FX Trending:
Towards Prime Brokers or Custodians?

The new regulatory environment has prompted a rethink of business strategies across the financial industry. Hedge funds are taking more of an interest in custodial services, while traditional asset managers are eyeing up prime brokers. Joy Macknight looks into the developing trends in FX.

Tougher rules on bank capital and liquidity are causing a major shake-up across the financial industry. Banks are feeling the pressure on their balance sheets as they gear up for 1 January when both the Basel and the US Liquidity Coverage Ratio (LCR) phase-in begins, initially with a threshold minimum requirement of 60% for the former and 80% for the latter.

The new capital requirement framework has forced many banks to re-evaluate a number of business streams – and foreign exchange prime brokerage (FXPB) has come under scrutiny because it consumes a lot of balance sheet. Some banks have decided to exit the business altogether, for example in May, Rabobank announced that it was winding up its FXPB business. Others, such as SEB just a month later, decided to continue running the existing business, but has shut its doors to new clients.

The FXPBs that have stayed in the game have repeatedly cautioned their clients that these tougher rules on bank capital and liquidity will force them to increase financing charges and reduce the amount of leverage they provide to clients.

The new environment has left hanging some of the traditional users of FXPB services, such as hedge funds, that are now looking around for alternatives.

The Attraction of Custodians

Jim Webb, managing director of the currency administration business in Europe, the Middle East and Africa (EMEA) at BNY Mellon Global Markets’ Currency Administration, believes that a developing trend over the past few years has seen hedge funds turning to custodial solutions.

Webb traces the trend back to just after the global financial crisis, which prompted a move towards custodians because of safekeeping services and counterparty stability, as well as more advantageous cost structures. “Much of that centred on transferring long assets and exchange traded assets out of prime brokers and into custodians,” he says. “So more on the asset side, as opposed to specifically FX, and as such, many hedge funds continued to use their PBs for FX services as well.”

But he believes that overall, this has led to a more engaged relationship with custodians.

In response, custodians such as BNY Mellon hired dedicated experts and developed more of a client service function specific to hedge funds, which in turn led to a natural evolution of service standards. “Custodians have been improving their service options. This trend has allowed custody banks to evolve and enhance their services by getting in front of those clients and finding out what they need,” he explains.

Paul Fleming, senior managing director and global head of enhanced custody at State Street, agrees. He says, “The new environment has generated interesting conversations with customers. I haven’t seen wholesale re-pricing across the market or clients moving out of prime brokerage, but recent developments have created some dislocation and, ultimately, opportunities for new entrants, such as enhanced custody, to enter the small- to mid-size space.”

Launched in 2008, State Street’s enhanced custody solution is an integrated platform that allows clients to
"...there is a pretty strong trend towards using a platform or provider that has this notion of best practice, whether that is in execution, counterparty diversification or building the right structure for their portfolio hedge."

Michael Miranda,
Mesirow Financial

borrow and finance from a segregated custody account; it can reduce counterparty risk, provide additional transparency and give clients greater control over their assets, according to the firm.

Fleming explains that it is mainly an equity finance product, not specific to FX. "In enhanced custody, we service a different set of customers, who are also custodial clients, through performing a financing function; so we lend securities directly to those end users, as well as help them finance their short positions."

"We approach enhanced custody from a custody perspective and a servicing relationship, as opposed to the more conventional way that this service is delivered through a margin account at a broker-dealer," he says.

In addition to the financing business, Fleming sees a trend where hedge funds want to have an independent administrator and a custodian, effectively a place where they can keep their fully paid-for securities and cash away from their prime brokers. "So, even if they don't need to use enhanced custody as a financing provider, in many cases hedge funds, as a matter of best practice, are looking for a custodian that is independent from their prime broker."

Similarly, a greater number of hedge funds are considering BNY Mellon's services, especially around FX, says Webb. "This has been mainly in the passive space, where they are managing currency risk or supporting global distribution. Some of the big custody banks, ourselves included, have developed robust solutions for the traditional market space, but they are equally compelling and complementary in the hedge fund space," he adds.

"In the currency administration business, we have seen a gravitation towards using our services and we are certainly working with large hedge funds. But that has to do with the solution and the service, more than it being a case of custodian versus prime broker," he argues.

