Post-Crisis: Hedge Funds, Custodial Risk and Prime Brokers

by Ron Suber and Aaron Vermut

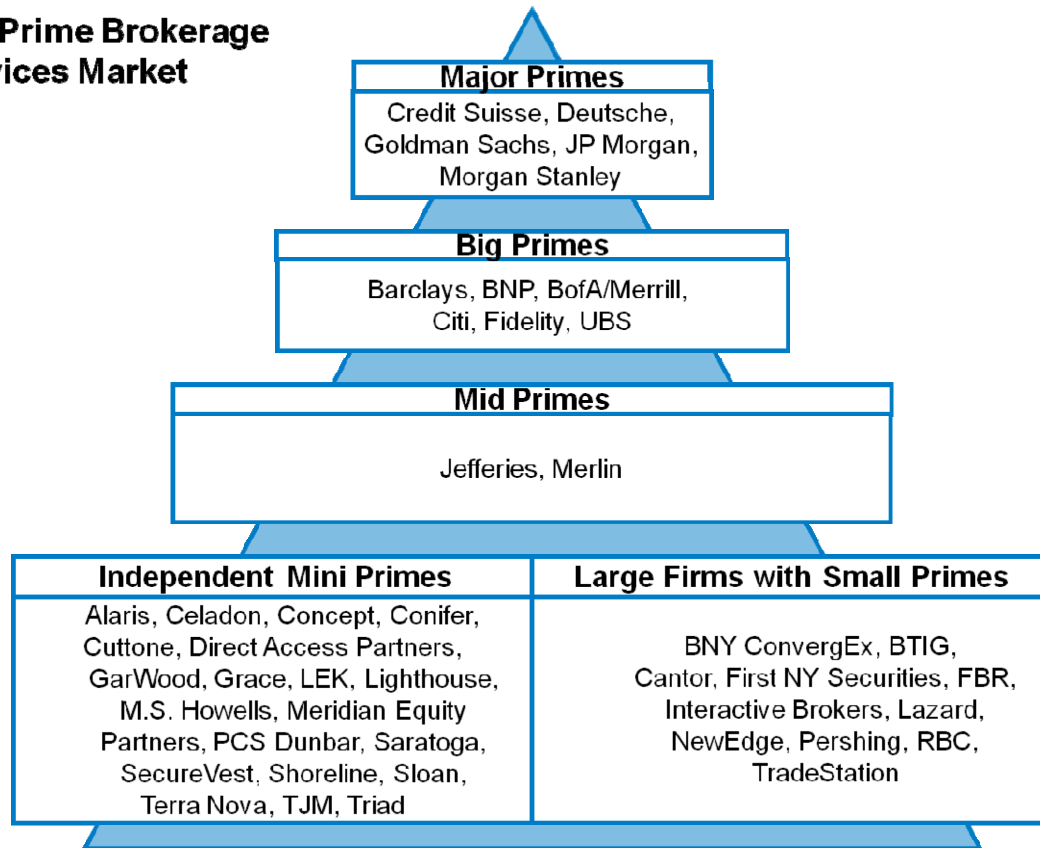
Prior to the most recent financial crisis, money managers had an awareness of counterparty and custodial risk in concept, but it wasn't a priority. We were coming off a 25-year bull-run in the financial markets during which the industry did not experience the failure of a single significant custodial bank. In addition, the broker-dealers that failed (e.g., Drexel) were handled in such a way that custodial risk remained a non-issue. So, while the awareness was there, the reality of custodial risk was not entirely appreciated by the majority of hedge funds and their investors.

The financial crisis and the associated global securities firm failures caused a dramatic shift in the way managers select and work with their prime brokers. Custodial risk quickly rose to the forefront as an issue for hedge fund investors. It naturally follows that hedge fund managers would respond, and today multi-prime and multi-custodian relationships are considered best practice in the industry.

This shift is all the more significant when one considers that for 20 years the prime brokers operated more or less as an oligarchy, dominated by a few bulge bracket firms. During that time hedge funds, even large ones, typically maintained only one or two prime brokerage relationships that provided custody, clearance, stock loan, technology and a host of other services.

The largest hedge funds have always been the most attractive segment of the market to the major prime brokers. They borrow large amounts of money and generate significant trading commissions and securities lending revenue. In addition they generate sizeable revenue for the various profit centers of the global firm, including derivatives, research and capital markets, and they generally provide for their own operations and infrastructure. After the crisis, the big banks intensified their focus on the top 250 or so managers at the expense of the smaller hedge funds. The past 18 months has been an unprecedented period of custody change as funds switched their primary prime brokerage relationships and went multi-prime. The oligopoly of the last 20 years was broken as the global players (Deutsche Bank, Credit Suisse) penetrated the market with the strength of their balance sheets and as the dominant U.S. broker-dealers retrenched. Across Wall Street, services for smaller funds were pared back; customer service staffs were reduced, capital introductions and hedge fund consulting groups were decimated and, at most firms, investment in technology for hedge fund reporting came to a halt. Funds with less than $1 billion in assets under management found themselves without the support, technology and service that they relied on and had come to expect from the large providers.

