# DerivSource Podcast KVGs & EMIR

**Welcome to a DerivSource podcast. I'm Julia Schieffer, Editor and Founder of DerivSource.com, and today I'm speaking to some experts about KVG and the challenges that KVGs face as they prepare for central clearing under EMIR. In this podcast we will be discussing some of the legal and structural challenges that KVGs face, including selecting a clearing broker and matching asset segregation offerings with their obligation.**

**With me today I have Caroline Herkstroeter, Partner, Investment Funds and Regulatory Law at Norton Rose Fulbright. I also have with me Marc Diedenhofen who is a Senior Legal Counsel at HSBC INKA.**

**Welcome Caroline and Marc.**

*Caroline*: Hi Julia

*Marc*: Hello Julia.

**Let's start today by briefly explaining to our readers what a KVG is and what our readers, especially outside of Germany, should know about these organizations. Caroline, would you like to start by giving us this introduction?**

*Caroline*: Yes, thank you. A KVG is the management company of investment funds - be it UCITS or AIF. With respect to the fund investors, and therefore the fund assets, the KVG has a trustee function and it's obliged always to act in the best interest of investors. The KVG and its activities is controlled by a repository which has to be appointed for each fund, be it UCITS or AIF. Since it's a general rule that the KVG has to act in the best interests of the investors (and that holds true for all decisions the KVG makes on behalf of the fund), this has always to be kept in mind and also for any activities or decisions made with respect to EMIR requirements and we will speak about this later. The KVG is bound by the German Investment Law which is called KAGB *Kapitalanlagegesetzbuch* and it goes without saying by the fund rules and general and special funds rules and guidelines agreed with the investor as the case may be.

*Marc*: Caroline, may I add one issue just so it's clear?

Most of the KVGs in Germany have a lot of funds and administration as you said of AIF and UCITS and so they use several custodian banks. This means of course there's only one custodian bank for a fund but all KVGs have more than one custodian bank; usually ten or more custodian banks, and also the so-called master-KVGs, as we are, for example, they have delegated the portfolio management to external asset management companies so there are also several external asset management companies involved.

**Perfect. Now that we know what a KVG is and some of the background in terms of the custodians and their structure, let's talk a little bit about the structure of the KVGs in detail and look at some of the ways in which the existing business model will have to change to support CCP Clearing under EMIR.**

*Marc*: Okay, so in the current work we have bilateral OTC trades which are mostly done with the huge investment banks, and on the other side we have exchange-traded derivatives which are already today cleared through a clearing broker. Now, under EMIR in the new EMIR collateral and CCP world, one of the most important issues or tasks for a KVG is to set up a collateral margin process for each fund. Therefore, the KVGs mostly use a professional central collateral manager. In most of the cases there is even more than one collateral manager involves, so most of the KVGs use two or three different collateral managers for their funds.

The task of the collateral manager is mainly to monitor all the margin calls of the CCPs through the different clearing brokers and also the margin calls of the bilateral OTC clearing parties. The collateral manager calculates the collateral and instructs the relevant custodian banks to provide relevant collateral to pay cash out of the fund or to deliver securities out of the fund as collateral.

Secondly, we have to set up or implement a clearing broker for the CCP clearing. The KVGs who have set up two clearing brokers for each fund with regard to reporting ability only in this case is it possible that in the case of clearer default the underlying assets as well as the securities can be ported to and back a clearing broker.

As we said in the beginning, we have also different custodian banks within the KVG and also different asset managers, more than one clearing broker and more than one collateral manager, you can imaging that there are various constellations which need to be legally in operation and implement.

Another important issue in this regard is that with regard to AIF, these have mainly one or few institutional investors in Germany, for example, insurance companies or pension trusts. These investors are always involved in the process of a fund, so they choose the KVG, they choose the custodian bank, and then of course with regard to EMIR they also want to know who's the clearing broker that's implemented, who's the collateral manager, because they want full transparency about their fund. So that's another important aspect which KVGs need to consider.

