The evolution of the prime brokerage model

Challenges & opportunities

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Fresh challenges for prime brokers in era of low leverage

By James Williams

For the prime brokers on whom hedge fund managers rely so much on, there’s not been a huge amount to shout about in 2011. Trading volumes are down and leverage is stuck at modest levels of 2.1x to 2.4x (compared to 4x leverage prior to 2008), despite record-low financing costs. It’s fair to say that 2011 hasn’t exactly been a halcyon year for prime brokers.

“Less leverage means lower balances, which drive prime brokerage revenues,” says Glen Dailey, Managing Director and Head of Prime Brokerage at Jefferies.

This is a business where margin levels are tested at the best of times, let alone those when political inertia in the eurozone conspires to push fund managers to the sidelines. “None of the managers that we speak to have been asked by their brokers to reduce risk,” explains Patric de Gentile-Williams, COO of FRM Capital Advisors.

Sovereign debt problems, and a ban on financial stock short selling by the likes of France and Italy in August led managers to begin shifting assets to other regions. Within this bearish climate, however, securities
lending levels have increased. Two big trends have emerged this year. One has been the shorting of European government bonds and corporate bonds, the other has been a marked increase in shorting China stocks listed in Hong Kong.

Tim Wannenmacher, Head of Prime Services, APAC, UBS Hong Kong, estimates that there’s been approximately “a 20 per cent increase year-on-year in the bank’s Asian securities lending business”, noting that demand mainly has come from global equity I/s managers and, to a lesser extent, multi-strategy managers.

Although market volatility has been tough on money managers, Jefferies, the New York-based prime brokerage, has seen trading volumes spike at times this year. “As a broker, volatility increases trading volume so certainly months like August were record months for us from a transaction standpoint. Our business continues to grow and a lot of that comes from the transaction side, the commission side,” explains Dailey.

For China, there are a couple of reasons why shorting volumes have increased. First is the questionable accounting standards which led to stocks like Sino Forest getting hammered. Second is the risk of a China hard landing if the global economy slows down – bears like Jim Chanos have long criticised China’s burgeoning real estate market.

“Short sellers looking at China themes have to take into consideration where government spending policy is going. Sectors like industrial, technology, shipping, basically all the big macro-themed sectors that are affected by growth in the US and Europe – these are all potential targets for short sellers,” explains Dan Sofianos, Equity Finance Sales Trader, UBS Hong Kong.

Sofianos said that in some cases there’s been a fivefold increase in shorting volumes. “Within China’s H share market there’s been a concentration of interest from managers in financial firms due to tightening capital requirements and non-performing loans. We would say that interest in shorting financials is up 50 per cent on last year. The H share market is quite liquid so it’s popular with managers as a macro play,” he said.

Ben Sofoluwe, Head of Securities Lending, Deutsche Bank says the sector that’s come under the most pressure has arguably been the alternative energy sector, citing global macro concerns but adding that government subsidies, which commenced several years ago, are starting to expire. “It’s by far the heaviest shorted sector and we expect that to continue into 2012,” says Sofoluwe. By contrast, managers have been going long healthcare and utilities sectors.

Capital introduction has become an important value-add service to prime brokerages. Raising funds has been tough this year, and as with 2010, the trend continues to be one of assets flowing to the biggest and best managers. Recent figures by Hedge Fund Research show that net inflows this year are USD70.7 billion. Nine funds alone have attracted 38 per cent of that money, with London CTA Winton Capital enjoying a 10 per cent slice of the pie. As Emma Sugarman, global head of capital introduction at BNP Paribas, New York, told Bloomberg succinctly: “It’s been a tough slog.”

Mairead Kenny, head of European capital introduction at Bank of America Merrill Lynch, takes a cautionary stance on these figures: “If you look at AUM numbers in the industry they vary from USD1.9 trillion up to USD2.5 trillion so it’s hard to ascertain precisely what percentage of inflows a hedge fund or hedge fund strategy is capturing.”

Certainly the industry is getting more polarised. There’s less career risk for institutional investors choosing established managers, it’s easier to get such investments approved by the board of trustees.

However, Kenny observes that there has been renewed appetite for start-up managers amongst FoFs and family offices, as well as a resurgence in seeding vehicles over the last 12 months.

