Accessing the financial power grid

Hedge fund financing challenges under Basel III and beyond

By AIMA and S3 Partners
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1 Introduction

While the impact on banks of Basel III and associated rules has been discussed at length in industry publications, it is clear that many hedge fund management firms are still struggling to assess how these changes in the banking sector will affect their cost of doing business.

With this research report, we are hoping to cut through some of the noise and provide a snapshot of what managers have seen so far and how they expect their relationships with their prime brokers and other financing counterparties to change over the coming years. The report also offers a perspective on how hedge fund managers can help to make sure that their prime brokerage relationships remain mutually beneficial to the manager and bank alike, so that the market for what you could call "financial electricity" continues to operate smoothly. Given that individual banks are responding differently to regulatory reform (reflecting their client profiles, business lines and overall strategies), this is a key ongoing challenge for managers.

The report draws on an extensive industry survey undertaken during August and September 2015, which gathered data from managers with assets under management of more than $400bn. Respondents ranged from small single-strategy managers, to the largest global multi-strategy managers. The survey has provided a detailed view of what is currently happening to financing relationships, seen from the angles of cost and availability of services.

As part of our survey, we also looked at whether there is a common industry understanding of some of the key concepts that drive how participants manage counterparty relationships, from ROA to optimization, and from margin validation to collateral management. The responses to the survey demonstrate that industry participants need a common language to define industry terms, and we hope to offer an insight into how managers and their financing counterparties can work together to manage their relationships effectively.

We would like to thank the many clients and members of AIMA and S3 Partners who took the time to complete the survey on which this paper is based. We continue to field a huge number of queries on this topic and hope that this paper will help to demystify this topic.

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2 Summary

The results presented in this paper are based on a survey of 78 alternative asset managers, ranging in size from under $100mm of assets under management (AUM) to over $10 billion of AUM, and representing a diverse range of strategies and geographic locations. Their responses provide powerful insights into the **perceptions** and the **realities** of maintaining balanced, fair and economically viable relationships with critical sources of portfolio financing — what you could term “financial electricity” — as the impact of regulation takes full effect throughout the global banking sector.

Among the **key takeaways** from our survey are the following:

1. **All types of alternative asset managers are feeling the effects of regulation on their financing relationships:** The impact of regulation on hedge funds' prime brokerage and financing relationships is fairly consistent regardless of a hedge fund manager's size, strategy or location.
2. **Financing costs have already gone up, and most hedge fund managers expect further cost increases:** 50% of respondents have already seen an increase in financing costs, with an even split between those who quantified the level of cost increase as being below 10% and those who put the figure at greater than 10%. Three quarters of respondents are expecting further cost increases during the coming two years, although the results suggest that the level of those increases are difficult to quantify.
3. **The number of financing relationships looks set to persist for the time being:** Close to 90% of survey respondents have seen the number of their financing relationships remain the same or increase during the last couple of years. For smaller managers, the number of financing relationships is driven primarily by counterparty risk considerations. For larger managers, the ability to access liquidity is the more pressing concern. The average number of financing relationships stands at 4.
4. **Understanding how banks calculate Return on Assets (ROA) and Return on Equity (ROE) is a major challenge for hedge fund managers:** Only a fifth of survey respondents said that they "have a clear understanding of how their banks calculate ROA". Fewer still have the data necessary to calculate ROA/ROE themselves. At the same time, different banks are feeling the impact of regulation in different ways, reflecting differences in strategy, client base and jurisdiction, meaning that there is no simple way of quantifying a standard impact associated with new rules across the range of a manager's bank counterparties.
5. **Hedge fund managers are having to rethink their prime brokerage relationships:** Three-quarters of survey respondents have been asked to change how they do business with their prime brokers, with more than two-thirds being asked to decrease their free cash balances.
6. **Hedge fund managers can put themselves in a stronger position to deal with the changing nature of the prime brokerage relationships.** To maintain **access** to the "grid" of financing, manage their overall cost of doing business, and **optimise** the mutual value of their prime brokerage and counterparty relationships within the new regulatory landscape, hedge funds and other investment managers must increasingly:
   - make sure they have the right data, including unbiased data sources;
   - use a different set of analytic tools and calculations;
   - make sure that they and their financing counterparties are speaking a common language to promote beneficial financing relationships and effective collateral management activities.

