Collateral, UCITS and the re-use of assets
Entering a new era in collateral management
Counterparty risk arising from Efficient Portfolio Management techniques (EPM) and financial derivative transactions is commonly mitigated by the use of collateral.

Collateral is either transferred by the counterparty to the UCITS or pledged on behalf of the UCITS. The aim of the collateral is obviously to protect the UCITS from the default of the counterparty and to decrease any anticipated loss in the event of default by the counterparty. In the event that the counterparty is unable or unwilling to fulfil its obligations, collateral received can be sold by the UCITS to offset the amount lost by the counterparty’s default.

UCITS, Alternative Investment Funds, pension funds or insurance companies hold large amounts of liquid financial assets and may be tempted to re-use these assets to maximise returns over the holding period. This may take place through securities lending1 or by using liquid assets as collateral to finance some of their investment strategies. On the other side, large prime brokers and custodians may re-use2 the pool of assets of their clients and/or collateral received to fund their balance sheets or to generate additional revenues through collateral management services. Collateral may also be captured by money market funds in exchange for the financing they supply to the market through reverse repo transactions3. Despite having different purposes, these techniques have in common the re-use of assets and collateral and liquidity management. Recent changes in the regulatory framework surrounding collateral and re-use of assets launched post the 2007-2008 crisis aimed at reducing systemic risk in the financial system but resulted in a reduction of the overall availability and velocity (i.e. speed of allocation) of collateral. Therefore, liquidity management is being redefined.

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1 The business of securities lending, where specific securities are lent to meet a need for those given securities, is driven inter alia by short sellers borrowing securities when anticipating a fall in price or broker/dealer in need of particular securities to complete a settlement (purchase/sale to clients).
2 Re-Use and Re-hypothecation. Re-hypothecation means the use of financial collateral by a collateral taker as security for his own obligations to some third party (i.e. onward pledging). Re-use is broader in scope, encompassing not only re-pledging but also any use of the collateral compatible with ownership of the property (such as selling or lending it to a third party). Rights of re-use are thus inherent in title transfer financial collateral arrangements (because ownership of the property actually changes) whereas under a pledge, the collateral taker will only enjoy rights of re-hypothecation if the parties have expressly agreed to this in their written pledge agreement. Re-hypothecation is standard market practice in the hedge fund industry allowing a prime broker to propose reduced fees for its services through a reduction in operating costs as a result of access to this collateral. Re-use is common practice in the UCITS industry where collateral is held by the depositary where there is a title transfer.
3 In reverse repurchase agreements repo, one will lend cash and receive collateral to secure the loan.
Regulatory changes

Regulation in the financial industry (i.e. credit institutions, investment funds, insurance companies) has recently been reinforced, resulting in an increase in requirements surrounding collateral and could turn into a run on high quality collateral.

For UCITS funds, the ESMA guidelines 2014-937 (CSSF Circular 14-592 in Luxembourg) set up rules on received collateral. In particular, four relevant aspects are particularly impacted by the ESMA guidelines with direct consequences for UCITS: scoping of collateral, diversification, eligibility and usage. By determining that all assets received in the context of EPM techniques and OTC derivatives transactions are to be considered as collateral, ESMA sought to ensure a consistent and unified approach to collateral management across the investment funds industry. As will be seen later in this article, this provides an opportunity for a fully integrated collateral management set-up across vehicles, counterparties, strategies and financial instruments.

These guidelines clarified the definition of eligible collateral, based on various criteria such as liquidity, valuation, issuer’s credit quality, correlation between issuer and counterparty – or absence thereof. The regulatory texts listed above also cover restrictions on the use of received collateral. Non-cash collateral received may not be sold, re-invested or pledged while cash collateral received can only be invested in high-quality government bonds. Overall, securities lending becomes less attractive for UCITS assets managers. As an illustration of the impact of these measures and how the industry may adjust to the new requirements, it has been observed that the use of traditional repurchase agreements by UCITS, of which the profitability is significantly impaired by the new requirements, is slowly being replaced by synthetic repos techniques – using financial derivatives.

Management companies are now required to document their collateral management policy and justify the haircut levels applied. Meeting these regulatory requirements – now compulsory – creates the ideal starting point for financial actors to engage in a re-think of their collateral management strategy for the future. As an example, the decision between an in-house collateral management function or delegated services will have to be made to consider all factors including to minimize operational burden, ensure regulatory compliance and benefit from opportunities arising from the new regulatory framework as described below.

Ucits V brings its fair load of new responsibilities to be carried out by depository banks, increasing the controls requirements and financial risk. In particular, depositaries will not be allowed to re-use the assets held in custody for their own account, as was the case under the previous regime (although the extent to which this was in effect done is debateable). The re-use on behalf of the UCITS will remain possible upon direct instruction of the management company, in the interests of the unit holders and provided transactions are covered by high quality and liquid collateral. This may have significant impacts on the revenues generated by the security lending activities of depositary banks and may increase servicing costs for UCITS funds.

