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BNY MELLON

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THINK Magazine - In Conversation



## IN CONVERSATION

**Scott Linden**

Managing Director and Global Product Manager, Derivatives Collateral Management Services at BNY Mellon, shares his thoughts on Dodd-Frank, the march towards central clearing, and life at the world's largest custodian.



**THINK:** You joined BNY Mellon (then Bank of New York) about seven years ago. What was the collateral management landscape like when you arrived?

**SCOTT:** It was quite open ended. The bank was supporting a couple of clients using a tri-party repo infrastructure, which was a fairly standard practice. But we were starting to hear a lot from our clients, primarily custodial clients, through RFPs and other industry discussions, that there was an interest in something called derivatives collateral management.

There was a little uncertainty as to what that really meant from a service offering. At the time there weren't really any providers offering this specific service, so let's say we became fairly interested.

**THINK:** What did you discover?

**SCOTT:** We saw the emergence of products targeting this client need. And what these collateral services had in common was an integration of platforms specifically designed for the derivatives collateral space. Concurrent to these launches, we were investigating third party technologies that could be used to support the complexity of what we needed out of a derivatives collateral system.

The first iteration of the service launched at the end of 2007 and met with some success. But the pace of growth changed as a result of two fundamental events that affected our standing in the market, and the way clients viewed derivatives collateral management.

**THINK:** What was the first event?

**SCOTT:** Bank of New York merged with Mellon, becoming BNY Mellon. We became, indisputably, the world's largest custodian. Most firms who were interested in derivatives collateral management services were buy side institutions, and in some way, most of them had relationships with this new entity overnight.

We leveraged expertise that Mellon had across the derivatives landscape, and some aspects of their post-trade services with the collateral management experience Bank of New York brought forward to create a richer offering.

**THINK:** I'm guessing the second event was the financial crisis.

**SCOTT:** Yes. Even more impactful than our standing in the market was the market changing itself. The view that buy side institutions took towards collateral changed to a much more pro-active process. Before the crisis, a lot of buy side institutions were satisfied to have excess collateral sitting with their counterparties. Bear Sterns shook things up a bit, but when Lehman failed, it became accepted that what worked in the past wasn't going to work anymore.

Attitudes changed in regards to relying solely on your counterparty values without challenging that valuation. If you didn't have the capability to value transactions yourself, it was suddenly time to look for someone who could independently do it on your behalf.

**THINK:** And this led to a growth in pro-active management?

**SCOTT:** Yes, specifically with the reconciliation process. Dealers had already begun to adopt a more pro-active stance, and had been growing their reconciliation process with each other, but this hadn't happened to the same extent with the buy side. So the buy side, especially among the more complex, larger institutions, realized that the trade booking process and the valuation of derivatives needed additional support. With derivatives, you really needed to get down to the individual trade. Derivatives collateralization is conducted at the portfolio level via the ISDA Credit Support Annex, but it's not until you really get under the covers and do a trade-by-trade proactive reconciliation that you can begin to eliminate some of the disputes.

**“ATTITUDES CHANGED (AFTER THE FINANCIAL CRISIS). IF YOU DIDN'T HAVE THE CAPABILITY TO VALUE TRANSACTIONS YOURSELF, IT WAS SUDDENLY TIME TO LOOK FOR SOMEONE WHO COULD INDEPENDENTLY DO IT ON YOUR BEHALF.”**



**THINK:** What are your reactions to the Dodd-Frank Act?

**SCOTT:** I don't look at it as "Dodd-Frank"; I look at it as "centrally cleared". What I mean by that is, I am not solely focused on the impact of Dodd-Frank in the U.S., but rather the impact derivatives reform will have globally. The services that we offer, and the scope of our clients' business, are global. I'm looking at, and probably most interested in, how Europe will be able to navigate its current uncertainties and come up with a consensus across different markets to come in line with the expectations of Dodd-Frank.

And if they're not in line time-wise with Dodd-Frank, what sort of regulatory arbitrage is that going to create? Right now that's the most interesting aspect. It strikes us as an enormous challenge to develop rules that are similar enough to not inhibit business so much, and avoid regulatory arbitrage opportunities, particularly in the face of what has been a series of not particularly optimistic financial news over the past few months.

**THINK:** Whenever something on this scale changes, timing becomes a concern. What's happening from a scheduling perspective?

**SCOTT:** Once the rules of a new process are finalized, there follows an implementation period. But it hasn't been a smooth process, and the rule making process has led to, in some cases, more questions than answers. Scott D O'Malia, Commissioner of the Commodity Futures Trading Commission, addressed this in recent testimony before the Commission.

He was pretty clear on one point: that the Commission can't "continue to pretend" that all of the Dodd-Frank rulemakings will be in place by December 31, 2011, which was the stated goal. He also shared the observation that while the schedule for reform is converging internationally, the underlying policies aren't converging at the same pace. Faced with these challenges, and a mandate to put central clearing in effect by Q4 2012, a lot of firms could find themselves in for a rude awakening. It's going to be very interesting.

