Basel III set to create new array of prime brokers

Hedge funds face threat of growing funding costs

Benefits of holistic approach to prime services
In this issue...

03 Prime brokers focus on holistic relationships  
By James Williams

05 A new chapter begins  
An interview with James Shekerdemian, Societe Generale Prime Services

08 Well placed to grow prime brokerage offering under AIFMD  
Interview with Gildas Le Treut, ABN AMRO Clearing

11 Opportunities for hedge funds  
Q&A with Ben Challice, Global Head of Prime Finance, Nomura

13 Benefits of holistic approach  
Interview with Paul Kelly & Stephen McCreath, Linear Investments Limited

15 A new paradigm for prime brokers  
Interview with John Stracquadanio, Scotiabank

16 Basel III set to create a richer array of prime brokers  
By James Williams

18 Threat of rising funding costs  
Interview with Jack Seibald, Concept Capital Markets

21 Providing a gateway for new entrants  
Interview with Chris Chanod, PrimeOne Solutions

24 Prime-of-Prime service launched for institutional investors  
Interview with Charalambos Psimolophitis, FxPro
Prime brokers focus on holistic relationships

By James Williams

A wise man adapts himself to circumstances as water shapes itself to the vessel that contains it. (Chinese Proverb)

It’s a well-known fact that adversity breeds innovation. As tough as it has become to do business in today’s financial markets, there are always opportunities to evolve, to re-assess one’s priorities, to build strength through consolidation.

One particular segment of the industry in which this is being borne out is prime brokerage. Primes of all shapes and sizes face a new reality today: the need to become both operational and balance sheet-efficient, and to broaden out the product suite to help managers adapt and thrive in today’s regulatory miasma.

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Celebrating its 150th year anniversary in 2014, Societe Generale took the decision in May 2014 to buy out Credit Agricole’s 50 per cent stake in Newedge, a leading provider of clearing and execution services in OTC and listed derivatives. This gave Societe Generale full ownership of the agency broker.

“We have bolted on some significant businesses to become a fully functional global prime services business,” says James Shekerdemian, Global Head of Prime Brokerage Sales at Societe Generale Prime Services, formerly Newedge. “Alongside our clearing and custody, execution and financing platform of old, we now have the strength of Societe Generale’s client-facing equity finance business and substantial inventory from which Newedge clients can benefit. We are now the customer-facing, prime brokerage arm of the bank.”

Newedge has carved out a market-leading position in the CTA and global macro space. Now wholly integrated within Societe Generale, the Prime Services business is poised to extend its reach further into the equity space, supporting equity long/short, event-driven and market neutral strategies, alongside 40 ACT & UCITS products.

“We’ve gone from a prime brokerage business, a cross-asset financing, and an execution services business, to one prime services business. We have OTC clearing, FX and fixed income prime brokerage and listed derivatives, and now we have an enhanced equity prime brokerage (cash & synthetic) too. With a consolidated reporting system and cross-margining across all our products, clients can benefit from simplicity, visibility and efficiency.

“In the equity long/short space, much focus is placed upon supply. We now have deep inventory from which to source, and since becoming a fully-fledged business of Societe Generale’s Global Markets Business Line we’ve started to attract more equity long/short managers,” comments Shekerdemian.

Newedge already had an electronic trading platform. Now it can tap in to the expertise of Societe Generale’s quantitative team and offer clients access to trading algorithms, transaction cost analysis tools etc, extending the suite of prime brokerage services.

“In addition, we can leverage the bank’s research capabilities, which again we didn’t have at Newedge being an agency broker. Now we have global research, single stock research and macro research. Such a comprehensive prime services offering puts us firmly in the game,” says Shekerdemian.

Another benefit is that everything is run off a single platform, without the pain of legacy that other banks face today where their equity prime brokerage teams are separate from their listed derivatives, fixed income, and FX prime brokerage teams. At Societe Generale, it is a single operating model.

“Some of the tier one primes are looking at their business models, deciding what to do and how committed to be. Societe Generale has historically had a market leading equity finance business, but it never had a full-service prime brokerage business. At Newedge, the reverse was true. By joining forces, we are aligning the needs of the client with a carved out prime services business,” states Shekerdemian.

What is also paramount is that the Newedge prime services business, perhaps helped in part by not having legacy issues, has the total backing of the Societe Generale Corporate and Investment Bank: a key attribute today given the uncertainty that Basel III is throwing up.

“Our message is clear: we have broadened our offering, we are committed to supporting clients across the spectrum of both Investors and Managers, and we are most definitely in growth mode,” concludes Shekerdemian.
brokerage with a market leading reputation in clearing and execution services for CTAs and global macro strategies, having the full backing of an investment bank now offers Newedge – now Societe Generale Prime Services – the potential to ramp up its activity in equity-based strategies.

“We are speaking to a number of long/short equity managers running offshore, UCITS and onshore AIFs: we’ve brought on quite a few and our pipeline is strong,” says James Shekerdemian, Global Head of Prime Brokerage Sales at Newedge. “We’re putting a flag in the ground and saying ‘We’re here, we can service all your needs across the value chain of Prime Services’.

One area that primes are having to focus all of their attentions is on balance sheet utilisation.

Balance sheet is a scarce resource everywhere and it always will be. As Shekerdemian points out, “It’s about how efficient you are at managing it”.