“Mathematically, many allocators limit the maximum percentage they wish to be of a
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The tumultuous events of the eurozone debt crisis, which sent the markets into a tail spin this summer, have caused a lot of headaches for investment professionals. But for HSBC’s Prime Services offering, which launched around the time of Lehman’s imploding, this year’s volatility has actually been playing right into its hands.

This has, in large part, been down to investors and managers alike scrutinising the strength of prime brokers’ balance sheets, and more importantly, determining whether their assets are being held somewhere safe.

“We launched Prime Services in response to client demand really. Hedge fund clients we knew were asking us to step into the void, post Lehman’s, and offer them a custody-based solution. Investors were nervous, as were the managers,” explains Chris Barrow, HSBC Prime Services’ global head of sales.

Prime Services evolved out of the HSBC Bank global custody platform, a custodian in 96 global markets. This allows the bank to offer a fully integrated ‘prime custody’ solution, the two businesses sitting side by side under the HSBC Bank Plc umbrella.

Concerns over counterparty exposure have ebbed and flowed the last couple of years but as Barrow notes: “With the eurozone crisis rumbling on and becoming more of a worry, counterparty credit and the issue of protecting clients’ assets has moved to the top of the agenda. We’ve seen a clear increase in interest.”

Currently, Prime Services has more than 50 global fund managers going through the onboarding process and putting a structure in place.

As well as offering all the usual prime brokerage services – leverage, financing, securities lending, market access, trade execution – Prime Services provides segregated accounts for client assets as part of its global custody offering. It is not, therefore, a standalone custodian like BNY Mellon for example. “Within segregated accounts we only need to take a charge on client assets as and when they build up exposure on the trading side and we start lending them money,” notes Barrow.

Bigger multi-billion dollar hedge funds typically have separate custody arrangements but this requires the broker and custodian to efficiently move assets back and forth on clients’ instructions. “What we can do is offer both those services with HSBC. It’s a more streamlined operational process,” says Barrow.

He adds that today’s eurozone pressures, which started as a country debt issue, are migrating into the banking sector and that what we’re now seeing in the market is a capital and liquidity squeeze, which is being further exacerbated by regulation. Basel III and the FSA’s liquidity regime are increasing capital and liquidity ratio requirements and “putting more stress on the free flow of funding. That’s also affecting hedge funds in terms of managing their own balance sheets.”

A strong balance sheet, then, is probably more important to prime brokers than ever before. Barrow considers it a huge factor: “Aside from performance, which is important, I believe that’s investors’ primary concern. Investors are more closely looking at the balance sheets of their prime brokers.”

“They want to know: is my broker going to receive stable funding during times of stress? Are they confident the terms of their margin or swap financing are going to be consistent? I think there’s a lot more focus now on stability of funding and liquidity rather than price of funding and liquidity.”
fund’s assets, so those that write big tickets need to allocate to larger funds. However, there’s also now a considerable number of tickets being written to smaller funds,” says Kenny, with Charlotte Burkeman, head of EMEA prime brokerage at Bank of America Merrill Lynch, adding: “They might write a ticket for USD300million so it’s hard for a small fund where you can only allocate perhaps USD20million. However, the number of tickets being written to small funds overall seems to have grown.”

The more a prime brokerage can leverage off existing institutional relationships, for example in private banking, asset management, and match them up to managers the greater is the potential for them to grow their assets. It’s a symbiotic relationship. Both the manager and broker have vested interests.

Although the start-up market has not traditionally been an area of focus, Burkeman says it is something that they are increasingly more focused on: “It’s definitely something we’re focusing on more because we believe it’s important to be there to support managers early on. This is increasingly true as many managers are now starting with a full compliment of prime brokers so the opportunity to be added later has diminished. We’ve won a good number of start-up mandates this year. The pipeline for next year is very strong and we’re working with several that we expect to start with USD500million+ next year.”

One of its newer clients is London-based Skyline Capital Management, a global equity l/s specialist with a specific focus on emerging markets established by Geoff Bamber and Vernon West last year. As the firm’s COO, Andrew Brown, comments: “Some prime brokers are better set up to deal with smaller funds and start-ups. We want to work with people that understand what it is to be a small but fast-growing fund management business. They’ve been excellent with us at every stage.”