In the next section, we consider the regulatory background to this topic, before returning to a more detailed discussion of our survey work and findings.

3 The evolving regulatory landscape

Financial crises or disruptions often trigger a cycle of responses among regulators and industry participants that typically play out in stages:

1. a regulatory or policy response and series of actions intended to stabilize the system as well as "immunize" it from further future shocks;
2. an initial economic response and reshuffling of risk, cost, and value across different players;
3. a broader, longer-term technological response and data-driven re-alignment of interests and opportunities — a "new normal" (which can transition over time to new sets of crises or disruptions, causing the cycle to begin again).

Following the financial crisis of 2008, governments and regulatory bodies around the world began implementing policies intended to bolster the resilience of the global banking sector. Many of these changes derive from the Basel III package, a comprehensive set of reform measures developed by the Basel Committee on Banking Supervision (BCBS) to strengthen the regulation, supervision and risk management of the banking sector. These measures are aimed at improving the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and strengthen banks' transparency and disclosures.

The main components of the Basel III framework[1] are summarised below:

Leverage	A non-risk-based **leverage ratio** that includes off-balance sheet exposures will serve as a backstop to risk-based capital requirements. Also designed to help contain system wide build-up of leverage.
Liquidity	**Liquidity coverage ratio:** The liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors. **The net stable funding ratio** (NSFR) is a longer-term structural ratio designed to address liquidity mismatches and reduce reliance on short-term wholesale funding. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.
Capital	**Quality and level of capital:** Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions. **Capital loss absorption at the point of non-viability:** Contractual terms of capital instruments will include a clause that allows – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard. **Capital conservation buffer:** Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range. **Countercyclical buffer:** Imposed within a range of 0–2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build-up of systematic risk.
Risk coverage	**Securitisations:** Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures. **Trading book:** Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecuritised credit products and takes liquidity into account. **Counterparty credit risk:** Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures. **Bank exposures to central counterparties (CCPs):** The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default fund.

[1] See http://www.bis.org/bcbs/basel3/b3summarytable.pdf for additional detail.

From the point of view of banks, these regulatory changes are associated with a number of significant changes[2] to their operations, as highlighted below:

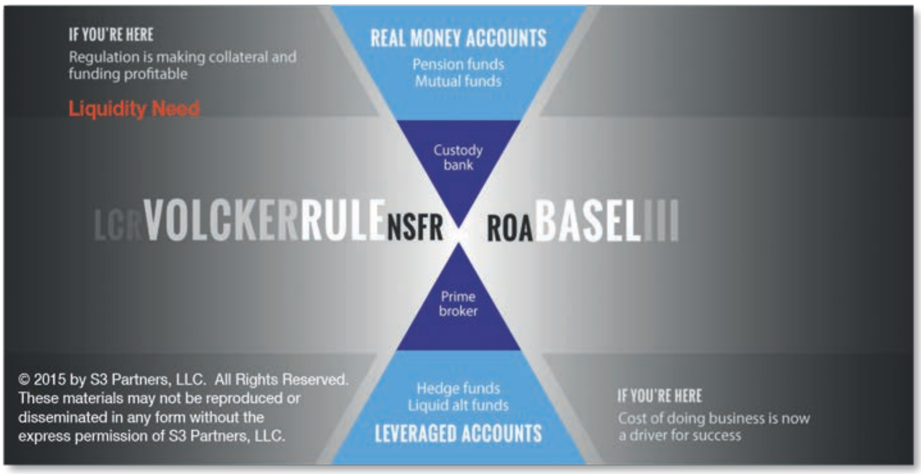
Leverage ratio	Leads to a reduction in availability of balance sheet and greater sensitivity to how balance sheet capacity is allocated. Other business lines could be prioritised over prime brokerage. Clients whose strategies involve significant use of a bank's balance sheet (e.g. highly levered, directional portfolios; credit funds focusing on distressed corporate debt, for example) are likely to be at risk of repricing or withdrawal of services.
Liquidity coverage ratio	Leads to a reduction in the availability of balance sheet and off-balance sheet business for client-facing business. Leads to an increase in funding costs and a reduction in potential internal efficiencies.
Net stable funding ratio	Banks will have to hold long-term debt or equity against hard-to-finance assets, implying an increase in funding duration, and thereby increasing funding costs. Having longer liabilities will reduce banks' balance sheet capacity. Clients with less liquid strategies that require funding of assets that do not qualify as high-quality liquid assets (HQLA) will likely be most impacted.
Capital and risk coverage	Leads to a reduction in the availability of balance sheet and off-balance sheet business for client-facing business. Leads to an increase in funding costs and a reduction in potential internal efficiencies.

