



# ETFs reduce risk through collateral management



Throughout the stellar growth of the European ETF market since the first fund launch in 2000, we have witnessed innovative new providers battling for market share amidst growing investor appetite for more transparent and liquid products.

Developed to deliver more accurate total return replication (by reducing tracking error to a benchmark index and lower costs associated with index rebalancing), swap based or synthetic ETFs are arguably the most successful innovation and currently represent more than 650 of the 1,000 plus ETFs available in Europe.

However swap based products have raised concerns over transparency and credit risks associated with possible swap counterparty default

Collateral provides the answer – UCITS rules dictate that collateral has to be provided for 90% of the fund's net asset value where the swap provider is a European bank (95% if non-European) though most over collateralise. But what is the collateral, how liquid is it, how reliable is pricing and in the event of a credit event, how can it be realised?

Several ETF providers have recognised the benefit of third party collateral management that has been used for decades in the repo and stock loan markets and is a proven and robust risk mitigation tool.

## Collateral management for swap based ETFs

The complexity of handling large baskets of diverse collateral cannot be underestimated and it is critical to get it right because clearly collateral will only be relied upon should the swap provider fail. At such time the ETF provider would need to quickly liquidate a large basket of assets (that are unlikely to be correlated to the underlying index) potentially in distressed market conditions.

BNY Mellon, as a market leader in the provision of collateral management services, offers bespoke solutions to collateral receivers seeking to optimise investment performance and improve operational efficiency, while simultaneously minimising risk and investment in back-office infrastructure and technology.

So it is not surprising that we have

partnered with a number of market leading ETFs to deliver multi asset class collateral management through proven and robust infrastructure.

BNY Mellon safe keeps equity and fixed income collateral and provides value-added services including:

- Daily mark-to-market of collateral vs. underlying principal exposure
- Margin calls/Return of surplus collateral
- Application of security and cross-currency haircuts
- Security/Geographic concentration limits
- Collateral substitutions
- Processing of income & corporate actions
- Transaction & Exposure reporting

## Alternative ETF structures

Swap based ETFs fall into two broad groups – those based upon a funded swap with pledged collateral and those based upon an unfunded swap with repurchase agreement (repo) based collateral.

In the first, subscription proceeds are used to buy a basket of securities, the return on the basket is exchanged with a swap counterparty for the return on an index via an unfunded swap.

Alternatively, subscription proceeds are paid directly to the swap counterparty who contracts (via a funded swap) to pay the fund the index return, pledging collateral via the collateral manager.

The key differentiation from a collateral management perspective is whether collateral is held under a repo



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or a pledge structure. Whilst the relative merits of pledge versus ownership prompts debate, the fundamental collateral management characteristics are the same; segregation of collateral with daily mark to market valuation utilising independent pricing sources, application of agreed margins and concentration limits.

## Credit Event

In the event of default by the swap counterparty the issuer will take ownership under pledge (delivery under repo) and realise it in order to satisfy any amounts owed by the swap counterparty.

Clearly collateral cannot guarantee zero loss in the event of a credit event. However, daily mark to market valuation of collateral as well as application of margin and concentration are key components of an overall risk mitigation program to limit and reduce the risk of loss.

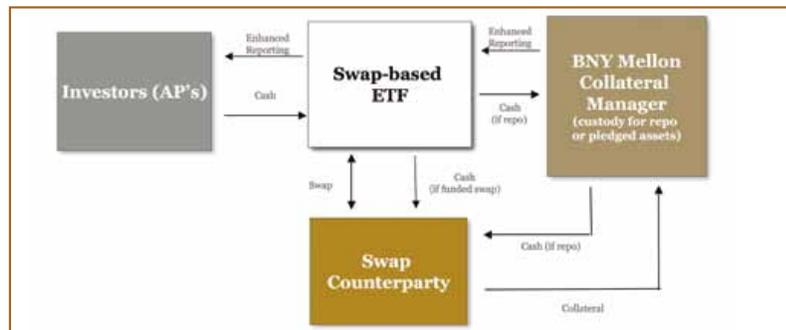
## Summary

Throughout the credit crisis BNY Mellon demonstrated that our platforms and processes could stand the test of the most difficult market conditions. Robust processes and transparency were critical.

The ability to 'look into the box' and see what is there with confidence has never been more important.

To find out more from a pioneer in collateral management, currently servicing more than \$1.8 trillion daily in collateral balances, please contact our team of specialists.

Chart 1: Swap collateral management process – increased transparency and risk mitigation



Source: BNY Mellon