As for where the smart money has flowed this year, Kenny notes that assets have been going to managers who can play volatility effectively. Those running global macro and CTA strategies have, like 2008, seen an upsurge in interest. “Quantitative strategies such as statistical arbitrage have also

“The number of tickets being written to small funds overall seems to have grown.”

Mairead Kenny, Bank of America Merrill Lynch

been doing very well and interest in them is at levels we haven’t seen for a while,” observes Burkeman.

Generating alpha is the key priority for hedge fund managers. To that end, they expect their brokers to provide market access solutions in order to gain exposure to hard-to-access securities, particularly in emerging markets. Consequently, synthetic prime brokerage (Delta One desks) is gaining in popularity. UBS’s Wannenmacher notes that the use of synthetic equities solutions continues to grow in Asia: “We’ve seen trading volumes growing for us as a firm but also for the market at large.”

Swap counterparties like hedge funds favour synthetic equities because not only do they enjoy the benefits of ownership, without actually having them sit on their balance sheet, but also because of the lower costs involved e.g. no transaction costs. Wannenmacher comments that if you want to be a full-service prime brokerage “you have to offer a seamless solution across synthetic and cash prime brokerage. Pre- and post-trade execution, securities lending and value-add services have to be exactly the same. They’re an integral part of our offering and there should be no obvious difference in terms of cost and availability.”

The only caveat to that is if the prime broker is unable to source the securities and needs to go to another bank, in which case trades are executed at slightly different prices.

Hedge funds push the envelope when it comes to finding the next best trading idea. As they look towards less transparent markets, the reliance on synthetic equities is likely to see more prime brokers ramp up these services.

HSBC Prime Services is doing precisely that. “We’re launching our synthetic prime offering in the US in January 2012 called Prime Swap. We’re conscious that 70 per
financing, stock borrowing and market access products.

As to what is the current challenge facing prime brokerages, Wannenmacher opines: "We believe counterparty strength and the ability to fund hedge funds in a stable and reliable way and access to the entire capital markets business are the most important considerations for choosing a prime broker today."

He adds: "The demands on our services continually change in response to client needs, market regulation, Basel III capital requirements etc. It’s important as a prime broker to partner up with hedge funds you think can be important to you, and that you can be equally important to them. The prime broker is your access point to the entire firm – that’s the real value proposition to fund managers and one that UBS can offer."

Heitsenrether echoes Wannenmacher’s point on funding: “I think capital and a strong balance sheet are going to be paramount because it’s those brokers who are going to be able to support activity and be there consistently on the financing side. The ability for managers to have access to balance sheet is going to be key.”

JP Morgan acquired Bear Stearns’ prime brokerage business in 2008 and this year rolled out its operations in Europe. Teresa Heitsenrether, head of EMEA prime brokerage, is very much taking a long-term view and isn’t too concerned at launching the business in a year when leverage is down and balances are off. She’s confident that conviction will return. When managers start putting money back to work “we’ll be part of the equation”. Consequently, there’s been no kneejerk reaction to get managers onboard quickly to scale up the business.

“We’re not worried. We have the strength of balance sheet that affords us to take a long-term view, we’re not under any urgency or pressure in that respect, we only want to bring on business that makes sense to us,” explains Heitsenrether.

HSBC’s Barrow adds that key revenue drivers this year have derived from custody, financing, stock borrowing and market access products.

“Centralised clearing is going to be on interest rate swaps initially. I think we’re two, three years’ away from equity swaps being centrally cleared so long term I think we’ll benefit.”

Glen Dailey, Jefferies
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Two of the more obvious trends that have occurred in prime brokerage post-Lehman’s are perhaps, unsurprisingly, intrinsically linked to counterparty risk. The first is the move away from mono-prime to multi-prime mandates. The second, more recent trend, is the growth in prime custody solutions, accelerated in part by the likes of HSBC and JP Morgan, both colossal global custodians, entering the prime brokerage arena.