“We don’t have the pain of legacy. We feel we are in a strong position to support, build and help distribute products and provide a platform for clients. We’re not in this business for the short-term. We’ve got commitment from the bank and that’s vital. Alongside the strength of our offering, I think commitment is at the forefront of any client discussion these days.

“Clients need to know that their prime brokers are going to be there to provide a service,” adds Shekerdemian.

David Clarkson is EMEA Head of Prime Brokerage at JP Morgan. Rather than worry about the reduced levels of leverage that are set to impact the hedge fund space under Basel III, Clarkson takes a more sanguine view: “Basel III has the potential to further change the competitive landscape because banks now have an additional scarce resource to optimise. If a prime broker has a finite amount of balance sheet to deploy with client generated activity, it needs to be utilised in such a way as to maximise the long-term profitability of the business, whilst also recognising the increasing importance of non balance sheet-intensive client revenue opportunities,” says Clarkson.

This suggests that prime brokers will need to adapt their operating models and enhance their operating efficiency. That means taking a far more holistic view of the client relationship to ensure that the right services are being offered at the right price.

“Regulation is pushing banks to become more efficient around resource usage, and increasing the amount of netting or internationalisation is a key part of the process. Rather than simply taking in balances ad hoc across multiple strategies, to generate the best potential return you want balances that naturally complement each other. Longs covering shorts would be the most basic example.

“The relationship is getting a lot more scientific and this should strengthen as primes and hedge fund managers become more efficient financing partners. Managers will potentially become a lot more selective and concentrated in the counterparties they work with,” comments Ben Challice, Global Head of Prime Finance at Nomura.

Two years ago, senior management at Nomura decided that the right approach moving forward was to bring together its three existing businesses – a prime brokerage platform, a product-rich Delta 1 (synthetic equities) desk and a core equity financing business – into a fully integrated product-agnostic financing business.

“We are product and asset class-agnostic when approaching clients and can offer cross-margining across various products. The ability to view the relationship holistically across not just asset classes but sub-asset classes and trading products is paramount. Under the leadership of Steve Ashley, two years ago we undertook a root and branch assessment of the equities and fixed income business and merged them into a unified Global Markets structure. Everybody sits
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Well placed to grow prime brokerage offering under AIFMD

Interview with Gildas Le Treut

Today’s evolving regulatory landscape is playing to the strengths of ABN AMRO Clearing, certainly with respect to EMIR and AIFMD. Over the last 35 years, ABN AMRO Clearing has built a nexus to global market infrastructures to provide execution services and post-trading facilities across most markets and products.

“We saw EMIR as an opportunity to expand our capacity. We are one of the largest clearingers in the world and we’ve used this capacity to extend our clearing expertise into OTC derivatives such as IRS. It’s an opportunity for us to step in, demonstrate that we are a leading clearer, and expand our range of products,” comments Gildas Le Treut, Global Head of Prime Services at ABN AMRO Clearing.

With respect to AIFMD, the power has shifted from the primes to the custodian banks who are liable for the restitution of an AIF’s assets should anything go awry; this applies to onshore AIFs as opposed to offshore AIFs, who are able to avail of a ‘Depo Lite’ solution with the custodian.

“We have DNA in post-trading, and as a custodian, we understand what is needed in respect to segregation of assets. We’ve found that in discussions with custodian banks looking for a low risk prime broker for their clients, we are very much on their short list. That’s when we realised we have an important role to play in this game,” says Le Treut.

Indeed, how a prime broker is organised will become much more important under AIFMD where a fund’s assets will need to be segregated from a bank’s own assets.

“We are a global custodian and sub-custodian and a direct member on a number of central depositaries so we have full capacity to go into flexible account segregation and account naming on behalf of the depositary bank.

“Compared to other prime brokers, we are focused on fewer execution and post-trades with this quality of asset segregation and that is definitely an interest in the market. Not all depositaries are banks and that means they will automatically have to lean on their clients’ prime brokers. The advantage of ABN AMRO Clearing having balance sheet behind it, along with this tradition of asset protection, is a great asset in today’s climate,” adds Geert Vanderbeke, Executive Director of ABN AMRO Clearing.

Currently, ABN AMRO Clearing is supporting both synthetic and cash products but is focusing more on cash prime brokerage. What is interesting to note is that AIFMD is pushing depositary banks to request more synthetic products because there is no liability for restitution when using swaps.

Unfortunately, says Le Treut, when one extends this to Basel III and CRD IV, synthetics will be extremely expensive. He notes, “We are at a crossroads now with AIFMD and Basel III where primes will either have to move very fast into synthetics and use their balance sheet more selectively, ensuring they have a completely hedged book, or they will move back to become pure cash primes, which was the case pre-2008. I think we might see a return to that old model but with clear rules on segregation.

“That will benefit us, where we can demonstrate full transparency on asset segregation and margin protection. The days of Lehman where nobody knew where the assets were are over now that we have AIFMD and Basel III.”
on the same trading floor. This gives us full visibility on clients across products: from a return on financial resources perspective, it is first-class,” states Challice.

Nomura also has a centralised business resource management group to focus resources on where the best opportunities are.

“This helps us better identify which managers are good to partner with and which aren’t,” adds Challice.

Firms like Linear Investments Limited, which aren’t a part of global banking groups, are stepping in to the breach and servicing hedge funds of a greater size as tier one primes cut clients. This in itself is requiring a degree of adaptation because as CEO Paul Kelly points out: “If you want to engage with mid-size, larger clients you need to offer a level of protection that they are accustomed to. Pre- and post-trade controls are critical.”

