Executive Summary

The financial crisis has changed the relationship between hedge funds and prime brokers for good. With the default and quasi-default of some of the leading providers in the space, funds have realized that they should diversify their prime broker relationships and require more transparency on the operational processes of their prime providers. However, as the funds industry regains momentum, they are more than ever turning to their prime brokers to provide the services that will support business expansion. Hence, prime brokers need to adapt their offering and IT infrastructure to respond to the changing market environment by:

- Implementing true multi-asset and multi-market capabilities. In their quest to generate alpha, funds are expecting their prime brokers to provide an extended product and geographic breadth through one platform. This is putting some significant pressure on the prime broker platforms that need to process asset classes and manage credit, risk and exposure, collateral, and margin across products and entities.
- Improving transparency. Prime brokers' customers are expecting them to carry real time processing and statuses, intraday business controls, and real time settlement and position status. This is obviously challenging in a multi-asset and multi-market environment. Prime brokers also expect a high level of operational transparency and are now particularly sensitive to rehypothecation risk. Finally, funds are requesting a clear segregation between the execution and the prime business of its provider, to avoid any information leakage and ensure that each of them earn business on their own merits.
- Ensuring operational efficiency. With most funds having implemented a multi-prime strategy, it has become easier for them to compare providers' services, operations, and risk. Eventually, funds will choose to concentrate assets with the provider that stands apart in the three dimensions already mentioned. This situation is fostering an increased reliance on workflow, reconciliations, reference data, and exception management.

- Focusing on creating value-added services. For prime brokers that have already achieve a high level of operational efficiency, the focus is now on differentiating by leveraging internal and external expertise. Services such as consulting (HR, real estate, strategy, etc.) and capital introduction are being highlighted by the Tier I providers to reinforce their market position.

Introduction

The financial crisis has changed risk behavior and risk tolerance within the capital markets industry. The bankruptcy of Lehman Brothers, leaving US$65 billion of hedge fund assets frozen, has pushed hedge funds to reconsider their relationship with the leading prime brokers. The multi-prime broker model that, before 2007, was slowly being adopted has gained momentum and is now considered best practice within the industry. In parallel, due to concerns about the resilience of some of the leading prime brokers, hedge funds have turned to prime brokerage providers that had strong balance sheets. This phenomenon has clearly benefited the leading global banks, such as Deutsche Bank and Credit Suisse, which have gained significant market share in the past two years and positioned themselves among the top five prime brokerage providers. It has also prompted the interest of other financial institutions such as Société Générale, HSBC, and State Street.

However, the market turmoil has not only impacted the relationship between the hedge funds and their prime brokers, it has also greatly changed the demand and requirements of investors towards the hedge funds they invest in from mostly alpha generation and historical returns to greater focus on risk management practices and transparent reporting capabilities. Since these new requirements were not part of the core expertise of hedge funds, this evolution has had a knock-on effect on their various providers, be they third party solution providers, prime brokers, or custodians.

Now that the dust has settled, the prime brokerage industry shows some signs of strong recovery. Assets under management in the hedge funds industry, while not yet at their 2007 level, increased by close to 12% between 2009 and 2010 (see Figure 1 on page 6). The concern about counterparty risk has not disappeared, but the leading prime brokers seem to be recovering market share. The drive that benefited the mini-prime providers has clearly slowed down. However, the positions are not set in stone. With fierce competition among providers in this space, there is a clear window of opportunity for financial institutions.

The multi-prime model increases competition for financing, margining, and securities lending services. On the flip side, it increases operational complexity with disaggregation of data from multi-prime trades, as captured in Table 1.

Table 1: Comparison of Single Prime and Multi-Prime Brokerage Models

Single prime	Multi-prime
Large counterparty risk with single custodian.	Mitigation of counterparty risk with multi-custodians/triparty accounts.
Consolidated PB view of portfolio, risk, and cash balances.	Disaggregated data from multi-prime trades/accounts.
Monopoly of PB financing, margining rates.	Competitive sources of financing, margining, and securities lending.

Source: Celent

Daily interactions with multiple prime brokers will give a fund a good view into the operational efficiencies and risk of each prime broker, and logically funds will concentrate assets where processes are most efficient. This evolution puts greater pressure on prime brokers to differentiate and increase the reliance on workflow, reconciliation, reference data, and exception management. It also drives the need to develop additional services like consulting and capital introduction to reinforce the relationship with customers.

Implementation of Multi-Asset Trading and Multi-Market Strategy

Multi-asset trading is a widely accepted trading model. Increased adoption of electronic trading and development of advanced cross-asset algorithms have played a vital role in the adoption of multi-asset trading strategies by hedge funds. A multi-asset front end has become one of a prime broker's core offerings. Access to multiple liquidity sources along with a wide range of asset classes are key considerations for hedge fund firms. For example, we have seen a significant increase in hedge fund participation in foreign exchange; according to the latest statistic, hedge funds now account for 11% of the volume executed in the global FX market. The challenge for the prime broker lies in managing the additional complexity in post-trade, collateral management, and cross-margining. The key requirement from a prime broker is really the reporting on multiple asset classes. The prime brokerage platform needs to process across asset classes and manage credit, risk, collateral, and margin across products and sometimes entities.

Multi-markets connectivity is a must have. The traditional home bias that has always prevailed within the investor community has been steadily blurring during the last decade with the implementation of

- Provide true multi-asset capabilities. The market is still dominated by single asset solutions, but the movement is clearly toward a multi-asset prime brokerage platform supporting clients' expansion into new asset classes. This integration by increasing the quality of client services will reinforce the relationship and encourage the customer to drive more volume toward the prime broker.
- Deliver transaction status in real time. In a volatile market, this information is crucial to funds. It's clearly a must have.
- Facilitate data aggregation. Adoption of the multi-prime model has put a greater burden on funds, especially for data aggregation, which can be delivered by prime brokers with the right technology in place. The platform should be required to produce unified reports from disparate structures and formats provided by different brokers, and deliver a unified view of positions, trades, and balances. Also, additional tools are needed in the risk management context to accurately compute the portfolio's exposure and other risk measures. Therefore, the platform should not be limited to providing a consolidated view of positions and integrated reporting.
- Serve global capability. The prime broker platform has to be robust and flexible enough to integrate new clearing and settlement connectivity to support the expansion of clients into new territories. The platform should be the core underlying architecture that helps clients manage their books and records globally. The time to market for adding markets should be closely monitored to ensure that future market expansion will not be delayed.

Market messaging and collateral review. Based on our extensive experience with your potential clients, we assess your marketing and sales materials—including your website and any collateral.

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