Asset Management

The game changes for prime brokers

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PricewaterhouseCoopers

The game changes for prime brokers

Learning from the past year's market crisis, and especially the Lehman Brothers insolvency, prime brokers are evolving their operating models to win market share and protect profitability.

Darren Ketteringham
PricewaterhouseCoopers (UK)
+44 20 7213 5255
darren.g.ketteringham@uk.pwc.com

The past year's severe market dislocations and stresses – including the credit crunch, liquidity crisis, discovery of Ponzi schemes and the impact of the Lehman Brothers insolvency – have changed the investment management industry's priorities. Investors are becoming more discerning about their investment criteria. They are focusing on ensuring that assets and their associated risks are well managed, with more transparency and reporting over transactional and operational activities. At the same time, hedge funds have lost confidence in their prime brokers.

The Lehman insolvency has heightened concerns over asset security and protection. Hedge funds are increasingly renegotiating their prime broker agreements, revising and often reducing their rehypothecation levels. They are insisting that their unencumbered assets (those assets not subject to rehypothecation) are placed into segregated accounts, which afford better protection and speedier access in stress scenarios such as broker insolvency.

Both investors and hedge funds are seeking increased assurance about the manner in which assets are controlled, secured and managed when in the hands of their brokers and custodians.

Profitability pressure

There are multiple pressures on prime brokers' cost bases. Hedge fund clients are becoming more demanding at a time when there are fewer assets to lend. Reduced levels of rehypothecation are combining with asset managers' and banks' diminished appetite for lending securities, and jurisdictional bans on short selling, with the effect that there are fewer assets available for prime brokers to finance, borrow and loan. This in turn is increasing their funding costs.

In addition to increasing funding costs, further costs are being incurred as a result of client demand for more assurance, risk management and reporting. There is also an expectation that the cost of regulation will be higher going forward. Regulators will, no doubt, be looking to revise and enhance existing client asset (including client monies) rules in response to recent market events, to ensure appropriate lessons have been learned, and to help ensure client assets are better protected going forward.

Revising operating models

Faced with these issues, prime brokers are revising their operating models. They are responding to client needs by tailoring their products and services, improving the control environment, and increasing the transparency and quality of reporting. Operational structures are being revisited, with some players considering bankruptcy-remote vehicles. These would segregate client assets, so allowing continued and immediate access in insolvency. In addition, questions have arisen over role, choice and independence of custodian and sub-custodian relationships.

The change in operating models, will undoubtedly impact pricing. Fees will need to be unbundled to reflect required service levels and client demand across transactional, custodial and administrative activities.

Agility will be rewarded

The rules of engagement between investors, hedge funds and their prime brokers have significantly changed. We have already witnessed a big shift in prime broker market share since the end of 2008. Those prime brokers which are most agile and who respond most appropriately to changing market conditions, and client demand, have a unique opportunity to sustainably increase market share and protect profitability.

Global Asset Management contacts

Asset Management News is produced by experts in their particular field to address important issues affecting the Asset Management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PricewaterhouseCoopers or one of those listed on these pages.

Global Asset Management Leadership Team

Marc Saluzzi
PricewaterhouseCoopers (Luxembourg)
Global Asset Management Leader
+352 49 48 48 2511
marc.saluzzi@lu.pwc.com

Kees Hage
PricewaterhouseCoopers (Luxembourg)
Global Real Estate Leader
+352 49 48 48 2059
kees.hage@lu.pwc.com

Barry Benjamin
PricewaterhouseCoopers (US)
Americas Asset Management Leader
+1 410 783 7623
barry.p.benjamin@us.pwc.com

Pars Purewal
PricewaterhouseCoopers (UK)
UK Asset Management Leader
+44 20 7212 4738
pars.s.purewal@uk.pwc.com

Brendan McMahon
PricewaterhouseCoopers (Channel Islands)
Global Asset Management
Private Equity Leader
+44 1534 838234
brendan.mcmahon@je.pwc.com

Robert Grome
PricewaterhouseCoopers (Hong Kong)
Asia Pacific Asset Management Leader
+852 2289 1133
robert.grome@hk.pwc.com

David Newton
PricewaterhouseCoopers (UK)
Global Asset Management
Tax Leader
+44 20 7804 2069
david.newton@uk.pwc.com

Tony Artabane
PricewaterhouseCoopers (US)
Global Asset Management
Hedge Funds Leader
+1 646 471 7830
anthony.artabane@us.pwc.com

If you would like to receive copies of this newsletter or would like further information about PricewaterhouseCoopers Asset Management publications, please contact Denise Cook at denise.cook@uk.pwc.com

Editor: Rupert Bruce

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