*Caroline*: What we realized during the last month is that there are a number of market participants, especially those whose core business is not trading financial instruments but, for example, real estate, and where the derivatives business is just an annex business to what they normally do, that they are not really well prepared yet. And I think it's now really time for them to do what Marc just set out and to prepare for proper set-up to do their due diligence, gap analysis, see what derivatives they trade in and what is required according to EMIR obligations.

**That's great. Now, focusing on asset segregation, this is obviously a very big issue under EMIR. I want to know what some of the legal requirements for segregation are under German law and what is the best match from the CCP segregation offerings available, for instance full segregation, to really ensure that KVGs meet their obligations. Caroline, would you like to start?**

*Caroline*: As a general rule, KVGs have to segregate one fund's asset from other fund's assets, or other sub-fund's assets, as well as its own assets. This is mandatory according to the German Investment Law. As a consequence, all the collateral belonging to a fund has to be allocated to the fund it belongs to. This is where the general idea of segregation in the fund business comes from. To which extent this leads to requirements to have segregated accounts throughout the whole clearing structure, and not only on the clearing broker (that means clearing member level), but also on the CCP level, has been highly discussed and is still subject to discussion.

You can take the view that the contractual relationship is just between the KVG and the clearing broker and therefore it is absolutely sufficient to segregate assets on such a level.

However, taking into account the general duty to act in the best interest of the fund investors, a segregation on a CCP level can be the most favorable option since it avoids, in case of insolvency of a clearing broker, that collateral is liquidated and the individual funds can just get a pro-rata share of the liquidated whole pool.

Having said this, and leaving the real segregation of accounts aside, it can be said that an administrative segregation allowing for the allocation of the collateral to an individual fund is indispensable for a KVG. This also leads to the question of how to deal with fund segments, which are not funds on their own but sub-funds, that are just artificial pools or sums of money allocated to normally a third-party asset manager. The KVG has to know what belong to the segment of the fund and therefore which third-party asset manager is responsible for the derivatives trades and the collateralization.

Finally, each model you can choose has to be analyzed with respect to the existing master agreement, be it the German Master Agreement or the ISDA, and its consequences to this standard documentation and to which extent it has to be amended or changed.

So, in a nutshell you can say that a segregation model is favorable for the KVG and for the funds; however you have to be careful with what it means and what CCP offers what because it's not alike, even if they talk about segregation models.

**And Marc, what do you think?**

*Marc*: One thing I would like to mention: we also think that it's favorable for a KVG to use the full segregation model with asset segregation at the CCP level. As you might know, the ISA model of LCH for example, it's important especially because KVGs are often in a position to use Euro-Government bonds as collateral for the initial margin and so if they post such government bonds to a CCP then it's really important for KVG that in the case of a default they receive these bonds back into the fund.

**What about netting? Are there any comments or that you may want to make about netting before we move on?**

*Caroline*: Netting is also something which is discussed in the market; to which extent you can do it and to which extent you *have* to do it as a KVG for your fund. I think it can be said that netting helps to deal with the lack of eligible collateral which means if you do netting, if you do netting of a fund, or of a segment of a fund, you really save eligible collateral and you put the fund in a better situation. However, netting for most funds is difficult because, as we said, each fund has collateral allocated to them and you cannot net the collateral of one fund with the collateral obligations of another fund.

So some KVGs, as far as we learned, still tend not to net at the moment but a lot of them think about netting over segments at least to save eligible collateral which will be a rare source at the end of the whole process. Marc, do you agree?

*Marc*: Yes. That's also what we see and I can also say that our preference is to net on the fund level.

**Perfect. Now, moving on from segregation, I want to ask about the selection of CCPs and clearing brokers: what criteria is most important with regard to this process, the selection of CCPs and their clearing brokers that KVGs must really take on board? Marc, would you like to lead on this?**

*Marc*: Of course, Julia. I think a very important issue in this regard is the offer of products which can be cleared by a CCP and related to this the liquidity and experience of clearing of certain instruments that actually because in the beginning the KVGs will not start clearing with three or four CCPs, most likely they will start with one or two so it's really important that there's a broad range of products which can be cleared at one CCP.

