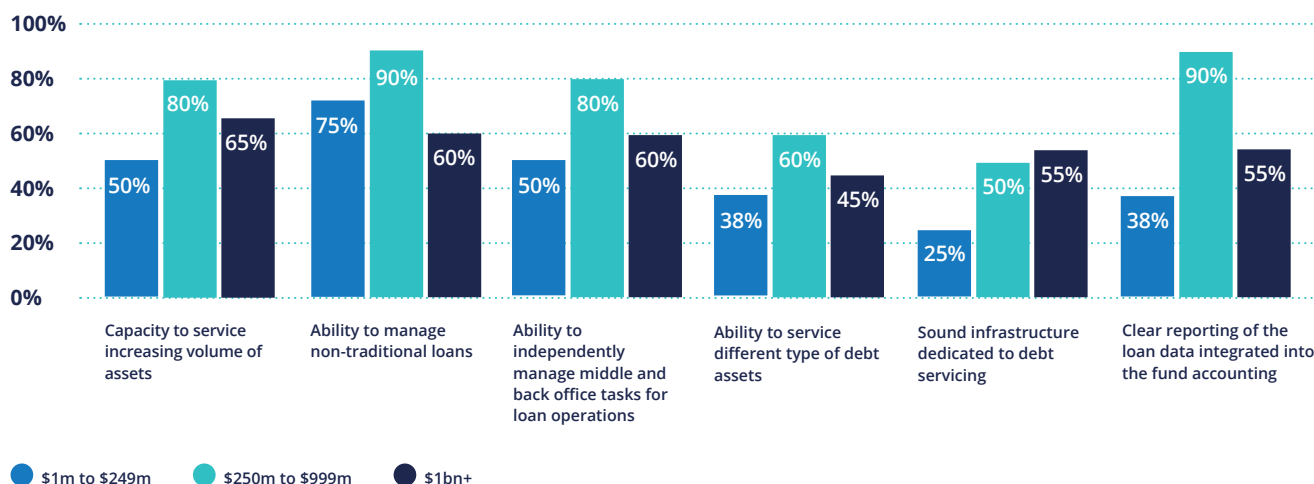
The importance of this bespoke nature is again reinforced by looking at what private credit managers of differing sizes suggest that loan administrators can most improve about their service. As shown in Figure 13 (see next page), no matter the size of the private credit manager, all of them require a service provider who has experience in the administration of non-standard loans.

Figure 11. Which of the following aspects of loan administration service providers could be most improved?



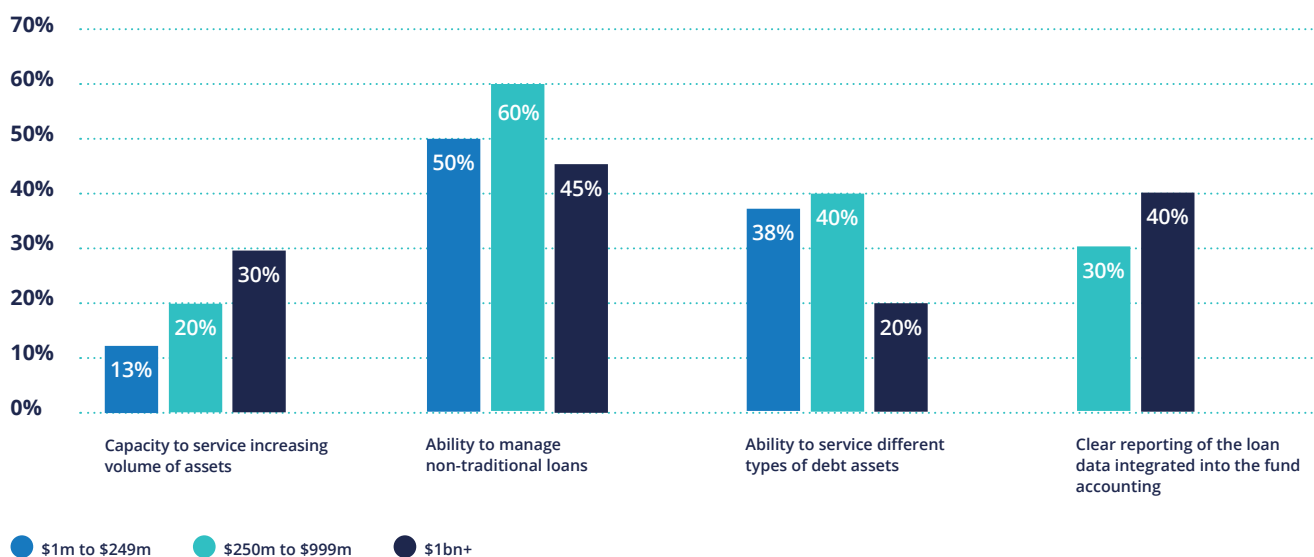
Respondents were given the choice to select multiple answers.

Figure 12. Which of the following aspects of loan administration services do you find most valuable for your firm? (Based on level of capital committed to private credit)



Respondents were given the choice to select multiple answers.

Figure 13. Which of the following aspects of loan administration service providers could be most improved? (Based on level of capital committed to private credit)



Respondents were given the choice to select multiple answers.

Conclusion

Despite the impressive growth of the past several years, the private credit industry is still growing and maturing. Many private credit managers, from the smallest to the largest, are faced with the challenge of upgrading their own internal infrastructures to keep pace with their growing businesses. To complicate matters, however, they must do so while retaining their ability to offer customised credit solutions—the very thing that has driven the growth with which they are now dealing. The fact that loans remain a primarily ‘paper-based’ asset only adds to the difficulty of ensuring efficient, accurate loan administration.

Private credit managers, no matter their size or location, need to develop robust, efficient loan administration functions. For some managers this may mean building out their internal administration capabilities; other managers may choose to use third-party loan administrators.

By delegating the administration of loans to a dedicated fund service provider, private credit managers may be able to handle more loans than might otherwise have been the case. The expertise of those service providers, meanwhile, allows them to support the complex, non-traditional loans that are the hallmark of the private credit industry.

Whether kept in-house or delegated to a service provider, a robust loan administration function enables private credit managers to focus on their core skills: meeting the needs of their investors and providing credit to borrowers in need of tailored solutions. This, in turn, allows them to continue providing financing to the real economy, helping create jobs, nurture new industries, and drive economic growth.

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