In addition, banks face a host of additional regulatory changes that are not directly related to Basel III:

Structural reform	The US Volcker Rule, the UK's Vickers reforms and the EU's proposals on Bank Structural Reform all restrict the activities that can be undertaken by a banking entity, as well as the investments that it is able to make.
Total Loss-Absorbing Capacity (TLAC)	The TLAC standard developed by the BCBS and Financial Stability Board (FSB) applies to global systemically important banks (G-SIBs) and is designed to ensure that if a G-SIB fails it has sufficient loss-absorbing and recapitalisation capacity available in resolution to implement an orderly resolution that minimises impacts on financial stability, ensures the continuity of critical functions, and avoids exposing public funds to loss.

[2] For a more detailed prime brokerage perspective on Basel III and its impact, see:
- JPMorgan Prime Brokerage: 'Leveraging the Leverage Ratio', 2014. Available online at: https://www.jpmorgan.com/cm/cs?pagename=JPM/DirectDoc&urlname=is_leveragingtheleverage.pdf&track=no
- Barclays Prime Services: 'More with Less: Impact of Regulations on the Hedge Fund Financing Model', June 2015. Available online at: http://www.barclayscommunications.com/CapSol_Publications/536451/MoreWithLess_A4.pdf

How are PBs/Banks responding to regulation?



How are Asset Managers responding to their PBs/Banks?

The reforms discussed above have combined to effectively put a "squeeze" on the availability of capital, funding and balance sheet capacity: no longer can banks simply seek to maximize revenues, they must now carefully assess the capital implications and other constraints of individual clients and business lines. As a result, the securities financing market, where an estimated $10 trillion of collateral is lent and borrowed by the market participants depicted in this diagram, is experiencing the effects of rationing of financial electricity supply, as banks increasingly focus on their Return on Assets (ROA) and Return on Equity (ROE) profiles.

The net effect of financial regulation on this "money supply" of collateral activity has been to shrink dealer liabilities, reduce proprietary or principal trading inventories of banks and substantially limit trading flows. This in turn puts pressure on the efficient exchange mechanism for collateral between sources of collateral/users of liquidity (i.e. real money accounts) and sources of liquidity/users of leverage (i.e. hedge funds, whose rising numbers have *de facto* made them a market maker and provider of liquidity to the global financial system). Regulation effectively has made Return on Assets and Return on Equity metering devices for banks' services.

As noted above, by penalizing institutions that do not de-lever and significantly reduce exposure to assets deemed more risky, regulation has increased bank internal funding costs, reduced the profitability of balance-sheet heavy business lines, and limited the supply of leverage/collateral that banks can manufacture or gain access to in the system.

Banks are now focused much more on the ROA/ROE profile of prime brokerage customers, i.e. how much funding, capital and balance sheet do they require to generate returns and at what efficiency to the bank? They are using these measures, not just traditional revenue generation, to gauge the value, importance and profitability of each client. Though the equations for ROA/ROE are straightforward the components of the equations are complex, like asset mix, net payables and receivables, internalization, liquidity, and collateral characteristics, among others.

Accordingly, different banks are feeling the impact of regulation in different ways, reflecting differences in strategy, client base and jurisdiction: there is no simple way of quantifying a standard impact across the universe of bank counterparties. Individual prime brokerage units will also be differently impacted, reflecting the particular product mix that is offered under prime services.

This leaves asset managers, as the consumers of financial electricity, in the position of increasingly having to 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. A customer's asset/revenue size may or may not correspond to a positive ROA/ROE profile. And a large provider of prime brokerage services may or may not be cost effective for a manager in terms of the overall economics of their business on behalf of investors. As we will see, this is an "optimization" proposition for all of the players in the system to individually and collectively solve for, addressing both relationships with individual counterparties and the overall profile of a manager's different funding relationships.

