

# The rise of bank-owned administrators

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As independent administrators become essential to hedge fund operating models, this is accelerating the consolidation of the hedge fund services industry and leading to convergence between banks and administrators.

When a Swiss private bank, one of the world's largest investors in hedge funds, demanded in late 2008 that all of the hedge funds it invested in should be independently administrated, this was the latest and one of the paramount events set to change the face of the fund administration industry.

Recent events, including problems with valuation transparency and trading activity validation, that have come to light are increasing investor anxiety. Since then, many large US hedge funds have retained administrators (Asian and European hedge fund operating models typically already included them) in order to quell investor fears. In this way, they have split the roles of investment management and valuations and accounting. This also pre-empts likely Securities & Exchange Commission regulations to make independent administration mandatory.

The credit crisis, and its impact on the hedge fund industry, is having a profound impact on administrators. The large hedge funds are favouring those administrators with the capital strength to make them credit worthy counterparties. They are also looking for administrators that can offer the widest range of services, often including those typically delivered by banks. All of this is favouring bank-owned administrators.

This turn of events is placing the remaining independent administrators, which lack capital strength and scale, at a competitive disadvantage. Consequently, consolidation is accelerating and banks are likely to take the opportunity to acquire niche operators to build out their fund administration offerings – with a focus on higher margin services.

## Converging with banks

Indeed, as hedge fund managers look to administrators for a broader range of services, this is acting as a catalyst for convergence with banks. Hedge funds favour bank-owned models for ease of access to facilities and 'one-stop

shopping', including lines of credit, cash management, custody and global trustee services. In addition, direct securities lending by large hedge funds is increasing the pressure on administrators to support their transaction bookkeeping, settlement, collateral management and margin requirements.

Hedge fund managers in particular want administrators to protect them from counterparty risk. By using the administrator as a neutral, third party transaction facilitator and central counterparty, they considerably reduce the danger of counterparties losing assets through the bankruptcy or fraud of other third party counterparties. Once again, this favours the administrators owned by banks with strong balance sheets which are willing to take on credit risk with hedge funds.

## Technology enables

As ever, technology is the key enabler. The leading fund administrators recognise that their IT architectures need to be flexible enough to accommodate new products and more complex portfolios, while providing consistent and accurate computations of valuations and risk exposures. Hedge funds are also looking to fund administrators for straight-through-processing platforms that have multi-market, multi-asset class and multi-entity capability. This minimises reliance on manual processes and, consequently, reduces operational risk and operating costs.

What all of this means is that for the banks with strong credit ratings there is an opportunity to develop fund administration businesses with high quality earnings. At the same time, current events are accelerating consolidation in the industry. There is still room for independent operators, but they will be fewer and differentiate themselves through superior technology offerings and a focus on alternative investment niches.



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