Linear has made further investment in technology to better support cross-asset classes. Although this is achieved by working with multiple providers, clients only ever face off to Linear.

“We use multiple front-end providers that plug in to our hub. We have risk management in place to look across all the asset classes our clients trade; we have a back-end infrastructure to support all the sub-accounts. So although we back in to our providers with one omnibus account, all our clients have their own accounts,” explains Stephen McCreath, Head of Prime Services at Linear, confirming that Linear has had to build out a number of pre-trade risk systems.

“Before we send any client orders to execute we check that the client has sufficient funds, we look at their existing exposure on the market and if it passes all our system checks, only then do we release the order to the market.”

Stephen McCreath, Linear Investments

One area that Clarkson says JP Morgan is looking at is the convergence in corporate governance requirements of UCITS and AIFMD regulated funds. For example, both sets of regulation require the appointment of depositaries to undertake various fund oversight duties. This is proving beneficial to banks like JP Morgan who, as universal banks, can offer all the products a fund will need to meet their regulatory requirements, not just prime brokerage services.

“UCITS funds and AIFs require swaps, custody arrangements, fund administration and depositary services, whilst AIFs also need more traditional prime brokerage services. As a universal bank we offer all these services. To be successful in the new banking environment a firm needs to think holistically to bring all these services to the client. JP Morgan’s prime brokerage product sits within Investor Services which offers all these services,” comments Clarkson.

Over at Societe Generale Prime Services, through its alternatives-based research and reporting services, the focus has primarily been in global macro as opposed to single
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Japan attracted significant international interest following the launch of Abenomics – how should global hedge fund managers assess Japan, and the rest of Asia, as a long-term source of capital?

The first two pillars of Abenomics, fiscal stimulus and monetary easing, gave a significant boost to the Japanese economy. The effect of the “third arrow” – structural reforms to stimulate growth – will be more gradual. However, since Abe’s re-election, there have been signs that Japan is embracing change and that it will impact all areas of the economy.

For example, the Government Pension Investment Fund of Japan (GPIF), the world’s biggest state investor, is shifting its asset allocation away from Japanese government bonds towards domestic stocks and international securities. As a result, GPIF’s investment in international assets will increase by around USD190bn. Where GPIF leads, other pension funds and investors follow. With that momentum, we should expect greater diversification in asset allocation by Japanese investors, including into the alternatives space. This presents a sizeable opportunity for hedge funds to raise capital.

Are there any particular qualities Nomura can offer clients as an Asian dealer?

As Asia’s only full service prime broker, Nomura is well positioned to provide access to this region. However, with more than 65 per cent of our wholesale revenues generated outside Japan, Nomura has a comprehensive global offering. We bring meaningful geographical diversification for clients, away from traditional US and European providers.

Our capital introduction service provides clients with unparalleled access to Japanese institutional and retail investors via our dedicated local team. As well as extensive relationships with active asset allocators in Asia, the team runs highly regarded flagship events across the region and globally.

We can also leverage our strength in Japan and Asia by sourcing hard-to-access securities via our links with our Retail and Asset Management divisions. This provides market-leading stock lending availability, covering approximately 98 per cent of listed stocks in key Japanese markets, for example. Regulatory and market changes are causing many sell-side firms to re-evaluate their businesses. How has Nomura adapted to this evolving landscape?

Regulation remains at the forefront of the agenda for sell side institutions, with EMIR, AIFMD, Dodd Frank and Basel III all in play. Banks are re-evaluating their business models in light of new capital and liquidity rules. These are causing most firms to recalibrate how they view clients and the profitability of their businesses. Nomura sees this as an area of opportunity as we have already embedded these metrics into our business model, and can therefore offer market-leading solutions to our clients.

What do these changes mean in terms of relationships with hedge fund clients?

Regulation has been a major driver of change for hedge funds as much as sell-side firms. In this increasingly challenged environment, Nomura has taken a consultative approach in helping clients navigate these changes; for example helping them implement the requirements of OTC and listed reporting under EMIR, or working with them to efficiently allocate balances across providers.

The client and prime broker relationship is becoming increasingly symbiotic, with a focus on transparency of pricing. There is an opportunity for clients and banks to work together as financing partners, as they both optimise their allocation of resources, particularly in high quality liquid assets. Nomura is well positioned given our clean and robust balance sheet, coupled with our unique cross-asset global markets structure. This allows us to be more efficient and holistic in our inventory management, which helps us to be competitive on pricing as well as quality of service.
Throughout 2015, Linear’s McCreath says the firm will move to provide more comprehensive stock loan services and views it as an area “where we see big opportunities”.

“We see ourselves as a smaller version of a tier one prime. We aim to mirror the services managers were getting there. As a result, we plan to add capital introduction services as well.

That said, emerging managers and start-ups will always be a key audience for us. When I was at Lehman, we took on a EUR12m fund and it grew to EUR3bn; we want to be in a position to see acorns become oak trees.”

Nomura’s Challice envisages more activity in the synthetic equities space.

