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Prime Brokerage

Basel III Raises Prime Brokerage Costs for Hedge Fund Managers

Feb. 18, 2016

By Vincent Pitaro, *Hedge Fund Law Report*

Prime brokerage relationships are a critical source of financing and other services for hedge fund managers. See "Factors to Be Considered by a Hedge Fund Manager When Selecting a Prime Broker" (Dec. 4, 2014). However, as revealed in the survey report, entitled *Accessing the Financial Power Grid – Hedge Fund Financing Challenges Under Basel III and Beyond* (Report), released by the Alternative Investment Management Association (AIMA) and data and analytics firm S3 Partners (S3), regulatory requirements – particularly those around capital and leverage – are causing prime brokers to raise financing fees and to be more selective in choosing clients. As a result, hedge fund managers may have to think more strategically about the value they offer to prime brokers; opening an account and depositing assets may no longer be sufficient. In their survey of 78 asset managers, AIMA and S3 explored the effect of Basel III and other new regulations on prime brokerage relationships with hedge fund managers. This article captures their key findings. See also "Barclays Predicts Increased Financing Costs for Hedge Funds Due to Regulatory Changes Affecting Prime Broker Financing" (Oct. 18, 2012).

Survey Methodology and Demographics

AIMA and S3 conducted a survey of asset managers (Survey) in August and September 2015. They asked 26 questions about the impact of regulation on prime brokers and their counterparties and related matters. Responses to those questions were supplemented by one-on-one conversations with respondents and a round table discussion with private fund managers.

The respondents included 78 alternative asset managers with assets under management (AUM) ranging from less than $100 million (13% of respondents) to over $10 billion (15% of respondents). The largest segment of respondents (32%) had between $1 billion and $5 billion in AUM. The Report indicates that responses were generally consistent across the size spectrum of respondents.

Just over half of respondents were U.S.-based. Nearly one-third were based in the U.K. The rest were drawn from the Asia-Pacific region; continental Europe, the Middle East and Africa; and Latin America.

Respondents pursue a broad range of strategies, the most common being equity long/short (21 respondents) and multi-strategy (15 respondents).

Impact of Basel III

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In response to the 2008 global financial crisis, regulators sought ways to reduce systemic risk. Commencing in 2011, the Basel Committee on Banking Supervision (BCBS) adopted a comprehensive set of reforms, commonly known as "Basel III," aimed at improving banks' risk management, transparency and ability to withstand financial shocks.

The Report highlights several of the key components of Basel III and how those features will affect banks:

- Leverage constraints may cause some banks to shift "balance sheet capacity" away from prime brokerage.
- Minimum liquidity requirements, implemented through liquidity coverage ratios and net stable funding ratios, may increase funding costs and make it more difficult to fund less liquid strategies.
- Minimum capital and risk coverage requirements will also increase financing costs and limit both balance sheet and off-balance sheet availability for client business.

The Report also points out that prime brokerage activities will be affected by other regulatory developments, such as the Volcker Rule and the total loss-absorbing capacity standards for globally systemically important banks adopted by the BCBS and the Financial Stability Board. The combined effect of these measures, according to the Report, is to "put a 'squeeze' on the availability of capital, funding and balance sheet capacity . . ." which will "shrink dealer liabilities, reduce proprietary or principal trading inventories of banks and substantially limit trading flows." See "Grant Thornton Broker-Dealer Industry Symposium Focuses on Capital Requirements, Fiduciary Standards, the JOBS Act, the Volcker Rule and Use of Social Media" (Sep. 6, 2012).

Critically, banks are focusing on the effect that prime brokerage and other business activities have on their return on assets (ROA) and return on equity (ROE). As a result, asset managers must "increasingly . . . understand, assess, and attempt to monitor or adjust their ROA/ROE 'footprint' with their various counterparties in order to maintain access to the financing 'power grid' and manage their overall cost of doing business."

The Report concludes that asset managers should seek better data from prime brokers concerning their impact on the brokers' ROA/ROE; seek to standardize terminology regarding finance and collateral management; and develop analytic tools to help them optimize their relationships with prime brokers. See also "Ernst & Young Report Explains How Prime Brokers Select, Onboard and Charge Hedge Fund Clients" (Oct. 11, 2013). The Report summarizes the Survey's key findings.

Key Survey Findings

Regulations Have Increased Financing Costs

Half of respondents indicated that their financing costs had increased in the past year, including one-quarter whose costs had increased by more than 10%. Three-quarters expect such costs to increase in the next two years; most expect an increase of more than 10%.