Our survey was designed to explore the real-world impact of the regulatory changes discussed above. In the next sections of the paper, we discuss the design of the survey and our key findings.

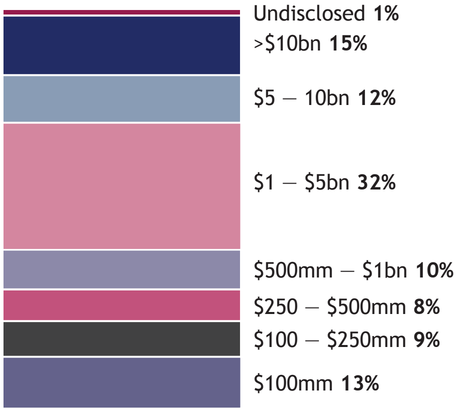
4 Survey objectives and overview

The survey was conducted by AIMA and S3 Partners over the course of August and September 2015 to gain a better collective understanding among alternative asset managers of the perceived impact which Basel III and other related financial regulation is having on financing, and the downstream effects in hedge fund managers' overall relationships with their prime brokers, ISDA counterparts and custodians.

Survey participants included a broad cross-section of 78 alternative asset managers, representing a diverse range of AUM size, investment strategies, and geography. The combined AUM of survey respondents exceeded $400bn.

The survey comprised 26 questions which were designed to elicit responses in seven key areas of interest/value to managers:

AUM



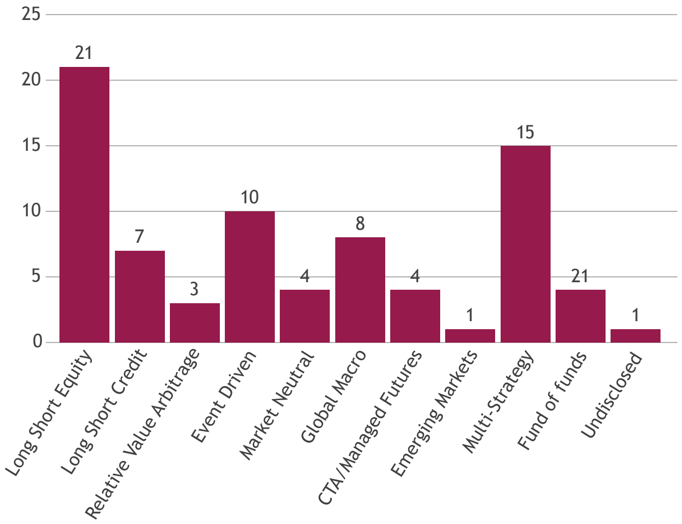
1. How has regulation impacted financing costs and what further future changes are anticipated?
2. What is industry understanding of how banks calculate Return on Assets, a key regulatory measure of capital efficiency that is of increasing importance to and impact on bank customers?
3. How are managers being asked to change the way they do business with their prime brokers and what drives these changes?
4. Which prime services offerings are viewed as most important to managers in today's operating environment?
5. Is there a market standard and consistent communication about securities finance and collateral management practices?
6. What is the number of bank financing relationships currently maintained and how is this expected to change going forward?
7. What are managers' views on how to be "better" prime brokerage customers?

The report has also been informed by feedback gathered from one-to-one meetings with hedge fund managers and prime brokers, as well as a roundtable of hedge fund managers held on 7 October 2015 at the New York office of S3 Partners.

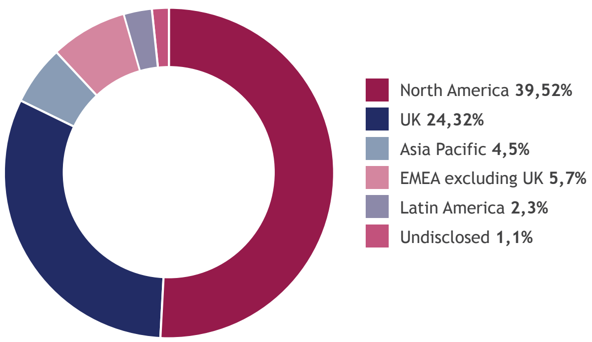
Survey results are generally consistent across all participants regardless of size, strategy, or geography (certain differences in select areas/questions are noted below). As such, the impact of regulation on the fundamental relationship between hedge funds and their prime brokers is being seen and felt fairly consistently across the alternative asset management landscape. Scale, scope, or location of managers' businesses and operations do not appear to materially alter the degree to which the effects of banking regulation are being experienced across the overall community of alternative managers. Certainly specifics around how managers are interacting with and experiencing service from their prime brokers can and will vary based on many of these factors, and we have already seen that regulation is putting particular pressure on certain strategies, but the general consensus on most of the seven areas above is notable.