A new wave of players has emerged in the prime brokerage services market to fill the gap, and what was a market of roughly 20 providers circa 2007 has more than doubled. The landscape today consists of four tiers, as represented in the chart below:



The increased competition in the prime brokerage market has brought a number of benefits to managers, who now have more options and can select the optimal mix of providers to suit their specific needs. With each of the four tiers comes a distinct set of advantages and disadvantages:

The Major Primes
This group represents the major global banks who have committed significant capital and full firm resources to building out and maintaining robust global prime brokerage businesses. While these firms handle a portion of most of the largest funds in the world, they are also highly selective, working primarily with the top 250 high-profile funds generating very significant fees across their franchise. The challenge and opportunity for the Major Primes now is how to protect their market share while deepening their relationships with their large fund clients. This is complicated by large funds and institutional investors requiring custodial diversification for their assets. The Major Primes remain interested in smaller funds with good pedigrees and those deemed as high-probability growth opportunities. However, smaller funds run the risk of not getting the attention they need and possibly facing higher fees if their growth lags.

The Big Primes
Comprised entirely of large financial institutions, the Big Primes have significant prime operations but typically act as a second prime to the top funds. While less selective than the Major Primes, the Big Primes' brand and balance sheets help them remain a force in the industry. However, they lack the cache, breadth and depth of resources and technology solutions to compete effectively with the Major Primes. Their dilemma is that they want to leverage their

large balance sheets by working with the top managers but have not committed the resources to provide the type of technology and service traditionally furnished by the Major Primes.

The Mid Primes
The Mid Primes, by definition, each have over 300 hedge fund clients that custody, finance and trade with them, and each have in aggregate an estimated $10 billion in client assets. Their hedge fund clients are typically emerging managers with assets of $20 million to $1 billion. The Mid Primes seek to provide the same level of dedication to their clients that the larger firms provide, including high service levels, advanced technology and access to world-class custodians and third-party trading systems. However, funds will usually have to trade or custody away to get access to sophisticated financial products that are typically structured by the custodian (e.g., derivatives, swaps, repo and ISDA agreements).

The Mini Primes
The Mini Primes are a heterogeneous group, consisting of two main segments: 1) small, independent introducing brokers and 2) large firms with smaller prime brokerage divisions. Both segments of the Mini Primes have many hedge fund, high-net-worth retail and day-trader clients, however, there is no single independent mini prime with over $1B in client assets, and the larger firms with mini primes have fewer than 300 clients or $10 billion in client assets.

The Independent Mini-Primes: The small, independent introducing brokers are generally undercapitalized and essentially sell access to a clearing broker and the clearing broker's products with little value-add. These firms are under pressure as their biggest clients often outgrow their services and move on to the higher tier providers, and because of the intense competition in this tier, managers can often find firms willing to negotiate aggressively on price. This segment is rife for significant consolidation as regulatory agencies increase net capital requirements and clearing firms increase clearing deposits and revenue requirements. In addition, the clearing firms have reputational and financial risk in providing services to the Mini Primes and have begun to scrutinize their current and potential Mini Prime clients.

The Larger Firms with Small Primes: The larger firms with small prime brokerage divisions are comprised mostly of new entrants and generally have yet to prove their capabilities and their commitment to the business. Will they be able to build technology platforms, attract clients and move upstream in a post-financial-crisis environment? Can they establish the custodial relationships necessary to make their clients comfortable? Only time will tell if these firms have the patience, commitment and resources to develop a successful prime business platform.

The Outlook for 2010 and Beyond

Hedge fund managers now judge their prime brokers by a different set of criteria. No longer is it sufficient for a prime broker simply to provide the basics: custody, leverage, capital introductions and batch reporting. Managers today expect their prime broker to provide them with the tools, solutions, knowledge and capabilities to generate Alpha. Specifically, they demand a broader suite of services, including:

- Leading-edge technology – trading, analytics, risk and reporting for multiple prime and custodian relationships

- In-house expertise – risk management, connectivity, operations, securities lending, international trading and fund strategy specialists
- Capital introductions including dialogue and feedback with potential investors
- Product and geographic breadth

The hedge fund and prime brokerage industry is poised for tremendous growth driven by performance returns, new investors and the world's best talent joining the industry. Today's low leverage, muted volatility, record low interest rates and reduced commission environment will lead to continuing changes for funds and their prime brokers.

Looking forward, we expect broad change across all four tiers:

- The Major Primes will recapture many of the clients they lost and continue to gain market share among the top hedge funds.

- The Big Primes, seeking to solidify their position as the number two brokers for large funds, are in the process of redefining their value proposition, brand and market segment.
- The Mid Primes, in turn, have an opportunity to take on a more significant portion of both emerging and mid-sized funds – as well as some larger funds seeking their unique solutions.
- The consolidation already taking place in the Mini Prime segment will accelerate over the coming year as these undercapitalized firms face higher capital requirements, increasing competition from within their tier and a shrinking client pool as their biggest funds upgrade to larger prime brokerage platforms. In addition, many of the parent companies that entered the prime space will opt out of an increasingly crowded field as they face mounting balance sheet constraints and lose patience with what they find to be a more complex and intensive business than they had anticipated. Yet, in spite of all this, new entrants appear on the horizon including Bloomberg, HSBC, Nomura, Société Générale, State Street and Wells Fargo.

For hedge fund managers these changes should be viewed as net positive: the industry is shaping up and shaking out in order to better match the growing demands and requirements that managers place on their prime brokerage providers. The key is in selecting the right providers, at the right tier, early in the process to minimize the impact and cost of inevitable change.

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