



# Collateral Management Transformed

## New tri-party structures help funds mitigate collateral risk

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Among the more significant challenges facing the hedge fund industry right now is the ability to manage collateral amid unprecedented credit and liquidity concerns. When performed effectively, collateral management can be a very reliable risk mitigant in a volatile market environment. If performed poorly however, it can create a whole host of problems, up to and including hedge fund insolvency.

Collateral management came under the intense glare of institutional investors with the stunning implosion of Lehman Brothers in September 2008. With a seemingly solid financial institution reduced to ruins, hedge funds began to question the creditworthiness of each of their counterparties and this significant lack of trust led to a significant lack of liquidity.

Eager to avoid the consequences of another Lehman-like debacle and seeking to increase transparency amid pressure from institutional investors, hedge funds have started to move cash and securities away

from prime brokers and toward highly-rated bank custodians. At first glance, this flight to safety of assets appears disastrous to the prime brokerage industry. However, prime brokers still have a vital, if evolving, role to play in the way collateral is managed. Efficient collateral management is critical to the sustainability of the prime brokerage and hedge fund relationship. It is important that old efficiencies remain intact in any new operating models.

### Redefining standards, restructuring operations

Historically, the hedge fund industry benefited from having prime brokers subsidise hedge funds' operational infrastructure. The severe turmoil affecting prime brokers has put a sudden end to this lifeline, forcing hedge funds to bear the full cost of operations. From a manager's perspective, the combination of multiple factors, including poor investment returns, unexpected illiquidity, rapid market deleveraging, major counterparty failures and unprecedented fraud has caused investors to redefine

standards for transparency and business risk, forcing hedge funds to restructure their operations.

A recent white paper published by The Bank of New York Mellon and Casey Quirk sheds new light on the issue. The white paper, entitled *The Hedge Fund of Tomorrow: Building an Enduring Firm*, reveals that the future operating model for hedge funds will be characterised by:

- A greater reliance on non-conflicted third parties for a growing range of operational and administrative functions;
- Stronger in-house operations and controls to shadow and verify these third parties; and
- Deeper and timelier reporting to investors and regulators, demonstrating robust and segregated compliance.

The white paper projects a growth of assets under management (AUM) to \$2.6 trillion by 2013, up from current AUM of \$1 trillion. With such projected growth, it is important to structure the operating model to ensure that there is no risk to any principal investments. The risk that a hedge fund, or any other investor should face, is the investment risk they knowingly take, not operational risk, or the risk of not being able to move or sell assets when they need to.

### Evolving model: complementary, not competitive

Custody has traditionally been a high-volume business that supported large institutions, such as mutual funds and pension funds, that require high levels of automation. Prime brokers on the other hand, offered a fuller range of services that were customised to relatively smaller financial firms such as hedge funds, with aggressive deadlines around asset and portfolio servicing to support hedge fund trading strategies. While there was some overlap of services, bank custodians and prime brokers rarely competed against one another. However, the extent of recent liquidity concerns, and the determined search for solutions, has prime brokers and bank custodians complementing rather than competing with each other as they work to form a new hybrid servicing model.

The new model typically involves the segregation of responsibilities between prime brokers and custodians, whereby custodians hold and service the long assets and prime brokers provide financing and lending for short positions. In this evolving model, which allows each party to focus on its strengths, a bank custodian can act as collateral manager for both the hedge fund and the prime broker.

### Hedge fund operational flow

When a hedge fund places collateral with a custodian bank, prime brokers can still use that collateral

