



## COMMENT & ANALYSIS

### THE LONG VIEW

**BRIAN RUANE**

on the evolution of the prime custody model in the US and Europe



“DRIVEN BY THE NEED FOR GREATER ASSET PROTECTION AND CONTROL, HEDGE FUNDS ARE PUSHING PRIME BROKERS TOWARDS SERVICE MODELS SIMILAR TO THOSE FOUND IN THE US”

As we enter 2012, concerns mount over the scale and depth of the European sovereign debt crisis. While initially focused on the peripheral countries, it has now spread, impacting even the largest economies. Mixed data surrounding a potential US recovery and the risk of a slowdown in Asia have exacerbated investor fears.

However, in every market cycle there are unique opportunities – not only for investment but for innovation. With the reconfiguration of investment banks, fund managers and prime brokers, the universe of companies providing services to hedge funds has shifted. During the credit crisis, hedge funds gained a new appreciation for counterparty risk and financial strength. They looked to partners, particularly custodian banks, who could provide this improved security. Investors also pressed managers for increased transparency. These events were the genesis for the growth of the prime custody model, although there are differences between its evolution on both sides of the Atlantic.

In the US following the crash in 2008,

hedge funds sought strong custodians to safe-keep and service their unencumbered cash and securities. Through a Federal Deposit Insurance Corporation (FDIC) member bank custodian, hedge funds had the reassurance that un-invested cash balances in certain transaction accounts were 100% FDIC-insured until December 2012. The custody model expanded as services traditionally reserved for the prime brokerage sector, such as cash management, global clearing capabilities and collateral management, became essential components of a service partnership. Middle-office services also grew, with increasing demand for fail management and claims management products that are able to co-ordinate the resolution of failing trades and related claims between the client and counterparty.

The European interpretation of prime custody is different, as hedge funds primarily use custodian banks to provide collateral management services on initial and variation margin. European hedge funds are also moving towards a self-financing model. In this instance, emphasis is on using reverse repo processing to offset

short sales. This removes constraints on collateral notification and allocation, which helps to ensure market liquidity across clearing banks.

The most recent development is in the US model, which has now advanced to accommodate partnerships with primes. This type of partnership enables prime brokers to maintain their current relationship with their hedge funds, while providing the fund with the ability to hold assets with a third-party custodian. This is now expanding to Europe as well and we believe this is a potential growth area in 2012.

The partnership with a prime service model appeals to hedge funds because it allows them to stay in control of their assets at all times through a direct relationship with their custodian. Unencumbered assets are held away from the primes, but primes continue to provide hedge funds with a consolidated view of holdings at both the prime broker and custodian. The custodian bank can also segregate hedge fund securities to act as collateral for leverage with a third-party prime broker.

For many EU-based hedge funds, today's relationship with custodial banks remains either indirect or non-existent. Prime brokers maintain a direct relationship with the custodian and enjoy direct control over unencumbered assets. This service model is being challenged; driven by the need for greater protection and control, hedge funds are pushing prime brokers towards service models similar to those in the US.

Next year will be another testing one for investment managers, those that service them and their investors. But that is the challenge of a truly great firm; the ability to turn market lows into revenue opportunities. Thus, we will likely witness the continued evolution of prime custody models based around the increased demand for transparency. ■

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