“I also think we’ll see significant inflows into ETFs, both in Asia and Europe. The ability to offer custom baskets of securities as a combined product—alongside traditional clearing and custody and short selling abilities—coupled with an ability to cross-margin, is going to be an interesting opportunity moving forward.”
Benefits of holistic approach
Interview with Paul Kelly & Stephen McCreath

“In 2011, we identified that larger prime brokers were pulling back on smaller hedge funds. We saw our opportunity at that point,” states Paul Kelly, CEO of London-based Linear Investments Limited; an FCA-approved full service mini prime broker (Linear Mini Prime) providing full prime brokerage, custody and execution services to small and mid-sized hedge funds.

Back then, Linear Investments carved a niche supporting managers with USD5m or less in AuM. Aside from prime brokerage services, Linear also set up an FCA-approved regulatory umbrella for managers in a bid to keep operating costs to a minimum.

“It was a good fit for us to support smaller managers,” says Kelly. “We were able to offer them desk space and provide a full one-stop service.”

Eighteen months ago, however, things started to change at Linear Investments. With Basel III regulation leading tier one primes to concentrate on the top 10 to 20 per cent of their clients, managers with substantially higher assets (USD10-50m) started knocking on Linear’s door.

“What we heard was that unless clients were making EUR250-500m in revenue they were being told to find an alternative broker. We are an aggregator. We can pull in a lot of these smaller managers and then feed that aggregated AuM as a larger client to our prime broker. We have the ability to hold client money, execute trades etc, but we back that in to our own prime broker; it’s a pure omnibus account structure that we use,” explains Kelly.

Stephen McCreath is Head of Prime Services at Linear. By working with additional providers behind the scenes, Linear is able to hold managers’ fund assets in multiple locations, allowing them to benefit from a proxy ‘multi-prime’ arrangement through a single counterparty.

“A hedge fund using three primes today is going to need EUR300m to EUR400m in AuM to meet the revenue targets of each broker, whereas we can give managers a similar arrangement in a much more cost-efficient way,” says McCreath.

Although banks have been scaling back their equity trading desks to adjust to regulation, at the same time operational staff numbers have increased; the net effect being that there’s an ever-increasing cost base to distribute to a shrinking number of revenue-generating desks.

“A lot of clients that we have may have been paying for execution services in a previous arrangement but not paying for prime services. As a result, they are being offloaded by primes because the revenues are falling short, whereas we can take a more holistic approach,” says McCreath.

“We may not get a lot of leverage out of the strategy but a manager might be trading a lot on a daily basis so collectively, they are viewed more favourably by us,” adds Kelly.

This silo-based arrangement has become a problem for banks where execution desks have a separate P&L to the prime services desk. As a result, primes are becoming much more focused on the amount of balance sheet they are willing to use to support a client.

“We are finding that banks are focusing on their top 100 clients. It’s more cost-effective to increase the wallet share of a USD10bn hedge fund from 5 per cent to 7 per cent than add 10 new clients,” concludes Kelly.

Over the last two years, Linear has grown its business to include Capital Introductions, a comprehensive range of asset classes, a Wealth Management team as well as Custody and Stock Loan solutions.
Scotiabank is one of North America’s premier financial institutions with an A+ rating1, and one of the world’s safest banks2. We provide clients with a full-service equity finance operation. Our experienced professionals in North America, Europe and Asia support multiple asset classes on various regulatory and proprietary margin regimes and offer comprehensive transaction expertise, timely research and innovative ideas to help clients maximize capital efficiency.

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1As at January 15, 2015, Standard and Poor’s. 2Ranked the third-safest bank in North America (2013-2014) by Global Finance.
Scotiabank is one of a stable of Canadian banks that have decided to enter the prime services space as regulation begins to shake up the established order. Basel III and other regulations are providing new entrants with similar opportunities that arose following the ‘08 financial crisis as managers adopted a multi-prime approach.

“Regulatory issues impacting the established set of banks are providing opportunities for new players. We are a recipient of this dislocation that is causing a lot of re-pricing conversations between managers and banks,” says John Stracquadanio, Head of Prime Services, Scotiabank.

“Tier one banks are dealing with many different regulatory and other events converging at once and this is impacting the organisational structure of prime services divisions within these banks. The end result,” says Stracquadanio, has been:

• “A reduction of existing business that consumes a large amount of the bank’s assets.

• Re-pricing that business and assessing whether or not the client has enough non-balance sheet related revenue to meet their required return on assets (ROA) hurdle.

“We are hearing in the market that, in certain cases, the need to shed assets has sparked internal reviews, during which our competitors are identifying clients where ROA hurdles have not been met or, what might previously have been a decent ROA, might no longer work because the cost of funding is higher than it was pre-crisis.”

“In other words, the dislocation in ‘08 led to services potentially being mispriced in the hope that banks could use their balance sheets and widen out their revenue pool. I think what we are seeing now is that the widening of that revenue pool was not as high as expected for banks to meet their net revenue targets,” opines Stracquadanio.

Increasingly, the onus is on banks to become more strategic in terms of competing in specific sectors where they are confident they can deliver a tangible edge to clients. This is Scotiabank’s approach as it brings forward its expertise in Canadian equities.

“We are not encumbered as a tier one prime broker that’s in need of strengthening or reducing its balance sheet. Rather, we are selectively allocating usage at the right pace and with the right returns,” notes Stracquadanio.

“It is not inconceivable that the prime brokerage space could, going forward, adopt a more specialist mindset as banks pull back from supporting all types of managers and strategies that revenues just won’t support.”