In the next section, we explore the survey results in greater detail.

Strategy



Geography



5 Survey Results

Responses to questions in each of the seven areas surveyed with managers are summarized here, along with issues or questions raised by these results. Implications for managers and the industry, as well as conclusions to take away from this survey, follow.

1 How has regulation impacted financing costs and what further future changes are anticipated?

- **50%** of respondents have seen **financing costs increase** — about half of these by up to 10% and half by more than 10%. The remaining respondents predominately experienced flat costs the past year.
- **75%** of all respondents expect **financing costs to increase over the next two years** and most expect this cost increase to be 10% or more.

What is the basis for this? There is an overall sense that the price for accessing financing is going up, a reflection of the fact that a purely revenue-driven approach on the part of banks is no longer viable in the new regulatory paradigm. At the same time, alternative mechanisms to access leverage haven't yet been developed.

As well as considering overall financing costs, we also asked respondents to provide information on whether particular types of financing have become relatively more or less expensive, distinguishing between: repo, margin lending, securities, and synthetic forms of finance.

For all of these forms of financing, with the exception of repo, the majority of respondents suggested that the cost of financing had not changed in relative terms. In the case of repo, **59%** of respondents who used this type of financing reported that it had become relatively more expensive, a development that is reflected in comments from members.

Another theme that comes across from interaction with members is that a contraction in capacity is particularly pronounced in fixed income services (notably custody and settlement of large, actively-traded fixed income portfolios), reflected in the widespread restructuring of fixed income divisions and the presence of fewer viable "full service" banks.

2 What is industry understanding of how banks calculate Return on Assets and Return on Equity, the key regulatory measures of capital efficiency that are of increasing importance to and impact on bank customers?

- Only **22%** of all respondents said they have a **"clear understanding** of how their banks calculate **ROA"**.
- Only **17%** of all respondents believe they have **"all the data necessary** to calculate **ROA themselves"**.
- **79%** of all respondents, when asked, **did not provide an estimate of ROA** – either a formula/calculation or a general explanation/description/definition (understandable given the response rates to the prior two questions, which spanned managers of all types and sizes).

These results prompt the following question for the majority of managers in today's environment:

How can you be a "capital efficient" customer if your ROA/ROE profile is either unknown or not able to be calculated?

With many managers expecting to maintain or increase their counterparty relationships (as we will see below) while still anticipating further increases in the costs of these relationships, accessing the data required to gain a better sense of ROA/ROE is increasingly strategically and operationally important. In part this calls for closer dialogue with financing counterparties, to ensure that those counterparties are providing the data necessary for a client to understand how it is perceived when it comes to ROA/ROE considerations. It also increases the importance of external data sources that hedge fund managers can access to make their own assessment of how the allocation and make-up of their financing activities can be optimised.

3 How are managers being asked to change the way they do business with their prime brokers and what drives these changes?

- **75%** of all respondents said they have been "asked to **change** how they do business with their PBs".

For the majority of managers asked to make changes, the reasons included:

ROE	2/3+	Asked to decrease free cash balances
ROE	1/3	Asked to move a portion of their book to swap
ROE/ROA	1/3	Asked to change type of collateral posted
ROE/ROA	5 – 15%	Some combination of terminate relationship, reduce leverage, focus on easier to finance securities and/or increase portfolio turnover

Many managers were asked to make more than one of these types of changes, and as the arrows denote, change requests can be driven both by ROA and ROE factors. The most frequently cited reasons for change are not as much risk reduction driven as ROE and profitability driven factors for PBs/banks. This leads to a second strategic business question:

Are you a more "capital efficient" customer by increasing ROA? Or ROE? And how do you know?

Our survey results suggest that most managers are experiencing a **mix** of requests for changing the way they do business with some or all of their PBs, further underscoring the need to collect, process, and analyse data across securities financing activities to better **understand, manage,** and **optimise** their **capital efficiency profile** with banks at a **reasonable cost** of doing their own business.