Traditionally, hedge funds have strong relationships with their prime brokers, so the shift towards custodians has been relatively slow. "With the increased regulation and scrutiny around prime brokers and hedge funds, such as leverage restrictions, there is less focus on counterparty risk, for example. Therefore, some hedge funds are gravitating back towards the PB services because the services are still different."

"But there has nonetheless been a shift in attitudes over the past few years, and that has given us the opportunity to get in front of these clients. And if custodians continue to evolve our services and provide flexible solutions, then we could see a bit more momentum and an increase in the usage of custodians versus the traditional PB route," says Webb.

Michael Miranda, CFA, CIO of Mesirow Financial Currency Management, agrees that global custodians are adapting to the needs of clients, whether that is providing execution services or greater customisation than previously. However, he believes that there is a long way to go for that segment of the marketplace to provide what clients are searching for, from a best practices' standpoint, particularly in the currency hedging space.

As a result, Miranda is less convinced that hedge funds are making the move for FX-specific solutions. "Although some clients are engaging or maybe interacting more with their custodial platforms for their FX needs, certain others are migrating away."

"There has certainly been a lot of press over the past few years over the inherent conflicts of interest with custodial banks executing FX hedging needs for clients, whether hedge funds or others," he adds.

While a custodian may give the hedge fund a view over their assets and it may be operationally efficient for the hedge fund to utilise the custodian more broadly, custodians are often incentivised to profit from FX transactions, which can create a conflict of interest.

"I still think there is a pretty strong trend towards using a platform or provider that has this notion of best practice, whether that is in execution, counterparty diversification or building the right structure for their portfolio hedge," says Miranda. "Many are still migrating towards currency specialists, and in this respect, the PB platform remains a beneficiary. But as to the specific custodial aspect, I don't perceive that to be a real trend in the marketplace right now."

Theodore Qi Shou, international chief investment officer, Skybound Capital, based in Hong Kong, does see a movement, but not a very strong one so far.

"I see it as a trend and not just in FX - mainly because some of the largest custodians are trying to significantly enhance their product offerings. In recent years many people, especially hedge fund managers, have heard about prime custodians, in addition to prime brokers. Therefore, on top of the traditional services, today's custodians are trying to compete in certain areas with prime brokers. I have even seen custodians that offer trading services," says Shou.

He identifies two types of hedge fund managers that might opt for prime custodians. "One is the large, $1 billion-plus manager, who simply wants to depend less on their prime brokers. Therefore, they may look towards custodians, but that doesn't mean that they are utilising the new services that the custodians are offering, such as FX trading."

"The other is the medium-sized manager, who is basically trying to choose between prime brokerage and custodians when both parties are providing similar services. In the past, they shopped around prime brokers, but now they are considering those custodians who are trying to compete with the prime broker services," Shou says.

Like Miranda, he emphasises the inherent conflict of interest. "Custodians should be doing what they are
supposed to do – the ‘old school’ custodian work – instead of extending themselves too far in competition with other service providers,” he argues.

When it comes to FX trading, Shou sees a stronger trend towards outsourcing to a third party agent, independent of a prime broker or custodian. “The third party provider might be an FX specialist broker or agent who helps to significantly lower FX trading costs, in comparison to the average trading cost that custodians are charging for FX trading.

“There is an element of expertise in this, too. Even though we see some of the custodians merging into the FX trading arena, many investment managers still believe that there are better people in the market who are more specialised and experienced,” he adds.

Mike O’Brien, CFA, vice president, director of global trading at Eaton Vance, says that the only reason he could think of to move to a custodian is to have greater flexibility. “If you are using FX as an asset class – unless you are looking to diversify your counterparties, which in itself would be an important thing to do – I wouldn’t think there was much of a trend going in that direction, compared with asset managers moving towards prime brokerage.”

Are Asset Managers Considering FXPB?

Although he isn’t sure if this trend has actually taken off yet, O’Brien believes that increasingly asset managers will be contemplating using FXPBs and this will be a trend going forwards. “Whether we use a PB or not is something we get asked about a lot, especially from institutional clients. It is not always specific to FX, but FX always comes up,” says O’Brien.