“I believe we are entering such an age. I do think there is a place now for specialist prime brokers. Before the crisis, there was a universal concept that unless you could do everything, you really couldn’t do anything. I believe that concept is gone,” says Stracquadanio.

“That is what might allow for this continued entry of new players into the prime brokerage space. Less affected banks are getting the chance to compete where they might not have been able to compete in prior years. Each of these new entrants, like Scotiabank, will come with some sort of specialty. It’s going to be incumbent on banks to put together what they think their best portfolio of product offering relative to their balance sheet is, as opposed to supporting a massive product offering where they have become not only incredibly wide in scope but also incredibly shallow.”

“I think things are shifting now where prime brokers need to become narrower and deeper.”
On 4 August 2014, the Wall Street Journal reported that Goldman Sachs had commenced culling its hedge fund client roster, offloading managers who simply weren’t generating enough return on equity. Fast forward to 7 December 2014. Reuters reported that Credit Suisse was considering scaling down its prime brokerage business, as Switzerland contemplates imposing a tier one capital ratio of 4 per cent on its banks by 2019, 1 per cent higher than the Basel III ratio.

This is the start of a process of serious soul searching for tier one primes as they weigh up the costs of using balance sheet and to whom this increasingly scarce commodity should be offered.

Hedge funds that aren’t utilising credit lines, or holding a cash surplus in their accounts will either be asked to leave or face higher charges. Shorting stocks will increase and managers who have historically used significant leverage to run their strategies could be impacted.

Fixed income arbitrage funds – one of the most leveraged strategies at 13 times NAV – could be hit hardest, with returns falling an estimated 40-80bp according to Barclays. Multi-strategy hedge funds, especially those active in credit and convertible arbitrage, would also feel the squeeze, with an estimated performance drop of 15-30bp.

So it’s fair to say that regulation is set to throw the cat among the pigeons. If tier one primes proceed to cull hedge funds, it
will – and is already creating – significant opportunities for new entrants.

One such entrant is ABN AMRO Clearing. The firm has built out a cash and, to a lesser extent, synthetic prime services business using a holistic operational model that avoids many of the legacy system issues of established primes. Crucially, by working with managers in this way, ABN AMRO is in a better position to understand their full potential, even if they aren’t generating high revenues across the board.

“Managers like a global approach but historically they’ve had to face one prime broker but different legal entities; one doing FX, one doing securities services, one doing clearing and another one doing investment banking. This is how some of the large names built their PB offering. When every department has to look at their own P&L, suddenly they say ‘We don’t like this client let’s ask them to leave’, even though they might be a good client in other departments.

“We have the chance to be one single legal entity for a manager. Profitability on OTC clearing might not be great, for example, but we look at the client more holistically and that allows us to make a clearer decision on whether to continue to give them leverage and finance,” explains Gildas Le Treut, Global Head of Prime Services at ABN AMRO Clearing.

As ABN AMRO Clearing manages the collateral from one single point of entry, they can see at any moment the full risk that they bear on any one client. This helps them to price their services more accurately.

The silo-based business divisions that tier one banks have built over the years and cobbled together as ‘prime services’ are today being exposed as brutally inefficient.

One could argue, therefore, that Basel III is a catalyst for positive change; primes have to now engage in a deep-dive analysis of every piece of business they have in terms of defining their resources: manpower, operational support as well as the amount of balance sheet being chewed up by holding an account and trying to ascertain how to improve the return on equity by tweaking things.

“As they go through that analysis, account by account, it’s not unlikely that they would find that the costs related to servicing certain types of accounts trading certain asset classes are higher than others. That might cause a bank to draw a conclusion on the asset class, as opposed to just the underlying managers,” says Jack Seibald, managing member at Concept Capital Markets LLC, one of North America’s leading introducing brokers.

“If accounts A, B, C and D that all trade a similar asset class have higher resource utilisation and no commensurately higher revenue stream than accounts E, F, G and H, which trade a different asset class with a better revenue-to-cost, it may lead the bank to conclude that it might not be worth continuing to support the less economically attractive asset class as a whole,” adds Seibald.

Seibald raises an interesting point here. Ultimately, no prime broker wants to lose clients. But if, as expected, Basel III prompts them to get their house in order, one might see tier one primes returning to their core competencies, potentially supporting key asset classes in which they know they can deliver excellence and balance sheet optimisation. And turn their back on asset classes that simply do not make economic sense.

That will require a fundamental shift in mind set.

Infrastructure and the rise of new entrants

After all, prior to 2008, prime brokers went after as many managers and supported every type of hedge fund strategy possible and it worked; revenues were booming, managers were trading in volume and leverage levels were high. But the financial crash changed all that. Suddenly, trading...
“Our history is that we’ve been very welcoming to start-up hedge funds. Even as the opportunities to service larger managers grow, we’re not just walking away from what has been a significant part of our business,” says Jack Seibald, managing member at Concept Capital Markets LLC, one of North America’s leading introducing brokers.

Introducing primes like Concept Capital face a unique situation: on the one hand, they are well placed to grow as the quality and size of managers coming through the door increases as tier one primes reduce the number of managers they serve directly. On the other hand, they need to be careful not to stray away from their core audience; emerging managers, who need more support than anyone in these tough regulatory times.