Both trends are rooted in a common objective: to minimise counterparty risk. The fact that MF Global imploded last month, amidst allegations that client accounts were being used intraday for its own trading purposes, put the spotlight on how safe exactly client’s assets are. Some rumour mongers began targeting mid-tier investment bank Jefferies, who responded swiftly by cutting their exposure to Club Med debt securities by half.

The firm’s prime brokerage business has had a clearing partnership with JP Morgan since 2008 and gives its clients the option of putting their assets in custody with the tier one investment bank, should they wish. “We’ve called clients and said, ‘look, with all this noise, if you’re uncomfortable let’s move
your assets over to JP Morgan’. We have nothing to hide, we don’t want to sit there and just say ‘trust us, don’t worry’. That’s the worst thing you can do. We just said to clients ‘you can do this, it’s your choice’, and we’ve had lots of people thank us for telling them,” explains Jefferies’ Glen Dailey.

Hedge fund managers, who pride themselves on adept risk management, are increasingly looking to segregate their assets and it’s a trend that Citigroup’s Mark Harrison expects to see continuing into 2012.

“Every prime broker has to be able to offer some kind of custody solution. Asset protection and segregation is something every manager is focused on,” says Harrison. “We have significantly more money held in client money segregated accounts than we did last year.” The other trend being observed, he says, is that managers are keeping limited cash with the prime brokers, pooling it centrally either through money market funds or a custodian.

That’s not to say that all hedge fund managers are segregating assets with their broker or third party custodian. These things cost money. Global billion-dollar funds are more likely to use several prime brokers and a separate custodian. A start-up fund will stick with one prime broker and probably won’t even choose to segregate assets until it reaches critical mass of say USD100million. Also, highly levered funds that use all of their assets have no particular need for prime custody.

Prime brokers that offer full segregation of assets via prime custody under one brand are no doubt able to structure more competitive pricing than a third party custodian but it’s another tier of risk management that most start-ups probably can’t afford.

According to Teresa Heitsenrether at JP Morgan, recent market dislocations have heightened interest in prime custody: “We think it’s an essential part of the offering and comes up regularly in our discussions with clients.”

By leveraging its global custody platform, JP Morgan integrates its prime brokerage service in Europe with its prime custody service, using a completely separate set of reporting which helps ease the operational burden on managers. And this goes back to the issue of cost. As Heitsenrether explains: “The concerns we hear most frequently from managers are the increased operational challenges and the costs of using a third party custodian.”

Although prime custody assets in Europe are relatively small at present, Heitsenrether reckons that AUC in its US custody solution, which has been up and running since the Bear Stearns days, “has seen a fivefold increase” this year.

Increased client segregation suggests that re-hypothecation levels are falling, given that prime brokers can’t touch the assets. Post-Lehman’s, it’s become a far more transparent issue. Up until last year, prime brokers didn’t have to fully disclose what they were re-hypothecating. Then the FSA proposed introducing a requirement “for contractual re-hypothecation provisions to be summarised in a disclosure annex attached to each PBA (Prime Brokerage Agreement)”. Now, all prime brokers have to show exactly what’s being re-hypothecated. That’s an encouraging trend.

Some prime brokers like Citigroup are now capping levels with Harrison confirming: “We have a policy that we’ll only ever re-hypothecate up to 200 per cent.” In the US, it is capped at 140 per cent.

One prime brokerage executive, who asked not to be named, emphasized that they were transparent on what would realistically be re-hypothecated and what impact that would have on a manager’s pricing.

Certainly, managers better understand the economics of the business and aren’t pushing for 100 per cent – or no exposure – because by doing so pushes up prime brokers’ costs of funding. Anything less than 140 per cent has cost implications.

Richard Frase at Dechert LLP agreed that managers are monitoring this activity more...
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Technology solution supports demand for managed accounts

Interview with Mike Rosen

The outsourcing of middle- and back-office services as well as increased demand for better technology in areas such as portfolio analytics, performance measurement and risk management are key trends that Concept Capital Markets is continuing to focus on.

As the firm’s senior managing director, Mike Rosen, explains: “These are the things we’ve been focusing on as a company in an effort to help our clientele meet the needs of the investing community, in particular institutional allocators.”