From his perspective as a real money manager, there are two downsides to using a PB: first is the necessity of posting initial margin; and second is the possibility of counterparty risk concentration.

“However, as more regulatory reforms are put in place, the advantage of using a custodian may be whittled away because of the margin issue, ie, mandatory margin on non-cleared trades. Then it makes more sense for real money managers to look towards PBs,” he explains.

One of the downsides of a prime broker is that an asset manager doesn’t have to put in place an International Swaps and Derivatives Association (ISDA) agreement with every execution counterparty. “ISDAs are time-consuming and expensive, and asset managers could see an advantage in avoiding them,” says O’Brien. “Another advantage is being able to trade on additional platforms where prime brokers are required.”

The fact that some banks are exiting the FXPB business and using their capital elsewhere doesn’t surprise O’Brien; however, he also hears about others entering or building up the business. “The advantage of the PB business is that it may attract more FX flows in the bank’s direction, especially when many PBs don’t charge for FX trades done with their own execution desks.” Generally, he believes that PB services will continue to be offered.

Currently, O’Brien is considering whether it makes sense in the new regulatory environment for Eaton Vance to use an FXPB for its accounts. “We run one hedge fund, so we do use FXPB. But most of our accounts are real money, which are governed by the US Investment Company Act of 1940. This means they are the highest quality funds, and so we don’t use a PB for those accounts. I am not planning to take any immediate action in the near future, but it is something that I have been thinking about for a while.”

Webb believes that the shift of asset managers towards PB and hedge towards custodians are co-mingled, but almost equal and opposite. “We have seen many hedge funds begin to act more like traditional asset managers and look for custodial services. Equally, many asset managers are becoming more and more sophisticated in this area and are looking for specialised solutions, so they are driving market change,” he explains.

For that reason BNY Mellon has made its service offering solutions-based, to provide for those asset managers looking for services that are more similar to a PB structure. “This could be for an asset manager looking at execution for service provisions,” says Webb. “Equally, there are many situations, particularly in the passive space, where the focus is more on what is appropriate for the funds they are managing. Then there is little reason to move away from a custody-based principal model.”

BNY Mellon’s solutions are all about flexibility, says Webb. “We try not to pigeonhole a client simply based on their structure or the type of fund, but rather seek to determine the best solution for that client’s specific needs. Hence, whether it is a hedge fund that needs a share class hedging service, or a traditional asset manager that needs an agency execution model, we have developed our solutions so we can accommodate that. That is the trend: ultimate flexibility in service provision.”

On the whole, Miranda believes there is more of a trend towards using PB in the currency arena. “Certain clients will migrate towards FXPB because it makes it more efficient for them in credit and operational aspects; but on the other hand, some will migrate away because of counterparty concentration and higher fees. But on average, there has been a slight migration towards PB across the board over the past few years, particularly those outside of the hedge fund space that maybe hadn’t used it historically.”

“...if custodians continue to evolve our services and provide flexible solutions, then we could see a bit more momentum and an increase in the usage of custodians”

Jim Webb
Mesirow Financial Currency Management (“MFCM”) is a division of Mesirow Financial Investment Management, Inc., (“MFIM”) an SEC-registered investment advisor, a CFTC registered commodity trading advisor and a member of the NFA. The information contained herein is intended for Qualified Purchasers and Qualified Eligible Persons only and is for informational purposes only. This information has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. It should not be assumed that any recommendations incorporated herein will be profitable or will equal past performance. Mesirow Financial does not render tax or legal advice. Nothing contained herein constitutes an offer to sell or a solicitation of an offer to buy an interest in any Mesirow Financial investment vehicle(s). Any offer can only be made through the appropriate Offering Memorandum. The Memorandum contains important information concerning risk factors and other material aspects of the investment and should be read carefully before an investment decision is made. Mesirow Financial refers to Mesirow Financial Holdings, Inc. and its divisions, subsidiaries and affiliates. The Mesirow Financial name and logo are registered service marks of Mesirow Financial Holdings, Inc. © 2016, Mesirow Financial Holdings, Inc. All rights reserved. Investment management services provided through Mesirow Financial Investment Management, Inc., a SEC-registered investment advisor.