“With each passing day we see additional evidence that the big banks are taking a hard look at their prime brokerage businesses. Goldman Sachs, Merrill Lynch, and JP Morgan, among others, have all been in the news on this subject in recent months,” says Seibald.

Recently, it emerged that Credit Suisse too was actively reviewing its prime brokerage business as the Swiss government considers raising the tier one capital ratio on its banks to 4 per cent.

This squeeze, facing many of the tier one primes, is manifesting itself through a more forensic assessment of the revenue potential of their clients.

“The unintended consequence of banking regulation is that it removes the capacity from the banking system to provide liquidity to the economy. The more you have to store away the less you have to lend; or conversely, the more you lend, the more you’ll want to earn.

“The fact that firms of the magnitude of Credit Suisse are thinking of paring back their prime brokerage business is going to lead managers to question whether they should start making alternative arrangements before they’re told to,” says Seibald.

It is estimated that benchmark revenues for hedge funds at large prime brokers are rising to USD$500k annually.

“These numbers are not inconsequential. What will happen a year or two from now if in fact there’s a significant migration of these types of accounts from the big banks to firms like ours? Time will tell, but we’ve already begun to see certain introducing brokers informing clients that their revenue requirements are increasing from what they have been in the previous 12 months.

“If the industry keeps going the way it is, we too at some point may have to reconsider our position, and will need to decide whether it will make sense to increase our personnel to be able to service smaller, more marginal clients that can’t find a home,” says Seibald.

It’s a tough balancing act for all concerned. If leverage levels fall at tier one primes, as is expected – which will hit strategies like fixed income arbitrage – the corollary to that is that the banks will still need to generate revenues.

“If balance sheets are restrained, the less there will be to lend out, and banks will have to consider how to make up that potential shortfall in revenue. The obvious answer is by charging more for the amount they’re lending out. So spreads will widen going forward. Even as banks cull their hedge fund client numbers, I still think the cost of doing business as a hedge fund, especially on the funding side, is likely to go up,” concludes Seibald.
volumes slumped, managers embarked on a multi-prime mission and prime brokers were left with out-of-date technology infrastructures that could no longer provide the efficiency needed to operate in a post-regulatory world.

“It’s not like anyone’s dropped the ball. Banks were aligned with the environment that suited them at that time and the technology solutions they had worked perfectly well. Now that business model has shifted. Regulation is forcing people to change and become more efficient and better understand the quality of their relationships. It’s all about quality and efficiency today, to benefit everyone,” comments EJ Liotta, Global Head of PrimeOne Solutions, part of CoreOne Technologies which provides a gateway for new entrants to the prime finance space without the complexity and cost burden of having to build internal technology infrastructures.

The PrimeOne Solutions team comes from a global banking background so they know the issues that tier one primes face today. The technology infrastructure they’ve built, spanning global cash and synthetic PB and securities lending, is giving new entrants and tier two primes the ability to start building out their own prime services solutions to compete with the established players.

Their clients include tier one banks that would generally be considered tier two primes i.e. they’ve been in the prime finance space to a limited extent but are now turning it into a more substantial business, mini primes, both introducing and self-funded and self-clearing mini primes.

“In addition, we are starting to deal with tier one primes who are facing up to the infrastructure challenges. They have an issue that needs to be solved and we can honestly say that we are the only vendor equipped in this marketplace to help them solve that problem on a global scale across their entire platform,” says Chris Chanod, Global Head of Business Development, PrimeOne Solutions. “The minimum revenue targets on a USD150m hedge fund have increased on average from USD150-200k pre-crisis to greater than USD500k annually.”

Liotta notes that the order of magnitude PrimeOne Solutions can offer in terms of cost reduction is approximately 80 per cent.

“We can re-platform tier one primes to get their costs in line with the current state of the industry. In the tier two realm, the perfect storm has metastasized where tier one primes are jettisoning smaller hedge funds. So now you have this demand coming down the pipe that is providing an opportunity for tier two primes with strong balance sheets. The argument not to get involved in the past was because it was overly complicated from an IT technology perspective. We now solve that problem,” says Liotta.

One new entrant availing of PrimeOne Solutions is Canadian bank, Scotiabank. “Ten years ago, I might have needed to fund the entire technology platform internally and that would have come with a multi-million dollar price tag. We felt the ongoing costs for this particular technology was best suited to us using a vendor.

“We are potentially the only Canadian bank that has a full suite of prime services solutions that is consistent with the larger tier one banks; i.e. cash and synthetics PB, global securities lending, trade execution services and capital introductions, all under the roof of prime services,” comments John Stracquadanio, head of prime services, Scotiabank.

Aside from the infrastructure benefits, Scotiabank is just one example of how banks are entering the prime services space with a balance sheet where they can price services correctly, as opposed to pre-crisis “when perhaps some banks were utilising their balance sheets too quickly and too cheaply”, suggests Stracquadanio.

“The key point to make is that we are coming from a different starting place. We don’t necessarily have the same urgency to shed balance sheet like other prime services

“Regulation is forcing people to change and become more efficient and better understand the quality of their relationships. It’s all about quality and efficiency today, to benefit everyone.”

EJ Liotta, PrimeOne Solutions
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“Basel III and other regulatory issues and restrictions have a number of driving factors and downstream effects on tier one primes, which drives our whole investment thesis here at PrimeOne Solutions,” states Chris Chanod, Global Head of Business Development, PrimeOne Solutions, part of CoreOne Technologies.