Taking account of the regulatory context, use of cash as initial margin for uncleared swaps is also going to be problematic, due to segregation and custodianship requirements. While cash has not been eliminated entirely, U.S. regulations will require the posting party to instruct the custodian to invest the cash into eligible non-cash collateral "within a reasonable period of time," or the posting party must deliver substitute eligible non-cash collateral.

"The fact that free cash balances are no longer wanted by our bank financing counterparties is insane. If you can't deposit cash with a bank, then where…??"

Survey respondent

4 Which prime services offerings are viewed as most important to managers in today's investment and operating environment?

We asked survey respondents to tell us how they rate the various services that can form part of the prime brokerage relationship. The table below details the percentage of respondents who rated the service in question as "very important" or "important" in the context of the execution of their trading strategy.

	99%	Settlement and custody
	97%	Securities lending
COST	93%	Clearing
	93%	Reporting and technology services
	91%	Synthetics
	89%	Asset servicing
	86%	Execution
CAPITAL	84%	Margin finance
	81%	Collateral management
	80%	Reconciliation
	70%	Research
	69%	Repo
SERVICE	63%	Corporate access
	60%	Capital introduction
	53%	Consulting services

Not surprisingly, responses to these questions clustered in the groups denoted above. Most important to managers are factors related primarily to the **cost of doing business**. Next most important are those with **capital implications** for banks/counterparties and **access implications** for managers. And of lesser importance for the most part are **"softer" services** offered with overall PB services. This again highlights the balancing act for asset managers between maintaining access to the financing power grid through their PB/bank counterparts while controlling costs of operations. As financing costs rise, costs passed through to underlying investors are coming under greater scrutiny and pressure.

We also asked specific questions on the availability of clearing services. From interaction with our members and clients, we have heard reports that clearing services have become more difficult to access following the withdrawal from clearing of several large dealers. This has prompted larger hedge fund managers to consider the possibility of self-clearing, although default fund contributions and other requirements associated with becoming a clearing member mean that this is really only a consideration for the largest managers. The survey results suggest that these difficulties are not being felt universally, with over 80% of managers reporting that they have not seen any particular difficulties associated with accessing central clearing. However, for strategies that depend heavily on clearing, the impact could be significant.

5 Is there a market standard and consistent communication about securities finance and collateral management practices?

In this section of the survey, we asked respondents a series of questions on margin practices and collateral management concepts. A common language and standard definitions for margin and collateral is a critical ingredient for aligning bank interests with manager interests. As can be seen by the responses, words that are commonly used have more than one meaning to the respondents. Throughout this section we use shaded boxes to highlight the components that we believe underlie the key terms in question.

The key to the definition of "reconciliation"

About half the respondents to the survey could fully complete the standard definition for what represents "Reconciliation".

92%	Positions
89%	Cash balances
67%	Trading activity
48%	Interest accruals
44%	Margin
44%	Fees
35%	Security pricing
30%	Commission
3%	Other

How often PB reports assets that are re-hypothecated*

We asked respondents to tell us about the frequency of reports that they receive from financing counterparties regarding re-hypothecation of their assets. In this area, larger AUM size and certain types of fund strategies were more likely to benefit from daily or on-demand reporting, but there still were some larger funds in the "not at all" category in addition to smaller managers. Understanding how PBs are re-purposing collateral consistent with contractual provisions, at what fee level, and to what benefit to the bank is critical for all players in this operating environment.

43%	Daily
26%	On request
25%	Not at all
3%	On a periodic basis of greater than one week
25%	Not at all

*The practice by banks and brokers of using, for their own purposes, assets that have been posted as collateral by their clients. Clients who permit rehypothecation of their collateral may be compensated either through a lower cost of borrowing or a rebate on fees.

Some of the survey questions in this section focused on collateral management practices and concepts, revealing that there was little consensus among managers on definitions and approaches in this area. The range of responses given is summarized below; those highlighted in boxes are the ones which in our experience are key for economically, reliably and optimally accessing rates, spread and margin at fair pricing levels.

How is "collateral management" defined?

Collateral is a unique and important concept because it can have a direct impact on the bank balance sheet, yet it is effectively in the control of each fund/manager. This question illustrates the differences in managers' thinking and definitions of this critical function in today's regulatory environment.

