



## THOUGHT LEADERSHIP: BNY MELLON

# Collateral management for German funds: BNY Mellon's innovative solutions for stock-loan transactions

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As the German investment industry liberalises to the form of the international model, German institutional and retail funds are adopting innovative techniques to mitigate risks in capital markets around the world. Since 2009, German Kapitalanlagegesellschaften (KAGs) have been allowed to appoint third-party collateral managers with a Depository bank licence to manage and safe-keep their collateral with stock-borrow loan-independently from the KAG's funds' depository bank. This allows KAGs and investors to gain access to new solutions that will help them compete even more effectively across global markets. This innovation has been also described in the Federal Financial Supervisory Authority's (BaFin) 2010/6 circular.

Among some of the tools available to funds to perform an efficient portfolio management are stock-loan transactions, which involve bonds or equity (as assets) being exchanged for collateral between the fund as a lender and a borrower. The borrower generally uses the assets to meet short-term needs such as investment hedging, facilitating arbitrage opportunities and avoiding settlement failure. The collateral market has traditionally been heavily dependent upon cash as collateral when delivered bilaterally, with a reliance on the reinvestment of the cash for a return. Following the market events of 2007 and 2008, lenders in the market have faced the same challenges in how to manage the cash reinvestment risk. As a consequence some lenders have taken a strategic view and converted to securities



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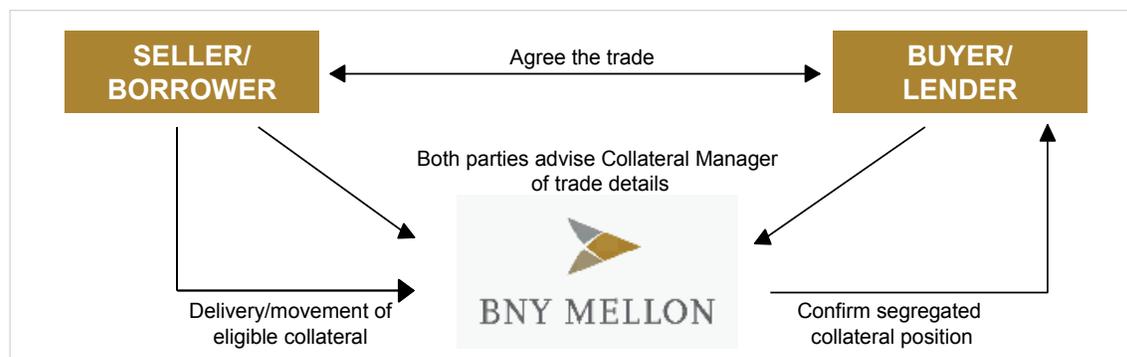
as collateral, moving away from cash collateral. This is a trend that is consistent across most securities lending activities in the market. This, at first, seems simple enough, but collateral management can be a tricky proposition as the assets fluctuate in value due to daily market movements.

Never has risk and exposure management been in such focus as it is today. Indeed, the collateralisation of various types of trading exposure has risen to the top of many companies' agendas. Once there, how it will run is a major consideration. There are several options, but it is very important for clients to recognise that tri-party collat-

eral management has been tested and proven as strong and reliable.

As a truly global business, we recognised the need to operate within certain local market standards, while offering a global market solution. BNY Mellon pioneered the form of collateral management known as 'tri-party' in New York over 25 years ago. This process applies a three way relationship with the borrower, the investor as lender and BNY Mellon as an independent service provider running the operational duties.

How does it work? With sophisticated deal-matching capabilities, a collateral manager acts upon matching instructions from both principal counterparties with a view toward maintaining sufficient collateralisation. Put simply, it means that the collateral agent is required to collateralise an exposure with agreed securities and asset classes applying the margin agreed between



the lender and the borrower to achieve the appropriate collateral level. Both parties can, on a real time basis, monitor the status of the instructions to be matched, removing any uncertainties of the required collateralisation level. The collateral manager allocates to each client or fund's segregated collateral account only those securities which both parties have agreed as eligible collateral. This is very important, as only approved collateral that meets defined client standards should be applied for accurate risk management. Borrower and lender both agree on the 'eligible collateral set' up front and leave it with the collateral manager to ensure the correct assets are applied automatically day-to-day.

The collateral manager covers a range of tasks throughout the full-term of each trade. These are recognised as:

- Daily mark-to-market of collateral
- Monitoring concentration limits on both the securities and country level
- Margin calls
- Return of surplus collateral
- Collateral substitutions
- Application of haircuts
- Processing of income

The collateral management process, from initiation through to settlement, is completely transparent as the collateral manager provides extensive reporting on all aspects of collateral management transactions. This includes security descriptions, market values, margin requirements and ratings. KAGs and their depository banks can view their collateral movements in real-time, generate daily reports and obtain account information for specified time periods.

The tri-party model was fully tested in Europe during the Lehman Brothers collapse, with practitioners of tri-party collateral management recognising the benefits of outsourcing collateral management to a specialist during this difficult time. During and after the market dislocation it was noted that the speed of margin calls, combined with a breadth of valuation sources and ability to manage

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collateral exposures on an asset class level proved a very efficient way to mitigate risk.

BNY Mellon's Frankfurt based operations provide German KAGs with a structured collateral management service model, helping them take full advantage of the latest rule changes, described in the BaFin 2010/6 circular. Counterparties to these trades are able to leverage their existing relationship with BNY Mellon as tri-party agent, utilising their current operational infrastructure, whilst contracting under German law.

As a collateral manager, BNY Mellon assists KAGs to reduce the burden of administrative tasks and enables them to focus on their core activities. BNY Mellon's technology and distinct expertise provide German KAGs with comprehensive operational control of securities lending collateral for their funds from the moment collateral has been delivered into the tri-party collateral management system through all post-trade processing of a transaction.

DWS Investments\* is one of BNY Mellon's first KAG clients for tri-party collateral management in Germany. Its Luxembourg funds went live on the platform in 2009 and its German funds followed in 2010. Mrs. Silvia Wagner, board member of DWS Holding & Service GmbH, confirmed: "We have been breaking new ground in Germany and Luxembourg and some time ago we identified the need to implement true tri-party collateral management for our regional funds. That's why we started a beauty contest to select an independent collateral manager and after a very comprehensive selection process we appointed BNY Mellon. Based on our good experience in Luxembourg, we now look forward to expanding the service for our German

funds over the course of the summer".

BNY Mellon's acquisition of BHF Asset Servicing GmbH (BAS), including its wholly-owned subsidiary Frankfurter Service Kapitalanlage-Gesellschaft mbH (FSKAG), expanded BNY Mellon's existing capabilities to include the provision of German domestic custody and KAG fund administration. The acquisition, which closed in 2010, positions BNY Mellon as one of the largest securities servicing providers with combined assets of €538bn (US\$764bn) under custody and administration and a volume of €132bn (US\$188bn) in custody as a depository bank.\*\*

For some, the uncertainty of bilateral processing and reliance on single points of data will have been a concern. Specialised tri-party collateral managers help to control some of this concern, offering a full range of collateral management capabilities that can not only manage risk, but improve financial and operational returns.

Since the firm's first tri-party collateral transaction in 1985, the business has grown substantially. BNY Mellon currently manages over \$1.8 trillion worldwide in collateral transactions every single day. **■**

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\*The mutual fund arm of Deutsche Asset Management

\*\*BNY Mellon Asset Servicing GmbH was merged into The Bank of New York Mellon SA/NV Garden Tower Branch Frankfurt as of June, 1st, 2011.

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