PrimeOne Solutions provides a gateway for new entrants to the prime finance space as well as an avenue for Tier 1 and Tier 2 prime brokers to reduce infrastructure and technology costs.

One of the key driving factors Chanod refers to is a reduction in profitability for primes. Margins have shrunk. This is pushing tier one primes to embark on drastic cost reduction, specifically around inefficient legacy infrastructure.

“The costs of a tier one prime to run their global infrastructure platform ranges anywhere from USD75-200m a year. One point that everyone agrees on is that that cannot remain the same. Seven years ago, when leverage boomed and financing activity increased, banks attempted to make their infrastructure more efficient, but in many cases they inadvertently ended up making it more expensive,” says Chanod.

Back in 2007, throwing money at global infrastructure platforms was fine because balances were rising, profits were growing. But although we live in a different age today, what has remained in stasis is the inexorably high operating costs to running these platforms. This is the nub of the problem.

“There’s a misalignment because the technology was developed for a different era,” says EJ Liotta, Global Head of PrimeOne Solutions. “Their infrastructure doesn’t work, not only from a cost perspective but because of the way primes operate. A prime broker is an intersection of many different services of a bank; balance sheet, reporting, clearance, execution, derivatives and so on.

“In the past, the banks stitched everything together and called it Prime Finance. Now, it’s about closer evaluation of the quality of collateral held at the bank. Now, people have to dynamically evaluate the quality of that relationship based on assets, and because that infrastructure is not necessarily suitable, banks are not always able to ascertain what the quality of that relationship truly is. So it’s not just about reducing cost, it’s about having more efficient software to more effectively evaluate the quality of that relationship.”

This plays precisely to the strengths of PrimeOne Solutions. The firm has engaged in a series of strategic platform lift outs from tier one banks and re-platformed proven, battle-tested prime finance technology. It was, as Chanod points out, the first vendor to lift out a global cash PB system and securities lending system, specifically from Barclays.

“We also lifted out a sixth generation global synthetics PB platform for global swaps trading. We’ve coupled those three solutions, across global cash PB, global securities lending and global synthetic PB with a front-end client reporting platform that sits on top (Prime Reporter),” says Chanod.

What PrimeOne Solutions is able to do is provide new entrants with a pure plug-and-play platform for global prime finance. As Liotta points out, “the order of magnitude in terms of cost reduction is 80 per cent”.

“Secondary providers need to become scalable and have an infrastructure that rivals tier one banks. They can’t support the increase in volume and sophistication of clients without using a proven vendor model because they can’t afford to, nor do they have the time to build it internally,” concludes Chanod.
providers. The market is re-pricing as we speak and we have the opportunity to be the recipient of pricing which is much more reflective of the risk and cost of the balance sheet. We are starting from a position of adding as opposed to subtracting, and at the right price.”

**Managers might need to cull their prime brokers**

JP Morgan recently published a white paper on the impact of regulation and how managers might need to reassess their PB relationships. In the paper, they write:

“Managers should understand in detail the holistic value of their relationship with the prime broker’s organisation, considering all elements of wallet allocation – long and short financing – along with the non-capital/ balance sheet consumptive services such as custody and fund administration as well as execution. This may necessitate a review of service providers resulting in a concentration of the total wallet amongst a smaller group of banks that provide the full service suite of investor services.”

Much of the media debate is through the prism of the prime brokers and how they need to adjust to Basel III but hedge funds themselves need to reassess their PB relationships. In the paper, they write:

“As managers themselves get more efficient and realise they are getting less from their prime broker(s) overall they will become more particular about who they work with,” says Radi Khasawneh, author of the TABB Group paper.

“There still isn’t enough independent data available on transaction cost analysis (TCA) in equities and fixed income. But if you talk to highly leveraged hedge funds – the Citadel’s and Renaissance Technologies of this world – they need a clear idea of how the cost of trading will affect the strategy to optimise the way they trade with their PBs. They’ve been doing it for years. The point is, everyone else is going to have to run to catch up.”

To that end, Khasawneh does not think it is a negative that primes are culling hedge funds because the industry needs to go through “a period of right-sizing”.

“In the fixed income markets, with OTC clearing and the electronification of trading, it’s all about efficiency. I don’t get the sense that anyone within the prime brokerage space has found an answer yet to achieving greater efficiency,” opines Khasawneh.

**A fragmentation of the field: more specialist PBs?**

One might well find that as primes focus on how to deploy their balance sheet more strategically that they become more
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Prime-of-Prime service launched for institutional investors

Interview with Charalambos Psimolophitis

FxPro Financial Services Limited (‘FxPro’) has launched a Prime-of-Prime service in a bid to attract institutional investors and enable them to benefit from greater transparency and trading cost efficiencies. With FxPro Prime, hedge funds, in particular start-ups (as well as other asset managers), will be able to trade against the high quality liquidity pool that FxPro has across 11 liquidity providers and avoid having to establish prime brokerage relationships.

“Those initial set-up costs can be high, the manager has to put up a lot of collateral, making it quite inaccessible for start-up funds or small operators. The way a prime-of-prime service works is that we have the established relationships. The client then deals with us for everything from collateral, to give-ups and trade reporting,” says Charalambos Psimolophitis, CEO of FxPro.