60%	The movement, settlement, tracking and collateral account maintenance
56%	Managing cash balances, excess margin and margin requirements
52%	The process of meeting margin calls via the transfer of cash or securities
43%	Minimising finance costs and maximising finance revenue
32%	Forecasting future collateral needs
2%	Other

What is "collateral optimization"?

Prime brokers do have contractual and collateral pricing levers, and will encourage clients to post those assets as collateral that are most advantageous for the bank from a profitability, regulatory, and relationship standpoint. If clients have a clear understanding of how to reconcile, manage, and optimise the margin they post, they will be better able to balance their ROA profile with their own treasury, balance sheet and cost considerations.

48%	Posting the least amount of collateral required to meet margin requirements (no excess)
40%	An enterprise-wide process of allocating collateral to providers based on a multi-factored algorithmic and subjective model
36%	Consideration of the quantity and eligibility of your posted collateral
34%	Consideration of the cost and demand of your posted collateral
26%	Posting the fewest number of positions/minimising the number of transactions
17%	The diversification or availability of your posted collateral
2%	Other

This is only possible if there is greater consistency across managers/funds around the nomenclature and protocols of collateral management/optimisation to create a "win-win" for them and their counterparties. In other words, managers should ask themselves:

How can we make sure we are speaking a common language and using consistent measures of cost, service, risk and value?

As noted above, an open dialogue with financing counterparties is key in this regard. Different banks will perceive clients in different ways based on their overall business and client base.

6 What is the number of bank financing relationships currently maintained and how is this expected to change going forward?

- **87%** of respondents have **maintained or added to** the number of PB providers they use over the last two years. Those that reduced were most often requested to leave by their banks.
- **80%** of respondents intend to **maintain or add to** the number of PB providers they use over the next two years. The vast majority of these — 93% — cited market access, better rates, and counterparty risk management/diversification as the reasons for this. Larger AUM managers tended to focus on the first two reasons, and smaller AUM managers, not surprisingly, on diversifying counterparty risk/reducing dependence on one or a small number of providers.
- The mean number of financing relationships for survey respondents was 4, although the modal average for the number of relationships was higher at 5.

These are fairly typical moves on the part of managers with respect to counterparty access, economics and diversification, but this response does not in and of itself solve for the ROA/ROE-driven challenges of the new regulatory operating reality, as we have seen above. Managers not only need to consider the number of relationships that they maintain, but also the ability of particular counterparties to provide the right service, in light of the overall makeup of the manager's financing relationships and needs. This also creates space for new prime brokerage market entrants, who could seek to service strategies or client types that are no longer well served in the market.

The spectrum of answers given in our next and last set of questions underscores how managers are starting to think (if not yet collectively act) differently as clients in the new financing reality.

7 What are managers' views on how to be "better" prime brokerage customers?

ROA vs ROE	68%	Providing a high ROA
	42%	Using few resources
	37%	Paying commission income
	34%	Generating large financing fees
	32%	Allocating Long/Short Balances
	23%	Providing access to liquid collateral via your portfolio
	6%	Using high amounts of leverage
	11%	Other *(grow AUM, fees, minimize default risk, operational excellence, blend of all)*

The majority of respondents believe they can be "better" customers going forward by being a source of higher ROA, a clear reflection of regulatory pressure and pass through effects from PBs and other counterparties. Once again, many of the other responses above focus more on ROE levers (where net bank revenues are the numerator) vs. ROA drivers (where gross bank revenues are the numerator). This poses a final summary question facing managers today, the answers to which are addressed next.

How can relationships with prime brokers and financial counterparties be managed to mutually optimise cost, risk and value in the new regulatory paradigm?

6 Implications and conclusions

How can relationships with prime brokers and financial counterparties be managed to mutually optimise cost, risk and value in the new regulatory paradigm?