Post-trade analytics is one area the firm has been enhancing throughout 2011. The technology it uses can take Fix drop copies from any execution management system in the marketplace and aggregate all that data onto one screen on a real-time basis, explains Rosen. This enables a firm to take files from any custodian and upload onto the system, making for a highly efficient tool because as Rosen says, “you have the ability to more effectively run assets across multiple custodians and use multiple trading tools to do business.”

Concept Capital does not itself custody assets, but is instead an introducing broker, working with a number of leading global custodians. “However, our technology is set up so that we can deal with assets that are held in custody anywhere,” explains Rosen, adding that the firm’s prime brokerage business works with around five custodians. ConceptONE, the firm’s technology affiliate, deals with 20 to 25 different custodians, aggregating data for each of them.

Prime brokers with the strongest balance sheets are likely to dominate the space going forward but that’s not to discount smaller brokerages with a technology edge. “Increasingly you’ll have companies like ours that have the technology and trading capabilities to deal with assets regardless of where they’re held in custody,” suggests Rosen.

“Our vision is to be able to deal with any type of asset class within any type of trading strategy on one side, and on the flip side be able to deal with anywhere those assets need to be cleared and put into custody. Ultimately our goal is to fulfil managers’ needs and help them perform better.”

Another key trend this year has been the increasing number of managed accounts. “A lot of the work we’re doing on a portfolio management and risk basis is to service those managed account entities. It’s an area in which we’ve seen specific growth. Ultimately, we end up being the intermediary - we have to deal with each separate manager, provide them with the information necessary to do their job, but we also have to provide all the information to the allocator so they can effectively monitor what’s going on in each sub account.”

Rosen thinks the growth of managed accounts and multi-custody solutions will continue for the foreseeable future, particularly in light of what’s happened with MF Global. The inability to move assets quickly to a custodian presents a huge business risk. “If you’re not set up with multiple custodians and don’t have the ability to trade assets across those custodians, you could get stuck. It makes sense for certain investors to control their assets in managed accounts. Companies like ours can provide all of the tools necessary to do this in a cost-effective fashion.”
“Multi-prime seems to be more of an option than it used to be but for a start-up the important thing is to get a prime broker who takes you seriously and you can work with.”

Richard Frase, Dechert LLP

12 closely but stressed: “Generally, the prime broker will say that anything below 140 per cent will cost more, and at this point the manager settles for 140 per cent.”

A fund’s returns, re-hypothecation limits and term structures are all elements of pricing a prime broker needs to consider. As for the managers themselves, selecting a prime broker they’ve already worked with plays a big part in the selection process and typically leads to more favourable cost terms.

Andrew Brown, COO of Skyline Capital Management, which launched last year, confirms that the founding team came from existing institutions. “For the prime brokers, they know who they’re backing. Two of the three prime brokers we short-listed were actually institutions the founding partners had come from.” He added: “We wanted to build relationships that didn’t just sit in the prime brokerage space but could be leveraged across various parts of the institution.”

Multi-prime is a well-established model today but this is just one of several prime brokerage models available. The common denominator is size of assets. Start-ups with less than USD100million go the mono-prime route, well-established funds with assets north of USD100million will likely choose two or three brokers, whilst the giant billion-dollar funds have multiple prime brokers and separate custodians.

Prime brokers are happy to be the second or third choice, provided the manager is doing meaningful business. It’s all about having enough skin in the game. As UBS’s Tim Wannenmacher posits: “How many brokers do you need before you spread yourself too thinly?”

“The age of the sole prime broker is not totally over but multi-prime is being driven by fund managers’ concerns with counterparty exposure, as well as investors. They want to see diversification and every round of due diligence they do with a fund, they’re going to ask that question,” comments Harrison.

Prime brokerage accounts are not cheap to service. A broker will think nothing of shutting an account if it’s not being used properly. Harrison says the objective is to be the ‘prime’ prime broker, of which Citi has a top 20 of clients in this category. There are clients who building and some who don’t currently do a lot but he says they keep them on the books “because we want to grow the relationship”.

“Multi-prime seems to be more of an option than it used to be but for a start-up the important thing is to get a prime broker who takes you seriously and you can work with,” says Frase. Even though Skyline Capital Management currently uses one prime broker, this might change moving forward as the firm grows.