**THINK:** How are CCPs going to affect institutions from a collateral management perspective?

**SCOTT:** It's becoming a consensus that we're looking at an increase in collateral requirements to the magnitude of 2-3 trillion USD. ISDA's last survey estimated that the amount of collateral in circulation in the OTC derivatives market was approximately \$2.9 trillion by year-end 2010. Based on that figure, you're looking

at a huge leap in growth just to support the newly cleared OTC business. If the rules are implemented as currently discussed, it's going to have an enormous impact on liquidity.

The additional collateral required to post to clearing members is going to be a factor. Some of the rules that have been proposed around what remains OTC will require significantly higher margin requirements, initial margins or independent amounts and lower or zero credit thresholds or no credit thresholds will also be a factor. Depending how everything gets finalized, and whether some client sectors such as insurers get an exemption, there are numerous variables that are going to affect the final picture. But everything that I've seen, and I think the industry has seen similar studies, indicates that there's going to be a huge increase in demand in the market to acquire good collateral. And there's only so much to go around.

**THINK:** What are you hearing about from clients today?

**SCOTT:** Central clearing is raising the most questions. It's driving, or is on the edges of, all the conversations we're having. However, the demand and the interest we're seeing in the OTC derivatives collateral management service has not begun to slow in any way, as the substantive changes are still 18-24 months away.

A scenario we're seeing a lot right now is clients who have been running services internally and are wondering whether it's feasible to continue down that road. There are investments in technology, and investments in additional resources, which are required to support mandates for clearing and trading. Many institutions, aware that these changes will be coming, are finding this a time to find a partner to outsource this service to, who can help guide them into the future of a centrally cleared environment.

That's been the overarching theme of many of the client discussions that we're having where the realization is that OTC isn't going away anytime soon, but there's something else coming that's going to make it that much more difficult. It makes outsourcing a very attractive option for a number of firms.

**THINK:** Are you hearing from any clients who plan to bring these services in-house?

**SCOTT:** Some are, but the real challenge isn't the desire to take ownership over the process, or even the additional resources. The main concern is the uncertainty that surrounds it. You can't plan and build for something now when you don't know what the final picture is going to look like.



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**THINK:** Will this lead to self-funding becoming a more important option?

**SCOTT:** A theme of our collateral management programs in general has been to see investment banks and large institutions with a lot of collateral on their books using our tri-party vehicle to fund their assets.

On the other hand you have the traditional buy side asset managers, and we've seen an expansion of sorts in this group, an expansion of who the traditional user of this kind of service is. While it's not a complete parallel, I do think this is the way the world will go. We'll continue to see more of a convergence between hedge funds and investment banks. One of the reasons we brought the hedge fund business and broker/dealer services together under the same management a few years ago at BNY Mellon is because these institutions were starting to look more and more alike. As a result, you can imagine that the overlap in services that this type of self-funding creates, particularly in terms of the types of services we offer, would be something that more buy side institutions would be interested in picking up.

This isn't happening yet, but when you look at the specter of additional collateral requirements, you can see that coming.

**THINK:** When you joined BNY Mellon, you were trying to anticipate what the derivatives collateral management space would be. How different is that first picture from what the market needs today?

**SCOTT:** It has definitely evolved. It's a much richer service than it was before, primarily due to two factors. First, the definition of derivatives collateral management has expanded in scope. More clients view pro-active portfolio reconciliation as part of the collateral management process for example, and this has been validated by demand in the market. A series of ancillary derivatives services, including portfolio reconciliation, also valuations, and affirmation confirmation, have been added to the scope of services that we offer, and that are available in the marketplace.

Second, the underlying technology has changed. At first, we relied on technology to help migrate our clients onto a new platform that could be supported as a streamlined, efficient operating model. But now it gives us the flexibility to pursue more advanced services down the road. Whatever central clearing throws at us, and particularly having started from a modular perspective, we know that the pieces are in place to evolve and support the market as future requirements reveal themselves. ■



### About TH!NK

TH!NK magazine explores the world of financial risk management, with an editorial focus on the space between inspiration and implementation. An award-winning publication written by and for risk professionals, TH!NK features engaging, original content on thought leadership, designed to inspire conversations about the challenges of today and the possibilities of tomorrow. TH!NK is published twice a year by Algorithmics, an IBM company. [algorithmics.com](http://algorithmics.com)

### About BNY Mellon

Established in 2007 from the merger of Mellon Financial Corporation and The Bank of New York Company, Inc., BNY Mellon is a leading investment management and investment services company, uniquely focused to help clients manage and move their financial assets and succeed in the rapidly changing global marketplace. Headquartered in New York, BNY Mellon has \$25.9 trillion in assets under custody or administration and \$1.2 trillion under management. [bnymellon.com](http://bnymellon.com)