The respondents indicated that the relative cost of various finance tools had not changed, with the exception of repurchase agreements (repos), which had become relatively more expensive. The respondents also noted a reduction in capacity for fixed income custody and settlement services. See "Ernst & Young's 2015 Global Hedge Fund and Investor Survey Probes Hedge Fund

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Growth Priorities, Fee and Expense Climate, Prime Brokerage and Operational Matters" (Dec. 3, 2015).

Asset Managers Lack Understanding of ROA/ROE Calculations

As indicated above, AIMA and S3 believe that a manager should be cognizant of how its business will affect a bank's ROA/ROE. Not even one-quarter of respondents said they understood how banks calculate ROA. Even fewer said they had all the data necessary to calculate ROA. Most respondents (79%) "did not provide an estimate of ROA . . ."

AIMA and S3 encourage asset managers to seek data to enable them to calculate their ROA/ROE "profiles," as this will affect the willingness of prime brokers to do business with them and broker pricing. For more on prime brokers' return on capital, see "Interest Rate Swap Compression for Hedge Fund Managers: Mechanics, Fee Savings, Risk Consequences and Regulatory Context" (Feb. 26, 2015).

Regulations Have Changed How Asset Managers Do Business With Prime Brokers

Three-quarters of respondents said they had been asked to change how they do business with their prime brokers. The key drivers of change were ROE and profitability, rather than risk reduction.

More than two-thirds had been asked to reduce cash balances. One-third had been asked to "move a portion of their book to swap" and/or change the type of collateral posted. Other requested changes, cited by 5% to 15% of respondents, included terminating the relationship, reducing leverage, using "easier to finance securities" or increasing portfolio turnover. The Report notes that, paradoxically, banks' ROE/ROA and U.S. regulatory considerations make them less likely to accept cash as margin on swaps.

Settlement and Securities Lending Top List of Important Prime Brokerage Services

Nearly all respondents indicated that settlement and custody (99%) and securities lending (97%) were "very important" or "important" prime brokerage services. From 93% to 84% deemed the following, in descending order, to be important: clearing, reporting and technology, synthetics, asset servicing, execution and margin finance. Roughly 80% cited collateral management and/or reconciliation; about 70% cited research and/or repos. At the bottom of the list, cited by from 63% to 53% of respondents, were corporate access, capital introduction and consulting. The Report cites anecdotal evidence that clearing services have become more difficult to access.

Disparate Understandings of Finance and Collateral Management Terminology

There was considerable variation in how respondents described certain common terms used in securities finance and collateral management: about nine out of ten respondents described "reconciliation" to include positions and/or cash balances; two-thirds said it includes trading activity; just under half enumerated interest accruals, margin and/or fees; and only about one-third cited security pricing and/or commissions.

"Collateral management" also drew disparate responses, with 60% saying it includes "movement, settlement, tracking and collateral account maintenance." Just over half cited managing cash and

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margin requirements. Others cited minimizing finance cost/maximizing finance revenue (43%) or forecasting collateral needs (32%).

There was even less consensus over "collateral optimization." The greatest number (48%) described it as posting the minimum collateral needed to meet margin requirements. Forty percent said it was allocation of collateral based on a "multi-factored algorithmic and subjective model." Roughly one-third cited either cost of collateral or quantity/eligibility of collateral. Even fewer referred to minimizing postings or transactions (26%) or diversification (17%).

AIMA and S3 call for "greater consistency across managers/funds around the nomenclature and protocols of collateral management/optimisation to create a 'win-win' for them and their counterparties." See "Celent Report Identifies Best Practices for Over-The-Counter Derivatives Collateral Management" (Jul. 29, 2009).

The Survey also found that many managers do not pay close attention to rehypothecation of collateral by prime brokers. Just 43% receive daily reports. About one-quarter receive reports on request; a few receive them weekly or less frequently. One-quarter do not get any reports at all. For more on rehypothecation, see "How Can Hedge Funds Structure Their Prime Brokerage Arrangements to Protect Themselves?" (Oct. 10, 2008).

Managers Expect to Increase Financing Relationships

On average, each manager had four or five financing relationships. Most managers (87%) said they have maintained or added financing relationships in the last two years. Nearly the same number (80%) expect to maintain or add relationships in the coming two years. Most managers cited market access, cost control and counterparty risk management as reasons for doing so.

Being a "Better" Prime Broker Customer

More than two-thirds of respondents said that they could be "better" prime brokerage customers by providing a high ROA. As indicated above, however, the Survey found that managers may not know how to do so. Forty-two percent cited "using few resources." Roughly one-third cited paying commissions or large financing fees and/or "allocating long/short balances." Nearly one-quarter cited providing access to the manager's liquid collateral. See also "Prime Brokerage Arrangements From the Hedge Fund Manager Perspective: Financing Structures; Trends in Services; Counterparty Risk; and Negotiating Agreements" (Jan. 10, 2013).

The full Report of the Survey is here.

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