**Fig.1 Old versus new operating paradigm**

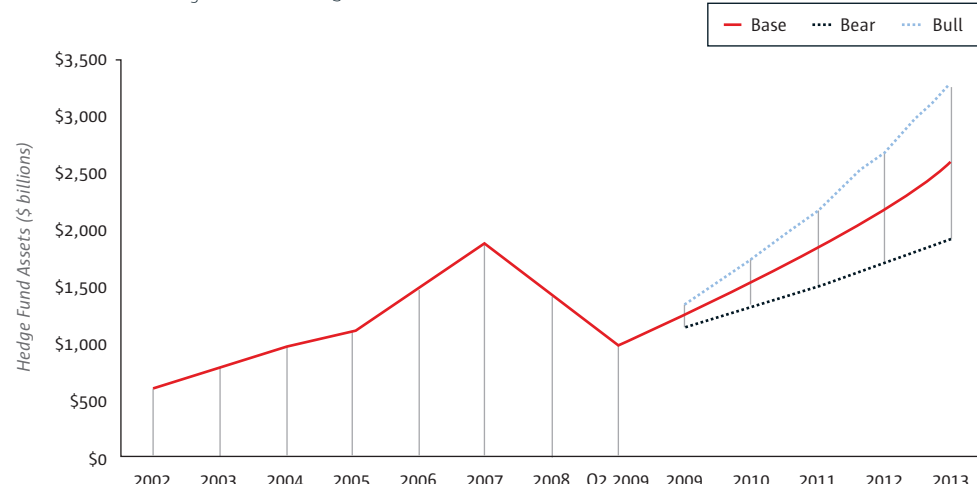
Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

LEGACY OPERATING PARADIGM	NEW OPERATING PARADIGM
<b>Concentration:</b> Managers rely primarily on 1-2 Prime Brokers	<b>Concentration:</b> Managers diversify business across multiple Prime Brokers
<b>Custody:</b> With Prime Broker	<b>Custody:</b> 3rd Party
<b>Cash:</b> With Prime Broker, passive	<b>Cash:</b> 3rd Party, actively managed
<b>Pricing:</b> In-house	<b>Pricing:</b> 3rd Party
<b>Administrators:</b> Clerical functions	<b>Administrators:</b> Operational functions
<b>Cost:</b> Subsidised via Prime Broker lending	<b>Cost:</b> Higher, borne by managers
<b>Investor scrutiny:</b> Ad-hoc	<b>Investor scrutiny:</b> Real

**Fig.2 Projected hedge fund assets by scenario**

Source: HFR, The Bank of New York Mellon and Casey Quirk Analysis 2009

December 2002 through December 2013



as initial margin. This tri-party structure enables prime brokers to continue to transact with hedge fund managers while reassuring all stakeholders that their cash is better protected. It is important that a distinction is made between where, and by whom, the assets are held and the right each party has to the assets. There is a difference between rehypothecated assets, encumbered assets and fully-paid-for long assets. For instance, prime brokers can no longer use cash deposited with them as initial margin by hedge fund managers to fund their own business. However, they can use the bank custodian tri-party services in order to raise funding in the repo market, moving the rehypothecated assets within a clearly defined operating environment.

**Moving beyond cash as collateral**

When it comes to types of collateral, cash is still the undisputed king, particularly in the derivatives space. It is the very definition of liquidity; simple to transact and its value is known to all at face. But it is not without its drawbacks. A significant downside is the associated depositary risk if the financial institution holding that cash fails. One way to mitigate this is by investing in cash equivalents such as money market funds, individual money market securities or within a repo transaction. These too have their respective risks, but the increasing use of investment portals which offer access to a wide range of investment options from a single source, brings great amounts of transparency to the process. These tools allow the manager to tailor risk in accordance with their policies and preferences. A money market fund is an off-the-shelf product, whereas a repo transaction is tailored in duration and collateral requirements to the manager’s specification.

Cash collateral may be relatively expensive for firms holding substantial non-cash assets. Why should they be required to pledge cash as collateral when they have other acceptable assets, including stocks, bonds and derivatives readily available? Basel II pushes the ‘collateral envelope’ by providing capital relief for a wider range of collateral asset classes (previously, only unsubordinated sovereign and supranational debt were eligible for capital relief), which should provide further incentives for the expansion of collateral types.

In terms of non-cash collateral, the advantage of the new arrangements is that a set of services provided to hedge funds by prime brokers on an integrated basis can now be unbundled. Different prime brokers will always have divergent views on which services they are willing to offer, and in working with Aaa rated custody banks, they now have partners who complement their services. This can only be good news for hedge funds and their investors, who rely on both prime brokers and custodian banks to help weather market volatility and mitigate risk. **THFJ**

The views expressed herein are those of the author only and may not reflect the views of The Bank of New York Mellon.

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**ABOUT THE AUTHOR**

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**Fig.3 Hedge fund operational flow**