Based on this sample population, there are a number of challenges or potential conflicts that need to be addressed from the managers' point of view in order to answer the above question and preserve their access to the "financial power grid":

1. For the most part, funds continue to maintain or add counterparties to their mix of service providers much as they typically have done in the past, even though they acknowledge changes in the underlying regulatory environment that are affecting their PBs, themselves, and ultimately how they do business together. Adding more counterparties, however, is not necessarily the most effective solution to the challenges that managers face. For some managers, part of the solution has been an expansion in the scale of their treasury operations in order to become more effective at how they manage their financing activities.[3]
2. Managers accept that their out-of-pocket costs are going to increase over the coming years, potentially in a very material way, but also cite cost factors as the most important elements in assessing service value of PBs.
3. The majority view increasing ROA as the primary way to be a better client, but many managers lack the knowledge, information, framework and/or tools to really do this in a consistent or meaningful way.
4. ROA and ROE factors and drivers blend together in managers' overall view of how and why they are changing, or being asked to change, the ways in which they do business with their PBs and counterparties.
5. Managers are incentivised to optimise their collateral mix, but do not necessarily or broadly agree on a standard definition of what this means or a discipline for going about doing it.
6. In today's environment, adding new counterparties may not be an effective way to ultimately solve for risk and cost; while it is certainly true that market access often does require multiple relationships, it is no longer the case that simply opening a PB account and leaving assets on account will satisfy or even be a benefit for the bank.

[3] TABB Group: 'Equity Prime Brokerage: Exploring Unchartered Territory', 2014.

In closing…

With regulations squeezing bank balance sheets and generating regulatory capital charges, there is increased pressure on prime services businesses to hit revenue targets, a challenge that will intensify as all aspects of Basel III bite and further rules are written. Those targets certainly can be met through increased fees, but optimization of the portfolio and the collateral posted by the fund are also ways to create a client "value profile" with bank counterparties, who will each have their own constraints and priorities, reflecting their client base and business mix. The ultimate value of the portfolio transcends traditional alpha. There is value in liquidity, jurisdiction, securities lending rates, and perceived riskiness, all of which are unrelated to the closing price of a given instrument. Allocating assets to those counterparties that are best equipped to maximize their value, and therefore transfer that value to the client, can help solve for many if not all of the conflicts above.

How has our survey helped us better understand and answer this question, or at least provide a framework for managers to answer this question for themselves going forward? Three key themes or "takeaways" emerge from this study that are consistent with our on-going dialogue and collaboration with a broad cross-section of both alternative and traditional asset managers:

1. Managers need an industry-wide protocol on **what key terms** for securities financing and collateral management mean.
2. Managers need reliable, unbiased, relevant, timely and actionable **data**.
3. Managers need specific treasury management **analytic tools** to make optimal collateral management and relationship management decisions.

INDUSTRY TERMS:

The results of this survey highlighted the need for a common **language** for the key terms of securities financing and collateral management. The absence of a common language could lead to poor spending decisions on systems and data to manage ROE/ROA.

DATA:

An important starting point for managers is to ensure that they maximize the quantity and quality of data that they receive from their financing counterparties to provide them with a clearer perspective on how they are perceived as a client: an appreciation of individual counterparties' constraints and priorities is vital. For some managers, however, data from an average of 2–5 prime brokers or counterparties with just managers' own position information and collateral pricing might **not be enough** in a world where top-tier PB balance sheets are estimated to be well over $1 trillion. Many managers are looking to independent and unconflicted data sources as a basis for managing their financing activities. Therefore, data integrity is a paramount issue to manage for ROA/ROE.

TECHNOLOGY:

As we discussed above, one of the longer term responses to the market effects of regulation is to harness **technology** in managing how business is conducted with bank counterparties. Just as they have with portfolio attribution and EMS and OMS systems, managers require **analytic tools** for understanding, interpreting, and acting on an increasing amount of increasingly complex data/calculations necessary to calculate ROA/ROE. These types of tools are being developed and offered in the marketplace; they can be invaluable to managers, especially when confronting the central challenge/conflict raised in this study — differentiating as a PB client between **capital efficiency** (ROE) versus **balance sheet optimization** (ROA). And then managing their collateral portfolios and bank counterparty relationships to strike the right balance of **fairness** for themselves and for each of their Prime Brokers.

Alternative Investment
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About AIMA

The Alternative Investment Management Association (AIMA) has over 1,700 corporate members and over 10,000 individual contacts in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members collectively manage more than $1.5 trillion in assets. All AIMA members benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals, and its excellent reputation with regulators worldwide. AIMA is a dynamic organisation that reflects its members' interests and provides them with a vibrant global network. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists. For further information, please visit AIMA's website, www.aima.org.

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