

The Effects of AIFMD on Tri-party Collateral Management

The rules for asset segregation under the Alternative Investment Fund Managers Directive (AIFMD) may have an adverse impact on tri-party collateral management.

The European Securities and Markets Authority (ESMA) is planning to issue guidelines setting out requirements for the segregation of alternative investment fund (AIF) assets. If these guidelines include the segregation of AIF assets from other client assets in the sub-custodian's books, we believe this will increase operational costs, potentially add systemic risk, and have an adverse impact on tri-party collateral management.

BACKGROUND

The main AIFMD legislative text was published in the *Official Journal of the European Union* in July 2011. It was supplemented by a more detailed Delegated Regulation that was published in March 2013. With the public policy objective of improving investor protection, AIFMD requires depositaries for AIFs to segregate in their own books AIF assets from non-AIF assets.

Controversies around AIFMD and asset segregation relate to the degree to which the segregation requirements placed on the depositary have to be replicated down the custody chain to the sub-custodian level. This is an important point as the final set of AIFMD segregation requirements may also apply to UCITS (Undertakings for the Collective Investment in Transferable Securities) under the UCITS V Directive.

These questions arose via the consultation paper published by ESMA in December 2014 (ESMA/2014/1326, "Guidelines on asset segregation under the AIFMD"). ESMA will determine what any future guidelines might say in this respect. The industry is waiting for final guidelines as to whether the segregation by AIF requirement would be mandated throughout multiple layers of the sub-custody chain.

While ESMA contemplated five options in their consultation paper, they have, as of the paper's publication date, broadly discounted Options 3, 4 and 5. Public response to the paper demonstrates the broad industry consensus that Option 4 should be permitted, but that overall, the industry requires flexibility to utilise all five options as necessary to achieve investor protection.

Final guidance from ESMA is expected in Sep/Oct 2015. Until then, the standard and accepted industry practice of utilising client omnibus accounts at lower levels in the sub-custody chain will remain.

THE EFFECT OF SEGREGATION ALONG THE CUSTODY CHAIN

With asset segregation throughout the sub-custody chain, the tri-party collateralisation process will change significantly. Currently, tri-party collateral management uses a combination of client omnibus accounts and books and records segregation (vs. external movements) which allow for the internalisation of

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settlement. Books and records segregation identifies which assets belong to the collateral provider (unallocated) and which belong to the collateral receiver (allocated). Internalising the movement of collateral at the tri-party agent gives the agent the flexibility to:

- handle substitutions (recalls or record date events) on a real-time basis and
- continue to move collateral between counterparties without being constrained by external deadlines.

If AIFMD asset segregation rules require that AIF assets and non-AIF assets be held in different accounts at a sub-custodian, then this would prevent internalisation of settlement, and tri-party agents would have to send individual settlement instructions to the sub-custodian for every collateral allocation to an AIF client. These settlement instructions would need to be processed not only in the tri-party agent's system but also throughout the sub-custodian chain, exposing the business to external movements and external deadlines.

We are raising this systemically important issue not just from a financial service provider's perspective, but more importantly, as an issue for the real economy and market participants (notably pension funds, asset managers and other providers of savings vehicles) who would be adversely affected by these proposals and who would not receive any clear identifiable benefit.

Our view is that the proposal for asset segregation throughout the custody chain is predicated on the following premises.

1. Asset segregation at the sub-custodian between AIF client assets and non-AIF client assets provides increased investor protection.
2. In the event of a custodian insolvency, an administrator would be better able to promptly return client assets from a segregated account than they would from an omnibus account.

We believe that both of these premises are misleading.

We believe that segregation in established books and records can achieve investor protection, and that segregation in accounts throughout the sub-custody chain introduces additional operational and settlement risks to the investor. Segregation would also introduce settlement delays, increase counterparty exposure and significantly impede the collateral substitution, optimisation and movement process.

In addition, segregation at the sub-custodian level would have a number of unintended negative consequences, including the following

- In our view, no tri-party collateral management agent would be able to perform tri-party collateral management services for AIFs if all collateral transfers also needed to occur at the sub-custodian level. This is due to the delay that would result from the necessary movements at the sub-custodian level. It would mean that intraday books and records movements of collateral, on which the market relies, could not occur. The non-AIF market would continue to operate under a tri-party collateral management model.
- The AIF and their counterparties would be forced to move to a bilateral collateral management world in which counterparty, credit, settlement and operational risk would be increased.
- Groups who need to source eligible collateral to post as margin to satisfy European Market Infrastructure Regulation (EMIR) obligations would not be able to efficiently and cost-effectively source inventory as a consequence of the required collateral being held in multiple segregated accounts.
- Many thousands of accounts within T2S would be required to be opened in order to support the segregated structure at the domestic CSD, which would be exported on to T2S. We understand that the T2S platform was not designed to support many thousands of additional accounts, given that the development of T2S assumed that omnibus account structures would continue to be widely used.

If you would like more information on AIFMD and tri-party collateral management, please contact your Relationship Manager.

ABOUT THE AUTHORS



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Ross is responsible for reviewing regulations affecting BNY Mellon Markets Group, conducting impact assessments on our business and clients, and determining with product management, legal, compliance and risk what our business response should be.

Ross has been with BNY Mellon for seven years and prior to joining the Markets Group, he was Business Manager and Head of Offshore, Continental Europe, Nordics, Middle East and North Africa for the Asset Servicing business. In the 13 years prior to joining BNY Mellon, he built out the international consulting practice at Thomas Murray.

Ross had previously managed Morgan Stanley's European Sales Group for Prime Brokerage, Securities Lending, MSCI and the Trust Company.



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As product manager for collateral management based in Frankfurt, Gesa focuses on regulatory initiatives and their impact on tri-party collateral management. Key topics include EMIR and related ESMA standards for collateralisation of derivatives, collateralisation of central bank exposures, AIFMD and UCITS implementation and the impact on efficient use of collateral management products.

Gesa has over 15 years industry experience. Prior to joining BNY Mellon in 2013, she worked at Eurex Clearing, Europe's largest central counterparty clearing house (CCP), where she was head of derivatives clearing business development. Through her role at Eurex Clearing, she has extensive experience in collateral management and segregation solutions for CCP cleared products. Gesa has also previously held roles at KPMG and Deutsche Bank.

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