“It’s a trade-off between managing counterparty risk and the cost of doing that. Our intention is to add another prime broker with time but our priority at present is to keep fees in the fund as low as can be. Multi-prime needs to be a model you can support viably,” says Brown.

Heitsenrether believes fund managers are being thoughtful and understand they need to be relevant to the institution. “Some managers that are already diversified are reassessing that mix and thinking that diversification needs to be realigned because the world has changed.”

When Basel III comes into effect, banks will need to increase their tier one capital ratios to 4.5 per cent, with up to a 2.5 per cent countercyclical buffer. Leverage levels are at historic lows and overall fund performance has been quite poor in 2011. Add in the technology costs and the question arises: How much pressure are prime brokers’ margins under?

Patric de Gentile-Williams, COO of FRM Capital Advisors, the hedge fund seeding

“How many brokers do you need before you spread yourself too thinly?”

Tim Wannenmacher, UBS Hong Kong
arm of FoF firm Financial Risk Management, has seen prime brokers becoming more ruthless about profitability. Many have culled relationships and refused to do business with smaller managers, leading to the emergence of mini primes like BTIG, Merlin. De Gentile-Williams notes that because banks’ own financing costs have gone up things like netting have become history.

“That’s now become much harder to get, you have to be a pretty valued client to get that.”

Multi-prime reduces prime brokers’ business volumes with hedge funds, but perversely, it also reduces a manager’s ability to get attractive pricing. “I don’t think the main players are any more aggressive than they were but it’s probably harder for managers to get more attractive terms,” notes de Gentile-Williams.

Under increasing pressure to show a return on capital, it’s likely prime brokers will put greater focus on the profitability of hedge fund clients. Some will have to decide whether it’s worth staying in the game - this year has already seen Mizuho Securities close its Singapore prime brokerage operation in April this year.

More could feasibly follow if they’re not fully committed to what is a continuous investment process. “If you don’t have the scale I think it would be hard on the margin to compete and be profitable. If you’re a mini prime it’s more of a challenge,” opines Heitsenrether.

Dailey thinks there’s room out there for a handful of mini primes although admits one or two might go by the wayside. “I said two years there were too many brokers, there’s probably room for 12 and I think we’re pretty close to that number. Whether there’s one or two that consolidate moving forward I’m not sure.”

The way prime brokers finance hedge funds under Basel III will surely have to change. One undisclosed source says he’s ‘dumbfounded’ by the rates that universal banks currently finance hedge funds, claiming it makes no economic sense. “I don’t know how these banks are lending billions of dollars at 25 basis points. It’s been a race to the bottom,” he says.

“I think any reasonable person would say that the rates universal banks charge hedge funds, which are ridiculously low because of market competition, have to rise,” adds Dailey.

“Some managers that are already diversified are reassessing that mix and thinking that diversification needs to be realigned because the world has changed.”

Teresa Heitsenrether, JP Morgan

“I think the market will continue to improve pricing structures to more accurately reflect the liquidity of the underlying assets and the tenor of the financing. The anomaly of getting term financing at an overnight price is not sustainable,” comments Heitsenrether. She says that JP Morgan is talking with its clients about the need for a lock-up and what denotes an appropriate lock-up given the construct of a manager’s portfolio. “You don’t want to pay for more than you need or leave yourself too short either. We’re having constructive discussions with clients on the term structure of that pricing. Most managers have the foresight in an environment of increasing capital requirements and shrinking balance sheets to understand that not having these kinds of discussions might actually be cause for concern,” she says.

De Gentile-Williams adds: “The growth and ‘market share at all costs’ approach has been replaced by a more forensic approach to the bottom line.”

With AIFMD, Basel III and a raft of other regulation in the pipeline, the next challenge for prime brokers will be how they adapt to these conditions, whilst at the same time ensuring margins remain strong and quality of service remains first-rate.

“There may be more partnering between prime brokers and the big custodians,” suggests Frase. “Smaller players are always moving in and out of the market but I imagine the AIFMD will discourage them from moving in.” The potential liability costs simply won’t be worth it.

“Regulation is definitely a challenge moving forward. It’s something we spend a long time on, understanding it and making sure we’re aligning our business correctly with it,” concludes Harrison.