The European implementation of the Basel III guidelines, known as the single rule book or CRD IV package, will increase the need for quality collateral (e.g. high quality government bonds,) due to new capital requirements. This new regulatory framework is likely to sustain the demand from banks for the very same high quality bonds that are also used as collateral by other financial counterparts. Moreover, financial derivatives transactions that are not centrally cleared will be more capital intensive for banks, as the Credit Valuation Adjustment (CVA) capital charge will add on their solvency ratio, whereas centrally cleared derivative transactions will increase the demand for collateral. The European Market Infrastructure Regulation (EMIR) sets collateral requirements for cleared and bilateral financial derivatives transactions. In addition to the IT, reporting and data management burden from an operational standpoint, asset management issues also arise. Considering that the re-use of assets is by far more restricted for UCITS managers and asset servicers than previously, and considering the new regulatory requirements mentioned above, collateral is more difficult to source, to monitor, to value and to manage on a day-to-day basis. Buy-side and fund managers will have to better address the collateral access, velocity and transformation to be aligned with the new market conditions and collateral requirements, transforming dramatically the organisation and operations of the collateral value chain within the asset management industry.

In addition, Ucits V (in alignment with AIFMD) introduces the obligation of full safekeeping, supervision and cash monitoring obligations on collateral owned by the fund, meaning, on collateral received by the fund with transfer of property and collateral given by the fund without transfer of property.
All financial actors are in scope and one can be sure that collateral management is entering a new era. The tightening of the regulatory framework regarding re-use of assets and collateral management implies a redesign of EPM techniques for Asset Managers and the need to optimise the sourcing, allocation and management of collateral. At the crossroads of EMIR, AIFMD, CRD IV and UCITS regulations and in an environment where risk management and corporate governance is a must, collateral management becomes a key function for asset managers. Some Management Companies’ Risk Management and Compliance functions may need assistance from the asset servicing industry in order to reconcile in the most efficient way compliance obligations with budget objectives.

First movers in asset servicing will seize opportunities to provide new services to their clients and help them to minimize the cost of collateral management. Astute asset managers will avoid the downside of focusing on the changing regulatory framework, seek assistance in meeting these new requirements and will focus on their core activities and innovation.

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Nevertheless, the same studies point out that due to, for example, the non-streamlined market infrastructure in Europe, frictions are likely to arise from the changes as they pertain to collateral.

If not scarce, eligible collateral is likely to become scarcer and one can expect that its costs will increase following the economics law of supply and demand. Especially when combined with collateral diversification requirements (although not applicable for government bonds most often used in such transactions). Furthermore, depositary banks are likely to incur operational cost due to regulatory requirements, potentially the opportunity cost from not re-using their clients’ assets and to the increased regulatory risk – e.g. liability over collateral held in the name of the fund.

As a consequence of the eligibility rules on collateral applicable across regulations (EMIR, CRD IV, UCITS, AIFMD) and of the investment policy and holdings of certain categories of actors (e.g. a UCITS investing in equities and OTC FX derivatives), collateral transformation services offered by prime brokers or global custodians are likely to develop further in the investment fund industry. This service consists of packaging and pooling assets currently held by investment funds or financial counterparties, such as equities or corporate bonds, into securities that can be used to satisfy CCP margin requirements, such as cash and government bonds. This is where the securities lending or repo markets come back into play, as an enabler between financial players owning high quality assets and willing to lend them to others which then may pledge them to CCPs. The repackaging of collateral enables higher velocity of eligible collateral and eases the ability of firms to meet their increasing collateral requirements and therefore creates a service opportunity for custodians and a product that could solve the collateral puzzle for asset managers. But it can be argued that if the original reason behind pushing OTC derivative transactions to be cleared on CCPs was to reduce systemic risk, collateral transformation is likely to merely relocate it to counterparties providing these services. As in any transaction, it is yet to be seen how collateral transformation will react in stressed market conditions where the demand for high-quality collateral can increase significantly and quickly, pushing up the price of eligible assets and eventually squeezing repo markets.

Academics studies⁴ show that there should be no shortfall of collateral in absolute terms. If appropriately allocated, there is enough quality collateral available to satisfy all needs.

Consequences

4 See for instance:  
  - Anderson and Joeveer 2013, ‘The Economics of Collateral’  

5 The difference being that unlike traditional bi-lateral repo or security lending transactions, these transactions will most likely be tri-partite agreements between the security/cash lender, borrower, and the broker/clearer/custodian.
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