The 11 liquidity providers FxPro currently uses, including the likes of Goldman Sachs and Nomura, are used to taking their retail flow. Consequently, the trade rejection rates are very low. With FxPro Prime, institutional investors will now be able to interact with that unique and high quality retail liquidity.

FxPro moved from a being a market maker to an agency model broker in 2012; something that was important to Psimolophitis, who says: “We believe that the industry in general should push towards the agency model, especially in FX, because there are huge conflicts of interest when you are a market maker. As we believe in the model, we’ve invested a lot of capital over the last couple of years and have created one of the best aggregation engines. We can give hedge funds, and other institutional investors, very competitive prices.”

Not only are clients’ interests more closely aligned with FxPro Prime, the cost efficiencies are enhanced, as well as margining requirements.

In general, a hedge fund would have costs of approximately USD50-60 per USD1m traded. With FxPro Prime, the overall cost is around USD35-50 per USD1m traded; a near 30 per cent cost reduction.

“Suppose you’re a hedge fund trading EUR100m of EUR/USD. You would have to post 2 per cent margin to the prime broker to hold that position because it’s a directional trade, requiring the bank to take the opposite position. In our case, the manager’s trade is netted off against other clients’ trades and would require them to only post 1 per cent margin.

“Also, because the bank is the market maker, if a hedge fund is not trading much or in an unconventional way, the result can be a gradual widening of the spread to the point where it’s no longer profitable for the hedge fund. Since FxPro has so many LPs and considerable flow coming from many different clients, our spreads would not widen in the same way,” says Psimolophitis.

The aim is to have at least 20 liquidity providers supporting exotic currency pairs as well as all major currencies. “We are also working on a sophisticated reporting tool that will allow the counterparty to have all their liquidity exposures presented in real time; at the millisecond level. We hope to launch that in February,” confirms Psimolophitis.

“We want to see greater adoption of the agency model so that brokers no longer trade against their clients. We now offer the ability for hedge funds, asset managers etc, to leverage off our technology and relationship with the banks via FxPro Prime.”
specialist, rather than generalist. Firms like Newedge, for example, have a leading reputation for supporting CTAs and global macro strategies.

“Regarding specialisation, I think banks would have a much easier time leveraging their resources and capabilities by doing more within fewer business lines; the cost effectiveness would be clear. What that might actually mean is that they won’t be able to service the entirety of an account. If they decide to no longer provide financing on certain securities or no longer accept certain assets as collateral, what will that mean for managers running multi-strategy funds with both an equity and fixed income component?” comments Seibald.

Khasawneh thinks that the general premise of prime brokers becoming more specialist is possible, but notes that the core strengths of the largest and most successful primes are vast.

“Large primes can still offer everything to everyone, even if they do retreat to their core strengths. They have the capacity to service everyone but it will still allow niche players who wish to operate and specialise in a certain area.

“We’ve seen that happen in the US treasury markets with smaller dealers moving in to compete with primary dealers by specialising in a specific area of the yield curve or in specific instruments.

“There’s similarly a real service opportunity in prime brokerage for firms who have regional strengths or preferred strategies they like to service on the financing side or custody side. You’ll see a fragmentation of the service offering which will make things interesting,” comments Khasawneh.

“If you think about what the intention of some of these new regulations are, like what’s come out of Basel III, it’s to take away concentrated risk from a small number of counterparts and spread that risk to a wider audience of potential players. It’s creating a scenario such that whereas previously all the risk was concentrated in a small number of tier one primes, that risk is beginning to spread to other participants in other regions. It’s analogous to 2009 when managers wanted to spread their counterparty risk.

Concept Capital’s Jack Seibald on rising costs

“I think securities lending and financing costs to hedge funds will go up irrespective of whether benchmark rates go up or not. The more important point to make, however, is not whether rates will go up but that spreads will widen. The banks are going to require a wider spread on the lending they engage in.

“When rules are written by regulators in the aftermath of crises they’re not necessarily thinking through the potential consequences of those rules and what it may mean for markets. Those investors who engaging in short selling are:

• Providing an important source of liquidity to the market
• Providing a counterbalance to those who are long-only.

“Regulations will simply make short selling more expensive and there could be a myriad of unforeseen consequences for the markets in terms of liquidity and how they function.

“I’m sure a lot of large hedge funds are actively going through internal discussions with their primes to understand all of the implications because they need to be prepared. They can’t just wake up one day and start operating under a whole new set of rules. I’ve been around markets long enough to know that when you change the rules by which the markets function, it will have an impact, and it won’t be immaterial.”

“I think we’ll see a growing number of new entrants providing balance sheet or collateral in line with their particular area of specialty. I think the days of building universal platforms to service everyone are gone,” states Stracquadanio.

Chanod confirms that PrimeOne Solutions is actively working through the analysis phase of some tier one primes’ infrastructure and providing potential solutions to solve their cost and efficiency issues.

“They recognise that something needs to change. We can simply craft our solution to their needs in a very quick period of time and the cost savings, in our evaluations, have been so impressive for them that saying they are excited by the opportunity is an understatement,” enthuses Chanod.

ABN AMRO Clearings’ Le Treut concludes with the final thought on the opportunities ahead: “You need to grow in small steps. Work with the strategies you are good at supporting and which fit your business model. I believe we will see more of a return to cash PB, specifically for us where we can demonstrate full transparency on asset segregation and margin protection. The days of Lehman where nobody knew where the assets and collateral were are over now that we have AIFMD and EMIR.”