Another very important aspect of course is the connectivity of the CCPs to the executing brokers and, as I mentioned, the outsourced asset managers in the beginning that we have asset managers that are managing our portfolios, so especially for our master KVGs it's important that the asset manager also has relationships to the CCPs and we do not need to implement a totally new process for an asset manager.

Another very important aspect is of course what Caroline has mentioned before, the different models of segregation at the CCPs, the asset protection and portability in case of a default is similar for most CCPs but it's not the same, so we have to have a close look at the legal framework of the segregation model, especially how can the margin securities that we have transferred to a CCP be ported to another CCP through the clearing broker. As I said, we might use very good Euro-government bonds as margin.

With regard to clearers, it's also really important that connectivity to the CCPs and information platforms is given, then of course the margin handling we prefer, and that's what we see at most of the clearing brokers to whom we have talked, that there's only one margin call required per day which is very important for a KVG to keep the process very smooth.

The third important aspect with regard to the clearing brokers is that asset protection in the case of clearer default, the portability framework together with the chosen CCP and a second clearer so that there can be a good process to port the assets and the margin securities.

Finally, it's quite important that there's a good reporting capacity of the clearing broker since the KVG and also collateral manager and custodian bank require position and margin reporting by the clearing broker so they are in a position to have a full review of all the assets and securities which have been posted to different counterparties.

*Caroline*: What's also important is maybe an exchange of collateral. It is very helpful to find a CCP offering a model that involves the depository of the fund in a way that an exchange of collateral, or the transfer of collateral at least, is easy and that the depository can exercise its extended control function and that really extended under the new law, can be exercised. As Marc said, you have to look at the whole package and at least from the pure operational perspective, that really works throughout the daily work.

**That's great advice. Just to wrap things up, I'm curious what the KVGs should be focusing on next: Caroline and Marc, can you both give us a little bit of your advice for what you think KVGs should be focusing on next? Caroline, would you like to start?**

*Caroline*: Yes. According to our experience, the work on the rest of EMIR is partly done which means reporting and collateralization of OTC derivatives, so we are now really are speaking about the clearing which means that now, as we just discussed, the single CCPs have to be analyzed, their contractual setup has to be reviewed whether it sits with the master agreements with what I, as KVG, would expect to see. Moreover, as I said earlier, you have to do some due diligence and a gap analysis of what derivatives are traded and to see now that some CCPs have got their license, have been approved, to be prepared for frontloading is a certain type of derivative will then be subject to clearing obligations and will be on the list. This means I have to keep and maintain the data I need and to be prepared that even though I don't have to clear now, I might clear derivatives which are not cleared by 18th March (because I think this was the date where the first CCP got its permission). This would be my advice: to be prepared for that.

**Great. Thanks, Caroline. Marc, what about you?**

*Marc*: Yes, I think KVGs should now quickly decide about the clearing brokers and CCPs they would like to set up and start the detailed setup process and also from a legal perspective because so many counterparties are involved, as we heard, like collateral managers, custodian bank, external asset managers. Then, it's also important to analyze the internal fund accounting system; most likely this will be amended as well with regard to the new margin requirements and position reconciliation but not least if we should talk about timelines and it's quite unclear about when it will actually start the clearing obligation in Europe but think that KVGs should aim to implement first funds for clearing in the next four to five months.

**Perfect. That's excellent advice and some clear actions for our readers and any KVGs listening as well to take on board for the next several months and beyond.**

**I want to thank Caroline and Marc for sharing their insights with us today. I hope everyone listening has enjoyed their insight and their advice. I do encourage everyone to go our podcast notes to learn more about both Marc and Caroline and to see other information on this podcast, including the full transcript.**

**Thank you for listening to another DerivSource podcast.**